

30 August 2010

Deceiving Deficit

- Trade deficit returns in July
- But trend improvement, for now
- We think annual surplus will shrink from here
- As commodity prices ease
- And imports grow

Following a mere six months of consecutive monthly trade surpluses, this morning's data showed the monthly trade balance slipped back into deficit. July's actual trade deficit of \$186 million was larger than the small deficit expected by the market. What happened to the export-led recovery – the one that the Minister of Finance was talking about as recently as last week?

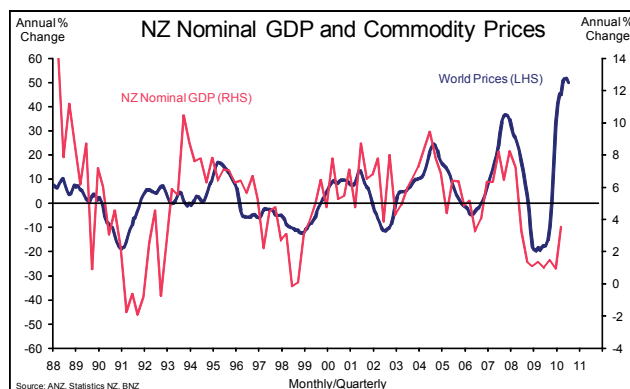
To us, it is still alive and kicking, judging by July exports being a hearty 12.4% above year ago levels. Usual seasonality and volatility are other reasons not to get too despondent with the headline monthly figures slipping back into deficit. The monthly trend figures, which remove seasonal effects and irregular items, show the trade balance posted its largest monthly surplus since 2001.

Dairy products led the annual increase in export values, with the value of milk powder, butter and cheese exports up almost a third compared to last July.

Much better dairy prices this year compared to last drove the increase. In fact, dairy export volumes were well down on a year ago no doubt affected by the drought in late summer/early autumn. It is worth noting that we have yet to fully see the drought effect come through the production data. We still think this will be a significant drag on Q2 GDP, something next week's manufacturing survey may shed some light on.

But it is buoyant international prices for NZ commodities in general that are currently providing strong support to the trade figures and to the wider economy. In fact, much of the 47% rise in world prices over the past 12 months is yet to show up in NZ's nominal GDP.

This will make for some reasonable looking growth figures over coming quarters, but the real question is where world prices go from here. We suspect that world prices, on average, for NZ primary products are past their peak – a view that we think this Wednesday's ANZ commodity price index will support. For the record, we're looking for this measure of world prices to ease around 1% or so.



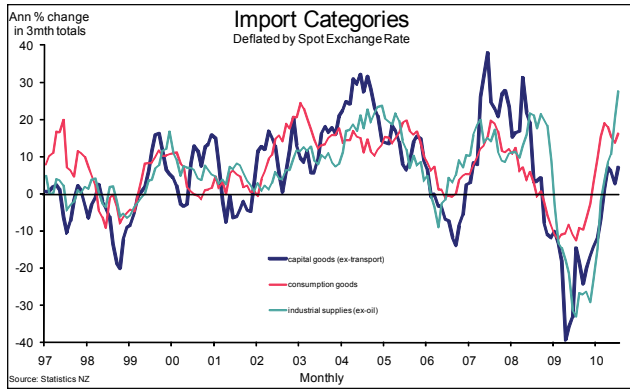
More important will be Fonterra's dairy auction scheduled for the early hours of Thursday morning, given it is a real time gauge on the dairy market. The dairy industry will be eager to see if the sharp declines of recent auctions are arrested, especially with current downside risk to forecast farmer payouts at current prices. While there is obviously a risk of yet another drop in prices, there is also a good chance of seeing signs of stability emerging.

From an economic recovery point of view, there was also some encouragement from this morning's trade data on the import side. Goods imports were up 12.0% in July compared to a year ago.

Stronger import demand is a positive signal for short-term growth but can also raise the seemingly-forever lingering questions about the sustainability of economic expansion given the vulnerable overall state of NZ's external accounts.

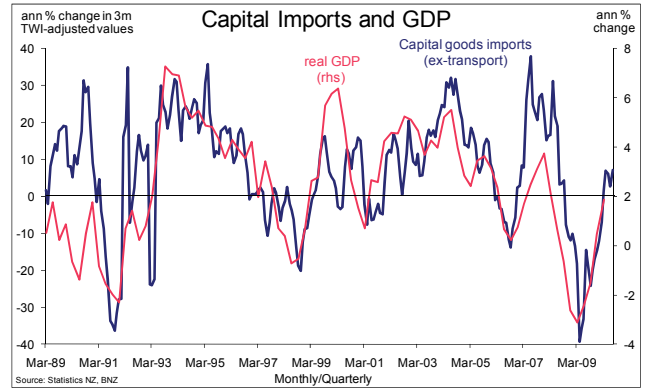
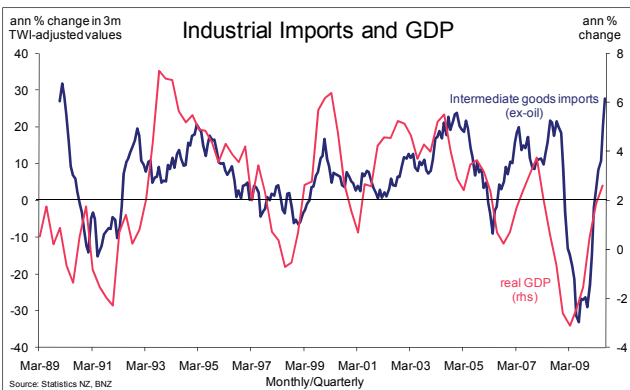
Indeed, as part of this, today's data shows that the recent improvement in the annual trade balance has stalled, with the annual surplus edging down to \$573m in July from \$581m in June. This fits with our thinking that the annual trade surplus has peaked and will shrink from here, which will underscore the upside we see for the current account deficit, from its recently flattered slimmness.

One positive in today's data is that import growth over the past year has been concentrated in intermediate goods for use in the production process, with slower growth in consumption goods imports. For example, intermediate goods imports, both total and excluding crude oil, rose almost 16% over the past 12 months, compared to less than 5% growth in consumption goods imports.



The nature of imports this time around suggests that the external deficit they contribute to in the short term will be used to raise income growth in future.

Less encouraging on this front were capital goods imports. While capital goods import growth is positive, it is still low reflecting ongoing caution from business regarding investment.



So, while the import mix has some encouraging signs about it, we think the broader external accounts will soon-enough raise questions about the sustainability of growth ahead.

Speaking of investment, this week we will get another indicator of such in the form of July's building consents tomorrow. We already have a weak non-residential construction track built into our forecasts, but are becoming increasingly concerned that the hole might be bigger than we current think. Another weak read in July will convince us to slice a bit more off our non-residential building forecasts for 2011.

Meanwhile the recovery in residential work looks to be running out of steam already, although we do still hope to see a moderate gain in July's consents numbers.

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Domestic Interest Rates

New Zealand interest rates saw a subdued week as the market took a breather from the large move we had seen over the past few weeks. The front of the curve has continued to rally, with the September MPS now pricing just a 25% chance of a hike and only around 45bp of total hikes now priced through to June next year. With the direction of the market it wouldn't surprise us if a September meeting hike is further priced out over the coming week. However a pause to the hiking cycle may force more aggressive hikes later, so we see a greater potential for a sell off further out the futures curve.

The NZ government bond market also saw a fairly quiet week, although the week's tender was a good size at \$350m and was well supported. It looked like market participants were using the opportunity to put on further paid EFP positions (long the bond and short to the swap date) with the bonds trading significantly above the swap rate to the same date. While this trade makes sense from a fundamental standpoint, liquidity is a significant issue as buyers of NZ bonds will always have the option of picking the bonds up directly through ongoing issuance. We will

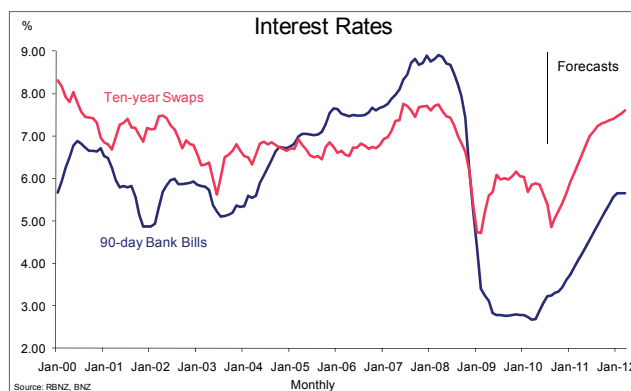
	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
20-Aug-10	3.23%	3.95%	5.14%	3.75%	4.78%	103
27-Aug-10	3.23%	3.96%	5.12%	3.75%	4.80%	105
Change (bps)	0	1	-2	0	2	2

Reuters pgs BNZL BNZM

likely take our lead this week from offshore, although continued supply will likely mean that NZ bonds will trade heavily relative to offshore.

The swaps market was also subdued, largely holding its ground over the past week. The market rallied early on but then with the very low outright levels reached the payside interest finally appeared and we sold off and steepened to finish the week. The mortgage books still appear to be relatively quiet as customers appear to still lean towards floating their borrowings. If this changes, we could see a sharp sell off to the swaps curve, but for now it is likely the swaps market will take its lead from offshore moves.

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Interest Rate Technicals

NZD 5yr Swap Rate

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

We saw profit taking towards our support level of 4.06%. Expect a move higher in coming weeks. However, the resistance level should not be breached.



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

Outlook: Rangebound
 MT Resistance: +75
 MT Support: +10

The market is sitting on near term support at +44. Should this break we will move to +10, otherwise the upper trendline resistance around +75 will cap.



Foreign Exchange Market

Reuters pg BNZFWDS

The NZD/USD spent most of last week shuffling sideways in a 0.6960-0.7120 range.

(which has a scale of 0-100%) spent most of last week jumping around either side of the 50% long-run average.

On Friday night, a clear improvement in risk appetite ensured the NZD/USD finished the week near the top end of this range. Not only was Q2 US GDP revised down by less than expected, but soothing words from Fed Chairman Bernanke allayed fears about the US growth outlook. Bernanke downplayed US recession concerns and said the Fed stands ready to provide "additional monetary accommodation" should the US outlook deteriorate further.

All the while, 'fundamental' support for the NZD/USD continues to fade. NZ-US 3-year swap spreads slipped below 290bps last week for the first time since late April. On their own, NZ-US interest rate differentials are consistent with NZD/USD trading closer to 0.7000. Indeed, our short-term NZD/USD valuation model (which is based on NZ-US 3-year swap spreads, NZ commodity prices and risk appetite) currently suggests a NZD/USD "fair-value" range of 0.6950-0.7150.

Market sentiment brightened noticeably. Global equity markets jumped 0.7-1.7% and oil prices surged almost 2.5%. In currency markets, investors trimmed positions in "safe-haven" currencies like the CHF and JPY in favour of the AUD, NZD and CAD. After starting the night around 0.7030, the NZD/USD finished the week closer to 0.7130.

Nevertheless, for this week, we suspect the fortunes of the NZD/USD rest with USD sentiment. While the local data calendar offers up mostly second tier data this week (with the exception of today's NBNZ business confidence survey), offshore markets are bracing for a week chock-full of event risk. Most notably, US markets are locked and loaded for the heavy-hitting ISM manufacturing and non-farm payrolls releases. Should this week's US data further calm fears about a double-dip recession, we'd expect a stronger USD to knock the NZD/USD lower. Initial support is eyed towards 0.7050, with sellers expected to emerge on bounces towards 0.7200.

In a broad sense, investors are still trying to decide: a) whether or not the US economy is heading for a double-dip recession; and b) will the sharp slowing in the US economy result in a deep global slump. The heightened uncertainty is tending to keep the NZD/USD trading choppily within familiar ranges as appetite for risk ebbs and flows. Our risk appetite index

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Foreign Exchange Technicals

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NZD/USD

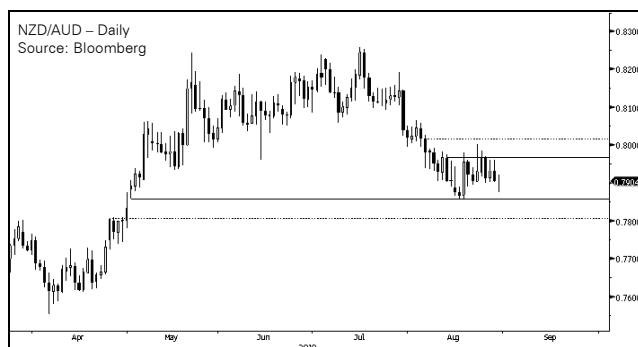
Outlook: Consolidation
 ST Resistance: 0.7145 (ahead of 0.7195)
 ST Support: 0.6995 (ahead of 0.6885)

NZD/AUD

Outlook: Consolidation
 ST Resistance: 0.7990 (ahead of 0.8050)
 ST Support: 0.7860 (ahead of 0.7805)

The failure to close below 0.7000 means the downtrend has stalled for now. A daily close above 0.7195 would re-establish the uptrend.

Momentum is neutral and we continue to look for consolidation in a 0.7860-0.8000 range. Sell a break below 0.7860.



Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 30 August				Wednesday 1 September			
NZ, Household Credit, July y/y			+2.5%	NZ, ANZ Comdty Prices (\$NZ), August			-2.8%
NZ, NBNZ Business Survey (own-activity), August			+32.4	Aus, Manufacturing PMI (AiG), July			54.4
Aus, Business Inventories, Q2	flat	+0.4%	+0.5%	Aus, GDP, Q2	+1.0%	+0.9%	+0.5%
Aus, HIA New Home Sales, July			-5.1%	UK, CIPS Manuf Survey, August		57.0	57.3
Aus, Company Profits, Q2	1.0%	+5.8%	+3.9%	US, ISM Manufacturing, August		52.8	55.5
US, Personal Spending, July		+0.3%	flat	China, PMI (NBS), August		51.5	51.2
Tuesday 31 August				Thursday 2 September			
NZ, Building Consents, July (res, #)	+1.0%	+2.0%	+3.5%	NZ, Fonterra Monthly Auction, September-8.3%			
Aus, Retail Trade, July s.a.	+0.2%	+0.4%	+0.2%	Aus, International Trade, July	+\$3.1b	+\$3.1b	+\$3.54b
Aus, Building Approvals, July	+1.5%	-0.7%	-3.3%	US, Productivity (non-farm), Q2 saar 2nd est		-1.9%	-0.9%P
Aus, Current Account, Q2	-\$6.7b	-\$6.5b	-\$16.6b	US, Factory Orders, July		+0.4%	-1.2%
Aus, RBA's DeBelle Speaks, Risk and Uncertainty				US, Jobless Claims, week ended 28/08		475k	473k
Jpn, Industrial Production, July 1st est		-0.2%	-1.1%	US, Pending Home Sales, July		-1.0%	-2.6%
Jpn, Retail Trade, July y/y		+3.5%	+3.2%	Euro, ECB Policy Announcement	1.00%	1.00%	1.00%
US, Shiller Home Price Index, June y/y		+3.6%	+4.6%	Euro, GDP, Q2 2nd est		+1.0%	+1.0%P
US, Chicago PMI, August		57.0	62.3	Euro, ECB's Trichet Speaks			
US, FOMC Minutes, 10 Aug Meeting				Friday 3 September			
US, Consumer Confidence, August		50.9	50.4	US, Unemployment Rate, August		9.6%	9.5%
Euro, CPI, August y/y 1st est.		+1.6%	+1.7%	US, ISM Non-Manuf, August		53.2	54.3
Euro, Unemployment Rate, July		10.0%	10.0%	US, Non-Farm Payrolls, August		-100k	-131k
Can, GDP, Q2 saar		+2.5%	+6.1%	China, Non-manufacturing PMI, August			60.1

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	3.00	2.50	NZD/USD	0.7120	0.7048	0.7265	0.6426
1 mth	3.09	3.10	3.08	2.77	NZD/AUD	0.7898	0.7943	0.8020	0.7983
2 mth	3.20	3.20	3.20	2.79	NZD/JPY	60.76	60.3200	62.76	61.82
3 mth	3.24	3.24	3.27	2.76	NZD/EUR	0.5576	0.5547	0.5561	0.4605
6 mth	3.32	3.33	3.44	2.82	NZD/GBP	0.4582	0.4535	0.4619	0.3893
GOVERNMENT STOCK					NZD/CAD	0.7472	0.7392	0.7479	0.7294
11/11	3.58	3.57	3.65	3.90	TWI	66.56	66.23	67.45	60.78
04/13	3.98	3.97	4.13	4.90	NZD Outlook				
04/15	4.43	4.43	4.61	5.54					
12/17	4.83	4.85	5.04	6.06	<p>Source: BNZ, RBNZ</p>				
05/21	5.14	5.16	6.53	-					
CORPORATE BONDS									
BNZ 05/13	5.05	5.03	5.39	-					
BNZ 09/16	6.00	5.95	6.47	-					
FON 04/14	5.58	5.53	5.89	-					
FON 03/16	6.08	5.87	6.22	-					
GEN 03/14	5.53	5.61	5.96	7.19					
GEN 03/16	6.06	6.02	6.44	7.98					
TRP 06/20	6.24	6.19	6.60	7.93					
SWAP RATES									
2 years	3.79	3.76	3.98	3.92					
3 years	3.98	3.95	4.25	4.67					
5 years	4.28	4.22	4.64	5.42					
10 years	4.85	4.78	5.23	6.20					

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