

27 September 2010

Strained Tea Leaves

- Thursday's business survey a post-quake pointer
- Can it withstand the negatives, overall?
- Second-tier August data also due, likely mixed
- As we soften our Q3 GDP growth estimate to 0.6%
- Still, we forecast stronger growth for 2011

Last week's Q2 GDP report queried the degree of momentum in the economy. We weren't expecting much, but saw even less. Sure, there was largely-predictable damage from the early-2010 drought, an associated eating into inventories and an odd-looking plunge in phone-call minutes. However, these were not to deny the underlying economic pulse was muted and thus a bit worrying.

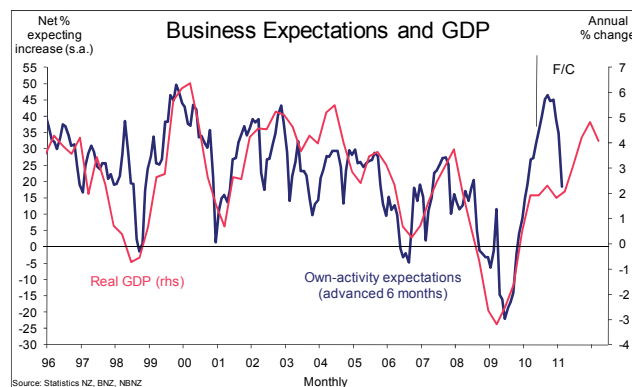
With this, every little bit of information will now be pored over more intently, amid fears the economy might be going flat altogether. For the record, we don't think it is. Well, not fundamentally anyway. Indeed, we still believe growth will pick up to a reasonable, even strong, pace through next year, albeit with the economy battling some material headwinds for the meantime.

As for this week's handful of economic indicators, the most closely watched will no doubt be Thursday afternoon's NBNZ business survey. How is New Zealand's business community seeing the way ahead, especially post the Canterbury earthquake? While there are obvious negatives bearing down on confidence and near-term activity, there are also medium-term positives to factor in (and not just in respect to the construction industry). Our gut feel is that the negatives will probably outweigh the positives in this survey.

Then again, who's to really know the way ahead? Earlier this year the NBNZ survey was signalling a veritable boom in activity was about to ensue. Try 6% growth. This clearly isn't transpiring. It's a reminder that the business sector has been as guilty as any in over-predicting the recovery.

Over more recent months, of course, the business sector's view has been cooling, with August's NBNZ survey readings essentially completing their move back to "average" in respect to economic growth expectations. So which way September?

And while we have taken a relatively conservative approach to the recovery process all along, we have certainly needed to tone down our growth expectations for this year as well. In the wake of last week's downbeat Q2 GDP details, we have specifically scaled back our Q3 growth estimate to 0.6% (while leaving Q4 at 0.5%).



As for whether this sort of pace is in the ball-park, we'll get a few testers this week.

We expect Wednesday's merchandise trade figures for August, for instance, to look reasonable enough with both exports and imports expected to be up 18% on last year's suppressed levels. However, such results would deliver a monthly deficit of \$846m, cementing stalled improvements in the trade balance, as part of the increasing trend we believe the current account deficit is on.

For Wednesday afternoon's credit aggregates, there might be a glimmer of expansion, again, in mortgages. But consumer credit and business and rural loans probably struggled to stand still in August. What's not obvious is why. If it reflects wanton de-leveraging, then this should be seen as a very good thing, real progress of a sort. However, if the soggy credit numbers reflect a lack of demand for funds, then they should be taken in a negative light. We believe a bit of both is at play.

The backdrop to Thursday morning's building consents is that July's residential numbers only looked reasonable (+3.2%, seasonally adjusted) because of a flush of apartments. Excluding these, the trend was flattening right off, at a sub-standard level. This does not auger well for August's consents, although we do have our fingers crossed for a slight further increase.

As for non-residential consents, we don't suppose their encouraging flutter of July can keep going in August, meaning the downtrend through 2010 to date will look even more obvious.

But then along came the Canterbury earthquake, which surely altered the path of New Zealand's construction

sector. Then again, most everything else has been buffeted, this way and that, in the economy at large. The recently appalling weather in Southland is but another example, which will restrain agriculture production.

The near-term indicators are promising to be even more problematic to interpret, in other words. It wasn't so long ago we thought it would mainly be this week's (1 October) GST rise and personal tax cuts that would cause the "noise". Oh for it to be that straightforward.

Nevertheless, we should at least be clear about our medium-term prognosis for the economy. And on this we still see good reason to be relatively positive. Indeed, growth potential for calendar 2011 might be getting legs from the very obstacles and delays the economy is working its way through at the moment. Strained as the recent tea leaves have become, they do not portend the end of the recovery.

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Domestic Interest Rates

New Zealand interest rates posted another rally last week despite a sell off in rates abroad, namely Australia. A significantly weak GDP print well below market expectations saw yields fall about 10 bps on the week, the market pricing out any chance of a hike by the years end, and only 19 bps of tightening priced until March next year. With yields at or near their lows, the risk at present is that too little is now priced into the curve and tightening cycle going forward.

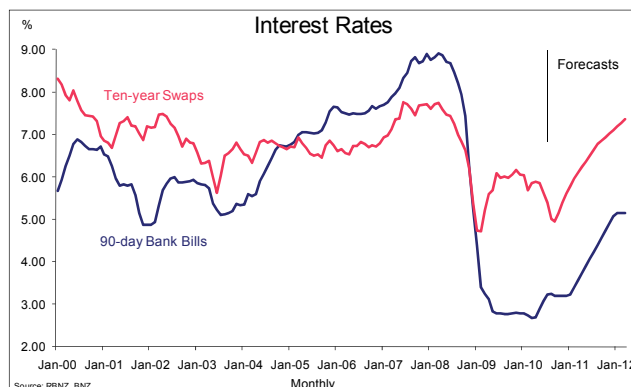
The bond market has performed well, longer dated bonds finally out performing equivalent swap yields bringing EFP inward from previously extreme levels. Kiwi bonds out performed relative to our Australian counterparts, as their rates saw a sizeable sell off with the RBA back in play. Kiwi bonds have seen good investor demand after the weak GDP figure. A fairly well bid tender saw the market soak up the 450m of bonds on offer. There's a chance that the DMO may issue a new 2019 bond in this week's tender.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
17-Sep-10	3.17%	4.05%	5.28%	3.80%	5.00%	120
17-Sep-10	3.18%	3.91%	5.14%	3.71%	4.90%	119
Change (bps)	1	-14	-15	-9	-10	-1

Reuters pgs BNZL BNZM

The swaps market has been fairly subdued following much of the aforementioned on very light volume. With the RBNZ on hold, there has been very little interest in fixed rate paying. The gradual move lower was accentuated with the weaker than expected GDP print. The curve movement has been relatively small; the spread between 2 year and 10 year has flattened a touch to 119bps. From a technical perspective 2 year swap looks like there's good support around the 3.70% level.

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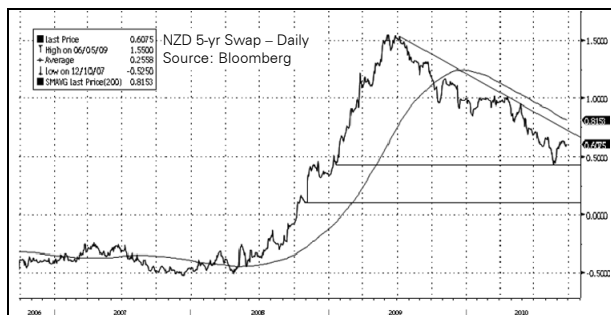


Interest Rate Technicals

NZD 5yr Swap Rate

Outlook: Neutral
 MT Resistance: 4.45%
 MT Support: 4.06%

Market is staying below downward sloping resistance now coming in at 4.45%. Look for break of range before taking a position.



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

Outlook: Rangebound
 MT Resistance: +73
 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 +73. A break of either of these lines will give us the next move.



Foreign Exchange Market

The NZD/USD climbed to an 8-month high above 0.7400 last week. But it was hardly an inspiring performance. More evidence of a lacklustre NZ economic recovery ensured the NZD fell against all of the other majors. Indeed, on a trade-weighted basis, the currency ended the week down 0.5%.

Last week's data provided further confirmation, if any more was needed, that the NZ recovery is a slow and bumpy one. Not only did the annual current account deficit increase from 2.4% of GDP to 3.0% in Q2, but June's meagre 0.2% GDP expansion undershot market and RBNZ expectations by a clear margin.

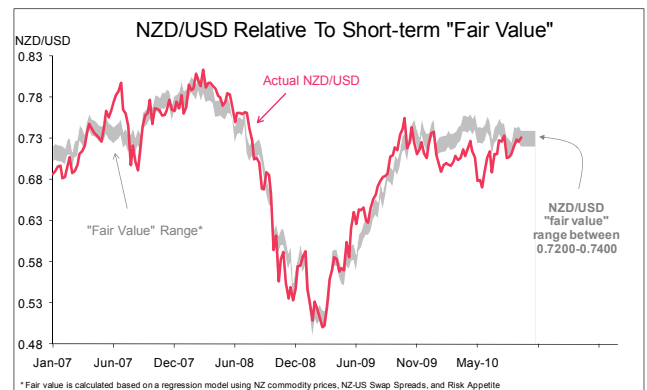
Despite this, the up-thrust from a broad-based weakening in the USD ensured the NZD/USD spent most of the week on the ascendency. Indeed, US markets' growing expectation the Fed will usher in a fresh round of quantitative easing saw the USD slide to 7-month lows last week.

Looking ahead, this week's mostly second tier data offering looks set to continue the recent dreary tone. Perhaps the most important release for the week will be Thursday afternoon's NBNZ business survey. On balance, our gut feel is businesses' optimism will ease a bit further.

So the domestic picture should remain a drag on the NZD/USD this week. However, we suspect a supportive

global backdrop will limit any dips to the 0.7200 region. Not only is USD sentiment in the doldrums, but investors' risk appetite finished last week on a buoyant note. The MSCI World Equity Index recorded its fourth straight weekly gain and our risk appetite index (which has a scale of 0-100%) jumped from 51.5% to 57.5% on Friday. Appetite for "growth-sensitive" currencies like the NZD/USD is likely to remain solid early in the week as a result.

Our short-term valuation model currently implies a NZD/USD "fair-value" range of 0.7200-0.7400. We suspect the NZD/USD will spend most of the week trading within this range.



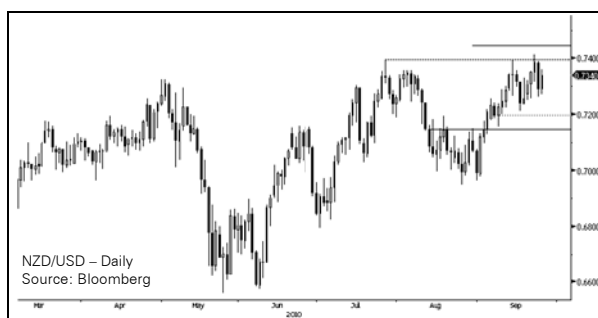
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Foreign Exchange Technicals

NZD/USD

Outlook: Consolidation
ST Resistance: 0.7395 (ahead of 0.7445)
ST Support: 0.7200 (ahead of 0.7145)

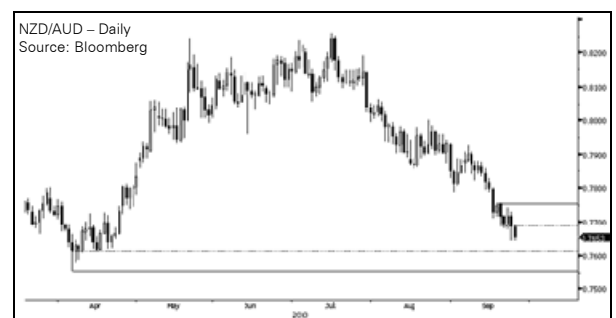
Repeated failures to sustain rallies towards 0.7395 suggest the uptrend is running out of steam, but momentum will remain positive while 0.7200 holds.



NZD/AUD

Outlook: Sell a rally
ST Resistance: 0.7690 (ahead of 0.7755)
ST Support: 0.7615 (ahead of 0.7555)

The downtrend remains intact and we look for further downside in the short-term. However, with the daily RSI close to "oversold" levels we'd expect 0.7615 support to hold near-term.



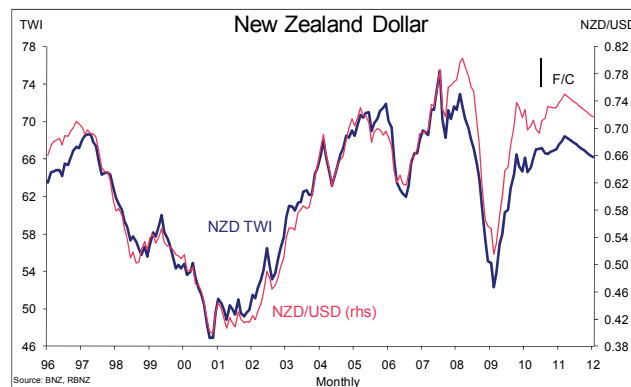
Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 27 September				Thursday 30 September <i>continued ...</i>			
Jpn, Merchandise Trade Balance, August		+Y522b	+Y610b	Jpn, Industrial Production, August 1st est	+1.1%		-0.2%
Euro, M3, August y/y		+0.3%	+0.2%	US, GDP, Q3 3rd est	+1.6%		+1.6%P
Tuesday 28 September				US, Chicago PMI, September		56.0	56.7
US, Consumer Confidence, September		52.3	53.5	UK, BOE Credit Conditions Survey, Q3			
US, Shiller Home Price Index, July y/y		+3.1%	+4.2%	Euro, CPI, Sept y/y 1st est.	+1.8%		+1.6%
UK, GDP, Q3 1st est		+1.2%	+1.2%P	Germ, Unemployment, September s.a.		7.6%	7.6%
UK, CBI Dist Trade Survey, September		+28	+35	Friday 1 October			
Wednesday 29 September				Jpn, CPI, August y/y		-0.9%	-0.9%
NZ, Household Credit, August y/y		+2.3%		Jpn, Unemployment Rate, August		5.1%	5.2%
NZ, Merchandise Trade, August	-\$846m	-\$500m	-\$186m	China, PMI (NBS), September		52.8	51.7
Jpn, Tankan (lge manuf), Q3		+7	+1	US, Personal Spending, August	+0.4%		+0.4%
Euro, Economic Confidence, September		101.3	101.8	US, ISM Manufacturing, September		54.5	56.3
Thursday 30 September				UK, CIPS Manuf Survey, September		53.8	54.3
NZ, Building Consents, August (res, #)			+3.1%	US, Construction Spending, August		-0.4%	-1.0%
NZ, NBNZ Business Survey, September			+16.4	Euro, Unemployment Rate, August		10.0%	10.0%
Aus, Building Approvals, August	+1.0%	flat	+2.3%	Germ, Retail Sales, August	+0.4%		-0.1%
Aus, Private Sector Credit, August	+0.5%	+0.3%	+0.1%	Sunday 3 October			
Aus, Financial Stability Review				China, Non-manufacturing PMI, September			60.1
Jpn, Retail Trade, August y/y		+4.7%	+3.8%				

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	3.00	NZD/USD	0.7353	0.7266	0.7120	0.6426
1 mth	3.12	3.12	3.09	3.14	NZD/AUD	0.7643	0.7739	0.7898	0.7983
2 mth	3.17	3.20	3.20	3.23	NZD/JPY	62.00	62.29	60.76	61.82
3 mth	3.16	3.15	3.24	3.28	NZD/EUR	0.5452	0.5567	0.5576	0.4605
6 mth	3.22	3.24	3.32	3.34	NZD/GBP	0.4646	0.4640	0.4582	0.3893
GOVERNMENT STOCK					NZD/CAD	0.7532	0.7496	0.7472	0.7294
11/11	3.53	3.63	3.58	3.90	TWI	66.54	66.93	66.56	60.78
04/13	3.92	4.05	3.98	4.90					
04/15	4.42	4.56	4.43	5.54					
12/17	4.87	5.01	4.83	6.06					
05/21	5.15	5.28	6.53	-					
CORPORATE BONDS									
BNZ 05/13	5.05	5.10	5.05	-					
BNZ 09/16	6.09	6.18	6.00	-					
FON 04/14	5.56	5.65	5.58	-					
FON 03/16	6.09	6.18	6.08	-					
GEN 03/14	5.54	5.63	5.53	7.19					
GEN 03/16	6.15	6.23	6.06	7.98					
TRP 06/20	6.29	6.39	6.24	7.93					
SWAP RATES									
2 years	3.72	3.80	3.79	3.92					
3 years	3.95	4.04	3.98	4.67					
5 years	4.32	4.42	4.28	5.42					
10 years	4.91	5.00	4.85	6.20					

NZD Outlook



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