Wednesday 13 September 2006

Global FX Strategy

FX

RBNZ Monetary Policy Statement Preview

Global

Key points.

- In the last week the market has again begun to think rates may be cut around mid-2007, with Jun-07 bill futures yielding 7.36%; 14bp below the current 3 month bill rate (7.50%).

- If the RBNZ move to an unchanged track through Q3-07 and a gradual easing beyond that, then the market reaction should be muted. However, if it forecasts rates to hold steady throughout 2007 (or beyond), then this may be considered bearish for the bond market, and bullish for the NZD.

- We do not think the MPS assessment will change much from the OCR statement a month and a half ago. At that time it already acknowledged that "economic activity has been a little stronger than expected" and they were seeing "slightly more short-term inflation pressure as a result of the continued upward trend in world oil prices". Furthermore, they had already absorbed the higher than expected Q2 CPI report.

- However, the risk is that the RBNZ may choose to drop its assessment that they "do not expect to tighten policy again this cycle". We doubt they will actually forecast a rising track for bank bills, but by dropping this line they will send a message that policy bias is more evenly balanced. They may choose this approach to ensure that the rise in yields since mid-year does not unwind. Such a result may see a knee-jerk rise in yields and the NZD.

- Activity and confidence measures generally recovered from low levels in Q1 to more moderate levels suggesting growth momentum has stabilised not far below potential. With inflation (4%) running well above the 1-3% target, further tightening in the labour market in Q2, and higher inflation expectations, the RBNZ may begin to wonder if they can confidently predict inflation will fall back into the target within the medium term. We anticipate that they will indeed do so but closer to the end of its 3 year forecast horizon.

- It is possible that the RBNZ may endorse the opinion of Finance Minister Cullen that there are downside risks for the NZD, as it has consistently promoted the need to rebalance demand in the economy away from domestic demand to net foreign demand to narrow the current account deficit (over 9% of GDP). However, the rise in the NZD since mid-year can be justified by the improvement in the NZD yield advantage and a recovery in NZD commodity prices. The terms of trade has risen in the last two quarters, so it is unlikely that the RBNZ will claim the NZD rise is unfounded.

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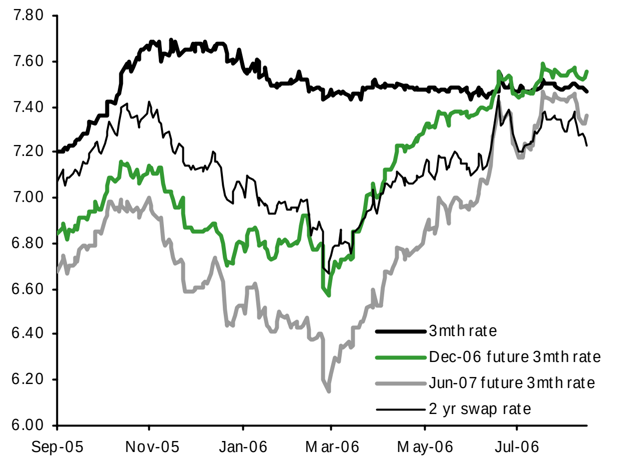
The evolution of market expectations

Chart 1 below shows the evolution of rate expectations in New Zealand in the last year. The three month bank bill rate has been steady around 7.5% since February reflecting a stable near term outlook for cash rates (7.25%). The yield curve has typically been inverted, increasingly so until late-March. At its most inverted the market anticipated between three and four 25bp rate cuts by year end and between 5 and 6 rate cuts by mid-2007, even though the RBNZ stance at that time was that they saw “no scope for easing” rates this year.

Just over a week ago, rate cut expectations before mid-2007 had been largely removed, and the market had a slight chance that rates would be hiked once more, with Dec and Mar-07 bank bill futures trading above the current bank bill rate.

However, in the last week the market has again begun to think rates may be cut around mid-2007, with Jun-07 bill futures yielding 7.36%; 14bp below the current 3 month bill rate (7.50%).

Chart 1 : NZD rate expectations



Source: ABN AMRO, Bloomberg

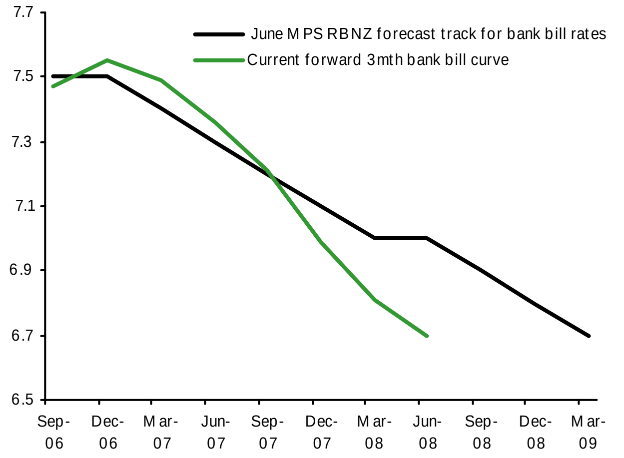
The RBNZ OCR review on 27 July slightly tightened its bias to say that there “will be some time before an easing in the OCR can be considered”, although maintaining their assessment that they “do not expect to tighten policy again this cycle”.

We expect that the RBNZ will indeed up its forecast track for bank bill rates last presented in its 8-June MPS to reflect a longer period of unchanged policy (as already implied in the 27 July OCR statement). This will be viewed by many as the true guide to how the RBNZ has changed its view.

As the chart below indicates the active front bill futures contracts out to Sep-07 have at least moved back to be at or above the track forecast by the RBNZ in June. Although there is still a tendency for the market to predict lower rates than the RBNZ from Q4-07 onwards.

This appears to be partly a structural issue in the New Zealand market, with a bias for the yield curve to be inverted, and trade lower in yield than the RBNZ expects. Nevertheless it would appear that the market is prepared for only a fairly minor lift in the RBNZ forecast track for bill rates over its forecast period. If the RBNZ move to an unchanged track through Q3-07 and a gradual easing beyond that, then the market reaction should be muted. However, if it forecasts rates to hold steady throughout 2007 (or beyond), then this may be considered bearish for the bond market, and bullish for the NZD

Chart 2 : RBNZ June MPS forecast bank bill track



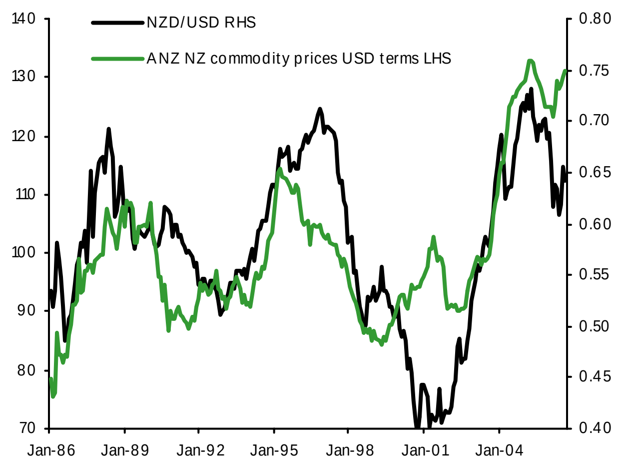
Source: ABN AMRO, Bloomberg

The NZD has been stronger than forecast by the RBNZ in its June MPS. At that time it predicted a gradual further decline in the NZD TWI even though it was down over 10% in the year to date. The NZD TWI has recovered to 64.4, above their Sep-06 forecast of 61. This attracted comments from the Finance Minister Cullen last week designed to discourage further strength in the NZD.

It is possible that the RBNZ may endorse these thoughts, as it has consistently promoted the need to rebalance demand in the economy away from domestic demand to net foreign demand to narrow the current account deficit; at over 9% of GDP.

However, the rise in the NZD can be justified by the improvement in the NZD yield advantage since mid-year and a recovery in NZD commodity prices (chart 3). The terms of trade has risen in the last two quarters, so it is unlikely that the RBNZ will claim the NZD rise is a surprise or unfounded.

Chart 3 : NZD and commodity prices



Source: ABN AMRO, Bloomberg

The policy outlook

The question then is: how will the RBNZ react to recent events? In general it will be pleased that the market has removed its rate easing expectations and is factoring in a more gradual path for rate cuts from Q3-07 onwards. This has helped push 2 year yields back to around their highs around the end of 2005, and suggests the market has reacted rationally to evidence of firming activity and higher inflation pressure (much more rationally than when it factored in several rate cuts around end-March).

This is very important for the transmission of monetary policy to households as around 80% of mortgages are set for fixed terms, most for 2 years. The Bank is likely to be somewhat more confident that the 'effective' mortgage rate will continue to rise through the remainder of 2006. As such they will continue to view the lagged effects of past tightenings coming through the pipe-line, acting to dampen domestic demand.

We do not think the MPS assessment will change much from the OCR statement a month and a half ago. At that time it already acknowledged that "economic activity has been a little stronger than expected" and they were seeing "slightly more short-term inflation pressure as a result of the continued upward trend in world oil prices". Furthermore, they had already absorbed the higher than expected Q2 CPI report.

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Activity and confidence measures generally recovered from low levels in Q1 to more moderate levels suggesting growth momentum has stabilised not far below potential. With inflation (4%) running well above the 1-3% target, further tightening in the labour market in Q2, and higher inflation expectations, the RBNZ may begin to wonder if they can confidently predict inflation will fall back into the target within the medium term. We anticipate that they will indeed do so but closer to the end of its 3 year forecast horizon.

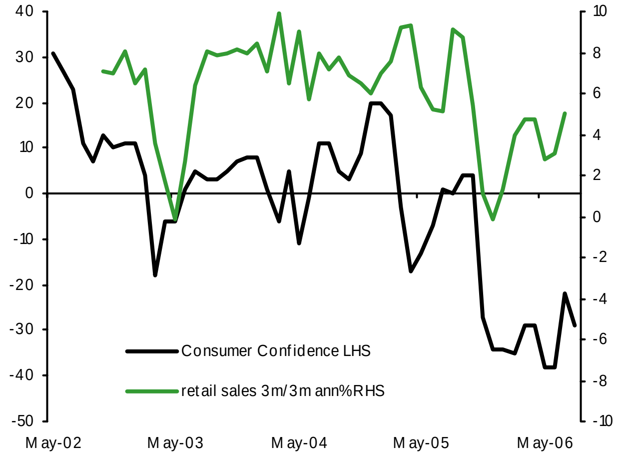
Employment and wages

Probably the most significant positive economic surprise since the 27 July OCR review was the stronger than expected labour report with a return in the unemployment rate to the record low reached in mid-2006 (3.6%). However, while this points to upward pressure on wages, the private sector Labour Cost Index eased slightly in Q2 from 5.5% to 5.3% over the year on an unadjusted basis, and remained unchanged at 3.0% y/y adjusting for productivity changes. The RBNZ will worry about tight labour market conditions but can maintain its view that the current high inflation rate arising from oil price rises and a lower exchange rate is not likely to become embedded in wages and thus become a longer term threat to inflation.

Retail sales and consumer confidence

Nominal sales were higher than expected in each of the last three months to July, although this came after virtually no growth over the preceding eight months; sales slowed to 4.1% 3m/yoy in July from a recent peak of 7.4% in August last year. On a real basis, Q2 sales fell 0.5% q/q. The Colmar-Brunton monthly consumer confidence measure recovered somewhat in July from -38% to -22%, but dipped back to -29% in August, well below levels prevailing a year earlier; see chart below.

Chart 4 : retail sales and consumer confidence

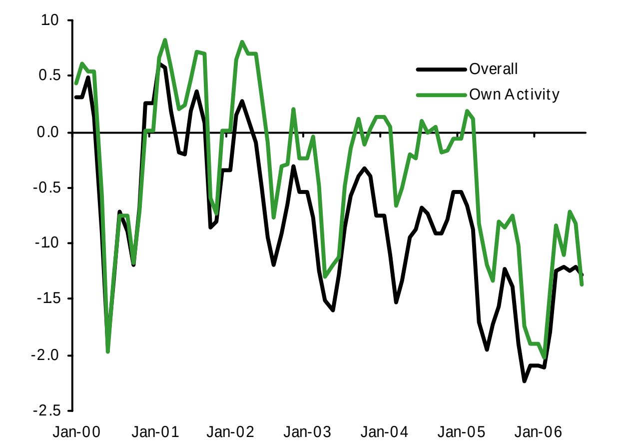


Source: ABN AMRO, Bloomberg

Business confidence

NBNZ Business confidence recovered from its lows early in the year to a recent high in June. The more closely monitored own-activity indicator rose from a low of -4.4% in Feb to +16.6% in June, its high since March-05. However, it has ebbed in July and August back to +6.1%, this is well below the long term average of +28%; suggesting growth may be well below trend.

Chart 1 : NBNZ biz conf. normalised since 1989

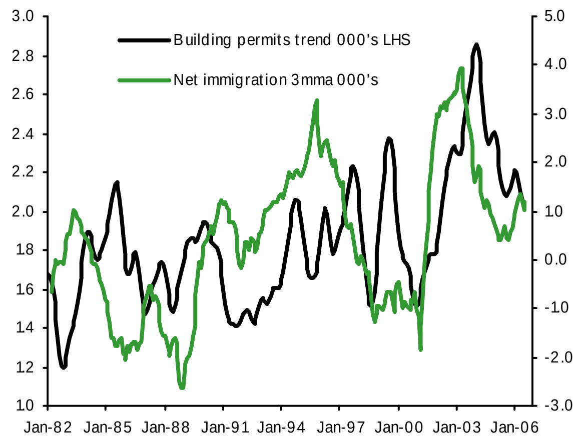


Source: ABN AMRO, Bloomberg

Immigration and building permits

Immigration has recovered this year after reaching a low point around Sep-05 at a net inflow of around 500 people; it has lifted to 1,200 people per month on average over the three months to July. This will provide some support to housing, but it remains well below the 3 to 4 thousand monthly inflow in the peak months in 2002 and mid-2003.

Chart 2 : building permits and immigration

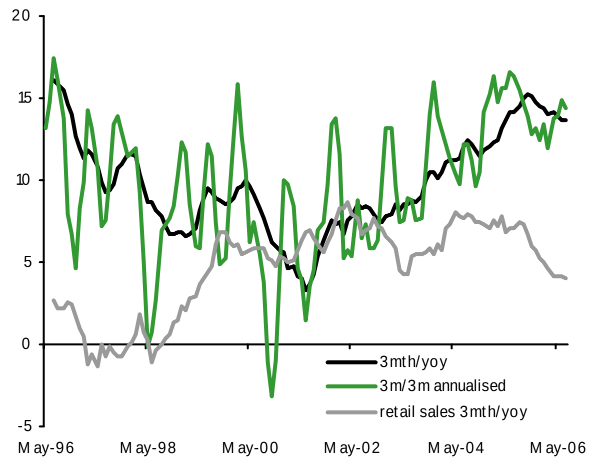


Source: ABN AMRO, Bloomberg, Econdata

Private sector credit

RBNZ aggregate private sector credit growth has ebbed somewhat from its peak of around 15% y/y around end 2005, but recent data suggests growth has picked up since Q1 with the 3m/3m annualised growth rising from a recent low in March to a recent high in June of 14.9%. As such the RBNZ can take little comfort that the pace of credit growth is slowing to more sustainable levels.

Chart 3 : RBNZ private sector credit growth

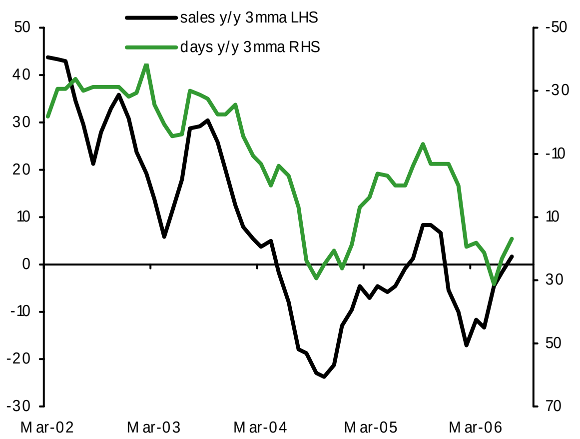


Source: ABN AMRO, Bloomberg

Housing sales and prices

Activity in the housing market has stabilised at still solid levels with sales little changed from year earlier levels in the three months ended July, up from sales that were declining around 15% y/y in Q1.

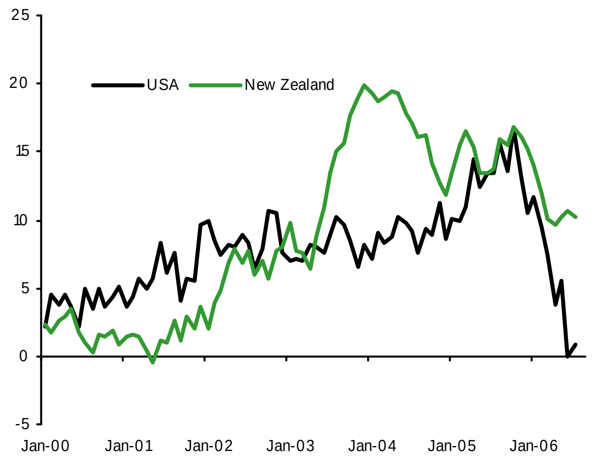
Chart 4 : REINZ housing sales and days on mkt



Source: ABN AMRO, Bloomberg

House price rises have also been relatively stable at a still solid rate over 10% y/y for the last four months to July, down from the peak last year of around 17% y/y in October, and near 20% y/y at end 2003. Price gains have held up much better than in the US where they have fallen to around zero in recent months.

Chart 5 : Existing home sales



Source: ABN AMRO, Bloomberg

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