

Business Weekly

Export incomes in the spotlight



This Week

The Reserve Bank can be very confident in the NZ economic recovery as we head into the June Monetary Policy Statement. The RBNZ has been upbeat on the commodity price outlook for some time now. Last week's payout forecast from Fonterra brought the stronger commodity outlook back into focus. Based off the 2010/11 forecast, dairy farmers' incomes are set to hit \$9.66 billion. Dairy has not been the only export sector to benefit from stronger commodity prices. Forestry prices have been improving off the back of recovering demand, particularly from the Asia-Pacific region. Meat prices are also improving (albeit muted by the weak pound and euro). In addition, other exporters have benefited from the low cross rate against the AUD over recent months and, more recently, the NZDUSD has fallen sharply to better levels for exporters.

Despite the improving outlook for export incomes and NZ employment growth, the market remains uncertain about the RBNZ's preparedness to increase the OCR in the current environment. The European sovereign debt crisis has seen confidence in the global recovery steadily deteriorate over the past month. The bail-out for troubled Eurozone governments is likely to be costly. Fiscal austerity measures and higher debt funding costs are expected to drag on the future economic performance of the Eurozone.

NZ is not directly affected by Europe's current troubles. There is no direct financial exposure to Europe and as a share of export income, the Eurozone is relatively low. However, NZ does remain vulnerable through other channels, particularly via credit markets. The question remains just how the RBNZ will weigh this potential impact versus the improving fundamentals for the local economy. Interestingly, the markets are looking at what happens in Canada this week as a guide. The Bank of Canada is widely expected to hike rates at its June 1 announcement. In the market's mind, if one central bank has the confidence to hike in this environment, it increases the chances the RBNZ will too.

In our view, the RBNZ will start the tightening cycle in June. Although events in Europe pose a large downside risk, a real impact on NZ is yet to be seen. Meanwhile at home, the inflation outlook is starting to get a bit uncomfortable. With an inflation set to spike to just under 6% the RBNZ does not want to get behind the curve. It is a bold assumption that inflation this strong will not affect pricing and wage setting behaviour. With 2-year ahead inflation expectations already close to the top half of the band at 2.8%, the RBNZ has little room to absorb upside surprises on the inflation front. Added to that, even once the tightening cycle begins short-term interest rates are likely to remain in stimulatory settings for at least another year.

Click here for:

[Foreign Exchange](#)

- NZD recoups some ground on the majors, but remains well off previous levels.

[Interest Rates](#)

- NZ short-term rates edge up as market sees in greater chance of June hike.

[Week Ahead](#)

- Light week for NZ data with just the wholesale trade survey due.

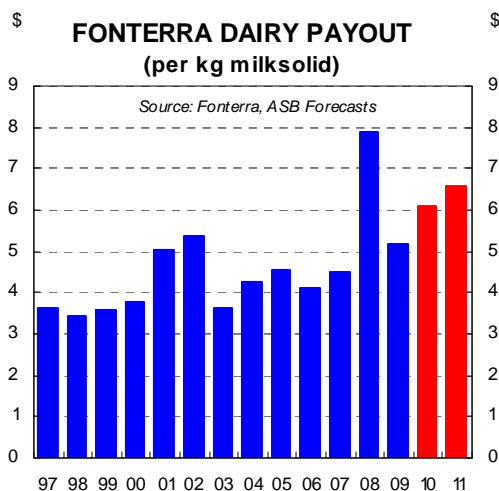
[Week in Review](#)

- Fonterra confident on outlook, inflation expectations creep up.

[Global Calendars](#)

- RBA and Bank of Canada rate announcements, US employment data.

Chart of the week



- Last week Fonterra delivered the first payout forecast for 2010/11 season. The milk price forecast of \$6.60 per kg milk solid was surprisingly strong, especially this early into the season.
- Fonterra is optimistic on the prospects for world dairy prices, flagging the potential for a record \$8 plus payout if prices were to hold at current levels.
- We are a bit more conservative in our forecast, with the potential for increased US production to lower prices over the next season. Being such a large producer, a small increase in US production can create a large increase in supply available to the export market.
- Nonetheless, the 2010/11 season is likely to be one of the strongest payouts in history and bring in around \$10 billion of dairy income.

General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.6771	0.6736	0.7250	0.7203	0.6276	FLAT	0.6650	0.6850
NZD/AUD	0.8017	0.8123	0.7792	0.7841	0.7956	FLAT	0.7950	0.8150
NZD/JPY	61.64	60.77	68.16	62.39	60.60	FLAT	60.00	64.00
NZD/EUR	0.5518	0.5386	0.5469	0.4780	0.4488	FLAT	0.5475	0.5575
NZD/GBP	0.4695	0.4652	0.4726	0.4343	0.3929	FLAT	0.4550	0.4750
TWI	65.8	65.3	67.6	63.9	59.8	FLAT	64.5	66.5

^Weekly support and resistance levels * Current is as at 1.00pm Monday; week ago as at Monday 5pm

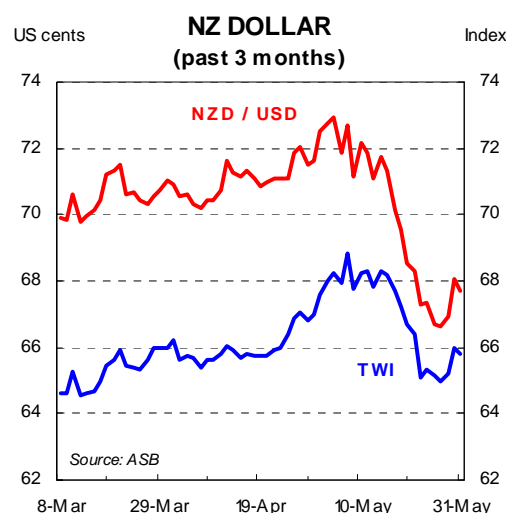
- The NZD reversed some of the previous week's moves, easing against the AUD and gaining on the other crosses. The NZD and AUD remain well down on the highs reached in April and May against the USD, EUR, and JPY. Risk aversion is weighing on both currencies.
- Public holidays in the US and UK will likely make the start of the week quiet in FX markets, but there is a lot for the market to digest over the remaining week. European concerns will remain in the spotlight, particularly after the Fitch Ratings credit downgrade for Spain over the weekend. European confidence surveys (released Monday night) will give markets a guide to how sentiment is holding up in the EU economies.
- A Bank of Canada interest rate decision and Non-farm Payrolls will provide a focus in North America on Tuesday and Friday nights. We expect the US economic data to continue to reflect improving economic conditions in the US. The all-important Non-farm Payrolls report should be strong in part because of a surge in census employment. Economists expect the unemployment rate to fall. Further signs that the US economy is outperforming the Eurozone economy should support the USD over the coming week.
- Across the Tasman a rate decision from the RBA and Q1 GDP both have the potential to move the AUD. Markets are widely expecting the RBA will leave interest rates on hold. However, pricing is still in favour of a June RBNZ rate hike. The prospect of a narrowing Australia-New Zealand interest rate differential could weigh on the AUD against the NZD over the coming week.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
Q1 Wholesale Trade Survey	4/6	10.45am	-

Potential currency movers from offshore this week: Euro business Climate Indicator (31st); EUR, CH Manufacturing PMI, US ISM manufacturing (2nd); Euro Retail Sales, US ADP employment (3rd); Euro GDP, US factory orders, Non-farm Payrolls (4th).

Speeches: Evans (1st), Lockhart (3rd), Bernanke, Rosengren, Hoenig, Fisher, Lockhart (4th).



Medium-term outlook: [\[Last Quarterly Economic Forecasts\]](#)

- The USD has firmed slightly earlier than we had previously anticipated. We expect the USD will continue to gain support. The US economic outlook continues to improve, with recent data demonstrating a broader-based expansion. 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. In addition, the AAA-rated US bond market remains the major alternative to the Eurozone government bond market.
- We have already revised down our EUR forecasts three times this year, and are revising down the outlook once again for the same reasons. 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.
- While we have revised down our NZD outlook slightly, we continue to see support coming from strong commodity prices and the looming RBNZ tightening cycle. 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 already made up quite a bit of ground. The NZD is likely to continue outperform the AUD as the RBNZ starts to lift rates, while the RBA remains on hold, narrowing the interest rate differential.

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	2.50	2.50	FLAT
90-day bank bill	2.99	2.88	2.73	2.80	2.75	FLAT
2-year swap	4.32	4.31	4.44	4.38	3.55	FLAT
5-year swap	5.20	5.22	5.32	5.50	5.05	FLAT
5-year benchmark gov't stock	4.87	4.93	5.26	5.31	4.58	FLAT
NZSX 50	3048	3061	3288	3123	2754	FLAT/DOWN

* Current is as at 1.00 pm 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. month ago).

- Global interest rates were volatile over the past week as concerns of European sovereign debt contagion remained the focus for markets. While interest rates declined in the first half of the week on emerging concerns that sovereign wealth funds were planning to diversify out of Euro-denominated assets, these moves were reversed later in the week as China's State Administration of Foreign Exchange (SAFE) indicated "Europe has been, and will be one of the major markets for investing China's exchange reserves".
- Australian interest rates largely moved in line with global interest rates. Markets are expecting the RBA to keep its cash rate at 4.50% on Tuesday, but there will be much interest in the accompanying statement to see how the RBA views recent developments in Euro zone.
- Domestic longer-term interest rates continued to take its cues from offshore, ending the week broadly unchanged. Meanwhile, short-term interest rates have edged up over the past week, reflecting the fact that markets are starting to price in a greater chance of an OCR increase in the June meeting.

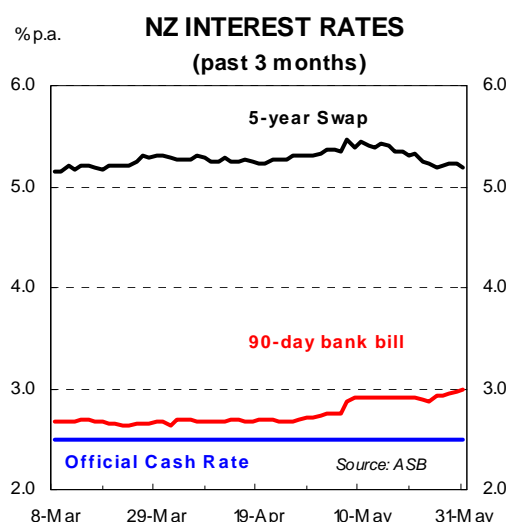
Short-term outlook:

Key data	Date	Time (NZST)	Market expects
RBA Rate Announcement	1/6	4.30 pm	4.5%
Q1 Wholesale Trade Survey	4/6	10.45am	-

Comment: Markets remain jittery on continued concerns about European debt contagion, with the latest downgrade of Spain's long-term rating to AA+ and news that reforms in the country are facing resistance weighing on market sentiment.

Offshore events will likely continue to dominate domestic markets. The release of Q1 wholesale trade survey at the end of the week will provide further insight into economic growth over the March quarter, ahead of the Q1 GDP data release on the 24th June.

Medium term outlook: [\[Last Quarterly Economic Forecasts\]](#)



- The RBNZ held the cash rate at 2.5% at the April OCR Review, and indicated monetary policy tightening will commence "over the coming months".
- The RBNZ left its near-term projection for the 90-day interest rate unchanged at the March MPS, but there was a downward revision in its medium-term 90-day track in recognition that current bank funding costs were likely to persist. This supports our expectation that OCR increases will be in 25 basis point increments over the tightening cycle this year. Furthermore, in a recent speech Governor Bollard validated the current market pricing, which assumed a similar profile for rate hikes.
- Inflation in the here and now has remained subdued, allowing the RBNZ some breathing room to assess recent trends. However, we expect inflation to lift to almost 6% over the next year, with a host of upcoming administrative inflation (including GST) boosting headline CPI, and thus posing a risk to price and wage setting behaviour. This is particularly in light of the latest inflation expectations survey result shows medium-term expectations of CPI annual inflation ticking up to 2.8%.
- Activity data has been mixed. The external outlook remains upbeat, with commodity prices strengthening. However, retail sales have been surprisingly subdued and the RBNZ remains concerned about the weakness in business credit demand. Nonetheless, the unequivocal strength in Q1 employment data should alleviate the RBNZ concerns on the underlying strength in the domestic recovery.
- The RBNZ expects to begin removing monetary stimulus in "coming months" assuming the economy evolves as expected. We now expect the first rate hike in June, barring a substantial deterioration in liquidity triggered by the European sovereign debt crisis.

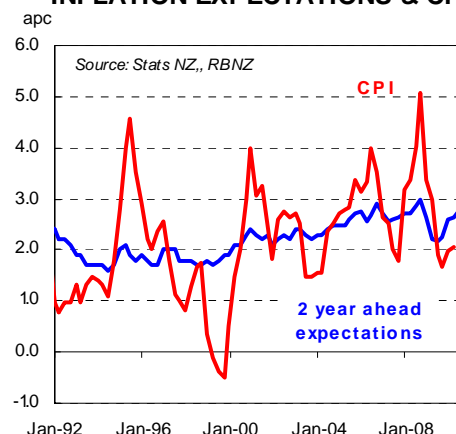
NZ Data Review: weekly recap

Q2 RBNZ Inflation Expectations

The RBNZ survey of 2-year ahead inflation expectations continued to tick up in the June quarter to 2.8% (2.7% previously). This measure often provides a useful indication of medium-term inflation pressures in the economy.

The June result is concerning in that it shows medium-term expectations approaching close to the top of the RBNZ's target band of 3%. However, it is perhaps not as strong as could be expected given the large amount of one-off factors which will boost headline inflation over the coming year and thus pose upside risks to wage and price setting behaviour. The result suggests inflation risks are stable for now, albeit concerningly high, and confirms that the RBNZ has little room to absorb any upside surprises.

INFLATION EXPECTATIONS & CPI



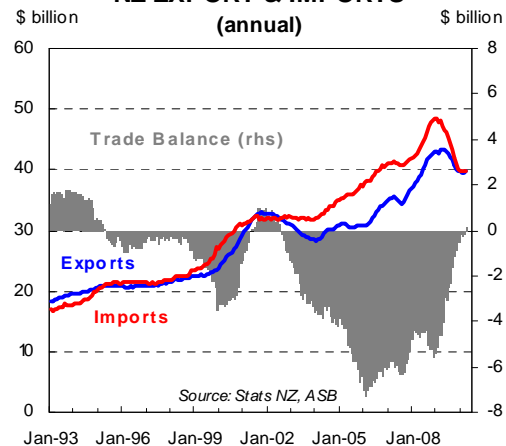
April Merchandise Trade Balance

The merchandise trade balance was stronger than expected, with a surplus of \$656 million compared to \$450 million expected by both us and the market. The stronger result pushed the annual trade balance into surplus for the first time since July 2002. Relative to our own forecasts, the surprise was entirely on the export side. Dairy exports remained robust, up 28.9% on year-ago levels, largely benefiting from continued recovery in prices. Fonterra indicated it was relatively optimistic on the outlook for dairy prices going forward. However, there are some uncertainties ahead, particularly the potential for increased production from the US over the next 6 months.

Imports were relatively subdued in April. Nonetheless, the trend is continuing to improve in line with the recovery in the NZ economy.

In contrast to 2009, where the improving trade balance was a result of weaker imports and the weaker economy, the current strength comes from improving export returns. Commodity prices have recovered a long way over the past year, and will help to support the economic recovery through stronger export incomes.

NZ EXPORT & IMPORTS

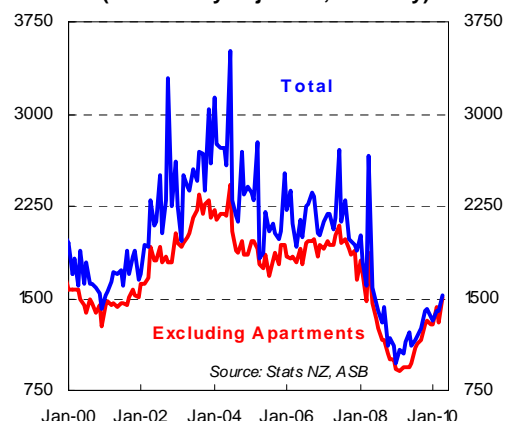


April Building Consents

Dwelling consent issuance picked up 8.5% over April, led by a 15.5% increase in core consent issuance (i.e. excluding the volatile apartment component). The surge in April follows a relatively disappointing March. Overall, building demand appears to be picking up, albeit gradually. The subdued recovery over the early part of the year could have been due to the uncertainty around the property outlook ahead of the May 2010 Budget. With the Budget details now revealed, it is possible that the recovery in consent issuance could gather more momentum from June. Adding to that, the prospect of higher GST after October may prompt some to bring forward construction plans.

Non-residential consent issuance remained subdued with year to date issuance now around 10.5% lower than that of the previous year. This is in line with the weak commercial building intentions seen in business surveys in recent months. That said, there was a rebound in the number of consents issued for the construction of shops, restaurants and taverns category as well as the factories and industrial buildings category. This suggests tentative signs of a recovery in non-residential investment by businesses.

NZ DWELLINGS CONSENTED
(seasonally adjusted, monthly)

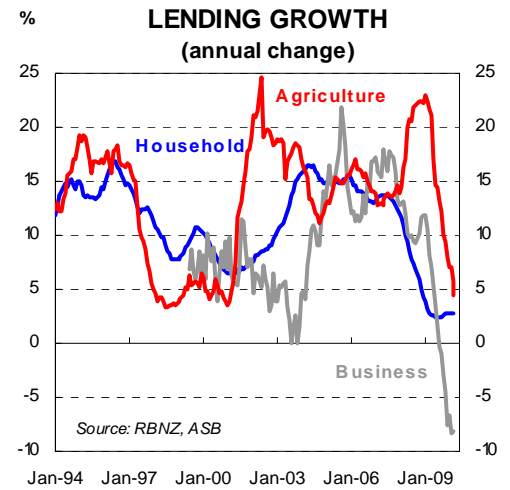


April RBNZ Credit Aggregates

Household credit growth continues to recover at a very slow pace, rising 0.2% in April to be up 3.1% on year-ago levels. While the result is far from strong, it does show some stabilisation in conditions such that we remain comfortable with our expectations of a recovery in household spending later this year.

Agricultural lending growth continues to decelerate, easing to 4.5% annual growth compared to 5.7% in March. We expect lending growth in this area to remain subdued, although the recent improvement in commodity prices may provide some support for credit demand.

Business credit remains very weak, down 8.2% on year-ago levels. This reflects continued caution amongst businesses. The RBNZ has continued to highlight its concern at the weakness in demand for business credit, and its desire to see "a return to moderate business credit growth over the coming year to support a gradual recovery in business investment activity". Credit growth will likely be a key influence on the pace with which the RBNZ raises the OCR over the coming year.



Global Data Calendars

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

Calendar - Australasia, Japan and China

Date	Time		Econ Event	Period	Unit	Forecast		
	NZT					Last	Market	ASB/CBA
Mon 31 May	11.50	JP	Industrial production	Apr	m%ch	1.2	~	~
					y%ch	31.8	~	~
	13.00	AU	HIA new home sales	Apr	m%ch	0.9	~	~
	13.00	AU	TD securities inflation	May	m%ch	0.41	~	~
					y%ch	2.9	~	~
	13.30	AU	Private sector credit	Apr	m%ch	0.5	~	0.4
					y%ch	2.1	~	2.3
	13.30	AU	Current account balance	QI	A\$m	-17,459	~	-15,800
	13.30	AU	Net exports contribution to GDP	QI	ppt	-1.3	~	0.0
	13.30	AU	Company operating profit	QI	q%ch	2.2	~	1.0
	13.30	AU	Inventories	QI	q%ch	0.2	~	0.4
	15.00	NZ	NBNZ business confidence	May	Index	49.5	~	~
	17.00	JP	Housing starts	Apr	y%ch	-2.4	~	~
	17.00	JP	Construction orders	Apr	y%ch	42.3	~	~
Tue 1 Jun	11.30	AU	Ai Group PMI	May	Index	59.8	~	~
	13.00	CH	PMI manufacturing	May	Index	55.7	53.5	~
	13.30	AU	Retail sales	Apr	m%ch	0.3	~	0.3
					y%ch	1.2	~	1.0
	13.30	AU	Building approvals	Apr	m%ch	15.3	~	-4.0
					y%ch	51.6	~	35.2
	14.30	CH	HSBC manufacturing PMI	May	Index	55.4	~	~
16.30	AU	RBA cash target	Jun	%	4.5	4.5	4.5	
Wed 2 Jun	13.30	AU	GDP	QI	q%ch	0.9	~	0.7
					y%ch	2.7	~	2.6
Thu 3 Jun	11.30	AU	CBA/Ai Group PSI	May	Index	52.3	~	~
	11.50	JP	Capital spending	QI	q%ch	-17.3	~	~
	13.30	AU	Trade balance	Apr	A\$m	-2,082	~	-500

Calendar – North America & Europe

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

Date	UK			Period	Unit	Last	Forecast	
	Time	Econ	Event				Market	CBA
Mon 31 May	10.00	EZ	Confidence Indicators	May	Index	~	~	~
	10.00	EZ	CPI estimate	May	y%ch	1.5	~	~
	13.00	CA	GDP (annualised)	Q1	q%ch	5.0	5.8	~
Tue 1 Jun	08.55	GE	Unemployment rate	May	%	7.8	~	~
	08.55	GE	PMI manufacturing	May	Index	58.3	~	~
	08.55	GE	PMI services	May	Index	53.7	~	~
	09.00	EZ	PMI manufacturing	May	Index	55.9	~	~
	09.00	EZ	Unemployment rate	Apr	%	10.0	~	~
	09.30	UK	PMI manufacturing	May	Index	58.0	~	~
	14.00	CA	Bank of Canada rate	Jun	%	0.25	0.50	0.25
	15.00	US	ISM manufacturing	May	Index	60.4	59.5	~
	15.00	US	ISM prices paid	May	Index	78.0	74.0	~
	15.00	US	Construction spending	Apr	m%ch	0.2	0.0	~
Wed 2 Jun	09.30	UK	PMI construction	May	Index	58.2	~	~
	15.00	US	Pending home sales	May	m%ch	5.3	3.6	~
Thu 3 Jun	09.00	EZ	PMIs	May	Index	~	~	~
	09.30	UK	PMI services	May	Index	55.3	~	~
	10.00	EZ	Retail sales	Apr	m%ch	0.0	~	~
	13.15	US	ADP employment change	May	'000	32.0	60.0	~
	13.30	US	Nonfarm productivity	Q1	%	3.6	3.8	~
	15.00	US	Factory orders	Apr	m%ch	1.1	1.0	~
Fri 4 Jun	15.00	US	ISM non-manufacturing composite	May	Index	55.4	56.0	~
	10.00	EZ	GDP	Q1	q%ch	0.2	~	~
	12.00	CA	Unemployment rate	May	%	8.1	8.0	~
	12.00	CA	Building permits	Apr	m%ch	12.2	-1.5	~
	12.00	CA	Ivey purchasing managers index	May	Index	58.7	59.5	~
	13.30	US	Change in nonfarm payrolls	May	'000	290.0	500.0	~
	13.30	US	Unemployment rate	May	%	9.9	9.8	~

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