Market Focus

New Zealand

30 June 2008

Open partnerships
Open possibilities

50-50

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ECONOMIC OVERVIEW

GDP data – and the composition – confirm the economy is heading (ed) backwards. We see this as providing little new information. But developments across a number of finance companies and the potential ripple effects through the economy, in association with a substantial easing in credit growth, have us increasingly erring towards the Reserve Bank moving in July. We put the odds of a July cut at 50-50 but will await more information before formally reviewing our September view.

What's ahead?

> **NZ May Building Consents Issued** (Monday 1045 NZST). After the surprising surge last month, we expect a substantial pull back to occur in May. This could be in the magnitude of 40 percent or more.

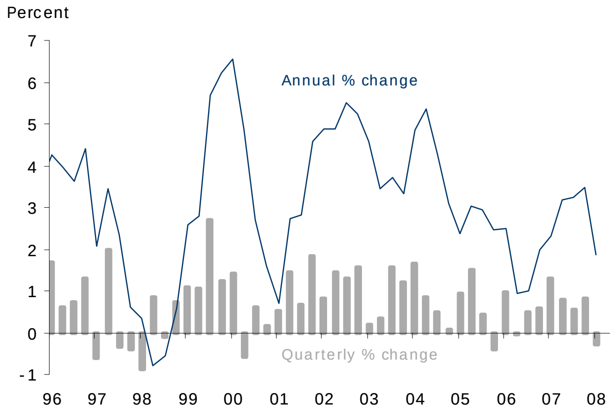
> **NBNZ June *Business Outlook*** (Monday 1500 NZST).

> **ANZ June Commodity Price Index** (Thursday 1500 NZST).

What's the view?

Last week provided final confirmation of what the partial and confidence indicators (not to mention anecdotes) had been telling us since the start of the year – that economic activity went backwards in the first quarter of 2008. While the -0.3 percent outturn for the March quarter GDP was in line with both the market's and the RBNZ's expectation, there is nothing in the GDP report that gives us any comfort about the state of the economy going forward.

Economic growth



Sources: ANZ National, Statistics NZ

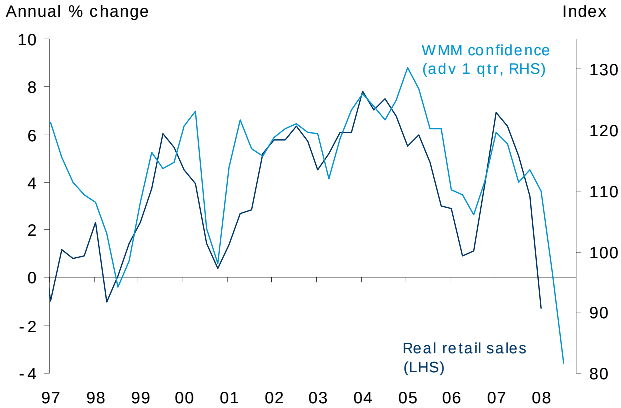
For a start, historical revisions meant the economy was not on as strong a footing as we thought at the end of last year. Add to that, just about all the growth on the expenditure side came from a large inventory rebuild, which points to further weakness ahead as this stock gets unwound in the coming quarters. Most of the increase in inventories are in the distribution sector (wholesale and retail), which we suspect is of an involuntary nature, given the slowdown in domestic demand. This means Q2 growth is looking very shaky.

If there is a positive to be had, it is that we are likely to see further retail price discounting as retailers seek to reduce their inventory levels, which may help offset the food and petrol price increases. Another positive is the 5.9 percent growth in plant and machinery investment, following a 4.4 percent rise in the previous quarter. One hopes that such investment will eventually result in improved productivity performance that will help drive the next upswing in the business cycle.

With the March quarter data now out of the way, focus will turn to how the current (June) quarter and how future prospects are holding up. In this regard, the indicators to date suggest the June quarter fared no better, and possibly worse, than the March quarter. The drought effect, which affected March quarter activity, will still be felt in the June quarter, particularly on agriculture production and electricity generation. More thermal generation due to low hydro lake levels create less value add, and is expected to shave up to 0.2 percentage points off June quarter GDP growth. And the sectors that appeared to still be holding up well in the March quarter, such as finance and personal services, are expected to ease given trends in some of the partial data such as credit growth and house sales. Judging by the recent profit warnings from the major listed retail companies, the retail sector is also set to remain under pressure.

The challenging environment facing the retail sector is well illustrated by the latest Westpac McDermott-Miller consumer confidence survey for the June quarter. The index showed another sharp fall in consumer sentiment, dropping to 81.7 – the lowest level since December 1991. Higher food and petrol prices, falling house prices and less job security in the face of an economic slowdown no doubt all had an influence on consumer sentiment. It is also confirmation (if the RBNZ needed any) that the upcoming tax cuts are being dwarfed by the headwinds hitting the household sector.

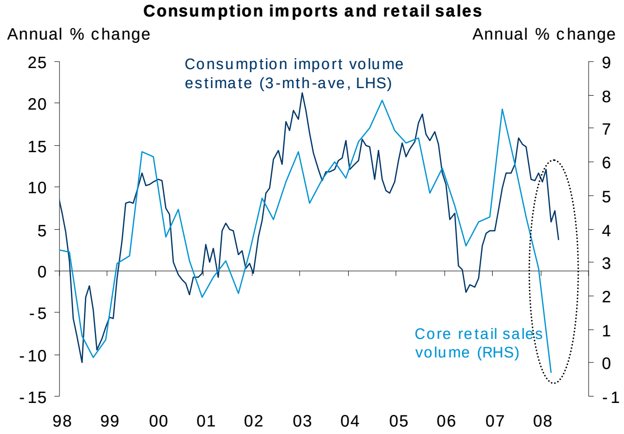
Retail sales and consumer confidence



Sources: ANZ National, Statistics NZ, Westpac MD-M

For retailers, the confidence reading suggests a sharper contraction in retail spending ahead – and the risk that those already high inventory levels could actually increase further in the near-term. Ultimately, this should see import growth, especially for consumption goods, slow markedly. We have already seen signs of this occurring, as evidenced by the May trade data released last week. But an even sharper slowdown in consumption import growth is required. This will help reduce the trade deficit, which is showing recent signs of widening again. It is also a pre-requisite to getting NZ's gargantuan current account deficit – which widened in the March quarter – to show sustained signs of improvement.

Consumption imports and retail sales



Sources: ANZ National, Statistics NZ

We've pencilled in a 0.4 percent contraction in GDP for the June quarter (with considerable downside), and given where confidence readings are at the moment, we're scratching our heads over where growth in Q3 will emerge from. Statistical quirks, tax cuts and a rebound from the drought curtailing primary production may assist Q4, but when you see credit growth (a leading barometer of activity) easing rapidly (especially in the business sector) it's hard to paint a rosy rebound picture. Abstracting from the rural sector, May credit growth showed further weakness, particularly given that there were five Fridays in the month. Household lending by the non-bank sector continues to decline, which is not being fully picked up by banks. Indicators for June credit growth look no better.

Bottom line is that the economy is even weaker than the generally sedate picture the Reserve Bank painted in their June MPS projections a mere three weeks ago. And remember, they had already pencilled in a very cautious track of 0.2 percent for Q2, zero for Q3 and 0.4 percent for Q4. Yet, we doubt an even weaker economy will be sufficient by itself to alter the Reserve Bank's view on rates yet, particularly given elevated global inflation pressure that is percolating.

We were also very interested to see the topics of the research articles released in the Reserve Bank's recent Bulletin: *"The relationship between monetary and financial stability", "Some perspectives on past recessions"* and *"The changing transmission mechanism of New Zealand monetary policy".* To us they merely reinforce the difficult balancing act and contrasting forces that are shaping monetary policy.

The other major news from last week was the growing difficulties emerging across a number of finance companies. Observers need to be careful commenting in relation to the sector for fear of exacerbating difficulties. But prudence also demands that we do not step away from analysis given the significance of the sector in terms of the property market.

Certainly the sector is small in the overall financial system. Total lending from finance companies is less that 3 percent of system wide credit. At present, collapses total $2.5 billion, with an average recovery rate of around 50 percent for those announced so far so $1.25 billion has implicitly been lost. Three firms last week announced they planned to seek moratoriums on payments or put repayment schemes in place. This brings the total to 22 companies, and while this is substantial, on the face of it it's hardly a reason to push the panic button when seen relative to the boost form tax cuts and the dairy payout.

However, we are in no doubt the ripple effects from current difficulties are material. The sector was a key driver of the speculative market, which rippled throughout the entire property market over the preceding years. This has been particularly apparent in section developments and 2/3rds of the growth in house prices has in fact come from the price of the land. It's been a simple story of ripple effects from speculative developments dragging up entire areas and suburbs. New Zealand does not have an excess supply of housing as such relative to the underlying demand within the economy. But travel around the country and you'll notice a glut of sections on the market. As noted in our 16 June *Market Focus*, there's been a steady rise in the proportion of properties on the market that are either apartments or sections, and particularly in renowned speculative hot-spots.

Diminished credit availability from the finance company sector as they consolidate balance sheets, and the potential unloading of assets into a declining property market, will be significant headwinds to the economy as the combination of easing asset prices and less spending / investment flow through to the wider economy.

While current difficulties are often cited as being driven by a lack of liquidity as reinvestment rates fall, this tells only a part of the story. The real story is that we are moving to stage two, where assets are being unloaded or revalued in a declining property market and there is not sufficient equity coverage to cover writedowns. Hence, it's a simple case of traditional credit risk, which has been exacerbated by the opening position where the assets being secured were often overvalued in the first place. In many ways it has the potential to become a vicious circle were declining property prices leads to further credit distress, even less credit, tightened standards, falling property prices, credit distress…and the spiral is in motion. It not will be until confidence returns that buyers will emerge and the market will stabilise. Alas, this tends to be how speculative bubbles unfold.

Certainly the Reserve Bank should not feel obliged to provide a lifeline given some of the behaviour and lending practices that have taken place, which liquidation recovery rates attest to. They've been warning against such speculative investment for years. Unlike the banking system, it was not regulated.

However, the second round and ripple effects should have the Reserve Bank watching closely as it partly reflects the fact the turn in the economic cycle has been too sharp and aggressive.

When we roll together even weaker growth, developments across a number of finance companies, and what we are seeing in terms of credit growth, we are increasingly erring towards the Reserve Bank moving in July. We put the odds of a July cut at 50-50.

Of course a July move still looks dependant on the Q2 inflation figures, and the inflation stories remain problematic, particularly when you see international oil prices at US$140/bbl. So we'll hold fire for now, and remain in the September camp like all and sundry. Yet we continue to be drawn to the concept of a couple of stabilisation rate cuts being driven as early as July. We have to stress that these would not be reflationary moves. More like helping to offset tighter financial conditions, which are being expressed via other avenues.

It's hard to envisage a "full" easing cycle until we see commodity prices ease. International central banks look to hold the key in this regard. We doubt emerging markets will save commodity prices if central banks across developed nations decide that enough is enough and start to lean collectively via the demand channel against the inflation (cost-push) genie.

Turning to the week ahead, we are expecting May building consents (released today) to show a substantial pullback following April's surge. Total dwelling consent issuance rose by 82.1 percent in April largely, but not entirely, driven by the approval of a couple of big apartment complexes. Whether they actually get built given the current economic environment remains to be seen, but we suspect consent issuance could fall in the vicinity of 40 percent for the month. The other data released today is the National Bank *Business Outlook* survey for June, while later in the week we get the ANZ Commodity Price Index for June.

Internationally, the big event this week is the RBA's interest rate announcement and some major data out of the US. The RBA is expected to leave rates unchanged at 7.25 percent and it really just remains a case of waiting for the June quarter CPI release to assess how inflation pressures are tracking. Our Australian colleagues expect the CPI release to be the smoking gun that will force the RBA to hike rates again in August. In the US, seeing as the Fed has now moved to wait-and-see mode, the data takes on added importance. This week we receive the key ISM reports, which provide a good indication of economic activity, as well as the non-farm payrolls report.

Recent data…

Credit Card Spending (May): Seasonally adjusted spending fell 1.1 percent, following a 4.4 percent rise in April.

Westpac McDermott Miller Consumer Confidence (June quarter): The index fell from 96.5 in the March quarter to 81.7 in June – the lowest level since 1991.

Balance of Payments (March quarter): The annual current account deficit improved to 7.8 percent of GDP, from 7.9 percent of GDP in the December quarter.

GDP (March quarter): Headline GDP fell 0.3 percent. Expenditure based GDP fell 0.6 percent.

Overseas Merchandise Trade (May): A trade deficit of $196 million was recorded.

Credit Growth (May): Household credit growth grew by 0.5 percent in the month.

IN THE BALANCE

The aftermath of the drought has many pastoral farms on a tight rope.

While profitability in 2007/08 is much better for some dairy and arable farms, much of the rest of the agriculture sector is having a struggle.

Pastoral infrastructure reform has stalled for Fonterra and the meat industry. Positive, acceptable and quick action is required to mitigate the key issues for Fonterra and to stop the sheep and beef industry haemorrhaging.

The big picture

The rate of change in the structure of New Zealand agriculture is faster than it has been over the past forty years by far. Many say we are on the edge of a new era in food production. In the meantime, more immediate issues prevail at the farm gate. They revolve around feed, stock condition, cash and industry infrastructure. As usual there is a wide range in the degree of seriousness of the immediate situation for individual farm businesses, but the feeling is that a distribution curve showing the degree of seriousness would be skewed to the left.

The hangover

The effects of the widespread summer/autumn drought continue to impact on most of the pastoral industry south of Auckland. While rainfall was been sufficient to restart pasture growth, the sub soil is far from fully wet in parts of the East Coast North Island, Marlborough, Canterbury and Otago.

The late autumn 'break' has meant that recovery of pastures and subsequent growth has been slower and less than farmers hoped for. Feed cover (the amount of available pasture) and the amount of conserved feed (hay, silage, baleage) on farms are a lot less than desirable. Winter feed crops (sown in the summer or autumn) are fair average. The winter has been kind to date, long may it continue. The consequence is that an early spring is being looked for as many feed budgets show significant deficits on average rates of spring pasture growth.

Livestock numbers have been reduced because of the dry weather. Stock condition also varies widely. The combined effects points towards slower growth weights in lambs in the spring and a higher proportion of empty cows in the autumn of 2009. It may be that peak milk production in 2008/09 disappoints many.

Profit and liquidity

The difference in the profitability between sectors within agriculture is also very wide.

Dairy farmers in districts not impacted by drought have wide smiles, as do arable farmers who chose not to take grain contracts last winter/spring. Revenue gain has out stripped disconcerting cost increases in 2007/08. Dairy farmers in drought districts are not so happy but the increase in payout has mitigated what otherwise would have been a significant cash loss. The prospects for both sectors in 2008/09 look good. The Fonterra forecast is $7.00/kg milk solids and contract grain prices are around $200/t higher than last season.

Farmers with a significant component of livestock (such as deer) are also benefiting from higher prices for venison, albeit it has been a long time between drinks (five years).

Kiwifruit and apples are looking better this year after fair to poor results from the 2007 harvest. Opening selling prices for export fruit in 2008 are encouraging on a weaker currency.

The viticulture industry is still on a roll as far as planting is concerned. Processing capacity was found wanting in Marlborough after a better than expected crop. Exports continue to grow in volume but margins are under pressure from the high NZD.

The mid season average for prime lamb is up by an estimated $5 from $55 last season to $60/head, albeit prime lambs have been sold at lighter weights. A higher proportion of lambs have often had to be sold as stores instead of prime – at significant loss making returns of $15 to $25/head compared to the unsatisfactory prices of $35 to $45/head last season.

Sheep and beef farms with very limited opportunity for alternate land (read dairy support) are grappling with low incomes and rising costs across the board and a second or third year of low profit or consecutive losses. Annual cash flows are red and stress levels in this sector are rising.

They wonder who will buy their store lambs next year. There were fewer buyers this year. Many of the traditional buyers are now a dairy support farm providing grazing or feed for dairy animals or growing more cereal or bio fuel crop instead of feeding sheep. Working expenses have been cut where possible with fertiliser the first to go even at the old price.

Quite radical changes are being made to stock policies, almost all of which involve fewer sheep. There is real concern at the increase in the price of super phosphate fertiliser from around $250 twelve months ago to $500/tonne plus freight and spreading costs.

The prospects for better returns for meat in 2007/08 are encouraging but there is a "believe it when I see it" attitude to murmurings from the meat processors about higher prime lamb and beef prices in 2008/09.

Back to the drawing board

The implicit rejection by Fonterra shareholders led to The Board withdrawing its November 2007 proposal to partially list the company before shareholders had the first vote. It is understood that the Board and management have been sifting for workable alternatives to address the issues of redemption risk, capital for growth and investment choice.

In the meantime, the new processors are aggressively attempting to cherry pick Fonterra suppliers with some success.

An unexpected downward revaluation of the fair value share has helped fill some shareholder pockets and left the pockets of other shareholders emptier than anticipated. The valuation process (or a market) always has a probability that the value of a share can go down as well as up, but that had been forgotten. The lack of signals that this might happen to Fonterra shares in 2008 has left some shareholders more perplexed than the actual reduction. That is another reason to revisit the capital structure of the co-operative.

In the next paddock are the four major meat processors and the Meat Industry Task Force. Pushing four companies into one in the time frame suggested was highly unlikely given the large differences in financial strength, product mix and company philosophy. Two into one maybe! It now appears (The Dominion Post June 28) that the Meat Industry Task Force has also been stymied in its task to find a framework to reform the structure of the meat industry. The processors will have to work fast on their own account to stop suppliers haemorrhaging and further exacerbating marketing and processing issues that must be causing processors some restless nights.

Underlying competitiveness

Rural land prices continue to escalate at eye watering rates but is there a long-term cost?

New Zealand does not have a low cost farming system. The cost of capital is now very significant and working expenses escalating rapidly. The dairy industry is busy importing feed or feeding NZ grown grain and replicating Northern Hemisphere management systems.

Competitive advantage is being eroded in our view. It does matter if food prices are going to remain high allowing Northern Hemisphere competitors to profitably farm without subsidies. Pie in the sky? Then why has there been a steady exodus of dairy farmers to Australia and increasing investment in agriculture by New Zealanders in North and South America?

Should the ‘collective we’ do anything about it? Ideally yes, practically no. The market will prevail. That should eventually slow the rate of increase in land prices but we are not holding our breath. In the meantime are we blowing a bubble?

The nub

A large part of the pastoral sector will be delicately balanced from a husbandry point of view at least until the end of October. Within the sector some are struggling with lack of profits.

Capital structure issues for Fonterra and infra-structure reform in the meat industry are also in the balance. Tip one way - success, tip the other……

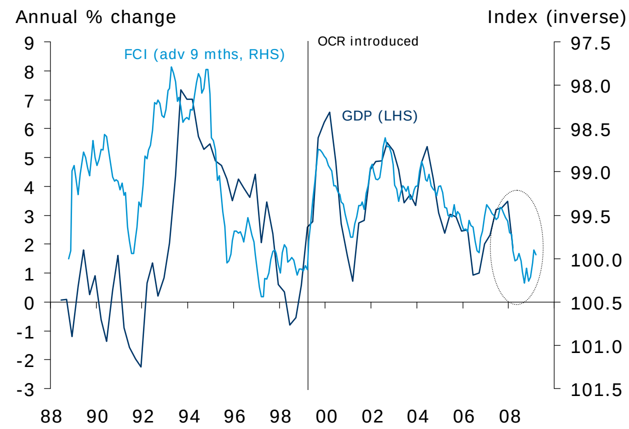
FINANCIAL CONDITIONS UPDATE

After easing in the past two months, financial conditions were largely unchanged over June. Declining asset prices and weaker credit growth have offset the impact of a lower currency. Our Financial Conditions Index suggest little growth this year, and only a modest recovery early next year.

Regular readers will be familiar with our Financial Conditions Index[1], which we monitor and provide periodic updates in this publication. Unlike the conventional Monetary Conditions Index, our Financial Conditions Index includes a wider array of variables to recognise the different channels through which monetary policy influences the economy. Our Financial Conditions Index provides a timely gauge of economic activity 6 to 9 months into the future, and more importantly it has been successful in predicting key turning points in the growth cycle.

After easing over the past two months, our Financial Conditions Index has started to tighten again – albeit extremely marginally. At this stage it's probably better to refer to it as stabilising. Despite a lower currency, a stronger than expected terms of trade, as well as lower wholesale interest rates; these have been more than offset by a widening in the US 2-year swap spread (a proxy for the cost and supply of credit) and declining asset prices (both equities and housing). In addition, credit growth has slowed markedly and liquidity conditions continue to tighten.

GDP vs Financial Conditions Index

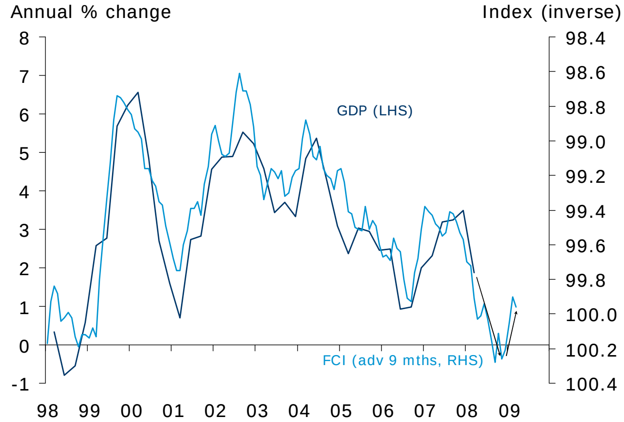


Sources: ANZ National, Statistics NZ

Our Financial Conditions Index has been pointing towards a sharp slowdown in growth over 2008 for some time. The contraction in Q1 GDP and the continued soft economic data pertaining to Q2 (such as the Westpac consumer confidence reading) certainly suggests this is very likely to be the case. In fact, our Index suggests very little growth, if any at all, for this calendar year. And the rebound in early 2009 look to be very modest at best at this stage.

While our Index captures a wider range of variables, it is not able to adequately capture the impact of recent difficulties in the finance company sector or the rising cost of international credit. Nor is it able to fully capture the impact of the credit channel of monetary policy. This is an area we are currently attempting to integrate into our index. Suffice to say, across all these areas financial conditions are tightening.

GDP vs Financial Conditions Index



Sources: ANZ National, Statistics NZ

Indicators	Comment	Impact on activity
Currency, adjusted for the terms of trade	TWI lower over June and terms of trade higher.	↔/↑
Interest rates	Yields moved lower but still well above neutral.	↔/↓
US 2-year swap spread	Spreads have widened, reflecting renewed credit fears.	↓
Equity market index as a proxy for corporate wealth and liquidity	Equity market under downward pressure.	↓
House prices as a proxy for household wealth	House prices continue to head lower.	↔/↓
Private sector credit growth	Credit growth slowing.	↔/↓
Liquidity	Liquidity still there but tightening.	↔
Overall conditions	**Still restrictive and not suggestive of a strong rebound.**	↔/↓

Looking at the broad picture, interest rates and the currency (on a TWI basis) continue to respond to the deteriorating dataflow. It's a sign of an economic framework working well. However, leaning in the other direction are wide swap spreads, tightening liquidity conditions and falling asset prices, which show no sign of let up. This reinforces our core economic view that the NZ economy is set to go through a prolonged period of sub-par economic performance.

[1] Our index is calibrated so that there is a 70 percent weighting towards the internal (e.g. interest rates) variables and 30 percent towards the external (e.g. currency and US swap spreads).

GLOBAL WATCH

We present a table of global data outturns over the past week given the significance of the international backdrop at present. US data was mixed last week, although still consistent with an economy that is soft. Consumers received a big income boost from tax rebates, but confidence continues to tumble. Evidence continues to mount that the European and Japanese economies are slowing.

Country / Area	Indicator	Mkt	Actual	Last	Outturn vs market
US	S&P/CS Composite-20 (Apr) – yoy	-16.0%	-15.3%	-14.3%	Stronger
	Richmond Fed Manufacturing Index	-5	-12	-3	Weaker
	Durable Goods Orders (May) – mom	0.0%	0.0%	-1.0%	In-line
	New Home Sales (May)	512k	512k	525k	In-line
	FOMC Interest Rate Decision	2.00%	2.00%	2.00%	In-line
	GDP (Annualised) (1Q F)	1.0%	1.0%	0.9%	In-line
	Initial Jobless Claims (w/e Jun 22)	375K	384K	384K	Weaker
	Existing Home Sales (May)	4.95M	4.99M	4.89M	Weaker
	Personal Income (May)	0.4%	1.9%	0.3%	Stronger
	Personal Spending (May)	0.7%	0.8%	0.4%	Stronger
	PCE Deflator (May) – yoy	3.2%	3.1%	3.2%	In-line
	University of Michigan Confidence (Jun F)	56.7	56.4	56.7	Weaker
Europe	PMI Manufacturing (Jun A)	50.2	49.1	50.6	Weaker
	PMI Services (Jun A)	50.5	49.5	50.6	Weaker
	PMI Composite (Jun A)	50.7	49.5	51.1	Weaker
	Industrial New Orders (Apr) – mom	-0.5%	2.5%	-1.2%	Stronger
	M3 Money Supply (May) - yoy	10.4%	10.5%	10.5%	In-line
	Business Climate Indicator (Jun)	0.40	0.14	0.58	Weaker
	Economic Confidence (Jun)	96.5	94.9	97.6	Weaker
UK	GDP (1Q F) - qoq	0.4%	0.3%	0.4%	Weaker
Asia Ex-Japan					
Singapore	CPI (May) – yoy	7.8%	7.5%	7.5%	Weaker
	Industrial Production (May) – mom	-2.3%	-12.8%	-4.9%	Weaker
Taiwan	Unemployment Rate (May)	3.92%	3.89%	3.92%	In-line
	Export Orders (May) – yoy	15.00%	14.46%	15.69%	Weaker
	Industrial Production (May) – yoy	8.90%	5.33%	9.98%	Weaker
Philippines	Total Imports (Apr) – yoy	-	11.8%	12.2%	-
Japan	Corporate Service Price (May) – yoy	0.6%	0.6%	0.5%	In-line
	Jobless Rate (May)	4.0%	4.0%	4.0%	In-line
	Household Spending (May) – yoy	-2.0%	-3.2%	-2.7%	Weaker
	National CPI (May) – yoy	1.3%	1.3%	0.8%	In-line
	Industrial Production (May P) - mom	2.7%	2.9%	-0.2%	Stronger
	Retail Trade (May) - mom	-0.5%	-0.2%	-0.1%	Stronger

INTEREST RATE STRATEGY

With Q1 GDP out of the way, the rates market's focus will now turn to how Q2 evolved. Poor upcoming dataflow expected to see receive side bias. A July rate cut remains a distinct possibility.

Market themes…

> NZ economic activity contracts in Q1 and external imbalances still wide

> Fed on hold and perceived to be less hawkish by the market.

> US equities sold off aggressively, sparking safe haven flows into bonds.

Review and outlook…

It was a strange week where the NZ rates market underperformed the US despite confirmation that Q1 GDP contracted. NZ rates did rally on the weak GDP print, and for the week the swaps curve rallied 9 to 13bps. But the US curve rallied by 19 to 25bps as the FOMC statement was perceived to be less hawkish by the market. Given that the market has priced in aggressive hikes over the next 12 months, starting from August, there was always a good chance the market would be disappointed. The paring back of those rate hike expectations, alongside safe haven flows out of equities into bonds, resulted in the big rally in US rates.

With NZ Q1 GDP now out of the way, focus now turns to how Q2 evolved. Despite the GDP number coming in line with expectations, historical downward revisions and a weak composition points to more underlying weakness than the headline implies. In any case, a September start to the easing cycle remains on track, with the market now fully priced for it. And although our core view is also for a September easing, we continue to see an earlier move in July as a distinct possibility. Economic activity looks to have weakened even more over Q2, and recent difficulties in the finance company sector may yet have wider implications. In addition, global credit concerns are re-emerging. Sure, higher oil prices poses near-term upside risks to inflation. But they also pose a material downside risk to growth as well.

From our perspective, the market appears to be under-pricing the chance of a July move, with only 8bps currently priced in. We could well see the market rethink July following next week's NZIER Quarterly Survey of Business Opinion Survey, which is expected to show broadbased weakness and easing resource pressures. We continue to favour going long September bank bill futures as a play on a July move.

Looking at offshore events this week, we have the RBA and ECB interest rate decisions. The RBA is expected to be on hold, with the statement reiterating that the slowdown in domestic demand should be sufficient to ease inflation pressure. The ECB on the other hand, is widely tipped to lift the policy rate to 4.25 percent, though a follow-up move is unlikely. Expect the ECB to keep the talk tough to ensure inflation expectations remain anchored.

Gauges for NZ interest rates yields		
Gauge	**Direction**	**Comment**
RBNZ	↓	Market looking for September easing but July still a real possibility.
NZ data	↓	Domestic dataflow expected to remain poor
Fed Funds/front end	↔	On hold with markets paring back rate hike expectations.
RBA	↔	RBA to hold this week but still fret about inflation.
US 10 year	↔/↓	Inflation concerns overshadowed by safe haven flows.
NZ swap curve	↔/↓	Curve bias is still to steepen, given soft economic outlook.
Flow	↔	Bias towards receive side though offshore moves will dictate this week.
Technicals	↔/↓	Technically the picture is primed for a downward move given soft NZ data.

Borrowing strategies we favour at present

The domestic dataflow continue to back a September start to the easing cycle. Hence, we stick to our preferred strategy which is for borrowers to target the 1-year space, which benefits from positive pick-up. If borrowers are still worried about inflation (oil prices) delaying the easing cycle, they can consider borrowing in the 2-year space.

Probability of 25bps increase as implied by market pricing		
OCR dates	**Last week**	**This week**
Thu 24-Jul-08	-28	-32
Thu 11-Sep-08	-96	-104
Thu 23-Oct-08	-176	-188
Thu 4-Dec-08	-252	-268
Thu 22-Jan-09	-324	-336
Thu 5-Mar-09	-388	-400
Thu 23-Apr-09	-436	-444

Trading themes we favour at present

Stick with core strategy of receiving the belly of the curve (3-5 year), and buy September bank bill futures as a play on a July move.

CURRENCY STRATEGY

A very weak domestic economy continues to reinforce a downward bias for kiwi, and we now see a material risk of lower rates from July. The broad story against the USD remains complicated by a weaker greenback, and the broad direction for the EUR/USD – and whether it can break 1.58 – looks key.

Market themes…

> Q1 GDP data confirms the economy is heading backwards. Q2 shaping as no better.

> USD suffering from renewed credit concerns and poor equity market performance.

> Markets appear to be underestimating the risk the RBNZ cuts rates in July.

Review and outlook…

The environment remains a challenging one for the NZD. GDP data last week confirmed the economy headed backwards over the first three months of this year and the June quarter is shaping as no better. Risk aversion is increasing as global credit concerns resurface and equity markets are back under pressure as the combination of credit and inflation worries see the earnings outlook for many companies downgraded. The kiwi should continue to trade with a heavy bias.

Further falls against the EUR, GBP and AUD are likely as markets contemplate interest rate hikes in those countries (with the ECB and RBA announcing decisions this week, with the former expected to hike). However against the USD, it appears to be a case of same old same old in the near-term, with the NZD remaining stuck in its well-entrenched range.

Both the US and NZ economies appear to be in a race to post the weakest growth – a competition NZ looks to be winning at present. However, markets were disappointed last week by the FOMC statement, which although highlighted the Fed's concern with inflation, lacked any firm confirmation the Fed will be increasing interest rates as soon as August as some in the market had expected. This, along with an intensification of credit concerns, has seen the USD give back some of its recent gains. Commodities are higher as a result, and this is lending support to the AUD, with follow-on support to the NZD. The Fed look to be keeping their options open for monetary policy as the outlook remains extremely uncertain. This makes the upcoming data flow increasingly important and this week's ISM surveys and the key non-farm payroll report will be the major focus.

For the NZD to break through its range against the USD, it is increasingly looking like the RBNZ will need to actually act on the monetary policy front. Given the near-term growth outlook, tumbling consumer confidence, troubles occurring in the finance company sector, and ironically a NZD that is holding up, we cannot rule out the RBNZ cutting interest rates in July. However, the picture is equally complicated by USD sentiment with the EUR/USD now knocking on the door of 1.58 – its upper bound since April. A break opens the door for a test of 1.60 and new record highs, with flow-on to the NZD/USD.

This week, a lack of local data with the exclusion of May building consents and the NBNZ *Business Outlook* today is likely to mean that offshore sentiment will be the dominant driver of the kiwi. Across markets there is a growing dichotomy in terms of what credit, equity, and commodity prices are telling us. Until we see a consistent picture, we suspect ranges will continue to pan out.

Technically, the NZDUSD has found a solid base again in the low 0.75's and now attention will turn towards the top side with the 0.7640/50 level first resistance. The market is sitting short NZD and the carry is still prohibitive especially with massive rally in US rates over the last week. For the NZD/AUD we still prefer lower levels over the medium term and now target 0.7970 as the ideal sell level.

NZD vs AUD: monthly directional gauges

Gauge	Direction	Comment
Fair value	↓	Growth differentials favouring AUD.
Yield	↓	RBA to hike. RBNZ cut.
Commodities	↔	Same picture for both.
Partial indicators	↓	Better across the Tasman.
Technicals	↓	Sell zone around 0.7970.
Sentiment	↓	Terms of trade says it all.
Other	↔	AUD could be vulnerable to turn in commodities.
On balance	↓	**Trend is clear.**

NZD vs USD: monthly directional gauges

Gauge	Direction	Comment
Fair value – long-term	↓	Fair value 0.65 (and rising) given a structural shift in commodity prices.
Fair value – short-term	↔	Yield and commodity story factored.
Yield	↔	Watch US data this week.
Commodities	↔	The big one to watch.
Risk aversion	↔/↓	Credit concerns surfacing again.
Partial indicators	↓	NZ data now looking weaker than US.
Technicals	↔/↓	Range with bearish bias.
AUD	↔/↑	RBA to hike again?
Sentiment	↔	Kiwi on peoples watch list but not pulling the trigger
Other	↔	Inflation all round. EUR/USD direction key.
On balance	↔/↓	**RBNZ will need to cut to break range.**

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZST)
30 Jun	**NZ**	**Building Permits (May) - mom**	**-**	**82.1%**	**10:45**
		NBNZ Business Confidence (Jun)	**-**	**-49.7**	**15:00**
	JN	Nomura/JMMA Manufacturing PMI (Jun)	-	47.7	11:15
		Housing Starts (May) - yoy	-3.7%	-8.7%	17:00
		Construction Orders (May) - yoy	-	-8.4%	17:00
	AU	TD Securities Inflation (Jun) – mom	-	0.3%	12:30
		Private Sector Credit (Jun) – mom	0.6%	0.4%	13:30
	UK	GfK Consumer Confidence Survey (Jun)	-31	-29	11:01
		M4 Money Supply (May F) – mom	-	0.4%	20:30
		M4 Sterling Lending (May F) – mom	-		20:30
		Net Consumer Credit (May)	1.0B	0.9B	20:30
		Net Lending Sec. on Dwellings (May)	6.0B	6.4B	20:30
		Mortgage Approvals (May)	51K	58K	20:30
		Index of Services (Apr) - 3mth/3mth	0.3%	0.5%	20:30
	EU	CPI Estimate (Jun) – yoy	3.9%	3.6%	21:00
1 Jul	US	Chicago Purchasing Manager (Jun)	48.0	49.1	01:45
		NAPM-Milwaukee (Jun)	-	45.0	02:00
		Domestic Vehicle Sales (Jun)	10.2M	10.5M	16:00
	AU	AiG Performance of Mfg Index (Jun)	-	51.2	11:30
		RBA Interest Rate Announcement	7.25%	7.25%	16:30
		RBA Commodity Index SDR (Jun) - yoy	-	28.6%	18:30
	JN	Tankan Lge Manufacturers Index (2Q)	3	11	11:50
		Tankan Lge Mfg Outlook (2Q)	2	7	11:50
		Tankan Non-Manufacturing (2Q)	8	12	11:50
		Tankan Non-Mfg Outlook (2Q)	7	13	11:50
		Tankan Large All Indust Capex (2Q)	2.0%	-1.6%	11:50
		Labour Cash Earnings (May) - yoy	0.7%	0.6%	13:30
	GE	ILO Unemployment Rate (May)	7.4%	7.4%	18:00
		Unemployment Rate (Jun)	7.9%	7.9%	19:55
		Unemployment Change (Jun) – 000s	15K	4K	19:55
		PMI Manufacturing (Jun F)	52.3	52.3	20:00
	UK	Nationwide House prices sa (Jun) - mom	-1.0%	-2.5%	18:00
		PMI Manufacturing (Jun)	49.8	50.0	20:30
	EU	PMI Manufacturing (Jun F)	49.1	49.1	21:00
		Unemployment Rate (May)	7.1%	7.1%	21:00
2 Jul	US	ISM Manufacturing (Jun)	48.6	49.6	02:00
		ISM Prices Paid (Jun)	87.0	87.0	02:00
		Construction Spending (May) - mom	-0.5%	-0.4%	02:00

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Date	Country	Data/Event	Mkt.	Last	Time (NZST)
2 Jul cont.	US	Atlanta Fed's Lockhart to Speak on Economy, Financial Turmoil	-	-	10:00
	JN	Monetary Base (Jun) - yoy	-	-0.9%	11:50
	AU	DEWR Skilled Vacancies (Jun) – mom	-	-0.1%	13:00
		Retail Sales (May) – mom	0.1%	-0.2%	13:30
		Building Approvals (May) - mom	-3.4%	7.8%	13:30
	UK	PMI Construction (Jun)	43.1	43.9	20:30
		BoE Housing Equity Withdrawal (1Q)	£5.3B	£7.3B	20:30
	EU	PPI (May) – mom	0.9%	0.8%	21:00
3 Jul	US	ADP Employment Change (Jun)	-20K	40K	00:15
		Factory Orders (May)	0.4%	1.1%	02:00
	AU	AiG Performance of Service Index (Jun)	-	49.7	11:30
		Trade Balance (May)	-950M	-957M	13:30
		Exports (May) – mom	-	5.8%	13:30
		Imports (May) – mom	-	-2.2%	13:30
	NZ	**ANZ Commodity Price (Jun)**	**-**	**1.0%**	**15:00**
	GE	PMI Services (Jun F)	53.3	53.3	20:00
	EU	PMI Services (Jun F)	49.5	49.5	20:00
		PMI Composite (Jun F)	49.5	49.5	20:00
		Retail Sales (May) – mom	0.5%	-0.7%	21:00
		ECB Interest Rate Announcement	4.25%	4.00%	23:45
	UK	PMI Services (Jun F)	49.5	49.8	20:30
		Official Reserves (Changes) (Jun)	-	-$97M	20:30
		Bank of England Quarterly Credit Conditions Survey	-	-	20:30
4 Jul	US	Change in Non-Farm Payrolls (Jun)	-60K	-49K	00:30
		Unemployment Rate (Jun)	5.4%	5.5%	00:30
		Change in Manufacturing Payrolls (Jun)	-30K	-26K	00:30
		Average Hourly Earnings (Jun) - mom	0.3%	0.3%	00:30
		Average Weekly Hours (Jun)	33.7	33.7	00:30
		Initial Jobless Claims (w/e Jun 29)	385K	384K	00:30
		Continuing Claims (w/e Jun 22)	3,123K	3,136K	00:30
		ISM Non-Manf. Composite (Jun)	51.0	51.7	02:00
	NZ	**New Zealand Tax Receipts for May**	**-**	**-**	**10:00**
	GE	Factory Orders (May) - mom	0.8%	-1.8%	22:00

Key: AU: Australia, EU: Euro-zone, GE: Germany, JN: Japan, NZ: New Zealand, UK: United Kingdom, US: United States. Sources: Dow Jones, Reuters, Bloomberg, ANZ National Bank. All $ values in local currency. (Note: all surveys are preliminary and subject to change).

NEW ZEALAND DATA WATCH

Key focus over the next four weeks: The economy is heading backwards, but with inflation - a nasty mix for the RBNZ. Upcoming data is likely to confirm that the domestic economy remains weak. However, the key release on the horizon, prior to the RBNZ's *OCR Review*, is the June quarter CPI. The headline will be nasty, but the most important component will be non-tradable inflation and whether the weaker economy is feeding into reduced inflation pressure.

Date	Data/Event	Economic Signal	Comment
Mon 30 Jun (10.45)	Building Consents (May)	Correction	Given the surprising surge last month, we expect a relatively large downward correction in May.
Mon 30 Jun (15.00)	NBNZ *Business Outlook* (Jun)	-	-
Thu 3 Jul (15.00)	ANZ Commodity Price Index (Jun)	-	-
Tue 8 Jul (10.00)	NZIER Quarterly Survey of Business Opinion (Jun qtr)	Weak	We expect headline confidence and activity gauges to continue to deteriorate, in line with the National Bank *Business Outlook*. Capacity utilisation is also expected to fall following last quarter's surprising surge. Employment gauges are expected to weaken considerably. However, pricing intentions should remain elevated.
circa 11 Jul	REINZ Housing Report (Jun)	Weak	Recent data has shown the number of house sales continuing to fall, but prices remaining elevated. Until vendors become more realistic with their price expectations, sales will remain well down.
Mon 14 Jul (10.45)	Retail Sales (May)	Small rebound	Core retail sales are likely to rebound slightly following two soft months. However, headline sales are likely to be weak driven by a fall in motor vehicle sales.
Tue 15 Jul (10.45)	Consumers Price Index (Jun qtr)	High	Petrol and food prices are likely to contribute close to 1 percentage point alone to the CPI increase in the quarter. The mix will be equally important as the headline and we will be closely watching housing-related components to see if any softening is occurring and an early sign weak demand is capping pricing pressure.
Mon 21 Jul (10.45)	Electronic Card Transactions (Jun)	Weak trend	Given cost of living pressures, the underlying trend in retail spending is likely to be weak.
Mon 21 Jul (10.45)	External Migration (Jun)	Base forming	Recent monthly net migration inflows have improved. We expect a base to form around the current annual net inflow of 5,000.
Thu 24 Jul (09.00)	RBNZ *OCR Review*	50-50	Evidence is mounting that the economy is slowing sharply and in need of some support. Looks to be a 50-50 call at this stage.
On Balance		**An economy heading backwards, but with inflation**	**Growth indicators are awful. But inflation needs to be watched.**

SUMMARY OF KEY ECONOMIC FORECASTS

	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Mar-10
GDP (% qoq)	0.8	0.5	0.8	-0.3	**-0.4**	**0.1**	**0.3**	**0.3**	**0.5**	**0.5**
GDP (% yoy)	3.2	3.3	3.5	1.9	**0.7**	**0.2**	**-0.3**	**0.3**	**1.2**	**1.6**
CPI (% qoq)	1.0	0.5	1.2	0.7	**1.4**	**1.2**	**0.9**	**0.5**	**0.7**	**0.7**
CPI (% yoy)	2.0	1.8	3.2	3.4	**3.8**	**4.6**	**4.3**	**4.1**	**3.4**	**2.9**
Employment (% qoq)	0.5	-0.3	0.9	-1.3	**0.2**	**-0.2**	**0.0**	**0.1**	**0.1**	**0.2**
Employment (% yoy)	1.5	1.6	2.5	-0.2	**-0.6**	**-0.4**	**-1.3**	**0.1**	**0.0**	**0.4**
Unemployment Rate (% sa)	3.6	3.5	3.4	3.6	**3.8**	**4.0**	**4.2**	**4.3**	**4.5**	**4.7**
Current Account (% GDP)	-8.1	-8.3	-7.9	-7.8	**-7.3**	**-7.1**	**-6.9**	**-6.6**	**-6.5**	**-6.4**
Terms of Trade (% qoq)	0.4	3.7	2.7	4.1	**0.0**	**-1.0**	**-0.1**	**-1.5**	**-1.2**	**-1.0**
Terms of Trade (% yoy)	2.3	8.4	8.5	11.3	**10.8**	**5.8**	**2.9**	**-2.6**	**-3.8**	**-3.7**

KEY ECONOMIC INDICATORS

	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Retail Sales (% mom)	1.1	-0.4	1.8	0.0	0.2	-0.6	-1.2	1.0	..	..
Retail Sales (% yoy)	4.1	5.8	7.2	5.4	6.3	7.7	-1.0	4.1	..	..
Credit Card Billings (% mom)	2.2	-0.4	1.1	0.5	-	0.8	-3.4	4.0	-1.1	..
Credit Card Billings (% yoy)	9.3	7.7	9.5	7.6	8.6	8.0	3.3	8.2	5.9	..
Car Registrations (% mom)	-6.7	5.6	-3.6	-2.7	5.3	-4.2	-13.0	12.3	-15.2	..
Car Registrations (% yoy)	0.1	4.7	2.3	1.4	1.7	1.9	-13.2	-1.0	-20.6	..
Building Consents (% mom)	-10.5	-5.3	0.9	-4.1	3.9	-5.5	-14.4	82.1	..	..
Building Consents (% yoy)	-15.5	-16.1	-4.5	-6.5	-5.2	-17.7	-27.1	30.9	..	..
REINZ House Price (% yoy)	12.3	8.0	6.7	4.5	4.0	0.7	1.6	-1.1	-1.4	..
Household Lending Growth (% mom)	0.8	0.8	0.8	0.7	0.7	0.8	0.4	0.4	0.5	..
Household Lending Growth (% yoy)	13.2	13.0	12.8	12.3	11.9	11.6	10.8	9.9	9.3	..
Roy Morgan Consumer Confidence	121.3	122.0	121.9	126.6	121.2	116.0	111.7	99.9	89.2	86.5
NBNZ Business Confidence	-26.5	-12.9	-19.6	-24.9	..	-43.9	-57.9	-54.8	-49.7	..
NBNZ Own Activity Outlook	17.2	20.3	15.7	18.2	..	2.4	-6.4	-3.8	-4.4	..
Trade Balance ($m)	-572	-774	-628	39	-311	243	-44	-296	-196	..
Trade Balance ($m annual)	-6282	-5883	-5691	-5307	-4793	-4422	-4527	-4609	-4813	..
ANZ World Commodity Price Index (% mom)	0.4	1.8	0.8	0.0	-1.4	1.1	2.0	-0.3	1.0	..
ANZ World Commodity Price Index (% yoy)	35.7	37.8	35.9	30.9	27.4	26.9	26.9	20.7	18.7	..
Net Migration (sa)	630	220	440	0	90	250	530	510	1010	..
Net Migration (annual)	8309	7517	6588	5491	4799	4643	4678	4666	4931	..

Figures in bold are forecasts. mom: Month-on-Month qoq: Quarter-on-Quarter yoy: Year-on-Year

SUMMARY OF KEY MARKET FORECASTS

	Actual		Current	Forecast (end month)						
NZ FX rates	Apr-08	May-08	30-Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10
NZD/USD	0.791	0.778	0.761	0.770	0.750	0.720	0.680	0.640	0.630	0.620
NZD/AUD	0.851	0.819	0.792	0.762	0.721	0.720	0.723	0.719	0.724	0.738
NZD/EUR	0.502	0.500	0.482	0.494	0.484	0.468	0.453	0.441	0.450	0.456
NZD/JPY	81.1	81.1	80.8	80.1	78.0	75.6	73.4	70.4	69.3	69.4
NZD/GBP	0.399	0.395	0.381	0.393	0.389	0.379	0.364	0.346	0.346	0.344
NZ$ TWI	70.4	69.4	67.6	67.8	65.9	64.0	61.9	59.6	59.6	59.7
NZ interest rates	Apr-08	May-08	30-Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10
OCR	8.25	8.25	8.25	8.00	7.50	7.00	6.50	6.00	6.00	6.00
90 day bill	8.87	8.72	8.66	8.20	7.70	7.10	6.60	6.20	6.20	6.20
10 year bond	6.48	6.43	6.39	6.30	5.70	5.60	5.60	5.40	5.30	5.40
International	Apr-08	May-08	30-Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10
US Fed funds	2.00	2.00	2.00	2.00	1.75	1.75	1.75	2.25	2.75	3.25
US 3-mth	2.85	2.68	2.79	2.50	2.00	1.75	2.00	2.50	3.00	3.50
AU cash	7.25	7.25	7.25	7.50	7.75	7.75	7.75	7.75	7.25	6.75
AU 3-mth	7.80	7.79	7.82	7.90	8.10	8.10	8.10	7.80	7.20	6.70

KEY RATES

	27 May	23 Jun	24 Jun	25 Jun	26 Jun	27 Jun
Official Cash Rate	8.25	8.25	8.25	8.25	8.25	8.25
90 day bank bill	8.72	8.71	8.72	8.71	8.71	8.67
NZGB 07/09	7.16	7.08	7.08	7.06	7.05	6.99
NZGB 11/11	6.76	6.50	6.50	6.48	6.46	6.39
NZGB 04/13	6.65	6.41	6.41	6.39	6.39	6.34
NZGB 12/17	6.56	6.44	6.44	6.42	6.41	6.35
2 year swap	8.16	7.89	7.90	7.88	7.87	7.81
5 year swap	7.73	7.56	7.56	7.53	7.50	7.45
RBNZ TWI	69.9	68.2	67.9	67.8	67.7	67.8
NZD/USD	0.7894	0.7624	0.7561	0.7574	0.7576	0.7609
NZD/AUD	0.8207	0.7980	0.7944	0.7917	0.7899	0.7934
NZD/JPY	81.58	81.87	81.73	81.66	81.78	81.45
NZD/GBP	0.3983	0.3862	0.3850	0.3844	0.3836	0.3830
NZD/EUR	0.4998	0.4882	0.4873	0.4864	0.4832	0.4836
AUD/USD	0.9619	0.9554	0.9518	0.9567	0.9591	0.9590
EUR/USD	1.5793	1.5617	1.5515	1.5572	1.5679	1.5734
USD/JPY	103.35	107.38	108.09	107.81	107.94	107.05
GBP/USD	1.9818	1.9743	1.9640	1.9705	1.9749	1.9865
Oil	132.54	134.78	135.98	136.49	133.92	138.91
Gold	928.30	906.65	886.60	888.40	887.75	911.40
Electricity (Haywards)	37.49	30.81	30.66	31.37	29.04	25.65
Milk futures (US$/contract)	139	142	142	142	142	142
Baltic Dry Freight Index	11269	9211	9139	9244	9473	9599

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