ECONOMICS

9 Aug. 10

Business **Weekly**

Employment whiplash

This Week

The unemployment data are becoming reliable for one thing: upsetting the market. The June quarter Household Labour Force Survey (HLFS) delivered a very surprising lift in the unemployment rate, up to 6.8% from 6.0%. The sharp increase follows the previous quarter's dramatic dive from 7.1% to 6.0%. The exceptional degree of volatility in the unemployment rate has made interpreting the trend in unemployment extremely difficult over the past year. Nevertheless, the trend in the labour market appears weaker than many had expected.

Curiously, the result should not have triggered such a strong market reaction to the extent that the HLFS has become known for volatility and reduced reliability over the past year. Indeed, the detail of HLFS wasn't that bad. Particularly, the rising trend of full-time employment away from part-time employment points to increased confidence among employers. This indicates that the recovery in employment demand over the coming year will be sustainable, given firms tend to turn to hiring part-time staff when they want the flexibility to change headcount at short notice. Further still, last Tuesday the more stable (although for some reason considered less reliable) Quarterly Employment Survey actually pointed to reasonably strong employment growth and hours paid over Q2.

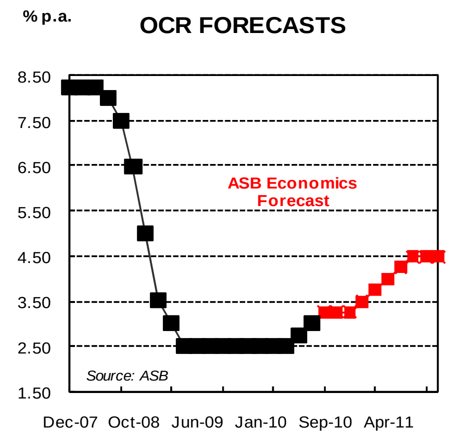
So why did the market react so strongly, when it should have been able to push aside this volatile and possibly misleading result. It all comes down to what the RBNZ was expecting. The RBNZ's forecast of Q2 unemployment of 6% was slightly head-scratching. It put the RBNZ at the very bottom end (strong) of the range, with the majority of forecasters picking a technical rebound. As a result, the RBNZ is now looking at a substantially weaker starting point for the labour market ahead of the September meeting. Importantly for inflation, the higher unemployment rate suggests the RBNZ will scale back its outlook for wage growth, which typically leads to downward revisions to non-tradable inflation (excluding housing). Further, this has not the only downside surprise the RBNZ had to contend with last week. Dairy prices fell sharply once again in the *globalDairy* trade auction, and we now expect that Fonterra will have to revise down its previous forecast of a $6.60 payout, to around $6. For the RBNZ, underpinning its strong growth outlook has been a very elevated Terms of Trade over the next year. The decline in dairy prices undermines this view.

Recall that prior to all this, the RBNZ had already revised down its growth outlook. The weaker labour market and waning support for dairy prices adds another blow to the growth outlook – and a reassessment of inflation pressures – and as a result we are expecting the RBNZ will not lift the OCR at the October and December meetings (see box below).

Click here for:

Foreign Exchange	• NZD lifts against the USD, but dips on other cross rates.
Interest Rates	• Interest rates ease further on weak local data and news.
Week Ahead	• Wage growth to remain subdued, employment to improve for second quarter.
Week in Review	• Wage growth remains subdued, employment slips in second quarter.
Global Calendars	• FOMC rate decision, AU employment report, US CPI and consumer confidence.

Chart of the week



- We have changed our OCR view, and now explicitly expect the RBNZ to pause in both October and December, with OCR increases resuming in January. In addition, we now expect a 4.5% OCR peak in 2011, down from 5%.
- We still expect an OCR increase in September, but now put a lower chance on that happening (60%, compared to market expectations of 65%). Recent events do point to a realistic chance the RBNZ could even pause then.
- When and if the RBNZ does pause is in reality going to be hard to predict with any degree of accuracy. The timing of any pause will be heavily data dependent, but the probably of a pause before the end of the year looks more likely than not. For the RBNZ to be confident enough to keep hiking meeting after meeting it will need to see data indicating a "respectable" recovery is firmly on track.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7336	0.7286	0.7100	0.6871	0.6705	UP	0.7250	0.7450
NZD/AUD	0.7982	0.8010	0.8101	0.7939	0.7995	FLAT/DOWN	0.7920	0.8020
NZD/JPY	62.64	63.02	62.91	61.34	63.92	FLAT	61.50	63.50
NZD/EUR	0.5520	0.5569	0.5597	0.5038	0.4667	FLAT	0.5450	0.5450
NZD/GBP	0.4590	0.4634	0.4685	0.4404	0.3995	FLAT	0.4550	0.4650
TWI	67.4	67.6	67.4	64.0	62.2	FLAT	67.0	68.0

^Weekly support and resistance levels * Current is as at 10.35 am Monday; week ago as at Monday 5pm

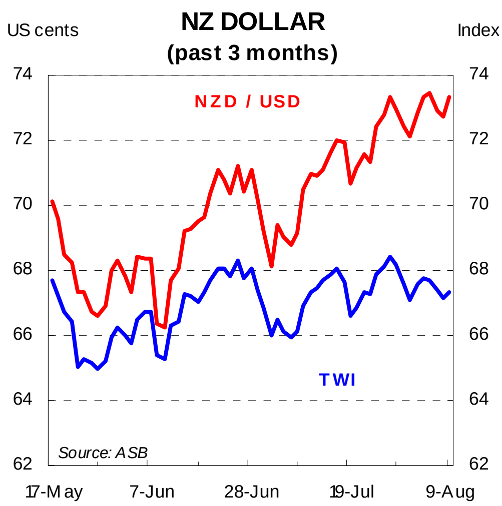
- The NZD posted a gain on a weak USD, but finished lower against all the other major crosses last week. The NZD was at its strongest at the beginning of past week, trading over 0.735 against the USD and 0.805 against the AUD on the 4th of August.
- A weak Household Labour Force Survey on 5th August saw the NZD slip over half a cent in a very short space of time on both crosses. The NZD has recovered against the USD and is back above 0.73 at the time of writing. However, the NZD remains below 0.80 against the AUD.
- This week we expect the NZD will largely continue to track sideways, although the weak USD provides some upside risk for the NZD/USD cross rate and the downward pressure on the NZD/AUD observed late last week may well continue this week, as data this week (including the Australian labour market report on Thursday) is expected to highlight the better health of the Australian economy.
- The big event for the USD is the FOMC meeting, released at 6.15am on 11 August. Speculators are now very short USD (i.e. betting the USD will fall). In our view, short USD positions are vulnerable to positive (or less negative) news about the US economy, and the USD could therefore strengthen if the Fed is less downbeat than the market is expecting.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
July REINZ House Sales yoy	13/8	10.00am	-
Q2 Retail Sales – total qoq	13/8	10.45am	+0.3%

Potential currency movers from offshore this week: FOMC rate decision, UK unemployment, Chinese Retail Sales, Industrial Production, CPI (11th) AU Employment Report, JP, EZ Industrial Production, US Weekly Jobless Claims (12th) EZ GDP, trade Balance, US CPI, University of Michigan Consumer Confidence (13th).

Medium-term outlook: [Last Quarterly Economic Forecasts]



- The momentum in the US economy appears to have slowed recently and, given the current sensitivity of the US dollar to bad economic news, we see downside risks to the USD in the short term.
- We expect the USD will gain support later in the year and over 2011. Despite the current soft patch, we believe the US economic outlook will continue to improve. We expect that US bond yields will eventually adjust higher reflecting the firmer US economy. As a result, the higher US bond yields will support the USD. The opposite is happening in mid-2010 - yields are falling - after a period of rising bond yields since early 2009. Importantly, the AAA-rated US bond market remains the major alterative to the Eurozone government bond market.
- We have revised down our EUR forecasts four times this year. Eurozone GDP growth is expected to under perform the US economy over 2010 and 2011. The deterioration in the EU growth outlook will see the differential between US and Eurozone interest rates widen, reducing support for the euro. In addition, more than half of Eurozone government debt is no longer AAA rated, with uncertainty continuing to cloud the outlook and reducing investor appetite.
- We continue to see support for the NZD coming from commodity prices and the RBNZ tightening cycle, despite the extent of tightening now likely to be less then previously forecast. In addition, NZ's relatively healthier outlook for net government debt will make the NZD look favourable relative to European and US peers.
- Relative to the AUD, the NZD has unwound some of the recent increase. The NZD is likely to modestly outperform the AUD as the RBNZ continues to lift rates slightly more over time than the RBA does.

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	3.00	3.00	2.75	2.50	2.50	FLAT
90-day bank bill	3.30	3.28	3.20	2.76	2.76	FLAT
2-year swap	3.97	4.05	4.26	4.27	4.04	DOWN
5-year swap	4.58	4.70	4.92	5.27	5.40	DOWN
5-year benchmark gov't stock	4.61	4.65	4.74	5.08	4.90	DOWN
NZSX 50	3045	3044	3005	3093	3063	DOWN

* Current is as at 10.35 am Monday; week ago as at Monday 5pm. Please note that we have recently changed the NZ govt 5-year benchmark bond to April 2015 maturity (from April 2013). This does cause some distortion in the comparison against the previous levels (i.e.6 months ago).

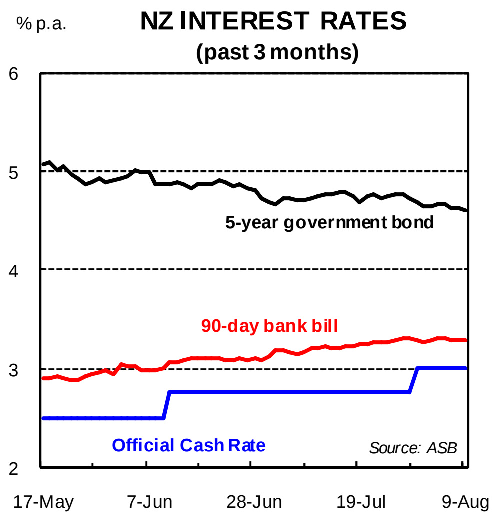
- NZ interest rates fell across the curve last week following Fonterra's announcement it would review its 2010/11 season payout forecast and weaker than expected employment data. Given the RBNZ had acknowledged in its July Review statement the previous week that the OCR may not have to be increased as steadily and by as much as it had been expecting at the June MPS, these two events led markets and most economists to now expect the RBNZ will pause later this year.
- Australian interest rates edged up slightly over the past week. The RBA's decision to leave its policy rate unchanged and its statement on monetary policy was broadly in line with market expectations. It considers current monetary policy settings as "*appropriate, at this stage*".
- Disappointing US employment data drove interest rates lower last week, with US 2-year yields falling to a record low of 0.51%. US 10-year yields have fallen by 9bp over the past week.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
July Electronic Card Transactions	10/8	10.45am	-
July Business PMI	12/8	10.00am	-
July REINZ House Sales yoy	13/8	10.00am	-
Q2 Retail Sales – total qoq	13/8	10.45am	+0.3%

Comment: With the key labour market data out of the way, market focus turns to Q2 retail sales data at the end of this week. Markets are generally expecting a subdued outturn, reflecting the very gradual recovery in household spending as households remain cautious.

Australian employment will also be on the radar. Markets will be keen to see if the strength in employment in recent months shows any signs of abating.



Medium term outlook: [Last Quarterly Economic Forecasts]

- The RBNZ continues to remove monetary policy stimulus, with a second 25 basis point OCR increase in July. In addition, the RBNZ indicated it will look to continue to increase the OCR over the coming year as economic and financial market conditions allow.
- The RBNZ noted the outlook for economic growth had softened since its June forecasts. In particular, it noted the outlook for trading partner growth had deteriorated, commodity prices had moderated, and net migration was slowing.
- Reflecting the weaker growth outlook, the RBNZ stated that "the pace and extent of further OCR increases is likely to be more moderate than was projected in the June Statement." It pays to bear in mind that the RBNZ did previously have a cash rate of 5.75% implied in its 90-day forecasts. Given ongoing funding costs, we never saw a peak this high as realistic. Nonetheless, the tone of the July statement brought into focus when and if the RBNZ will pause during the hiking cycle.
- The RBNZ forecasts headline CPI inflation to peak at 5.3% in June 2011, boosted by a raft of Government policy changes including tobacco excise tax, the implementation of the Emissions Trading Scheme and increase in GST to 15%. We expect these changes will boost headline inflation to well over 5%, and hence pose upside risks to the RBNZ's key assumption that medium-term inflation expectations will remain anchored.
- Nonetheless, the Fonterra's announcement of a likely downward revision to its payout for the 2010/11 season, and the weaker than expected Q2 employment data, lead us to believe the RBNZ will pause later this year. In addition, we now expect the OCR will reach 4.5% next year instead of 5%.

NZ Data Preview: a look at the week ahead

Data	Date	Time (NZST)	Previous	Market expects	ASB expects
July Electronic Card Transactions mom	10/8	10.45am	+0.4%	-	-
July Business PMI	12/8	10.00am	56.2	-	-
July REINZ House Sales yoy	13/8	10.00am	-24.3%	-	-
Q2 Retail Sales – total qoq	13/8	10.45am	+0.4%	+0.3%	+0.3%

Friday 13 August

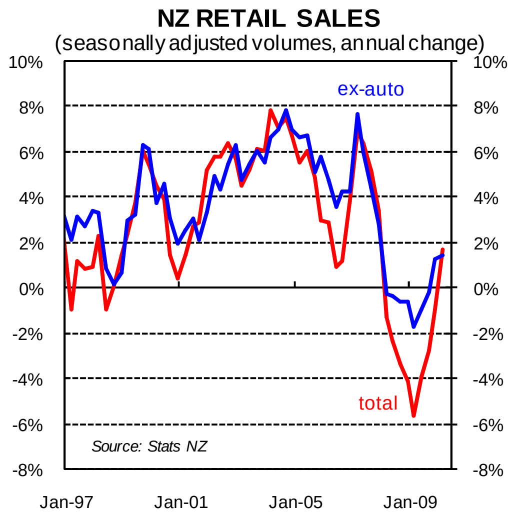
Q2 Retail Trade Survey

Total volumes: previous +0.4% qoq, f/c +0.3% qoq

Ex-auto volumes: previous -0.2% qoq, f/c +0.9% qoq

The recovery in retail sales has been very gradual to date, with households remaining cautious in regards to spending. This is unsurprising in light of waning optimism in the housing market and continued subdued wage inflation. In particular, households continue to hold off the purchase of big-ticket items, with recent inflation data indicating widespread discounting by retailers to encourage sales.

We expect retail sales to increase over the coming months as households bring forward the purchase of major household items ahead of the GST increase in October.

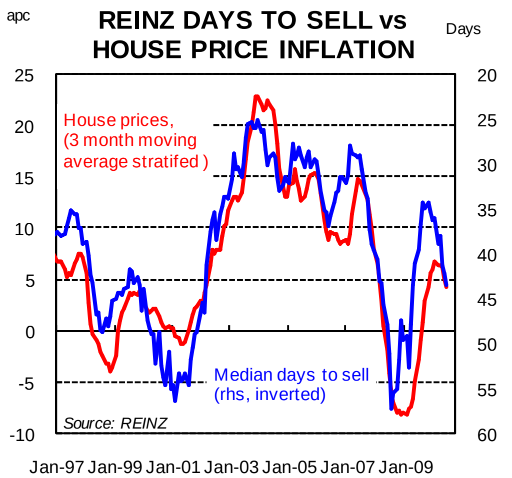


Friday 13 August

July REINZ House Sales

Previous (s.a.): Turnover -24.3% yoy

We expect housing market activity will remain subdued as housing demand continues to wane. As a result, the number of days taken to sell a house continues to tick up. However, house prices have held up surprisingly well despite the low level of activity. This reflects the low level of supply in the market at the moment. The changes announced in the Budget in May removing the ability to claim back depreciation on buildings has not triggered a rush of listings. We expect weakness in house prices in the near term. The low number of net migration inflows poses downside risk to house prices.



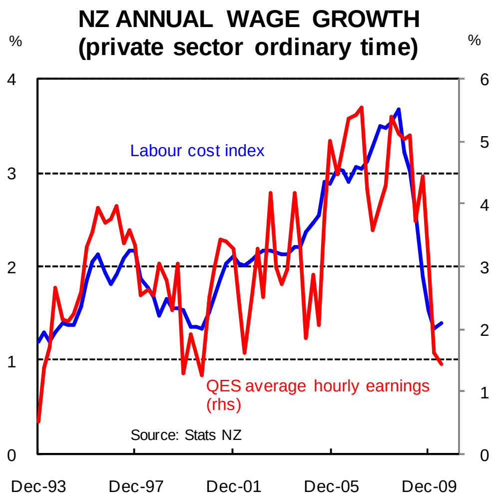
NZ Data Review: weekly recap

Q2 Labour Cost Index

Q2 Quarterly Employment Survey

Wage growth remained subdued in the June quarter, with the 0.4% increase in all sector ordinary time wage rates bringing it to annual wage growth of 1.6%. Looking at the distribution of wage increases, there was an increase in the proportion of workers who had a wage increase over the past year, particularly in the proportion of workers which had a wage increase of up to 3%.

The Q2 outturn points to a tentative recovery in wage growth from the low levels of 2009. Given wages are a lagging indicator of the economy, the subdued result largely reflects the weak state of the labour market over the course of the recession. We expect that a continued improvement in demand for labour will flow through to stronger wage growth over the coming year.

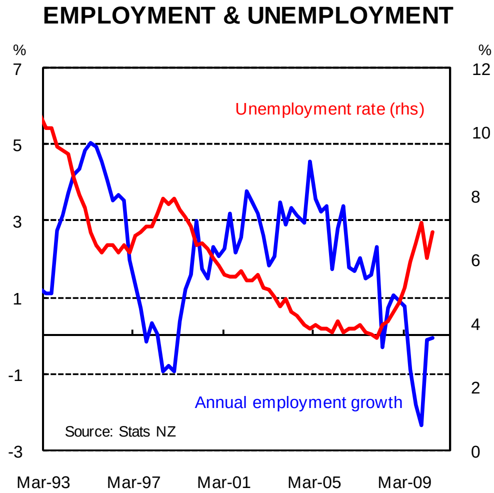


Q2 Household Labour Force Survey

The HLFS result was well below market expectations. Employment declined slightly against expectations of an increase, and consequently the unemployment rate rebounded to 6.8%. The result contradicts recent growth in economic activity, the lift in employment intentions, as well as the strength in the Q2 Quarterly Employment Survey full-time-equivalent employees and hours paid.

However, the decline in employment was driven by a decline in part-time employment, with full-time employment actually rising slightly in Q2. Looking at the past year or so, full-time employment shows a clear upward trend, while part-time employment has been trending down. This indicates that the recovery in employment demand over the coming year will be sustainable, given firms tend to turn to hiring part-time staff when they want the flexibility to change headcount at short notice.

Hours worked lifted at a subdued 0.6%, compared to the previous quarter's 1.3% surge. While still pointing to growth in labour demand, the pace of growth remains relatively modest and suggests that the building momentum in economic activity is yet to completely translate to stronger employment demand.



Global Data Calendars

Note: Calendar 2 is in UK times. Add 11 hours for NZ times.

Calendar - Australasia, Japan and China

	Time						Forecast	
Date	**NZT**	**Econ**	**Event**	**Period**	**Unit**	**Last**	**Market**	**ASB/CBA**
Mon 9 Aug	11.50	JP	Current account total	Jun	¥bn	904.8	~	~
	13.30	AU	NAB business conditions	Jul	Index	8.0	~	~
	13.30	AU	NAB business confidence	Jul	Index	4.0	~	~
	13.30	AU	Home loans	Jun	m%ch	1.9	-2.0	-2.0
	13.30	AU	Value of loans	Jun	m%ch	-0.3	~	2.0
	13.30	AU	ANZ job advertisements	Jul	m%ch	2.7	~	~
	17.00	JP	Eco watchers survey: outlook	Jul	Index	48.3	~	~
Tue 10 Aug	~	JP	BOJ target rate	Aug	%	0.10	0.10	0.10
	~	CH	Trade balance	Jul	USD bn	20.0	~	~
	~	CH	Exports	Jul	y%ch	43.9	~	~
	~	CH	Imports	Jul	y%ch	34.1	~	~
	10.45	NZ	Card spending	Jul	m%ch	0.4	~	~
Wed 11 Aug	11.50	JP	Machine orders	Jun	m%ch	-9.1	~	~
	13.00	AU	Westpac consumer confidence	Aug	%	11.1	~	~
	14.00	CH	Producer price index	Jul	y%ch	6.4	~	~
	14.00	CH	Consumer price index	Jul	y%ch	2.9	~	~
	14.00	CH	Retail sales	Jul	y%ch	18.3	~	~
	14.00	CH	Industrial production	Jul	y%ch	13.7	~	~
	14.00	CH	Fixed assets inv urban	Jul	ytd y%ch	25.5	~	~
Thu 12 Aug	10.30	NZ	Business NZ PMI	Jul	Index	56.2	~	~
	10.45	NZ	Food prices	Jul	m%ch	1.3	~	~
	13.00	AU	Consumer inflation expectation	Aug	%	3.3	~	~
	13.30	AU	Employment change	Jul	‘000	45.9	20.0	25.0
	13.30	AU	Unemployment rate	Jul	%	5.1	5.1	5.1
	13.30	AU	Participation rate	Jul	%	65.2	65.2	65.2
Fri 13 Aug	10.00	NZ	REINZ housing price index	Jul	m%ch	0.6	~	~
	10.45	NZ	Retail sales	Jun	m%ch	0.4	0.5	0.4
					q%ch	0.4	0.3	0.3

Calendar – North America & Europe

Please note all days and times are UK time, not local release day/times

Date	UK Time	Econ	Event	Period	Unit	Last	Forecast Market	Forecast CBA
Mon 9 Aug	07.00	GE	Trade balance	Jun	€bn	9.7	~	~
	07.00	GE	Current account	Jun	€bn	2.2	~	~
	09.30	EZ	Sentix Investor Confidence	Jul	~	-1.3	~	~
Tue 10 Aug	00.01	UK	BRC July retail sales monitor	Aug				
	00.01	UK	RICS house price balance	Jul	%	9.0	~	~
	07.00	GE	CPI - EU harmonised	Jun	m%ch	0.3	~	~
					y%ch	1.2	~	~
	09.30	UK	Total trade balance	Jun	£mn	3,817.0	~	~
	13.15	CA	Housing starts	Jul	'000	192.8	183.0	~
	13.30	CA	New housing price index	Jun	m%ch	0.3	0.2	~
	13.30	US	Nonfarm productivity	QII	%	2.8	2.0	~
	13.30	US	Unit labor costs	QII	%	-1.3	1.9	~
	15.00	US	Wholesale inventories	Jun	%	0.5	0.6	~
	19.15	US	FOMC rate decision	Aug	%	0.25	0.25	0.25
Wed 11 Aug	09.30	UK	ILO unemployment rate (3 mths)	Jun	%	7.8	~	~
	10.30	UK	Bank of England quarterly inflation report	Aug	~	~	~	~
	13.30	CA	International merchandise trade	Jun	C$bn	-0.5	~	~
	13.30	US	Trade balance	Jun	$bn	-42.3	-42.5	~
	19.00	US	Monthly budget statement	Jul	$bn	-180.7	-168.5	
Thu 12 Aug	10.00	EZ	Industrial production	Jun	m%ch	1.0	~	~
	13.30	US	Import price index	Jul	m%ch	-1.3	0.4	~
					y%ch	4.5	~	~
	13.30	US	Initial jobless and continuing claims	Aug	~	~	~	~
Fri 13 Aug	10.00	EZ	Trade balance	Jun	€bn	-3.0	~	~
	10.00	EZ	GDP	QII	q%ch	0.2	~	~
					y%ch	0.6	~	~
	13.30	CA	New motor vehicle sales	Jun	m%ch	0.2	~	~
	13.30	US	Consumer price index	Jul	m%ch	-0.1	0.3	~
					y%ch	1.1	1.2	~
	13.30	US	Advance retail sales	Jul	%	-0.5	0.4	~
	14.55	US	U. of Michigan confidence	Aug	Index	67.8	~	~
	15.00	US	Business inventories	Jun	%	0.1	0.3	~

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