ECONOMICS
12 Oct. 09

Business Weekly

RBA cat amongst the pigeons

This Week

Last week the Reserve Bank of Australia hiked its cash rate earlier than many were expecting. Beyond the knee-jerk reaction that spiked the Australian and New Zealand dollars higher, the move has triggered debate about the pace of future rate increases there, and also a few questions over the implications for NZ rates.

The RBA has hiked because the economy has held up far better than was feared, skating close to recession but never falling in. GDP shrank in 2008Q4 as the shock of the crisis rocked the world. However, fiscal and monetary stimulus worked quickly in Australia and the economy grew at a respectable pace in the first half of this year. China's strength is also giving the RBA confidence that Australia's export sector will fare well. Although there is the possibility of "policy fade" for household spending, the inflation outlook is such that the RBA's view is "that it is now prudent to begin gradually lessening the stimulus provided by monetary policy".

Are there any implications for the RBNZ? We stress that just because the RBA has hiked, that doesn't automatically imply the RBNZ will follow suit. Ultimately it is the inflation outlook that will dictate when the RBNZ will lift the OCR. In contrast to Australia, NZ's economy has shrunk 3% since the end of 2007. The starting point for inflation in NZ is of disinflationary, rather than inflationary, forces. It will be a while longer before the RBNZ has a similar degree of concern about inflation. The RBA's actions are also likely to have flow-on tightening impacts in NZ over time, nudging up the NZD and putting some pressure on NZ short-term interest rates (market expectations of NZ hikes will lift; competition to attract sufficient capital inflows).

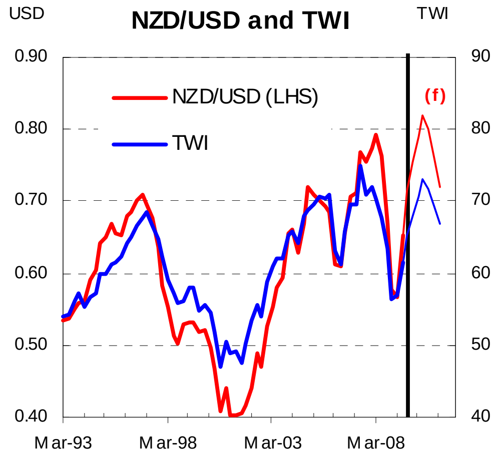
But one lesson from Australia is that there comes a time when central banks get uncomfortable about leaving interest rate settings at extraordinarily low levels, prompting lifts to a less stimulatory level. At the time of the RBNZ's September Monetary Policy Statement we brought forward our expectation of the first OCR to June 2010 from July and judged the risks were sooner rather than later. To us the RBA's action reinforces that risk: the RBNZ could also opt for a relatively early but gradual removal of some stimulus. And the RBNZ also has concerns over the unsustainable (code for housing-led) nature of NZ's nascent recovery.

Ongoing rate increases in Australia will light a fire under the Australian dollar, buoying it further and dragging the NZD in its wake to a degree. That Downunder strength will come against an environment in which it seems increasingly clear the USD has much further to fall. We have had strong currency forecasts all year, but have had to revise them up even further: we expect the NZD/USD to hit 0.82 by mid-2010. Beyond then we see the USD unwinding a small portion of its considerable weakness. We also continue to expect fixed-term rates to grind up, and the RBA will be hastening that process.

Click here for:

Foreign Exchange	• NZD sets new 2009 high on a weak USD. RBA rate hike sends NZD/AUD lower.
Interest Rates	• RBA delivers surprise rate hike. NZ short-term rates tick up.
Week Ahead	• Retail trade, CPI and REINZ housing data all due.
Week in Review	• NZIER's Quarterly Survey of Business Opinion improves.
Global Calendars	• Fed minutes, US, JPN, EU industrial production, and UK unemployment due.

Chart of the week



- Our new NZD forecasts are higher, given the background of USD and GBP weakness and expected AUD strength.
- We expect the USD to continue weakening to mid-2010, but now to a greater extent. Beyond then we expect that Federal Reserve tightening will claw back some of the weakness – though the USD will remain on the weak side.
- The AUD will drag the NZD along for the ride as the RBA tightens. In the short term the NZD will mildly underperform the AUD until the RBNZ also starts to lift rates.
- Our long-run forecasts have the NZD settling near average levels relative to the AUD, EUR and JPY but substantially above average against the USD and GBP. That outlook reflects the structural issues the US and UK face.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7342	0.7201	0.7040	0.5860	0.5973	FLAT	0.7250	0.7400
NZD/AUD	0.8116	0.8246	0.8139	0.8110	0.8983	FLAT	0.8100	0.8350
NZD/JPY	65.89	64.66	64.25	59.32	59.02	FLAT	64.50	66.00
NZD/EUR	0.4987	0.4920	0.4817	0.4432	0.4402	FLAT	0.4800	0.5050
NZD/GBP	0.4630	0.4505	0.4213	0.3989	0.3509	FLAT	0.4550	0.4700
TWI	66.3	65.6	64.2	58.3	59.3	FLAT	65.00	67.00

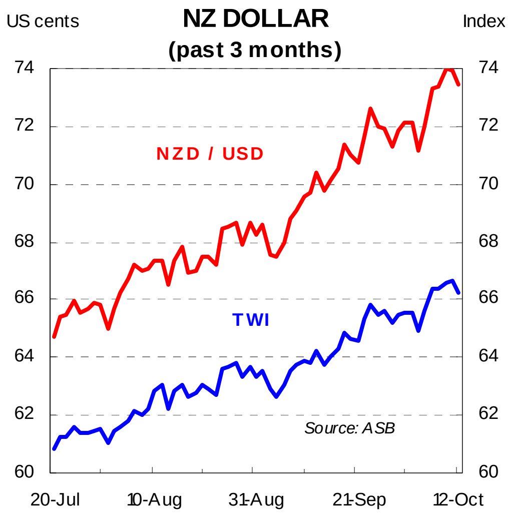
^Weekly support and resistance levels * Current is as at 12pm Monday; week ago as at Monday 5pm

- The NZD pressed higher last week, trading as high as 0.745 against a weak USD. The USD has continued to "bump along the bottom" against the major currencies. The minutes from the Federal Reserve's policy meeting and the retail sales and industrial production reports for September will likely garner the market's attention. The Fed's minutes are likely to be cautious about an economic recovery. We see the USD remaining at low levels this week.
- The NZD slipped against the AUD after the Reserve Bank of Australia unexpectedly lifted the cash rate. We expect New Zealand retail sales to increase only softly on Tuesday, pressuring the NZD lower.
- The NZD was up on the other cross rates, lifting 1% on a trade-weighted basis. We have revised our NZD forecasts higher, with a year-end forecast of USD 0.755.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
August Retail Trade Survey	13/10	10.45 am	+0.5%
REINZ House Sales	14/10	10.00 am	-
Q3 CPI	15/10	10.45 am	+0.8%

Potential currency movers from the US this week: retail trade, minutes from Federal Reserve's policy meeting, business inventories (14th), CPI, (15th), industrial production, consumer confidence (16th). Speakers: Bullard (11th), Summers (12th), Kohn, Dudley (13th).



Medium-term outlook: [Last Quarterly Economic Forecasts]

- We continue to expect the NZD to appreciate further against the USD over the next 6-9 months. However, we have revised up our expected peak to USD 0.82. The story remains primarily one of USD weakness, also overlaid by some Downunder strength.
- The reasons for the expected USD weakness remain similar to the drivers in place since mid-March, namely:
  - US residents increase their offshore investment, encouraged by improvement in the global economy, with USD liquidity demand and safe-haven buying also no longer boosting the USD.
  - Diversification out of USD is expected to occur due to concerns about US government debt.
  - And, related, concern about the USD's future role as a reserve currency.
- The NZD is also likely to mildly outperform other major currencies in the ongoing environment of improving global growth prospects and rising commodity prices. Outright weakness in the British Pound will continue to hold the NZD/GBP rate at very elevated levels. The Pound, like the USD, is being weighed down by debt concerns and the state of its financial sector – both of which have ramifications for the future growth rate of the economy.
- The buoyant Australian dollar is also likely to contribute to an overall strengthening of the NZD. The RBA is likely to continue gradually lifting its cash rate back to a less stimulatory level. Rising interest rates there will lift the AUD. The NZD will be caught somewhere in the middle: weakening slightly against the AUD but dragged up against other currencies.
- For more on the relative fundamentals driving the NZD see our Economic Note "NZD: The Flighty Bird".
- 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 (at the least, very risky) 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	2.82	2.76	2.76	3.19	7.60	FLAT
2-year swap	4.41	4.34	4.01	3.89	6.53	FLAT
5-year swap	5.49	5.50	5.30	5.07	6.63	FLAT
11/11 gov't stock	4.91	4.88	4.80	4.41	5.46	FLAT
NZSX 50	3181	3139	3134	2571	2809	DOWN

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

- The RBA surprised markets on Tuesday, delivering the first rate hike a month earlier than the market expected. The RBA lifted the cash rate 25 basis points to 3.25%, citing the need to gradually lessen the amount of stimulus provided by monetary policy now the risk of a serious economic contraction in Australia has passed. We expect the RBA will continue to lift the cash rate off 'emergency settings', with the possibility the bank may pause and further assess the economic outlook once the cash rate has reached 4-4.5%.
- The market has now fully priced in another 25 bp hike (from the RBA) in November, and is now speculating on the chance of a 50bp increase given the surprising strength in the labour market over September.
- In reaction to the early rate hike and stronger employment data, Australian swap rates increased strongly. In contrast the lift in NZ swap rates was fairly muted. Last week's RBA action highlights the difference in policy outlooks between Australia and New Zealand. Australia has managed to avoid recession; in contrast the NZ economy has contracted 3% and the outlook remains fragile. With Australia's greater exposure to China, export commodity prices have fared better than NZ's. In addition, Australia economy received greater and more direct policy stimulus. Our view on the RBNZ has not changed. We continue to expect the first hike in NZ will not be until June 2010, although note the recent improvement in economic data points to the risk of an earlier hike in April.
- US Treasury yields rose over the week, with 10-year yields up by 16 points and 2-year yields climbing 9 pts. Most of the lift came on Friday, after the Federal Reserve chairman raised the topic of future monetary policy tightening.

Short-term outlook:

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August Retail Trade Survey	13/10	10.45 am	+0.5%
REINZ House Sales	14/10	10.00 am	-
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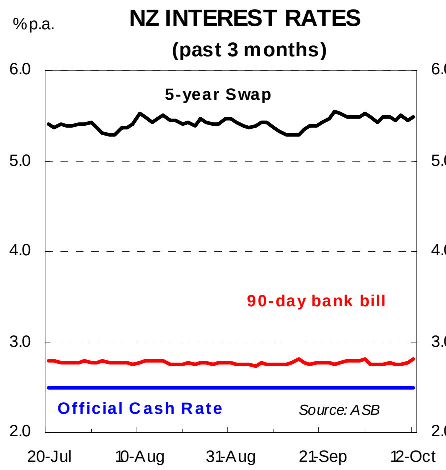
Comment: Interest rate markets likely to remain quiet in NZ this week. Monthly retail sales and house sales are often too volatile to induce a change in expectations. Near-term CPI rarely surprises the RBNZ, although recent reports have shown inflation pressures dissipating more rapidly than expected. Australian data calendar is light this week. Watch US markets with US retail sales, FOMC minutes and September industrial production scheduled for release.



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 financial 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 recent 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

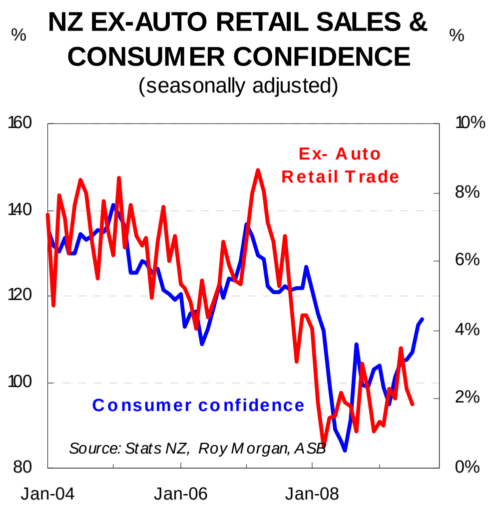
Data	Date	Time (NZST)	Previous	Market expects	ASB expects
August Retail Trade Survey	13/10	10.45 am	-0.5%	+0.5%	+0.1%
September REINZ House Sales	14/10	10.00 am	-1.9%	-	-
Q3 Consumers Price Index	15/10	10.45 am	+0.6%	+0.8%	+0.9%
September Food Price Index	15/10	10.45 am	-0.9%	-	-0.4%

Retail Trade Survey - August

Total sales: previous -0.5%; ASB(f): +0.1%

Ex-auto sales: previous -0.5%; ASB(f): -0.2%

Retail sales have been surprisingly soft over the past few months. The lift in net migration and consumer confidence points to a small recovery in retail spending. However, retail sales values have declined over the past two months, with heavy discounting possibly weighing on spending. Although the underlying demand in retail spending is improving we expect another weak month in core retail sales. Food prices fell sharply in August which could drag on spending at supermarkets (which accounts for a large chunk of the retail survey). In addition, August weather proved to be unseasonably warm which may put a dent in typical winter shopping patterns (this may effectively reverse the surge in sales of clothing and heaters seen over May, which was unseasonably cold!).

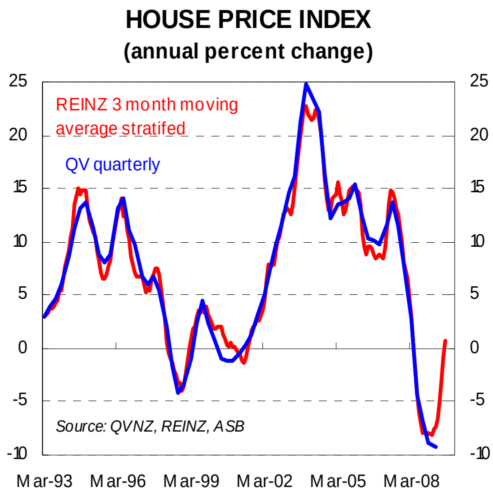


REINZ House Sales - September

Previous: house sales -1.9%, house prices +1.2%

Housing demand has remained steady over the past few months. Recent mortgage approvals and Auckland agent data suggest this trend continued in September. The pick up in demand has come at a time when new listings have been very low. Although the lift in demand has been small, the low level of supply has seen the housing market heat up over the past few months. The REINZ's new stratified median house price index shows that house prices have lifted surprisingly strongly over the past few months. However, the recovery in the housing market has also attracted potential sellers back into the market. New listings have recently picked up which should help temper the recent increase in house prices.

Quotable Value reported that house prices in the 3 months to September 2009 were 1.1% lower than in the same period a year ago.



Q3 Consumer Price Index

Previous: 0.6% qoq, 1.9% annual

ASB(f): 0.9% qoq, 1.3% annual.

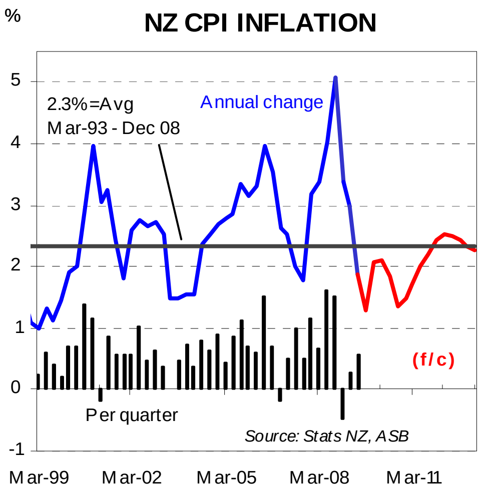
We expect the Q3 CPI to rise 0.9% qoq, pulling annual inflation down to 1.3%.

Housing-related inflation will be boosted by the annual increase in local council rates, though construction/maintenance costs should remain subdued relative to recent years. The sharp moderation in wage growth, combined with margin pressures, will further contribute to modest non-tradable inflation.

Impacts of the previous decline in the exchange rate were still filtering into imported goods prices over Q2. However, we expect import price inflation to be more muted in Q3, and for the NZD to rein in imported inflation over the following year.

Food prices over the quarter are likely to be 1.8% higher on average, impacted by the early arrival of winter.

We estimate that petrol prices rose 2.5% over the quarter, contributing 0.14 percentage points to the quarterly increase. However, relative to a year ago petrol prices have fallen around 19%, a key reason for the marked decline in annual inflation from its 5.1% peak is QIII 2008.



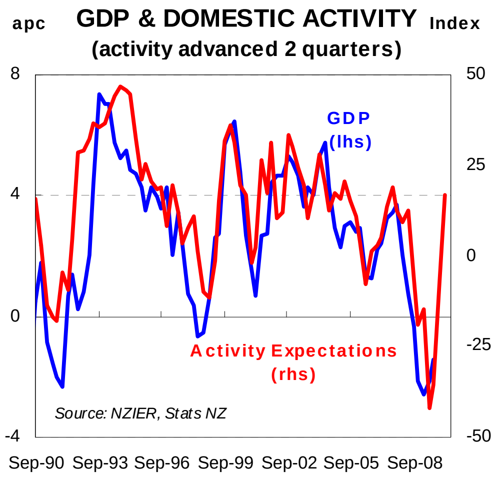
NZ Data Review: weekly recap

Q3 NZIER Business Opinion Survey

The NZIER quarterly survey confirmed that business confidence surged over the past few months. On the general economic outlook firms are the most optimistic in a decade, with net 27% expecting the general business situation to improve over the next 6 months. The turn-around was sharp, with the net balance of firms expecting own activity to improve increasing to 17%, from net 9% expecting activity to decline in the previous quarter. The improvement in confidence was widespread with the majority believing the recession is now over.

The extent of the bounce back in confidence suggests growth may recover faster than we had initially expected. Nevertheless, we remain wary of the headline result, given the weakness within some survey components. In particular, the ongoing weakness in the construction sector and the relative sluggishness in investment intentions suggest little short-term momentum from private capital expenditure.

In addition, the recovery was limited to forward-looking indicators, with firms continuing to report tough trading conditions in the September quarter. In particular, net 29% reduced staff levels (more than expected) and net 39% continued to see a decline in profitability.



Global Data Calendars

Note: Calendar 2 is in UK times. Add 12 hours for NZ times.

Calendar – Australasia, Japan and China

Date	Time NZT	Econ	Event	Period	Unit	Last	Forecast Market	Forecast ASB/CBA
Mon 12 Oct	14.30	AU	Treasurer Wayne Swan speaks in Sydney					
Tue 13 Oct	~	CH	Entrepreneur conf. index	QIII	Index	110.2	~	~
	~	CH	Business climate index	QIII	Index	115.9	~	~
	10.45	NZ	Retail sales	Aug	m%ch	-0.5	~	0.1
	10.45	NZ	Retail sales ex-auto	Aug	m%ch	-0.5	~	-0.2
	13.30	AU	NAB business conditions	Sep	Index	4.0	~	~
	13.30	AU	NAB business confidence	Sep	Index	18.0	~	~
	17.00	JP	BoJ monetary policy meeting					
Wed 14 Oct	~	CH	Exports	Sep	y%ch	-23.4	-21.0	~
	~	CH	Imports	Sep	y%ch	-17.0	-15.8	~
	~	CH	Trade balance	Sep	US$bn	15.7	17.3	~
	~	JP	BoJ target rate	Oct	%	0.1	~	0.1
	12.50	JP	Domestic CGPI	Sep	m%ch	0.0	~	~
					y%ch	-8.5	~	~
	13.00	AU	Westpac cons. confidence	Oct	m%ch	5.2	~	~
	12.30	AU	Building activity	QII	q%ch	-4.7	~	~
					y%ch	-1.7	~	~
	18.00	JP	Consumer confidence	Sep	Index	40.4	~	~
	18.00	JP	Consumer confidence h/holds	Sep	Index	40.1	~	~
Thu 15 Oct	10.45	NZ	Food prices	Sep	m%ch	-0.9	~	~
	10.45	NZ	Consumer prices	QIII	q%ch	0.6	~	0.9
					y%ch	1.9	~	1.3
	12.30	AU	RBA Governor Stevens speaks in Perth					
	13.00	AU	MI/WBC Cons. inflation exp.	Oct	%	3.5	~	~
	13.00	AU	MI/WBC unemployment exp.	Oct	Index	131.6	~	~
	13.30	AU	RBA Bulletin	Oct	~	~	~	~
	17.30	JP	Industrial production	Aug	m%ch	1.8	~	~
					y%ch	-18.7	~	~
	17.30	JP	Capacity utilisation	Aug	m%ch	3.9	~	~
	18.00	JP	BoJ monthly report					

Calendar – North America & Europe

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

Date	UK time	Econ	Event	Period	Unit	Last	Forecast Market	Forecast CBA
Tue 13 Oct	00.01	UK	BRC September retail sales monitor					
	00.01	UK	RICS house price balance	Sep	%	10.7	~	~
	09.30	UK	CPI	Sep	m%ch	0.4	~	~
	09.30	UK	Core CPI	Sep	y%ch	1.8	~	~
	09.30	UK	Retail price index	Sep	m%ch	0.5	~	~
	10.00	EZ	ZEW survey (econ sentiment)	Oct	Index	59.6	~	~
	13.30	CA	New housing price index	Aug	m%ch	0.3	0.2	~
Wed 14 Oct	09.30	UK	ILO unemp. rate (3mths)	Aug	%	7.9	~	~
	10.00	EZ	Industrial production	Aug	y%ch	-15.9	~	~
	13.30	CA	New motor vehicle sales	Aug	m%ch	5.3	0.0	~
	13.30	US	Import price index	Sep	m%ch	2.0	0.2	~
	13.30	US	Advance retail sales	Sep	%	2.7	-2.0	~
	15.00	US	Business inventories	Aug	%	-1.0	-0.8	~
	19.00	US	Minutes of Sept 23 FMOC meeting					
Thu 15 Oct	07.00	EZ	EU 25 new car registrations	Sep	%	3.3	~	~
	09.00	EZ	ECB October monthly report	~				
	10.00	EZ	CPI	Sep	m%ch	0.3	~	~
					y%ch	-0.2	~	~
	13.30	CA	Manufacturing sales	Aug	m%ch	5.5	1.0	~
	13.30	US	CPI	Sep	m%ch	0.4	0.2	~
					y%ch	-1.5	-1.4	~
	13.30	US	Initial jobless and continuing claims					
	13.30	US	Empire manufacturing	Oct	~	18.9	18.9	~
	13.30	US	Philadelphia Fed.	Oct	~	14.1	12.5	~
Fri 16 Oct	10.00	EZ	Trade balance	Aug	€bn	6.8	~	~
	12.00	CA	CPI	Sep	m%ch	0.0	0.1	~
					y%ch	-0.8	-0.8	~
	14.00	US	Net long-term TIC flows	Aug	$bn	15.3	~	~
	14.15	US	Industrial production	Sep	%	69.6	69.7	~
	15.00	US	Uni of Michigan confidence	Oct	~	73.5	73.5	~

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