

NEW ZEALAND ECONOMICS MARKET FOCUS

28 November 2011

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GETTING ON WITH IT

ECONOMIC OVERVIEW

The general election came and went with little fanfare. After a period of distraction firms can get on with business. The situation in Europe is deteriorating and this continues to dominate local nuances. While the direct impact on the NZ economy to date has been mild, we're becoming more wary regarding what the first half of 2012 may bring. In this environment interest rates will stay lower for longer and we've pushed out prospects for the OCR moving up until late 2012. This week's business confidence and commodity price data will provide an update on the extent of relative resilience of the local economy.

CURRENCY FAIR VALUE MODEL UPDATE

Our updated currency fair value models have seen our fair value estimates for NZDUSD revised higher to 0.70 and AUDUSD to 0.89 (from 0.67 and 0.88 respectively). Among the major currencies, JPY is the most overvalued, with GBP at the other extreme. Despite the NZD being almost 7 percent overvalued against the USD, on a trade-weighted basis the NZD is closer to fair value following its recent sell-off. The US dollar is not significantly undervalued at present, and while we could see the Greenback rally on the back of heightened risk aversion, history suggests that any rise in the DXY Index is likely to be capped close to its fair value at around 81.

INTEREST RATE STRATEGY

Uncertainty continues to escalate as the European sovereign debt crisis deepens. New Zealand interest rates have plummeted as a result, and the market is now fully priced for a rate cut by March. After such an extended move, some sort of rebound is to be expected. The NZ General Election over the weekend has removed one uncertainty. But unless we see meaningful and credible changes in Europe, we would regard any sell-off in rates as a "headfake" and an opportunity to get long again.

CURRENCY STRATEGY

This week will start on a positive note with some positive news to counter the negative headlines from Europe. The NZ election result removes uncertainty but only returns us to business as usual locally. US consumers have returned in force over the Thanksgiving weekend, breaking all sorts of trading records. Merkel and Sarkozy continue to make positive comments about stability pacts to cure Europe's ills. However, expect the positive influence on FX markets to be short-lived. Chinese PMI data suggests the next monetary moves will definitely be an easing.

THE ANZ HEATMAP

Variable	12 mth view	Comment	Risk profile
GDP	2.5%	Respectable but grumpy growth	
OCR	No change	OCR low for longer as opposed to outright lower	
CPI	2.6%	Medium-term inflation drivers remain sticky.	

ECONOMIC OVERVIEW

SUMMARY

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FORTHCOMING EVENTS

National Bank Business Outlook - November
(Monday, 28 November, 1:00pm).

SNZ National Employment Indicator - September
(Tuesday, 29 November, 10:45am). Falling job advertising suggests a 0.2 to 0.3 percent fall.

SNZ Building Consents - October (Wednesday, 30 November, 10:45am). A 5 percent lift in dwelling consents is forecast following the large decline in the previous month. Non-residential consent issuance of around \$275m is expected.

RBNZ Credit Aggregates – October (Wednesday, 30 November 3:00pm). Low annual rates of household and business credit growth, with agriculture credit levels expected to be around 1 percent lower than 12 months earlier.

SNZ Overseas Trade Indexes - Q3 (Thursday, 1 December, 10:45am). We expect a 1.5 percent increase in the terms of trade. Import volumes are forecast to rise 1.5 percent, with export volumes up 0.5 percent.

ANZ Commodity Price Index – November
(Thursday 1 December, 1:00pm).

WHAT'S THE VIEW

The NZ election has thrown up few big picture surprises, so can quickly be kicked for touch as **removing a potential layer of uncertainty**. In a world littered with uncertainty and fickle risk sentiment, we wouldn't characterise this as a potential positive, merely removing a potential negative. With uncertainty removed, it's imperative credibility is maintained, and this means forging ahead in regard to planned fiscal settings and driving a more saving-centric society.

Global developments are where our attention resides and the news is not getting any better; in fact the opposite is true. While far from being Euro-

centric in our areas of expertise we continue to respect the messages coming from a number of our proprietary indicators.

- Our Sovereign Risk Analysis has been highlighting for some time the obvious points of vulnerability (the top five including Greece *et al*) but those 6th -10th are also largely Euro-centric. Italy (ranked 10th) has been picked off. Belgium ranks 6th, and is now being touted as vulnerable with bond yields rising sharply. France is supposed to be one of the Eurozone anchors but ranks as 5th, and French 10 year yields have been drifting higher. Germany – the bastion of Eurozone strength – ranks at 22nd, 5 places above the US. This week's bond auctions in Italy, Belgium and Spain are shaping as watershed events following Germany's poor auction last week, where bids of only €3.9 billion were received for €6 billion of bonds on offer.
- Financial conditions continue to tighten in countries such as Italy, Spain, and Greece. Recessions are assured. Not exactly a great environment for improving the state of the public finances.

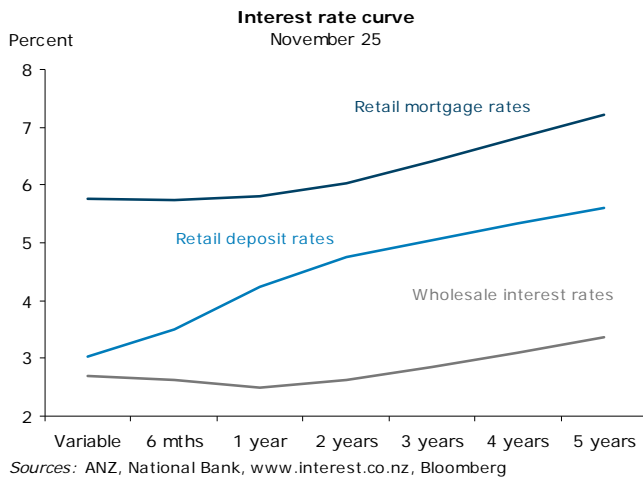
On top of our proprietary measures, we have witnessed an upward shift in Government bond yields in a host of nations (Italy, Spain, Portugal and Greece) that are now tracking massively above prospects for nominal GDP growth. The debt trap beckons and austerity hasn't even started. Italian 10-year yields are currently 7.22 percent, whereas those for Portugal have climbed to 12 percent. Greek 10-year yields are a staggering 26.5 percent (and in practice, this market has closed). Some constructive conversations appear to be happening in regard to the necessary fiscal union for Eurozone, but at present, this simply seems too little too late.

These developments continue to skew the risk profile for the NZ economy downwards. Of course at some stage we fully expect the game of chicken being played between policymakers and markets will cease, with policymakers blinking first. Indeed a package that weak would not surprise us. With options running out, we expect QE to be given serious consideration by policymakers, despite their protestations to the contrary. But not before maximum concessions in regard to fiscal austerity have been extracted, for it's not the job of central banks to bail out governments. Before this happens, the market will continue to watch, worry and wait. And even on the assumption we see a package we'll view it as mitigating extreme downside as opposed to underpinning a recovery. A long drawn out slog is still the crux of our view for Western Society.

ECONOMIC OVERVIEW

Locally we're seeing two things of relevance – right here and now.

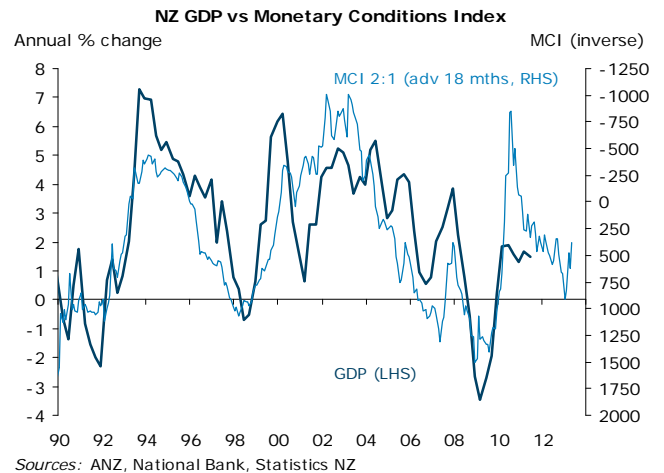
First, the impact collectively via confidence, commodity prices, cost of credit etc has been mild – to date. These remain critical channels to watch. We also have momentum heading into global dislocation, which can help. As noted last week in our feature article, Mother Nature has been kind. Downward commodity price risks are being buffered by higher volumes. New Zealand's growth picture is still scratchy, but relative to the counterfactual and what we are seeing in a host of other nations, scratchy is pretty good.



Second, the macro framework continues to respond via loosening financial conditions, or at least mitigating tighter conditions in certain areas. The New Zealand 2-year swap yield fell to a record low last week. While this implies potentially lower fixed-term mortgage interest rates, it is being circumvented by an increase in funding pressures, with bank CDS spreads pushing higher. A falling currency is providing a windfall for exporters. We're not huge fans of the old MCI but we still keep an eye on it and it's loosened of late. Of course, it doesn't include channels such as commodity prices. Currencies tend to be more liquid so they always move quicker, which means we are alert to the possibility that commodity prices may be about to play catch-up. (NB: some people use commodity prices to forecast currencies whereas we believe the latter move before the former).

We're paying particular attention to trade finance and deposit rates. The former is tightening up. This was a key transmission channel of recessions in the OECD into Asia in 2008-2009. With Asia now accounting for a larger proportion of New Zealand's exports (and NZ indirectly exposed via Australia as well), this channel is critical. The longer

offshore credit markets remain dysfunctional and effectively closed, the greater the potential for heightened competition for local deposits. We're not yet seeing anything like what we saw in 2008 with New Zealand banks today having a lot more long-term funding in place. However, **we're starting to see some tweaks in some deposit arenas** and we'll be paying attention to Australia as well in this regard.



In this environment interest rates will stay lower for longer and we've pushed out prospects for the OCR moving up until late 2012. Of course Murphy's Law could apply and aggressive collective action globally could remove current dislocations across markets. However, to bank on action being a permanent solution as your central scenario simply seems a stretch. We expect the RBNZ to come to the same conclusion in the December *Monetary Policy Statement* next week.

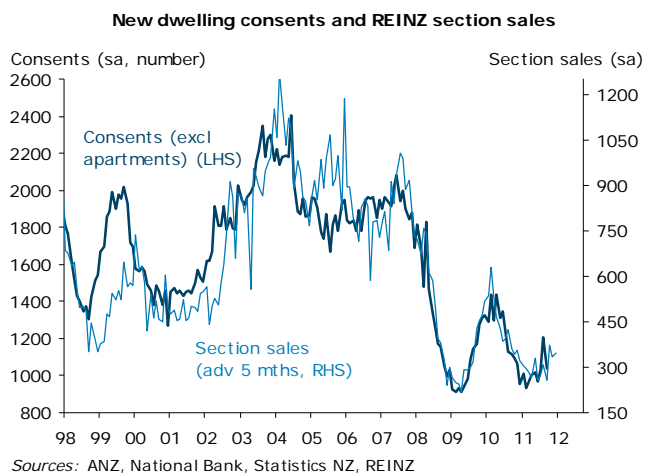
Of course **the NZ rates market is actively pricing an OCR cut** so the spectre of slow and gradual hikes, though a long way off, is not market connected. We're not concerned by this. Markets will be markets: they play a risk-return game, and if we see the OCR moving down it won't be by 25 basis points. It was only in July that the market thought the OCR could approach 4 percent by the end of 2012! We're relatively bearish regarding the global scene but are mindful of market-driven swings and the support NZ is getting via a lower currency. In such a situation it's the spirit of one's view that matters. Pushing out prospects for a hike until late 2012 is really saying the OCR is going nowhere for a long time.

Looking to the week ahead, **the November National Bank Business Outlook will provide a timely update on the relative resilience of the NZ economy.** To date, firms have shrugged off much of the global gloom. Will this persist, now that the Rugby World Cup is behind us?

ECONOMIC OVERVIEW

The September National Employment indicator will be worth only a cursory glance, given we already have the Q3 labour market data. Internet job advertising has been coming off in recent months, and we expect a fall in this indicator.

Building consents are expected to start following the housing market up from extraordinarily weak levels, although the timing of the school holidays, forthcoming election and RWC distractions could delay this improvement by a month or so. Non-residential construction activity is expected to remain weak.

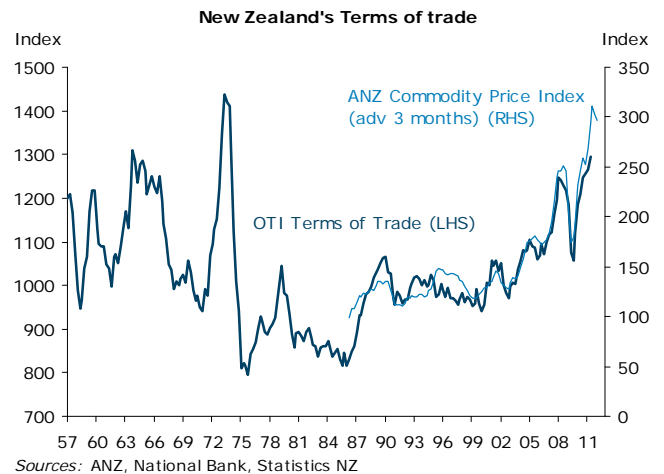


October credit aggregates are expected to confirm the deleveraging dynamic underway (i.e. debt falling relative to income) as households and firms continue to repair balance sheets. We expect private sector credit growth to be around 1 percent for the October year, considerably below annual nominal GDP growth of 5 to 6 percent. Another small seasonally adjusted fall in business credit is expected given the uncertain environment, with the low rate of household credit a reflection of the moribund housing market. The dairy cheques will help make inroads into high debt levels but we are also mindful that the rural property market has been pretty robust over the past six months, with some income finding its way into the property market as opposed to debt repayment.

The Overseas Trade Indexes will show the lagged impact of commodity price strength. **We expect a 1.5 percent increase in the goods terms of trade, which will take it to its highest level since late 1973**, nearly 30 percent above historical averages and a substantial support factor for the NZ economy. This week's commodity price data will provide important insights into its short-term direction.

The OTI volume data is expected to reveal a 0.5 percent lift in export volumes, with lower forestry and casein exports offset by strengthening aluminium and

fruit exports. Merchandise trade data suggests a Q3 fall in non-primary manufacturing export volumes, although the October trade figures were a little more encouraging. A 1.5 percent lift in import volumes is expected, underpinned by a sizeable lift in plant and machinery and transport equipment and an increase in consumption goods as retailers build up stocks.



RECENT LOCAL DATA

RBNZ Credit Card Billings – October. Spending on credit cards rose a seasonally adjusted 2.6 percent (7.9 percent y/y), driven by a 2.8 percent s.a. increase in domestic card spending.

SNZ International Travel and Migration – October. There was a net monthly permanent and long-term outflow of 640 persons s.a., with an annual net PLT outflow of 103 persons. Visitor arrival numbers fell 7.8 percent s.a. m/m (+16.8 percent y/y), while short-term resident departures rose 13.6 percent m/m (-11.6 percent y/y).

RBNZ Survey of Expectations – Q4. The 2-year-ahead expectation for CPI inflation eased slightly to 2.82 percent from 2.86 percent in Q3. CPI inflation one-year ahead fell to 2.72 percent from 2.94 percent.

SNZ Overseas Merchandise Trade – October. A monthly trade deficit of \$282m was registered, with the annual trade surplus easing to \$628m.

New Zealand General Election. With the special votes yet to be counted, the National Party have secured 60 seats, enough to govern with the support of United Future and ACT (1 seat each). Other seats were won by Labour 34, the Green Party 13, NZ First 8, the Maori Party 3, and the Mana Party 1.

CURRENCY FAIR VALUE MODEL UPDATE

SUMMARY

Our updated currency fair value models have seen our fair value estimates for NZDUSD revised higher to 0.70 and AUDUSD to 0.89 (from 0.67 and 0.88 respectively). Among the major currencies, JPY is the most overvalued, with GBP at the other extreme. Despite the NZD being almost 7 percent overvalued against the USD, on a trade-weighted basis the NZD is closer to fair value following its recent sell-off. The US dollar is not significantly undervalued at present, and while we could see the Greenback rally on the back of heightened risk aversion, recent history suggests that any rise in the DXY Index is likely to be capped close to its fair value at around 81.

FUNDAMENTALS RULE... EVENTUALLY

We have updated our fundamental fair value currency models to incorporate the latest economic data up to Q3 2011. It is important to note that we do not base our currency forecasts on the fair value models. No model can adequately forecast the path of the exchange rate, with studies showing that most fail to beat a random walk. Rather, we utilise currency fair value models for guidance on the extent of any over or under-valuation of the current spot rate, and to provide an anchor for medium-term currency projections.

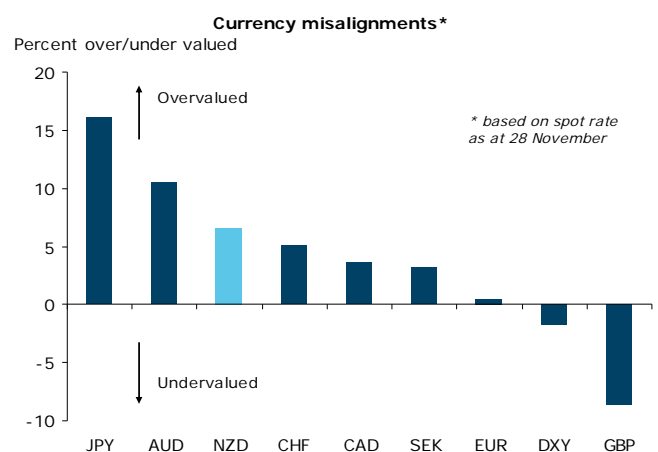
While currencies can deviate from fair value for considerable periods of time, they will ultimately revert towards fair value at some stage – though this can take several years. In addition, the fair value itself is not static. The deviation from fair value at a point in time helps to highlight how taut the rubber band has become and where the tensions, if any, lie between the various currency pairs. It also tells us whether the currency is at a stimulatory or restrictive setting for the economy, something which central banks pay a lot of attention to.

There are many approaches to currency modelling, ranging from the most basic (random walk) to complex systems such as the fundamental equilibrium exchange rate (FEER) approach, which is based on the desired level of the currency needed to bring a country's external position to sustainable levels.

No one approach is perfect. Our approach is to use several specifications taking the average of the results to form our fair value estimates. As a former central banker once said, use as many models as you can, but trust none of them. The choice of models is based on the empirical literature, and can be grouped into the following:

- **Purchasing power parity (PPP) based model.** The currency is a function of the relative price differential between countries. We use three different specifications, based on the consumer price index, producer price index, and GDP deflator differentials.
- **Sticky price monetary model.** This model assumes that prices are sticky in the short run, and that changes in the money supply cause a change in interest rates and capital flows, leading to changes in the exchange rate.
- **Balassa-Samuelson productivity model.** The more productive an economy is, the higher the currency in the long run. Conversely, a less productive economy requires a weaker currency to stay competitive.
- **Real interest rate differential model.** Countries with higher real interest rates will see their currencies appreciate relative to those with lower interest rates as high rates attract more capital inflows.
- **Behavioural equilibrium exchange rate (BEER) model.** This uses economic variables that are known to have an influence on the exchange rate, such as real interest rates, money supply, terms of trade differentials, current account balance, and unit labour cost as well as productivity differentials.

Rather than estimating each specification for each currency pair separately, we have modelled the major currencies (NZD, AUD, CAD, EUR, GBP, JPY, SEK and CHF) as a single system. The chart below shows the extent of currency misalignment for the majors based on our fair value estimates. The table below shows the results of our fair value estimates for the majors as well as the NZD cross rates.



Sources: ANZ, National Bank

CURRENCY FAIR VALUE MODEL UPDATE

Currency Majors	Fair Value	Current 28 Nov	Deviation from fair value (%)
NZDUSD	0.70	0.750	6.6
AUDUSD	0.89	0.982	10.5
EURUSD	1.33	1.333	0.5
GBPUSD	1.69	1.549	-8.5
USDJPY*	92.4	77.6	-16.1
USDCAD*	1.08	1.044	-3.6
USDSEK*	7.2	6.955	-3.2
USDCHF*	0.98	0.928	-5.0
US Dollar Index	81.0	79.6	-1.7

NZD Crosses	Fair Value	Current 28 Nov	Deviation from fair value (%)
NZDUSD	0.70	0.750	6.6
NZDAUD	0.79	0.762	-3.8
NZDEUR	0.53	0.558	5.3
NZDJPY	65.0	58.1	-10.5
NZDGBP	0.42	0.484	16.5
NZ TWI	65.6	66.9	2.0

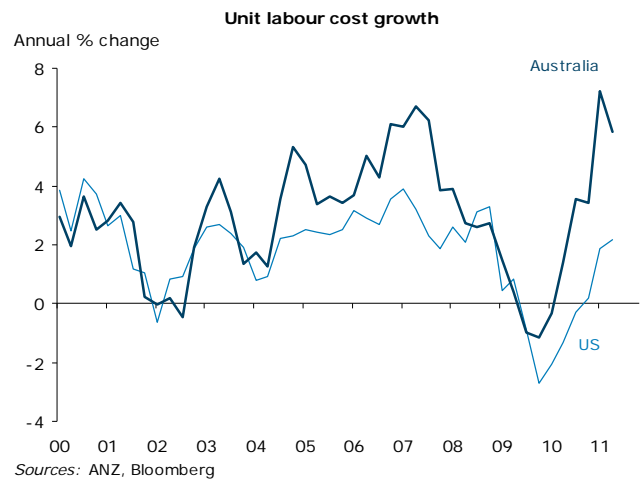
* A negative deviation implies overvalued.

CURRENCY TENSIONS

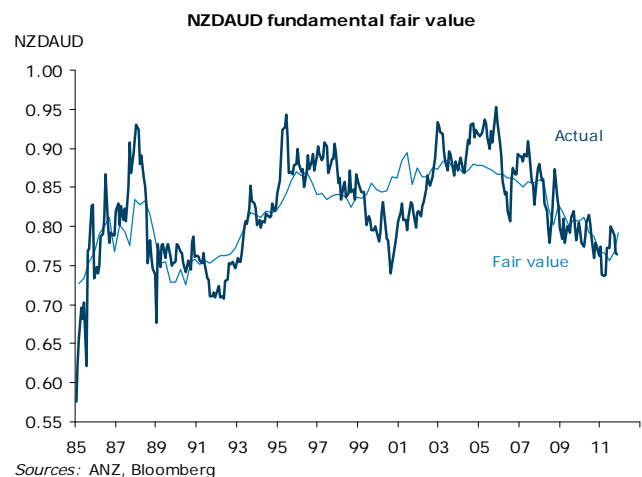
The key highlights from our updated estimates are:

- JPY is the most overvalued currency.** Our fair value estimate suggests USDJPY should be closer to 92 (our previous fair value estimate was 97.5) than the current 77.6 spot rate, meaning the yen is overvalued by around 16 percent. However, despite the threat of intervention, safe haven demand for yen is likely to keep the currency overvalued for some time. **At the other end of the spectrum, the pound is the most undervalued currency** with a fair value of 1.69 (down from 1.72 previously).
- Commodity currencies' fair values have been revised higher.** This is not surprising given the strong terms of trade boost from high commodity prices. Australia's terms of trade (measured as the export price deflator over the import price deflator) has risen close to 13 percent versus a year ago, while Canada's is up by 5 percent and New Zealand's over 3 percent. NZDUSD saw its fair value estimate raised from 0.67 to 0.70, with a narrowing current account differential and higher interest rate differential also assisting. Despite experiencing the strongest terms of trade rise, AUDUSD's fair value estimate only increased from 0.88 to 0.89. Poor productivity performance

and a sharp rise in unit labour cost (almost 6 percent higher from a year ago) have offset some of the terms of trade impact.



- The implied fair value for the NZDAUD cross rate is 0.79.** While this implies that the NZD is around three cents undervalued relative to the AUD, this is within the normal deviation range. What is interesting is that the fair value estimate for NZDAUD has been rising while the cross has been falling of late, which suggests that we could get a reversal in the spot rate in the near-term.

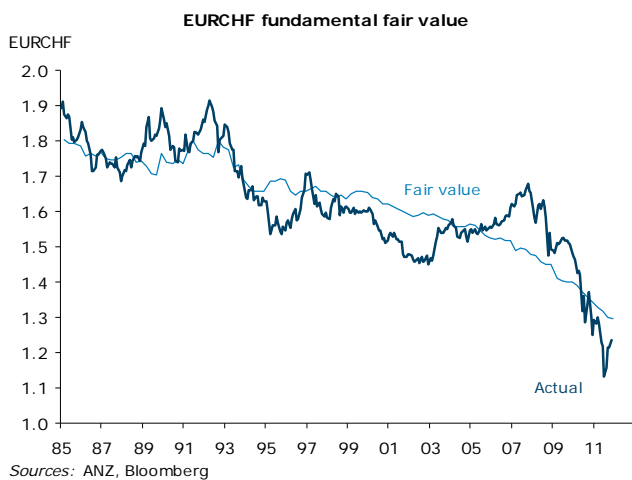


- Despite all of the Eurozone's woes, EURUSD fair value was still revised higher from 1.30 to 1.33, not too far off the current spot rate.** Our models do not take into account sovereign risk, so the upward revision to the euro's fair value reflects a better relative terms of trade position compared to the US, lower unit labour cost growth and widening yield differentials (up until most recently). Given the need for the Eurozone to grow their way out of their fiscal problems, a period of time when the euro stays

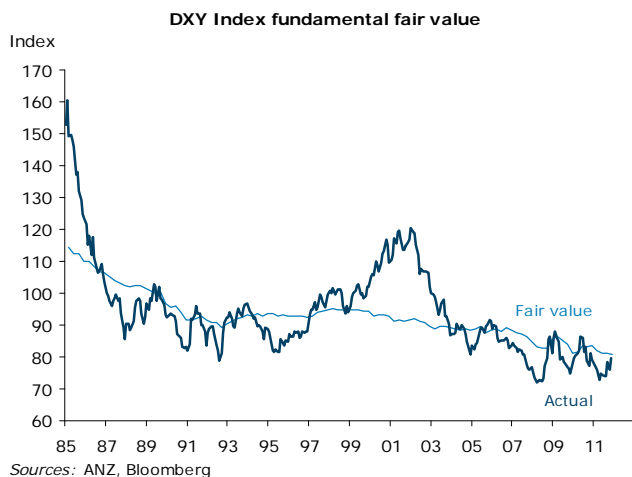
CURRENCY FAIR VALUE MODEL UPDATE

below fair value would be helpful. Then again, a lot of countries would like their currencies to be lower but not everyone can.

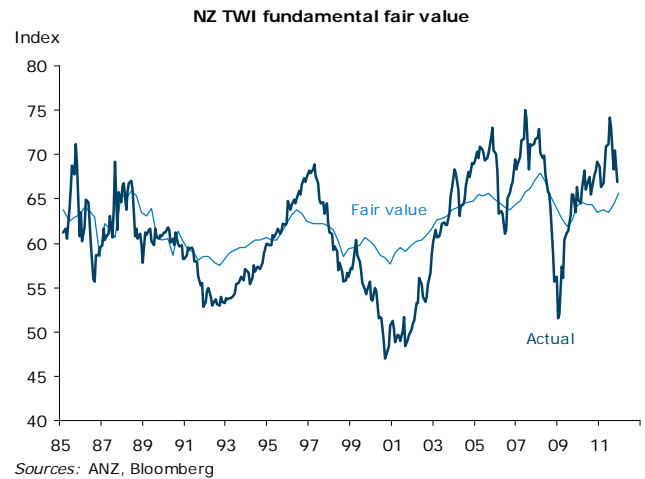
- **Fair value for EURCHF is close to 1.30.** This level is above the 1.20 floor set by the SNB in September, but is close to the level that many speculate the SNB would like to move the floor towards. The market is adhering to the floor for now, but it remains to be seen if the SNB will be tested should we see a bout of safe haven demand re-emerge for Swiss francs.



- **The US dollar, as measured by the DXY Index, is presently undervalued by around 2 percent.** This suggests that the US dollar is not significantly undervalued, and there is certainly scope for further declines based on past undershoots. Interestingly, rebounds in the US dollar on heightened risk aversion over the past two years have failed to materially push it too far beyond fair value. This suggests any rally in the US dollar will likely be capped at around 81 on the DXY Index.



- **When we derive the implied NZD cross rates, the NZD is most overvalued against the GBP by around 16.5 percent.** But on a trade-weighted basis, the recent selloff in the NZD has brought it close to fair value.

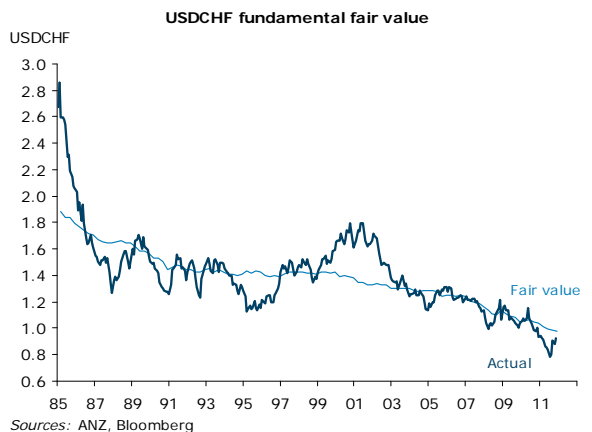
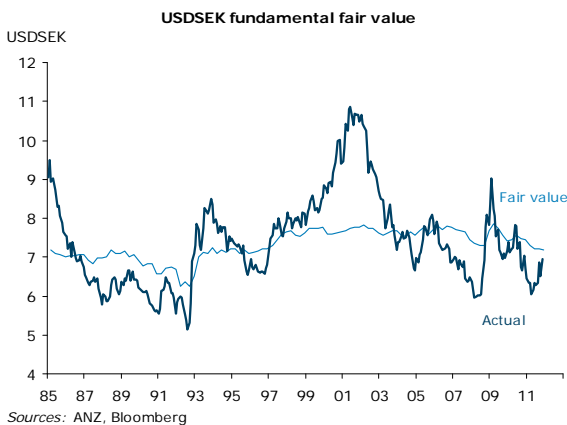
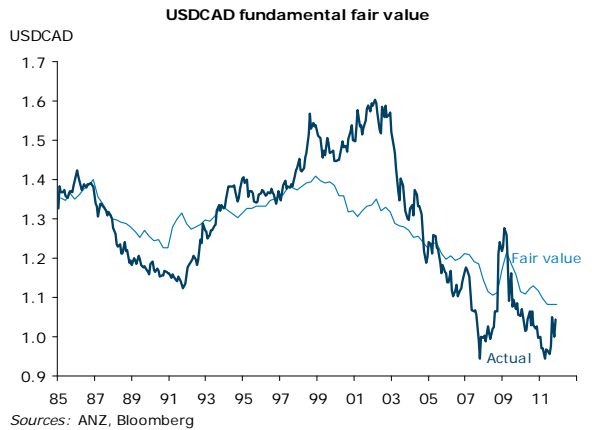
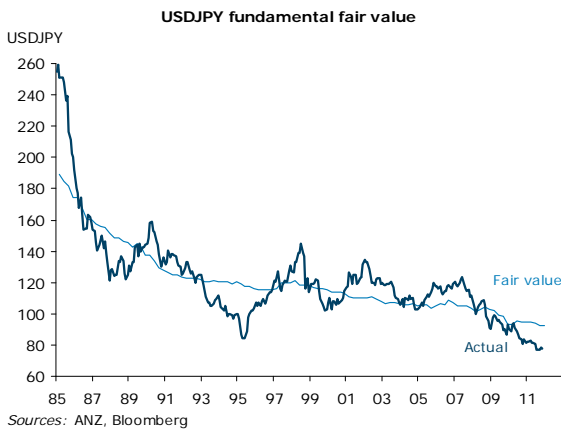
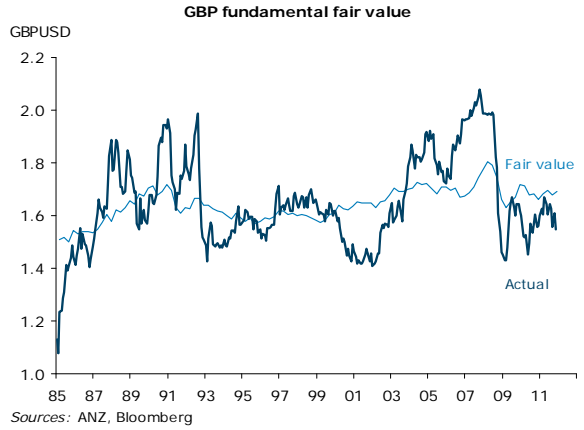
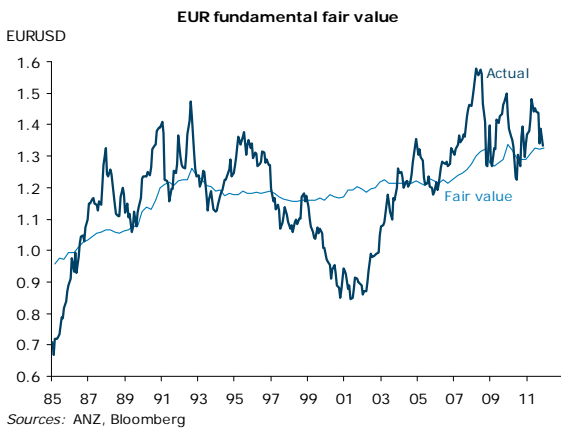
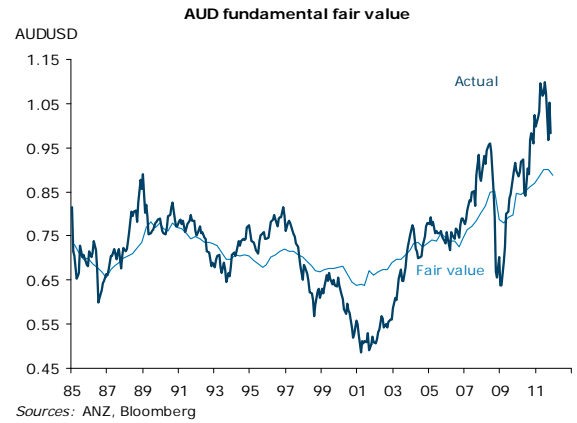
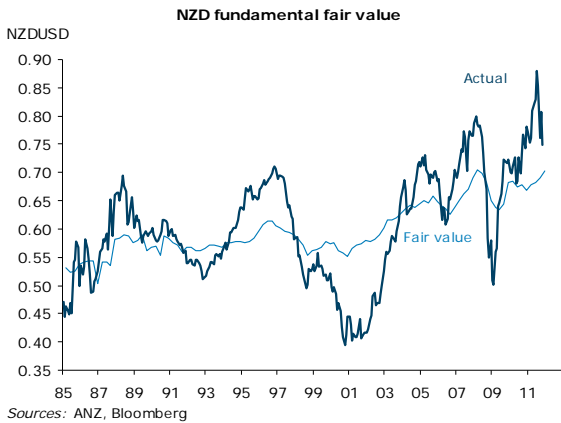


THE UPSHOT

Our fundamental fair value models provide an indication of how misaligned some currencies potentially are. But by themselves they do not necessarily tell us whether any misalignment will close. Indeed, currencies could deviate further from fair value and stay extended for a long period of time. The usefulness of fair value models is in helping set an anchor for medium-term currency projections, highlighting tensions, and identifying the possible next big directional moves should there be a large shock.

Looking at our fair value estimates over time, it is clear that there has been a structural shift higher for NZDUSD and AUDUSD, reflecting better fundamentals such as stronger terms of trade. Our latest fair value estimates suggest that businesses should plan based on longer-term forecasts for NZDUSD at 0.70 and AUDUSD at 0.90, both of which are higher than the commonly used 10-year average assumption (which is 0.665 for NZDUSD and 0.787 for AUDUSD).

CURRENCY FAIR VALUE MODEL UPDATE



INTEREST RATE STRATEGY

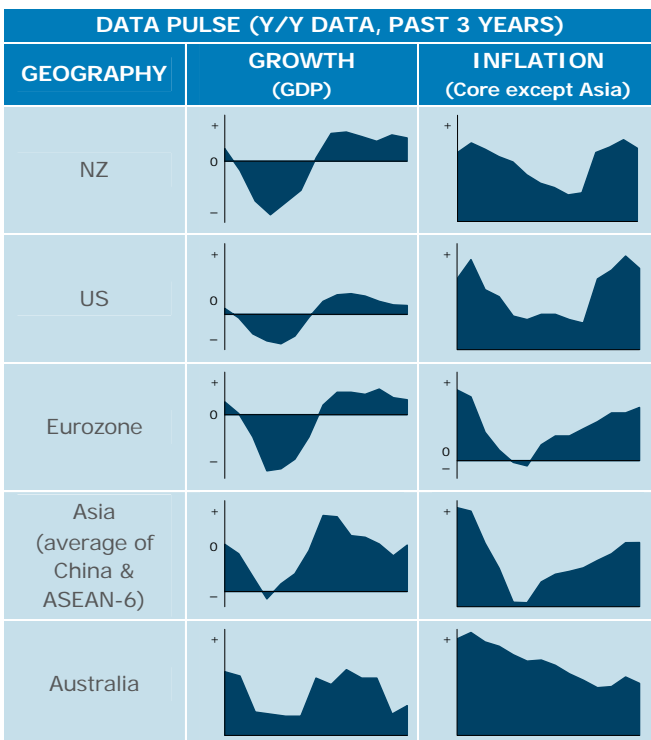
SUMMARY

Uncertainty continues to escalate as the European sovereign debt crisis deepens. New Zealand interest rates have plummeted as a result, and the market is now fully priced for a rate cut by March. After such an extended move, some sort of rebound is to be expected. The NZ General Election over the weekend has removed one uncertainty. But unless we see meaningful and credible changes in Europe, we would regard any sell-off in rates as a "headfake" and an opportunity to get long again.

THEMES

- **Interest rates have moved to new lows across the yield curve.** The local interest rate market is now pricing in roughly one-in-five odds of a rate cut next week, and a full cut by March. This is not our forecast, but it is clearly where the risks lie.
- **Last week's failed German bund auction was a significant development,** and has come at a time when demand for NZGS bonds has also started to slow, casting a long shadow over the market.
- **We remain extremely circumspect.** Even if we do see a rebound, we won't believe it unless it is backed by substance.
- The market will be relieved that there was a clear outcome at the weekend elections, and as such, **we expect bonds to be well bid.**

DATA PULSE



PREFERRED STRATEGIES – INVESTORS

We continue to favour playing the market from the long side, and have generally concluded that unless we see a meaningful policy response out of Europe, any rebound is likely to be a short-lived squeeze. The reality is that we are now well beyond the point where quick fixes will "do the trick".

Uncertainty remains the order of the day, and we expect volatility to remain at elevated extremes. With most of the volatility emanating from offshore, it makes little sense to put on outright NZ trades. Instead, **we favour "fundamental" trades such as OIS spreads** like the Mar/Sep OIS spread. This is close to flat, yet if the RBNZ are forced to cut, they will do more than just tinker.

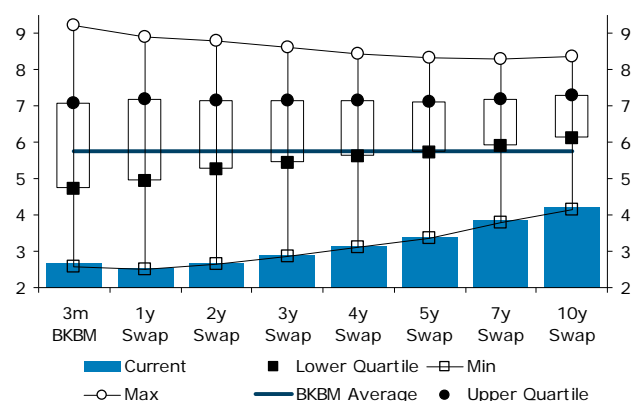
KEY VIEWS – FOR INVESTORS		
GAUGE	DIRECTION	COMMENT
Duration	Neutral/long	We are bearish and prefer to add duration on backups.
Curve	Neutral	Remains directional.
NZ-US 10y spread	Neutral	Bond spread has widened, but is still a tad tight.
Swap spreads	Negative	Bonds to outperform swaps following clear election outcome.

PREFERRED STRATEGIES – BORROWERS

We prefer to keep the duration of hedges short. Rates are at or close to record lows, but the outlook has changed too. We would caution against getting "blinker" by rates just because they are low.

KEY VIEWS – FOR BORROWERS		
GAUGE	DIRECTION	COMMENT
Hedge ratio	Mostly floating	Be careful using swaps with margins at risk of rising.
Value	Extreme	Rates are at record lows.
Uncertainty	Extreme	Suggest caution even with rates this low.

NZ Swap Rate History (since the OCR introduction)



Sources: ANZ, National Bank, Bloomberg

INTEREST RATE STRATEGY

GLOBAL SCENE

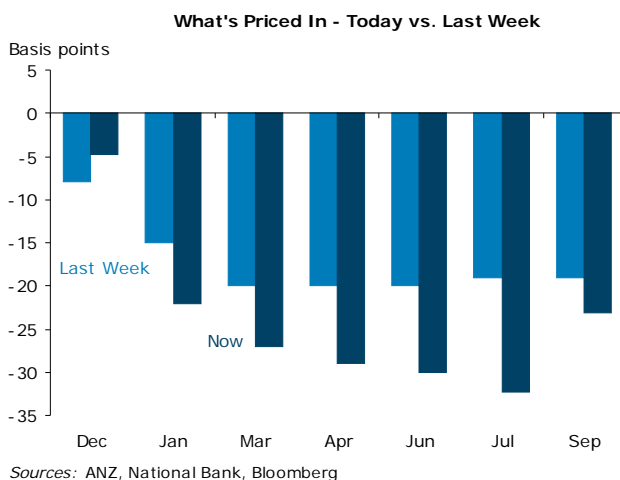
Europe remains at front and centre, and the level of fear in markets is growing by the day. What has been most troubling about the past week has been (a) the spread of contagion from the periphery to the core and the systemic risks this brings; (b) the heightened sense of uncertainty prevailing, even among central bankers; (c) the lack of political will to get serious about fiscal reform in the US (and for that matter Japan); and (d) the increased amount of free chatter about the end of the euro as we know it. Germany continues to talk tough, even if it is coming under fire itself. Of course, we may well yet see a shock and awe response from politicians and central banks – and if we do, interest rates will almost certainly spike higher. But if new initiatives are not backed by substance and credibility, any spike higher in interest rates is likely to be short-lived.

DOMESTIC

The clear election outcome over the weekend will come as somewhat of a relief to markets. While the opinion polls were pointing towards the National Party securing the most votes, there was uncertainty over whether they would have sufficient coalition partners to form the next government. That uncertainty has now been cleared away.

Notwithstanding the election result, with global markets in turmoil, expect domestic considerations to be relegated to mere nuances around the global scene. **Next week's MPS is the next major event**, but ahead of that, expect the focus to remain offshore.

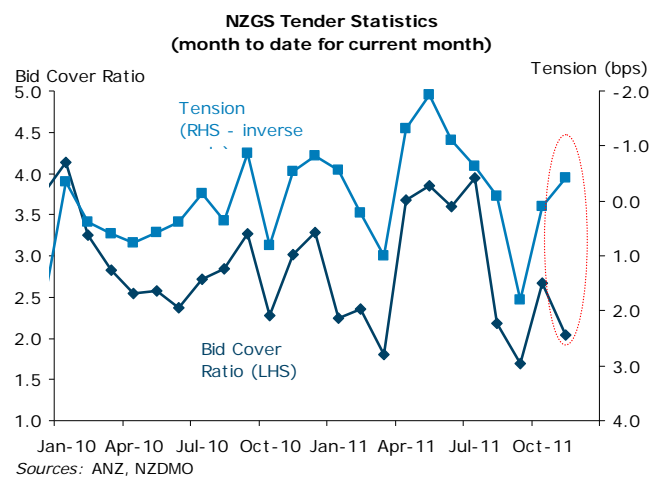
MONETARY POLICY AND MARKET PRICING



Local interest rates moved to all-time lows last week. Although the move initially had all the hallmarks of a domestic positioning “squeeze”, the market is now freely talking about the possibility of an

OCR cut. As we noted last week, what surprises us is how inconsistent market pricing has been. Even though this is typical of markets at turning points, we still think it is odd that the market has priced in such high odds of an early 2012 cut, but has the OCR rising again after July next year. **If the RBNZ starts cutting, they are unlikely to tinker with just one cut.** The 3mth-6mth spread has gone negative, and we suspect spreads further out on the curve like the 1yr-2yr will be next.

BONDS



Bond tender demand continues to fall. That's the bad news, and it has been reflected in bid cover, which fell to just 2.05 times for November as a whole. This is the third-lowest reading since 2009. **The good news is that price tension remains “tight”**, especially at the long end, which suggests there is real demand for duration, even with yields at these levels. The currency holds the key to bond demand from here – if the NZD continues to drift lower, expect offshore investors to be reticent about getting involved.

SWAPS AND SWAP SPREADS

Market participants were somewhat cautious last week ahead of the general election, likely preferring to wait until after the elections. With a clear outcome delivered, we expect interest in NZGS to return, resulting in bonds outperforming swaps. Therefore, we see **swap spreads heading further into negative territory**, particularly in the front end.

RELATIVE VALUE

No change to our view here. We still see the NZGS market offering the highest expected returns across the dollar bloc. But we need to see the market move unwaveringly toward pricing in RBNZ rate cuts for current valuations to be validated.

CURRENCY STRATEGY

SUMMARY

This week will start on a positive note with some positive news to counter the negative headlines from Europe. The NZ election result removes uncertainty but only returns us to business as usual locally. US consumers have returned in force over the Thanksgiving weekend, breaking all sorts of trading records. Merkel and Sarkozy continue to make positive comments about stability pacts to cure Europe's ills. However, expect the positive influence on FX markets to be short-lived. Chinese PMI data suggests the next monetary moves will definitely be an easing.

MARKET THEMES

- NZ election result to give a bid tone to NZD.
- US growth outlook gets a shot in the arm from Thanksgiving weekend sales.
- Merkel and Sarkozy continue to push for a crisis-buster.
- China growth outlook has turned soggy leaving AUD watchers wary.

REVIEW AND OUTLOOK

The NZ general election has delivered a sense of stability and business friendliness to the NZD.

The National Party has enough numbers to form a government alongside its traditional partners, producing a clear election outcome. However, once the post-election euphoria dies down, we will see a return to NZD being influenced by offshore events.

FX markets will take some comfort from the boomer Thanksgiving weekend retail sales adding to the perception of a slow but steady return of economic growth in the US. Last week's US data was a mixed bag but it seems the forward-looking data is generally improving. While GDP was weaker than expected at an annualised 2%, it is still positive. This week there is plenty of US data to latch onto including the ISM and Non-Farm Payrolls. The forecasters are looking for small improvements so expect USD support into these announcements.

In Europe the headlines keep coming out as Merkel and Sarkozy struggle to piece together a crisis-busting plan. The latest grand plan supposedly involves creating a coalition of EU members to commit to greater fiscal discipline. The approach seems to be about commitment to reform, but will the FX markets have the patience to wait to see the commitment become action?

Last week's HSBC China Flash PMI negatively surprised and fell below the all-important 50

threshold to 48.0. This all but confirms that the Chinese authorities will embark on a reasonably aggressive monetary easing to avoid the often talked about hard landing. This week's official PMI data will be important to confirm (or otherwise) the depth of the slowdown in China. FX markets could translate further weakness to the AUD given the likely flow-on effects of a China slowdown to the Australian economy.

Anecdotally it might just be time for a corrective rally in currencies (USD sell-off). The USD in the ascendancy for the last month (up 8.2% vs NZD, up 7.8% vs AUD and up 4.5% vs the EUR) it would be easy to see a corrective sell-off in the USD.

Importantly we would only see this as a correction and see renewed strength into next year as the growth dichotomy between the US and Europe takes hold.

NZD VS AUD: MONTHLY DIRECTIONAL GAUGES

GAUGE	DIRECTION	COMMENT
Fair value	↔/↑	Undervalued on a near-term cyclical basis.
Yield	↔	NZ market pricing RBNZ cut.
Commodities	↔	Commodities lower.
Partial indicators	↔	Data showing signs of slowing in NZ.
Technicals	↔↑	Support at 0.7560.
Sentiment	↑	See NZD undervalued vs AUD.
Other	↔	Global sentiment big driver.
On balance	↔/↑	Sentiment sees lazy buyers coming forward.

NZD VS USD: MONTHLY DIRECTIONAL GAUGES

GAUGE	DIRECTION	COMMENT
Fair value – long-term	↓	Above revised structural fair value estimate of 0.70.
Fair value – short-term	↔	Closer to short term FV.
Yield	↑	Official rates to stay low but investable yields support.
Commodities	↓	Softs falling.
Risk aversion	↔↑	Positive US data and short covering leads to risk on.
Partial indicators	↔	NZ data now mixed. US data improving.
Technicals	↑	Technical bounce given large fall during previous month.
AUD	↓	Breach of 1.0000 gives bearish outlook.
Sentiment	↔	Nothing special.
Other	↔	Nothing apparent.
On balance	↔	Election done. Back to focus on risk events offshore.

DATA EVENT CALENDAR

DATE	COUNTRY	DATA/EVENT	MKT.	LAST	NZ TIME
28-Nov	NZ	NBNZ Activity Outlook - NOV	- -	26.1	13:00
	NZ	NBNZ Business Confidence - NOV	- -	13.2	13:00
	UK	Hometrack Housing Survey (YoY) - NOV	- -	-2.8%	13:01
	EC	Eurozone M3 s.a. 3 mth ave. - OCT	3.1%	2.6%	22:00
	EC	Eurozone M3 s.a. (YoY) - OCT	3.4%	3.1%	22:00
	EC	EC OECD November Economic Outlook	- -	- -	23:00
	CH	Leading Index - OCT	- -	100.43	28-30 Nov
	GE	Consumer Price Index (MoM) - NOV P	0.0%	0.0%	28-29 Nov
	GE	Consumer Price Index (YoY) - NOV P	2.4%	2.5%	28-29 Nov
	UK	BoE Housing Equity Withdrawal - 2Q	-\$6.0B	-\$5.8B	28 Nov - 1 Dec
29-Nov	UK	CBI Reported Sales - NOV	-12	-11	00:00
	GE	GfK Consumer Confidence Survey - DEC	5.1	5.3	01:00
	US	New Home Sales - OCT	313K	313K	04:00
	US	New Home Sales MoM - OCT	0.0%	5.7%	04:00
	US	Dallas Fed Manf. Activity - NOV	5	2.3	04:30
	JN	Retail Trade YoY - OCT	0.7%	-1.2%	12:50
	JN	Retail Trade MoM SA - OCT	0.6%	-1.5%	12:50
	JN	Large Retailers' Sales - OCT	-1.2%	-3.6%	12:50
	AU	HIA New Home Sales (MoM) - OCT	- -	-3.5%	13:00
	UK	Nat'wide House prices nsa(YoY) - NOV	1.3%	0.8%	20:00
	UK	Net Consumer Credit - OCT	£0.5B	£0.6B	22:30
	UK	Net Lending Sec. on Dwellings - OCT	£0.5B	£0.3B	22:30
	UK	Mortgage Approvals - OCT	51.8K	51.0K	22:30
	UK	M4 Money Supply (MoM) - OCT	- -	-0.4%	22:30
	UK	M4 Money Supply (YoY) - OCT	- -	-1.7%	22:30
	UK	M4 Ex OFCs 3M Annualised - OCT	- -	4.9%	22:30
	EC	Business Climate Indicator - NOV	-0.30	-0.18	23:00
	EC	Eurozone Consumer Confidence - NOV F	-20.4	-20.4	23:00
	EC	Eurozone Economic Confidence - NOV	93.9	94.8	23:00
	EC	Eurozone Indust. Confidence - NOV	-7.6	-6.6	23:00
	EC	Eurozone Services Confidence - NOV	0.0	0.2	23:00
	UK	OBR Releases Economic and Fiscal Forecasts	- -	- -	29-30 Nov
30-Nov	US	S&P/CS Composite-20 YoY - SEP	-3.0%	-3.8%	03:00
	US	Consumer Confidence - NOV	44.0	39.8	04:00
	US	House Price Index MoM - SEP	-0.1%	-0.1%	04:00
	US	House Price Purchase Index QoQ - 3Q	- -	-0.6%	04:00
	NZ	Building Permits MoM - OCT	- -	-17.1%	10:45
	AU	RPData-Rismark House Px Raw - OCT	- -	-0.2%	12:30
	AU	RPData-Rismark House Px S.A - OCT	- -	-0.2%	12:30
	JN	Industrial Production (MoM) - OCT P	1.1%	-3.3%	12:50
	UK	GfK Consumer Confidence Survey - NOV	-33	-32	13:01
	AU	Private Sector Credit MoM% - OCT	0.4%	0.5%	13:30
	AU	Private Sector Credit YoY% - OCT	3.6%	3.4%	13:30
	AU	Private Capital Expenditure - 3Q	8.0%	4.9%	13:30
	JN	Labor Cash Earnings YoY - OCT	-0.2%	0.0%	14:30
	NZ	Money Supply M3 YoY - OCT	- -	5.0%	15:00
	JN	Housing Starts (YoY) - OCT	-6.3%	-10.8%	18:00
	GE	Retail Sales (MoM) - OCT	0.1%	0.4%	20:00

Continued on following page

DATA EVENT CALENDAR

DATE	COUNTRY	DATA/EVENT	MKT.	LAST	NZ TIME
	GE	Retail Sales (YoY) - OCT	2.0%	0.3%	20:00
	GE	Unemployment Change (000's) - NOV	-5K	10K	21:55
	GE	Unemployment Rate (s.a) - NOV	7.0%	7.0%	21:55
	EC	Eurozone CPI Estimate (YoY) - NOV	3.0%	3.0%	23:00
	EC	Eurozone Unemployment Rate - OCT	10.2%	10.2%	23:00
1-Dec	US	Challenger Job Cuts YoY - NOV	-	12.6%	01:30
	US	ADP Employment Change - NOV	130K	110K	02:15
	US	Nonfarm Productivity - 3Q F	2.6%	3.1%	02:30
	US	Unit Labor Costs - 3Q F	-2.1%	-2.4%	02:30
	US	Chicago Purchasing Manager - NOV	58.5	58.4	03:45
	US	Pending Home Sales MoM - OCT	1.5%	-4.6%	04:00
	US	Pending Home Sales YoY - OCT	-	7.9%	04:00
	US	NAPM-Milwaukee - NOV	56	55.5	04:00
	US	Fed's Beige Book	-	-	08:00
	NZ	Terms of Trade Index (QoQ) - 3Q	-	2.3%	10:45
	AU	AiG Performance of Mfg Index - NOV	-	47.4	11:30
	NZ	ANZ Commodity Price - NOV	-	-3.5%	13:00
	AU	Retail Sales s.a. (MoM) - OCT	0.4%	0.4%	13:30
	CH	PMI Manufacturing - NOV	49.9	50.4	14:00
	CH	HSBC Manufacturing PMI - NOV	-	51	15:30
	AU	RBA Commodity Price Index Au - NOV	-	107.5	18:30
	AU	RBA Commodity Index SDR YoY% - NOV	-	19.4%	18:30
	GE	PMI Manufacturing - NOV F	47.9	47.9	21:55
	EC	PMI Manufacturing - NOV F	46.4	46.4	22:00
	UK	PMI Manufacturing - NOV	47.0	47.4	22:30
	UK	Halifax House Prices sa (MoM) - NOV	-	1.2%	1-9 Dec
	UK	Halifax House Price 3Mths/Year - NOV	-	-1.8%	1-9 Dec
2-Dec	US	Initial Jobless Claims - 26-Nov	390K	393K	02:30
	US	Continuing Claims - 19-Nov	3650K	-	02:30
	US	Construction Spending MoM - OCT	0.3%	0.2%	04:00
	US	ISM Manufacturing - NOV	51.5	50.8	04:00
	US	ISM Prices Paid - NOV	45	41	04:00
	US	Total Vehicle Sales - NOV	13.40M	13.20M	11:00
	US	Domestic Vehicle Sales - NOV	10.40M	10.29M	11:00
	AU	Building Approvals (MoM) - OCT	3.3%	-13.6%	13:30
	AU	Building Approvals (YoY) - OCT	-14.4%	-12.0%	13:30
	UK	PMI Construction - NOV	52.0	53.9	22:30
	EC	Eurozone PPI (MoM) - OCT	0.2%	0.3%	23:00
	EC	Eurozone PPI (YoY) - OCT	5.6%	5.8%	23:00
3-Dec	US	Change in Nonfarm Payrolls - NOV	120K	80K	02:30
	US	Change in Private Payrolls - NOV	145K	104K	02:30
	US	Change in Manufact. Payrolls - NOV	9K	5K	02:30
	US	Unemployment Rate - NOV	9.0%	9.0%	02:30
	US	Avg Hourly Earning MOM All Emp - NOV	0.2%	0.2%	02:30
	US	Avg Hourly Earning YOY All Emp - NOV	2.0%	1.8%	02:30
	US	Avg Weekly Hours All Employees - NOV	34.3	34.3	02:30
	CH	China Non-manufacturing PMI - NOV	-	57.7	14:00

Key: AU: Australia, EC: Eurozone, GE: Germany, JN: Japan, NZ: New Zealand, UK: United Kingdom, US: United States, CH: China.

Sources: Dow Jones, Reuters, Bloomberg, ANZ, National Bank. All \$ values in local currency

Note: All surveys are preliminary and subject to change



LOCAL DATA WATCH

Key focus over the next few weeks: With the Rugby World Cup and general election behind us, the next few months will provide insights into the state of underlying demand. The relative resilience of the NZ economy continues to be put to the test, although the high number of RWC visitors suggests a larger temporary spending boost. The global outlook remains troubling, and a soft start to 2012 beckons. The OCR will eventually need to move higher, but this will be conditional on the global scene improving, something we can't envisage for quite some time.

DATE	DATA/EVENT	ECONOMIC SIGNAL	COMMENT
Mon 28 Nov (1:00pm)	National Bank Business Outlook	- -	- -
Tue 29 Nov (10:45am)	National Employment Indicator - Sep	Down	Falling job advertising suggests a small fall is in prospect. We expect a 0.3 percent fall.
Wed 30 Nov (10:45am)	SNZ Building Consents – Oct	See-saw	A 5 percent lift in dwelling consents is forecast following the large decline in the previous month.
Wed 30 Nov (3:00pm)	RBNZ Credit Aggregates – Oct	Subdued	Low annual rates of household and business credit growth, with falling agriculture credit expected as dairy cheques are banked.
Thur 1 Dec (1:00pm)	SNZ Overseas Trade Indexes – Q3	Peaking?	We expect a 1.5 percent increase in the terms of trade. Import volumes to rise 1.5 percent, with exports up 0.5 percent.
Thur 1 Dec (1:00pm)	ANZ Commodity Price Index – Nov	- -	- -
Mon 5 Dec (10:00am)	NZ Govt financial statements – Oct	Weaker than forecast	Core crown revenue to continue undershooting the PREFU forecast.
Mon 5 Dec (10:45am)	Value of Work Put in Place – Q3	Down	We expect a 5 percent fall in work put in place volumes, with both residential and non-residential posting declines.
Wed 7 Dec (early am)	Global Dairy Trade auction	High	Prices are expected to consolidate at historically high levels.
Thur 8 Dec (09:00am)	RBNZ December <i>MPS</i>	On hold	Global concerns and a benign short-term inflation outlook will keep the RBNZ on the sidelines.
Thur 8 Dec (10:45am)	SNZ Wholesale Trade Survey - Q3	Up	Accelerating retail activity is expected to underpin a 1 percent increase in wholesale trade activity.
Thur 8 Dec (10:45am)	Economic Survey of Manufacturing – Q3	Up	Primary manufacturing volumes are expected to rise 3 percent. Ex-primary volumes are expected to track sideways.
Fri 9 Dec (10:45am)	Electronic Card Transactions - Nov	RWC hangover	A 0.8 percent fall in ECT spending is forecast, with falls for fuel and apparel sales.
Fri 9 Dec (1:00pm)	ANZ - Roy Morgan Consumer confidence	- -	- -
Wed 14 Dec (10:00am)	REINZ housing market report - November	Lifting	Low mortgage interest rates and no further RWC distractions should see a 2 percent plus gain in sales volumes.
Thur 15 Dec (10:30am)	BNZ Business NZ Manufacturing PMI	Subdued	Another sub-50 print is in prospect, although we expect a climb from the 46.5 level recorded in October.
Wed 21 Dec (10:45am)	International Travel and Migration - Nov	Soft	We expect a net PLT outflow of 500 persons. With no Rugby World Cup visitors a 20 percent fall in visitor arrivals is expected.
Wed 21 Dec (10:45am)	Balance of Payments – Q3	Holding	We expect an annual deficit of around \$7.5bn (3.7 percent of GDP), despite a large goods surplus.
Thur 22 Dec (10:45am)	Gross Domestic Product – Q3	RWC boost	A 0.8 percent increase is expected, with strong retail, agricultural activity offsetting weakness in construction sector activity.
On Balance		Local vs global	Domestic gauges for H2 should remain positive but global concerns suggest caution for early 2012.

KEY FORECASTS AND RATES

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
GDP (% qoq)	0.9	0.1	0.8	1.1	0.2	0.5	0.7	1.0	0.9	0.7
GDP (% yoy)	1.7	1.5	2.4	2.9	2.2	2.6	2.5	2.4	3.1	3.3
CPI (% qoq)	0.8	1.0	0.4	0.3	0.6	0.7	0.9	0.4	0.6	0.7
CPI (% yoy)	4.5	5.3	4.6	2.5	2.3	2.1	2.5	2.6	2.6	2.6
Employment (% qoq)	1.2	0.0	0.2	0.3	0.2	0.5	0.4	0.3	0.3	0.3
Employment (% yoy)	1.8	2.0	1.1	1.8	0.8	1.3	1.4	1.4	1.5	1.3
Unemployment Rate (% sa)	6.5	6.5	6.6	6.4	6.4	6.2	6.1	6.0	6.0	6.0
Current Account (% GDP)	-3.6	-3.7	-3.7	-3.6	-3.9	-4.0	-4.2	-4.5	-4.6	-4.7
Terms of Trade (% qoq)	0.8	2.3	1.5	2.1	-0.8	-0.8	-0.8	-0.8	-0.7	-0.7
Terms of Trade (% yoy)	6.7	7.0	5.5	6.8	5.1	2.0	-0.3	-3.1	-2.9	-2.9

	Feb-11	Mar-11	Apr-11	May-11	Jun-11	Jul-11	Aug-11	Sep-11	Oct-11	Nov-11
Retail ECT (% mom)	-0.2	1.4	1.5	-0.7	1.1	0.3	-0.6	0.7	1.5	..
Retail ECT (% yoy)	6.2	6.6	10.0	6.8	9.0	8.0	8.4	7.5	7.4	..
Credit Card Billings (% mom)	-0.4	-1.0	1.9	0.5	0.5	1.1	-1.2	1.3	2.6	..
Credit Card Billings (% yoy)	5.9	2.1	6.5	5.6	4.6	7.4	4.8	5.3	7.9	..
Car registrations (% mom)	-2.0	-0.1	-5.3	3.5	-2.3	-1.9	9.1	-12.3	0.4	..
Car registrations (% yoy)	2.8	-1.0	-10.5	-3.7	-9.5	-6.0	1.9	-12.2	-8.8	..
Building consents (% mom)	-9.7	2.4	-1.1	3.4	-1.2	13.6	16.7	-17.1
Building consents (% yoy)	-28.8	-26.1	-32.5	-21.8	-25.3	-15.6	18.7	-3.9
REINZ House Price Index (% yoy)	-0.7	-1.8	-0.4	-0.7	0.0	0.5	0.7	2.7	3.4	..
Household Lending Growth (% mom)	0.1	-0.1	0.2	0.1	0.1	0.2	0.1	0.1
Household Lending Growth (% yoy)	1.5	1.2	1.3	1.2	1.2	1.2	1.1	1.1
ANZ Roy Morgan Consumer Confidence	108.1	101.4	101.4	103.3	112.5	109.4	113.3	112.6	112.2	109.0
NBNZ Business Confidence	34.5	-8.7	14.2	38.3	46.5	47.6	34.4	30.3	13.2	..
NBNZ Own Activity Outlook	36.6	14.7	29.5	39.7	38.7	43.7	43.3	35.4	26.1	..
Trade Balance (\$m)	184	583	1158	550	201	103	-695	-789	-282	..
Trade Balance (\$m ann)	765	741	1238	1019	999	1288	1023	689	627	..
ANZ World Commodity Price Index (% mom)	2.7	4.7	1.6	0.4	-1.2	-0.2	-1.4	-2.0	-3.5	..
ANZ World Commodity Price Index (% yoy)	20.3	23.5	19.8	19.6	20.6	22.2	22.0	16.5	9.1	..
Net migration (sa)	450	-510	-90	-270	-260	-200	110	-690	-640	..
Net migration (annual)	8249	6554	5508	4625	3867	2867	2257	773	-103	..

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

KEY MARKET FORECASTS AND RATES

FX RATES	ACTUAL			Forecast (end month)						
	Sep-11	Oct-11	Today	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
NZD/USD	0.761	0.807	0.750	0.77	0.80	0.83	0.86	0.89	0.90	0.90
NZD/AUD	0.788	0.766	0.762	0.79	0.80	0.79	0.78	0.81	0.82	0.82
NZD/EUR	0.569	0.582	0.558	0.57	0.58	0.59	0.61	0.61	0.62	0.62
NZD/JPY	58.67	63.06	58.14	57.8	60.0	59.8	61.9	64.1	63.0	63.0
NZD/GBP	0.489	0.502	0.484	0.50	0.51	0.52	0.53	0.55	0.55	0.55
NZ\$ TWI	68.3	70.4	66.9	68.4	70.3	71.3	72.8	74.8	75.4	75.4
INTEREST RATES	Sep-11	Oct-11	Today	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
NZ OCR	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.25	3.50
NZ 90 day bill	2.86	2.73	2.68	2.70	2.70	2.80	2.80	3.20	3.70	3.80
NZ 10-yr bond	4.42	4.50	3.96	4.30	4.30	4.30	4.30	4.40	4.40	4.60
US Fed funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
US 3-mth	0.37	0.43	0.52	0.35	0.35	0.35	0.35	0.35	0.35	0.35
AU Cash Rate	4.75	4.75	4.50	4.50	4.25	4.25	4.25	4.25	4.25	4.25
AU 3-mth	4.92	4.71	4.60	4.70	4.60	4.60	4.50	4.50	4.50	4.50

Forecasts finalised as at 28 November 2011

	25 Oct	21 Nov	22 Nov	23 Nov	24 Nov	25 Nov
Official Cash Rate	2.50	2.50	2.50	2.50	2.50	2.50
90 day bank bill	2.69	2.66	2.66	2.65	2.65	2.66
NZGB 04/13	2.78	2.49	2.45	2.45	2.42	2.42
NZGB 04/15	3.35	2.83	2.79	2.79	2.76	2.79
NZGB 03/19	4.33	3.72	3.74	3.74	3.69	3.72
NZGB 05/21	4.57	3.97	3.99	3.99	3.94	3.97
2 year swap	3.15	2.70	2.70	2.65	2.64	2.66
5 year swap	3.98	3.44	3.44	3.39	3.36	3.38
RBNZ TWI	70.0	66.9	66.4	66.4	66.4	66.5
NZD/USD	0.8069	0.7564	0.7467	0.7450	0.7433	0.7419
NZD/AUD	0.7699	0.7579	0.7583	0.7614	0.7631	0.7653
NZD/JPY	61.40	58.08	57.56	57.38	57.28	57.39
NZD/GBP	0.5043	0.4799	0.4774	0.4770	0.4779	0.4798
NZD/EUR	0.5797	0.5587	0.5534	0.5530	0.5555	0.5571
AUD/USD	1.0481	0.9980	0.9847	0.9785	0.9740	0.9694
EUR/USD	1.3919	1.3538	1.3493	1.3471	1.3381	1.3317
USD/JPY	76.09	76.79	77.08	77.02	77.06	77.35
GBP/USD	1.5999	1.5760	1.5642	1.5617	1.5555	1.5463
Oil (US\$/bbl)	91.07	97.68	96.74	97.72	95.79	97.04
Gold (US\$/oz)	1657.40	1723.10	1675.85	1708.15	1691.10	1692.80
Electricity (Haywards)	6.55	5.10	4.00	6.42	7.07	6.70
Baltic Dry Freight Index	2161	1874	1854	1830	1814	1807
Milk futures (USD)	148	143	144	144	144	144

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