9 February 2009

Hope versus Reality

- Housing market dynamics remain net negative
- Jan's ECT data will test spending hopes, Wednesday
- With Friday's December/Q4 retail likely mixed
- Thursday's PMI an area of vulnerability
- NZ CPI relief foiled by resurging fuel prices
- Will January's food prices be another frustration?

Here we go again, with the latest US fiscal package and credit market "remedies" seen as saving the world economy, this time. The real news, meanwhile, continues to highlight the economic and financial abyss from which the government policies will need to rescue things. It's a titanic battle of hope versus reality.

We do have to question the objectivity of folk, though, when monumental jobs losses, as were reported for the US over the weekend, are seen as positive (equities rose strongly), in that they were viewed as giving the green light to even grander policy responses.

The fact is the global economy is unwinding some massive imbalances – ones which were many years in the accumulation. There is only so much that public policies will be able to do to soften the blow. This is not a Hollywood blockbuster. There is no Bruce Willis in Bernanke and Geithner. And Arnie is no longer the Terminator, but now simply the Governor, of a bankrupt California. Reality can stink. But escapism makes it worse.

Don't get us wrong. We're all for meaningful stimulus packages, especially at such delicate junctures. However, it's never a good sign when all the focus is simply on the almighty dollar quantum. Robust debate about the composition and quality of the policy responses appears to have been thrown right out the window the world over. We trust New Zealand doesn't fall into the same trap.

In the meantime, the severity of the economic news should not be overlooked by blind hope. There will be no shortage of poorly international data, in our view. However, following last Thursday's Q4 labour market figures, there are not a lot of show-stopping NZ economic reports to hang our hats on over the near term. The next big one is probably the end-February NBNZ business survey, ahead of the Q4 GDP indicators over the first half of March.

So, for NZ markets, it will mainly be an exercise of reading the local tea leaves, but with the global trends having every potential of being foist upon us.

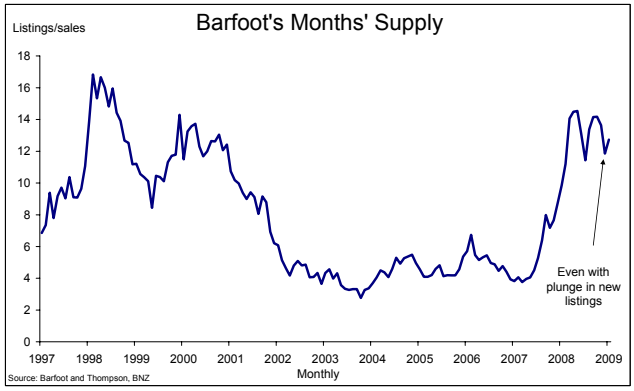
With this in mind, keep an eye on New Zealand's company reporting season, which kicks off in earnest this Thursday, with Fletcher Building. Telecom reports on Friday. While reported profits might well frame the underlying squeeze, the big question is how cash-flow is looking for the coming year. Not that good at all, in our view. Recent business surveys say the same. Shrinking profits are exactly why companies are restructuring, trimming staff and becoming more conservative around capital expenditure.

As for this week's economic reports there are a good number, which, while minor per se, could be important for the more general macro stories we're keeping a tab on.

Take the housing market. It will be very interesting to see how it performs over the coming three to six months, given the many positive and negative factors coming its way. On the plus side we have tumbling mortgage rates, 1 April tax cuts, the probability of rising immigration and the low NZ dollar making property look cheap to foreigners. However, we also have strong negatives in the form of a rapidly deteriorating labour market, dissipating wage inflation, a dairy-driven collapse in farming incomes and ongoing issues with NZ house price over-valuation.

We believe the negatives will continue to outweigh the positives – much like is still happening to date. January's QVNZ house price index, for example, fell 8.3% on an annual basis, extending the deceleration since it first went negative back in July. And, as QVNZ said, "The signs of a slight recovery in property values we saw at the end of 2008 have not continued into 2009, with the market dropping further."

This was certainly the impression we got from last week's Barfoot and Thompson real estate report for January. Auckland-centric sales languished at 515. This implied the flutter upwards we saw in December, which had us wondering whether a pick-up was at hand, was essentially quashed in January, on a seasonally adjusted basis.



The deeper sign of distress was that new listings continued to dry up. While this has limited the damage to the home selling market for the meantime, it simply creates the potential for a bigger flood of selling once owners see either signs of stabilisation, simply give up waiting, or cash out ahead of expected further house price falls.

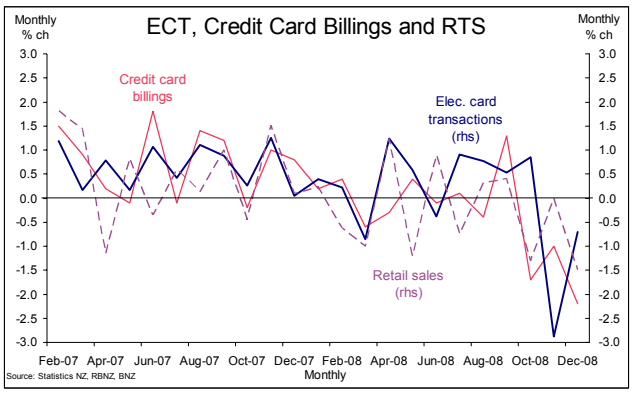
With this reserved tone for the Auckland housing market, we look forward to January's nationwide data from the Real Estate Institute. There is a good chance of seeing these before this week is out.

Wednesday delivers the Electronic Card Transactions for January (brought forward from its original released date of 19 February, as Statistics means to release sooner after month-end). While this series has been extremely difficult to read over recent months, any further negative results would be more meaningful, with any positive surprises likely to be flattered by the big rise in fuel prices during January.

We say this in the view that Friday's retail sales numbers will probably be mixed, albeit with negative undertones. We are looking for December's turnover to have fallen 1.5% overall (reflecting the last of the petrol price falls) and ex-auto to have slipped 0.3%. This would generate a 0.4% drop in Q4 volumes, with real ex-auto retail spending up just 0.1%. While such results would hardly be awful, they would extend the flat-to-negative trend we've seen for a good year now.

In any case, the other message we'd like to get across is that consumer spending, even the home selling market, are not the prime areas to be monitoring at the moment to get a steer on the economy. More so, anything to do with employment, capital expenditure, construction especially, and in particularly NZ-produced goods and services directly exposed to the international implosion seem the ones to watch most carefully.

For these reasons, Thursday's Performance of Manufacturing Index, surveyed during January, will be a litmus test. Surely it will struggle to recover any further from the 42.5 level it clambered up to in December – especially with the global PMI mired heavily in contraction territory, in the mid-30s.



But while we can imagine the economic data – both here and abroad – remains dreadful and concerning for the near term, we should also point out that the NZ CPI relief we see for New Zealand is now looking much less obvious.

To be sure, domestically-driven inflation will keep dissipating, in line with the cooling economy and labour market. However, the 27% resurgence we've seen in petrol prices over the last five weeks, and the broader upward pressure on local prices via the continuing drop in the currency, promises to curtail the degree of CPI deceleration we can expect over the near term.

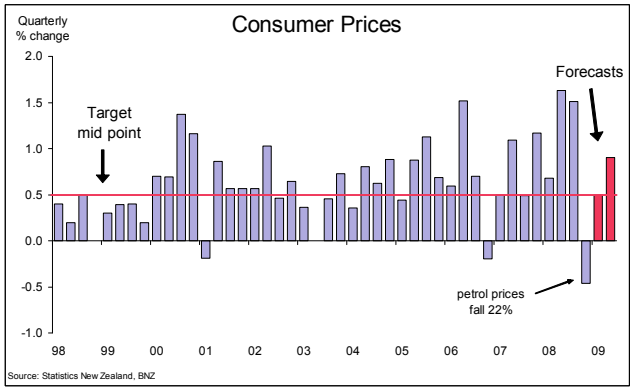
Specifically, we now estimate the Q1 CPI will advance 0.5%. This would still mean further moderation in annual CPI inflation compared to Q4's 3.4%, but to 3.2% rather than the 2.7% number we had in mind before this year's petrol hikes came roaring through.

The petrol price spikes to date also quarterly-average their way into the June quarter. This has bumped our Q2 CPI pick up to 0.9%, for 2.5% y/y. We now see a low of 1.5% y/y by September (previously 0.7%), but then a jump to 2.6% by December, as base effects wash out.

With this in mind, things such as the Food Price Index may well prove important at the margin. We're expecting Thursday's reading for January to increase 0.5%. We'll be particularly interested to see if the recent collapse in global commodity prices is wending its way into local prices, as it hasn't, discernibly, to date.

The potential stickiness in headline inflation is a reminder to keep an eye on all that should be important to any sober central bank, even though it's clear the alarming picture around the global economy and financial system are clearly dictating the NZ OCR path for the meantime, by the Reserve Bank's own admission.

Second marriages, as they say, are a triumph of hope over experience. To be sure, we're still hopeful, in the sense of New Zealand coming through this downturn with less damage, and with better growth prospects, than the great majority of countries can reasonably claim. But we're not so starry-eyed as to ignore the reality of us being wedded to a nasty international recession, and dysfunction financial system, which threatens all manner of trouble and strife.



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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates pulled away from their lows last week as rates followed those around the world higher. The biggest mover of the week was the Reserve Bank of Australia cutting by 100 basis points, a move that disappointed the market somewhat and lead to a significant sell off in Australian rates. The spread between New Zealand and Australian March bank bill futures, which peaked at over 200 basis points in early November, now sits at less than 10 points, suggesting that kiwi futures could well have further to sell off from here. Current market pricing has the OCR bottoming around 2.5% – we feel risks are to the upside with respect to market sentiment and a squeeze higher is quite possible.

The New Zealand bond market saw a significant sell off and steepening as the offers pushed the market higher. The bond tender saw very thin demand for the 2011 and 2013 maturity bonds available and sellers came to the forefront afterwards with bids few and far between. The back end of the market performed even worse, with 2017s following kiwi swaps, US 10yr notes and Australian 10yr bonds up in yield. Higher yields look likely in kiwi bonds from here, as a further correction seems necessary before we find stronger support for NZD bonds, especially considering the issuance calendar.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
30-Jan-09	3.66%	3.35%	4.32%	3.25%	4.48%	123
5-Feb-09	3.51%	3.45%	4.54%	3.39%	4.69%	123
Change (bps)	**-15**	**10**	**22**	**14**	**21**	**0**

The swaps market kept up the theme, selling off and steepening on the week. Borrowers looking to extend their hedging further out the curve helped to keep a bid tone to the back end of the curve while short end swaps followed the futures market in selling off. The risks do appear to be on the upside for the swaps market, but the market remains fairly thin with relatively small flows able to push the market significantly.

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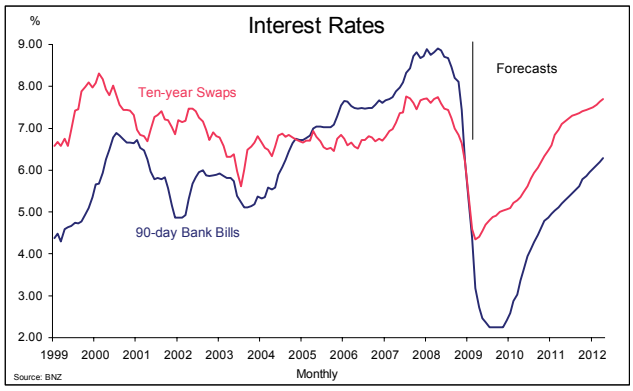

Interest Rate Technicals

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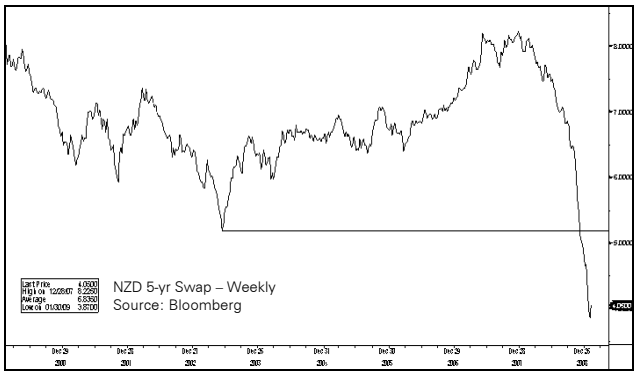
NZD 5yr Swap Rate

Outlook: Neutral
MT Resistance: 5.17%

The 5-year hit our previous target of 5.17% and has continued its freefall. Resistance is now the previous support of 5.17%, with support still nowhere to be seen!



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

Outlook: Neutral
MT Resistance: +60

The 2-5yr steepening has hit our earlier target of +60 and the steepening has continued. Resistance is now the previous support of +60.

Foreign Exchange Market

Reuters pg BNZWFWDS

After spending much of last week trading choppily within a 0.5000-0.5150 range, the NZD/USD surged dramatically on Friday night.

Friday night's US employment report was abysmal: non-farm payrolls fell 589,000 – the biggest drop since 1974 – and the unemployment rate rose to a 16 year high of 7.6%. However, instead of sparking panic about the health of the global economy, investors were heartened by hopes it would silence Republican criticism of Obama's proposed stimulus bill. Anticipation of swift approval of the US$800-900b stimulus package, combined with news the US Treasury was preparing to unveil a new plan to shore up confidence in the financial sector, bolstered risk appetite.

The S&P500 climbed 2.7% on Friday (and finished the week up 5.2%), which fuelled demand for risk sensitive currencies like NZD/JPY and a generalised bout of USD weakness. NZD climbed more than 5% against USD last week, from below 0.5000 to above 0.5350.

Locally, the economic news is still uninspiring. Quotable Value showed that NZ's house prices fell for seventh consecutive month to 8.3%y/y in January. This week's local data will likely reaffirm the problems afflicting the retail sector of late. Wednesday's Electronic Card Sales will provide the first hint at how household spending shaped up in January, while Friday's retail sales report should provide a more detailed picture on spending in the last quarter of 2008.

However, we suspect the performance of global equities and risk appetite will be the key to the fortunes of the NZD this week. While there are several corporate earning reports and some key US data towards the end of the week, the Senate's vote on Obama's stimulus bill and the unveiling of US Treasury's new bank bailout plan will likely overshadow everything else.

Over the weekend, various media reports suggested the stimulus bill is running against stiff opposition and unlikely to be passed until Tuesday. In addition, it looks like the US Treasury will not release details of the new bank bailout plan until after the bill is passed. As such, the delay and uncertainty surrounding the US stimulus measures may be cause for a bit of disappointment and help limit the topside in the very near-term.

Initial resistance is seen ahead of 0.5365, but a push up towards 0.5500-0.5550 is possible if the US stimulus measures and new bank bailout package helps restore investor confidence and produces a sustained rebound in global equities and risk appetite this week.

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Foreign Exchange Technicals

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NZD/USD

Outlook: Consolidation
ST Resistance: 0.5365 (ahead of 0.5500
ST Support: 0.5150 (ahead of 0.5020)

The repeated failure to break convincingly below 0.5000 suggests a period of consolidation is in order. A break above 0.5365 will open up the topside towards 0.5500.

NZD/AUD

Outlook: Buy a dip
ST Resistance: 0.8140 (ahead of 0.8190)
ST Support: 0.7810 (ahead of 0.7745)

The sharp reversal off 0.7750 suggests a consolidative bounce islikely. We'd view dips towards 0.7800 as a buying opportunity and look for a push back above 0.8100.

Key Upcoming Events

	Forecast	Median	Last
Monday 9 February			
Jpn, Machinery Orders, December		-8.6%	-16.2%
US, Treasury's Geithner Speaks, Fiscal Policies			
Tuesday 10 February			
Aus, NAB Business Survey, January			
Aus, Stevens Speaks, Financial System			
US, Wholesale Inventories, December		-0.7%	-0.6%
US, Bernanke Testifies, Lending Programmes			
US, Fed's Fisher Speaks, Financial Crisis			
Wednesday 11 February			
NZ, Electronic Card Transactions, January			-0.7%
Aus, Housing Finance, December	+9.0%	+4.0%	+1.3%
Aus, Consumer Sentiment - Wpac, February			89.9
UK, Average Earnings, December 3m y/y		+3.0%	+3.1%
UK, Unemployment rate (ILO), December		6.3%	6.1%
UK, BOE Inflation Report			
US, International Trade, December		-$36.0b	-$40.4b
US, Fed's Evans Speaks, Economic Outlook			

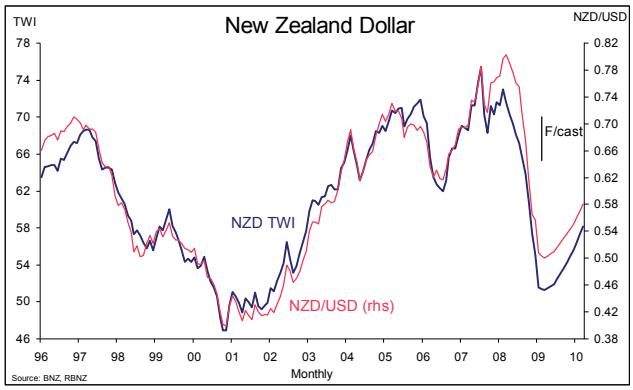
	Forecast	Median	Last
Thursday 12 February			
NZ, BNZ PMI (Manufacturing), January s.a.			42.5
NZ, Food Price Index, January	+0.5%		-0.2%
Aus, Employment, January	-25k	-15k	-1k
Aus, NAB Business Survey, Q4			
Aus, Unemployment Rate, January		4.7%	4.5%
Euro, ECB Monthly Bulletin			
Euro, Industrial Production, December		-2.5%	-1.6%
US, Business Inventories, December		-0.9%	-0.7%
US, Jobless Claims, week ended 07/02		610k	626k
US, Retail Sales, January		-0.8%	-2.7%
Friday 13 February			
NZ, Retail Trade, Q4 vol s.a.	-0.3%		-0.9%
NZ, Retail Trade, December	-1.5%		flat
Euro, GDP, Q4 1st est		-1.3%	-0.2%
Germ, GDP, Q4 1st est		-1.8%	-0.5%
US, Mich Cons Confidence, February 1st est		61.0	61.2

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	3.50	3.50	5.00	8.25
1 mth	3.96	3.90	5.18	8.59
2 mth	3.72	3.73	4.97	8.71
3 mth	3.54	3.46	4.61	8.77
6 mth	3.20	3.17	4.43	8.82
GOVERNMENT STOCK				
07/09	3.16	3.15	3.85	7.25
11/11	3.45	3.34	4.17	7.00
04/13	3.86	3.69	4.36	6.86
04/15	4.24	4.03	4.60	6.55
12/17	4.54	4.32	4.71	6.36
CORPORATE BONDS				
BNZ 09/09	3.82	3.76	4.95	8.88
BNZ 09/12	5.56	5.39	5.83	8.71
NZP 04/09	4.29	4.22	5.17	8.97
NZP 11/11	5.10	4.94	5.33	8.61
TRP 12/10	4.10	3.95	4.64	8.51
TRP 06/20	5.87	5.74	5.82	7.81
SWAP RATES				
2 years	3.45	3.25	4.25	8.53
3 years	3.75	3.54	4.46	8.33
5 years	4.12	3.87	4.65	8.05
10 years	4.76	4.48	4.99	7.62

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.5303	0.5066	0.5879	0.7871
NZD/AUD	0.7855	0.7980	0.8400	0.8772
NZD/JPY	48.68	45.60	52.98	84.45
NZD/EUR	0.4092	0.3965	0.4360	0.5419
NZD/GBP	0.3585	0.3500	0.3881	0.4043
NZD/CAD	0.6479	0.6220	0.6983	0.7875
TWI	53.15	51.55	57.59	72.71

NZD Outlook



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