

6 September 2010

## Shaken – But Not To The Core

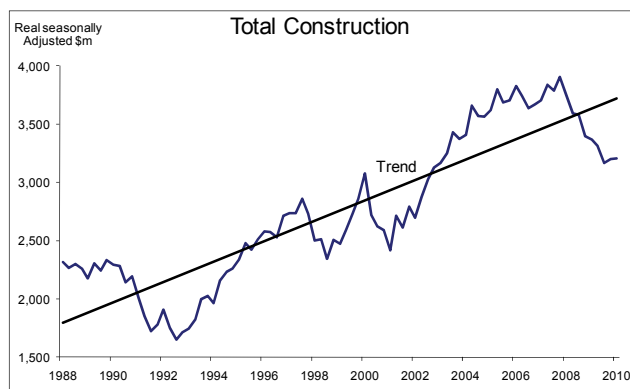
- Christchurch earthquake dominates thinking
- A local disaster, a national headache
- GDP impact, ironically, net positive
- Financial markets little affected
- Key GDP partials due this week

Matters economic seem of little consequence as New Zealanders focus their attention on the damage caused by the weekend's Christchurch earthquake. The scenes of devastation appearing on TV, and in newspapers, and the tales of anguish recounted by those affected have not only been moving but have been a stark wake up call for all New Zealanders that we do live in a country that sits bang on top of a very active and very large faultline. It is even more disconcerting that experts tell us that this "wasn't the big one".

That there were no deaths is remarkable. That there was not even more damage even more so and is a huge tick for the construction standards that prevail in this country. This will be no solace for those who have suffered as a consequence of this quake in a physical sense, whether that be injury, loss of property or damaged goods. Moreover, the psychological damage of the event will have a significantly more widespread impact on the many who really thought that the end might be nigh.

Be that as it may, it is important to note that one shouldn't extrapolate from individual angst to economic cost, in its most general sense.

One of the ironies of natural disasters such as this, is that they can turn out to be GDP positive. In the first instance, reduced retail sales, folk staying at home to look after their affairs, reduced output from factories and costs



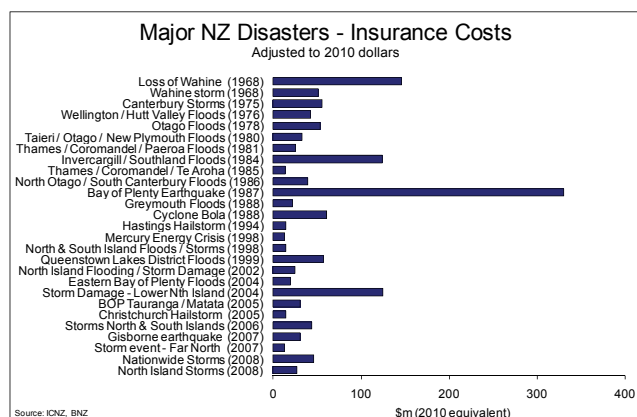
faced by people for goods that were uninsured will detract from GDP. However, the negative impact of this is likely to be swamped by reconstruction of homes, commercial buildings and infrastructure.

As it turns out, if such a disaster was to happen, it couldn't have happened at a better time. Currently, the building sector should have significant spare capacity as activity levels have been clobbered by the current economic malaise. Indeed, the non-residential construction sector is probably one of the poorest performing sectors in the economy. If it had happened a few years back the industry would have had no capacity to respond and the ability for suppliers to significantly hike prices would have been great.

Some price pressures can inevitably be expected but we do not think that these will be sufficient to have a significant impact on New Zealand wide inflation. Accordingly, there is little implication of this event for central bank policy.

It will cost central Government to the extent that central Government assets are adversely impacted. This will include Government-owned buildings, key roading infrastructure and the railway line. There will be significant costs here but they should not have a major bearing on the overall fiscal position.

Of interest will be the extent by which Government decides to stump up with payments to those folk who chose not to be insured. There is always a clamour for Government to move into this space but it raises moral hazard issues and questions as to why those who chose to insure should subsidise those who didn't.



It seems unlikely that Government will bear any direct cost for business though may be called upon by local authorities for help. To the extent that help is provided via policing and the utilisation of military resources it should not add substantially to Government costs. Overall then, there is no reason to assume that the earthquake will have any meaningful impact on the economy's term structure of interest rates. Bond yields did edge higher after the earthquake but this was as much a function of a deteriorating global market, and investors seeking an excuse to sell off securities that were already seen as expensive, as anything else.

Perhaps the biggest cost burden will lie directly with the local authorities. There is likely to be huge expense associated with the reconstruction of water and sewerage infrastructure across the region in addition to work on the roading system. With the majority of the water and sewerage infrastructure underground it could well take an extended period of time before these issues are resolved.

Of course, one tends to look at such matters as a local government problem whereas the truth of the matter is that the ratepayers of the region will have to pay up for these costs in due course.

The other folk who will come under direct financial pressure, of course, are the insurers. These fall into three broad groups: The Earthquake Commission (EQC); local Insurers; and the global reinsurers. In time the costs imposed on the industry will come home to roost for locals as insurance premia adjust accordingly. In this manner, as is the case through the tax system, costs will be shared by all and sundry not just those in the earthquake zone. Likely sales of Government Bonds by EQC via the Debt Management Office may have a modest but short-lived impact on bond yields too.

For a quick snapshot as to how financial markets saw the costs and "benefits" of the earthquake it was notable that at market open the share price of listed company Steel and Tube rose 4.6%; Fletcher Building was up 4.4%; whereas AMP opened 4.6% down and Tower 8.4% lower.

More generally, the disaster is an unwelcome reminder to investors in New Zealand that there are very real risks here over and above core economic ones. In this regard, we have no doubt that New Zealand's vulnerability to natural disaster is one of the factors, amongst many, that ensures our real interest rates are lofty by international comparison.

For currency markets there should have been little in this to get excited about. The initial news may have been reason to sell the currency down but the wider picture would suggest no such reaction is warranted. At the margin perhaps a modest uplift might be justified.

On balance then a disaster for those affected but not a disaster for all.

**A snapshot of the Christchurch/Canterbury Region**

There are 559,200 people in Canterbury out of 4,315,800 nationwide. This represents 13.0% of the nation's population. (2009 data)

There are 211,700 households in Canterbury out of 1,552,600 nationwide. This represents 13.6% of total (2006 data).

According to the 2006 Census there are 202,698 dwellings in Christchurch compared with 1,478,709 nationally. That's 13.7% of total.

The following table represents the number of business units in Canterbury.

**Christchurch\Canterbury Business Numbers and Employment**

		Waimakariri	Selwyn	Christchurch City	Canterbury	NZ
Number of	Businesses	5829	5317	38013	65033	512580
	Employment	10460	12130	188980	257720	1919290
% of Canterbury	Businesses	9.0	8.2	58.5	100.0	
	Employment	4.1	4.7	73.3	100.0	
% of NZ	Businesses	1.1	1.0	7.4	12.7	100.0
	Employment	0.5	0.6	9.8	13.4	100.0

There are 510,700 folk in the working age population out of 3,412,100, nationally. That's 15.0% of total.

There are 336,900 people employed in Canterbury out of 2,165,600 nationally (15.6% of total)

Retail sales in Canterbury in the Year to June 2010 were \$8.5 billion out of \$66.0 billion nationally, 12.8%.

While the earthquake's after effects will dominate thinking over the week ahead it would be remiss of us not to point out that there is a swathe of domestic economic data out this week which will have a significant bearing on our analysis of the strength of the New Zealand economy. These data include several indicators that will feed directly into the all-important Q2 GDP estimate.

The GDP-related data are as follows:

- Tuesday sees the release of Wholesale Trade data. We have assumed that Wholesale Trade, measured on a national accounts basis, grew 1.0% over the June quarter. This reflects the improvement in retail sales seen across the quarter, improved external trade activity and stronger vehicle sales. That said, softer fuel volumes, generally modest economic activity and weakness in food processing could yet create a downside surprise. Whatever the case, note that the headline numbers will not necessarily give a clear indication of the GDP effect thanks to the impact of inflation and translation difficulties between the Wholesale Trade series and the national accounts data.

- On Wednesday the Quarterly Survey of Manufacturing and Building Work Put in Place come out. We have a 0.2% increase in manufacturing output penned based on the expectation that an increase in "core" manufacturing will just dominate the negative impacts associated with a draught related decline in agricultural processing. There will be equalising offsets in the building data too. We are again expecting a small increase as a substantial pick up in residential building (8.0%) collides with a 7.0% drop in non-residential activity.
- The Overseas Trade Indices are due for release on Friday. We are looking for these to confirm our view that import growth outstripped export growth for the quarter hence acting as a hand brake on GDP for the quarter. At the same time, we are forecasting a further improvement in the terms of trade thanks to the fact that our commodity exports continued to go from strength to strength over the period while import prices should have been relatively constrained. For the record, we are forecasting the terms of trade to rise 2.2% to be up 12.5% on year earlier levels.

Other data to watch for include:

- Latest QVNZ data, due for release Thursday, are expected to confirm REINZ figures that the housing

market has stalled. Turnover remains very low so we would expect prices to be flat, if not negative for the month.

- Electronic Card Transactions Data for August are out on Thursday too. We are looking for a reasonably solid number following on from an unexpectedly weak July reading. It may be a tad early, but we suspect we should be starting to see the first signs of a pre-GST-hike effect by now too.
- Accommodation data for July are due for release on Friday. A modest improvement is anticipated.

And last, and probably least, Wednesday sees the launch of Alan Bollard's book *Crisis: One Central Bank Governor and the Global Financial Collapse*. We haven't seen a copy of the said book yet but those who have suggest there will be little in it to get excited about. It sounds very much like a simple summary of events rather than any significant insight. We're open to be pleasantly surprised. Whatever the case, don't expect it to provide any indication whatsoever on the RBNZ's upcoming decision on its cash rate.

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## Domestic Interest Rates

New Zealand interest rates sold off and steepened over the week as the rates market followed offshore moves towards higher yields. The front end of the curve was largely unchanged with September still priced at around 25% at the end of the week. The remainder of the futures curve sold off somewhat, although the priced hiking cycle was very gentle at around 50bps through to June 2011. The Canterbury earthquake over the weekend will be the big market mover and it seems likely the market will almost completely price out hikes in September and October. Further out the curve is somewhat more interesting, however, as the market will digest the effect of a short term hit to GDP but the likely inflationary impact of increased construction in the Christchurch area going forward.

The NZD bond market saw rates rise over the week as ongoing supply weighed on the market. There seem to be a lack of end holders at current levels and it was reflected in the market as bonds traded heavily all week. This seems likely to continue over the coming week as the stronger Non Farm Payrolls number in the US has pushed up offshore yields. In addition to this, the local earthquake

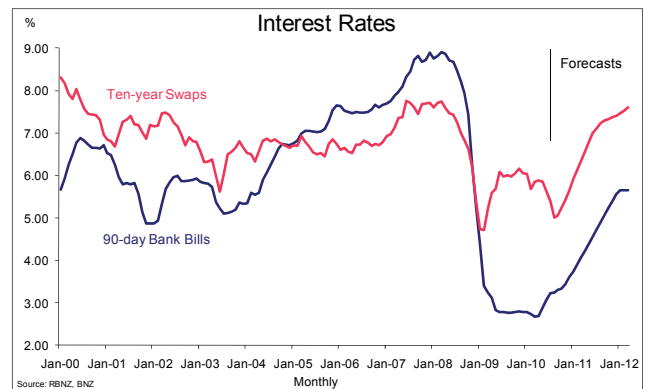
	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
27-Aug-10	3.23%	3.96%	5.12%	3.75%	4.80%	105
3-Sep-10	3.21%	4.10%	5.29%	3.80%	4.98%	118
<b>Change (bps)</b>	<b>-2</b>	<b>14</b>	<b>17</b>	<b>5</b>	<b>18</b>	<b>13</b>

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will likely impact the sovereign fiscal position, which could lead to more issuance going forward.

The swaps market has steepened back to remove some of the massive flattening we had seen over the past few weeks. The back end of the curve was fairly well bid as several payers took the opportunity to hit the lower levels and there seemed to be some players entering into or extending a paid EFP position of buying the bond while paying the swap. For this week, the market will be digesting the financial impact of the earthquake. It is likely the curve will steepen further, with lower rates in the shorter dates but higher yields further out the curve.

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## Interest Rate Technicals

### NZD 5yr Swap Rate

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

Market bounced strongly down towards our 4.06% level and is now currently back at 4.42%. Only a breach of 4.53% or 4.06% will indicate a new trend.



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

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

Market rejected near term support at +42. Look for a range trade between +42 and downward sloping resistance now coming in at +74. A break of either of these lines will give us the next move.



## Foreign Exchange Market

Considering the magnitude of the disaster, news of Saturday morning's Christchurch earthquake had only a relatively minor effect on the currency. In fact, the NZD/USD closed last week a smidge below 3½ week highs of 0.7220.

USD weakness was the overriding theme in currency markets last week. Indeed, the USD index slid nearly 1.5% over the latter stages of the week, providing a default boost to most of the major currencies. Demand for "safe-haven" currencies like the USD and JPY was sapped by a string of upbeat economic data, which tended to allay fears of a sharp slowing in the global economy.

The August Chinese PMI suggested Chinese manufacturing activity remains firm, Australian GDP rocketed ahead 1.2%q/q in Q2, and the heavy hitting US ISM manufacturing and non-farm payrolls releases both easily outstripped analysts' gloomy expectations. Risk appetite and equity market sentiment was bolstered accordingly. The S&P500 finished the week 3.7% stronger and our risk appetite index (which has a scale of 0-100%) jumped 5 percentage points to 59.4% – the highest since May. Against a broadly weaker USD, the NZD/USD climbed from around 0.7000 to a three-week high above 0.7200.

Looking ahead, partial indicators for Q2 GDP dominate the NZ data flow in the week ahead. However, local attention will undoubtedly be focused on the economic impact of the Christchurch earthquake.

### Reuters pg BNZFWDS

There are clearly some timing effects to consider. There is no doubt the disaster imposes a significant drag on South Island economic activity in the short-term. However, as the cleanup gets underway, some economic support can be expected from increased construction activity, downstream support services, and consumer spending. At the margin, these pressures could manifest themselves in a steeper local yield curve and some additional support for the currency.

There are also some balance of payments effects to consider. These are neatly summarised in a 1997 RBNZ Bulletin article as likely being "quite modest"<sup>1</sup>. The RBNZ goes on to say "insurance and reinsurance transfers from overseas insurers could match the cost of the additional imports required to repair property, and any loss of export earnings. This being the case, it is not obvious that the "fundamentals" would change in a way such as to cause sharp adjustments to the exchange rate."

All up then, we suspect the enduring NZD impact of Saturday's quake will be fairly muted. The simple fact is that trends in global risk appetite will remain the bigger driver of the currency in the short-term. As ever, we'll be keeping a close eye on equity market sentiment for clues in this regard, particularly given the offshore data calendar is looking fairly light this week.

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## Foreign Exchange Technicals

### NZD/USD

Outlook: Buy a dip  
 ST Resistance: 0.7240 (ahead of 0.7350)  
 ST Support: 0.6950 (ahead of 0.6990)

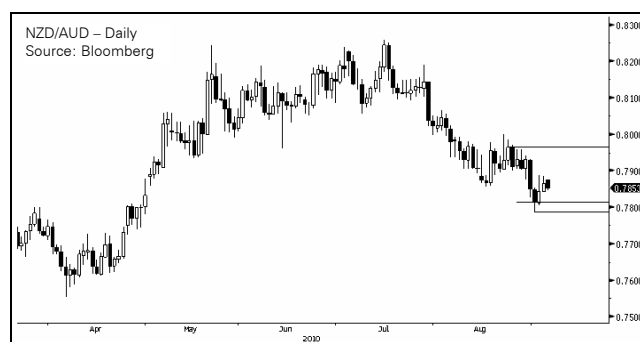
The break above 0.7195 strengthened the uptrend and momentum factors have switched from negative to neutral. Buy a dip towards 0.7000.



### NZD/AUD

Outlook: Consolidation  
 ST Resistance: 0.7965 (ahead of 0.8045)  
 ST Support: 0.7785 (ahead of 0.7740)

The downtrend remains intact and we look for a test of support towards 0.7785 in coming sessions.



<sup>1</sup> Preparing for natural disasters – where does the Reserve Bank fit in? Reserve Bank Bulletin, Vol 60 No. 4, White (1997)

## Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
<b>Monday 6 September</b>				<b>Wednesday 8 September Cont'd</b>			
Aus, TD Inflation Gauge, August y/y			+2.8%	UK, Industrial Production, July	+0.4%		-0.5%
Aus, ANZ Job Ads, August			+1.3%	Germ, Industrial Production, July	+1.0%		-0.6%
US, Holiday, Labor Day				Germ, Trade Balance, July s.a.	+€13.0b		+€14.1b
<b>Tuesday 7 September</b>				Can, BOC Policy Announcement			0.50%
NZ, Wholesale Trade, Q2 (\$) s.a.			+2.3%	<b>Thursday 9 September</b>			
Aus, RBA Policy Announcement	4.50%	4.50%	4.50%	NZ, Electronic Card Transactions, August			-0.2%
Jpn, BOJ Policy Announcement	0.10%	0.10%	0.10%	Aus, Employment, August	+55k	+25k	+23k
China, Manpower Survey, Q4			+27%	Aus, RBA's DeBelle Speaks			
UK, BRC Retail Sales Monitor, August y/y			+2.6%	Euro, ECB Monthly Bulletin			
Germ, Factory Orders, July		+0.5%	+3.2%	US, International Trade, July		-\$47.0b	-\$49.9b
<b>Wednesday 8 September</b>				UK, Trade Balance, July		-£3.3b	-£3.3b
NZ, Bollard's Book Launch				UK, BOE Policy Announcement	0.50%	0.50%	0.50%
NZ, Building Work Put In Place, Q2 vol s.a. +2.0%			+0.7%	<b>Friday 10 September</b>			
NZ, Manufacturing Sales, Q2 vol s.a.			-2.7%	NZ, Terms of Trade, Q2	+2.2%	+5.0%	+5.9%
Aus, Housing Finance, July	+1.0%	+1.0%	-3.9%	Jpn, BOJ Minutes, 9/10 Aug Meeting			
Jpn, BOJ Economic Report				Jpn, GDP, Q2 2nd est		+0.4%	+0.1%P
Jpn, Machinery Orders, July		+2.0%	+1.6%	China, Trade Balance (\$US), August		+\$26.8b	+\$28.7b
US, Beige Book				US, Wholesale Inventories, July		+0.4%	+0.1%

## 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	3.00	3.00	NZD/USD	0.7188	0.7120	0.7335	0.6426
1 mth	3.09	3.09	3.12	3.14	NZD/AUD	0.7847	0.7898	0.7982	0.7983
2 mth	3.18	3.20	3.20	3.23	NZD/JPY	60.62	60.76	62.64	61.82
3 mth	3.19	3.24	3.27	3.28	NZD/EUR	0.5578	0.5576	0.5518	0.4605
6 mth	3.27	3.32	3.44	3.34	NZD/GBP	0.4654	0.4582	0.4587	0.3893
<b>GOVERNMENT STOCK</b>					NZD/CAD	0.7469	0.7472	0.7531	0.7294
11/11	3.70	3.58	3.63	3.90	TWI	66.68	66.56	67.40	60.78
04/13	4.16	3.98	4.12	4.90	<b>NZD Outlook</b>				
04/15	4.62	4.43	4.60	5.54					
12/17	5.08	4.83	5.02	6.06	<p>Source: BNZ, RBNZ</p>				
05/21	5.38	5.14	6.53	-					
<b>CORPORATE BONDS</b>									
BNZ 05/13	5.08	5.05	5.30	-					
BNZ 09/16	6.14	6.00	6.36	-					
FON 04/14	5.56	5.58	5.85	-					
FON 03/16	6.11	6.08	6.17	-					
GEN 03/14	5.59	5.53	5.82	7.19					
GEN 03/16	6.20	6.06	6.32	7.98					
TRP 06/20	6.38	6.24	6.50	7.93					
<b>SWAP RATES</b>									
2 years	3.78	3.79	3.96	3.92					
3 years	4.01	3.98	4.20	4.67					
5 years	4.41	4.28	4.58	5.42					
10 years	5.01	4.85	5.17	6.20					



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