

28 February 2011

## Signs of Momentum, Pre-Earthquake

- January's exports tripped by late-2010 drought?
- Imports ticking forth, in right components
- NBNZ business survey to affirm impetus, pre-earthquake
- Overseas Trade Indexes to keep Q4 growth hopes alive
- Fonterra auction to highlight ongoing commodity boom

While the latest Christchurch earthquake has significantly changed assessments and forecasts of the economy, it will still be important to gauge how things were going leading into the tragic event. We say this noting that views on the economy were already diverging prior to the 22 February quake. So those folk already thinking the economy was either in, or re-entering, recession probably found it easy to conclude the Reserve Bank should now cut the OCR.

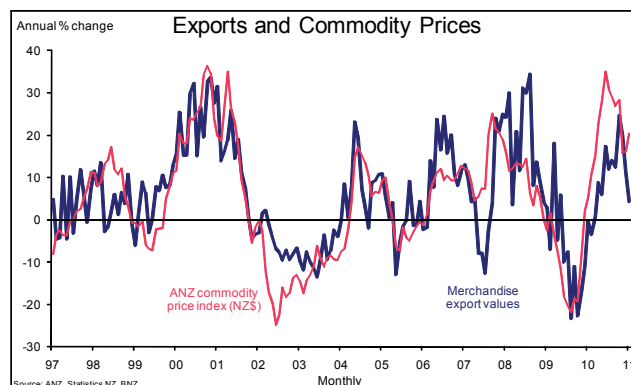
For us the cash-rate consequences remain much more complex. We have already been through our arguments of why the OCR is probably the wrong tool for the job, with cuts not only having little immediate impact on the Christchurch economy but also having the potential to create distortions and imbalances in the wider economy. And why use such a blunt nationally-set tool, creating indiscriminate winners and losers (even in the unaffected areas), when more direct, fiscal-driven, responses are by far the most appropriate and effective?

In respect the latter, watch for the package the Government announces later today.

For more on our thoughts and responses, please see our pieces from last week entitled *A More Devastating Earthquake* and *Our Post-Earthquake Macro Forecasts*. These should make it plain we most of all see the earthquake as having sizable and extended impacts on the economy. It takes a lot to scale back national GDP by 1.5%, which we have done for this year. But also that rate cuts are no obvious solution to what we now all have to face.

However, we do understand why people would conclude otherwise, in their search for anything that would seem to help. In this context, we would even understand if the RBNZ chose to cut, and would have no particularly problem with this, per se.

One of the reasons we haven't jumped to the rate-cut conclusion is that we thought the economy, far from being on its knees to begin with, was actually still in recovery mode. Moreover, that it would pick up strongly through 2011, having simply been through a patchy

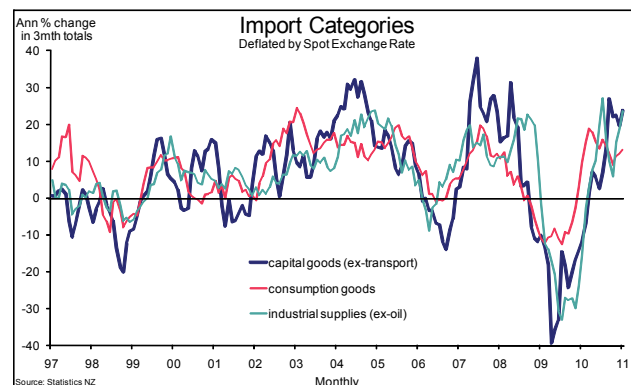


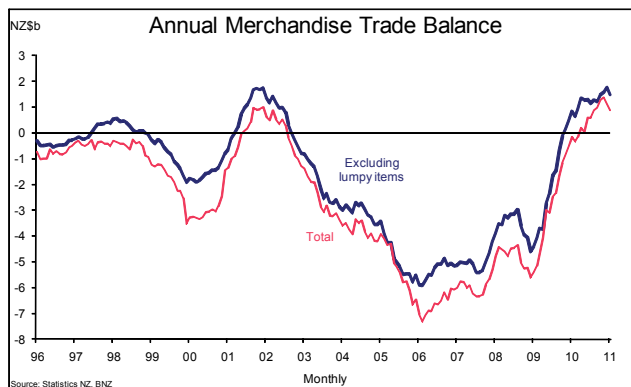
period over the second half of 2010, partly on the basis of specific impingements. Along with this, we already saw upside pressure on inflation ahead.

To be sure, this morning's merchandise trade figures did not look that encouraging regards the economy. Their headline results were weaker than expected, with a seasonal surplus of just \$11m.

This was mainly from the exports side of the ledger, with annual growth subsiding to 4%, from 11% in December, leaving a \$400m shortfall to expectations (the market's and ours). However, we wonder if we've simply underestimated the lagged impact of the late-2010 drought. Recall that this was a real issue at the time, crimping rural production, and was expected to get horribly worse if rains didn't come.

The dairy export volume indicators certainly waned in January, with milk-powder, butter and cheese down 5% y/y, and casein down 14%. On this annual basis there were also weaknesses in wool, forestry, meat, apple and even aluminium export volumes, which would seem to be just part of the normal monthly ups and downs, so nothing to draw alarm from.





The imports side of the ledger was only moderately shy of expectations. Headline growth slowed to 14%, from 18%, but considering December's result had a large aircraft in it (and January did not), it was actually a pretty robust result. Indeed, the ex-aircraft imports series picked up to a 16% annual pace in January, from 9% in December.

And this involved core capital goods maintaining a solid annual pace, circa 18%, while industrial supplies (excluding oil imports, which happened to be weak) were up a hefty 25% on a year ago. These are inconsistent with the notion the economy was going flat, before the latest earthquake in Christchurch.

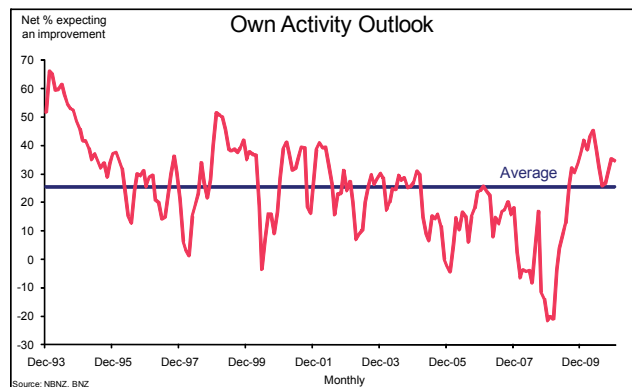
Even imports of consumer goods maintained positive annual growth in January, at about 5%, suggesting holiday season sales weren't an abject disaster.

So while the merchandise trade figures did look weak at a headline level, they were not all that inconsistent with the idea of some underlying momentum coming through. Imports were ticking forward in January, especially in the preferred components. And exports looked at least partially impinged by lagged impacts of the late-2010 drought.

The clear disappointment, for us, was the headline balance, which was \$500m south of expectations. This is not good news for the current account, although only in the sense of capping the trend toward increasing trade surpluses that had been underway since 2008.

Then again, this will almost surely be lost in the wash, with the 22 February earthquake having the silver lining of "boosting" the current account in 2011 Q1, by way of another big dollop of reinsurance money from abroad. This perverse fillip will probably be enough to slim the annual current deficit to just 1.0% of GDP for the year to March 2011 (with the ex-reinsurance reading at more like 3.2% of GDP). Indeed, once the reinsurance estimates are finalised (in retrospect) there is every chance the current account will be in headline annual surplus – for the first time since 1973.

For a better indication (than the trade figures) that the economy was still in recovery mode into the early part



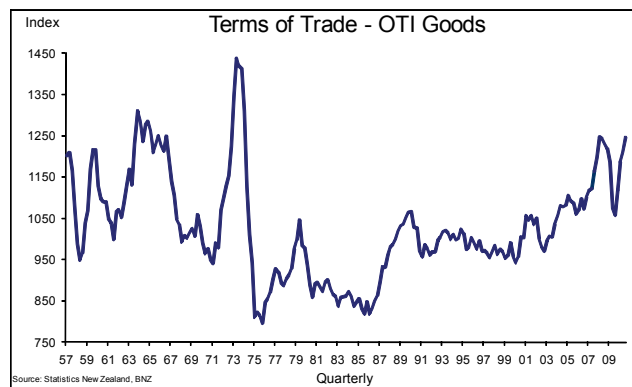
of 2011 we can probably look to this afternoon's NBNZ Business Outlook. Canvassed in the weeks before the earthquake, we expect this survey to confirm a decent amount of impetus in February, shored up by a much-improved agriculture sector, following the crucial rains that have fallen since the last survey was conducted, back in December.

As for this afternoon's credit aggregates (seemingly delayed from their initial release date of last Friday) we're not expecting any material improvement – not with ongoing signs of de-leveraging and increased saving. However, we do note that the business credit measure (ex-agriculture) was just starting to creep up again over final stages of 2010, consistent with the relatively health we think the NZ corporate sector is in.

For the remainder of the week's NZ data, note that Statistics NZ has announced delays in some of its publications, on account of disruptions to its Christchurch offices. So please make sure you consult an up-to-date calendar.

January's building consents, for example, were due this morning but are now delayed until further notice; same for the Q4 construction report, and January's International Travel and Migration, which were both due Friday.

We still have confirmed, however, the December quarter Overseas Trade Indexes, for Tuesday morning. We expect these will probably be a moderate net positive – in terms of export volumes increasing by more than import



volumes and export prices outpacing those of imports. Such results would be supportive of Q4 GDP, which we still have pegged at 0.3% growth (albeit with downside risks around that number).

And speaking of strong terms of trade, note tomorrow's ANZ commodity price indices as well as Fonterra's latest fortnightly auction which still looks on track for Wednesday morning (NZ time). Global dairy prices have already lifted 25% since November, part of the explanation for Fonterra recently announcing an upgraded dairy payout, implying nearly \$1b more for dairy farmers this season.

Of course, every bit of strength will be crucial in keeping the national economy going, post last Tuesday's earthquake in Christchurch. However, we believe this will prove to be the case, and supported by an eventual recovery in the Christchurch economy itself. In short, aside from the obvious immediate impacts, we don't agree with some commentators that the Canterbury economy is out for the count and will drag the national economy down with it.

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## Domestic Interest Rates

With the disaster in Christchurch, we have seen a huge rally in short end rates. And with the market now expecting the RBNZ to cut rates the very short end of the curve is now inverted. All bank bill futures rallied hard, ranging from 33bps in the March 2011s to 59bps in the March 2012s. We have seen a dramatic change in the OIS curve. The first meeting in March now has 30bps of cut priced in, with the hint of re-tightening creeping back towards the end of the year.

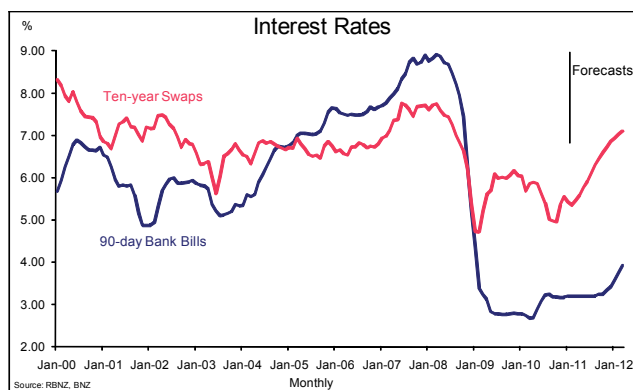
The swap curve has also rallied. On the day of the earthquake we saw the 2-yr yield decrease 15bps, and the 3-yr yield decrease 11bps closing the day at 3.66% and 4.05% respectively. We also saw a decrease in the 10-yr swap, although not as extreme, down 4bps to 5.39%. But by the end of the week the 2-yr yield had plummeted 42bps to finish at 3.36% and the 10-yr yield had taken a 21bp dive to 5.20%. The 2s/10s spread has widened 21bps to 184bps from 163bps caused mainly by the larger collapse in 2-yr yields.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
18-Feb-11	3.17%	3.88%	5.61%	3.78%	5.41%	163
25-Feb-11	2.86%	3.53%	5.52%	3.36%	5.20%	184
<b>Change (bps)</b>	<b>-31</b>	<b>-35</b>	<b>-9</b>	<b>-42</b>	<b>-21</b>	<b>21</b>

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New Zealand government bonds had a large rally last week. We saw the 13s down a huge 35bps, and 21s rally 9bps to bring the yields down to 3.53% and 5.52% respectively. Looking ahead we expect to see some volatility, as the market continues to focus on Christchurch and the effect it will have on the economy. Not much local data, but there is the RBA cash target on Tuesday. Also, keep an eye out for any development in the Middle East situation.

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## Interest Rate Technicals

### NZD 5yr Swap Rate

Outlook: Lower  
 ST Resistance: 4.57%  
 ST Support: 4.20%

As anticipated, the move through support of 4.55/58 signalled a move lower. That support now becomes resistance and should cap any move higher. Still expect eventual move to support at 4.20%.



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

Outlook: Higher  
 MT Resistance: +117  
 ST Support: +80

Our resistance at +100 has been breached (just). Look for a move to +117



## Foreign Exchange Market

News of the devastating Christchurch earthquake was the main driver of the NZD last week. The market's initial response was to drive the NZD/USD lower by 2.4%. However, the currency appears to have stabilised quite quickly after last Tuesday's fall. On Friday, the NZD/USD rose from close to 0.7460 to around 0.7520, ending the week down 1.6%. Friday's rebound was partly underpinned by a broad rise in global risk appetite, and continued strength in commodity prices. The CRB futures index (a global commodities index) has now risen to levels last seen in September 2008.

Interest rate markets also responded quickly to news of the disaster. The 3-month swap rates declined around 30bp last week, and 1-2 year rates declined around 40bp, as markets looked for the RBNZ to cut rates in response to the event. We continue to believe that a RBNZ cut is unlikely, although we accept that all options must be considered, as the full effects of the quake become known.

We have lowered our NZD forecasts, in line with other changes to our economic forecasts. Still, it is important to note that, while weaker domestic growth will provide less support to the currency than we previously expected, global commodity prices are still going from strength to strength. They will continue to support the "commodity-linked" currencies including the NZD. Therefore we would caution against expecting the currency to fall out of bed completely.

Reflecting the competing influences on the currency, we have simply flat-lined our NZD/USD forecasts for the rest

### Reuters pg BNZFWDS

of the year, at 0.7500. From 2012, a pick-up in trading partner growth and rising offshore interest rates are still expected to reduce the yield and growth differential of the NZD, resulting in a gradual downtrend from early 2012. We expect the NZD/USD to decline gradually next year from elevated levels, although we believe recovering NZ macro-economic factors should limit the decline.

More broadly, risk aversion was the key driver of currencies last week, as political tensions in Libya remained in the spotlight. Over the week the VIX index (a proxy for risk aversion) rose, equity markets declined, and US 10-year bond yields fell, indicative of declining risk appetite. The CHF and JPY were the strongest performing currencies over the week rising 1.84% and 1.77% respectively, as demand for 'safe haven' assets rose.

Friday saw some reversal in sentiment, with the VIX index declining to 19% from 21%, (although still well above the 16% it ended the previous week) and equity markets showing solid gains. Higher commodity prices helped to underpin Friday's best currency performers, the "commodity sensitive" AUD, NZD, and CAD. The DXY index rose slightly on Friday night, after the market reacted positively to the University of Michigan consumer confidence reading that rose to 77.5 (75.5 expected) from 75.1 previously. The Q4 GDP release on Friday night came in at 2.8% annualised (3.3% expected). Despite this disappointment the DXY rose from 77.00 to around 77.30, although it ended the week down around 1%.

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## Foreign Exchange Technicals

### NZD/USD

Outlook: Sell a rally.  
 ST Resistance: 0.7660 (ahead of 0.7750)  
 ST Support: 0.7430 (ahead of 0.7345)

Momentum factors are negative and we suspect rallies will be limited to 0.7650 in the near-term.

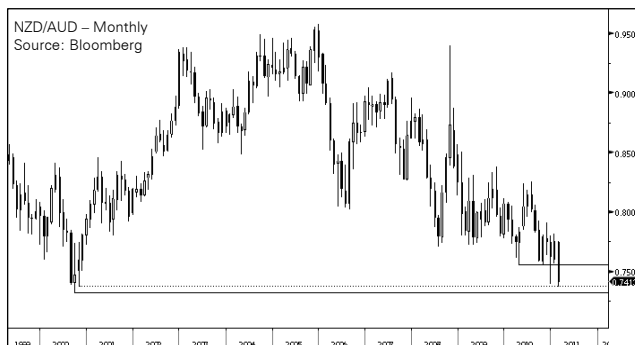


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### NZD/AUD

Outlook: Sell a rally.  
 ST Resistance: 0.7560 (ahead of 0.7660)  
 ST Support: 0.7380 (ahead of 0.7320)

The daily close below December's 0.7400 low suggests the currency has entered a new downtrend. Sell a rally towards 0.7560.



## Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
<b>Monday 28 February</b>				<b>Tuesday 1 March <i>continued...</i></b>			
NZ, NBNZ Business Survey, February			+29.5	US, ISM Manufacturing, February		60.8	60.8
NZ, Household Credit, January y/y			+1.6%	<b>Wednesday 2 March</b>			
NZ, Merchandise Trade, January	+\$514m	-\$25m	-\$250m	NZ, Fonterra Auction			+3.9%
Aus, Private Sector Credit, January	+0.3%	+0.3%	+0.2%	Aus, GDP, Q4	+0.4%	+0.6%	+0.2%
Aus, Company Profits, Q4	-3.0%	+1.0%	-1.5%	US, ADP Employment, February		+180k	+187k
Jpn, Industrial Production, Jan 1st est		+4.0%	+3.3%	US, Beige Book			
US, Chicago PMI, February		67.5	68.8	<b>Thursday 3 March</b>			
US, Personal Spending, January		+0.4%	+0.7%	Aus, Building Approvals, January	+3.0%	-3.0%	+8.7%
<b>Tuesday 1 March</b>				Aus, International Trade, January	+\$1.70b	+\$1.65b	+\$1.98b
NZ, Terms of Trade, Q4	+0.9%	+1.0%	+3.0%	China, Non-manufacturing PMI, Feb			56.4
NZ, ANZ Comdty Prices (\$NZ), Feb			+2.2%	Jpn, Capital Spending, Q4 y/y		+5.9%	+5.0%
Aus, Retail Trade, January s.a.	+0.2%	+0.3%	+0.2%	Euro, ECB Policy Announcement	1.00%	1.00%	1.00%
Aus, Current Account, Q4	-\$6.60b	-\$7.00b	-\$7.83b	Euro, Retail Sales, January		+0.3%	-0.6%
Aus, RBA Policy Announcement	4.75%	4.75%	4.75%	Euro, GDP, Q4 2nd est		+0.3%	+0.3%P
China, PMI (NBS), February			52.9	UK, CIPS Services, February		53.7	54.5
Jpn, Unemployment Rate, January		4.9%	4.9%	US, ISM Non-Manuf, January		59.4	59.4
Jpn, Household Spending, Jan y/y (real)		-1.4%	-3.3%	US, Bernanke Six-monthly Testimony			
Euro, Unemployment Rate, January		10.0%	10.0%	<b>Friday 4 March</b>			
UK, CIPS Manuf Survey, February		61.0	62.0	US, Non-Farm Payrolls, February		+190k	+36k
US, Construction Spending, January		-0.5%	-2.5%	US, Factory Orders, January		+2.0%	+0.2%

## 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	2.50	NZD/USD	0.7496	0.7622	0.7697	0.6996
1 mth	2.93	2.91	3.16	2.67	NZD/AUD	0.7384	0.7513	0.7779	0.7780
2 mth	2.86	2.86	3.17	2.70	NZD/JPY	61.25	63.31	63.11	62.09
3 mth	2.86	2.86	3.21	2.70	NZD/EUR	0.5448	0.5559	0.5662	0.5118
6 mth	2.89	2.89	3.24	2.86	NZD/GBP	0.4654	0.4688	0.4862	0.4600
<b>GOVERNMENT STOCK</b>					NZD/CAD	0.7337	0.7518	0.7708	0.7363
11/11	2.81	3.26	3.32	3.69	TWI	66.34	67.68	68.80	64.66
04/13	3.54	3.88	3.89	4.50	<b>NZD Outlook</b>				
04/15	4.35	4.52	4.54	5.02	New Zealand Dollar				
12/17	5.05	5.19	5.11	5.48					
05/21	5.53	5.61	6.53	-	<p>Source: BNZ, RBNZ</p>				
<b>CORPORATE BONDS</b>									
BNZ 05/13	4.56	4.96	5.05	-					
BNZ 09/16	6.14	6.41	6.41	-					
FON 04/14	5.10	5.43	5.69	-					
FON 03/16	5.81	6.08	6.20	-					
GEN 03/14	5.27	5.50	5.62	6.46					
GEN 03/16	6.01	6.28	6.26	7.10					
TRP 06/20	6.42	6.63	6.63	7.11					
<b>SWAP RATES</b>									
2 years	3.37	3.79	3.86	4.14					
3 years	3.80	4.14	4.19	4.63					
5 years	4.39	4.67	4.64	5.14					
10 years	5.20	5.42	5.36	5.82					

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