11 October 2010

Warning: Wobbly Data Ahead

- We remain optimistic for growth in 2011
- Despite growing weather risk to primary production
- This week heralds the start of wobbly data
- As weather events, tax changes and earthquake effects come through

Last week's Quarterly Survey of Business Opinion was certainly disappointing. Business confidence turned negative, seasonally adjusted and on net, to -9 in Q3 from +26 in Q2. This was a big enough drop to be meaningful and surely more than a reflection of the atrocious weather that most of the country has been dished out recently.

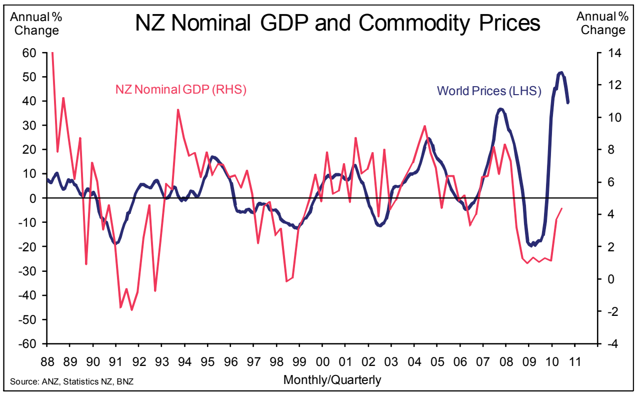
But, as soft as some of the headline indicators were, picking through the information-rich details of the NZIER survey we were left with the distinct impression that the economy is hanging in there. We do not think this survey foretells the death knell for the recovery. For example, employment and investment intentions, while far from strong, were around about their historical averages. Firms would not have these intentions if there was not some optimism in their own business.

As such, we are still optimistic for 2011. With some large positives like the (net) tax cuts just delivered, the impulse from the Rugby World Cup, the Canterbury rebuild following the earthquake and high commodity prices, we think there is enough in the pipeline to lift economic activity over the coming year. Our forecast of 3.6% economic growth for 2011 is even solid, in fact.

Speaking of commodity prices, last week we learnt that the world is buying our primary products at near-record prices. Indeed, prices are within 1% of their highs. The strong NZ dollar means not all of these gains are accruing to the export sector. Even so, the 33% lift in world prices for our key primary products over the past 12 months is a major support to the economy.

The 'but' comes on the primary production side, given a suite of spring storms that have lashed various parts of the country. The significant stock-losses, particularly in Southland and South Otago, and generally poor grass growing conditions will limit the economic boost from better prices, as has been the case over recent years.

Moreover, there remains the ever-present risk of further adverse weather. We say this not in a clichéd way. As we have been highlighting for some months now, there remains a significant risk to (late summer/autumn) production, especially in west and south-western regions,

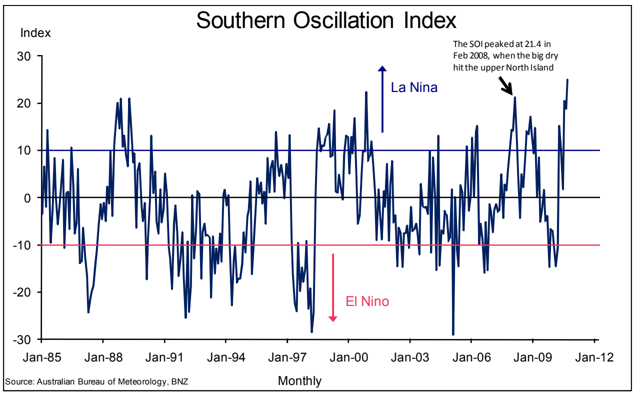


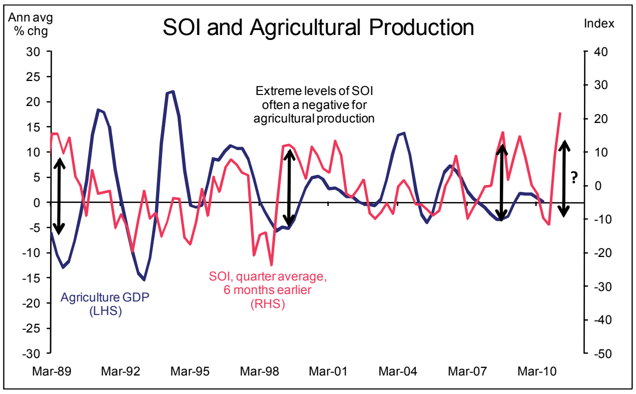
given that the current La Nina weather pattern is projected to extend into, and beyond, autumn.

The current La Nina is a strong one, judging by the Southern Oscillation Index hitting +25 in September. Indeed, this is the highest monthly SOI reading since November 1973. To find the SOI this high in September you have to go back to 1917!

We are not weather forecasters, but we are very mindful of the destruction caused by the early 2008 La Nina (when the SOI hit 21.4 in February 2008) through much of the North Island. Agricultural production in these areas was hit hard. This event played a significant part in putting NZ into recession – before the global financial crisis struck!

It is worth noting La Nina type conditions can sometimes boost national agricultural production, but it is the extremity that raises concern this time around. As such we have downgraded the outlook for national agriculture production to 1% to 2% growth in the year to June 2011, albeit still with downside risk. The anticipated small rise reflects partial recovery from previous droughts rather than genuine growth. Indeed, national agricultural output



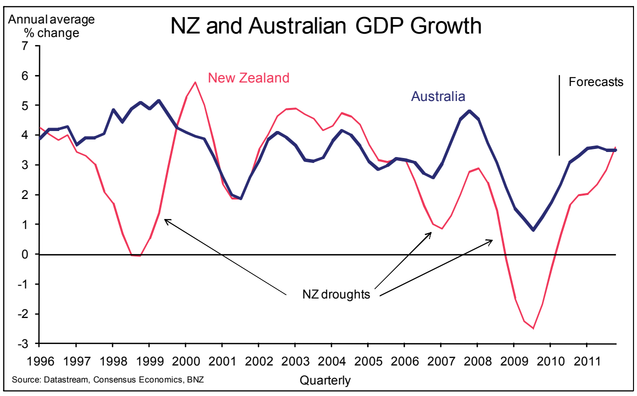


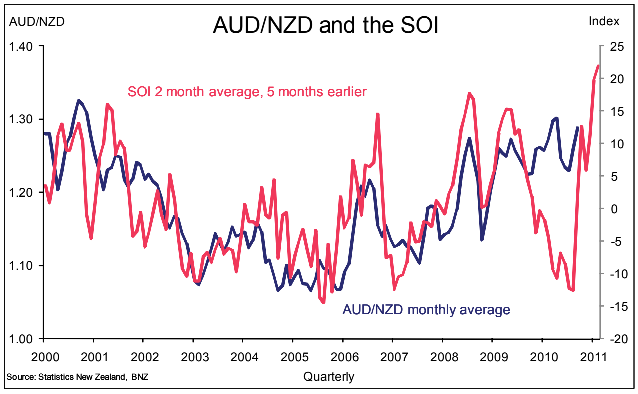
has gone largely sideways over the past three years, as various regions have been negatively affected by the weather. So, if there is to be any growth it will be coming off a static base.

The effects of adverse weather on the NZ economy are also evident when comparing NZ's economic performance to Australia. Not that we think the weather explains all of the difference in economic growth rates, but the droughts of 1997/98 and the past three years over various parts of NZ are no doubt part of the reason for NZ's under-performance in those periods. Of course, Australia has also had its fair share of adverse weather too, but agriculture is not as important to the Australian economy as it is to the NZ economy.

For currency watchers, this weather-induced economic growth differential often shows up in the AUD/NZD crossrate. There appears to be around a five months lag, perhaps related to the time it takes for the adverse weather to dent primary production and/or to show up in the national statistics. Again, it is obviously too much to suggest that the difference in economic performance and currency movements are all due to the weather! But, it is clearly one factor.

Obviously, other factors were in play over the past 12 months when, despite the SOI being negative, the AUD/NZD remained strong. No doubt the RBA tightening cycle, relative commodity prices and other factors made contributions. For what it is worth, amid the multitude of





important factors for currency markets, the current strong La Nina weather conditions suggests further upside to AUD/NZD over coming months.

The adverse weather may even start showing up in some of the data this week with the release of the Food Price Index for September. Even though food prices seem due a technical downwards correction in September, the chances of this occurring appear limited given the adverse weather. We're looking for a 0.8% gain, but with a wide margin for error given the usual volatility in such prices coupled with the possible and difficult-to-judge influences from the weather.

Turning to other economic data this week, much of it has a consumer focus including this morning's electronic card transactions data for September. This data was much as expected, showing a reasonably solid 1.0% lift overall with the retail component rising 1.5% thanks to some last minute shopping late in the month to beat the 1 October GST hike. People filled up their cars and brought-forward some big ticket purchases judging by the 2.9% and 4.0% increase in fuel and durable spending respectively, although the durable increase was partly a rebound from a dip in August.

Overall, however, the pre-GST spend up seems to have been relatively muted and so too, one would expect, will be any unwind through October. However, we are also aware of the negative spending effects, especially early in the month, as a result of the Canterbury earthquake. Just maybe the pre-GST spend up was a bit bigger than some would think, masked by other factors. Time will tell.

The ECT data for September overshadows the official retail sales data for August due on Thursday. But for the record, and because the market still reacts to the official data, we have our fingers crossed that retail sales nudged forward in August. We're expecting a 0.4% increase overall, and 0.2% ex-auto.

Also on Thursday, we will get the latest batch on REINZ housing statistics that are likely to remain moribund. The 'news' will be in how much worse the national data looks given the likely hit to the Canterbury market as a result of the earthquake.

Completing a big data Thursday, but departing from the consumer theme, we get the BNZ PMI for September. The manufacturing sector was jogging on the spot according to this indicator in August. We wait to see what September brings especially with the early effects of the earthquake coming through.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates generally took a back foot to offshore moves as rates moved slightly higher in yield. The very front end of the curve remains largely unchanged with the futures and OIS pricing slightly less than a 25bp hike for March next year, with slightly less than 50% chance of hikes in each remaining meeting for 2011. The market seems comfortable with the current level of pricing and barring a major shock it is likely the short end of the curve will continue to trade tight ranges.

The bond market struggled somewhat in the past week and the market backed up around 10bps across the curve. The tender was somewhat disappointing with a significant tail to the bids, particularly the new 2019 bond. We feel the NZGB market will perform more strongly over the next week, with coupons payable feeding some additional cash into the market and a disappointing US non-farm payrolls number from last Friday keeping yields down offshore.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
1-Oct-10	3.17%	3.82%	5.02%	3.71%	4.86%	115
8-Oct-10	3.18%	3.92%	5.11%	3.76%	4.91%	115
Change (bps)	**1**	**10**	**9**	**5**	**5**	**0**

The swaps market was also relatively quiet, with 2-yr pushing towards the top of its recent ranges at 3.80% on Thursday, before rallying back to finish the week. We seem to be rangebound in the front end of the curve and expect payers around 3.65% and further receiving around 3.80%. The market seems to be comfortable with current pricing and is seeing limited amounts of flow, so will likely remain in these ranges for the time being.

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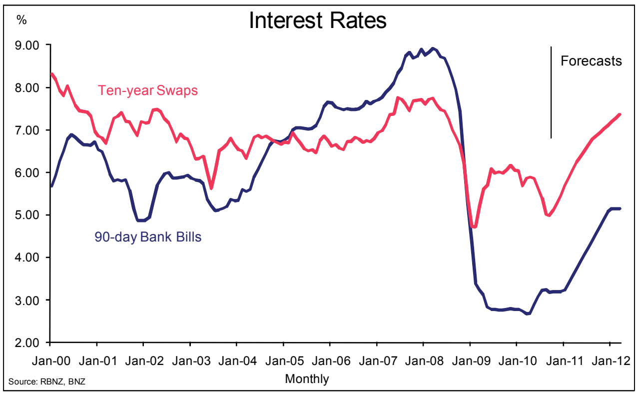

Interest Rate Technicals

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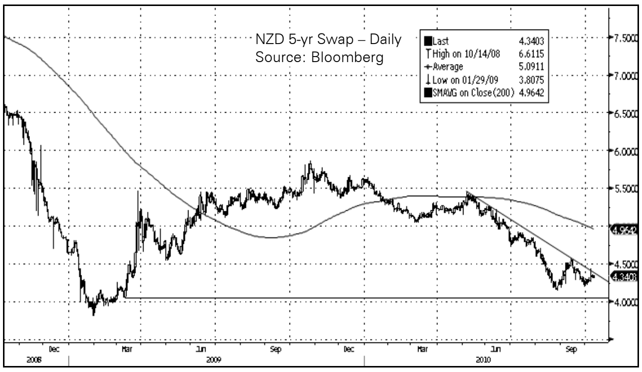
NZD 5yr Swap Rate

Outlook: Neutral

MT Resistance: 4.40%

MT Support: 4.06%

Market is staying below downward sloping resistance, which is now coming in at 4.40%. Look for a break of the recent range before taking a position.



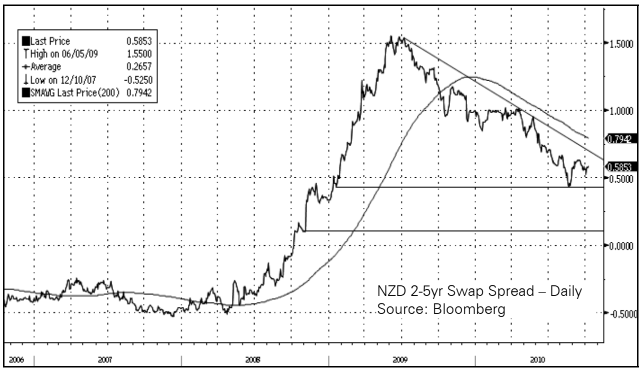
NZ 2yr-5yr Swap Spread (yield curve)

Outlook: Rangebound

MT Resistance: +70

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 +70. A break of either of these lines will give us the next move.



Foreign Exchange Market

Reuters pg BNZWFWDS

It was a rocky road higher in the NZD/USD last week. After starting the week around 0.7450, the NZD/USD spent most of the week grinding choppily higher, to eventually reach an 11-month high of nearly 0.7600.

Further evidence of a fizzling domestic recovery had little impact on the NZD last week. Instead, a broadly weaker USD underpinned the NZD/USD as US markets became convinced the US Federal Reserve will soon embark on quantitative easing Mark II. Friday's downbeat US non-farm payrolls report (-95,000 jobs vs. -5000 expected) simply reinforced this trend.

The impact of the weaker USD was marked. Gold prices soared to record highs, USD/JPY fell to 15-year lows, and the EUR/USD and AUD/USD climbed to 8-month and 27-year highs respectively. While the NZD/USD was also a reluctant benefactor of the USD fire sale, it was notable that the NZ trade-weighted index barely moved last week and remains 2.9% below May's 2010 high, and 13% below 2007's peak. As such, the RBNZ will be relatively unruffled by the recent period of NZD 'strength'.

Looking ahead, there is no doubt the NZD/USD is starting to look overstretched on the basis of economic 'fundamentals'. Indeed, the last time the NZD/USD was above 0.7450, NZ-US 3-year swap spreads were around 340bps; this time spreads are closer to 320bps. The NZD/USD is also trading above the 0.7300-0.7500 "fair-value" range implied by our short-term valuation model.

In addition, CFTC data shows the speculative community now hold the largest short USD position since November 2007. Net shorts increased 8% to US$31b last week. Should this week's US data throw up a positive surprise, there's every possibility a short-covering rally in the USD will result. In this respect, the Fed's FOMC minutes on Wednesday morning and Friday's slew of US data will be worth keeping an eye on.

All of this raises the risk of a near-term pullback in NZD/USD. However, we suspect positive momentum and buoyant risk appetite will ensure any NZD/USD dips are limited to around 0.7300-0.7350 in the short-term. It's worth noting, our risk appetite index (which has a scale of 0-100%) rose to 62% last week, the highest since May. Appetite for "growth-sensitive" currencies like the NZD and AUD is likely to remain firm early in the week as a result.

Certainly, sentiment towards the USD will remain the key near-term driver of NZD/USD. This is particularly so given this week's relatively light local data offering (with the highlight being August's retail trade, due Thursday). Resistance on NZD/USD will be found towards the 2009 high of 0.7640, with initial support on dips towards 0.7340.

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Foreign Exchange Technicals

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NZD/USD

Outlook:	Buy a dip
ST Resistance:	0.7635 (ahead of 0.7760)
ST Support:	0.7340 (ahead of 0.7255)

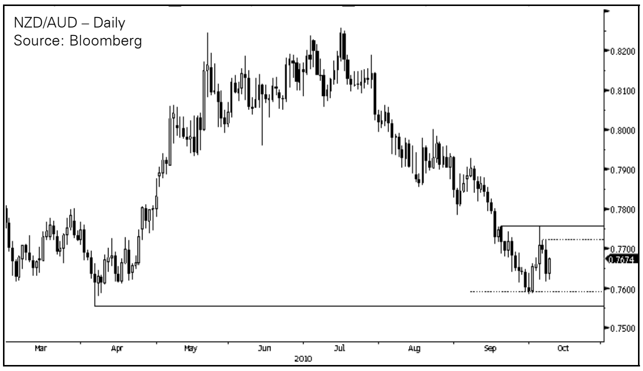
The daily close above January's 0.7445 high saw the uptrend gain traction. A close above 0.7635 would pave the way for a test of 0.7800.

NZD/USD – Weekly
Source: Bloomberg

NZD/AUD

Outlook:	Sell a rally
ST Resistance:	0.7720 (ahead of 0.7755)
ST Support:	0.7600 (ahead of 0.7555)

The failure to sustain rallies towards 0.7750 confirmed the downtrend. Momentum is negative and we look for a test of 0.7600 support in coming days.



NZD/AUD – Daily
Source: Bloomberg

Key Upcoming Events

	Forecast	Median	Last
Monday 11 October			
Aus, Housing Finance, August		+1.0%	+1.7%
Tuesday 12 October			
Aus, NAB Business Survey, September			
Jpn, Consumer Confidence, September			42.5
UK, CPI, September y/y		+3.1%	+3.1%
UK, Trade Balance, September			-£4.9b
UK, BRC Retail Sales Monitor, September y/y			+2.8%
UK, RICS Housing Survey, September		-36%	-32%
US, FOMC Minutes, 21 Sep Meeting			
Wednesday 13 October			
NZ, Food Price Index, September	+0.8%		-0.1%
Aus, Consumer Sentiment - Wpac, October			113.2
China, Business Climate Indicator, Q2			135.9
China, Trade Balance ($US), September		+$17.5b	+$20.0b
Jpn, Machinery Orders, August		-3.9%	+8.8%
Euro, Industrial Production, August		0.8%	0.2% R
UK, Weekly Earnings, August 3m y/y		+1.6%	+1.5%
UK, Unemployment Rate (ILO), August		7.8%	7.8%
US, Import Prices, September		-0.2%	+0.6%

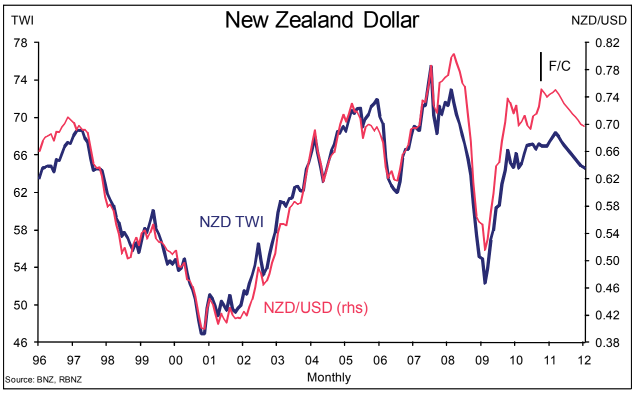
	Forecast	Median	Last
Thursday 14 October			
NZ, BNZ PMI (Manufacturing), September			49.3
NZ, Crown Financial Statements, June			
NZ, Retail Trade, August	+0.4%	+0.3%	-0.4%
NZ, REINZ Housing Data, September			
Euro, ECB Monthly Bulletin			
UK, CBI Industrial Trends (circa), October			-17
US, Jobless Claims, week ended 09/10		443k	445k
US, PPI ex-food/energy, September y/y		+1.5%	+1.3%
US, International Trade, August		-$44.1b	-$42.8b
Friday 15 October			
China, Leading Index (Conference Board), August			+0.5%
Jpn, Industrial Production, August 2nd est			-0.3%
Euro, CPI, Sept y/y 2nd est.		+1.8%	+1.8%P
Euro, Trade Balance, August		flat	+€6.7b
US, Empire Manufacturing, October		+6.00	+4.10
US, CPI ex food/energy, September		+0.9%	+0.9%
US, Retail Sales, August		+0.4%	+0.4%
US, Business Inventories, August		+0.5%	+1.0%
US, Mich Cons Confidence, October 1st est		69.0	68.2

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	3.00	3.00	3.00	3.00
1 mth	3.14	3.14	3.11	3.14
2 mth	3.15	3.16	3.19	3.23
3 mth	3.19	3.16	3.19	3.28
6 mth	3.23	3.22	3.27	3.34
GOVERNMENT STOCK				
11/11	3.53	3.47	3.80	3.90
04/13	3.92	3.83	4.24	4.90
04/15	4.39	4.31	4.72	5.54
12/17	4.83	4.75	5.15	6.06
05/21	5.11	5.03	6.53	-
CORPORATE BONDS				
BNZ 05/13	5.08	5.01	5.18	-
BNZ 09/16	6.11	6.03	6.23	-
FON 04/14	6.86	5.50	5.72	-
FON 03/16	6.83	6.05	6.21	-
GEN 03/14	7.25	5.48	5.70	7.19
GEN 03/16	7.65	6.11	6.29	7.98
TRP 06/20		6.20	6.42	7.93
SWAP RATES				
2 years	3.76	3.72	3.90	3.92
3 years	3.99	3.95	4.13	4.67
5 years	4.33	4.28	4.51	5.42
10 years	4.91	4.87	5.07	6.20

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7567	0.7442	0.7302	0.6426
NZD/AUD	0.7635	0.7646	0.7855	0.7983
NZD/JPY	61.94	61.96	61.56	61.82
NZD/EUR	0.5400	0.5392	0.5745	0.4605
NZD/GBP	0.4738	0.4710	0.4753	0.3893
NZD/CAD	0.7634	0.7584	0.7553	0.7294
TWI	66.99	66.65	67.83	60.78

NZD Outlook



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