

# VOLATILITY'S BACK

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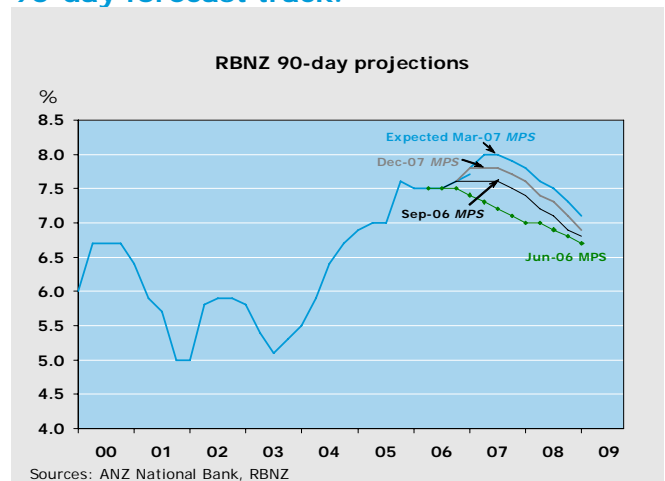
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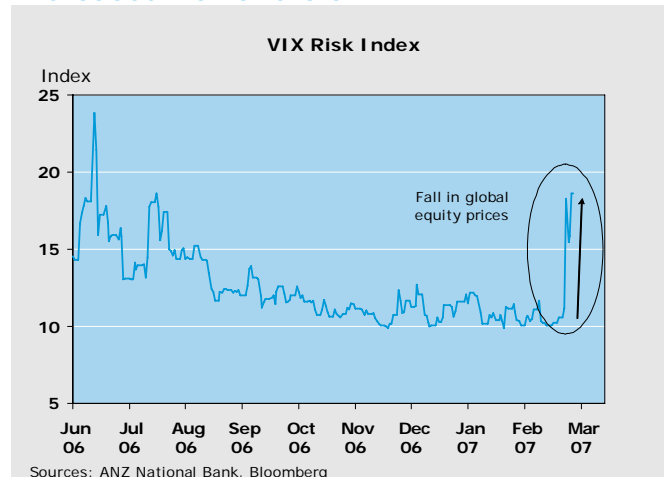
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## Increased risk aversion.



## ECONOMIC OVERVIEW

**Increased volatility was the theme of last week with risk appetites diminishing, equities softening, a flight to quality, and the carry trade under pressure. At this stage it has not extended sufficiently to materially impact on Thursday's monetary policy decision, with the Reserve Bank expected to increase the OCR by 25 basis points. But watch the next 48 hours.**

### What's ahead...

- The big event this week is the Reserve Bank's March *MPS* (Thursday 0900 NZDT). With an acceleration in wage inflation and no evidence of a moderation in the housing market, look for the Bank to increase interest rates by 25bps and deliver another hawkish statement.
- The Q4 Wholesale Trade Survey (Monday 1045 NZDT) should show solid growth, in line with retail sales growth.
- The Q4 Overseas Trade Indices (Thursday 1045 NZDT) should record a large increase in the terms of trade due to falls in oil prices and high soft commodity prices.
- The Q4 Value of Building Work Put in Place (Friday 1045 NZDT) should report a modest increase in residential construction work.

### What's the view

The Reserve Bank takes centre stage this week, and there seems little to deter what looks to be an inevitable increase in the OCR in response to a domestic economy that remains too strong for the Bank's liking. The labour market continues to underpin domestic demand. Easing medium-term inflation pressure requires the labour market to turn. While business sector earnings remain luke-warm, we simply do not seem to be at the inflection point where firms' appetite to hire is waning.

Data last week was mixed. Credit growth remains strong. Business confidence is pointing to 2.5 percent plus growth and momentum regained in late 2006 being maintained into 2007. Migration trends remain solid, although if there was some solace to be taken from the January report it was that the growth rate has stabilised and is not accelerating. At the other end of the spectrum, easing inflation expectations and a falling trend in building consents will have provided some comfort. But on balance, the scene remains set for a further upward movement in interest rates.

The only potential spanner at present is extending unease across equity markets. The Chinese equity market fell 9 percent on Tuesday night, with the government stating it was going to clamp down on illegal activity. Yet even prior to this the combination of rising oil prices, US-Iran tension and subprime mortgage defaults had the market on edge. The trend extended over the week, with volatile sessions in the US bond market, falls in

other global equities and some evidence of carry trade liquidation in the NZD and emerging markets.

We know from history that major periods of economic dislocation initially permeate through asset markets. We remain wary of leverage, which is generally thought to be huge. Volatility across oil prices and other commodities has already led to some major cleanouts. Given the large swings across asset classes and significance of the JPY as a funding currency at present, it seems probable that we could see some more. At present it is difficult to envisage this as a systemic issue. As a benchmark, the collapse of a major fund at the onset of the Asian crisis was preceded by a 20 percent fall in equities. On the surface equities would have to weaken markedly further to invoke systemic issues and deter the RBNZ, particularly with movements looking corrective in nature. However, the Bank's experience of overly tight policy and mis-reading global asset market signals in 1997 can not be overlooked if lessons from that period were heeded. If weakness in equities and the contagion across other markets develops over the next 48 hours, the OCR decision becomes a real throw of the dice.

We currently characterise sentiment as one of risk reduction as opposed to risk aversion. Liquidity remains ample. Fundamentals across Asia look strong. Growth within the US economy is solid. With asset classes priced for perfection, they are always going to be susceptible to changes in sentiment. In some cases such changes can be refreshing and a welcome reminder. After a 135 percent gain in the Chinese equity market over the last 12 months, a degree of pullback was inevitable.

The key in our eyes remains global inflation trends. The market has so far brushed aside the slight tick-up in the US core CPI, PCE deflator, and pricing gauges from manufacturing surveys, which are on the ascent. The US bond market is priced for interest rates to move down by mid-year. Lower interest rates will once again under-pin liquidity and valuations. What the market appears to be missing is that some stickiness to inflation may limit the Fed's ability to act as the liquidity provider if anything does go wrong.

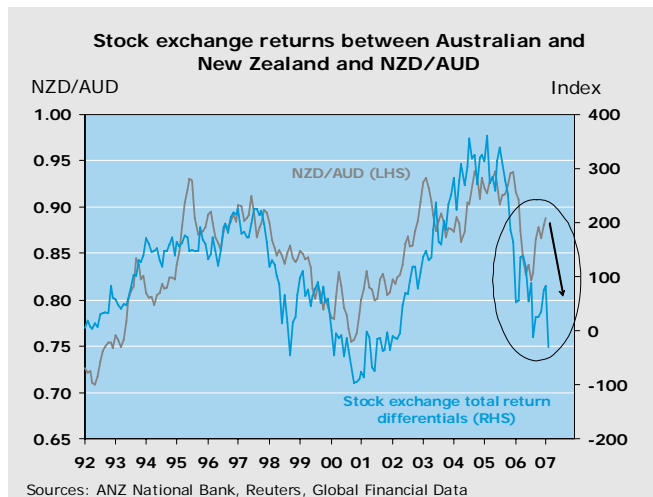
### Data last week...

- **NZ Overseas Merchandise Trade (Jan).** Larger than expected trade deficit of \$833m.
- **NZ Credit Growth (Jan).** Total household claims rose by 1.1 percent.
- **NZ RBNZ Inflation Expectations Survey.** 1-year inflation expectations fell to 2.7 percent, while 2-year expectations fell to 2.6 percent.
- **National Bank *Business Outlook* (Feb)** reported an improvement in business confidence to -5.9 from -7.7 in December, the highest level in over three years.
- **NZ Building Consents (Jan)** rose by 3.9 percent, although the trend continues to ease.
- **NZ External Migration (Jan)** rose by 450, taking the annual increase to 14,120.

## TIME TO REPORT

The reporting season has highlighted differing performances between New Zealand and Australian corporates. This reinforces contrasting paths for the business cycles. The end-game to this will be a lower NZD/AUD and a narrower yield differential.

The Q4 and Half-Year earnings reporting season for listed companies is well under way in New Zealand and Australia and the results are a timely measure of the business cycle. The earnings result clearly show that the two economies are on different paths with reported profit growth in Australia much higher than in New Zealand. Australian firms are visibly experiencing happier times than their New Zealand counterparts with the median increase in reported profits for companies on the S&P/ASX50 around 19 percent. This is in contrast to a 2 percent median increase for companies on the NZX50. And as a general theme, Australian results have surprised 2:1 on the upside, while NZ results have surprised 2:1 on the downside.



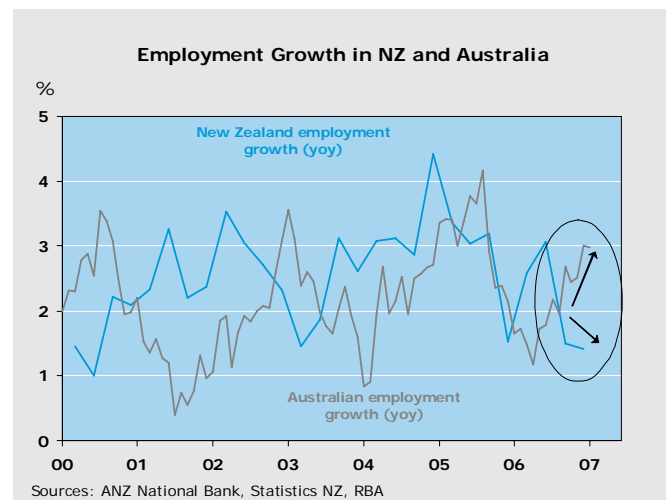
Recent performance of large corporates on the NZX50 and the ASX50		
	Earnings growth since last report (median)	P/E Ratio
Australia	19%	17.7
New Zealand	2%	21.8

It is easy to identify reasons for the divergent performance:

- **The New Zealand economy is relatively softer.** Annual GDP growth in NZ is currently below 1½ percent, while it is over 2½ percent in Australia.
- **Terms of trade are significantly higher in Australia.** Australia's terms of trade have grown by 20 percent since September 2004 due to phenomenal growth in hard commodity prices, while New Zealand's terms of trade, although still at a high level, were flat over the same period.

- **New Zealand firms are facing greater margin pressure.** In the past twelve months, New Zealand PPI margins have fallen by 2 percent, while Australian PPI manufacturing margins are basically unchanged.
- **Financial conditions are tighter in New Zealand.** Interest rates are higher in New Zealand. The NZD/USD is currently 19 percent above its post-float average, compared with only 9 percent for the AUD/USD.
- **NZ firms are facing greater capacity constraints.** With an unemployment rate in NZ of 3.7 percent compared to 4.5 percent in Australia, NZ's labour market is tighter. Capacity utilisation in NZ, at over 91 percent, is also higher than Australia's 83 percent, indicating greater economy-wide capacity pressures. Firms are struggling to expand.

Differing profitability is expected to accentuate business cycle divergence. Profitability gives businesses the flexibility to "invest" in their future through hiring and investment. Such "investment" keeps an economy on the so-called circle of economic success, where jobs drive spending, profits, investment, jobs...and so on. The latest CAPEX figures for Australia highlight a significant surge in investment plans for 2007/08. The respective paths for employment are already diverging, although this may reflect a degree of limited labour supply from the NZ side. The RBNZ is set to tighten financial conditions further, while the RBA is standing pat.



### The upshot

The earnings cycle is a key cyclical indicator of the business cycle. Strong profitability gives firms the flexibility to invest in their future. Conversely, earnings pressure ultimately entails consolidation, less investment and fewer jobs. The reporting season is highlighting a large divergence between NZ and Australian businesses. The end-game will be a lower NZD/AUD and narrower yield differential.

## INTEREST RATE STRATEGY

**With the market almost fully priced for a March rate hike attention will focus further out on the curve. We expect a selloff on the day, which will present a good receiving opportunity as we do not believe the Reserve Bank will deliver a follow-up move.**

### Market themes...

- Market to sit on the sidelines ahead of the March *Monetary Policy Statement*.
- Tight ranges and light volumes expected heading into Thursday.
- Offshore moves to see further curve inversion courtesy of lower yields at the long end.

### Outlook...

The global market moves of last week, triggered by Tuesday's 9 percent fall in the Shanghai A share index, sparked some life into the local interest rate market. However, the movements were not as extreme as those seen offshore. Even at the height of the global market correction, the market never pared back its expectations of a rate hike from the Reserve Bank this Thursday, with the probability staying firm at around 80 percent.

The market pricing is unlikely to alter before Thursday, as it is a clear run to the March *Monetary Policy Statement* due for release at 0900 NZDT. There are no major data releases that will have any bearing on the Reserve Bank's decision. The market is fully expecting a 25bps hike from the Reserve Bank and hawkish rhetoric in the statement. While the recent global market action will be closely monitored by the Reserve Bank, it is unlikely to stop them from delivering a rate hike. Domestic concerns around the housing market and medium term risks to the inflation outlook remain unchanged. The Reserve Bank will judge that, fundamentally, nothing has changed despite recent events. The unwinding of the carry trade, which has seen the NZD move from over 0.71 against the USD to 0.6890 currently, will in fact be viewed as a positive development by the Reserve Bank, which has long desired for a lower currency to assist in the rebalancing of the economy.

Global developments will dominate in the lead-up to Thursday. The risk aversion theme will continue, with flight-to-safety flows keeping US bond yields low, which will spillover into local yields – leading to further curve inversion courtesy of the long end. The market is unlikely to be taking large positions on either side heading into Thursday, so tight ranges and light volumes are expected for most of the week. We expect a selloff on the day, and the market to price in a higher chance of a follow-up move if a hawkish statement is delivered, which will present a good receiving opportunity.

Gauges for NZ interest rates yields		
Gauge	Direction	Comment
RBNZ	↔/↑	March locked and loaded.
NZ data	↔	No major data to drive direction this week. All focus on Reserve Bank.
Fed Funds/front end	↓	US 2-year yields down to 4.54 and market now pricing in two rate cuts by year end.
RBA	↔/↑	RBA look to be on hold for the rest of the year but upside risk remain.
US 10 year	↓	Flight-to-safety flows driving yields lower.
NZ swap spreads	↔	Spreads look to test wider with pay side pressure ahead of Thursday. Bonds better bid given offshore moves.
Flow	↔	Pay side the stronger side ahead of RBNZ
Technicals	↔	Local developments verses offshore developments may see technical levels tested.

### Borrowing strategies we recommend at present

Upwards pressure on rates continues despite offshore volatility – the overall view remains the same with the majority of the market looking for a 25 basis point hike this Thursday. There is still some pick-up in the 3-5 year part of the curve relative to floating and borrowers should ensure a high amount of fixed cover is in place to safeguard against further tightening. Option strategies can provide this protection whilst also allowing flexibility.

### Probability of 25bps increase as implied by market pricing

OCR dates	Last week	This week
Thu 8-Mar-07	76	80
Thu 26-Apr-07	128	128
Thu 7-Jun-07	144	136
Thu 26-Jul-07	144	136
Thu 13-Sep-07	136	128
Thu 25-Oct-07	136	128
Thu 6-Dec-07	124	120

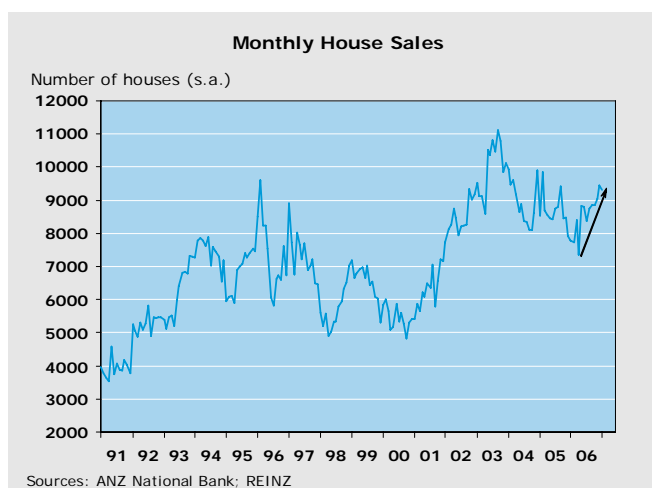
### Trading themes we favour at present

We favour going short ahead of the Reserve Bank decision and receive after as we do not expect the Reserve Bank to deliver on a second hike.

## MARCH MONETARY POLICY STATEMENT PREVIEW

We expect Governor Bollard to raise the OCR by 25bps to 7.50 percent and deliver a very hawkish statement. We see a strong probability of the central projection signalling an additional hike beyond the one they deliver.

After upping the ante in the last few assessments, we expect Governor Bollard to deliver a 25bps hike at the March *Monetary Policy Statement*. The housing market and domestic demand were the Reserve Bank's key focus in its January assessment, stating that a failure to moderate will likely result in further policy tightening. The dataflow since then, while mixed on retail spending, show no signs of the moderation that the Reserve Bank is seeking in the housing market. The continued tightness in the labour market and steady inflows of net migration will convince the Reserve Bank that moderation will not occur in the absence of higher interest rates.



### Not all the dataflow has been one-way traffic.

Retail sales have shown signs of a moderating trend in the monthly growth rates, while building consents data has been trending down since August 2006. Employment growth fell in Q4 last year, although the labour market remains tight. The recent reporting season for listed companies has been lack-lustre. However, on balance, the partials are pointing towards a solid print for Q4 GDP, and forward indicators suggest some spillover into Q1.

**While the near-term inflation outlook is benign, the Reserve Bank will remain concerned over medium-term inflation pressures and risks.** Two years of below trend growth and restrictive monetary policy settings have so far failed to adequately tame inflation pressures. In addition, the economy is not rebalancing away from domestic demand towards the external sector. We suspect deliberations at the Monetary Policy Committee meetings will focus on the risks to the inflation outlook stemming from:

- **Gathering economic momentum from the end of last year.** With resource pressures already tight, the Reserve Bank will view any pick-up in economic momentum as adding to inflation pressures. The National Bank *Business Outlook* survey, a key leading indicator of economic activity, points to momentum being sustained into early 2007, and more worryingly for the Reserve Bank, driven mainly by the domestically orientated sectors.
- **Accelerating wage inflation at the end of last year** will now be added to the list of risks facing the inflation outlook. In their December projections, the Reserve Bank expressed confidence that wage inflation will remain contained and slow from the second half of this year. The surprising pick-up in wage inflation in Q4 and continued tightness of the labour market will add another worry bead to the Reserve Bank's inflation concerns.
- **Inflation pressure still building in the pipeline.** Producer price data show margins continuing to contract, with input price growth outstripping output price growth in 9 out of the past 11 quarters. The risk is that this build-up of pipeline inflation pressure will spill over into consumer prices at some stage, particularly in the non-tradable sector, if economic momentum continues to rebuild.
- **Inflation expectations may have eased courtesy of lower petrol prices, but they remain elevated.** The Reserve Bank will be keeping a wary eye on the rebound in world oil prices over the past few weeks. While oil prices, currently around US\$59/bbl (Dubai) is at the level the Reserve Bank was expecting in its December *Statement*, a further push higher will reignite concerns over a spike up in headline inflation and inflation expectations in the second half of this year.
- **Fiscal stimulus in 2008 poses the greatest upside risk to inflation.** The Government has earmarked \$1 billion in the 2008 Budget for its *Business Tax Package*. There is growing pressure on the Government to deliver personal tax cuts as well. Although still some time away, the Reserve Bank will need to be mindful of a strong likelihood that the fiscal stimulus could end up much larger than expected, given that 2008 is an election year.

Key themes we expect to emerge within the March *Statement* include:

- **Stronger domestic demand** compared to the December *Statement*, particularly from the housing market and fiscal policy, and the risk this poses to medium-term inflation pressure.
- **The housing market and domestic demand will once again be singled out.** With the Governor's patience having run out with regards

to the housing market, expect further jawboning in an attempt to get the housing market to moderate. Another shot across the bows over fiscal policy can also be expected.

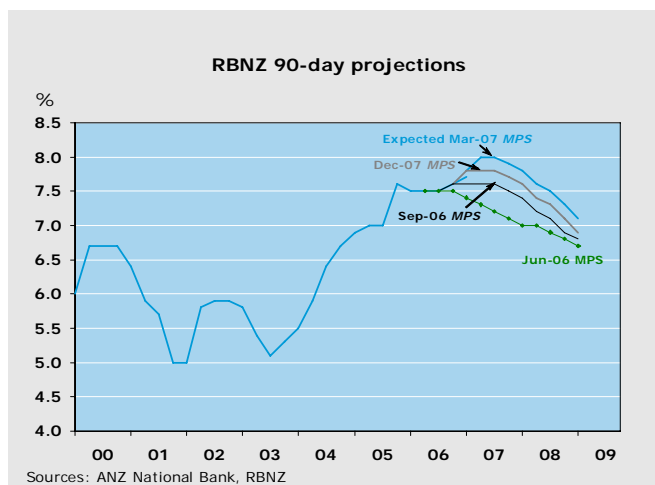
- **Acknowledgment of an easing in near-term inflation pressure** and the drift down in inflation expectations. Inflation expectations play a key role in medium-term inflation trends, we note that the Reserve Bank's growth forecasts will have to be revised up markedly for 2008 inflation trends to mirror those portrayed in the December *Statement*.
- **Persistent pressure being placed on medium-term inflation trends** courtesy of capacity constraints and strong domestic demand.

Governor needs to send a strong signal. Ultimately such signalling does not have to be followed through on. However, the housing market's bullet-proof persona needs a shot across the bow.

**Global conditions need to deteriorate further for a pause to be expected.** Recent global gestations will not have gone unnoticed at the Reserve Bank. Late cycle moves are inherently risky in themselves, and the risk becomes exponential if in association with global fragilities. Yet at this stage we are simply not seeing the breadth of fragility across markets to imply continued stability on the interest rate front. However, if weakness seen over late last week does extend and spiral into early this week, Thursday's decision will become a 50-50 call.

**Financial market implications...**

At the time of writing the market was pricing in an 80 percent chance of a rate hike for March and a reasonable chance of a follow-up move in either April or June.



**We see a strong probability of the central projection signalling an additional hike.** We note that the December *Statement* included a scenario where a combination of a stronger housing market and looser fiscal policy required additional policy tightening, with the 90-day rate peaking at 8.3 percent. As we highlighted in last week's *Market Focus*, the Reserve Bank has essentially missed hitting a large chunk of the mortgages coming up for renewal that were locked in at the height of the 2005 mortgage war, resulting in a lower effective mortgage rate than previously expected. To get more traction in the effective mortgage rate requires two successive hikes, and even then the effect will only be evident in the second half of this year. Put simply, we suspect the

Expectations for OCR announcement dates as implied by market pricing		
OCR announcement date	Change (bp)	Cumulative
Thu 8-Mar-07	20	20
Thu 26-Apr-07	12	32
Thu 7-Jun-07	2	34
Thu 26-Jul-07	0	34
Thu 13-Sep-07	-2	32
Thu 25-Oct-07	0	32
Thu 6-Dec-07	-2	30
Thu 24-Jan-08	0	30
Thu 6-Mar-08	-3	27
<b>Total Priced in</b>		<b>27</b>

From a tactical perspective we think the probability of a follow-up hike is less than implied by market pricing, particularly given recent events. Yet prospects for a higher 90-day track vis-à-vis the December projections leave us very wary. Strategically we prefer waiting for the market to have the second hike almost full-priced before acting. Given global developments we expect any fillip in the currency to be sold in to.

Our forecasts of RBNZ Projections for March MPS (December MPS Projections)					
Half year average	H2 2006	H1 2007	H2 2007	H1 2008	H2 2008
90 day	7.6 (7.6)	7.9 (7.8)	8.0 (7.8)	7.7 (7.5)	7.4 (7.2)
TWI	65.3 (64.8)	68.3 (65.6)	66.7 (64.2)	65.2 (62.8)	63.9 (61.7)
March years	2007	2008	2009		
CPI (APC)	2.4 (2.7)	2.5 (2.7)	2.5 (2.7)		
GDP (AAPC, prodn)	1.8 (2.1)	2.8 (2.7)	2.6 (2.5)		

## CURRENCY STRATEGY

**The market is caught between carry trade unwind and prospective yield pick-up courtesy of a hike from the Reserve Bank. Expect the former to set the scene against the majors, and the latter for the NZD/AUD.**

### Market themes...

- Carry trade unwind as risk appetites are pared back.
- Equities weak, bonds strong.
- JPY the out-performer.
- Against this backdrop Fed Governors' continued inflation rhetoric, and stronger US PCE deflator and ISM prices paid confirms risk.

### Outlook...

How quickly things can change. A few weeks ago the carry trade was under pressure ahead of the G7. Unease subsequently subsided, and the NZD soared ahead of an expected hike from the RBNZ. Last week was a reminder that it is not all about yield. Two equally important aspects to the carry trade – risk appetites and volatility – have delivered a timely wake-up call.

The market is currently caught between prospects for continued carry trade unease – with each move lower in equities and the USD/JPY giving additional impetus to unwinding the carry trade – and a hike from the Reserve Bank. The path of least resistance simply looks to be down across the G3, but bid against AUD. Certainly when we look back to the NZD's massive run in 2004, it was largely confined to the majors, and the NZD/AUD remained well supported.

Global equity gyrations are key at present, and Friday also saw some signs of nervousness extending into the commodities arena. Stabilisation will be met with support for the NZD, and notably ahead of the Reserve Bank assessment. Conversely, if we continue to see international unease and a flight to quality, the NZD will remain under pressure. At present, it certainly doesn't feel like contagion, but there is clearly some nervousness and position squaring is having a massive impact. The near term picture for the kiwi looks bearish, but long-term support is nearby. Key levels from a technical perspective for the NZD/USD include support at 0.6850 and 0.6775, and resistance at 0.6920 and 0.6960 on the upside. A head and shoulders pattern has emerged in the NZD/AUD, with the top working well, and the base at 0.8750 providing major support for this week, but should break for the next leg lower.

Watch for some consolidation ahead of the Reserve Bank this week, most notably across the dollar-

bloc. Global GDP stats generally surprised with weakness for Q3 2006, and Q4 has seen mostly upside surprises. Keep an eye on Australian GDP this week, with a solid (0.9 percent) print expected. Strength will be required to cap the NZD/AUD ahead of the RBNZ.

Standing back, the story looks to be one of a cap being in place for the kiwi. Even if equities stabilise and carry trade unease subsides, we suspect the market will have limited appetite to drive the NZD materially higher given volatility seen over the past week. The bigger picture is one of a Reserve Bank that seeks to turn the economy, and the NZD will eventually follow. Importance should be attuned to the asymmetric risk profile they are facing.

NZD vs AUD: monthly directional gauges		
Gauge	Direction	Comment
Fair value	↓	Above the 0.85-0.88 zone.
Yield	↑	Yield differential has widened, RBNZ this week.
Commodities	↔	Messy in an elevated range.
Partial indicators	↔	Trade balance shows some weakness.
Technicals	↔	Head and shoulders top working well, 0.8750 major support.
Sentiment	↓	Carry trade unwind.
Other	↓	Australian exporters are looking impatient.
<b>On balance</b>	↔	<b>Holding pattern this week ahead of RBNZ.</b>

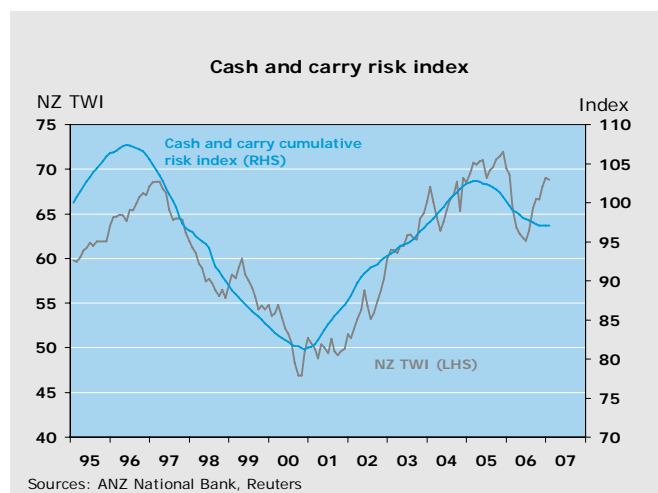
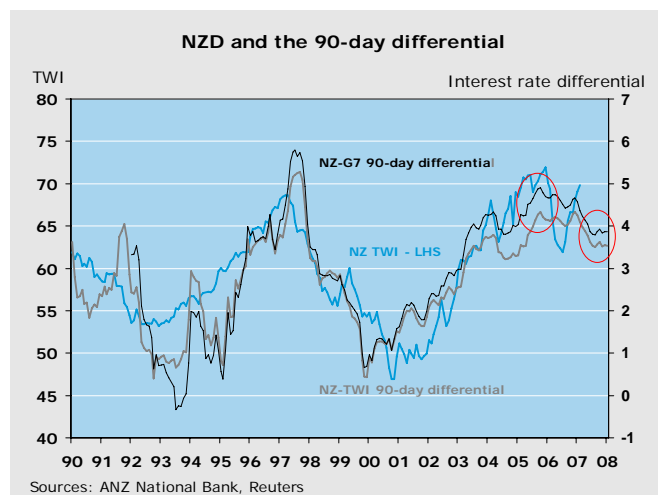
NZD vs USD: monthly directional gauges		
Gauge	Direction	Comment
Fair value – long-term	↓	Fair value 0.60. It may be higher given a structural shift in commodity prices.
Fair value – short-term	↔	NZD more fairly valued on commodity models.
Yield	↑	NZ yield still attractive.
Commodities	↔	Dairy prices are insulating the dairy sector but meat prices looking suspect.
Risk aversion	↑	Increasing. Iran and China are key.
Partial indicators	↔	US rates rally again despite price risks.
Technicals	↔	Short-term bearish but approaching long-term support.
AUD	↔	Australian data improving.
Sentiment	↓	Now everyone can see a cloud.
Other	↓	Market was overbought, but is normalizing on recent moves.
<b>On balance</b>	↔	<b>Carry vs RBNZ.</b>

## AVERAGING DOWN

The downward move in the NZD looks to have legs despite prospects for a hike from the Reserve Bank. We would place a 25 percent probability on a sustained run to levels seen in 2004 and 2006. This biases us towards an averaging approach to export cover.

This move in the NZD looks to have legs.

- **It is coinciding with a major event.** Carry trade unease has been percolating for some time across policy circles. While yield remains a dominant theme in the market, rises in risk aversion and volatility have sent the market covering positions, and the size of these are thought to be bigger than Ben Hur.
- **We have been here before.** As noted two weeks ago, there are strong similarities between now and 2004, when the NZD/USD fell 10 cents in the space of 3 months.
  - The RBNZ was tightening policy.
  - The “catalyst” stemmed from China.
  - Global equities were under pressure (the DJIA dipped below 10,000, and the Nikkei below 11,000) and risk was being re-priced. Longer dated US Treasuries rallied 30 basis points.
- **The JPY is now flavour of the month.** The latest IMM data shows 114,626 short JPY positions (where one contract equals JPY 12.5 million). NZD strength on a TWI basis has generally been associated with JPY weakness, which implies reciprocal potential.
- **We have seen aggressive movements across other markets** such as oil, copper, zinc, and now gold.
- **Psychology is likely to play a key role.** The NZD is a story of liquidity and greed. It is a small exit door when all and sundry are trying to get out. Once we see movement in either direction, the NZD tends to become flavour of the month and a trade that everyone wants to be on.
- **The NZD still looks expensive on yield metrics.** The yield differential is 80 basis points lower than the last time the NZD/USD hit 0.70. While our cash and carry yield index is giving a neutral reading on direction for the NZD, as a starting position, the NZD still looks 4 cents overvalued.



Of course nothing is guaranteed. Talk of a weaker NZD across the G3 still faces material challenges.

- **In the absence of signs of contagion from the recent fall-out in equities, the Reserve Bank is likely to hike**, and deliver a very hawkish assessment. Of course there is also huge event risk if they do not hike in terms of where the NZD could head, and potential inflation problems three months on.
- **Soft commodity prices remain exceptionally high.** The rural sector – a key source of housing demand – will quickly reaccelerate under a high commodity price, low currency outcome. This will underpin growth, and also rural housing demand.
- **Financial conditions will loosen**, providing impetus to growth.
- **There is still an abundance of liquidity** looking for a home, which implies continued appetite for yield and good appetites for risk. Funds, with mandates to outperform, have little choice but to seek carry.

At this stage we would place a 25 percent probability on a sustained run down to levels seen in 2004 and 2006. This places exporters in a quandary. The Reserve Bank is waiting to hike.

Yet pulling the trigger on cover now, risks missing an opportunity. When we look at the spirit of our currency views at the qualitative level, we are mindful of three themes.

- **The NZD has the potential to move further than everyone expects.** If the NZD gets through the 0.6750 level, and there is a hike from the Reserve Bank, the odds will shift markedly towards this move being a repeat of 2004.
- **An aggressive move at this juncture is likely to be followed by a bounce** similar to 2006 in the absence of an exceptionally large fall in commodity prices. Recent indications are that dairy prices, a mainstay of New Zealand's exports, continue to track up.
- **The currency will not stay strong indefinitely** with the Reserve Bank on the warpath against the housing market. In the absence of a sharp fall then bounce in the kiwi at this juncture, a sustained run is likely 3-6 months down the track.

We can implicitly identify two alternate trajectories. One, based on recent unease not extending extensively, the RBNZ hiking and turning the housing market, sees the NZD rebound slightly and then getting belted around Q3 this year (our central view). The other is a further 8 cent fall against the USD, hitting the 2004 and 2006 lows of 0.5960, and then subsequent bounce to the 0.65-0.68 region. (We will certainly be mindful of our experience in 2006 at this point. After calling the run to 0.60, and then a brave bounce when everyone else was talking currency free-fall, we will be taking a very conservative stance towards any potential peak this time around!).

Given the uncertainty, we are biased towards an averaging approach to cover, where the duration of cover is extended by 3 months each time the NZD hits key trigger levels. The table below illustrates this approach. At current spot levels, we recommend three months duration (covering off the hike and rebound potential), with this extending to 4-6 months on a further 2 percent move. If the NZD/USD falls to 0.6250 we would recommend cover to be extended to a 9-12 month duration to cover off the likely bounce that tends to occur on

major drives. (Note that we have limited our analysis to NZD against the majors on the view that the NZD/AUD is unlikely to weaken materially until a strong signal is given on the respective business cycles).

The levels chosen are generally linear and indicative only. We would recommend consulting our spot desk on key resistance and support levels. For instance the 0.6775 region looks to be key in determining whether the move extends, which suggests the trigger level for extending duration to 4 to 6 months should be marginally above 0.6775 as opposed to 0.6750. Indeed, if we get through 0.6775 we are likely to be off to the races!

The net effect of the approach is to provide topside protection in the near-term (risk mitigation), yet recognising the ability of the NZD to go a long way, and acknowledging the strong probability of a subsequent bounce. The key assumption is that, lacking weakening economic performance, weakness in the NZD will not be sustained. A weaker domestic economy is a necessary condition to sustained weakness in the currency and we are simply not there yet.

Alternative option based strategies also look appealing. Yet when we stand back and look at it all, a simple averaging approach just looks an efficient means of capturing the spirit of our views.

Suggested term of cover for an exporter					
	3 months	4-6 months	6-9 months	9-12 months	12+ months
NZD/USD	spot	0.675	0.650	0.625	0.600
NZD/JPY	spot	78	74	70	66
NZD/EUR	spot	0.515	0.500	0.488	0.476
Assumes					
USD/JPY		116	114	112	110
EUR/USD		1.31	1.30	1.28	1.26

## DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
Mar 5	<b>NZ</b>	<b>Wholesale Trade Survey (4Q) – qoq</b>	-		<b>10:45</b>
	JN	Capital Spending (4Q)	13.7%	12.0%	12:50
		Capital Spending – excluding software (4Q)	-	11.9%	12:50
	AU	Company Operating Profit (4Q) – qoq	2.5%	0.6%	13:30
		Inventories (4Q)	0.5%	-1.5%	13:30
	GE	PMI Services (Feb)	57.9	58.3	21:55
	EU	PMI Services (Feb)	57.6	57.9	22:00
	UK	PMI Services (Feb)	59.0	59.2	22:30
Mar 6	US	ISM Non-Manufacturing (Feb)	57.0	59.0	04:00
		Fed's Poole Speaks in Santiago, Chile on Inflation and Economy	-	-	07:00
		Fed's Warsh Speaks on Liquidity at Bankers Conference	-	-	08:00
	AU	Trade Balance (Jan)	-\$1,100m	-\$1,336m	13:30
		Exports (Jan)	-	\$17,781m	13:30
		Imports (Jan)	-	\$19,118m	13:30
		Building Approvals (Jan) – mom	0.5%	-1.9%	13:30
		Building Approvals (Jan) – yoy	-	-1.5%	13:30
	EU	Euro-Zone Retail Sales (Jan) – mom	-0.4%	0.3%	23:00
		Euro-Zone Retail Sales (Jan) – yoy	1.3%	2.1%	23:00
		Euro-Zone GDP (4Q P) – qoq	0.9%	0.9%	23:00
		Euro-Zone GDP (4Q P) – yoy	3.3%	3.3%	23:00
		European Commission GDP Forecasts	-	-	23:00
Mar 7	<b>NZ</b>	<b>ANZ Commodity Price Index (Feb)</b>	-	-	<b>15:00</b>
	US	Non-Farm Productivity (4Q F)	1.5%	3.0%	02:30
		Unit Labour Costs (4Q F)	3.2%	1.7%	02:30
		Pending Home Sales (Jan) – mom	-1.4%	4.9%	04:00
		Factory Orders (Jan)	-4.5%	2.4%	04:00
		Fed's Plosser Speaks to Economists at Harvard Club in New York	-	-	07:00
	AU	Reserve Bank of Australia Interest Rate Decision	6.25%	6.25%	11:30
		RBA Assistant Governor Edey Speaks	-	-	13:10
		Gross Domestic Product (4Q) – qoq	0.5%	0.3%	13:30
		Gross Domestic Product (4Q) – yoy	2.0%	2.2%	13:30
		Foreign Reserves (Feb)	-	\$76.8b	18:30
	JN	Official Reserve Assets (Feb)	-	\$895.4b	12:50
		Bank of Japan Deputy Governor Iwata to Speak at Financial Meeting	-	-	14:30
		Coincident Index (Jan P)	55.6%	75.0%	18:00
		Leading Economic Index (Jan P)	35.0%	31.8%	18:00
	UK	Nationwide Consumer Confidence (Feb)	82	84	13:01

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
Mar 8	GE	Factory Orders (Jan) – mom	0.4%	-0.2%	00:00
		Factory Orders (Jan) – yoy	6.7%	1.7%	00:00
	US	ADP Employment Change (Feb)	100k	126k	02:15
		Fed's Moskow Speaks on Economic Outlook in Chicago	-	-	07:00
		US Treasury's Paulson Speaks About Financial Markets in Shanghai	-	-	16:30
		Fed's Beige Book	-	-	08:00
		Consumer Credit (Jan)	\$7.0B	\$6.0B	09:00
	<b>NZ</b>	<b>Reserve Bank of New Zealand Monetary Policy Statement</b>	<b>7.50%</b>	<b>7.25%</b>	<b>09:00</b>
		<b>Terms of Trade Index (4Q) – qoq</b>	-	-1.9%	10:45
		<b>RBNZ's Bollard Appears at Finance Select Committee</b>	-	-	11:30
	JN	Money Supply M2+CD (Feb) – yoy	1.1%	1.0%	12:50
		Broad Liquidity (Feb) – yoy	2.7%	2.6%	12:50
Mar 9	GE	Industrial Production (Jan) – mom	0.4%	-0.5%	00:00
		Trade Balance (Jan)	14.4b	10.8b	20:00
		Current Account (Jan)	10.0b	9.8b	20:00
		Imports (Jan) – mom	0.5%	5.0%	20:00
		Exports (Jan) – mom	-0.5%	-2.0%	20:00
		Wholesale Price Index (Feb) – mom	0.0%	0.0%	20:00
	UK	Bank of England Interest Rate Decision	5.25%	5.25%	01:00
		Industrial Production (Jan) – mom	0.2%	-0.1%	22:30
		Manufacturing Production (Jan) – mom	0.2%	0.2%	22:30
	EU	ECB Interest Rate Decision	3.75%	3.50%	01:45
		ECB's Trichet Speaks at ECM Monthly News Conference	-	-	02:30
JN	Machine Orders (Jan) – mom	1.3%	-0.7%	12:50	
Mar 10	EU	Euro-Zone OECD Leading Indicator	-	109.3	00:00
	US	Trade Balance (Jan)	-\$59.6b	-\$61.2b	02:30
		Change in Non-Farm Payrolls (Feb)	100k	111k	02:30
		Unemployment Rate (Feb)	4.6%	4.6%	02:30
		Change in Manufacturing Payrolls (Feb)	-20k	-16k	02:30
		Average Hourly Earnings (Feb) – mom	0.3%	0.2%	02:30
		Average Weekly Hours (Feb)	33.8	33.8	02:30
		Wholesale Inventories (Jan)	0.1%	-0.5%	04:00
		US Fed's Bies Speaks at Charlotte Risk Management Conference	-	-	06:30
		US Fed's Kohn Speaks at Washington Inflation Conference	-	-	07:30
US Fed's Kroszner Speaks at Washington Inflation Conference	-	-	09:30		

Key: AU: Australia, CA: Canada, EU: European Union, GE: Germany, JP: Japan, NZ: New Zealand, UK: United Kingdom, US: United States.

Source: Dow Jones, Reuters, Bloomberg, ANZ National Bank. All \$ values in local currency. Na= not available. (Note: all surveys are preliminary and subject to change).

## NEW ZEALAND DATA WATCH

**Key focus over next four weeks:** All eyes and ears will be centered on the Reserve Bank this week as they present their March *Monetary Policy Statement*. With no signs of moderation yet in the housing market, we expect the Reserve Bank to increase interest rates by 25 basis points. The statement is expected to be hawkish and the door to further rate hikes left wide open.

Date	Data/Event	Economic Signal	Comment
Mon 5 Mar (10.45)	Wholesale Trade Survey (Dec qtr)	Up	Growth in this quarter should be strong, in-line with retail sales growth.
Wed 7 Mar (1.00)	ANZ Commodity Price Index (Feb)	-	-
Thu 8 Mar (9.00)	RBNZ March <i>Monetary Policy Statement</i>	25 basis point hike	We expect the Reserve Bank to hike the OCR by 25bps, taking it to 7.50 percent and back that up with very hawkish rhetoric.
Thu 8 Mar (10.45)	OTIs (prices and volumes)	Terms of trade up	Large falls in oil prices and high commodity prices should see New Zealand's terms of trade increase.
Fri 9 Mar (10.45)	Value of Building Work Put in Place (Dec qtr)	Mixed	Residential work put in place to post a modest increase in real terms, but non-residential to show a decline although the level of activity remains high.
Tue 13 Mar (10.45)	Retail Trade Survey (Jan)	Up	A modest rise in retail spending expected, though a big increase in food prices will inflate the food related spending numbers.
Wed 14 Mar (10.45)	Manufacturing Survey (Dec qtr)	Mixed	Manufacturing sales to be subdued due to a high NZD, but a rebound in production expected as firms rebuild stock levels.
circa 15 Mar	REINZ Housing data (Feb)	Steady	Housing market activity to again be solid although show limited evidence of acceleration.
Tue 20 Mar (10.45)	External Migration (Feb)	Steady	After an easing in recent migration gains, we expect annual migration to stabilise around 14,000 per annum.
Wed 21 Mar (15.00)	Credit Card Billings (Feb)	Steady	A modest rebound expected after January's decline, but not strongly accelerating away.
Mon 26 Mar (10.45)	Merchandise Trade (Feb)	Imbalanced	An improvement in the monthly trade deficit is expected. Exports to be supported by higher commodity prices, although higher oil prices will add to imports.
Wed 28 Mar (10.45)	Building Consents (Feb)	Easing	We expect building consents to continue its recent easing trend.
Thu 29 Mar (10.45)	Balance of Payments (Dec qtr)	Large	We expect the current account deficit to post a slight improvement although still remain at an unsustainable level.
Fri 30 Mar (10.45)	Gross Domestic Product (Dec qtr)	Strong	Q4 GDP growth is shaping up as close to 1 percent after a weak result in Q3. A rebound in stocks and private consumption takes the lead.
<b>On Balance</b>		<b>Q4 strength but early signs of Q1 mixed.</b>	<b>Strong momentum end of last year. Still questions over 2007.</b>

### NZ Economics

**Cameron Bagrie**  
Chief Economist  
+64 4 802 2212

**Sean Comber**  
Economist  
+64 4 802 2286

**Philip Borkin**  
Economist  
+64 4 802 2199

**Khoon Goh**  
Interest Rate Strategist  
+64 4 802 2357

**Steve Edwards**  
Economist  
+64 4 802 2217

**Kevin Wilson**  
Rural Economist  
+64 4 802 2361

## SUMMARY OF KEY MARKET FORECASTS

NZ FX rates	Actual		Current	Forecast (end month)						
	Jan 07	Feb 07	5 Mar 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
NZD/USD	0.695	0.694	0.688	0.700	0.680	0.640	0.620	0.600	0.580	0.550
NZD/AUD	0.888	0.887	0.880	0.909	0.895	0.853	0.849	0.833	0.817	0.786
NZD/EUR	0.535	0.530	0.521	0.530	0.523	0.496	0.481	0.472	0.464	0.447
NZD/JPY	83.7	83.7	80.3	84.0	79.6	72.3	68.2	64.8	61.5	59.4
NZD/GBP	0.355	0.354	0.354	0.361	0.354	0.337	0.328	0.321	0.312	0.299
NZ\$ TWI	69.1	68.9	67.8	69.5	67.7	63.7	61.7	60.0	58.2	55.8
NZ interest rates	Jan 07	Feb 07	5 Mar 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
OCR	7.25	7.25	7.25	7.50	7.50	7.50	7.25	7.00	7.00	7.00
90 day bill	7.70	7.74	7.82	7.80	7.70	7.60	7.20	7.20	7.20	7.10
10 year bond	5.93	5.96	5.86	6.00	6.00	6.20	6.10	6.20	6.40	6.50
International	Jan 07	Feb 07	5 Mar 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
US Fed funds	5.25	5.25	5.25	5.25	5.25	5.25	4.75	4.75	4.75	5.00
US 3-mth	5.36	5.35	5.35	5.40	5.40	5.00	4.60	4.75	4.90	5.25
AU cash	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.00	5.75
AU 3-mth	6.39	6.35	6.35	6.40	6.40	6.40	6.40	6.30	5.80	6.00

## KEY RATES

	2 Feb	26 Feb	27 Feb	28 Feb	1 Mar	2 Mar
Official Cash Rate	7.25	7.25	7.25	7.25	7.25	7.25
30 day bank bill	7.53	7.64	7.66	7.67	7.69	7.69
90 day bank bill	7.68	7.78	7.80	7.78	7.80	7.82
NZGB 07/09	6.56	6.65	6.65	6.64	6.66	6.66
NZGB 11/11	6.37	6.41	6.40	6.39	6.41	6.41
NZGB 04/13	6.19	6.17	6.16	6.14	6.15	6.16
NZGB 12/17	6.01	5.91	5.86	5.84	5.84	5.83
1 year swap	7.88	7.95	7.95	7.92	7.92	7.94
2 year swap	7.71	7.76	7.75	7.73	7.74	7.76
5 year swap	7.35	7.36	7.35	7.33	7.34	7.37
RBNZ TWI	67.9	70.0	70.1	69.1	69.0	68.3
NZD/USD	0.6817	0.7085	0.7100	0.7006	0.7001	0.6923
NZD/AUD	0.8822	0.8945	0.8943	0.8900	0.8904	0.8825
NZD/JPY	82.29	85.62	85.51	82.97	82.88	81.50
NZD/GBP	0.3466	0.3608	0.3615	0.3568	0.3566	0.3538
NZD/EUR	0.5235	0.5370	0.5384	0.5302	0.5293	0.5257
AUD/USD	0.7727	0.7921	0.7939	0.7872	0.7863	0.7845
EUR/USD	1.3021	1.3193	1.3186	1.3213	1.3227	1.3169
USD/JPY	120.72	120.84	120.43	118.43	118.38	117.72
GBP/USD	1.9671	1.9637	1.9639	1.9633	1.9632	1.9568
Oil	57.35	60.28	60.86	61.46	61.78	61.97
Gold	656.00	687.55	678.90	670.25	672.15	659.45
Electricity Price Index	2.87	5.09	5.34	5.55	5.75	5.97

## Important Notice

Australia and New Zealand Banking Group Limited is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11005 357 522

10th Floor 100 Queen Street, Melbourne 3000, Australia

Telephone +61 3 9273 6224 Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited

ABN 11 005 357 522

Minerva House, PO Box 7, Montague Close, London, SE1

9DH, United Kingdom

Telephone +44 20 7378 2121 Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of NASD and SIPC)

6th Floor 1177 Avenue of the Americas

New York, NY 10036, United States of America

Tel: +1 212 801 9160 Fax: +1 212 801 9163

NEW ZEALAND by:

ANZ National Bank Limited

Level 7, 1-9 Victoria Street, Wellington, New Zealand

Telephone +64 4 802 2000

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