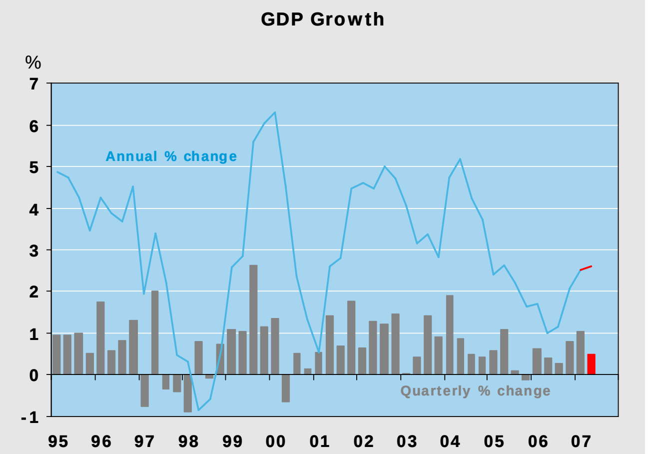
FED TO THE RESCUE

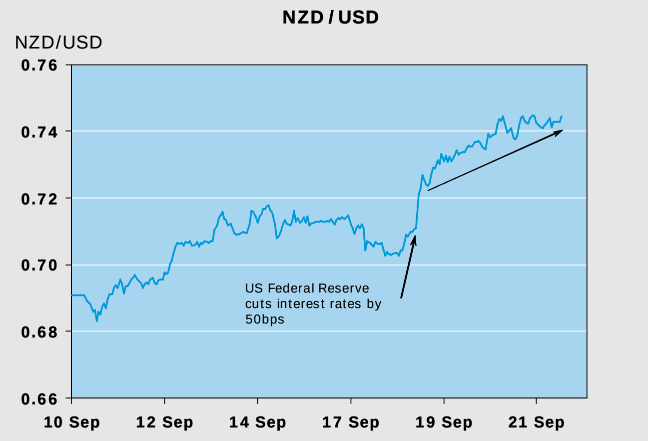
CONTENTS

We expect June quarter GDP to expand by 0.5 percent.



Sources: ANZ National Bank, Statistics NZ

The Fed's surprise 50 basis point interest rate cut has provided support to the NZD.



Sources: ANZ National Bank, Bloomberg

ECONOMIC OVERVIEW

The Federal Reserve's aggressive interest rate cut has boosted confidence, risk appetites, and likewise the NZ dollar. However, an undercurrent of wariness is likely to remain. Locally, GDP data will be key.

What's ahead…

- September quarter Westpac McDermott Miller Consumer Confidence (Wednesday 0100 NZST). We expect a small fall.
- NZ August Overseas Merchandise Trade (Wednesday 1045 NZST). Trade balance yet to show signs of the surge in dairy prices. Import demand still holding up.
- NZ August Building Consents Issued (Thursday 1045 NZST). We expect dwelling consent issuance to continue to trend lower.
- NBNZ *Business Outlook* (Thursday 1500 NZST).
- NZ June quarter GDP (Friday 1045 NZST). We expect GDP to expand by 0.5 percent (refer page 9 for our full preview).

What's the view

What a difference a week makes. All the talk this week was the US Federal Reserve's surprise 50 basis point interest rate cut. A cut was expected, but the size took many – ourselves included – by surprise. There were two possible interpretations – the Fed had some inside knowledge regarding something or was not prepared to run the risk and provided a pre-emptive strike. The markets have run with the latter. Risk appetites have returned, equity markets have rallied, bond and swap spreads have reduced, the S&P VIX index has fallen and the carry trade is back on. The NZD has surged back over US 74 cents almost as quickly as it came off its post float highs back in July. With the USD now looking decidedly weak, we will be having a close look at our FX forecasts.

We are cautious about whether this means an end to the volatility seen of late. On the face of it, the 50 basis point cut merely offsets the tightening in financial conditions that had manifested through swap and credit spreads. Concern continues to surround the US property market, and we are less than half way through the subprime mortgage reset process. The wider concern remains the extent of leverage in the system and in the presence of increasingly integrated global markets, the degree to which an apparently manageable credit event like subprime sets off processes which can cause a disorderly unwinding of leveraged balance sheets that results in widespread asset price declines.

Moreover, if there is a cautionary take on the Fed's action last week, it comes from the rise in inflation expectations, as evidenced by the steady rise in the US 10 year bond. Oil and other commodity prices likewise tracked up. The insurance taken out by the Fed does not come risk free.

Looking domestically, last week's data provided mixed signals on retail sales. Easing migration data will be welcome in terms of moderating demand for housing, but the continued rise in outflows to Australia will intensify pressure on resources. Kiwibank fired the opening salvo in competing for mortgages, and others have been quick to respond. All power to the consumer, but it's another reason for the Reserve Bank to remain vigilant.

The Reserve Bank's job at the moment is by no means easy. Domestic demand is slowing, although considerable stimulus via the dairy payout and fiscal policy is pending. Inflation risks are still mounting. Last week's announcement on ensuring NZ meets its green-house gas targets implies further marginal pressure on inflation through 2009 and beyond from petrol and electricity. Sure, they are one-offs and are not excessive. Yet, there is little scope to absorb such pressure and the one-offs all seem to be heading one-way! Such pressures present clear challenges to our expectations of a lower cash rate in early 2008 – a view we took 3 weeks ago given global and domestic developments. We remain comfortable holding the view for now, largely in our belief that global developments have yet to fully extend, and likewise for stresses in some leveraged pockets of the New Zealand economy, as the process of repricing risk takes place. Internationally, we are closely watching the UK. Not for its economic significance, but for similarities with New Zealand in terms of the housing cycle, central bank action, and leverage to the global credit cycle in general.

GDP data will be critical this week. While historical, it is nevertheless very important for the Reserve Bank's output gap calculations. With the September *Statement* projections showing inflation sitting near 3 percent for an elongated period, they have zero capacity to absorb additional inflationary pressure via a more positive output gap or opening position. We are "Joe Consensus", expecting a 0.5 percent rise, although the greater interest in our eyes will reside in the composition. The upside risk (a strong result could raise some hackles) – stems from stocks, which would imply some payback in Q3 and Q4. Expect the market to pay close attention to Q3 indicators including consumer and business confidence, particularly given the Reserve Bank's lofty 0.8 percent projection (or 0.6 percent excluding the contribution from the Tui oil field coming on line) for the quarter.

Recent data…

- **NZ Electronic Card Transaction (Aug).** Retail ECT spending was up 1.4 percent.
- **NZ Balance of Payments (June qtr).** The annual current account deficit improved to an estimated 8.2 percent of GDP.
- **NZ External Migration (Aug).** There was a seasonally adjusted net migration inflow of 750 in August, taking the annual total to 8,730.
- **NZ Credit Card Spending (Aug)** fell 0.3 percent, after a 0.1 percent fall in July.

DAIRY GOLD?

The dairy industry is on a roll. What milk price is necessary to justify the exuberance being shown for spending around $8.6m buying and then converting a sheep farm to dairying? Our high level analysis suggests that the milk price has to be sustained at around $6.50 per kilogram milk solids to get the economic return near seven percent on the example investment. We do not expect indicative international dairy prices to be sustained at current record levels but they can fall a long way and still be very good.

The opening shot

So you want to invest in a dairy farm by buying a sheep farm and converting it to dairy? We present a high level analysis of potential economic returns. There can be a wide range in the answers, depending on the assumptions used. We stress at the outset, that actual reality can also be quite different from a generalisation. The numbers are based on a hypothetical conversion of a sheep farm in Southland.

The base case

What ever you spend on the base sheep farm, expect to spend about as much again to get it to a fully operational dairy farm. A 500 cow farm is likely to cost around $8.6m ready to go. Conversion is not for the faint-hearted.

Estimated Total Capital	
Item	**Cost ($000)**
175 hectare sheep farm	4,375
Added infrastructure	1,200
Total Land	**5,575**
Plant	150
Stock 500 cows plus replacement heifers	1,125
Fonterra Shares	1,300
Project Management etc	75
Contingency	350
Total	8,575
Say	**8,600**

Some Detail

The added infrastructure includes a second house, cowshed, effluent treatment, water supply, fencing and raceways. A tractor, silage wagon and farm bikes make up the plant. You need to buy over 600 head of cattle by the time you get a full complement of replacement heifers. Young cattle need to be added to the herd each year to replace cows that have worn out, become infertile or died.

Establishment fees include a project manager to stitch the conversion together and the legal and accounting fees associated with buying the land and setting up the ownership structure. Cost overruns and the unexpected items are to be expected.

Potential Returns

Potential economic return on capital from our investment could range between three and six percent per annum after we agree on the necessary assumptions and those assumptions are turned into fact.

The property hits its straps at a run. We have made a superb job of buying a good farm, buying good stock and secured a top manager and staff (non-trivial tasks in the current environment!). First year production is right up there at 1,100 kg ms per hectare (192,000 total).

Return on Capital – Base Scenarios				
Milk Price $/kg ms	**5.00**	**5.55**	**6.00**	**6.50**
Revenue (000)	**1,020**	**1,096**	**1,192**	**1,288**
Expenditure				
Working				
Depreciation				
Manager				
Total Exp	**700**	**700**	**700**	**700**
Avail For Debt Servicing	**320**	**396**	**492**	**588**
Return on Capital				
Base Scenarios	3.7	4.6	5.7	6.8
Production + 5%	4.2	5.1	6.3	7.5
Costs + 10%	2.9	3.8	4.9	6.0
Potential Debt				
$m at 9%	3.6	4.4	5.5	6.5
$m at 8%	4.0	5.0	6.2	7.4

As usual, return on capital calculations are very sensitive to small changes in the assumptions used in deriving the reward to capital.

Is the reward big enough?

The reward looks low from conventional corporate investment analysis when the cost of capital has to be somewhere in excess of seven percent. So is there an immediate capital gain from conversion? Opinion is divided on an answer. There are very few established properties on the market at this time of the year to make a valid comparison (traditionally a quiet time for selling). What about longer term capital gain? History says yes. The macro investment environment in New Zealand is conducive to land at least holding its value but that does not make it immune to a major and prolonged negative shock. Capital gain adds to wealth. It adds to cash only when realised. It doesn't fund cash flow in the interim.

What milk price is required?

The milk price has to be sustained at around $6.50 per kilogram milk solids to get the cash return on our model capital investment near seven percent.

Influence of leverage, ownership and tax

An ability to leverage the investment, various ownership structures and offsets against other income can well make the return better than projected in this article. But that is a topic best left to experts and specific situations.

What is the outlook for dairy prices?

We do not expect indicative international dairy prices to be sustained at current record levels. This suggests $6.50 or potentially $7 may be as good as it gets. But prices can fall a long way and still be very good.

World demand for quality food is increasing, and is broad based both by food type and region. Dairy products are part of this scenario. Western economies are looking for special food products or food with special attributes (health, wellness). Steady or better economic growth in Eastern countries is resulting in a more affluent and growing population who look for more and alternative sources of protein. Dairy products fit both parts of the demand equation.

The current very high dairy commodity prices are due to a combination of circumstances. They include growing demand, switches in the dairy product mix manufactured and overall growth in production dented by weather or constrained by agricultural policies. Higher grain prices from bio fuel feed stock demand are now reflected in the milk pricing model of the USDA and show in the domestic price of US dairy products.

Economic growth is steady and the outlook for dairy prices is positive. High prices will generate a positive supply response but nature limits the speed at which that can happen. Only a muted negative consumer response to increases in prices has been noted to date but remains a concern. Similarly, the potential political policy responses to higher inflation from food prices in general (the ethanol effect) have yet to appear. But indicative international dairy commodity prices can fall a long way from current levels and still be very good.

The Risks

Returns from agriculture are volatile. The risks mainly revolve around adverse events that can seriously dent cash flow.

The list of risks is long but risk is also about probabilities. Be sure to do a risk analysis on both the business and your own circumstances before investing.

The probability of some adverse events can be objectively measured; many others can only be assessed subjectively. Some of the risks are manageable, some unmanageable.

The macro risks revolve around economics and the environment. How long will international dairy prices stay at current levels? The micro risks can be broken further into establishment and ongoing operational risk. Finding the contractors to do the necessary work on time and to budget, finding the herd etc are part of the establishment risk. Examples of ongoing risk include labour turnover, finding winter grazing for cows etc.

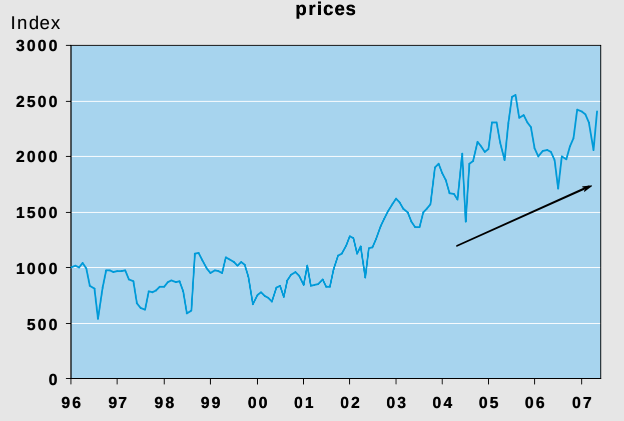
Summary

The numbers and issues will differ if the same analysis is done by a different person or for a different locality. Economies of scale over time will add a positive bias to the figures. However, we have attempted to provide a broad overview as to the return on a standard unit.

The outlook for dairy is positive. International prices could fall and still provide strong income growth. Yet, equally, a lot of this good news already needs to be factored into the equation, and has been quickly capitalised – both into stock and land.

An investment in pastoral agricultural has different dynamics to other business e.g. the business works within restrictions applied by mother-nature. It can be a roller coaster. Land prices need to keep increasing for agriculture to realise a return on equity comparable with other investments. The combination of strong productivity growth, economies of scale and rising commodity prices has fostered this historically. All are important going forward. Yet, the big challenge for the sector may well be to identify the next wave of factors and issues that is going to take the sector to a sustainable new plane.

Ratio of dairy land prices to NZD dairy commodity prices



Sources: ANZ National Bank, REINZ

NZ INFLATION WATCH

Food price inflation and services based sectors where cost-push inflation is dominant are the key sources of inflationary pressure over the coming year. But some inflation relief is expected from construction costs, transport services and retail goods. The latter courtesy of competitive forces limiting the extent of pass-through from a lower NZD.

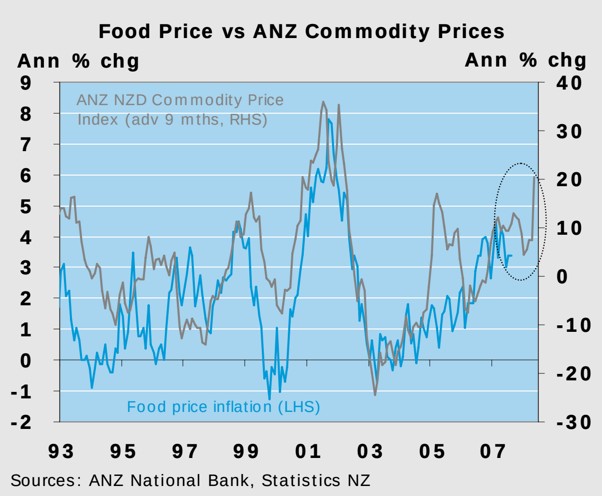
The Reserve Bank remains concerned about the risks to inflation, judging that inflation pressures remain intense. The Bank's September *Monetary Policy Statement* projects headline inflation at the top of their 1-3 percent target band until mid 2009.

When we look at the level of inflation pressure in the economy, we typically look at aggregate indicators such as capacity utilisation, pricing intentions surveys and wage inflation. While this is useful at a broad level, it does not tell us which areas those inflation pressures are coming from.

To do this, we had a look at the components of the CPI against their major drivers. This method does not come up with a precise point estimate or forecast of future CPI inflation. Rather, its usefulness is in identifying the areas where inflation pressure is still prevalent, where some inflation relief is likely to come from, and potential sources of future inflation risks.

Food Prices (17.38% weight)

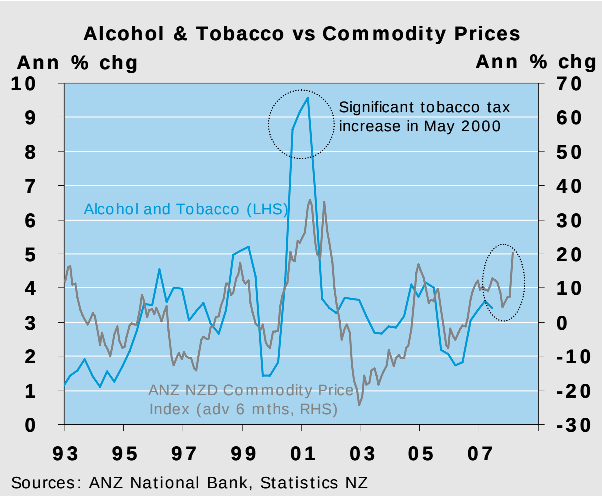
Food price inflation is the Reserve Bank's latest concern. With a structural shift in soft commodity prices underway, courtesy of growing demand out of emerging economies and for biofuels, food price inflation is very likely to keep rising over the next two years. The extent of any rises depends on how much of the increased cost is absorbed by the supermarket chains. We suspect some of the cost will get passed on to consumers, as we have already seen with the recent rise in the price of butter. Based on where the ANZ NZD Commodity Price Index is, food price inflation could rise from the current 4 percent towards 5-6 percent by the end of 2008. While the Reserve Bank has stated they will largely look through the initial direct price effects, they will respond to second round effects. Keep an eye out for the prices of those muffins and lattes over coming weeks!



Sources: ANZ National Bank, Statistics NZ

Alcohol and Tobacco (7.2% weight)

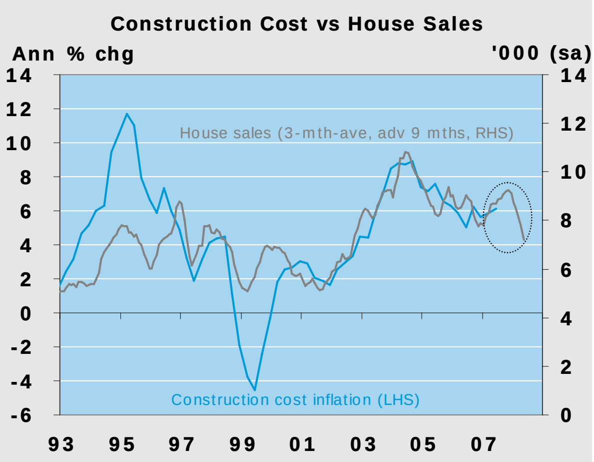
The price of alcohol and tobacco attracts a hefty tax, which is increased by the rate of inflation every year (1 June for alcohol and 1 December for tobacco). But the production costs of alcohol and tobacco are not too dissimilar to food generally. We find that the ANZ NZD Commodity Price Index provides a reasonably good proxy for future alcohol and tobacco price inflation. This suggests that, while prices rise when the taxes are inflation adjusted, producers also take advantage of these price adjustments to push through higher prices if their input costs are also rising. Like food price inflation generally, alcohol and tobacco prices are likely to remain elevated at around 4 percent next year. The biggest risk remains one-off increases in 'sin tax', though these tend to be looked through by the Reserve Bank.



Sources: ANZ National Bank, Statistics NZ

Construction Costs (4.66% weight)

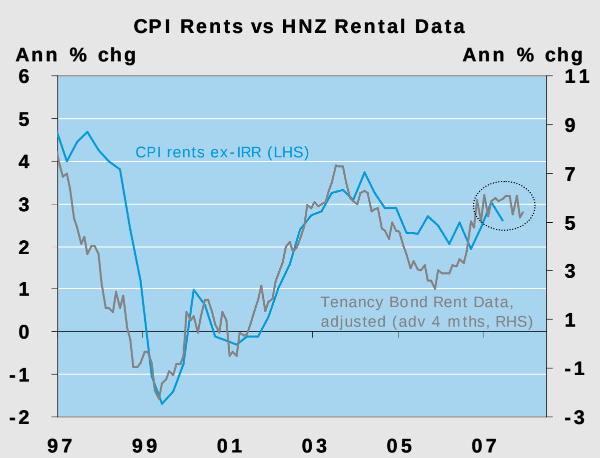
This is an area the Reserve Bank has been trying to dampen down. Construction cost inflation has been high, contributing to elevated non-tradable inflation. With firm evidence that the housing market has at last turned, construction cost inflation should start to ease from the current 6 percent towards 4 percent by next year. Non-bank financial institution difficulties may result in funding drying up for property development projects and this could see easing in the demand for resources. Higher building materials cost (due to high hard commodity prices) may keep construction costs up, but overall we expect an easing in inflation pressure as the housing market continues to soften.



Sources: ANZ National Bank, Statistics NZ, REINZ

Rents (6.87% weight)

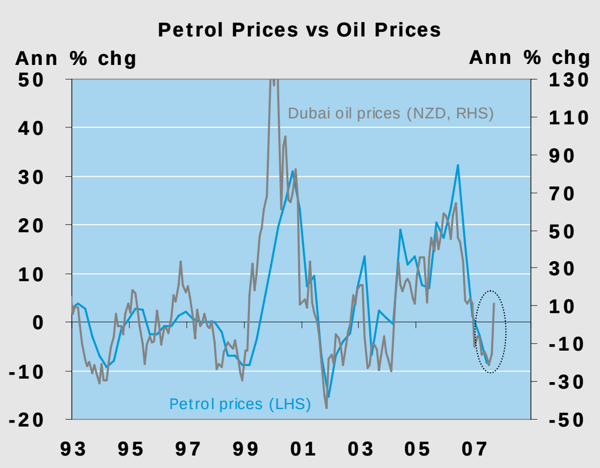
Rental inflation has managed to remain relatively subdued despite rising house prices in recent years. The near-term outlook for rental inflation suggests it will remain stable at around current 2.5 percent levels. An easing in net migration (including student numbers) mean less demand for rental accommodation, which should help keep a lid on rent prices.



Sources: ANZ National Bank, Statistics NZ, DBH

Petrol (5.38% weight)

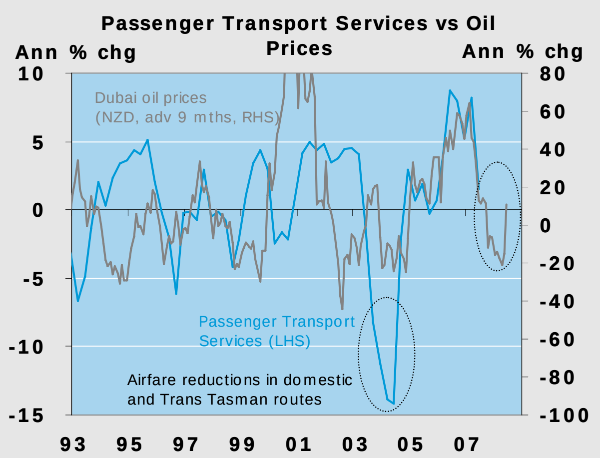
Petrol prices are driven by world oil prices and the NZD. With oil prices reaching new highs, the risk is pointed firmly upwards for petrol prices. There is not a lot the Reserve Bank can do to influence pump prices. The Bank has always looked through spikes in petrol prices, but will guard against second round effects. Various taxes (NLTF, ACC, GST etc) account for 42 percent of the pump price. Future increases in petrol taxes, due to regional taxes to fund infrastructure projects or as part of the Government's climate change policy, remains a key source of upside risk to petrol prices along with higher oil prices.



Sources: ANZ National Bank, Statistics NZ, Bloomberg

Passenger Transport Services (2.73% weight)

Airfares make up the bulk of this component. While seasonality and competition have a strong influence on price changes, the price of fuel also has a major say. Over the coming year, airfares should be a source of deflation as increased domestic competition courtesy of Pacific Blue hold domestic airfares down. The ongoing popularity of discount airlines and further competition (Tiger Airways has started flying into Australia) will also help keep international airfare increases down. Again, any new taxes targeted at air travel as part of a climate change policy will be a key source of upside risk to passenger transport services. But this could be offset, to some extent, should public land transport services be offered increased subsidies.

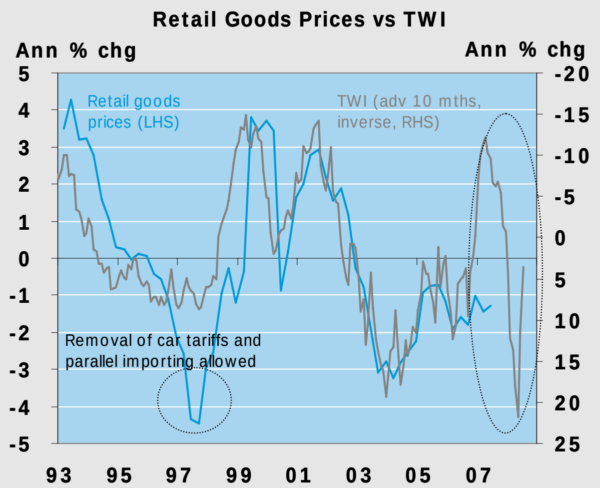


Sources: ANZ National Bank, Statistics NZ, Bloomberg

Retail Goods (19.89% weight)

This is a collection of items that are largely retail related, ranging from clothing and furniture to electronic equipment. As a large proportion of consumer goods are imported, the NZD and world manufacturing prices, along with competition in the retail sector, play a large part in price setting.

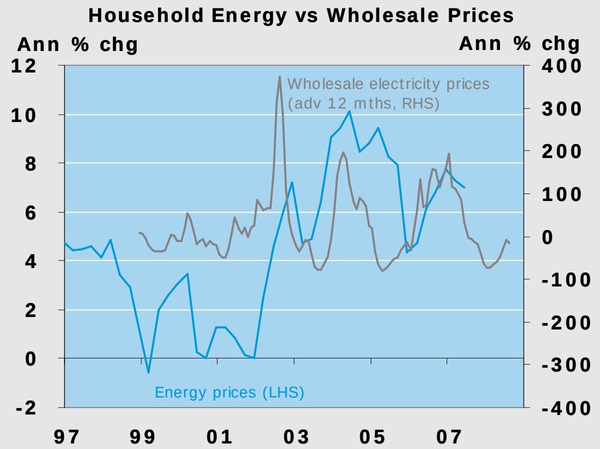
Retail goods inflation has been negative since 2003, courtesy of a higher NZD over that period (there seems to be a lagged effect of about 10 months, suggesting hedging or other timing issues play a part). But we continue to benefit from globalisation and the pace of technological change which pushes the world price of manufactured goods down. Though the decline in the NZD since early August signals possible increases in retail goods inflation, we are heartened by the lack of price increases when the NZD fell over the first half of 2006. This suggests that competition forced retailers to absorb the lower NZD in their margins. With consumer demand softening as higher interest rates start to take hold, we expect retail goods to remain a source of deflation over the next year.



Sources: ANZ National Bank, Statistics NZ, Reuters

Household Energy (3.82% weight)

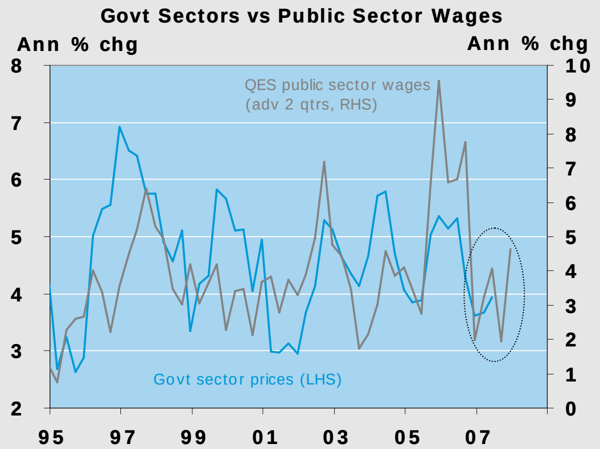
Wholesale electricity prices have an influence on domestic energy prices, but there are other considerations as well including future investment needs and other costs. Residential customers are insulated from temporary spikes in the wholesale electricity market, but will ultimately be hit if wholesale prices remain high. Based on the (rather loose) relationship between wholesale electricity prices and energy prices, an easing in the former suggests a corresponding easing in the latter. However, energy price increases are expected to remain elevated at around 6-7 percent next year, with the potential for higher increases in future years as a result of the Government's climate change policy.



Sources: ANZ National Bank, Statistics NZ, M-Co

Government Dominated Sectors (9.75% weight)

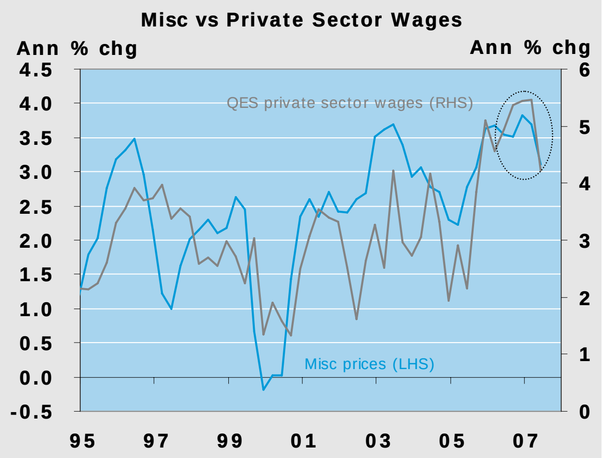
This group covers areas that are dominated by government – local authority rates, health and education. Although there are private providers in health and education, the reality is that public sector wage settings have a major influence (due to benchmarking and relativity adjustments). With wages accounting for a large share of costs in these sectors, they have a large influence on price changes. Increased subsidies, particularly for health and the Government's 20 hours 'free' ECE for 3 and 4 year olds, will help reduce price inflation in the September quarter but this is a one off. Public sector wages are expected to remain elevated (nurses got a 12 percent rise over three years two weeks ago) which will keep inflation in the government dominated sectors at around 4-5 percent over the year ahead.



Sources: ANZ National Bank, Statistics NZ

Miscellaneous (18.45% weight)

This group is a collection of items that are not covered by the other groups above, which are mainly service orientated. As such, wages are likely to be a main cost for the providers of these services, and hence a major driver of cost increases. There seems to be a reasonable relationship between inflation in this miscellaneous group and private sector wages as measured in the QES. Therefore, the outlook for inflation in this group is dependent on the labour market and wage inflation. With the labour market expected to remain tight in the near-term keeping wage inflation elevated, miscellaneous inflation is expected to remain at current 3 percent levels into next year.



Sources: ANZ National Bank, Statistics NZ

Summary

While higher food price inflation will feed directly into headline CPI, it will also reduce household's disposable income in much the same way as a rise in petrol prices does. While there is some degree of substitutability (households can choose to reduce their spending on some food items but not all), the price elasticity of food is still low. Reduced disposable income will see less spending on other items (and perhaps a confidence effect as well), which will lead to further softening in consumer spending in other areas – and hence less inflation pressure there. But the Reserve Bank will be on the lookout for any effects of higher food prices on inflation expectations.

Along with food price inflation, other potential sources of further inflationary pressure look to be in the government dominated sectors and miscellaneous, both of which appear to be driven by strong cost-push inflation. With a CPI weighting of over 28 percent, both of these groups are influenced by the labour market and wage inflation, though in reality, there is limited ability for the Reserve Bank to influence public sector wage bargaining. Areas where there look to be some inflation relief are in construction costs (assuming the housing market continues to soften), passenger transport services (due to increased airline competition) and retail goods (courtesy of competitive forces limiting the extent of pass-through from a lower NZD).

DATA PREVIEW

GDP – JUNE 2007 QUARTER (due Friday 28 Sept 10:45am)

	ANZ National	RBNZ	Market
Quarterly % change	**0.5**	0.5	0.5
Annual % change	**2.6**	2.6	2.6
Ann. ave. % change	**2.1**	2.1	2.1

Key points

- **Q2 GDP growth of 0.5 percent expected.**
- **Services to drive most of the growth on the production side.**
- **On the expenditure side, investment will be the main driver, including a large stock contribution.**
- **Early partial indicators to date pointing to soft Q3.**

We expect headline (production) GDP growth to print at 0.5 percent for Q2. This follows growth of 1.0 percent in Q1, and will take annual growth to 2.6 percent. Our forecast is similar to both market expectations and the Reserve Bank's.

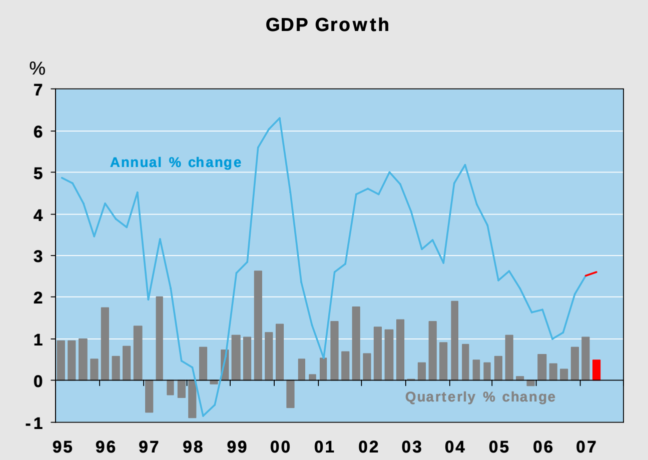
The services sectors will be the main contributor to growth in the quarter, in particular the financial, business and real estate services sectors. Housing market and borrowing activity remained robust during the June quarter.

The goods producing sectors are expected to make a flat contribution to growth. Expansion in the non-primary manufacturing sector and growth in the construction industry (courtesy of increased residential activity) are expected to be offset by falls in primary food manufacturing and the utilities sector. The latter is due to a switch away from hydro towards more thermal generation in the quarter, which has the effect of reducing the value-add in the sector.

On an expenditure basis, most of the growth is expected to come from investment and a strong positive contribution from stocks, as some of the de-stocking in Q1 gets unwound. The broad stock story is one of a sharper slowing in domestic demand, leaving retailers holding more stock than they otherwise would. Public consumption will make its usual positive contribution to growth, while net exports is expected to subtract from growth due to soft exports and an increase in imports.

We see some potential upside risk to our GDP estimate. Manufacturing production rebounded more strongly than we expected in Q1, and strong manufacturing exports and robust Business NZ PMI readings point to a potentially stronger outturn in Q2 than we have allowed. We also note that the correlation between Australian and NZ quarterly GDP growth has been 0.8 over the past three years, and the Australian GDP growth for Q2 came in above expectations at 0.9 percent.

Looking at the broader picture, growth looks to be transitioning. Following strong consumption demand in Q4 2006 and Q1 this year, consumer spending looks to have ground to a halt, a welcome development for the Reserve Bank. Partial data to date are pointing towards a soft Q3, particularly in domestic demand. But with no signs yet that the transition for growth will switch to the export sector anytime soon, this leaves the economy void of a strong economic engine over the second half of this year.



Sources: ANZ National Bank, Statistics NZ

Components of Expenditure on GDP for Q2	Quarterly % change	%-point contrib..
Private Consumption	0.0	0.0
Public Consumption	0.8	0.1
Change in Inventories	..	0.6
Residential Buildings	3.0	0.2
Other Fixed Assets	1.5	0.3
Exports of Goods and Services	0.3	0.1
Imports of Goods and Services	3.5	-1.3
Chain-linked Residual and Balancing Item	..	0.5
Expenditure GDP	**0.5**	**0.5**

Financial market implications

The Reserve Bank's inflation projections show they have zero capacity to absorb more inflation pressure. In this environment, they (and the market) are likely to be particularly sensitive to the upside risk in the GDP outturn, and the opening output gap assumption within their inflation forecasts. However, with the upside risks largely stemming from stocks (with the likelihood of reversing in H2), we expect the composition to cap.

INTEREST RATE STRATEGY

The local rates market will continue to take its cues from offshore early this week. But focus will shift towards the domestic dataflow later in the week. We expect the bias is for the curve to steepen and for swap spreads to narrow.

Market themes…

- Fed surprised the markets with a 50bps cut but offers no clear policy bias.
- US 10-year bonds sold off as growth concerns give way to inflation concerns.

Outlook…

The main focus of last week was on the Fed. The decision to cut by 50bps surprised the markets, causing a bearish steepening of the US yield curve while sending US equities higher and the USD to record lows. While the larger than expected cut can be seen in part as a pre-emptive move, it does not come without risks. The Fed continues to recognise inflation risks, and this has been picked up by the bond market, with the long-end yields rising sharply over the course of the week. The US bond market selloff came despite weaker than expected August inflation data. But with oil prices near record highs, the USD at record lows, and two large negative CPI months dropping out of the annual calculation in September and October, the bond market is reacting to the prospect that headline inflation will be heading back above 3 percent.

The local rates market has been dominated by global moves, and this is set to continue for the early part of this week. The local dataflow gets heavy later in the week, and should start to attract attention. While Q2 GDP due on Friday is the key release, this will be viewed as largely historical and get a muted reaction, unless it surprises on the upside. August trade and consents data, and consumer and the National Bank Business Confidence surveys will be closely watched for cues on momentum.

Though the 2-year swap yield has broken out of its recent 8.1-8.3 percent trading range on the back of offshore moves, we expect yields to drift back towards the middle of the range. Payside pressure in the 3-5 year part is expected due to aggressive mortgage discounting currently underway. We continue to favour the 2s10s curve to steepen and for swap spreads to narrow on the back of bond moves.

Offshore focus will be on US data, particularly for housing, and more Fed speeches. The data calendar is also busy in Japan and Europe, and commentary from ECB officials this week will also be closely scrutinised. Should credit conditions continue to stabilise, market attention will shift towards the inflation outlook.

Gauges for NZ interest rates yields

Gauge	Direction	Comment
RBNZ	↔	RBNZ on hold but remains concern over inflation. In data-watch mode for now.
NZ data	↔/↓	Busy data week culminating in Q2 GDP on Friday, to show economic momentum softening.
Fed Funds/front end	↔/↓	Fed delivers a 50bps cut. Market still expecting expecting at least one more 25bps cut by year's end.
RBA	↔/↑	Tightening financial conditions courtesy of global developments not 'unwelcome' by RBA. Bias still for higher rates.
US 10 year	↔/↑	Growth concerns have now given way to inflation concerns following Fed's cut.
NZ swap spreads	↔/↓	We continue to favour swap spreads to narrow, albeit a slow grind.
Flow	↔/↓	Receive side flows to dominate after last week's selloff in offshore markets.
Technicals	↔/↓	Markets will look for support levels after the Fed decision last week.

Borrowing strategies we favour at present

Despite a 50 basis point rate cut from the US Federal Reserve, NZ interest rates in the short-end of the yield curve actually pushed higher with credit concerns continuing to dominate the market. Fixing rates for durations of 2 or more years still provides a significant cash flow pick-up against floating. However, clients should also consider incorporating some form of optionality to allow participation if rates do eventually fall in the 2nd half of 2008.

Probability of 25bps increase as implied by market pricing

OCR dates	Last week	This week
Thu 25-Oct-07	-8	-4
Thu 6-Dec-07	-24	-8
Thu 24-Jan-08	-56	-16
Thu 6-Mar-08	-88	-48
Thu 24-Apr-08	-140	-80
Thu 5-Jun-08	-200	-116
Thu 24-Jul-08	-256	-152

Trading themes we favour at present

We expect swap yields to drift lower on corrective moves following last week's selloff, which pushed rates past the top of recent ranges. The bias is for the curve to steepen.

CURRENCY STRATEGY

US housing market data this week is likely to keep the US dollar heavy.

Market themes…

- Fed provides pre-emptive strike.
- Risk appetites return and USD bashed.
- Look out for the US housing market data.

Outlook…

The attention of currency markets was firmly offshore over the past week, with local Balance of Payments data (which came in slightly better than expected by the market) not even blinked at. Rumours of an Australian bank in difficulty (later dismissed by the RBA) sparked a wave of risk aversion early in the week, which saw the kiwi test support at the 200 hour moving average (0.7020). This support held, and proved to be a great buying opportunity for the rally later in the week following the Fed's surprise 50 basis point cut.

US equity markets, which are the gauge-du-jour for market risk appetites, rallied strongly following the Fed's rate cut, and the rally extended through the second half of the week. There were also other signs of returning risk appetites – emerging market stocks have risen, the S&P VIX index is at its lowest level since July and credit default swaps are at their lowest level in over two months. The rate cut, speculation of further rate cuts, and ongoing concern about the state of the US housing market have all contributed to the US dollar index falling to a 36-year low on Friday night. With risk appetites returning and the US dollar under pressure, it is no surprise that the NZD rallied strongly through the week, pushing firmly back through US$0.74. Despite clear signs of slowing domestic demand, the NZ dollar is still looking a tall pygmy.

Is it game over for the USD and recent global financial market disclocation? We are not sure. Stepping back, one thing we are wary of is that there looks to be strong behavioural function appearing across markets. All are desperate to get some positive returns after tough months. Movements and trends are being actively pursued, pushing beyond macro conditions for fear of missing the boat. Views do not appear to be as strong as price action would dictate. Until we see the US housing market stabilise (unlikely this week), and clear crystallisation of losses associated with subprime and the like, we expect markets to remain volatile and whippy.

While offshore developments are likely to dominate, some focus should return onshore this week, with the National Bank Business Outlook released on Thursday, and Q2 GDP data on Friday. GDP is expected to record a modest 0.5 percent increase on the quarter but looks to contain some upside risk.

After the NZD pushed through 200 day moving average resistance, it is now providing support around 0.7250. Technical resistance emerges around 0.7550 (the 61.8 percent Fibonacci retracement of the move from July's highs to lows last month). The NZD/AUD has broken out of its down trend, and 0.8490 is now providing initial support while significant resistance is seen around 0.8630.

NZD vs AUD: monthly directional gauges

Gauge	Direction	Comment
Fair value	↔	Growth differentials favouring AUD. But below 0.85 we are competitive.
Yield	↔/↑	Swap spreads moved in NZ's favour.
Commodities	↔	Still supportive of both. And both doing well in weak USD environment.
Partial indicators	↓	Aussie ahead of us in the terms of trade cycle.
Technicals	↔	Break of down trend removes downside bias.
Sentiment	↓	AUD data is better.
Other	↓	Australian economy is stronger.
On balance	↓/↔	**Solid resistance at 0.8630.**

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	↔	US data is weak as well.
Yield	↑	Yield differential widened by Fed cut.
Commodities	↑	Higher commodity prices are still a major factor.
Risk aversion	↔	Volatility measures down, market "calm" for now.
Partial indicators	↔	Neutral here. Two pygmies.
Technicals	↔/↑	NZD uptrend re-established.
AUD	↑	Fundamentals solid across the Tasman. AUD doing well.
Sentiment	↔/↑	It's a USD story.
Other	↔	Kiwi benefits from calm.
On balance	↔/↑	**A USD story, housing data holds the key.**

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZST)
24 Sep	UK	Public Finances (PSNCR) (Aug)	3.5B	-13.1B	20:30
		Public Sector Net Borrowing (Aug)	6.5B	-6.5B	20:30
	EU	Industrial New Orders (Jul)	-3.0%	4.4%	21:00
25 Sep	US	Fed's Fisher Speaks in Dallas on Higher Education	-	-	01:00
		Fed Board Holds Public Meeting on Banking Regulation	-	-	01:00
		Fed's Evans Gives Introductory Remarks at Conference	-	-	04:30
		Fed's Bernanke Speaks on Education in Washington	-	-	05:00
	JN	BoJ Monetary Policy Minutes for August	-	-	11:50
	AU	RBA's Battellino Speaks on Financial Trends	-	-	13:00
	GE	IFO – Business Climate (Sep)	105.0	105.8	20:00
		IFO – Current Assessment (Sep)	111.0	111.5	20:00
		IFO – Expectations (Sep)	99.4	100.4	20:00
	UK	Total Business Investment (2Q F) – qoq	0.8%	0.8%	20:30
26 Sep	**NZ**	**Westpac NZ Consumer Confidence**	**-**	**111.4**	**01:00**
		Trade Balance (Aug)	**-**	**-$791.0m**	**10:45**
		Exports (Aug)	**$2.55B**	**$2.64m**	**10:45**
		Imports (Aug)	**$3.50B**	**$3.43b**	**10:45**
	US	Consumer Confidence (Sep)	104.4	105.0	02:00
		Richmond Fed Manufacturing Index (Sep)	5	7	02:00
		Existing Home Sales (Aug) – mom	-4.6%	-0.2	02:00
		Fed's Plosser Speaks About Economy, Productivity in New Jersey	-	-	09:30
	EU	ECB's Liebscher Speaks in Vienna	-	-	02:00
	JN	Merchandise Trade Balance Total (Aug)	¥230.0B	¥666.5B	11:50
		Adjusted Merchandise Trade Balance (Aug)	¥739.5B	¥822.6B	11:50
	AU	Conference Board Leading Index (Jul)	-	0.4%	12:00
	GE	GfK Consumer Confidence Survey (Oct)	7.0	7.6	18:10
	UK	GDP (2Q F) – qoq	0.8%	0.8%	20:30
		GDP (2Q F) – yoy	3.0%	3.0%	20:30
		Current Account (2Q)	-11.5B	-12.2B	20:30
27 Sep	US	Fed's Poole Speaks to Small Business Owners in St Louis	-	-	00:30
		Durable Goods Orders (Aug)	-3.5%	5.9%	00:30
		Durables Ex Transportation (Aug)	-0.8%	3.7%	00:30
	EU	ECB's Trichet Speaking In Maastricht	-	-	03:10
	NZ	**Building Permits (Aug) – mom**	**-**	**-15.5%**	**10:45**
		Current Account (2Q) - % of GDP	**-8.5%**	**-8.5%**	**10:45**
		Money Supply M3 (Aug) – yoy	**-**	**9.2%**	**15:00**
		NBNZ Business Confidence (Sep)	**-**	**-33.8**	**15:00**

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZST)
27 Sep cont.	JN	BoJ Board Member Suda to Hold Press Conference	-	-	16:30
	GE	Unemployment Change (Sep) – 000s	-20k	-15k	19:55
		Unemployment Rate (Sep)	8.9%	9.0%	19:55
28 Sep	US	GDP Annualised (2Q F)	3.9%	4.0%	00:30
		Personal Consumption (2Q F)	1.4%	1.4%	00:30
		GDP Price Index (2Q F)	2.7%	2.7%	00:30
		Core PCE (2Q F) – qoq	1.3%	1.3%	00:30
		New Home Sales (Aug)	828k	870k	02:00
		Fed's Evans Gives Opening Remarks at Globalisation Conference	-	-	02:40
		Fed's Mishkin Speaks at Fed Conference on Domestic Prices	-	-	09:30
	AU	RBA's Lowe Speaks	-	-	03:30
		TD Securities Inflation (Sep) – yoy	-	2.9%	12:30
	NZ	**GDP (2Q) – qoq**	**0.5%**	**1.0%**	**10:45**
	JN	Overall Household Spending (Aug) – yoy	1.2%	-0.1%	11:30
		National CPI (Aug) – yoy	-0.2%	0.0%	11:30
		National CPI Ex-Fresh Food (Aug) – yoy	-0.1%	-0.1%	11:30
		National CPI Ex Food, Energy (Aug) – yoy	-0.3%	-0.5%	11:30
		Industrial Production (Aug P) – mom	3.1%	-0.4%	11:50
		Retail Trade (Aug) – yoy	-0.5%	-2.3%	11:50
		Vehicle Production (Aug) – yoy	-	-10.5%	16:00
		Housing Starts (Aug) – yoy	-15.8%	-23.4%	17:00
		Construction Orders (Aug) – yoy	-	-10.4%	17:00
	EU	Consumer Confidence (Sep)	-4	-3	21:00
		Industrial Confidence (Sep)	4	5	21:00
		Economic Confidence (Sep)	109.0	110.0	21:00
		Services Confidence (Sep)	19	20	21:00
	UK	GfK Consumer Confidence Survey (Sep)	-6	-4	21:00
29 Sep	US	Personal Spending (Aug)	0.4%	0.4%	00:30
		PCE Deflator (Aug) – yoy	-	2.1%	00:30
		PCE Core (Aug) – mom	0.1%	0.1%	00:30
		Chicago Purchasing Manager (Sep)	53.0	53.8	01:45
		Fed's Lockhart Speaks on US Economic Outlook in Tennessee	-	-	02:00
		Construction Spending (Aug) – mom	-0.2%	-0.4%	02:00
		University of Michigan Confidence (Sep F)	84.0	83.8	02:00
		Fed's Yellen Speaks at Federal Reserve Bank in Boston	-	-	02:15
		Fed's Poole Speaks on Central Banking at Princeton Club in New York	-	-	05:00
		Fed's Mishkin Speaks at Chicago Banking Conference	-	-	05:15

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: June quarter GDP is the big release this week and it should still show the economy expanding at a modest pace. Consumer and business confidence measures will also be important to gauge sentiment after recent global financial market turmoil and volatility across markets, including the New Zealand dollar. Further evidence of slowing domestic demand is expected from building consents, REINZ, and retail sales data in the next few weeks.

Date	Data/Event	Economic Signal	Comment
Wed 26 Sep (01.00)	Westpac McDermott Miller Consumer Confidence (Sep qtr)	Down	Consumer confidence is expected to ease.
Wed 26 Sep (10.45)	Overseas Merchandise Trade (Aug)	Imbalanced	Trade balance yet to show signs of the surge in dairy prices. Import demand still holding up.
Thu 27 Sep (10.45)	Building Consents (Aug)	Trending down	With the housing market slowing and net migration easing, the demand for new dwellings will slow – resulting in a downward trend in building consent issuance.
Thu 27 Sep (15:00)	NBNZ *Business Outlook* (Sep)	-	-
Fri 28 Sep (10.45)	GDP (Jun qtr)	Modest	Soft private consumption and a detraction from net exports is expected to be offset by increases in business investment and inventories. We expect GDP to expand by 0.5 percent for the quarter.
Thu 4 Oct (15.00)	ANZ Commodity Price Index (Sep)	-	-
Tue 9 Oct (10.00)	NZIER Quarterly Survey of Business Opinion (Dec qtr)	Down	Global uncertainty and softer domestic demand to weigh on confidence. But, a lower NZD to provide some cheer to exporters. Indicators of resource pressures to remain elevated.
circa 10 Oct	REINZ housing report (Sep)	Down	The housing market has turned. This report is expected to show further evidence of softness with easing house sales, an increase in the days to sell a house, and slowing house price growth.
Fri 11 Oct (10.45)	Retail Sales (Aug)	Small rebound	After two particularly soft months, we expect a small rebound in retail sales in August. However, the underlying trend will remain one of softness.
Mon 15 Oct (10.45)	Consumers Price Index (Sep qtr)	Non-tradable still high	We expect the headline CPI to increase by 0.7 percent in the quarter keeping the annual inflation rate at 2.0 percent. The worry for the RBNZ is that non-tradable inflation is expected to remain elevated, recording growth of 1.0 percent in the quarter.
Fri 19 Oct (10.45)	External Migration (Sep)	Easing	The recent softening trend in net migration inflows is expected to continue.
Fri 19 Oct (15.00)	Credit Card Spending (Sep)	Rebound	After two consecutive monthly falls, we expect a small rebound in credit card spending in September.
On Balance		**Slowing**	**Dairy versus housing (credit). We are backing the latter.**

NZ Economics	
Cameron Bagrie Chief Economist +64 4 802 2212	**Khoon Goh** Interest Rate Strategist +64 4 802 2357
Sean Comber Economist +64 4 802 2286	**Steve Edwards** Economist +64 4 802 2217
Philip Borkin Economist +64 4 802 2199	**Kevin Wilson** Rural Economist +64 4 802 2361

SUMMARY OF KEY ECONOMIC FORECASTS

	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08
GDP (% qoq)	0.3	0.8	1.0	**0.5**	**-0.2**	**0.3**	**0.3**	**0.4**	**0.4**	**0.6**
GDP (% yoy)	1.1	2.1	2.5	**2.6**	**2.2**	**1.6**	**0.9**	**0.8**	**1.4**	**1.7**
CPI (% qoq)	0.7	-0.2	0.5	1.0	**0.7**	**0.7**	**0.5**	**0.8**	**0.8**	**0.8**
CPI (% yoy)	3.5	2.6	2.5	2.0	**2.0**	**2.9**	**2.9**	**2.6**	**2.7**	**2.8**
Employment (% qoq)	-0.4	0.1	1.2	0.7	**-0.1**	**0.0**	**0.0**	**0.1**	**0.1**	**0.2**
Employment (% yoy)	1.5	1.4	1.7	1.5	**1.8**	**1.7**	**0.6**	**0.0**	**0.2**	**0.4**
Unemployment Rate (% sa)	3.8	3.7	3.7	3.6	**3.7**	**3.8**	**3.9**	**4.0**	**4.2**	**4.3**
Current Account (% GDP)	-8.8	-8.7	-8.3	-8.2	**-7.9**	**-7.5**	**-7.0**	**-6.5**	**-6.7**	**-6.8**
Terms of Trade (% qoq)	-2.2	2.5	1.5	0.6	**5.1**	**1.7**	**1.1**	**0.1**	**-0.2**	**-0.6**
Terms of Trade (% yoy)	-1.3	3.8	4.5	2.5	**10.1**	**9.2**	**8.7**	**8.1**	**2.7**	**0.4**

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

KEY ECONOMIC INDICATORS

	Nov-06	Dec-06	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07
Retail Sales (% mom)	-0.1	0.8	0.4	2.2	0.9	-1.2	1.0	-0.4	0.0	..
Retail Sales (% yoy)	4.5	3.6	6.9	6.4	7.4	7.4	6.7	4.8	5.7	..
Credit Card Billings (% mom)	-0.8	2.8	-1.1	1.5	1.0	-0.8	0.5	2.1	-0.1	-0.3
Credit Card Billings (% yoy)	7.8	10.0	6.8	8.2	7.4	7.8	5.7	9.3	7.9	8.4
Car Registrations (% mom)	-1.9	-3.7	13.2	-9.2	0.4	-1.2	5.9	-4.5	7.4	1.9
Car Registrations (% yoy)	-15.3	-17.8	-5.8	-12.5	-11.0	-4.8	-2.5	-1.5	7.0	10.9
Building Consents (% mom)	-11.1	-4.2	4.9	6.6	-1.4	1.1	4.9	14.2	-15.5	..
Building Consents (% yoy)	-1.0	-20.8	-5.6	-8.4	3.0	9.9	2.3	33.4	-3.9	..
REINZ House Price (% yoy)	10.0	11.9	9.0	13.6	13.7	14.4	14.8	12.1	10.4	12.9
Household Lending Growth (% mom)	1.1	1.0	1.1	1.1	1.2	1.1	1.1	1.1	0.9	..
Household Lending Growth (% yoy)	13.1	12.9	13.0	13.1	13.3	13.6	13.6	13.6	13.6	..
Roy Morgan Consumer Confidence	123.7	128.0	136.8	133.8	129.3	128.6	122.1	121.0	121.1	122.4
NBNZ Business Confidence	-14.0	-7.7	..	-5.9	-12.5	-19.4	-48.3	-37.2	-38.5	-33.8
NBNZ Own Activity Outlook	23.7	24.0	..	25.7	24.1	22.5	7.8	14.8	12.4	16.7
Trade Balance ($m)	-820	-346	-825	-127	60	-215	9	-511	-791	..
Trade Balance ($m annual)	-6047	-6082	-6013	-5767	-5776	-6024	-5899	-6217	-6315	..
ANZ World Commodity Price Index (% mom)	2.1	3.8	1.3	1.4	2.0	4.9	2.6	6.3	4.6	1.4
ANZ World Commodity Price Index (% yoy)	5.3	9.4	11.1	13.0	17.1	20.9	21.1	29.8	35.1	36.3
Net Migration (sa)	1840	1020	400	530	620	220	400	590	470	750
Net Migration (annual)	14757	14609	14116	13151	12081	11222	10682	10078	8966	8730

SUMMARY OF KEY MARKET FORECASTS

	Actual		Current	Forecast (end month)						
NZ FX rates	Jul 07	Aug 07	24 Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09
NZD/USD	0.786	0.729	0.743	0.680	0.650	0.620	0.620	0.610	0.590	0.580
NZD/AUD	0.907	0.877	0.858	0.829	0.783	0.765	0.775	0.782	0.776	0.773
NZD/EUR	0.573	0.535	0.527	0.496	0.478	0.463	0.470	0.469	0.465	0.468
NZD/JPY	95.6	85.3	85.7	80.2	77.4	74.4	74.4	72.0	69.6	67.3
NZD/GBP	0.386	0.362	0.368	0.342	0.332	0.320	0.323	0.323	0.316	0.315
NZ$ TWI	75.4	70.2	70.3	65.7	63.0	60.7	61.1	60.6	59.3	58.7
NZ interest rates	Jul 07	Aug 07	24 Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09
OCR	8.18	8.35	8.25	8.25	8.00	7.50	7.50	7.50	7.25	6.75
90 day bill	8.44	8.72	8.77	8.70	8.30	7.90	7.70	7.70	7.30	6.80
10 year bond	6.79	6.40	6.40	6.30	6.40	6.50	6.50	6.70	6.70	6.50
International	Jul 07	Aug 07	24 Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09
US Fed funds	5.25	5.25	4.75	4.50	4.50	4.50	4.50	4.50	5.50	5.75
US 3-mth	5.36	5.62	5.20	4.80	4.70	4.65	4.65	4.65	5.75	6.10
AU cash	6.25	6.50	6.25	6.50	6.75	6.75	6.75	6.75	6.75	6.75
AU 3-mth	6.62	6.89	6.87	6.80	6.90	6.90	6.90	6.90	6.90	6.90

KEY RATES

	21 Aug	17 Sep	18 Sep	19 Sep	20 Sep	21 Sep
Official Cash Rate	8.25	8.25	8.25	8.25	8.25	8.25
30 day bank bill	9.02	8.65	8.65	8.65	8.60	8.60
90 day bank bill	9.05	8.76	8.77	8.75	8.76	8.76
NZGB 07/09	7.15	6.92	6.93	6.98	6.99	6.99
NZGB 11/11	6.73	6.54	6.55	6.61	6.63	6.63
NZGB 04/13	6.60	6.46	6.47	6.53	6.56	6.56
NZGB 12/17	6.20	6.17	6.18	6.24	6.26	6.26
1 year swap	8.65	8.54	8.56	8.58	8.59	8.59
2 year swap	8.39	8.21	8.23	8.26	8.29	8.29
5 year swap	7.96	7.74	7.76	7.81	7.83	7.83
RBNZ TWI	67.6	68.1	67.3	69.5	69.9	69.9
NZD/USD	0.6968	0.7141	0.7033	0.7309	0.7360	0.7360
NZD/AUD	0.8674	0.8469	0.8463	0.8576	0.8566	0.8566
NZD/JPY	80.14	82.24	80.82	84.73	85.29	85.29
NZD/GBP	0.3506	0.3556	0.3535	0.3632	0.3681	0.3681
NZD/EUR	0.5170	0.5144	0.5075	0.5229	0.5266	0.5266
AUD/USD	0.8033	0.8432	0.8310	0.8523	0.8592	0.8592
EUR/USD	1.3477	1.3882	1.3859	1.3979	1.3977	1.3977
USD/JPY	115.01	115.17	114.92	115.92	115.88	115.88
GBP/USD	1.9873	2.0082	1.9894	2.0126	1.9997	1.9997
Oil	71.12	79.14	80.55	81.51	81.99	81.99
Gold	659.30	710.70	716.65	724.35	723.15	723.10
Electricity Price Index	5.34	5.57	5.37	5.15	5.05	5.01

Disclaimer

ANZ Bank, Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2000 Fax 64-4-496 8639
http://www.anz.com/nz e-mail ecnmcs@anz.com