WeeklyCommentary

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A **weekly outlook** for New Zealand, Australia and US markets

20 July 2009

The other 'R' word

Last week saw an increased focus among officials on the prospects for recovery in New Zealand, and the accompanying risks.

In a speech on Tuesday, RBNZ Governor Bollard said there are early signs that the global economy is starting to recover, and noted that New Zealand could recover more rapidly than many of our major trading partners. As detailed in our latest quarterly *Economic Overview*, also published last week, we share this assessment. The prospects of a more rapid exit from recession in New Zealand reflect the fact that the initial drivers of the recovery are likely to be home-grown – in particular, surging population growth and residential construction.

However, Dr Bollard noted that the recovery could displace another important factor for the economy: rebalancing. The recession has seen a dramatic slowing in the rate of growth of household debt, and an increase in precautionary saving. But the RBNZ sees a risk that as the economy recovers, households could return to their previous borrowing and spending patterns, perhaps spurred on by rising house prices. While this isn't a new concern – it was proposed as an 'alternative' scenario in the June Monetary Policy Statement – the amount of attention it has garnered in recent weeks suggests that the 'alternative' is becoming more of a 'central' view.

These concerns about a return to unbalanced growth were echoed to varying degrees last week by Prime Minister Key, Finance Minister English, and – less encouragingly – by ratings agency Fitch, who surprised the market by placing New Zealand's long-term credit rating of AA+ on negative outlook. Fitch's assessment went a step further, noting the risk that overseas investors could demand higher returns in order to keep lending to New Zealand, leaving the country in a trap of high interest costs and low growth potential.

As we've said before, this is a risk that should be taken seriously. But there's an unspoken assumption here: that households will have the incentive to resume borrowing and bidding up house prices as the economy recovers. And in our research on the housing market, we've shown that by far the most important determinant of changes in house prices is interest rates.

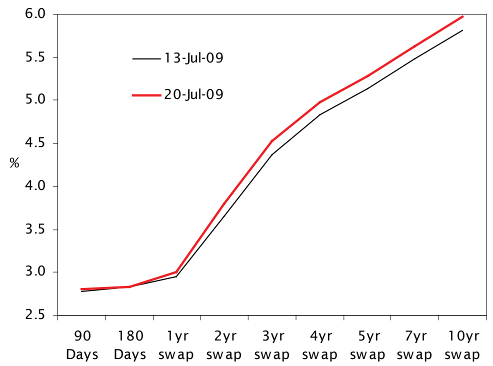
So if the RBNZ is genuinely concerned about a resurgence in the housing market, shouldn't they be raising interest rates in response? Unfortunately, this would have little bearing on the balance of economic growth – OCR hikes will impact all of the productive sectors of the economy through higher borrowing rates, and possibly a rise in the exchange rate. While interest rates will inevitably need to be returned to more neutral levels, the RBNZ will be reluctant to do so while the economic recovery is still fragile.

Dr Bollard's speech suggests that the RBNZ will be more inclined to use prudential tools – such as its recently-introduced policy on liquid asset and core funding requirements for banks – to moderate the next housing cycle. While this could play an important role in the supply of loans, it doesn't address the underlying question of demand. In the absence of some voluntary changes in household behaviour, it seems that the price mechanism – that is, higher interest rates – will still need to play a major role.

The RBNZ's willingness to keep interest rates low can also be tied to the fact that the outlook for inflation – their mandated goal – remains subdued. Annual inflation fell from 3.0% to 1.9% in June, a whisker from the mid-point of the RBNZ's 1-3% target band. There were clear signs that the drawn-out recession has kept domestically generated inflation in check, with non-tradable, general services and housing-related inflation all easing on an annual basis.

The closely watched non-tradables component posted a modest 0.5% increase, bringing annual inflation down from 3.8% to 3.3%, the lowest rate since

NZ Interest Rates



**Yield curve is yields on bank bills to 180 days, fixed interest rate swaps for 1year onwards.*

June 2002. Weakness was widespread within the housing group (rents 0.3%, home ownership 0.2%, property maintenance 0.4%, property rates –0.2%). The exception was household energy (mainly electricity), up 1.6%.

Tradable prices were decidedly perkier, rising 0.8%. There were stronger-than-expected price increases in clothing, footwear, household contents and motor vehicles – a stark reminder of the cost to consumers of a weaker currency through 2008 and early 2009. Food prices also rose sharply, up 0.9% for the quarter, as growing conditions were affected by the extreme cold weather in May and June. Against this, tradable inflation was significantly dampened by a large 14.4% drop in international airfares and the flow-on effect to the price of package holidays, which fell by 17.3%.

We think annual inflation is likely to print close to the bottom of the RBNZ's target band next quarter, at around 1%. But for monetary policy it is the medium term inflation outlook that matters more. The outlook over the coming 18 months looks benign – domestic inflation is expected to continue easing as a result of the extended recession, and tradable inflation will be dampened by the stronger NZD in recent months.

The data calendar this week is light, aside from net migration figures on Tuesday. The market tends to give this data less recognition than it deserves – as we detailed in our latest *Economic Overview*, migration can be an important swing factor for the New Zealand economy. We expect the annual net inflow to reach 25,000 or more by year-end – slightly less than in previous migration cycles, but a major part of the expected home-grown recovery.

Fixed vs. floating: With the RBNZ nearing the end of its easing cycle, short-term rates are unlikely to fall significantly further, while long-term rates will continue to anticipate the next tightening cycle. For those borrowers currently on floating rates who have been looking to time their re-entry into fixed rates, we recommend fixing now for six months to one year, which are easily the most favourable rates on offer.

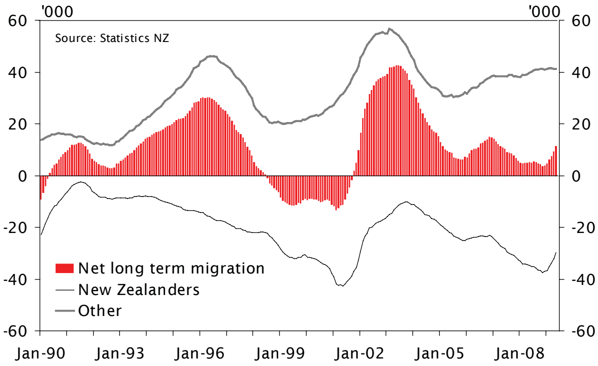
Key Data Previews

NZ Jun external migration ann.

Jul 21, Last: 11,200, WBC f/c: 13,000

- Net migration is surging, driven by fewer New Zealanders leaving and more coming home. In 2008 net migration was just above 3,000 for the year. Now net migration is running at closer to 3,000 people per month.
- We expect June seasonally adjusted monthly net migration of 3,300, stronger than May's 2,700. This would take annual net migration to 13,000. Annual net migration is heading for 25,000+ by year-end. The surge of people will be a huge swing factor for the economy, and has already contributed to a housing market turnaround. The RBNZ has become more hawkish on the back of this data, so markets should watch closely.
- Weekly data point to a large negative month for visitor arrivals, possibly -5% to -10% m/m. Possible swine flu impact?

Net migration

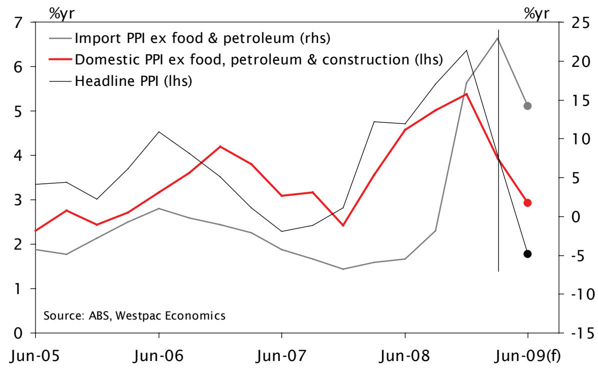


Aus Q2 PPI

Jul 20, Last: –0.4%, WBC f/c: –1.2%, Mkt f/c: –0.2%, Range: –1.5% to 1.0%

- The Q1 PPI was –0.4%qtr, 4.0%yr. Non-core items subtracted 0.38ppts from the qtrly rate with food –0.9% & petroleum –9.0%. Core import prices rose 4.8% with latent pressures from AUD weakness in Q4, but the overall core PPI held flat (weakest since 2003Q4) with a fall in building construction (–1.6%) & the domestic core ex-construction and utilities –0.3%qtr (weakest since began this subset in 2002) & 3.0%yr.
- The core PPI is f/c to be weaker still in Q2, with a strong AUD cutting core import prices (f/c –8.5%), although firmer outcomes are expected in building construction (f/c flat) & the domestic core ex-construction & utilities (f/c flat), amidst improved demand. This gives –1.3% for the core PPI. Food prices are expected to fall another 0.9% but with petroleum up 3%, the total PPI is tempered to a 1.2%qtr fall. Still, this more than halves the annual rate to 1.8% (lowest since 2004Q1) from 4.0%.

PPI: qtrly domestic tame, core M weak (A$ up)

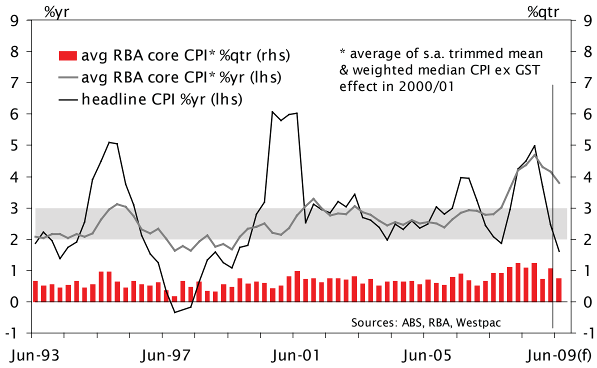


Aus Q2 CPI

Jul 22, Last: 0.1%, WBC f/c: 0.6%, Mkt f/c: 0.5%, Range: 0.1% to 0.8%

- While our Q2 headline CPI forecast is higher than Q1, it cuts the annual rate to 1.6% (lowest since 1999Q2). Drivers of the higher quarterly pace include seasonal rises in items from New Year sales levels, but less than usual with June discounting & talk of 'savaged' margins. This applies to clothing, household & recreational goods. Stronger demand should see firmer house purchase costs (forecast 0.7%) after a surprise –0.5% prev, & transportation (forecast 1.6% vs –1.5% prev) will be pressured by petrol (+4% vs –8.1% prev). After their shock –14.1% fall in Q1, deposit & loan facilities are forecast to revert to –1.6%, more in line with movements in interest rate margins.
- Our avg RBA underlying CPI f/c is 0.7%qtr, 3.8%yr (vs 1.1%qtr, 4.2%yr prev), the lowest annual rate since 2007Q4. The lower quarterly pace is largely courtesy of June dept store discounting and lower import prices. Base effects should drive the annual core rate sharply lower in Q3 (+1.2%qtr drops out from last year).

Inflation: annual headline & core CPI falling

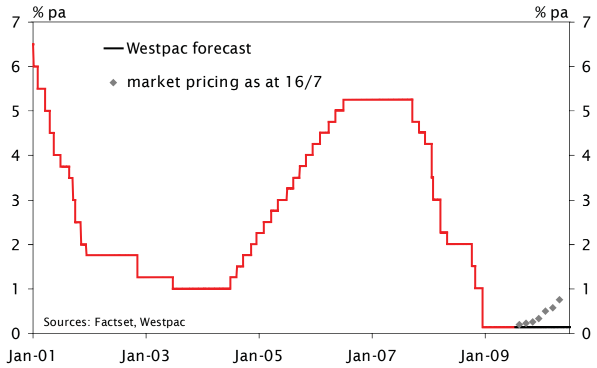


US Fed monetary policy report and Bernanke testimony

Jul 21

- The mood in markets, banking and the economy has improved considerably since Chairman Bernanke delivered his previous his semi-annual testimony on February 24. The economy was in meltdown, and "overall, the downside risks probably outweigh those on the upside", though he expressed the view that if the wide range of measures taken by the Fed, Congress and Administration succeeded in restoring financial stability, "and only if that is the case, there is a reasonable prospect the current recession will end in 2009 and 2010 will be a year of recovery".
- Five months later, things seem to be on track. The June 24 FOMC meeting minutes revealed the Fed's upward revised central tendency forecasts, so focus will be on Bernanke's colouring of the risks, and also on any further communication/transparency changes he might announce.

Fed funds target rate

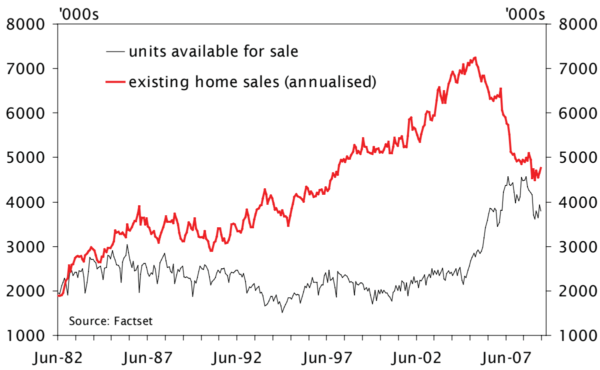


US June existing home sales to post further gain

Jul 23, Last: 2.4%, WBC f/c: 2.0%, Mkt f/c: 1.3%

- Most housing indicators point to activity in the sector bottoming out at very weak levels. Existing home sales have see-sawed within a tight 4.5-5.0mn annualised range since October last year, about 35% below their 7.25mn peak in 2005; new home sales have also levelled off since the start of this year, about 75% below their 2005 peak.
- Pending sales of existing homes rose 13% in the four months to May, way stronger than the recent profile for finalised existing home sales, up 6% since the start of this year. Sharply lower prices, distressed sales of foreclosed homes and (temporarily) lower mortgage rates have all boosted sales, and June should see the existing sales report 'catch up' somewhat to pending sales, which purport to measure essentially the same thing, albeit at different stages of the sale process. There is upside risk around our 2% forecast gain.

US existing housing sales

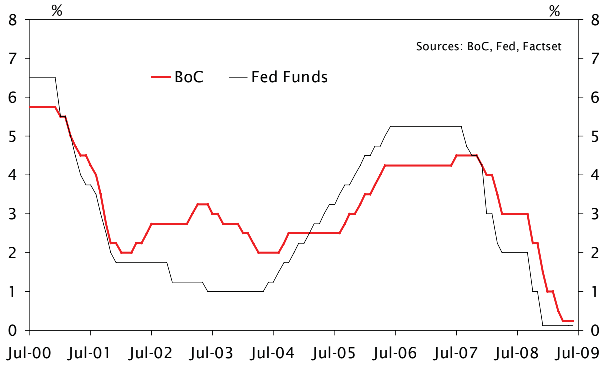


Bank of Canada rate decision

Jul 21, Last: 0.25%, WBC f/c: 0.25%, Mkt f/c: 0.25%

- In April, the BoC committed to hold rates steady at 0.25% till mid 2010, conditional on the outlook for inflation. At the early June window, the BoC reiterated that conditional commitment. Despite strong hints about a quantitative easing program back in March, BoC officials have since suggested that there is less need for QE than in other economies, and the latest credit conditions survey showed a marked improvement.
- Canadian data have revealed a considerably less weak economy thus far in 2009 relative to late 2008 (including jobs, housing, retail and business surveys). The rapid appreciation of the Canadian dollar up until early June has unwound some since then, helping ease the BoC's concerns in that area.
- The July statement should contain nothing new. We expect the conditional commitment re low rates to be retained.

Bank of Canada



Key Data and Events

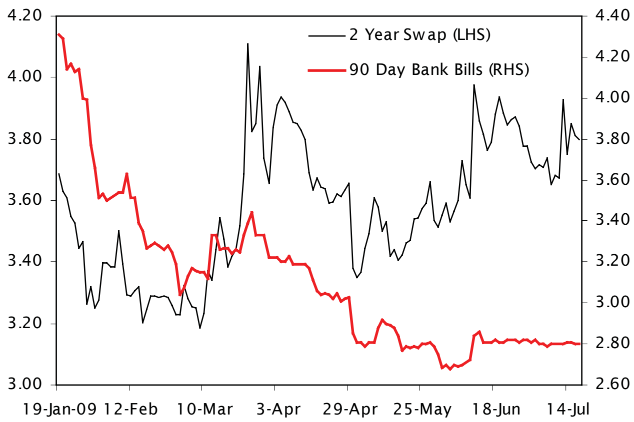
		Last	Market Median	Westpac Forecast	Comments
Mon 20 Jul					
Aus	Q2 Producer Price Index %qtr	-0.4%	-0.2%	-1.2%	Stable domestic core, weak M core (A$ up) = -1.3%qtr core PPI; fuel up.
US	Jun Leading Index	1.2%	0.5%	0.4%	Heading for strongest quarter of gains since at least 2004.
	Fedspeak	–	–	–	Lockhart on economic outlook.
Ger	Jun Producer Prices %yr	-3.6%	-4.1%	-4.8%	Base effects still hugely favourable, but not after July.
UK	Jul House Prices %yr	-5.5%	–	-3.5%	Rightmove index. Base effects will drive sharp gain in annual rate.
	Jun M4 Money Supply %yr	16.6%	14.6%	–	Still waiting for evidence in this indicator that QE is working.
Can	May Wholesale Sales	-0.6%	-2.1%	–	Has not posted a gain since Aug last year.
Tue 21 Jul					
NZ	Jun External Migration ann.	11,200	–	13,000	Strong migration is dragging NZ out of recession.
	Jun Credit Card Transactions	-0.4%	–	–	Highly volatile of late; expect flat billings in June.
Aus	Jul RBA Meeting Minutes	–	–	–	Adding colour to the more upbeat rhetoric in July's statement.
	Jun New Motor Vehicle Sales	5.4%	–	10.0%	Industry figs showed big jump on tax break boosted business spend.
US	Jun Chicago Fed National Activity Index	-2.30	–	–	Compiled from 80 previously released economic indicators.
	Fed Monetary Policy Report	–	–	–	Presented by Fed chair Bernanke during testimony to House panel.
Jpn	Bank of Japan Minutes (May)	–	–	–	Commentary should reflect the advanced nature of inventory cycle.
UK	Jun PSNCR £bn	18.8	20.2	–	The black hole that is UK public finances...
Can	BoC Rate Decision	0.25%	0.25%	0.25%	No new information expected; commitment to low rates reiterated.
Wed 22 Jul					
Aus	Q2 Headline CPI %qtr	0.1%	0.5%	0.6%	Seasonal rises after NY sales; petrol & housing up; lesser d&l facil. fall.
	Q2 Avg RBA Underlying CPI %qtr	1.1%	0.7%	0.7%	June discounting & lower M prices to temper seasonal rises; 3.8%yr.
	RBA Assistant Governor Debelle Speaking	–	–	–	On panel at a Mortgage Finance Industry Assoc forum (12.00pm AEST).
US	May House Prices	-0.1%	-0.2%	–	Lesser watched FHFA index.
Eur	May Industrial Orders	-1.0%	1.9%	2.5%	German orders jumped 4.4% in May.
UK	Jul BoE Minutes	–	–	–	Decision to wait until Aug for further QE decision probably unanimous.
	Jul Industrial Trends Survey	–	–	–	Expanded quarterly version of monthly survey.
Can	May Retail Sales	-0.8%	0.6%	0.5%	To be boosted by auto sales (known up 1%) and higher gasoline prices.
Thu 23 Jul					
Aus	RBA Assistant Governor Debelle Speaking	–	–	–	To Whitlam Institute Forum (5.00 pm AEST).
US	Initial Jobless Claims w/e 18/7	522k	560k	545k	Ongoing distortion from summer auto sector layoffs.
	Jun Existing Home Sales	2.4%	1.3%	2.0%	Boosted by distressed sale of foreclosed properties.
Jpn	Jun Trade Balance ¥bn sa	222	514	–	Current slim surplus should widen in trend terms from here.
Eur	May Current Account Balance €bn sa	-5.9	–	–	In deficit since March last year.
UK	Jun Retail Sales	-0.6%	0.3%	0.5%	Surveys point to June weather-related bounce.
	Jun Bank Mortgage Lending £bn	31.2	–	–	Guide to large chunk of the home lending market.
Can	BoC Monetary Policy Report	–	–	–	More detail underpinning Tuesday's rate decision.
Fri 24 Jul					
US	Jul UoM Consumer Sentiment (F)	64.6a	65.0	65.5	Upward revision as stocks improve, gasoline prices level off.
Eur	Jul PMI Factory Adv	42.6	43.5	43.0	Both these surveys are expect to show that the pace of contraction
	Jul PMI Services Adv	44.7	45.2	45.0	in the Euroland economy was moderating heading into Q3.
Ger	Jul IFO Business Climate Index	85.9	86.5	87.0	Current index still stalled, but expectations are on the rise.
UK	Q2 GDP Adv	-2.4%	-0.3%	-0.5%	Still contracting, but at a much slower pace.

New Zealand Economic and Financial Forecasts

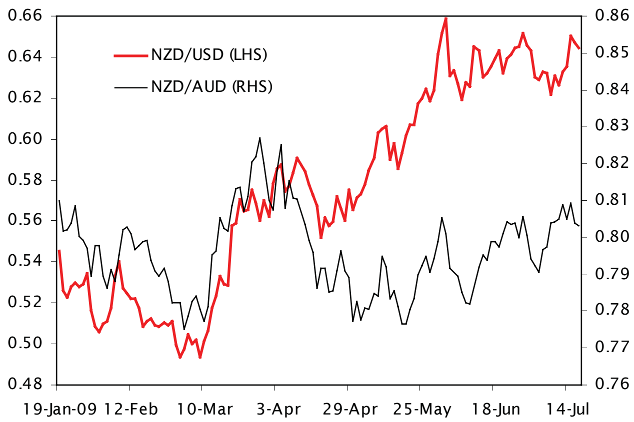
Economic Growth Forecasts		March years				Calendar years		
% change	2008	2009	2010f	2011f	2008	2009f	2010f	2011f
GDP (Production) ann avg	3.1	-1.0	-1.2	3.2	0.2	-2.1	2.6	3.6
Employment	-0.3	0.8	-1.5	1.6	0.9	-2.6	1.1	1.7
Unemployment Rate % s.a.	3.8	5.0	6.9	6.4	4.7	6.7	6.5	6.2
CPI	3.4	3.0	2.0	1.6	3.4	2.1	1.2	2.1
Current Account Balance % of GDP	-8.0	-8.5	-4.7	-5.7	-9.0	-4.9	-5.5	-6.5

Financial Forecasts	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Cash	2.50	2.50	2.50	2.50	3.00	4.00	5.00
90 Day bill	2.80	2.80	2.80	2.90	3.60	4.60	5.50
2 Year Swap	3.90	4.10	4.30	4.60	5.00	5.40	5.85
5 Year Swap	5.30	5.40	5.50	5.60	5.80	6.00	6.30
10 Year Bond	5.80	5.90	6.00	6.10	6.20	6.30	6.40
NZD/USD	0.60	0.59	0.62	0.65	0.68	0.70	0.71
NZD/AUD	0.79	0.80	0.81	0.81	0.83	0.84	0.85
NZD/JPY	55.2	53.1	57.7	62.4	67.3	72.1	75.3
NZD/EUR	0.43	0.43	0.45	0.46	0.47	0.48	0.48
NZD/GBP	0.38	0.37	0.38	0.38	0.39	0.39	0.38
TWI	57.4	56.8	59.0	61.3	63.6	65.6	66.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 20 July 2009

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.81%	2.82%	2.83%
60 Days	2.81%	2.79%	2.84%
90 Days	2.80%	2.80%	2.81%
2 Year Swap	3.80%	3.71%	3.94%
5 Year Swap	5.28%	5.23%	5.44%

NZ foreign currency midrates as at Monday 20 July 2009

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.6452	0.6328	0.6430
NZD/EUR	0.4572	0.4531	0.4612
NZD/GBP	0.3951	0.3892	0.3900
NZD/JPY	60.800	60.290	61.840
NZD/AUD	0.8039	0.7968	0.7973
TWI	60.710	59.940	60.770

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2004	2005	2006	2007	2008	2009f	2010f
Australia							
Real GDP % yr	3.8	2.8	2.9	4.0	2.3	–0.6	1.0
CPI inflation % annual	2.6	2.8	3.3	3.0	3.7	1.8	2.4
Unemployment %	5.4	5.1	4.8	4.4	4.3	6.2	7.9
Current Account % GDP	–6.1	–5.8	–5.3	–6.2	–4.3	–3.9	–5.7
United States							
Real GDP %yr	3.9	3.1	2.8	2.0	1.1	–3.1	1.4
Consumer Prices %yr	2.6	3.4	3.2	2.9	3.8	–1.0	1.0
Unemployment Rate %	5.5	5.1	4.6	4.6	5.8	9.5	11.2
Current Account %GDP	–5.7	–6.1	–6.0	–5.3	–4.9	–2.2	–1.9
Japan							
Real GDP %yr	2.3	1.9	2.8	2.2	–0.8	–6.8	1.4
Consumer Prices %yr	–0.1	–0.3	0.2	0.1	1.4	–1.1	–0.6
Unemployment Rate %	4.5	4.4	4.1	3.9	4.0	5.1	6.6
Current Account %GDP	3.3	3.6	3.9	4.8	3.2	2.4	2.5
Euroland							
Real GDP %yr	1.9	1.8	3.1	2.7	0.6	–4.9	–0.2
Consumer Prices %yr	2.1	2.5	2.0	3.1	1.6	0.3	0.7
Unemployment Rate %	9.0	8.8	7.9	7.3	7.8	10.0	11.5
Current Account %GDP	0.0	–0.2	–0.5	0.0	–0.2	0.0	0.4
United Kingdom							
Real GDP %yr	3.0	2.2	2.9	2.6	0.7	–4.6	0.3
Consumer Prices %yr	1.3	2.1	3.0	2.1	3.5	1.0	1.2
Unemployment Rate %	2.8	2.8	3.0	2.5	3.1	5.5	7.0
Current Account %GDP	–1.9	–2.6	–3.0	–2.8	–2.3	–6.0	–5.5

Forecasts finalised 10 July 2009

Interest Rate Forecasts	Latest (Jul 20)	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10
Australia						
Cash	3.00	3.00	3.00	3.00	3.00	3.00
90 Day Bill	3.11	3.20	3.20	3.20	3.20	3.30
10 Year Bond	5.45	5.50	5.20	5.50	5.60	5.75
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.64	3.50	3.25	3.75	4.25	4.75
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00

Exchange Rate Forecasts	Latest (Jul 20)	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10
AUD/USD	0.8026	0.76	0.74	0.77	0.80	0.82
USD/JPY	94.24	92	90	93	96	99
EUR/USD	1.4112	1.38	1.36	1.39	1.42	1.45
AUD/NZD	1.2440	1.27	1.25	1.24	1.23	1.21

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