20 December 2010

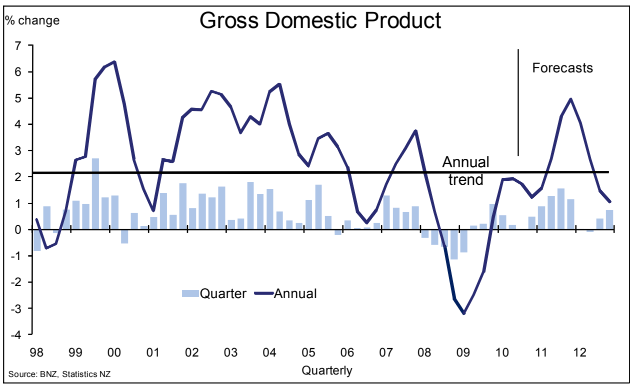
When Rain Portends Growth

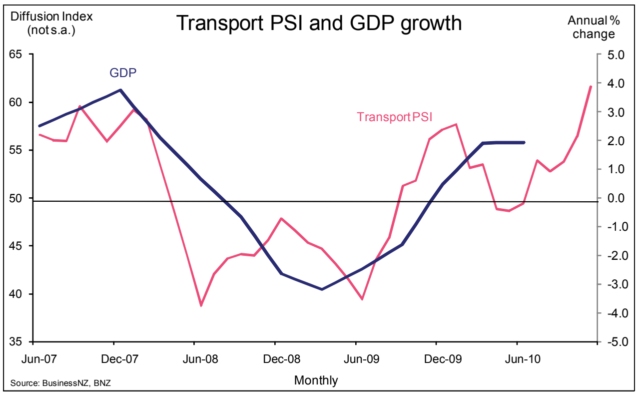
- About-flat Q3 GDP to exemplify disappointing 2010
- But we maintain our view of a (much) better 2011
- PSI sustains growth hopes, as does the weekend's rain
- NBNZ survey signals good growth (and better QBSO)
- Amid further signs of private-sector rebalancing
- Albeit with earthquake money flattering Q3 current a/c

Many will be pleased to see this year out – disappointed it wasn't a better one, but mindful that it could have been worse. Thursday's Q3 GDP report will likely exemplify the frustrations, in being about flat. Has this shaken our faith in the recovery? Not really. Sure, we were not conservative enough on 2010 growth, in the end, even with the excuses of a number of un-divine interventions. However, we still see underlying progress being made, as imbalances abate. And, providing the global recovery doesn't lose the plot, we maintain that 2011 will prove much better for the NZ economy than 2010, albeit aided by some transitory forces that should not evoke over-confidence.

In respect to September quarter GDP, we believe this will be about flat. It might be up a fraction, if manufacturing is not as negative as its Q3 survey statistics suggested, or down a bit, if any one of a number of components throws up a clanger, for example ongoing collapse in mobile call-minutes. The known negative is construction, but everything else is up for negotiation. With so much bobbling around, we have settled on a sideways move for Q3 GDP. This would deliver annual growth of 1.7%, continuing to mark this recovery as arguably the slowest on record.

The market's median expectation on Q3 GDP growth has been watered down to the point of 0.2%, with a range of -0.3% to +0.5%. The Reserve Bank, for the record, had 0.3% built into its December Monetary Policy Statement,





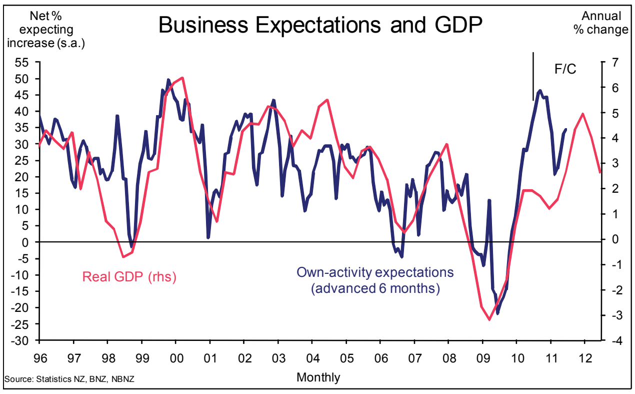
before the weak manufacturing and construction figures came to light.

While there is obvious potential for Q3 GDP to evoke negative headlines, the bigger task is to judge the undertones of the economy, and its way forth. In this regard, as mentioned, we remain positive.

For the immediate term, in support, we note this morning's Performance of Services Index. While hardly strong, it nonetheless remained in expansion mode, and with new orders, at a seasonally adjusted 54.4, suggesting ongoing progress in the pipeline. Its weaker elements still included retailing, amid anecdote of early and aggressive discounting on the high streets and at the malls (with tomorrow's credit card billings, for November, useful context). But the PSI also hinted at strength in the broader services sector, with the likes of the transportation industry hinting at improved volume expansion, at least. We also note the likelihood of positive tendencies in November's short-term visitor arrivals and net immigration, as per tomorrow's update.

In addition, we have had some divine intervention of a good sort, for a change, in the form of the weekend's rains, coupled with unusually warm temperatures. While this is no drought breaker, it certainly helps – increasing the odds of salvaging some growth this season, when unfavourable weather was otherwise threatening to quash any rebound in agricultural production from last season's drought-afflicted levels. The more it rains, the more things brighten.

The business sector certainly remains upbeat about growth prospects. We saw this, in sharp relief, in last week's National Bank of New Zealand survey. Indeed, its activity indicators were consistent with GDP growth



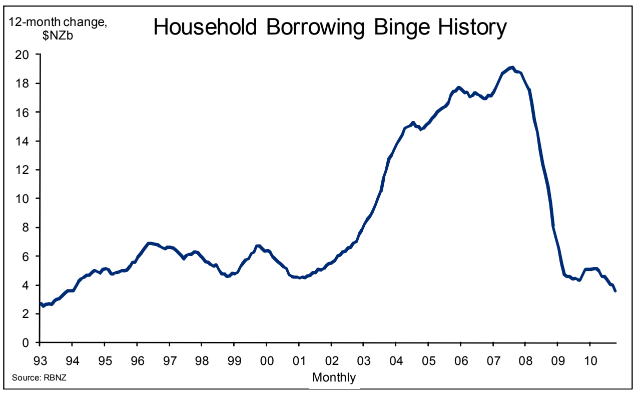
pushing 4% over the coming six to twelve months. Sure, these same measures, early this year, completely overestimated 2010 performance. However, we see more reason to believe them this time around, as we foresee GDP growth near 4% through 2011 as well, as it happens.

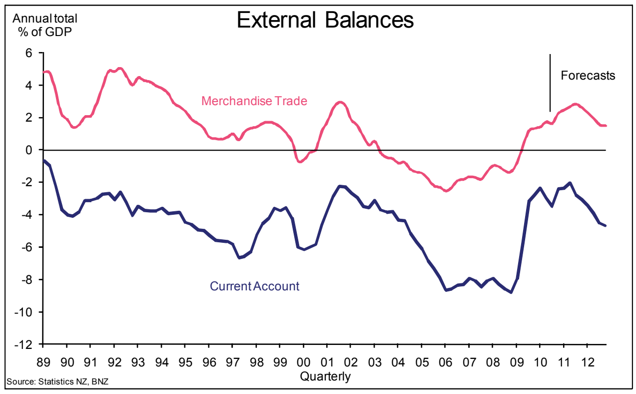
The NBNZ business survey is also a positive pointer to the next Quarterly Survey of Business Opinion (QSBO), due 11 January. While the QSBO has recently, and rightly, indicated immediate economic torpor there is every chance it will at least track the National Bank survey's general improvement over the last three months or so. A (slightly) improved QSBO would get the New Year data tone off on a reasonable note. And there should be further underpinnings to local interest rates, and the exchange rate, if the 20 January Q4 CPI surprises on the high side – as we think it will.

The other strengthening underway, we reckon, relates not so much to the GDP and inflation indicators but an underlying abatement in the economy's economic and financial imbalances.

Sure, in this respect, the fiscal situation is getting worse, as last week's Half Year Economic and Fiscal Update highlighted. But there is at least a firm resolve to turn it around.

The private sector, meanwhile, is already exhibiting clear signs of getting its finances in order. To be sure, last week's reported stark improvement in the household





savings rate, as part of the latest Institutional Sector Accounts, owed a lot to extracting the landlord sector's loss-making tendencies (placing them now in the non-incorporated business sector). Still, this left much less insufficiency in the rate of household savings proper. Not to say the problem is resolved, but making good progress all the same.

In this vein, we can also believe a good part of the recent flatness in credit aggregates reflects firms and households paying down debt. That's good for private sector balance sheets, even though it's obviously not for immediate spending and activity. For those still around on Friday, at 3pm, you'll get to see the updated data for November.

For the most general insight into rebalancing, however, we note Wednesday's Q3 Balance of Payments figures. Yes, these will be flattered by foreign funds from the earthquake reinsurance. But probably not as much as the $1.7b mentioned by Statistics NZ last week, as this is an "eventual" figure. The identifiable charge will likely be much less for the purposes of tomorrow's current account. We have made the working assumption of $1.0b.

Even with this "benefit", the current account deficit will probably expand on a year to September basis, to hit around 3.5% of GDP, from 3.0% in the year to June. This is mainly because of timing-related weakness in net export volumes, and the last of the banking tax judgment impacts (which reduced profit "outflows" to Australian parents) washing out of the annual calculations.

For the coming year we forecast the annual current account deficit to reduce to a benign-looking proportion of GDP, of around 2%, as the full benefits of the multi-decade highs in the terms of trade come through. However, just like with the improvement we foresee for GDP growth through 2011, no-one should get overly excited about it. On a multi-year view, there is still much to be cautious and conservative about.

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Domestic Interest Rates

A little bit of volatility in short end rates this week, but no real direction revealed. The 90-day bank bills ended the week unchanged at 3.17%. The low of the week was on Thursday, set at 3.16%, with the high on early Tuesday at 3.19%. The OIS curve has 15bps priced to June and 65bps priced in for the next 12 months. The 90-day bank bill margin ended the week unchanged at 16bps. Wednesday's current account data is something to look out for, but Thursday's NZ Q3 GDP will be the major event of the week, with potential to push round short end rates.

Last week we saw a continued steepening in the New Zealand government bond market. Early on in the week NZ rates received a boost due to a global decrease in risk aversion. However, Tuesday's terrible retail sales data pushed rates back down a little. As a result we saw a sell off of 3bps in the 13s, closing at 4.09. The 21s sold off 13bps, closing at 5.89%. Looking ahead for the week we should see demand for bonds continued up to Thursday's tender. As usual, direction will come from offshore events, but also we have significant local data, including Thursday's Q3 GDP to watch out for.

The NZ swap market steepened again last week. We saw a modest sell off over the whole curve. With a decrease in global risk aversion, we saw an increase in the 2-yr yield of 1bp, closing at 3.85%. The 10-yr sold off 9bps, closing at 5.60%. Hence, the 2s10s curve steepened 8 points, with the spread closing at 176bps. This week focus will be on Wednesday's current account data, Thursday's Q3 GDP data, and once again offshore events.

Reuters pgs BNZL BNZM

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
10-Dec-10	3.17%	4.05%	5.76%	3.83%	5.51%	168
17-Dec-10	3.17%	4.09%	5.89%	3.85%	5.60%	176
Change (bps)	**0**	**3**	**13**	**1**	**9**	**8**

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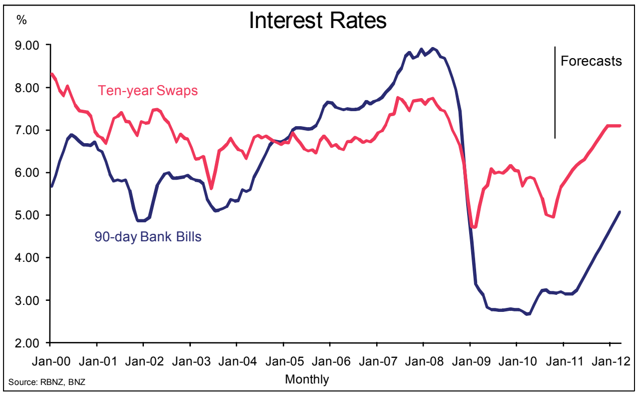

Interest Rate Technicals

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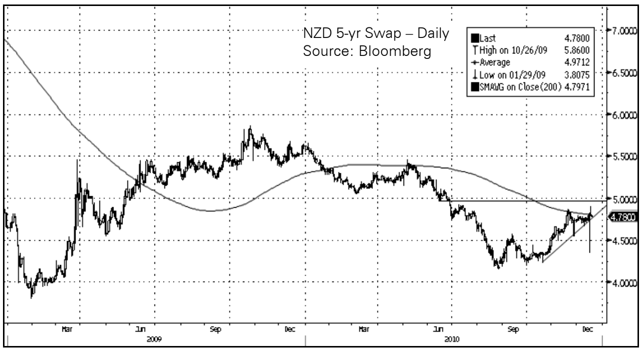
NZD 5yr Swap Rate

Outlook: Neutral
MT Resistance: 4.97%
MT Support: 4.57%

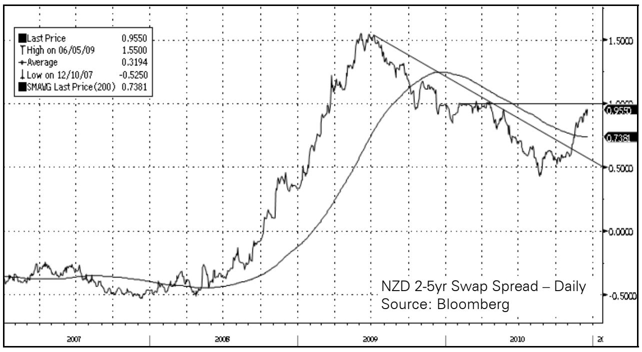
Short-term support now comes in trendline level of 4.76%. If this is breached, we may head lower towards medium-term of 4.57%. The 200-day moving average has been difficult to break on the topside and we recommend a neutral stance in the interim.



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

Outlook: Neutral
MT Resistance: +100
MT Support: +57

The market has not quite reached out target of 100. We suggest taking profit here as consolidation is likely. Only a solid breach of 100 will signal further steepening.



Foreign Exchange Market

Reuters pg BNZWFWDS

Much like the third Ashes test, it was a wild ride in the NZD/USD last week.

The NZD certainly started the week on the front foot. Global sentiment brightened noticeably as China held off on a rumoured rate hike and the US Senate passed Obama's fiscal stimulus package. Global equity markets rose, our risk appetite index hit the highest level since April this year, and the NZD/USD rocketed above 0.7550.

However, later in the week, the NZD/USD was bowled over by a broad strengthening in the USD and more uninspiring NZ economic data. Further gains in US bond yields and increased "safe-haven" demand on the back of European debt jitters bolstered demand for the USD. Meantime, local markets pushed back the timing of the first RBNZ rate hike out to July following October's terrible retail sales data.

As a result, NZ-US 3-year swap spreads were pushed down to the lowest level since April, NZD/AUD slumped to a decade low below 0.7500, and NZD/USD was eventually dragged below 0.7400 for the first time since early October.

Despite the onset of the holiday season, the week ahead is shaping up as anything but quiet for local markets and the NZD. The local data schedule offers plenty with Thursday's Q3 GDP figures likely to be the highlight. We are picking a dead flat result for the quarter (1.7% y/y), compared to the market's +0.1%q/q expectation and the RBNZ's 0.3%. The risk of a negative number certainly cannot be taken lightly. Wednesday's current account data will provide the curtain raiser and, again, the news is likely to be far from encouraging. We expect the current account deficit will push out to 3.5% of GDP for the year to September, from 3.0% (market 3.4%).

Should the data all pan out as we expect, there's every chance the NZD will remain heavy this week. The prospect of this week's deluge of US data adding to signs US momentum is gathering pace would only add to the downward pressure on the NZD/USD through a firmer USD.

It's worth noting, NZ-US 3-year swap differentials (an indicator of the yield attractiveness of the NZD/USD) have fallen over 20bps during December as US bond yields have surged and NZ interest rates have drifted lower. In the absence of a sustained recovery in this spread, we suspect the NZD/USD will encounter headwinds on any rallies towards 0.7500 in the short-term. Indeed, our short-term valuation model currently suggests a NZD/USD "fair-value" range of 0.7350-0.7550.

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Foreign Exchange Technicals

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NZD/USD

Outlook: Sell a rally
ST Resistance: 0.7580 (ahead of 0.7675)
ST Support: 0.7305 (ahead of 0.7225)

The daily close below 0.7405 signalled the emergence of a new downtrend. A test of 0.7305 support looks likely in coming sessions.

NZD/AUD

Outlook: Sell a rally
ST Resistance: 0.7540 (ahead of 0.7590)
ST Support: 0.7405 (ahead of 0.7320)

With the daily RSI deep in "oversold" territory we'd be wary of establishing shorts at current levels. Sell a rally towards 0.7590.

Key Upcoming Events

	Forecast	Median	Last
Monday 20 December			
Germ, PPI, November y/y			+4.3%
Tuesday 21 December			
NZ, External Migration, November s.a.			+680
NZ, Credit Card Billings, November			+0.6%
Aus, RBA Minutes, 7 Dec Meeting			
Wednesday 22 December			
NZ, Balance of Payments, Q3	-3.5%	-3.4%	-3.0%
Aus, Westpac Leading Index, October			flat
Jpn, BOJ Economic Report			
Jpn, BOJ Policy Announcement	0.10%	0.10%	0.10%
Jpn, Merchandise Trade Balance, Nov		+¥481b	+¥821b
UK, GDP, Q3 3rd est		+0.8%	+0.8%P
UK, BOE Minutes, 8/9 Dec Meeting			
US, Existing Home Sales, November		4.75m	4.43m
US, GDP, Q3 3rd est		+2.8%	+2.5%P
Thursday 23 December			
NZ, GDP, Q3	flat	+0.2%	+0.2%
UK, BBA Home Loans, November		30k	31k
US, New Home Sales, November		300k	283k
US, Durables Orders, November		-0.7%	-3.4%
US, Jobless Claims, week ended 18/11		420k	420k
US, Personal Spending, October		+0.5%	+0.4%
US, Mich Cons Confidence, Dec 2nd est		74.5	74.2P

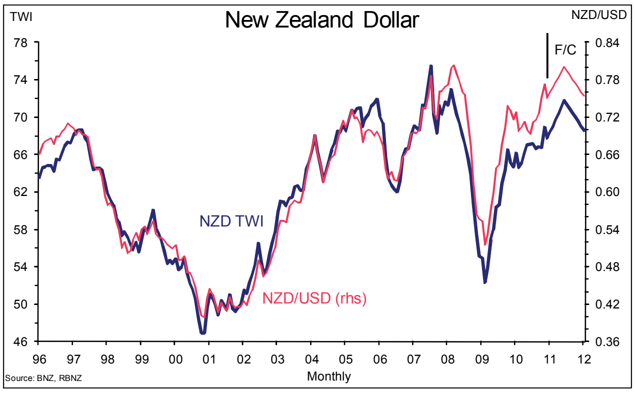
	Forecast	Median	Last
Friday 24 December			
NZ, Household Credit, November y/y			+2.0%
Wednesday 5 January			
NZ, Fonterra Auction			+2.4%
Monday 10 January			
NZ, Merchandise Trade, November			-$319m
Tuesday 11 January			
NZ, QSBO, Q4			+6
NZ, Building Consents, November (res, #)			-2.0%
Thursday 13 January			
NZ, ANZ Comdty Prices ($NZ), December			+1.4%
NZ, QVNZ House Prices, December			+0.3%
NZ, Electronic Card Transactions, December			+1.1%
Friday 14 January			
NZ, REINZ housing data (circa), December			
Aus, NAB Business Survey (circa), December			
Euro, Industrial Production (circa), November			+0.7%
Euro, Trade Balance, November			+€5.2b
UK, RICS Housing Survey, December			-44%
UK, PPI (core output), December y/y			+3.3%
US, CPI ex food/energy, December			+0.8%
US, Industrial Production, December			+0.4%
US, Retail Sales, December			+0.8%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	3.00	3.00	3.00	3.00
1 mth	3.10	3.10	3.11	3.14
2 mth	3.14	3.11	3.12	3.23
3 mth	3.16	3.18	3.16	3.28
6 mth	3.22	3.26	3.28	3.34
GOVERNMENT STOCK				
11/11	3.39	3.40	3.59	3.90
04/13	4.07	4.05	4.27	4.90
04/15	4.81	4.74	4.86	5.54
12/17	5.45	5.34	5.36	6.06
05/21	5.87	5.76	6.53	-
CORPORATE BONDS				
BNZ 05/13	5.10	5.11	5.27	-
BNZ 09/16	6.61	6.57	6.53	-
FON 04/14	5.78	5.77	5.84	-
FON 03/16	6.38	6.35	6.32	-
GEN 03/14	5.70	5.69	5.81	7.19
GEN 03/16	6.48	6.46	6.47	7.98
TRP 06/20	6.87	6.82	6.68	7.93
SWAP RATES				
2 years	3.83	3.83	4.02	3.92
3 years	4.22	4.20	4.37	4.67
5 years	4.78	4.73	4.84	5.42
10 years	5.58	5.51	5.51	6.20

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7361	0.7472	0.7800	0.6426
NZD/AUD	0.7456	0.7587	0.7893	0.7983
NZD/JPY	61.79	62.67	65.08	61.82
NZD/EUR	0.5588	0.5652	0.5676	0.4605
NZD/GBP	0.4743	0.4726	0.4875	0.3893
NZD/CAD	0.7450	0.7542	0.7932	0.7294
TWI	66.73	67.62	69.65	60.78

NZD Outlook



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