ECONOMICS

14 Sep. 09

Business Weekly

Idealism, realism, and resolve

This Week

Last week the RBNZ kept the OCR on hold at 2.5%. We felt there was a case for the RBNZ to cut the OCR to try and mitigate the strength of the NZ dollar. If the RBNZ wasn't prepared or sufficiently concerned to do anything then it needed to accept the NZD is likely to remain high and take on board the implications. The RBNZ chose to do the latter. The RBNZ has essentially resigned itself to the role of spectator, taking the view that the chances of making a lasting impression on the NZD aren't worth the risk of potentially adding more stimulus to the housing market.

Although the RBNZ doesn't believe the high NZD is fully justified, it has nonetheless started to accept that the NZD is likely to sustain a high level over the next couple of years. Its economic outlook has changed as a result. Previously the RBNZ continued to forecast what it sees as the ideal form of recovery: rebalancing of the economy via a weak NZD that resulted in an export-led recovery, while consumer spending growth remained very weak. But as the NZD continued to rebound that scenario looked increasingly unrealistic.

The RBNZ's September Monetary Policy Statement contained a more realistic scenario for NZ's recovery from recession, based off a higher NZD, slower recovery in exports and faster (but still very weak) consumer spending growth. With that shift in the mix of growth came renewed warnings of the danger of a household-led recovery. We entirely agree the NZ economy will be in much healthier shape if it can rebalance over time to be driven more by exporting than by consumer spending and house- building. However, given the phasing of the recession, expecting the initial stages of economy recovery to be export-led was always unrealistic. This recession was household led and began well before the global financial crisis reached its peak. Lower mortgage rates and petrol prices have already brought financial relief to many households. In contrast NZ's export earnings came under pressure from the global crisis much later, and the NZD/USD and NZD/GBP are headwinds for exporters using those currencies.

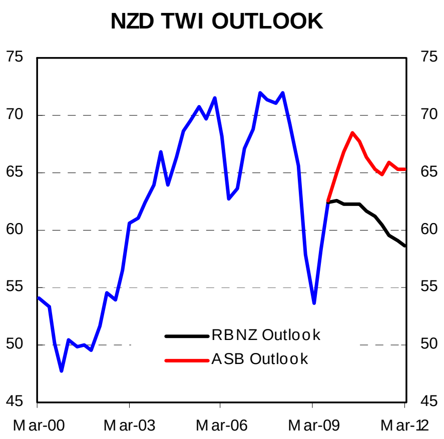
For making interest rate decisions the RBNZ needs to forecast the most likely economic outlook, which it has now done. However, the need for the NZ economy to rebalance is a very real issue, and one that will likely need steering by economic policy changes. Both the Government and the RBNZ have greater resolve to act.

Back to monetary policy: we expect the RBNZ will hike the OCR by June next year (previously July). The RBNZ is very unlikely to stand in the way of any further climbs in the NZD and wholesale interest rates. In the absence of a circuit breaker we expect those rates to continue trending up. The door to relatively low fixed-term rates will steadily close up, though short-term rates will remain low for 6 months or so.

Click here for:

Foreign Exchange	NZD breaks through old resistance at USD 0.69, hitting a 2009 high above 0.70.
Interest Rates	RBNZ fails to surprise market, NZ rates dip lower following Australian markets
Week Ahead	Survey of Manufacturing Tuesday, Tourism and Migration next Monday.
Week in Review	RBNZ holds, and continues to expect to keep OCR low until latter in 2010.
Global Calendars	US Retail Sales, BoJ rate decision, JPN, CH, EUR, US industrial production due.

Chart of the week



- Up until last week's MPS the RBNZ persisted with a view that the rise in the NZD is but a blip and it would soon drop and sustain a very weak level for years.
- That assumption put a lot of weight on NZ's external liabilities but insufficient weight on global factors such as: the recovery in risk appetites; growing wariness of the USD as a store of value; the plight of the UK economy. The NZD also tends to outperform during (anticipated) global upswings.
- Instead of assuming the Trade-Weighted Index would drop back to around 52 and stay there, the RBNZ's latest forecasts incorporate an outlook around 60. Currently the TWI is sitting around 64.
- We continue to expect the NZD to rise slightly further from recent levels, again largely on external factors.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7046	0.6880	0.6784	0.5235	0.6532	FLAT	0.6900	0.7150
NZD/AUD	0.8170	0.8074	0.8057	0.7978	0.8138	FLAT	0.8000	0.8200
NZD/JPY	63.66	64.07	64.56	51.42	70.03	FLAT	63.00	65.00
NZD/EUR	0.4830	0.4799	0.4755	0.4060	0.4665	FLAT	0.4750	0.4850
NZD/GBP	0.4225	0.4200	0.4095	0.3731	0.3714	FLAT	0.4150	0.4300
TWI	64.2	63.6	63.1	53.6	62.7	FLAT	63.00	65.00

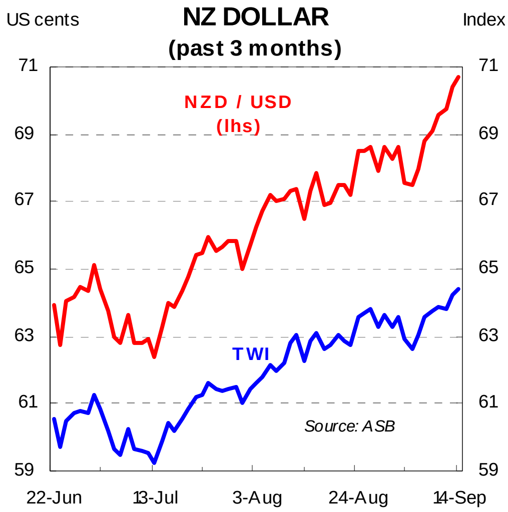
^Weekly support and resistance levels * Current is as at 12pm Monday; week ago as at Monday 5pm

- It was onwards and upwards for the NZD last week. After repeatedly testing the USD0.69 level it punched through early in the week and has established a beachhead above USD0.70.
- The NZD's reaction to the MPS was mild given the watering down of July's easing bias. The NZD was trading around USD0.696 prior to the MPS release, having briefly traded above USD0.70 the night before. The MPS initially triggered a very brief dip in the NZD to around USD0.691. However, the NZD pushed higher over Thursday and Friday, getting as high as 0.7088 against the very weak USD.
- In trade-weighted terms, the USD is at now its lowest rates since September 2008. The USD has continued to be sold off following further speculation it may lose its position as the dominant global reserve currency and improvements in risk appetite. The USD is likely to come under further pressure this week as the inflation report may disappoint expectations for a slowing in the pace of deflation. Further improvements in risk appetite could also guide the USD lower.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
Q2 Economic Survey of Manufacturing	15/9	10.45 am	-
August Net Migration (per annum)	21/9	10.45 am	-

Potential currency movers from the US this week: retail sales, Empire manufacturing index, business inventories (15th), Treasury International Capital System financial flows, industrial production, NAHB housing index (16th), housing starts and permits, initial jobless claims, Philadelphia Fed index (17th).



Medium term outlook: [Last Quarterly Economic Forecasts]

- We expect the NZD to appreciate further against the USD over the next 6-9 months. Much of that story is about the USD, not the NZD.
- We continue to expect the USD to weaken into 2010. The reasons for the expected USD depreciation remain similar to the drivers in place since mid-March, namely:
  - US residents increase their offshore investment, encouraged by improvement in the global economy.
  - USD liquidity demand and safe-haven buying of the USD is reversing.
  - Diversification out of USD is expected to occur due to concerns about US government debt.
- Against the expected backdrop of USD weakness we also expect some moderate and broad-based NZD outperformance. Despite being mired in recession since the start of 2008, NZ's economy is holding up well compared to those of many key trading partners. Over time the NZD is likely to be buoyed by the rising tide of improving confidence in the global economic recovery and firmer commodity prices. Moreover, a buoyant AUD, on improved prospects for its resource exports and speculation of early 2010 rate hikes, will drag the NZD along on its coat-tails.
- We expect the NZD to firm noticeably against the USD and yen as those currencies remain under sustained pressure. Against other key currencies the NZD is likely to appreciate but to a more modest extent. However, the likelihood of the RBNZ intervening to try and weaken the NZD remains low given the NZD itself is not particularly elevated relative to both underlying economic fundamentals and past movements.
- The September MPS made it pretty clear the RBNZ is unlikely to cut the OCR to try dampening the NZD. Direct FX intervention also appears unlikely with the dominant driver of the high NZD being the weak USD.

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	2.50	2.50	2.50	3.00	7.50	FLAT
90-day bank bill	2.77	2.77	2.79	3.26	7.80	FLAT
2-year swap	4.01	4.12	4.21	3.55	6.98	DOWN
5-year swap	5.30	5.43	5.51	4.53	6.87	DOWN
11/11 gov't stock	4.72	4.86	4.96	3.98	5.74	DOWN
NZSX 50	3137	3120	3151	2535	3366	FLAT

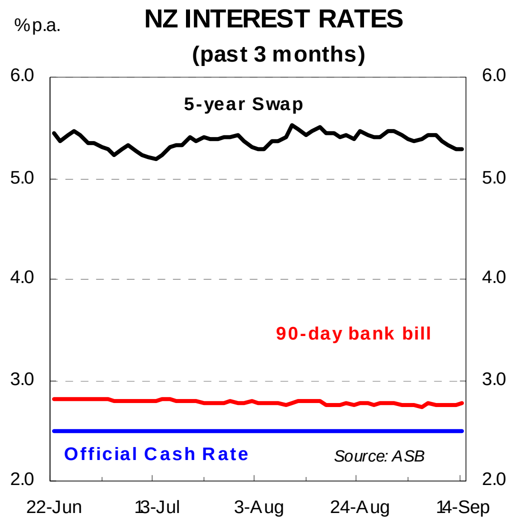
* Current is as at 12pm Monday; week ago as at Monday 5pm

- The RBNZ is likely to be pleased with the muted reaction in interest rate markets following Thursday's OCR announcement. The RBNZ dropped its easing bias, which could have risked market pricing for rate hikes becoming aggressive. However, weak sentiment in Australian markets dominated.
- 90-day rates remained broadly unchanged over the week. Rates, which spiked higher on Monday, were easing leading into the announcement but rallied 10 basis points after the RBNZ dropped its easing bias.
- Most interest rates fell over the week, dragged down by the sharp fall in Australian market (Australian 1-year swap rate fell around 25bp over the week). Disappointing retail trade and employment data was behind the weak sentiment.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
Q2 Manufacturing Survey	15/9	10.45 am	-
August Net Migration	21/9	10.45 am	-

Comment: Movements in Australian markets are likely to continue to dominate the NZ market. NZ data calendar is relatively light with just the manufacturing survey and net migration. In Australia, the RBA minutes are likely to receive scrutiny given the market's disappointment to the statement. Heavy US data flow could also be influential.



Medium term outlook: [Last Quarterly Economic Forecasts]

- The RBNZ continues to hold the cash rate at 2.5%, although has now backed off its easing bias. The market did not see a strong easing bias as credible given the number of stronger than expected indicators of late. The RBNZ continues to expect it will hold the cash rate at or below current levels until the latter part of 2010.
- The RBNZ declined to cut the cash rate at the September meeting, despite financial conditions tightening since its July statement. The Bank steered away from its earlier threat to cut should conditions not ease. This action has signaled the RBNZ is extremely unlikely to ever cut the OCR further in this downturn.
- The RBNZ has resigned itself to the role of spectator, accepting the current levels of the NZ dollar and interest rates. The RBNZ finally incorporated more realistic NZ dollar outlook (although still depreciating from current levels, in contrast to our view of further increase).
- The RBNZ's overall growth and inflation forecasts were unchanged, despite incorporating significantly stronger monetary conditions. The RBNZ sees more inflation pressure in the economy stemming from a less weak global outlook, a pick up in net migration supporting the housing market, and improved business confidence.
- The next move in the OCR is up, it's just a matter of when. We expect the RBNZ will hike by June next year (previously July). However, the risks are skewed to an earlier start. The RBNZ has a substantial amount of policy stimulus to unwind, the first steps are likely to be bigger (i.e. 50 basis point moves).

NZ Data Preview: a look at the week ahead

Data	Date	Time (NZST)	Previous	Market expects	ASB expects
Q2 Economic Survey of Manufacturing	15/9	10.45 am	-0.9%	-	-
August Net Migration (per annum)	21/9	10.45 am	14,488	-	-
August RBNZ Credit Card Spending	21/9	3.00 pm	+0.1%	-	-

Q2 Economic Survey of Manufacturing

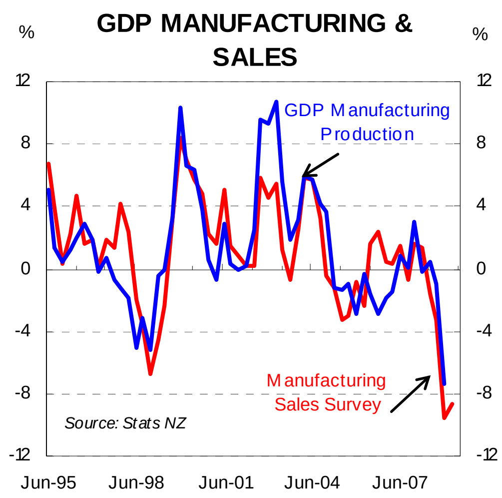
Previous: -0.9%

Manufacturing sales remained surprising resilient over Q1, with strength in dairy and meat sales offsetting a sharp decline in non-food sales.

However, underlying demand for manufacturing remains weak, reflecting the sharp drop in both domestic and foreign demand.

We expect manufacturing production fell around 2.5% over Q2, and sales are likely to mirror this weakness.

Looking ahead to the second half of 2009, manufacturing confidence has improved (although remains at low levels), pointing to a stabilisation in activity over Q3.

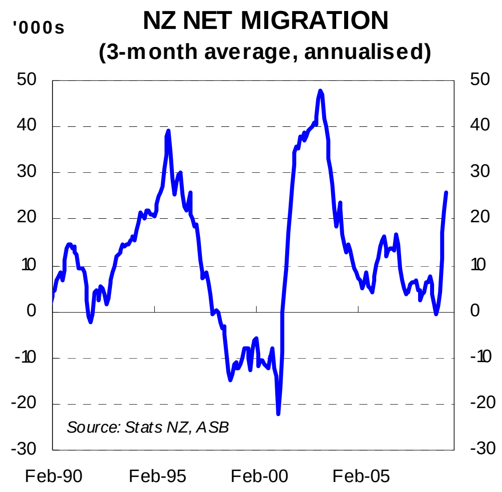


August International Travel and Migration

Previous: 14,488 net migrants (in year to August)

Net migration inflows have picked up strongly over the past few months, mostly owing to a dramatic fall in the number of departures, particularly to Australia. The deterioration in the world economy is likely to be behind the decline in departures as a weakening labour market in Australia has deterred New Zealanders from heading across the Tasman. We expect these trends to continue, supporting a modest pick up in net migration over the year, to around 25,000 net new migrants per annum. A boost to net migration will provide some underlying support to NZ's flagging housing construction sector.

Overseas short-term visitor arrivals are also expected to slow over the next year as weakening world growth reduces demand for international travel.

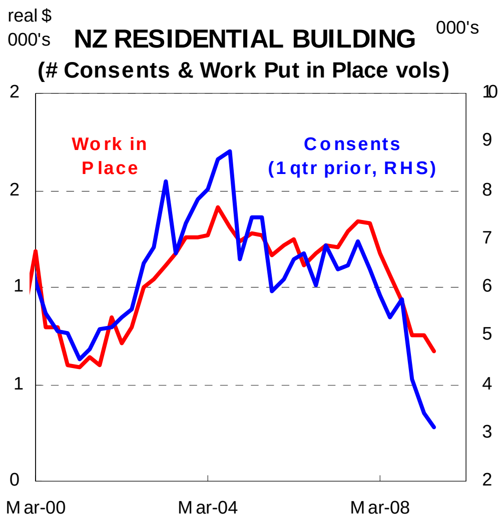


NZ Data Review: weekly recap

Q2 Building Work Put in Place

The volume of construction activity declined for the 6th consecutive quarter, falling 4.5% and down 24% since December 2007. The weakness was led by a 6.5% decline in residential construction activity, although the drop was not quite as weak as expected given the extent of decline in consent issuance. Residential construction activity has fallen 36% from its peak in September 2007, and is now likely to be close to its trough. Consent issuance has recently picked up in line with the improvement in housing demand and points to some stabilisation in construction activity over the remainder of 2009.

Non-residential construction activity fell 2.5%, although has held up well compared to the residential sector, up 2.5% on year-ago levels.

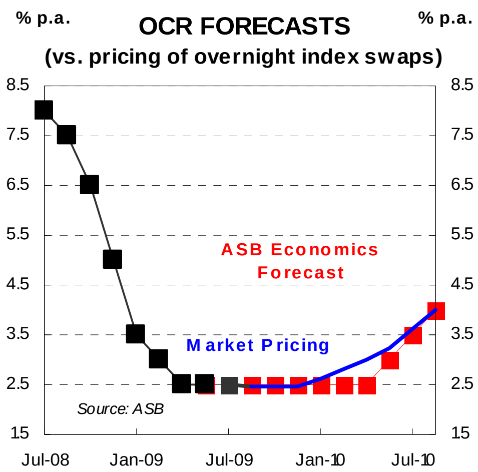


RBNZ OCR Announcement

The RBNZ left the OCR unchanged at 2.5%, as widely expected by the market. The RBNZ has essentially dropped its easing bias by removing the previous statement that there was scope for interest rates to move lower over coming quarters. Nonetheless, the RBNZ still expects to hold rates at or below current levels through to the latter part of 2010.

The main implication of Thursday's statement is that the RBNZ is very unlikely to stand in the way of any further climbs in the NZD and wholesale interest rates. Despite substantially tighter monetary conditions, the inflation outlook has not fallen - in other words the RBNZ's assessment of underlying inflation pressures has been lifted substantially.

Declining to cut last week has signalled that the RBNZ is extremely unlikely to ever cut further. The next move in the OCR is up and it's just a matter of when. We expect the RBNZ will hike by June next year (previously July). However, the risks are skewed to an earlier start. The RBNZ has a substantial amount of policy stimulus to unwind, the first steps are likely to be bigger (i.e. 50 basis point moves).



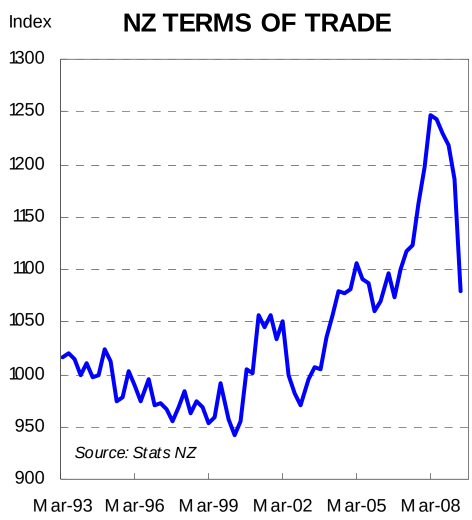
Q2 Terms of Trade

The Terms of Trade fell 9% over Q2: the decline was much steeper than ASB and market expectations (-3.5% and -2.5% respectively).

Export prices fell sharper than expected, down 11.6% over the quarter. While the weakness was centred on falling dairy prices, the declines were broad-based across all commodities – in part due to the 8.7% increase in the trade weighted exchange rate. The CBA commodity price index suggests further declines in export prices are yet to be recorded in official trade data. However, more recently prices have begun to stabilise, which will become evident in the latter part of 2009.

Import prices fell 2.9% over the quarter, following a 5.4% decline in the previous quarter. The declines were mostly due to the increase in the exchange rate over the quarter.

Export volumes picked up strongly over Q2, supported by an increase in dairy exports. Meanwhile, import volumes were weak, down 1.9%. The overseas trade volumes are pointing to a stronger net export contribution than expected. We currently expect GDP to contract 0.1% in Q2 (as does the RBNZ).



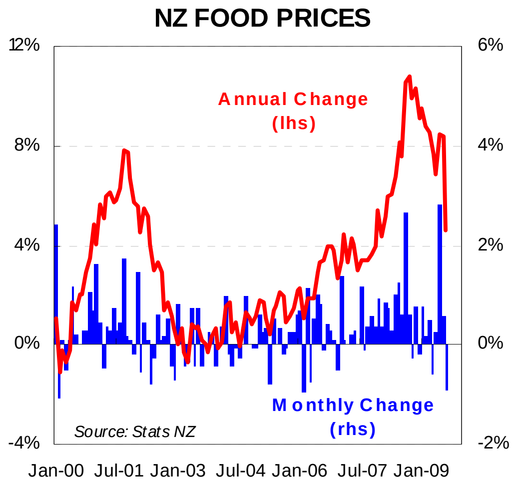
August Food Price Index

Food prices fell 0.9% in August, and are up 4.6% on year-ago levels. Movements within the key components were: grocery food prices fell 1.3 percent, fruit and vegetable prices fell 3.3 percent, meat, poultry and fish prices fell 0.4 percent, restaurant meals and ready-to-eat food prices rose 0.3 percent, non-alcoholic beverage prices rose 1.0 percent.

The 0.9% decline in food prices follows strong increases over the previous 2 months. In particular, fruit and vegetables fell 3.3% as they reversed July's spike. There were sharp declines in tomatoes, strawberries and broccoli. Meat prices fell 0.4%, with sharp increases in lamb (+4.6%) and pork (+6.2%) offset by a 9% fall in chicken. Grocery prices also reversed the past two months' increase.

Over the past year, the most significantly upward contributions have come from meat (up 9.2%) and non-alcoholic beverages (up 7.9%).

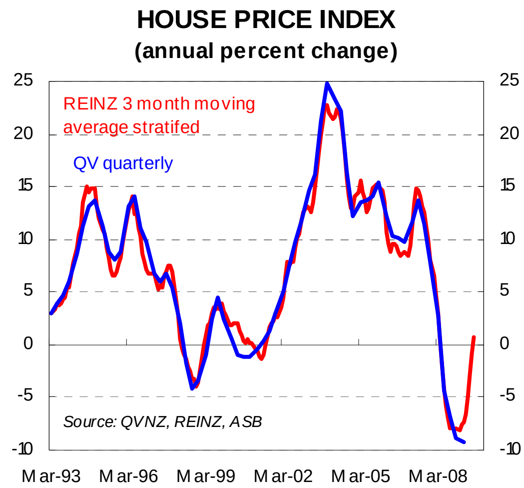
Food prices are stopping CPI inflation from falling to dramatically low levels in the short term. Nevertheless, by year-end inflation is likely to fall briefly to around 1.5%. From a policy point of view the RBNZ will look through the food-driven volatility.



August REINZ House Sales and Prices

Housing demand remained steady over August. Sales fell slightly (down 1.9% on our seasonally-adjusted estimate) and essentially continue to trend around 6000-6500 sales per month, slightly below the historical average of 7,200. The pick up in demand follows very low mortgage rates (for 1- and 2-year terms at least) and an increase in population growth (as the rate of permanent departures to Australian has fallen).

The median days to sell have fallen below its long-term average, now at 33.4 days on our seasonally-adjusted estimate. The shorter time to sell suggests the housing market has become tighter. Although the level of demand remains comparatively low (on an historical basis), the number of new houses being listed for sale is also low, causing some tension between supply and demand. At the minute this is leading to house prices being bid up, rising 1.2% over August (according to REINZ's stratified median).

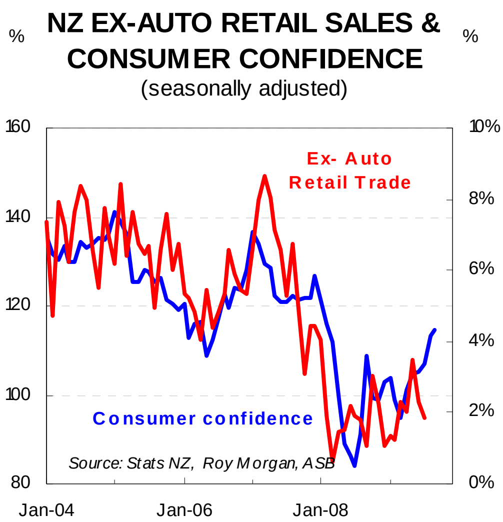


July Retail Sales

Retail sales fell 0.5% over July, surprising markets which were looking for a modest increase of 0.5%. The decline came as a surprise as consumer confidence and electronic card transactions pointed to retailing remaining much more robust over July and August.

The auto section remained unchanged with a decline in fuel sales (coinciding with a decline in petrol prices) offsetting the increase in motor vehicle sales. Car registrations suggest that vehicle demand has stabilised (after some very steep falls) and is now making a tentative recovery (although sales remain at very low levels).

Core retail sales fell 0.5%, dominated by declines in department stores (-2.2%), other retailing (-2.4%), cafes and restaurants (-1.6%), supermarket sales (-0.3%) and appliance retailing (-1.8%). In some cases, the decline followed a strong increase in July, which is not too surprising given the volatility in the monthly survey. However, the ongoing weakness in some areas did come as a surprise. In particular we had expected to see a pick up in tourist-related spending (i.e. bars and clubs, cafes and restaurants etc), given the strong surge in Australian tourist numbers which were reportedly hitting the ski slopes with their Australian Government tax rebate to spend.



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 14 Sep	10.45	NZ	Retail sales ex-auto	Jul	m%ch	-0.4	0.5	0.4
	13.30	AU	Lending finance	Jul	m%ch	1.0	~	~
	16.30	JP	Industrial production	Jul	m%ch	1.9	~	~
					y%ch	-22.9	~	~
	16.30	JP	Capacity utilisation	Jul	m%ch	~	~	~
Tue 15 Sep	10.45	NZ	Manufacturing activity	QII	q%ch	-0.9	~	-2.5
	13.30	AU	Dwelling starts	QII	q%ch	-4.0	1.0	-2.0
	13.30	AU	Reserve Bank's Board September minutes					
	18.00	JP	Machine tool orders	Aug	y%ch	-71.3	~	~
Wed 16 Sep	13.00	AU	Westpac leading index	Jul	m%ch	0.7	~	~
	16.00	JP	BoJ monetary policy meeting	Sep	~	~	~	~
Thu 17 Sep	~	JP	BoJ target rate	Sep	%	0.10	0.10	0.10
	11.50	JP	BSI large all industry	QIII	q%ch	-22.4	~	~
	11.50	JP	BSI large manufacturing	QIII	q%ch	-13.2	~	~
	11.50	JP	Tertiary industry index	Jul	m%ch	0.1	0.5	0.5
	13.30	AU	RBA Bulletin	Sep	~	~	~	~
Fri 18 Sep	17.00	JP	Leading and coincident index	Jul	Index	~	~	~
	17.00	JP	BoJ monthly report	Sep	~	~	~	~

Calendar – North America & Europe

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

	UK						Forecast	
Date	**time**	**Econ**	**Event**	**Period**	**Unit**	**Last**	**Market**	**CBA**
Mon 14 Sep	10.00	EZ	Employment	QII	q%ch	-0.8	~	~
	10.00	EZ	Industrial production	QII	q%ch	-0.6	~	~
	13.30	CA	Capacity utilisation rate	QII	%	69.3	65.0	~

Continued over

Date	time	Econ	Event	Period	Unit	Last	Market	CBA
Tue 15 Sep	00.01	UK	RICS house price balance	Aug	%	-8.1	0.0	~
	09.30	UK	CPI	Aug	m%ch	0.0	0.3	~
	09.30	UK	DCLG UK house prices	Jul	y%ch	-10.7	~	~
	10.00	EZ	ZEW (econ. Sentiment)	Sep	Index	54.9	~	~
	13.30	CA	New motor vehicle sales	Jul	%	-0.6	5.0	~
	13.30	CA	Labour productivity	QII	%	0.3	~	~
	13.30	US	Producer price index	Aug	m%ch	-0.9	0.8	~
					y%ch	-6.8	-5.3	~
	13.30	US	Advance retail sales	Aug	%	-0.1	1.7	~
	13.30	US	Retail sales less autos	Aug	%	-0.6	0.4	~
	13.30	US	Empire manufacturing	Sep	Index	12.1	14.0	~
	15.00	US	Business inventories	Jul	%	-1.1	-0.8	~
Wed 16 Sep	09.30	UK	ILO employment rate (3mths)	Jul	%	7.8	8.0	~
	10.00	EZ	CPI	Aug	m%ch	-0.7	~	~
					y%ch	-0.7	~	~
	13.30	US	CPI	Aug	m%ch	0.0	-2.1	~
					y%ch	0.3	-1.7	~
	13.30	US	Current account balance	QII	$bn	-101.5	-91.0	~
	14.00	US	Net long-term TIC flows	Jul	$bn	90.7	~	~
	14.15	US	Industrial production	Aug	m%ch	0.5	0.7	~
	14.15	US	Capacity utilisation	Aug	%	68.5	69.1	~
	18.00	US	NAHB housing market index	Sep	Index	18.0	19.0	~
Thu 17 Sep	09.30	UK	Retail sales	Aug	m%ch	0.4	0.4	~
	10.00	EZ	Trade balance	Jul	€bn	1.0		
	12.00	CA	CPI	Aug	m%ch	-0.3	~	~
					y%ch	-0.9	~	~
	13.30	US	Housing starts	Aug	'000	581.0	590.0	~
	13.30	US	Building permits	Aug	'000	564.0	~	~
	13.30	US	Initial jobless and continuing claims					
	15.00	US	Philadelphia Fed	Sep	Index	4.2	8.0	~
Fri 18 Sep	09.00	EZ	ECB current account	Jul	€bn	-5.3	~	~
	09.30	UK	Public sector net borrowing	Aug	£bn	8.0	18	~

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