5 March 2012

# Tightening Cycle Delayed Further

- RBNZ to delay tightening cycle further
- Strong currency and weak prices to blame
- But domestic growth indicators robust
- So tightening bias remains
- Q4 GDP indicators aplenty this week

There's quite a bit of domestic data due in the week ahead but, for financial markets, all this will be very much secondary to the release of the RBNZ's March Monetary Policy Statement on Thursday. It would come as a shot out of the blue if the Reserve Bank was to move its cash rate so the point of focus will be the Bank's forward track and the sentiments it expresses.

Like all of us, the Bank will be trapped between three scenarios of the world: the muddle through; the global disaster; and the possibility that the rebuild of Christchurch turns inflationary. The probabilities that the Bank attributes to each of these scenarios will delineate the interest rate track that it settles on.

But even if it was possible to be confident of a most likely outcome the surrounding risks mean that there is a multitude of ways that the Bank could approach its interest rate stance. At base level it would make sense to adopt the attitude that if you don't know what's happening change nothing. That's all well and good but even this opens up three options. Does do nothing mean keep with the interest track you had before because there is insufficient reason to change it; or does it mean go with market pricing because there is insufficient evidence to stand in the way of it; or does it mean publish a dead flat track on the basis that rates could yet go either way and why pretend otherwise. Any one of these options has a clear rationale.

Our view is that the best option would be to broadly maintain the track that was produced in the Bank's September MPS but given recent real and price developments that it would be pertinent to postpone the start of the tightening cycle to late this year or early next. Currently, our "official" forecasts have a September start, which is about a quarter later than the Bank's December MPS view. We are keen to push our own start point back to December 2012 or March 2013 but see no point in making the leap until we see the Bank's stance.

As an aside, it is worth noting than another factor to consider is that the current Governor will be relinquishing his position around October of this year. This may, at the margin, enter into the decision making process as Alan Bollard allows his successor the freedom to set the new course for the Bank.

Most of the comments the RBNZ made when it published its January OCR review still hold true:

- *Financial market sentiment has improved but the global economy remains fragile.* Indeed sentiment is probably better still and there have been some strong signs that the United States and Asia are on the improve. On the flipside, the possibility of a serious oil price shock has risen markedly.
- *"World prices for New Zealand's export commodities have remained elevated but the recent appreciation of the New Zealand dollar is reducing exporters' returns."* Still true on both fronts.
- *Funding costs are still elevated.* Though mortgage interest rates have dropped further and there is an increased likelihood that folk will fix rather than float reducing the leverage that the Reserve Bank will have when the cash rate does start to rise.
- *Modest growth in the domestic economy is still being observed as are delays to the Christchurch rebuild.*
- *Inflation pressures remain well contained.*

So it's all consistent with no change in the OCR.

Perhaps the better point of comparison is with the December MPS. Here there are some very strong differences and most point to the published delay in rate hikes that we anticipate.

Perhaps the key difference between the two is the strength in the NZD. RBNZ Forecasts are based on the TWI averaging 68.0 in the December quarter, 67.0 in March and then falling slowly from there. But right here and now the TWI sits at 73.5 – that's almost 10% higher than the Bank has assumed for this quarter. In the good old days that would have meant that the 90 day bank bill rate should be 500 basis points lower. Even if we go for a 10:1 ratio, 100 basis points is called for. Whichever way you look at it, the currency's appreciation must have a severely negative impact on the Bank's medium term inflation forecast.

Often we can overlook currency appreciation because it is accompanied by rising commodity prices. This was the case but is no longer so. Indeed, this is on the reasons why our fair value NZD model suggests the currency is overvalued at the moment. With this in mind don't be surprised if Alan Bollard, either in the MPS or in the post-match press conference, highlights the fact that he believes the currency is more expensive than it should be.

The other key development is that CPI inflation printed at -0.3% for Q4 2011 when the Bank had +0.4% pencilled in. Not only will this directly lower the Bank's annual inflation track for the next three quarters but it will also be helpful in driving inflation expectations lower which, in turn, may become self-fulfilling.

Rising oil prices may also be starting to worry the RBNZ. But increased fuel prices are always a double-edged sword. In the first instance, inflation rises but, provided inflation expectations are contained, the medium term impact on inflation is often down as the increase in oil erodes real disposable incomes and, hence, demand.

Overall, the above would recommend a dramatic lowering of the RBNZ's interest rate track. But they can't be seen simply in isolation. There are, after all, a whole pile of indicators out there that suggest the New Zealand economy remains on a fairly firm footing:

- The unemployment rate is falling and should fall further.
- Business and consumer confidence are consistent with grow well in excess of the RBNZ's forecasts. Indicative of this the BNZ Business Confidence reading, published this morning, rose to +27 from +13 in February. This was supportive of the recent increase in the National Bank business survey.
- There is growing evidence that the housing market is picking up a head of steam and there may be the first signs that folk are contemplating fixing, rather than floating, and thus reducing the leverage the Reserve Bank will have over borrowers. That said, this morning's Barfoot and Thomson data provided mixed messages. Latest Barfoot's data shows that house sales continue to trend higher. which is a positive leading indicator of prices and, eventually, building. House sales in February were 23% up on year earlier levels and 5.0% seasonally adjusted on the previous month. Sale prices, however, while still positive, were up only 2.7% on year earlier levels. Not enough to have anyone down at the RBNZ concerned. For the February quarter over the same quarter a year earlier the increase was a slightly more robust 4.6%. The stock of listings remains very low and was down 18.8% on year earlier levels. This can be interpreted in two ways: folk believe the market is too weak so are not listing implying that when the market picks up a flood of listings will keep prices constrained; or there are insufficient numbers of houses available for sale and when demand picks up there will be a strong price response. We think the former effect will outweigh the later but only to the extent that it will moderate house price appreciation rather than set off a further round of price declines.
- Construction activity should soon start to ramp up and we believe that this will be inflationary.

Given these positives it is hard to see how the Reserve Bank can't maintain a tightening bias despite the fact that it is likely to lower both its inflation and GDP track relative to its December MPS.

The MPS aside, there are also some interesting partial indicators that should help give us a steer on Q4 GDP. Today's Building Work Put in Place figures revealed that total construction activity rose 2.9%, residential was up 4.4% and non-residential 1.4%. This is consistent with our view that Q4 GDP prints at 0.7%. In fact, at the margin it may even suggest that 0.8% is in the offing.

On Wednesday we'll get Wholesale Trade data for Q4. For this to support our GDP view the data will have to be consistent with the wholesale sector (on a national accounts basis) growing 1.0% for the quarter. On Thursday the Economic Survey of Manufacturing comes out. Thanks largely to a drop in primary sector processing, we are looking for this sector to contract 0.8%.

Completing the real economy indicators for the week is Friday's Electronic Card Transactions data for February. We've pencilled in a 0.4% increase, which builds on the momentum already evident in retail spending.

On Tuesday we get the Crown Financial Statements for the seven months ended January. This will confirm the difficulty that the Government is having in getting to its desired surplus. And on Wednesday morning will be Fonterra's latest auction. We believe dairy prices will drift lower over 2012, there is some evidence of this already. Whether or not one would expect confirmation of this at this particular auction is a moot point.

This morning we saw the release of January migration data. This continues to be a negative for the economy in that more people are leaving than arriving. This not only implies lower demand in the economy but also has supply-side impacts as it reduces the pool of available labour. In the year to January 2012 there was a net loss of 3,100 people. This is the largest net loss since August 2001. We are assuming a net inflow develops over the medium term. If it does not this is a clear risk to our activity forecasts.

Net tourism numbers were also unhelpful. In the month of January inflows were up 0.5% on year earlier levels while outflows were up 9.7%. This is bad news for both the current account balance and GDP in Q1, 2012.

It is noteworthy that in a week when there are some significant domestic data releases there are a number of offshore events on the calendar that could have as much, if not a bigger, impact on domestic financial markets.

Offshore the big news items to keep an eye out for are:

- Friday's non-farm payrolls in the US. The recent drop in the unemployment rate is a positive development but it's been largely because the participation rate has fallen. We will be looking for confirmation that the fall is sustainable and that it's not just because folk have withdrawn from the labour market. The consensus is for a 203k increase in employment.
- On Tuesday the RBA is expected to keep its cash rate on hold. On Wednesday Q4 GDP is released and our colleagues in NAB are looking for a 1.1% increase in activity to be reported. Thursday sees employment data for February with NAB expectations of a 15k increase in jobs and the unemployment rate rising to 5.2%.
- The ECB and BOE do their thing on Thursday. It is expected that there will be no change in stance by either.
- And it's that week when all and sundry release their services indices.

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# Fixed Interest Market

Reuters pgs BNZL BNZM  Bloomberg pg BNZ BNZ

NZ swap yields have consolidated their recent gains, over the past couple of weeks. Swap yields closed almost unchanged last week, appearing to consolidate ahead of this week's RBNZ meeting. 2-year and 5-year yields have been range-bound around the 3.10% and 3.80% levels respectively.

The market continues to price 25bps of RBNZ rate hikes in the year ahead. This Thursday's RBNZ MPS will be dissected, and may act as a catalyst for the next leg up in swap yields. We expect the published 90-day bank bill track to push back the implied starting point of rate hikes, from the previously indicated September start. However, we still expect a clear and steady upward trajectory to be shown once hiking does start. Current swap curve pricing is consistent with a 4.00-4.25% peak in the OCR, as late as the end of 2015. We foresee a peak in the OCR at these levels, around the end of 2013. For this reason, we continue to see value in hedging interest rate risk over a 2 to 5-year time frame, even given the sharp run up in swap yields since the start of February. We have started to see some interest from businesses looking to lock in interest rate protection.

In terms of curve shape, we do not expect a sustained flattening trend until late 2012. For now the 2s-10s curve is quite stable around the 140bps level. We see near-term moves as favouring some curve steepening (to as much as 160bps). We see long-end yields shaking off the weight of stubbornly low global long yields (e.g US bond yields below 2.0%) and moving up ahead of the short-end. Later in the year we expect a flattening trend to become entrenched, as the short-end rises ahead of future OCR hikes. This will see the 2s-10s curve ultimately trough at below 100bps in 2013, in our view.

This week will also bring rate decisions from the RBA, ECB and Bank of England. The market prices 85% chance of the RBA remaining on hold at 4.25%. However, the market still prices a further 40bps of rate cuts in the year ahead, expectations we believe are too aggressive. The Bank of England and ECB are both expected to keep rates on hold at 0.50% and 1.0% respectively. Both central banks have moved to methods other than interest rates to stimulate the economy (Quantitative Easing for the BoE and the LTRO for the ECB).

The yield on NZGB21s finished the week at 4.17%, the highest level since mid-Nov. NZ-US 10-year bond yield spreads are revisiting 220bps, their high point since November. We expect US yields to continue to languish around the 2.0% level, given purchases of US Treasuries by the US Federal Reserve. However, we expect NZ 10-year yields will break loose, ultimately trading 260bps above US equivalents by year end. NZ-AU 10-year bond spreads sit at 5bps, comfortably in the middle of their -10bps to 15bps trading range.

| Date | 90 day bills | 04/13 NZGS | 05/21 NZGS | 2yr swaps s/a | 10yr swaps s/a | 2yr/10yr swaps(bps) |
|---|---|---|---|---|---|---|
| 24-Feb-12 | 2.76% | 2.62% | 4.14% | 3.09% | 4.50% | 141 |
| 2-Mar-12 | 2.75% | 2.66% | 4.17% | 3.10% | 4.50% | 141 |
| **Change (bps)** | **-1** | **4** | **3** | **1** | **0** | **-1** |

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## Key Fixed Interest Views

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| Category | | 5-Mar-12 | Tactical (1mth) | Strategic (12mth) | Comments |
|---|---|---|---|---|---|
| **NZ Money Markets** | **OCR** | **2.50%** | → | ↑ | RBNZ to begin rate hikes some time from Q3 2012, from historic low of 2.50% |
| **NZ Swap Yields** | **2-year** | **3.10%** | ↑ | ↑ | Yields are consolidating recent gains -Thursday's RBNZ MPS may be catalyst to next leg up |
| | **5-year** | **3.80%** | ↑ | ↑ | Pay-side interest is returning |
| | **10-year** | **4.50%** | ↑ | ↑ | Low global "safe haven" yields is becoming less of a constraint on NZ long yields |
| **NZ Swap Curve** | **2s-10s** | **140bps** | → | ↓ | Some consolidation expected near-term. Flattening trend to ensue from late 2012 |
| **NZ Bond Yields** | **NZGB 21s** | **4.17%** | ↑ | ↑ | Yields are re-testing the top of their range relative to US long yields |
| **NZ Swap-Bond Spread** | **10-year** | **33bps** | → | ↑ | Swap-bond spreads to rise late in 2012 as curve flattens |
| **US Bond Yields** | **10-year** | **1.97%** | → | ↑ | Fed bond purchases keeping US yields range-bound in near-term, despite improving US data |
| **NZ-US Bond Spreads** | **10-year** | **219bps** | ↑ | ↑ | NZ-US bond spreads have broken higher - Peak around 260bps in H2 |
| **NZ-AU Bond Spread** | **10-year** | **5bps** | → | ↑ | Range-bound near-term between -10bps and 15bps. Rise to 50bps by end 2012 |
| **NZ Credit Spreads** | **Fin** | | ↓ | → | Likely to narrow in line with rally in AU banks |
| | **Non-Fin** | | → | → | Supply constrained, although outperformance in 2011 means limited peformance in 2012 |

# Foreign Exchange Market

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD finished last week on a softer note. Global equity markets dipped into the red on Friday night, commodity prices eased, and bond yields fell. The more cautious global sentiment saw the NZD/USD again get a case of the wobbles above 0.8400. Before long, the kiwi had slipped back towards the bottom end of its well established 0.8250-0.8430 range.

For this week, investors may take some time out from Europe/Greece watching to focus on the data (although there is the Greek PSI participation deadline on Friday to keep an eye on). Indeed, the week ahead is chock full of event risk. Given this, and the still uncertain global environment, there is a good chance we finally see market volatility begin to rise from current (unsustainably?) low levels.

Risk appetite has been supported of late by signs global growth is picking up. Forward indicators have been encouraging. Last week's solid global PMIs kept this theme broadly intact. We'll need to see more of the same from this week's data-feast to keep the 'risk' rally going. Any disappointing data in the US, Europe, and /or China would see the 'growth-sensitive' NZD suffer more than most given a) the speculative community are extremely long NZD, and b) the currency remains overvalued on the basis of fundamental relationships with interest rate differentials and commodity prices.

Tonight's European and US services PMIs should hold in at supportive levels. However, Friday's US non-farm payrolls data has more potential to be a game changer. Fed chairman Bernanke's acknowledgement last week of a better US labour market has seen USD sentiment begin to improve. A US jobs result on or above the +210k gain markets expect would see investors further reassess the chances of a third round of US money printing (quantitative easing). The risk is that upcoming US data continues to exceed Fed expectations, resulting in a steeper US yield curve and stronger USD.

In NZ, Thursday's RBNZ meeting will be the highlight (unchanged at 2.5% expected). Markets have been coming round to our view recently that the RBNZ will retain its tightening bias at Thursday's meeting. Still, just one 25bps hike is factored into market pricing. With NZ leading indicators looking relatively perky of late, there is some risk the RBNZ's published interest rate track surprises markets on the hawkish side. If this proves to be the case, expect some modest interest rate support for the NZD.

All up, we remain of the view the balance of risks are skewed in favour of a NZD/USD pullback in coming weeks. Not only have recent gains in risk appetite driven the NZD/USD well above 'fundamentals', but the speculative community is already heavily 'long' NZD. In fact, net NZD long positions amongst the speculative community are around the highest level since mid 2007. This means that, if we do see NZD sentiment begin to switch to the downside, a squaring of these speculative positions could exacerbate NZD selling. Technically speaking, a daily close below pivotal NZD/USD support at 0.8250 would suggest the uptrend is over.

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| Currency Pairs | Tactical (1mth) | Strategic (12mth) | Comments |
|---|---|---|---|
| NZD/USD | ↓ | →↑ | Some pull-back likely near-term, but solid domestic fundamentals mean dips will be limited this year |
| NZD/AUD | ↑ | ↑ | Short-term and long-term fundamentals point to a move higher |
| NZD/GBP | → | → | Growth and monetary policy outlook still favours the NZD over the GBP. |
| NZD/EUR | ↑ | → | NZ's relatively brighter fiscal and economic outlook favours the upside. |
| NZD/JPY | → | ↑ | Easing risk aversion and higher NZ rates will slowly become more supportive |
| NZ TWI | ↓ | →↑ | Strong domestic fundamentals relative to our major trading partners should see the TWI move higher |

# Technicals

**NZD/USD**

Outlook: Consolidation

ST Resistance: 0.8425 (ahead of 0.8545)

ST Support: 0.8250 (ahead of 0.8190)

The currency continues to trade a narrow sideways range inside 0.8250-0.8430. A daily close below 0.8250 is needed to sap positive momentum and establish a downtrend.


**NZD/AUD**

Outlook: Consolidation

ST Resistance: 0.7830 (ahead of 0.7945)

ST Support: 0.7715 (ahead of 0.7680)

The failure to sustain gains above 0.7820 has set the NZD/AUD up for a period of consolidation. The 0.7715 level looms as key downside support.

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**NZD 5-year Swap Rate**

Outlook: Neutral

MT Resistance: 4.16%

MT Support: 3.60%

Although we still see higher rates we wouldn't be surprised if we see a rally back towards our 3.60% support area. The 200-day moving average at 3.87% is a likely area, and if it is breached on a closing basis the move higher will continue. Otherwise use the rally towards 3.60%as an opportunity to pay.


**NZ 2-year - 5-year Swap Spread (yield curve)**

Outlook: Steeper

MT Resistance: +79

MT Support: +59

As anticipated, the break of the downward sloping trendline signalled the current move higher. We expect a move towards MT resistance at +79. Support now comes in at +59

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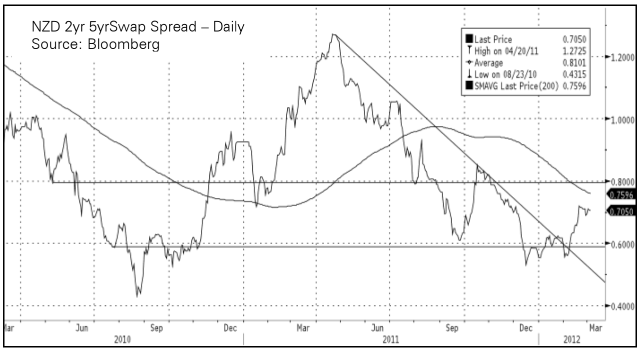


# Key Upcoming Events

| | Forecast | Median | Last |
|---|---|---|---|
| **Monday 5 March** | | | |
| NZ, Bldg Work Put In Place, Q4 vol s.a. | +1.0% | | -2.3% |
| NZ, External Migration, January s.a. | | | -520 |
| Aus, Services PMI (AiG), February | | | 51.9 |
| Euro, Retail Sales, January | | -0.1% | -0.4% |
| Euro, PMI Services, February 2nd est | | 49.4 | 49.4P |
| UK, CIPS Services, February | | 55.0 | 56.0 |
| US, ISM Non-Manuf, February | | 56.2 | 56.8 |
| US, Factory Orders, January | | -1.5% | +1.1% |
| **Tuesday 6 March** | | | |
| NZ, Crown Financial Statements, January | | | |
| Aus, Current Account, Q4 | | -$8.05b | -$5.64b |
| Aus, RBA Policy Announcement | 4.25% | 4.25% | 4.25% |
| Euro, GDP, Q4 2nd est | | -0.3% | -0.3%P |
| **Wednesday 7 March** | | | |
| NZ, Wholesale Trade, Q4 ($) s.a. | | | -2.2% |
| NZ, Fonterra Auction | | | -3.0% |
| Aus, Construction PMI (AiG), February | | | 39.8 |
| Aus, GDP, Q4 | | +0.7% | +1.0% |
| US, Productivity (non-farm), Q4 saar 2nd est | | +0.8% | +0.7%P |

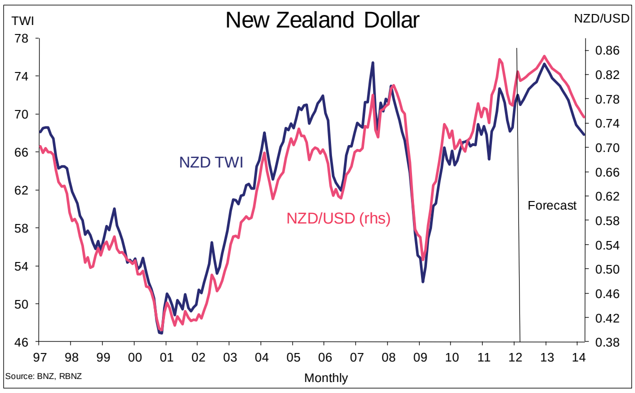
| | Forecast | Median | Last |
|---|---|---|---|
| **Thursday 8 March** | | | |
| NZ, Manufacturing Sales, Q4 vol s.a. | | | -1.4% |
| NZ, Monetary Policy Statement | 2.50% | 2.50% | 2.50% |
| Aus, Employment, February | | +5.0k | +46.3k |
| Aus, Unemployment Rate, February | | +5.2% | 5.1% |
| Jpn, Eco Watchers Survey (outlook), Feb | | | 47.1 |
| Euro, ECB Policy Announcement | 1.00% | 1.00% | 1.00% |
| UK, BOE Policy Announcement | 0.50% | 0.50% | 0.50% |
| Can, BOC Policy Announcement | | | 1.00% |
| **Friday 9 March** | | | |
| NZ, Electronic Card Transactions, Feb | +0.4% | | +1.0% |
| Aus, International Trade, January | | +$1.50b | +$1.71b |
| Aus, Building Approvals, January | | | -1.0% |
| China, PPI, February y/y | | 0.0% | +0.7% |
| China, CPI, February y/y | | +3.4% | +4.5% |
| China, Retail Sales, February y/y | | +17.3% | +18.1% |
| China, Industrial Production, February y/y | | | +12.8% |
| UK, Industrial Production, January | | +0.3% | +0.5% |
| US, Unemployment Rate, February | | 8.3% | 8.3% |
| US, Non-Farm Payrolls, February | | 210k | +243k |

# Historical Data

| | Today | Week Ago | Month Ago | Year Ago |
|---|---|---|---|---|
| **CASH & BANK BILLS** | | | | |
| Call | 2.50 | 2.50 | 2.50 | 3.00 |
| 1mth | 2.71 | 2.73 | 2.70 | 2.85 |
| 2mth | 2.72 | 2.72 | 2.71 | 2.82 |
| 3mth | 2.73 | 2.75 | 2.71 | 2.79 |
| 6mth | 2.75 | 2.73 | 2.71 | 2.86 |
| **GOVERNMENT STOCK** | | | | |
| 04/13 | 2.65 | 2.64 | 2.48 | 3.53 |
| 04/15 | 3.13 | 3.07 | 2.85 | 3.53 |
| 12/17 | 3.72 | 3.67 | 3.44 | 3.38 |
| 03/19 | 3.93 | 3.89 | 3.68 | 5.10 |
| 05/21 | 4.17 | 4.12 | 3.94 | 5.10 |
| 04/23 | 4.35 | 4.31 | 4.12 | 5.38 |
| **CORPORATE BONDS** | | | | |
| BNZ 05/13 | 3.93 | 3.73 | 3.78 | 4.53 |
| BNZ 09/16 | 5.51 | 5.24 | 5.32 | 6.10 |
| FON 04/14 | 4.25 | 3.87 | 4.00 | 5.05 |
| FON 03/16 | 4.88 | 4.51 | 4.55 | 5.75 |
| GEN 03/14 | 4.34 | 4.11 | 4.13 | 5.22 |
| GEN 03/16 | 5.11 | 4.85 | 4.83 | 5.96 |
| **SWAP RATES** | | | | |
| 2 years | 3.10 | 3.09 | 2.83 | 3.35 |
| 3 years | 3.34 | 3.33 | 3.01 | 3.77 |
| 5 years | 3.80 | 3.80 | 3.45 | 4.36 |
| 10 years | 4.50 | 4.50 | 4.20 | 5.24 |

| | Today | Week Ago | Month Ago | Year Ago |
|---|---|---|---|---|
| **FOREIGN EXCHANGE** | | | | |
| NZD/USD | 0.8301 | 0.8359 | 0.8114 | 0.7358 |
| NZD/AUD | 0.7729 | 0.7800 | 0.7705 | 0.7264 |
| NZD/JPY | 67.86 | 68.04 | 62.48 | 60.57 |
| NZD/EUR | 0.6293 | 0.6203 | 0.6230 | 0.5261 |
| NZD/GBP | 0.5240 | 0.5259 | 0.5210 | 0.4521 |
| NZD/CAD | 0.8205 | 0.8349 | 0.8172 | 0.7158 |
| TWI | 73.51 | 73.63 | 71.82 | 64.86 |

## NZD Outlook



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