

## CREDIT CONUNDRUMS

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### Page 2: Economic overview

- > New Zealand's economic "story" is evolving, with credit now a key area to watch. Indeed, after working against the Reserve Bank for the past four years, the credit channel of monetary policy is now likely to play a significant role over the coming years via tightened conditions.

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- > The financial conditions grip tightened during February, after a brief respite in January. Our Financial Conditions Index is now at a level which is consistent with sub-1 percent growth over the coming year, an outcome that is akin to a hard landing.

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- > Inflationary pressures remain intense, with most regions experiencing an increase in capacity pressures in the December quarter. A positive output gap still exists for the economy as a whole, reinforcing the point that a sticky and persistent inflationary dynamic will remain for some time.

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- > The focus returns to the local dataflow, with the RBNZ's inflation expectations survey and the National Bank Business Outlook key reads ahead of next week's *MPS*. Bias is still towards the payside, though global moves could yet over-ride domestic considerations.

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## ECONOMIC OVERVIEW

New Zealand's economic "story" is evolving, with credit now a key area to watch. Indeed, after working against the Reserve Bank for the past four years, the credit channel of monetary policy is now likely to play a significant role over the coming years via tightened conditions.

### What's ahead?

- > **RBNZ Survey of Expectations** (Tuesday 1500 NZDT). The key measure to watch is two-year ahead inflation expectations, and they are expected to remain elevated. We would not be surprised if they rose from their current level of 2.7 percent.
- > **NZ January Building Consents** (Wednesday 1045 NZDT). An easing trend is now clearly in place. We expect a fall of around 5 percent – similar to that recorded in December.
- > **NBNZ February Business Outlook** (Wednesday 1500 NZDT).
- > **NZ January External Migration** (Thursday 1045 NZDT). We expect annual migration to stabilise around current levels of 5,000, although the risks appear skewed to the downside.
- > **NZ January Credit Growth** (Thursday 1500 NZDT). Total household claims grew at the slowest pace since 2002 in December. Given housing weakness, we expect another soft result in January and around 0.7 percent growth for the month.
- > **NZ Overseas Merchandise Trade** (Friday 1045 NZDT). Another small trade surplus is expected following the surprise surplus in December. The impact of high dairy prices and Tui will continue to boost exports, although dry conditions may weigh on this slightly.

### What's the view?

Credit. It is in the process of surpassing inflation as the number one challenge, or issue, facing the economy over the coming year.

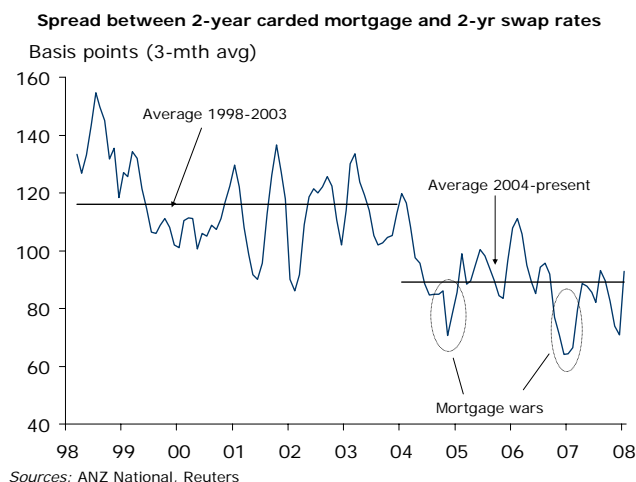
Indeed, if there is one point of difference between ourselves relative to the consensus, it is over the impact the altered credit environment, risk appetites and conditions are going to have on economic prospects. We made the rather brash call last August that global credit market unease had fundamentally changed the risk profile for the economy and the Reserve Bank would end up easing interest rates by March 2008. It was a call that was based on the conceptual issue that NZ was very reliant on offshore capital (credit) markets, and our suspicion that markets would not settle down. Rising oil prices and elevated inflationary pressures quickly quelled that notion, leaving the Reserve Bank no choice but to run a harsh line, and diminished their flexibility to respond. However, we remain inclined to the real risk of the economic cycle unfolding in an unfriendly manner.

The flow-on effects from subprime, the re-pricing of risk, and developments across credit markets leave us on edge.

As bank economists, credit is not normally a sphere we like to over-indulge in. Yet, the issue is at the forefront of our minds given the altered environment and the importance that credit plays within an economy. This has been highlighted by the aggressive actions a number of central banks have taken in response to deteriorating sentiment. Indeed, while a great deal of information and commentary is available, there seems some "shortfalls" in terms of connecting the dots. Prudence demands that we comment.

To fully understand the role that financial intermediaries, risk appetites and sentiment play within the economy, particularly in relation to monetary policy, we only need to cast our minds back. The past four years has been notable for the significant role the credit channel of monetary policy has played in leaning against the Reserve Bank's efforts to slow the economy. We can easily represent this via the spread between carded 2-year fixed mortgage rates and the 2-year swap rate. This spread compressed markedly from 2004. Part of the compression reflected aggressive discounting and the fabled 'mortgage wars'. In fact, the chart below is likely to significantly understate this impact given that many mortgages are written at interest rates below advertised (carded) rates. Yet a key reason for the compression was also remarkably favourable market conditions and low risk appetites, which reduced the margin between banks' funding costs and the swap curve. It was the ability of banks to fund cheaply that allowed the gap between fixed lending rates and swap rates to narrow. The latter point is not well cited or understood. This compression allowed attractive rates to be offered across retail, housing, rural and commercial borrowing.

Facing such credit accelerator forces, the potency of monetary policy was diluted, and the Reserve Bank ended up having to raise the Official Cash Rate more than would otherwise have been the case.

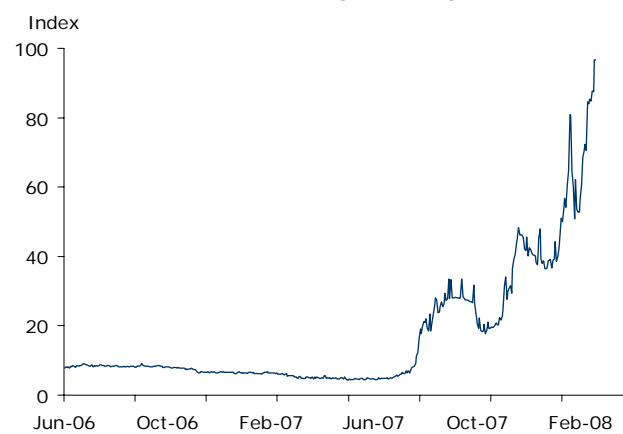


However, times are changing – and rapidly. Credit conditions are challenging. European credit spreads

opened up to record wide levels over this past week. The European iTraxx – which is a credit default swap index – rose to an index level of over 128 last week before easing slightly. Nevertheless it is still more than double its level from the start of the year. The US equivalent, or CDX, rose to over 153, and has also close to doubled since the start of the year. In NZ, funding costs are rising. The iTraxx for the four big Australian banks continues to skyrocket. New Zealand's 90-day rate sits at 60 basis points over cash. A competitor recently issued 2-year paper at 65 basis points over swap rate, which a year ago would have gone for 10 points. Don't expect the current gap between the swaps curve and carded 2 year fixed rate to remain at 100 basis points in that environment.

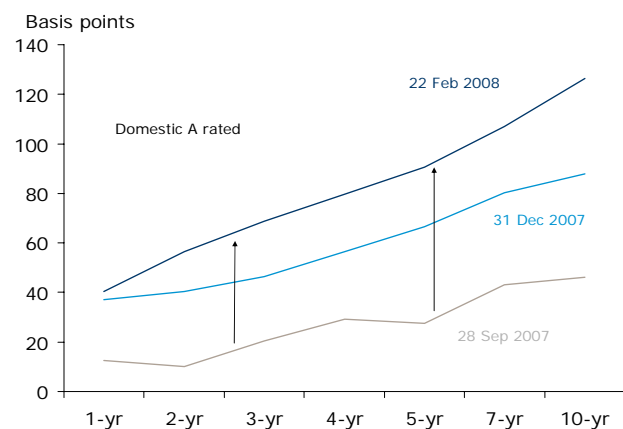
The combination above is exposing the nation's Achilles heel, namely a huge dependence on offshore capital markets, and poor level of savings. Borrowing costs will remain elevated unless credit sentiment improves markedly. That looks unlikely at present given continued uncertainty towards subprime exposure and the ripple effects from the repricing of risk.

**Australian iTraxx average four "big banks"**



Sources: ANZ National, Bloomberg

**Spread between NZ corporate bond and relative swap rate**



Sources: ANZ National, Bloomberg

Net on net, the Reserve Bank is in the process of getting a further substantial tightening in financial conditions. Our conventional financial conditions index is already pointing towards 0.5 percent growth (refer page 5) over 2008, and this measure does not fully

capture the credit channel of monetary policy. Even the currency, which tends to track down when momentum eases, is acting in an irregular fashion, with the weak USD restricting the ability of the NZD to operate as a shock absorber. Moreover, a higher currency adds to funding challenges. The tightening in financial conditions is coming at a time when cracks are strongly apparent in the housing market and filtering through into the broader economy. Last week's Electronic Card Transactions (ECT) data showed spending was again subdued in January, with total retail spending rising just 0.3 percent, and core retail spending falling 0.6 percent. Credit card spending was also soft, rising just 0.1 percent and this follows a subdued December.

Looking forward, a key risk at this juncture is that the tightening financial conditions move to restrict the supply of credit. The longer and more dysfunctional credit markets become, the less flexibility financial institutions have on their balance sheets to grow assets.

We can easily see a scenario where the Reserve Bank ends up cutting interest rates merely to offset the tightening in financial conditions that is being delivered via the credit channel of monetary policy. Consider it the reciprocal of the past few years. Borrowers won't get to see lower interest rates – higher international funding costs has put paid to that. But a lower cash rate would certainly help the export sector out via knocking the positive bias towards the NZD.

Of course such thoughts are just musings. (Actually we'd call them a lot more). The Reserve Bank being able to cut interest rates as a counter to the credit cycle is critically dependent on inflation pressures receding. Impetus from higher oil prices, which tested US\$100/bbl during the week, is one factor tying their hands. Capacity constraints within the economy remain rife, and our regional output gap gauges (see page 6) illustrate that they are relatively broad-based and consistent with inflationary pressures remaining sticky. In such an environment the tightening in credit conditions may merely be considered the necessary substitute to raising the Official Cash Rate. Yet we are in no doubt the game has fundamentally changed via the credit market. Lacking the credit fix, the real risk at this juncture is that the economy goes cold turkey. Forget tax cuts and the like (dairy). This nation is built/very dependent on credit.

For now we continue to take a very circumspect and watchful tone. But we are inclined to run against the herd and we are certainly tilted more towards an early and aggressive monetary policy easing cycle as opposed to rate hikes. Inflation pressure will not stay elevated in a hard-landing environment, which is the risk NZ currently faces given deteriorating price action across credit markets, and aggressive tightening in financial conditions.

While liquidity remains abundant, investors around the globe are being cautious. This is manifesting through wider spreads in general. Until investor confidence returns, we expect to see more of the same. Full

disclosure of subprime losses and other exposures are a precondition, and this is a process that is taking some time. In the meantime, risks from other areas are manifesting including writedowns on other securities on potential credit downgrades and rising prime defaults (notably in the US). Capital is tied up as banks meet customer needs of corporates who are unable to issue debt securities, leaving diminished flexibility to lend in other areas.

The Reserve Bank has repeatedly noted in their *Financial Stability Report* that New Zealand's banking system is sound so there are no worries on that front. Unfortunately, it's the old story of the few tarnishing all and sundry around the globe. Until the few are fully exposed / disclosed, all financial intermediaries continue to be tarred with the same brush via wider credit spreads. This, in turn, is placing pressure on funding costs for all financial intermediaries, which in turn impacts on the borrower.

Looking at the broader economic picture, last week confirmed to us that domestic demand is softening based on the ECT and credit card data mentioned earlier. Considering that petrol prices went up in January, this is a sign that disposable incomes are getting squeezed. Core retail sales have been flat-lining both in nominal and real terms over the past three quarters and this is all despite a very strong labour market and good labour income growth.

Moving to the data this week, it is a case of a number of second-tier releases prior to the Reserve Bank's *Monetary Policy Statement* in the first week of March. The key releases will be the NBNZ *Business Outlook* survey and the RBNZ's Survey of Expectations. The latter is likely to show inflation expectations remaining very elevated and we would not be surprised if the key 2-year ahead measure increased to 2.8 percent, from its current 2.7 percent level. In other data, January building consents issuance should continue to show a slowing trend given weak house sales. However, we'll be looking closely at non-residential issuance, and potential signs of the ripple effects from less lending across non-bank financial institutions. Credit growth is also likely to be soft.

External migration could be an interesting one to watch given that only a net 20 people permanently migrated to the country last month. Although not our central view, net migration has the real potential to turn negative in coming months as a greater number of New Zealanders depart these shores. This will be another factor likely to weigh on domestic demand over 2008 (although it will accentuate labour market shortages). Finally, trade data for January is also due and it is once again dairy and oil production from Tui, that should boost the export numbers. We expect another small monthly surplus to be recorded and see the annual trade deficit reduce to a 2½ year low.

Internationally, the major events this week will be again centred on any evidence of a US recession and whether weakness is broadening to other parts of the globe. US Q4 provisional GDP data will get some attention, and markets are expecting a small upward

revision from the 0.6 percent annualised growth previously recorded. Other important US data will be January PPI, as well as durable goods orders, with the latter providing a good early lead on business investment. Testimony by Fed Chairman Bernanke to Congress on monetary policy will be dissected by markets for any clues as to future policy moves by the Federal Reserve. In Europe, February business and consumer confidence data will be closely watched, particularly as sentiment has fallen sharply recently and portends of soft growth over 2008.

### Recent data...

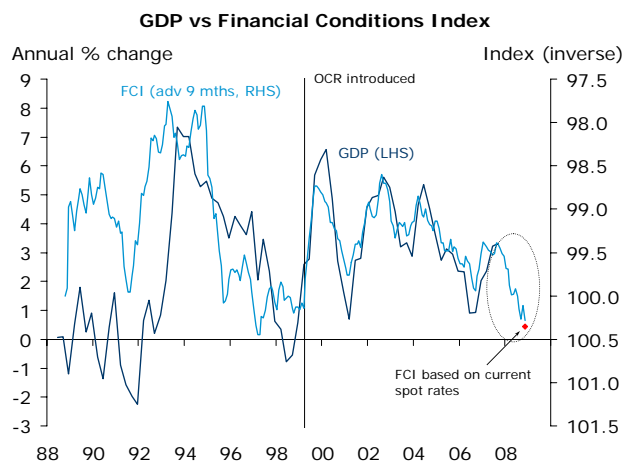
- > **NZ Electronic Card Transactions (January).** Retail sector related ECT transactions rose 0.3 percent, while core-retail sector ECT fell 0.6 percent.
- > **NBNZ Regional Trends (February).** The nationwide measure of economic activity rose by 0.7 percent in the December quarter. Taranaki had the strongest gain in activity, posting a 3.3 percent rise.
- > **NZ Credit Card Spending (January).** Total credit card billings rose 0.1 percent, following a 0.4 percent increase in December.

## FINANCIAL CONDITIONS UPDATE

The financial conditions grip tightened during February, after a brief respite in January. Our Financial Conditions Index is now at a level which is consistent with sub-1 percent growth over the coming year, an outcome that is akin to a hard landing.

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

Our Financial Conditions Index showed an easing in financial conditions over January on the back of lower domestic interest rates and a narrowing in US swap spreads from recent highs. However, this respite has proven to be temporary, with conditions tightening again during February.



What has been remarkable about our Financial Conditions Index for February is that all the components that make up our index tightened during the month, bar one. The TWI rose by over 2 percent. Both the 90-day and 2-year swap rates reversed their January declines. The US 2-year swap spread, a proxy for both the cost and supply of credit, widened on renewed global credit concerns. House prices in NZ have started to come under downward pressure, and credit growth is slowing (though off a high rate). The NZX 50 continues to head lower, falling for the fourth consecutive month. Our liquidity measure is the only component not to tighten, indicating that liquidity remains abundant and should provide some support for prospects, though it is off its peak. We also note

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

that our Financial Conditions Index uses averages over the month. Using current spot rates show that financial conditions are even tighter, mainly due to the higher TWI.

For some time, we have noted that our Financial Conditions Index has been telling us that the upswing in growth since mid-2006 was about to turn in early 2008. But the extent of the tightening in financial conditions over recent months is warning of a more sudden turn in growth prospects than initially thought. Our Financial Conditions Index is now at a level which is consistent with sub-1 percent growth (in annual percent change terms) over the coming year. This is a marked slowing from the pace of growth seen late last year, and is akin to a hard landing.

Indicators	Comment	Impact on activity
Currency, adjusted for the terms of trade	Further grinds up in the NZD.	↓
Interest rates	Both the 90-day and 2-year swap reversed January's decline.	↓
US 2-year swap spread	Spreads widened again on fresh credit concerns.	↓
Equity market index as a proxy for corporate wealth and liquidity	NZ equity market selloff continues for the fourth month in a row.	↓
House prices as a proxy for household wealth	House prices starting to show signs of downward pressure.	↔/↓
Private sector credit growth	Credit growth is slowing, though off a high rate.	↔
Liquidity	Liquidity remains abundant but is off its peak.	↔/↑
<b>Overall conditions</b>	<b>Getting tighter</b>	↓

On the face of it, a hard landing for the economy may appear to be a stretch given a tight labour market, pending fiscal stimulus, and still buoyant business sentiment at the end of last year. But we note that domestic demand has waned with the housing market in correction mode and growth in core retail spending effectively grinding to a halt. In addition, oil prices remain high, the global environment remains uncertain and drought conditions in some parts of the country will weigh on activity (though helped very recently by some much needed rain).

Our own core economic view is that growth will slow towards 1.5 percent in 2008. But the historical performance of our Financial Conditions Index warns us of downside risk to that. This week's National Bank *Business Outlook* report is shaping up to be a key read on how the economy will fare over the early part of this year.

## THE REGIONAL GAP

Inflationary pressures remain intense, with most regions experiencing an increase in capacity pressures in the December quarter. A positive output gap still exists for the economy as a whole, reinforcing the point that a sticky and persistent inflationary dynamic will remain for some time.

The linkage between excess demand and inflation pressure is well known. As economists, we frequently talk about the "output gap", noting that when the output gap is positive (i.e. actual economic growth exceeds "potential"), inflation pressures build. The period of strong growth recorded in New Zealand in recent years has seen a positive output gap open up and inflation pressures emerge. The Reserve Bank, seeing these pressures, has tightened monetary policy by raising the Official Cash Rate.

We have updated our regional output gap measures to examine which regions are responsible for the inflation pressures that persist in New Zealand. To refresh readers' memories, the regional output gaps are estimated using data from the National Bank's *Regional Trends* and *Business Outlook Survey*, and Statistics New Zealand's regional unemployment data.<sup>1</sup>

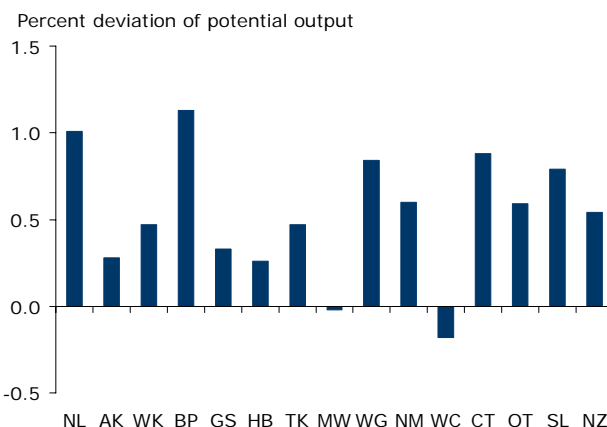
There are 5 key messages from this analysis:

- > A positive output gap still exists across the country as a whole, reinforcing the current inflation dynamic. Elevated capacity utilisation, and low unemployment rates contributed most to the positive output gap in the December quarter.
- > Capacity pressure is reasonably widespread with 12 regions showing a positive output gap.
- > However, unlike in the September quarter where all regions had positive output gaps (flat in the case of West Coast), two regions – namely Manawatu-Wanganui and the West Coast – are now detracting from inflationary pressures, albeit marginally.
- > The pattern across regions has become less clear, although rural-aligned regions continue to show the greatest capacity pressure. In particular, Northland, Bay of Plenty, Canterbury, Nelson-Marlborough, and Southland are the regions with large output gaps at present. We also note Wellington is showing high capacity pressure – testament to the impact that Government

<sup>1</sup> The estimates are generated using estimates of the output gap, unemployment gap (utilising Okun's Law) and a derived capacity utilisation gap from the National Bank business confidence survey. We chose a broad approach for two reasons. First it minimises some of the error that may surround simple regional activity statistics (which are only partial indicators). Second, the Reserve Bank uses a similar combination to derive its multivariate filter measure of the output gap for the entire economy. For each input we use a band-pass filter to derive the business cycle – a standard statistical technique that is available on modern statistical software. Individual output gap measures across activity, unemployment and capacity utilisation for each region are then given an equal weighting.

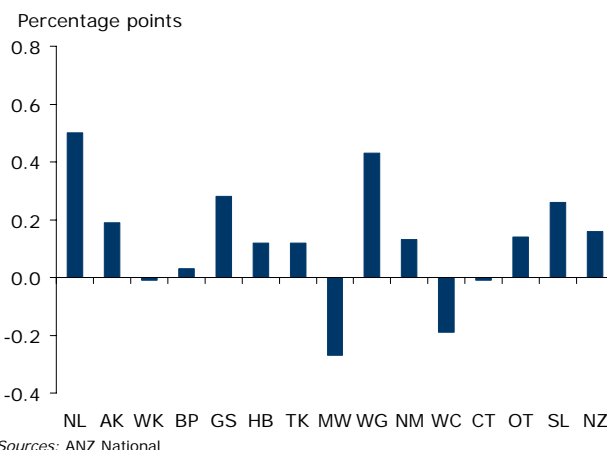
spending is having on inflationary pressures. One just needs to look at all the cranes at present on the Wellington horizon to get a feel for this.

### Estimate average regional "output gap" in Dec 07



- > The majority of regions have experienced an intensification of capacity pressures in the December quarter, with 10 of the 14 regions showing a more positive output gap. This was particularly the case for Northland, Gisborne and Wellington and has resulted in a larger output gap for the country as a whole. Manawatu-Wanganui and the West Coast are less capacity constrained than in September, while Waikato, Bay of Plenty and Canterbury are experiencing similar conditions.

### Change in regional output gaps over the past quarter



## The upshot

With the economy-wide unemployment rate easing to a record low and capacity utilisation rising over the December quarter, it is little surprise to see that inflationary pressures, as measure by our regional output gaps, have intensified. Given the broad-based nature of such pressure it reinforces that a sticky and persistent inflationary dynamic will remain for some time. Moreover, it is likely to take a period of very weak growth – as implied by our financial conditions index – for inflation to recede.

## GLOBAL WATCH

We present a table of global data outturns over the past week given the significance of the international backdrop at present. Data out of US was mixed, with CPI stronger than expected, but the Philly Fed suggesting the US may already be in recession. It illustrates a difficult environment for the Federal Reserve. European data was also mixed, although the services PMI bounced from last month's low. It was a quiet week in Asia, with the major releases (PPI and CPI) showing Chinese inflationary pressures remain intense.

Country/ Area	Indicator	Mkt	Actual	Last	Outturn vs market
<b>US</b>	NAHB Housing Market Index (Feb)	19	20	19	Stronger
	Consumer Price Index (Jan) – yoy	4.2%	4.3%	4.1%	Stronger
	Housing Starts (Jan)	1,010k	1,021k	1,004k	In-line
	Building Permits (Jan)	1,050k	1,048k	1,080k	In-line
	Philadelphia Fed (Feb)	-10.0	-24.0	-20.9	Weaker
	Leading Indicators	-0.1%	-0.1%	-0.1%	In-line
<b>Europe</b>	PMI Manufacturing (Feb A)	52.3	52.3	52.8	In-line
	PMI Services (Feb A)	51.0	52.3	50.6	Stronger
	PMI Composite (Feb A)	51.5	52.7	51.8	Stronger
	Industrial New Orders (Dec) – mom	-1.1%	-3.6%	-2.0%	Weaker
<b>UK</b>	M4 Money Supply (Jan P) – yoy	12.0%	12.9%	12.4%	Stronger
	Retail Sales (Jan) - mom	0.3%	0.8%	-0.2%	Weaker
<b>Asia Ex-Japan</b>					
<i>China</i>	PPI (Jan) – yoy	5.7%	6.1%	5.4%	Stronger
	Consumer Price Index (Jan) - yoy	7.0%	7.1%	6.5%	Stronger
<i>Singapore</i>	Non-Oil Domestic Exports (Jan) – yoy	-5.7%	2.8%	-4.5%	Stronger
	Electronic Exports (Jan) – yoy	-	-1.8%	-9.2%	-
<i>Philippines</i>	Total Exports (Dec P) – yoy	8.1%	21.4%	-2.1%	Stronger
	Bank Lending (Dec) – yoy	-	9.2%	7.5%	-
<i>South Korea</i>	Unemployment Rate (Jan)	-	3.0%	3.1%	-
	Export Price Index (Jan) – yoy	-	5.8%	3.4%	-
	Import Price Index (Jan) - yoy	-	21.2%	15.6%	-
<i>Malaysia</i>	Manufacturing Sales Values (Dec) – yoy	-	10.6%	4.0%	-
	CPI (Jan) – yoy	2.4%	2.3%	2.4%	Weaker
<b>Japan</b>	Tertiary Industry Index (Dec) – mom	-0.2%	-0.6%	0.0%	Weaker
	All Industry Activity Index (Dec) - mom	0.2%	-0.2%	-0.5%	Weaker
<b>Australia</b>	Wage Cost Index (4Q) - qoq	1.1%	1.1%	1.0%	In-line

## INTEREST RATE STRATEGY

The focus returns to the local dataflow, with the RBNZ's inflation expectations survey and the National Bank *Business Outlook* key reads ahead of next week's MPS. Bias is still towards the payside, though global moves could yet over-ride domestic considerations.

### Market themes...

- > Lack of local data sees thin volumes and direction influenced by flow and offshore moves.
- > Volatile trading in the US, with a tug of war between growth and inflation fears.
- > Hawkish RBA minutes now see two rate hikes almost fully priced in this year.

### Outlook...

It was a week where mortgage flow and offshore moves dominated the direction of the local rates market. Though electronic card transaction and credit card data for January suggests that consumer spending remains subdued, the data was sufficiently third-tier in nature that it did not elicit much response from the market. The moves from the Aussie curve provided most of the lead for the local market, with a sell-off earlier in the week following the release of hawkish RBA minutes sending NZ yields higher. That the RBA board considered hiking by 50bps in February was enough for the market to now almost fully price in two more hikes this year. But as the week progressed, profit taking in the Aussie curve, especially after an in-line wage print, led to a rally that sent NZ yields lower.

This week should see some focus return to the domestic dataflow. The RBNZ's inflation expectations survey on Tuesday should confirm that upside inflation risks remain, reinforcing a "higher for longer" view on rates. This should see the bias on the payside early in the week. Focus will also be on the National Bank *Business Outlook*, which will provide an important read ahead of the RBNZ's MPS next week.

Market pricing is largely unchanged from last week, with still a near 30 percent chance of another hike by July and a 40 percent chance of a rate cut by December. This looks to be another week of trading the ranges, with the 2-year swap yield expected to remain within a 8.35 to 8.65 percent range. NZ yields could yet be dragged higher by the Aussie curve, but with less payside expected to come from mortgage flows as the housing market continues to slow, and receiving interest still present with ongoing interest in Uridashi issuances, the topside is expected to hold. We see better receiving value further out the curve, particularly in the 7 and 10-year space.

In terms of offshore developments, the data calendar is rather busy with Japanese and Eurozone CPI, and US data on home sales, durables good orders, consumer confidence and consumer spending. The big focus will be on Fed Chairman Ben Bernanke's

testimony to Congress later in the week, which will set the direction for rates in the near-term.

Gauges for NZ interest rates yields		
Gauge	Direction	Comment
RBNZ	↔	Comfortable with direction of housing market and retail sales, but will be concerned at tight labour market.
NZ data	↔	Inflation expectations and NBBO key reads ahead of the March MPS.
Fed Funds/front end	↓	Downside risk to growth materializing. Fed likely to ease further.
RBA	↑	Markets now close to fully pricing in two rate hikes this year.
US 10 year	↔/↓	Inflation high, but recession fears dominating for now.
NZ swap spreads	↔	Spreads expected to consolidate. Bias still to widen.
Flow	↔	Payside flows expected to subside with yields in middle of range. Receivers still sitting on sidelines.
Technicals	↔	NZ swap yields remain range bound awaiting further developments.

### Borrowing strategies we favour at present

For borrowers, we continue to favour paying in the 2-year part of the curve, and for those with longer-term cover out to 5-year to consider taking profit and shortening duration. While indicators are that the economy is set to slow this year, inflation pressure poses the risk that the easing cycle may be delayed. The 2-year gives sufficient cover to guard against the risk of another hike (not probable) while being able to take advantage of the easing cycle when it does come.

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

OCR dates	Last week	This week
Thu 6-Mar-08	16	12
Thu 24-Apr-08	26	20
Thu 5-Jun-08	32	26
Thu 24-Jul-08	32	26
Thu 11-Sep-08	8	6
Thu 23-Oct-08	-16	-14
Thu 4-Dec-08	-40	-38

### Trading themes we favour at present

In the lead-up to the MPS, we continue to favour the Sept (buy) Dec (sell) spread at -16pts, targeting a move to -12pts. The MPS is unlikely to lead to a widening of the spreads, so the downside risk is fairly limited.

## CURRENCY STRATEGY

The NZD looks set for a further push higher this week as the USD continues to be weighed down by recessionary fears and yield demand wins out. New post-float highs cannot be ruled out.

### Market themes...

- > NZD broken through topside resistance and looks set to grind higher.
- > Recessionary fears continue to weigh on the USD.
- > European data this week will be key for assessing decoupling/recoupling theme.

### Outlook...

The NZD found plenty of buying interest last week, breaking through topside resistance levels to be currently sitting slightly below 0.81 against the USD. In fact, the NZD was the second best performing currency (of the 16 most traded) last week, behind only the Brazilian real, as it rose over 1½ percent against the USD.

Part of the recent strength in the kiwi can be put down to a weak greenback pushing the NZD higher by default. Recessionary fears and expectations of further Federal Reserve interest rate cuts continue to weigh on the USD. A weak Philly Fed result last week suggests the US economy may already be in recession. However, the NZD is also finding plenty of support in its own right courtesy of a massively wide yield differential. Throw in strong commodities (with gold and oil prices touching record high levels last week), a stronger AUD on the back of increased expectations of RBA hikes, strength in the euro from stronger than expected PMI data, and solid end of session equity sentiment on Friday on the back of reports of a pending rescue package for ailing bond insurer Ambac, and it's an Oscar winning combination.

This week, the stars look in alignment for further grinds higher for the NZD and new post-float highs cannot be ruled out. However, once again there is an aura of inconsistency across price action, with the NZD once again climbing (positions being squeezed out) against the AUD. Markets continue to want it both ways, with yield, and commodities forcing the NZD up, but not wanting to take the NZD/AUD lower despite diverging trends in coal vis-à-vis dairy prices (two commodity benchmarks), and a 30 point closing in the NZ-Aus 2-year swap differential over the past few weeks. Such an aura of inconsistency leaves the NZD prone to a massive reversal, but the trigger looks to reside in markets getting firm signals that the economic wheels are starting to fall off and uniform evidence of this is lacking at present. In the meantime the trend remains your friend.

Key to watch this week will be indicators of European growth. Slightly stronger than expected (although not overly inspiring) PMI data last week helped to support the EUR/USD biasing the NZD higher. This week German IFO, European economic confidence, and labour market data will help assess how European

growth is faring and whether it is decoupling or recoupling that will hold. As we have said previously, if the former holds, the NZD will stay higher for longer. However, if it is the latter, then brace for an aggressive easing. Other international events of importance this week will be testimony by Fed Chairman Bernanke to Congress along with US housing and durables good data. Locally, data is likely to confirm domestic demand continues to slow, although elevated RBNZ inflation expectations will reinforce inflationary risks within the economy.

Technically, a break above the 0.8030 level should see 0.8230 targeted over the coming two weeks. 0.7950 now becomes very solid support. NZD/AUD should find resistance between 0.8770 and 0.8800, for a consolidation period in the 0.8700's.

NZD vs AUD: monthly directional gauges		
Gauge	Direction	Comment
Fair value	↓	Growth differentials favouring AUD.
Yield	↔/↓	Yield spreads narrowing.
Commodities	↓	Gold, iron ore, coal all up...milk down.
Partial indicators	↓	Better across the Tasman. Terms of trade shocks bigger there.
Technicals	↔	Range trade on 0.8700's.
Sentiment	↓	AUD data is better.
Other	↓	RBNZ hold, RBA catchup.
<b>On balance</b>	↓	<b>AUD simply better/and its not even close.</b>

NZD vs USD: monthly directional gauges		
Gauge	Direction	Comment
Fair value – long-term	↓	Fair value 0.65 (and rising) given a structural shift in commodity prices.
Fair value – short-term	↔	Yield and commodity story factored in.
Yield	↑	Yield differentials at phenomenal levels.
Commodities	↔	Off highs but still high.
Risk aversion	↔	VIX Index may rally this week as bailouts continue.
Partial indicators	↑	NZ domestic economy is soft, but US is dire.
Technicals	↑	Break of 0.8030 suggests 0.82+. 0.7950 pivot.
AUD	↑	Aussie looks cheap.
Sentiment	↔	Domestic pain but global players not listening.
Other	↔/↑	USD disliked.
<b>On balance</b>	↔/↑	<b>Frustratingly it's a USD story. But looks unsustainable...</b>

## DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
26 Feb	US	Existing Home Sales (Jan)	4.80M	4.89M	04:00
	EU	ECB's Trichet speaks in Frankfurt	-	-	07:50
	<b>NZ</b>	<b>RBNZ Survey of Expectations</b>	-	-	<b>15:00</b>
	GE	GDP (4Q F) – qoq	0.3%	0.3%	20:00
		IFO – Business Climate (Feb)	102.9	103.4	22:00
		IFO – Current Assessment (Feb)	107.2	107.9	22:00
		IFO – Expectations (Feb)	98.7	99.0	22:00
	UK	Total Business Investment (4Q P) – qoq	0.9%	2.0%	22:30
27 Feb	US	Producer Price Index (Jan) – mom	0.4%	-0.3%	02:30
		PPI Ex Food & Energy (Jan) – mom	0.2%	0.2%	02:30
		S&P/CS Composite-20 (Dec) – yoy	-9.8%	-7.7%	03:00
		Consumer Confidence (Feb)	82.0	87.9	04:00
		Richmond Fed Manufacturing Index (Feb)	-10	-8	04:00
		House Price Index (4Q) – qoq	-1.0%	-0.4%	04:00
		Fed's Kohn speaks on Economy, Monetary Policy in North Carolina	-	-	06:15
	<b>NZ</b>	<b>Building Permits (Jan) – mom</b>	-	<b>-5.2%</b>	<b>10:45</b>
		<b>NBNZ Business Confidence (Feb)</b>	-	<b>-24.9</b>	<b>15:00</b>
	AU	Construction Work Done (4Q)	2.0%	2.8%	13:30
	GE	Import Price Index (Jan) – mom	0.3%	-0.1%	20:00
		GfK Consumer Confidence Survey (Mar)	4.4	4.5	20:10
	EU	Euro-Zone M3 (Jan) – yoy	11.3%	11.5%	22:00
		ECB's Noyer speaking	-	-	23:00
	UK	GDP (4Q P) – qoq	0.6%	0.6%	22:30
28 Feb	EU	ECB's Smaghi speaks in Florence	-	-	00:45
		ECB's Wellink speaks in New York	-	-	02:30
	US	Durable Goods Orders (Jan)	-4.0%	5.0%	02:30
		Durables Ex Transportation (Jan)	-1.4%	2.3%	02:30
		New Home Sales (Jan)	-0.7%	604k	04:00
		Fed's Bernanke Testifies Before House on Monetary Policy	-	-	04:00
	<b>NZ</b>	<b>External Migration (Jan) – 12 mth total</b>	-		<b>10:45</b>
		<b>Visitor Arrivals (Jan) – mom</b>	-	<b>1.2%</b>	<b>10:45</b>
	AU	Conference Board Leading Index (Dec)	-	0.8%	12:00
		Private Capital Expenditure (4Q)	3.1%	-6.5%	13:30
	JN	Industrial Production (Jan P) – mom	-0.8%	1.4%	12:50
		Retail Trade (Jan) – mom	1.8%	-0.8%	12:50
		BoJ's Mizuno speaks in Oita City	-	-	14:30
	<b>NZ</b>	<b>Money Supply – M3 (Jan) – yoy</b>	-	<b>7.4%</b>	<b>15:00</b>

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
Feb 28 cont.	GE	ILO Unemployment Rate (Jan)	7.7%	7.8%	20:00
		Unemployment Rate (Feb) – s.a.	8.0%	8.1%	21:55
Feb 29	US	GDP Annualised (4Q P)	0.7%	0.6%	02:30
		GDP Price Index (4Q P)	2.6%	2.6%	02:30
		Core PCE (4Q P) – qoq	2.7%	2.7%	02:30
	EU	ECB's Trichet, Wellink speak in Amsterdam	-	-	03:15
	<b>NZ</b>	<b>Trade Balance (Jan)</b>	<b>-180M</b>	<b>33M</b>	<b>10:45</b>
		<b>Exports (Jan)</b>	<b>3.242B</b>	<b>3.68B</b>	<b>10:45</b>
		<b>Imports (Jan)</b>	<b>3.477B</b>	<b>3.64B</b>	<b>10:45</b>
	JN	Jobless Rate (Jan)	3.9%	3.8%	12:30
		Overall Household Spending (Jan) – yoy	0.3%	2.2%	12:30
		National CPI (Jan) – yoy	0.7%	0.7%	12:30
		National CPI Ex-Fresh Food (Jan) – yoy	0.9%	0.8%	12:30
		National CPI Ex Food & Energy (Jan) – yoy	-0.1%	-0.1%	12:30
		Housing Starts (Jan) – yoy	-12.4%	-19.2%	18:00
		Construction Orders (Jan) – yoy	-	4.7%	18:00
	AU	Private Sector Credit (Jan) – mom	1.0%	1.1%	13:30
	UK	Net Consumer Credit (Jan)	0.8B	0.6B	22:30
		Mortgage Approvals (Jan)	70k	73k	22:30
		GfK Consumer Confidence Survey (Jan)	-15	-13	23:30
	EU	CPI (Jan) – mom	-0.4%	0.4%	23:00
		CPI (Jan) – yoy	3.2%	3.1%	23:00
		CPI – Core (Jan) – yoy	2.0%	1.9%	23:00
		Unemployment Rate (Jan)	7.2%	7.2%	23:00
		Business Climate Indicator (Feb)	0.75	0.78	23:00
		Economic Confidence (Feb)	101.2	101.7	23:00
1 Mar	US	Personal Income (Jan)	0.2%	0.5%	02:30
		Personal Spending (Jan)	0.2%	0.2%	02:30
		PCE Deflator (Jan) – yoy	3.5%	3.5%	02:30
		PCE Core (Jan) – mom	0.3%	0.2%	02:30
		Chicago Purchasing Manager (Feb)	49.6	51.5	03:45
		University of Michigan Consumer Confidence (Feb F)	70.0	69.6	04:00
		Fed's Mishkin, Rosengren speak at Monetary Policy Forum	-	-	04:15
		Fed's Lockhart speaks on Subprime Mortgage Crisis	-	-	06:15
		Fed's Evans, Poole speak at Monetary Policy Forum	-	-	07:30
	EU	PMI Manufacturing (Feb F)	-	52.3	22:00

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

## NEW ZEALAND DATA WATCH

**Key focus over the next four weeks:** There is limited data now prior to the RBNZ's *Monetary Policy Statement* due in the first week of March, with the key releases being the RBNZ's Survey of Expectations and the NBNZ *Business Outlook*. Data following this is likely to continue to paint a picture of slowing domestic demand and growing headwinds for the economy.

Date	Data/Event	Economic Signal	Comment
Tue 26 Feb (15.00)	RBNZ Survey of Expectations (Mar qtr)	Elevated	The key measure to watch is two-year ahead inflation expectations, and they are expected to remain elevated. We would not be surprised if they rose from their current level of 2.7 percent.
Wed 27 Feb (10.45)	Building Consents (Jan)	Soft	An easing trend is now clearly in place. Based on the falls in house sales, a further decline in consent issuance is expected.
Wed 27 Feb (15.00)	NBNZ <i>Business Outlook</i> (Feb)	-	-
Thu 28 Feb (10.45)	External Migration (Jan)	Steady	We expect annual migration to stabilise around current levels of 5,000, although the risks appear skewed to the downside.
Thu 28 Feb (15.00)	Credit Growth (Jan)	Slowing	Total household claims grew at the slowest pace since 2002 in December. Given housing weakness, we expect another soft result in January and around 0.7 percent growth for the month.
Fri 29 Feb (10.45)	Overseas Merchandise Trade (Jan)	Improving	Another small trade surplus is expected following the surprise surplus in December. The impact of high dairy prices is increasing as milk production ramps up, although dry conditions may weigh on this slightly.
Tue 4 Mar (10.45)	ANZ Commodity Price Index (Feb)	-	-
Wed 5 Mar (10.45)	Wholesale Trade Survey (Dec qtr)	Softening	Wholesale trade activity is expected to soften in line with slowing activity in the retail sector.
Thu 6 Mar (09.00)	RBNZ <i>Monetary Policy Statement</i>	Watching and waiting	The Reserve Bank won't have liked the messages from the labour market nor what is likely from their inflation expectations survey. But global conditions are weaker and so is housing. Expect a similar message to January.
Fri 7 Mar (10.45)	Value of Building Work Put in Place (Dec qtr)	Easing	Given an easing trend present in building consent issuance, we expect residential construction activity to detract from growth in the December quarter.
circa 10 Mar	REINZ Housing Report (Feb)	Soft	The housing market has well and truly turned. With demand soft and increased supply on the market, we expect the median number of days to sell a house to continue rising. This will place further downward pressure on prices.
Tue 11 Mar (10.45)	Overseas Trade Indexes (Dec qtr)	Terms of trade up	The impact of higher export commodity prices is expected to more than offset an increase in oil prices over the quarter and result in a further rise in the terms of trade.
Wed 12 Mar (10.45)	Food Price Index (Feb)	Solid	Given high commodity prices, annual food price inflation is expected to continue to head upwards.
Thu 13 Mar (10.45)	Retail Sales (Jan)	Flat	Both ECT and credit card spending was soft in January. We expect this to also be reflected in a soft retail sector as a whole for the month. An easing trend looks to now be firmly in place.
Fri 14 Mar (10.45)	Economic Survey of Manufacturing (Dec qtr)	Solid	Given strength in exports in the quarter, we expect this survey to be reasonably strong. However, we will be closely watching stock levels to see if the export strength came out of stocks.
Thu 20 Mar (10.45)	External Migration (Feb)	Steady	Unless there are any surprises in the January data, we expect annual net migration to stabilise around current levels.
<b>On Balance</b>		<b>Sub-trend growth</b>	<b>Inflationary pressures persist, but domestic demand waning. Big unknown is the credit cycle.</b>

## SUMMARY OF KEY ECONOMIC FORECASTS

	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09
GDP (% qoq)	0.7	1.2	0.8	0.5	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.5</b>	<b>0.6</b>
GDP (% yoy)	2.0	2.4	3.2	3.3	<b>2.9</b>	<b>1.9</b>	<b>1.4</b>	<b>1.2</b>	<b>1.4</b>	<b>1.7</b>
CPI (% qoq)	-0.2	0.5	1.0	0.5	1.2	<b>0.6</b>	<b>0.8</b>	<b>0.9</b>	<b>0.8</b>	<b>0.5</b>
CPI (% yoy)	2.6	2.5	2.0	1.8	3.2	<b>3.3</b>	<b>3.0</b>	<b>3.4</b>	<b>3.0</b>	<b>2.9</b>
Employment (% qoq)	0.1	1.2	0.6	-0.3	1.1	<b>0.4</b>	<b>0.3</b>	<b>0.2</b>	<b>0.3</b>	<b>0.1</b>
Employment (% yoy)	1.4	1.7	1.6	1.6	2.5	<b>1.8</b>	<b>1.5</b>	<b>2.0</b>	<b>1.2</b>	<b>0.9</b>
Unemployment Rate (% sa)	3.8	3.7	3.6	3.5	3.4	<b>3.5</b>	<b>3.6</b>	<b>3.7</b>	<b>3.9</b>	<b>4.0</b>
Current Account (% GDP)	-8.6	-8.2	-8.1	-8.3	<b>-8.0</b>	<b>-7.6</b>	<b>-7.0</b>	<b>-6.7</b>	<b>-6.8</b>	<b>-6.9</b>
Terms of Trade (% qoq)	2.5	1.5	0.4	3.7	<b>2.7</b>	<b>0.5</b>	<b>-0.5</b>	<b>-0.6</b>	<b>-0.4</b>	<b>-0.6</b>
Terms of Trade (% yoy)	3.8	4.5	2.3	8.4	<b>8.5</b>	<b>7.4</b>	<b>6.4</b>	<b>2.1</b>	<b>-1.0</b>	<b>-2.1</b>

## KEY ECONOMIC INDICATORS

	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08
Retail Sales (% mom)	-1.2	1.1	-0.4	0.2	0.3	1.1	-0.4	1.7	0.1	..
Retail Sales (% yoy)	7.4	6.7	4.8	5.7	6.3	4.1	5.8	7.2	5.4	..
Credit Card Billings (% mom)	-1.1	1.1	1.7	0.1	0.9	2.0	-0.6	1.2	0.4	0.1
Credit Card Billings (% yoy)	7.8	5.9	8.9	7.9	8.6	9.4	7.7	9.5	7.6	8.6
Car Registrations (% mom)	-1.6	6.1	-4.7	7.0	1.1	-6.7	5.6	-3.6	-2.6	5.6
Car Registrations (% yoy)	-4.8	-2.5	-1.5	7.0	10.9	0.1	4.7	2.3	1.4	1.7
Building Consents (% mom)	0.3	4.9	12.3	-15.6	4.9	-9.8	-4.7	-0.1	-5.2	..
Building Consents (% yoy)	9.0	2.9	33.0	-4.2	-1.5	-15.4	-16.0	-4.9	-6.7	..
REINZ House Price (% yoy)	14.4	14.8	12.1	10.4	12.9	12.3	8.0	6.7	4.5	4.0
Household Lending Growth (% mom)	1.0	1.0	1.1	0.9	0.9	0.8	0.8	0.8	0.7	..
Household Lending Growth (% yoy)	13.5	13.5	13.5	13.5	13.4	13.0	12.8	12.6	12.2	..
Roy Morgan Consumer Confidence	128.6	122.1	121.0	121.1	122.4	121.3	122.0	121.9	126.6	121.2
NBNZ Business Confidence	-19.4	-48.3	-37.2	-38.5	-33.8	-26.5	-12.9	-19.6	-24.9	..
NBNZ Own Activity Outlook	22.5	7.8	14.8	12.4	16.7	17.2	20.3	15.7	18.2	..
Trade Balance (\$m)	-215	8	-518	-808	-947	-572	-773	-628	33	..
Trade Balance (\$m annual)	-6024	-5900	-6226	-6340	-6336	-6282	-5882	-5690	-5311	..
ANZ World Commodity Price Index (% mom)	4.9	2.6	6.3	4.6	1.4	0.4	1.8	0.8	0.0	-1.4
ANZ World Commodity Price Index (% yoy)	20.9	21.1	29.8	35.1	36.3	35.7	37.8	35.9	30.9	27.4
Net Migration (sa)	240	430	620	490	740	680	280	530	20	..
Net Migration (annual)	11222	10682	10078	8966	8730	8309	7517	6588	5491	..

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

## SUMMARY OF KEY MARKET FORECASTS

NZ FX rates	Actual		Current	Forecast (end month)						
	Dec 07	Jan 08	25 Feb 08	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
NZD/USD	0.768	0.772	0.809	0.790	0.780	0.740	0.690	0.660	0.640	0.630
NZD/AUD	0.881	0.876	0.875	0.849	0.830	0.804	0.767	0.759	0.762	0.778
NZD/EUR	0.528	0.524	0.545	0.530	0.520	0.507	0.486	0.478	0.478	0.485
NZD/JPY	86.3	83.2	86.8	86.9	84.2	78.4	71.8	69.3	69.1	69.3
NZD/GBP	0.380	0.392	0.411	0.401	0.400	0.383	0.363	0.351	0.344	0.342
NZ\$ TWI	71.6	71.2	73.8	72.2	70.8	67.8	63.8	62.1	61.4	61.5
NZ interest rates	Dec 07	Jan 08	25 Feb 08	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
OCR	8.40	8.38	8.25	8.25	8.25	8.00	7.50	7.00	6.75	6.75
90 day bill	8.90	8.75	8.84	8.80	8.60	8.00	7.50	7.00	7.00	7.00
10 year bond	6.39	6.28	6.44	6.50	6.40	6.30	5.90	5.50	5.30	5.20
International	Dec 07	Jan 08	25 Feb 08	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
US Fed funds	4.25	3.00	3.00	2.75	2.25	2.00	2.00	2.00	2.00	2.25
US 3-mth	4.70	3.11	3.08	2.75	2.24	2.15	2.15	2.25	2.40	2.75
AU cash	6.75	6.75	7.00	7.25	7.50	7.50	7.50	7.50	7.50	7.50
AU 3-mth	7.24	7.35	7.76	7.70	7.90	7.90	7.70	7.70	7.70	7.70

## KEY RATES

	22 Jan	18 Feb	19 Feb	20 Feb	21 Feb	22 Feb
Official Cash Rate	8.25	8.25	8.25	8.25	8.25	8.25
90 day bank bill	8.72	8.85	8.84	8.87	8.87	8.85
NZGB 07/09	7.15	7.35	7.39	7.39	7.37	7.34
NZGB 11/11	6.91	7.08	7.12	7.12	7.10	7.07
NZGB 04/13	6.83	6.95	6.99	7.00	6.97	6.93
NZGB 12/17	6.21	6.43	6.47	6.47	6.45	6.41
2 year swap	8.33	8.55	8.60	8.59	8.57	8.56
5 year swap	7.91	8.13	8.19	8.17	8.15	8.12
RBNZ TWI	69.5	72.9	73.1	73.0	73.3	73.2
NZD/USD	0.7464	0.7945	0.7969	0.7958	0.7998	0.8014
NZD/AUD	0.8669	0.8701	0.8673	0.8687	0.8702	0.8720
NZD/JPY	79.35	85.69	86.18	85.99	86.43	86.06
NZD/GBP	0.3843	0.4051	0.4086	0.4081	0.4118	0.4078
NZD/EUR	0.5168	0.5412	0.5437	0.5404	0.5433	0.5413
AUD/USD	0.8610	0.9131	0.9188	0.9161	0.9191	0.9190
EUR/USD	1.4442	1.4679	1.4658	1.4726	1.4722	1.4804
USD/JPY	106.31	107.86	108.15	108.06	108.06	107.39
GBP/USD	1.9421	1.9612	1.9504	1.9498	1.9423	1.9654
Oil	88.62	95.57	95.91	99.99	100.86	98.57
Gold	861.50	905.25	908.30	927.10	941.30	945.70
Electricity (Haywards)	10.78	16.32	13.93	12.79	17.21	16.24
Milk futures (US\$/contract)	150	#N/A	134	133	133	132
Baltic Dry Freight Index	6437	7381	7319	7081	6998	7187

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