7 February 2011

Walking Lampposts

- Recovery further questioned by many
- But we still see underlying progress, pick-up
- Signs of life in January indicators
- Rents moving, at least in Auckland
- Further signs of inward migration to the biggest smoke?

Last week's unemployment figures were the latest in a run of disappointing economic news. They further question the notion of "recovery" and have even had some commentators entertaining the possibility of the next move in the Official Cash Rate being downward.

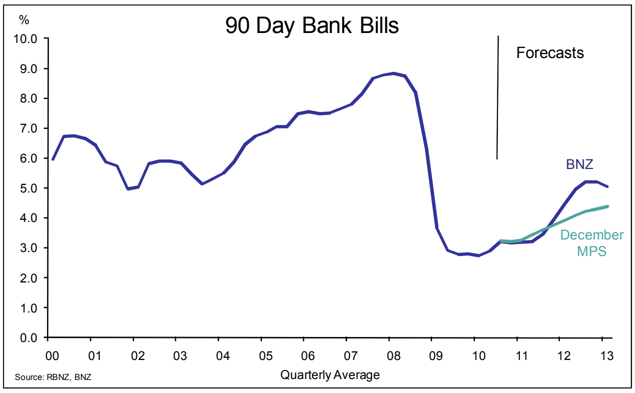
This is an important juncture we're at, no question. But we should make clear we still assess the economy is making good underlying progress, that GDP growth will strengthen this year, and that inflation will become more than a niggle sooner than many appreciate, thus forcing the Reserve Bank to resume nudging its cash rate higher.

It's like watching a jogger walking lampposts to get their breath back (having sprinted too much in earlier laps), not one about to collapse in a heap on the footpath. All that the recent data has made us unsure about is the point at which the jogger feels comfortable enough to resume, well, jogging. Hence our move last week to simply delay our profile of rate cuts, to now begin in September, rather than June, but with a maintained peak of 5.00% by the latter stages of 2012.

To be sure, with all the sub-standard economic news, some might think we're mad to stick fast to our recovery, inflation, rate-hike story. Yes, Q4 GDP could be another rough one, even technically negative. And there is a patent risk the recovery falls on its face proper. However, at this stage, we see this path as more of a scenario – amid a wide range of possibilities – not the most-likely course.

As for being called crazy, well, we're no stranger to this. We got it when at the start of 2008 we called recession. And we got brickbats just over a year ago when we said the market was chasing parked cars with its calls of meaty chunks on the OCR and calls for "rate hikes by Christmas". The markets are not always right, and things can change.

Indeed, it was arguably the overly aggressive back-up in yields into the early part of 2010, taking with it the currency, which disrupted the recovery and confidence, rather than the half-point of OCR hikes that ensued later on. Since the RBNZ hiked those couple of notches market interest rates have, more generally, trended downward.



For the bigger sources of volatility and ultimate disappointments for the NZ economy over the last three to six months, it's worth recounting the following:

- Savage storms in September that severely hit agricultural production including a 10% reduction in the lamb crop;
- A major earthquake in Canterbury with ongoing disruption from subsequent seismic activity;
- The receivership of South Canterbury Finance;
- Drought - through late spring / early summer again hurting primary production;
- Higher electricity costs as the next piece of the ETS scheme was rolled out;
- A hike in GST, accompanied by tax cuts;
- A lift in petrol excise tax and Road User Charges;
- Auckland at the business end of restructuring into a Super-city;
- 'PSA' disease outbreak that had the potential to severely dent $1 billion worth of kiwifruit exports;
- The Pike River mine explosion with a tragic loss of life, and receivership of a company with a market capitalisation of many hundreds of millions.

If that wasn't enough to suffer, we should also recall there was a renewed wave of uncertainty doing the rounds globally from about mid-2010, as talk of a double-dip recession intensified, equity markets swooned, and European sovereign debt and banking vulnerabilities came to the fore.

Even as late as September/October of last year, the international tones were still tender, as evidenced in the global PMI and PSI indicators reaching proximate low points around that time. However, since then these indices have roared back into life. Indeed, some of the country-based PMI and PSI measures we witnessed last week are now as strong as they've been in many years, and in some cases are as about as hot as these diffusion indices get.

This boosts the chances of seeing the more general international economic data strengthen over coming months, especially following many Northern Hemisphere indicators that have obviously been depressed by intensely inclement weather over December/ January.

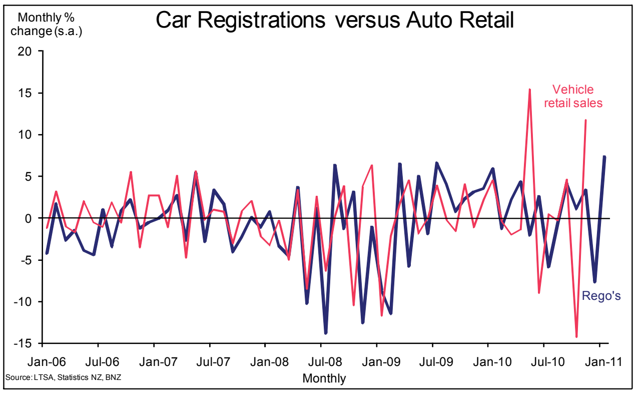
We are certainly hoping to see some improvement in the NZ indicators. It might even start with Wednesday's electronic card transactions (amid an otherwise very quiet NZ data week). We expect these bounced in January, following their 1.2% slump in December.

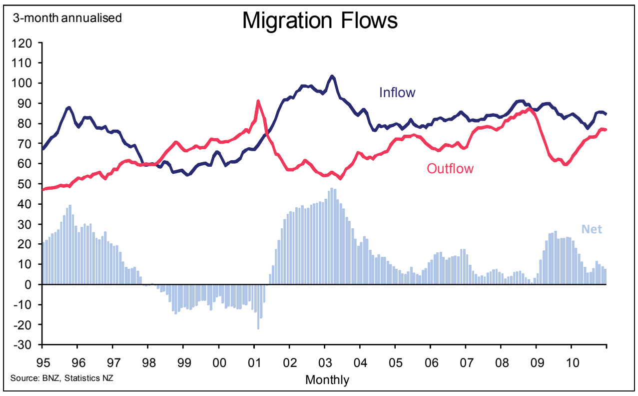
Car registrations certainly recovered their poise in January, essentially recovering the ground they lost in December. We judge a seasonally adjusted increase of 7% – spread evenly across new and used cars. As a backdrop to this we note consumer confidence improved a bit in January, to a relatively positive level.

Another factor favouring a bounce-back in January's domestic spending indicators (although not necessarily the ECT, because of how it's measured) is the reversal of what looks to have been a big leakage of spending abroad by New Zealanders during December.

We're not sure what was behind it, but about 22,000 (12%) more NZ residents left for short-term trips abroad in the final month of 2010 compared to the same time a year ago. This, in turn, accorded with the jump in credit card billings abroad, on NZ-issued cards, during December. To the extent this spike reverses then it will put something back into domestic spending in January.

As for short-term visitor arrivals in December, they were reasonable enough, up 1.3% y/y - although we note the composition of arrivals meant total visitor stay-days in Q4 were down a fraction on a year ago.



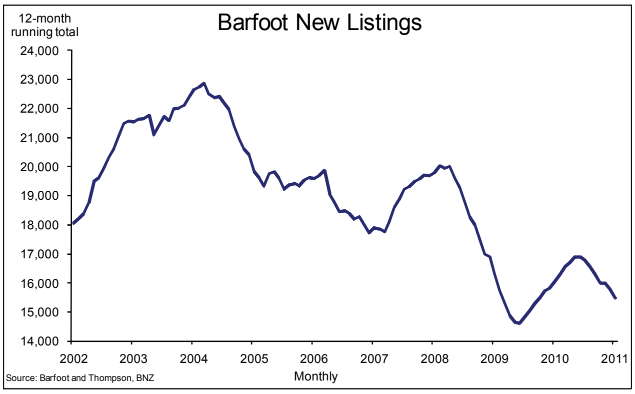


For even more granular detail on December's tourism flows we note tomorrow's International Visitor Arrivals publication. And as for how all of this is influencing such things as guest-nights and occupancy rates, Thursday's Accommodation Survey will be worth noting too.

In respect to migrants, New Zealand continued to be the net gainer of these during December 2010. The seasonally adjusted net inflow was 750, similar enough to November's 625 and the average over the previous six months or so. On top of local population (birth/death) dynamics it's consistent with overall population growth of just over 1% per annum.

Of course, this is not demonstrably supporting the housing market for the moment. Indeed, housing continues to struggle. We expect to see further evidence of this in Wednesday's Quotable Value NZ report for the month of January. We might even see the Real Estate Institute's statistics for the month before the week is out (we're not aware of any exact publication date, as yet).

Barfoot and Thompson's Auckland-centric housing results, released last week, were certainly subdued for January. While we judge their sales rose a seasonally adjusted 1.5% in the month, the level remains depressed, albeit up a clear margin from the recent low-point of October. The stock of listings was edging down, but only because of a further slump in new listings. The average sale price came off a bit further. But then it usually does in January. Allowing for the (always) shifting price-bracket proportions



we still get the impression nominal prices are drifting roughly sideways.

Nonetheless, there were signs in the Barfoot and Thompson report that rents were on the move. Not as much as that portrayed in the front page of today's NZ Herald, but edging higher nonetheless in January, up 3.7% on a year ago.

This is interesting, as we have been looking to rents as the litmus test to housing shortages. There has been little evidence of this to date, even up to the December quarter CPI, which harboured a residential rent index far more becalmed than we had imagined. But we are still on guard for upside, given that the ongoing low rates of new home-building activity cannot go on forever without causing supply and inflation concerns – even with the total availability of "rooms", if you like, having the potential to be more accommodating than just the addition of new homes.

Again, rents will be the ultimate test of pressure on available accommodation – just like it was in the last true housing shortage, back in the mid-1990s, predominant, as it was, in Auckland.

Yet this example also makes us wonder if the signs of rental movement in Auckland are unrepresentative of the country at large. For other cities and towns there is not the evidence of demand pressure. Christchurch has obvious supply restrictions of a special type, post the earthquake. And Wellington has recently reported a glut of rental properties, particularly inner-city apartments. Could the rental trends across the country thus reflect an inward migration to Auckland, perhaps as the ongoing response to difficult economic circumstances?

The final local economic report of the week is Friday's Food Price Index. For the month of January, we expect it increased 0.6%, following dips over the previous couple of months. We are also on guard for upside in the FPI in a more generalised fashion. As we noted in our Rural Wrap of last week entitled *Global Food Price Inflation – Mark II*, commodity inflation is gathering steam again, most notably in food. And while part of this looks set to crimp local disposable income, it is more broadly a major net positive for the NZ economy – directly by way of much-improved export income and, not to forget, indirectly by way of the increased purchasing power afforded by the likewise robust currency.

Such things are a reminder of what still promises to boost the economy this year, and create a bit of inflation concern, even though the data for the second half of 2010 proved decidedly dour. Sure, we might have to walk a few more lampposts yet. But if that's all it is then there is no reason to throw the towel in.

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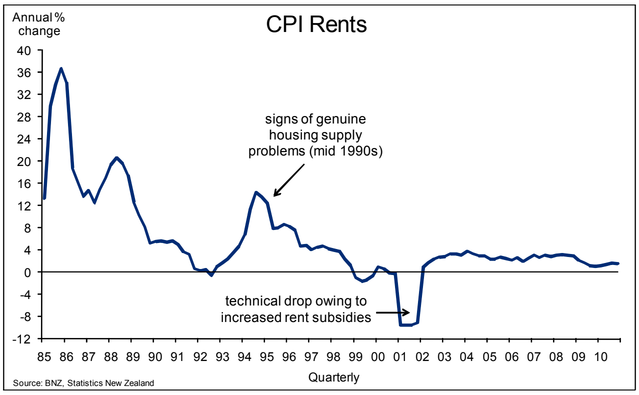

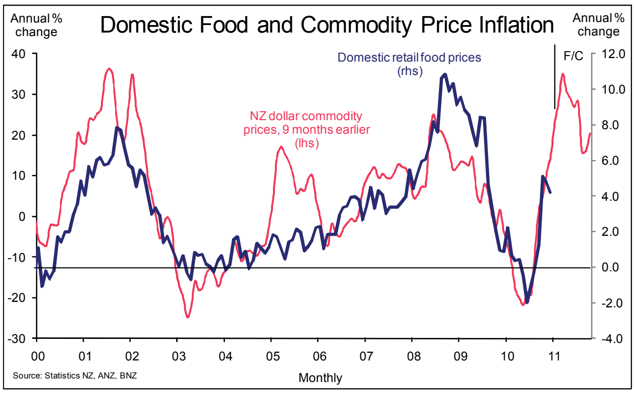

Domestic Interest Rates

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)
28-Jan-11	3.21%	3.90%	5.50%	3.86%	5.36%	150
4-Feb-11	3.19%	3.87%	5.52%	3.81%	5.36%	155
Change (bps)	**-2**	**-3**	**2**	**-5**	**0**	**5**

Last week was filled with disappointing domestic data which has had an impact on New Zealand's short end interest rates. We have had a decent sized rally which has seen yields in the September and December bank bill futures decrease 10bps. On Monday we had a terrible building consents number which was followed on Thursday by a sub-par employment number.
The unemployment rate came in at 6.8% which was higher than the market expectation of 6.5%. We started the week with 20bps priced in for the next four meetings and 53bps until the end of the year. By the end of the week we had 10bps priced in for the next four meetings and 40bps by the end of the year. This has come in a sizeable amount and we cannot see the Reserve Bank hiking rates anytime before September. All eyes will be following domestic data closely that is to be released in the next six months. The 3-month BKBM has decreased 2bps to 3.19%.

We had a relatively quiet week in swaps with a small decrease in the 2-yr yield. We saw a 5bp rally with the 2-yr finishing up at 3.81%. This saw 2s10s widen by 5bps. The 10-yr was unchanged at 5.36%. We aren't expecting much movement in the curve this week. If we get any movement in the back end of the curve, it is likely to be due to offshore flows.

Last week we didn't see much change in the New Zealand government bond market. We saw offsetting events, with bonds well bid in NZ due to unimpressive employment/unemployment data, but US and Australian bonds selling off. The yield in the 13s decreased 3bps, closing at 3.87%, and the yield in the 21s increased 2bps, closing at 5.52%. Looking ahead for the week, direction will come from offshore events, with focus on the current situation in Egypt. The local data for this week is quite light, but Wednesday's Electronic Card Transactions and House Prices, and Friday's Food Prices are worth noting.

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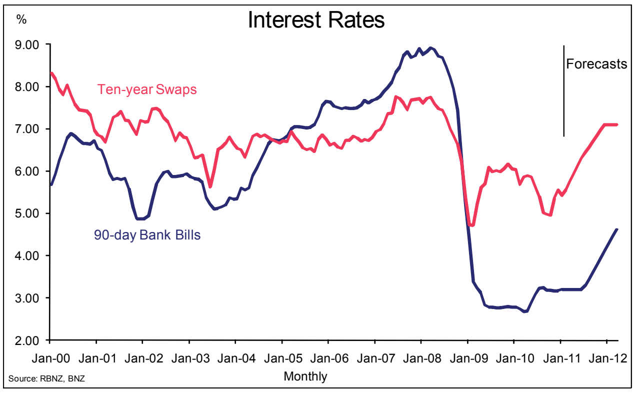

Interest Rate Technicals

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NZD 5yr Swap Rate

Outlook: Neutral
MT Resistance: 4.95%
MT Support: 4.26%

The market is consolidating around current levels.
ST support is at 4.55/4.58 and expect this to hold near term. A break of this level will open up 4.26%.

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

Outlook: Neutral
MT Resistance: +100
MT Support: +63

The market is now mid range. We await a break of horizontal lines before initiating a new trade.

Foreign Exchange Market

Reuters pg BNZWFWDS

The NZD/USD was one of the weakest performing currencies last week. After climbing to a mid-week high of nearly 0.7820, a sharp paring of RBNZ tightening expectations and a mild strengthening in the USD saw the NZD/USD skid back to around 0.7700 by Friday.

Broadly speaking, the NZD was buffeted by offsetting influences last week. On one hand, the global backdrop bestowed significant support on the NZD. Global risk appetite and commodity prices were buoyed by investors' more optimistic outlook for the global economy. Our risk appetite index (which has a scale of 0-100%) soared to 75.5% (from 62.9% last Friday), the ANZ NZ commodity price index rose 3.8%m/m to another record high, and milk prices jumped a further 7.2% at Fonterra's fortnightly auction. Global dairy prices are now some 20% higher than in mid-November.

On the other hand, the domestic picture remained a clear drag on the currency. Last week's surprise jump in the NZ unemployment rate (to 6.8%, from 6.4%) carried on the recent theme of negative NZ economic news. In response, markets pushed back the expected timing of the next RBNZ hike to October, dragging NZ interest rates lower across the curve. For the record, we shifted our own forecast of the next hike to September, from June.

In clear contrast, US markets brought forward the timing of the first Federal Reserve tightening on Friday (to around year end) following January's sharp drop in US unemployment (to 9.0% from 9.4%). US bond yields finished the week 15-25bps higher, indicative of the recent improvement in the US outlook. At around 3.6%, US 10-year Treasury yields are now sitting around the highest level since May last year.

It's worth noting, the recent contrast in NZ-US economic fortunes has seen the NZD's yield differential narrow noticeably. From above 290bps at the start of last week, NZ-US 3-year swap spreads slid to about 265bps on Friday – the lowest since August 2009. This erosion of 'fundamental' support means NZD/USD rallies should be limited to around 0.7800/0.7850 this week. Initial support is eyed towards 0.7560.

A quick "fair-value" analysis certainly suggests downside risks to the NZD/USD in the near-term. Our short-term valuation model (which is based on NZ commodity prices, NZ-US interest rate differentials, and global risk appetite) currently suggests a 0.7350-0.7550 NZD/USD "fair-value" range.

After the shenanigans in last week's data deluge, the local data calendar looks fairly quiet this week. Improved consumer confidence and car registrations in January are a good backdrop for a bounce in Wednesday's electronic card transactions. However, the QVNZ housing statistics for the month are bound to be still in a holding pattern. The other indicator to note is Friday's Food Price Index, for January, which we expect increased 0.6%, following falls over the previous two months.

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Foreign Exchange Technicals

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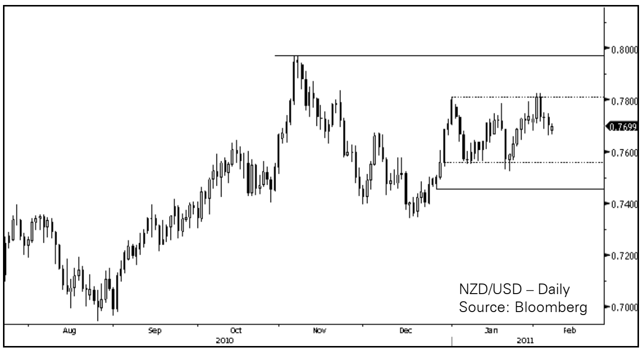
NZD/USD

Outlook: Sell a rally.
ST Resistance: 0.7810 (ahead of 0.7975)
ST Support: 0.7555 (ahead of 0.7455)

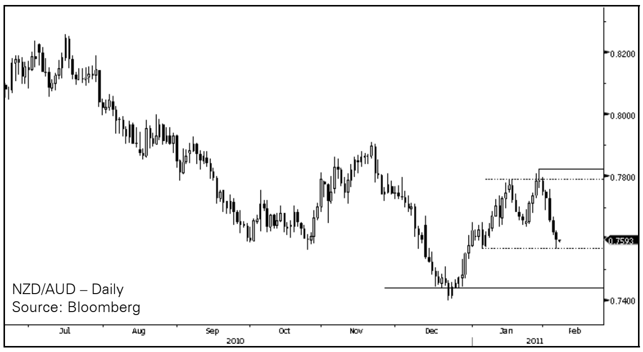
A lack of momentum and direction means more rangy trading is expected near-term. The 0.7555-0.7820 range looks well entrenched.



NZD/AUD

Outlook: Sell a rally.
ST Resistance: 0.7790 (ahead of 0.7820)
ST Support: 0.7570 (ahead of 0.7440)

Momentum factors have shifted from positive to negative. This, combined with the failure to close above 0.7790 suggests a new downtrend is in process.



Key Upcoming Events

	Forecast	Median	Last
Monday 7 February			
Aus, Retail Trade, December s.a.	+0.2%	+0.5%	+0.3%
Aus, ANZ Job Ads, January			+2.0%
Germ, Factory Orders, January		-1.5%	+5.2%
Tuesday 8 February			
Aus, NAB Business Survey, January			
Germ, Industrial Production, December		+0.2%	-0.7%
UK, BRC Retail Sales Monitor, January y/y			+1.5%
UK, RICS Housing Survey, January		-38%	-39%
US, Fed Speakers - Lacker, Lockhart, Fisher			
Wednesday 9 February			
NZ, Electronic Card Transactions, January			-1.2%
NZ, QVNZ House Prices, January			-0.9%
Aus, Consumer Sentiment - Wpac, February			104.6
China, Services PMI (HSBC), January			53.1
Jpn, Eco Watchers Survey (outlook), January			43.9
Jpn, Consumer Confidence, January		40.3	40.1
Germ, Trade Balance, December		+€12.0b	+€12.9b
UK, Trade Balance, December		-£4.0b	-£4.1b
US, Bernanke Testifies, Budget Committee			

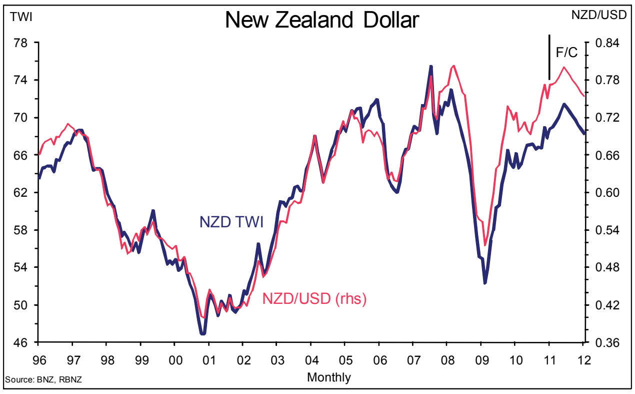
	Forecast	Median	Last
Thursday 10 February			
Aus, Unemployment Rate, January	5.0%	5.0%	5.0%
Aus, Employment, January	+10k	+20k	+2k
China, Trade Balance ($US), January		+$10.2b	+$13.1b
Jpn, Machinery Orders, December		+5.0%	-3.0%
Euro, ECB's Smaghi, Weber and Nowotny Speak			
Euro, ECB Monthly Bulletin			
UK, BOE Policy Announcement	0.50%	0.50%	0.50%
UK, Industrial Production, December		+0.5%	+0.4%
US, Treasury Budget, December		-$60.0b	-$80.0b
US, Wholesale Inventories, December		+0.8%	-0.2%
Friday 11 February			
NZ, (circa) REINZ Housing Data, January			
NZ, Food Price Index, January	+0.6%		-0.8%
Aus, Stevens Testifies			
Euro, ECB's Trichet Speaks			
UK, PPI (core output), January y/y		+3.0%	+2.9%
US, Mich Cons Confidence, February 1st est		75.0	74.2
US, International Trade, December		-$40.2b	-$38.3b

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	3.00	3.00	3.00	2.50
1 mth	3.17	3.16	3.09	2.72
2 mth	3.18	3.17	3.16	2.74
3 mth	3.18	3.21	3.19	2.74
6 mth	3.24	3.24	3.22	2.94
GOVERNMENT STOCK				
11/11	3.28	3.32	3.36	3.99
04/13	3.89	3.89	3.89	4.70
04/15	4.51	4.54	4.66	5.18
12/17	5.13	5.11	5.33	5.62
05/21	5.54	5.49	6.53	-
CORPORATE BONDS				
BNZ 05/13	5.01	5.05	5.00	-
BNZ 09/16	6.41	6.41	6.50	-
FON 04/14	5.66	5.69	5.67	-
FON 03/16	6.19	6.20	6.27	-
GEN 03/14	5.58	5.62	5.59	6.56
GEN 03/16	6.24	6.26	6.37	7.17
TRP 06/20	6.64	6.63	6.78	7.15
SWAP RATES				
2 years	3.83	3.86	3.78	4.38
3 years	4.16	4.19	4.15	4.84
5 years	4.62	4.64	4.69	5.30
10 years	5.37	5.36	5.51	5.88

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7671	0.7697	0.7583	0.6881
NZD/AUD	0.7580	0.7779	0.7635	0.7930
NZD/JPY	63.09	63.11	63.12	61.51
NZD/EUR	0.5659	0.5662	0.5887	0.5037
NZD/GBP	0.4734	0.4862	0.4885	0.4413
NZD/CAD	0.7584	0.7708	0.7531	0.7350
TWI	68.30	68.80	69.00	64.02

NZD Outlook



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