

ANOTHER YEAR OLDER

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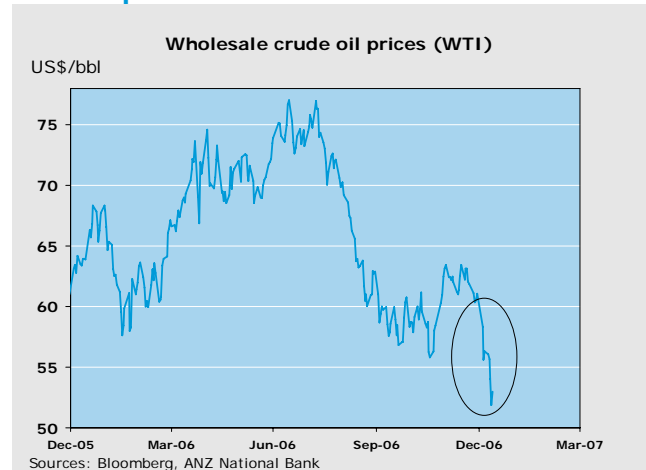
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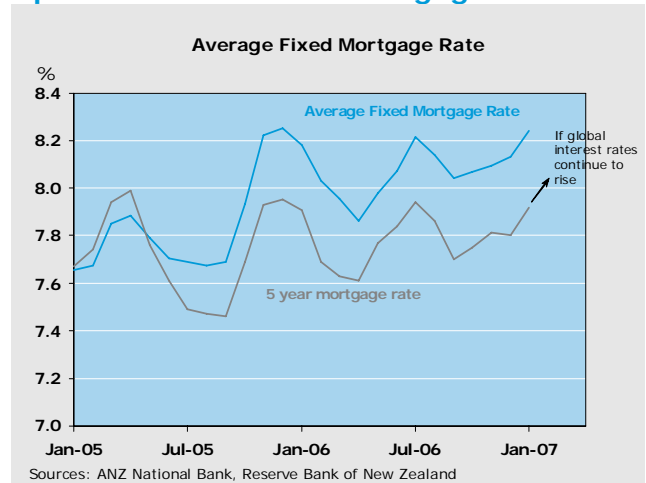
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ECONOMIC OVERVIEW

Data released this week is not expected to provide the RBNZ with a smoking gun to raise rates, although we remain wary over the path for non-tradable inflation in the December inflation report. Given developments over recent weeks we now ascribe a 30 percent probability to a hike compared with 40 percent pre-Christmas.

What's ahead...

- A key week for the RBNZ. NZIER *Quarterly Survey of Business Opinion* due 1000NZDT on Tuesday 16 January is expected to show a continued improvement in headline confidence, while the capacity utilisation figure is expected to fall slightly after a strong increase in September.
- December quarter NZ CPI (1045NZDT on Wednesday 17 January). We expect the headline number to be flat in the quarter due to falls in petrol prices but to overshadow stubbornly persistent non-tradables inflation. The Reserve Bank has the best inflation forecasting record around and is projecting a small fall in the headline inflation rate in their December *Statement*, and is expecting non-tradable to come in around 1 percent.
- November NZ Retail Trade Survey (1045NZDT on Friday 19 January) is expected to show a small fall in spending in the month.

What's the view

The key focal point for the start of the New Year is the upcoming RBNZ interest rate decision, particularly with the December *Monetary Policy Statement* explicitly forecasting a hike implying that economic activity only has to pan out as expected for a hike to occur at some stage.

Strong data pre-Christmas (particularly housing market and consumer spending) and a gradual sell-off in global rates saw the market almost fully pricing a hike in January a week ago. The market has now pared this expectation back slightly to 50 percent following weakness in building consents last week, lower oil prices, and the high currency, although remains attuned to a potential move in March. Clearly some wariness towards the RBNZ remains.

Against this backdrop we note Q3 GDP massively undershot expectations (0.3 percent versus the RBNZ expectations of 0.7 percent) and recent historical revisions mean there is a lower starting point for monetary policy. In the absence of lower estimates for potential growth (an assumption that is unlikely to change at an *OCR Review*), the Reserve Bank's output gap estimate will certainly be lower, which implies less pressures on medium term inflation trends. The NZD was higher than the Bank expected for the December quarter and remains well above their March quarter estimate. Petrol price falls of 5 cents last week and some aggressive discounting and travel deals to the Pacific Islands means Q1 CPI is looking softer than

the RBNZ's pick of 0.6 percent. Of course, petrol is a one off that the RBNZ has stated they will look through. Yet the reality is that inflation will still be back within the 1 to 3 percent policy band and this mitigates some of the risk of second round pricing effects developing through a persistently high headline rate becoming embedded in inflation expectations and pricing behaviour. Against this decelerating headline rate, medium-term pressures will remain given capacity constraints and particularly tightness in the labour market. The housing market will remain a key concern.

Looking to the data this week, the Reserve Bank will gather information in the form of confidence, capacity utilisation and of course inflation itself. The QSBO on Tuesday is expected to again show an improvement in business confidence but it is the capacity utilisation figure that the Bank will be watching most closely. This is expected to fall slightly. The CPI on Wednesday key. It is expected to print very weak courtesy of lower petrol prices, but the split between tradables and non-tradables is important. As noted pre-Christmas we remain very wary of a potential up-tick in the path for non-tradable inflation. The Reserve Bank may be prepared to accept a 0.1 percentage point error around their 1 percent forecast. Anything larger, and a clear accelerating annual rate of say 4.3 percent (a 1.2 percent non-tradable inflation out-turn for the quarter) will have the Bank's hackles raised.

At present we ascribe a 30 percent probability to a hike compared with 40 percent pre-Christmas. It just seems a hard ask to push for tighter monetary policy when annual GDP growth is below 1.5 percent and inflation is sub-3 percent.

Last week...

- **NZ Overseas Merchandise Trade.** The monthly trade balance improved by \$389 million to a \$785 million deficit in November and took the annual trade deficit to \$6.0 billion, the lowest deficit since September 2005.
- **NZ Building Consents.** After four strong months, residential building consents fell 12 percent (seasonally adjusted) in November. This fall was driven by a large fall in apartment consents issued with dwelling consents less apartments falling by only 5 percent.
- **AUS Employment.** Employment grew by 44.6k in December, much higher than expected, taking annual growth to 3.0 percent. The unemployment rate was unchanged at a 30-year low of 4.6 percent.
- **BoE Interest Rates.** The Bank of England raised its official Repo rate by 25 basis points to 5.25 percent, surprising the market somewhat.
- **ECB Interest Rates.** The European Central Bank left rates unchanged at 3.5 percent.
- **World Oil Prices.** WTI US\$ crude oil prices have fallen by over 10 percent since the start of 2007 largely as a result of warmer than expected weather conditions in North America.

KEY MACRO THEMES FOR 2007

We outline our thoughts on the Top Ten macro themes for the year.

1. Inflation still dominates the outlook.

Despite economic growth slowing to below 1.5 percent, medium-term inflation pressures, and particularly non-tradable inflation, remain persistent and elevated. We see inflation dipping temporarily in H1 2007 courtesy of lower petrol prices but pushing back up towards 3 percent in late 2007, then easing slowly subsequently. Such inflation persistence and risk necessitates a period of sub-par growth, which means financial conditions need to remain tight for some time. We expect 1.5 percent growth over 2007 – in effect a repeat of 2006. The Reserve Bank will not rest easy until non-tradable inflation is tamed, even if headline inflation stays within the target band.

2. Stronger productivity growth remains the missing link between improving economic prospects and receding inflation.

Labour productivity growth has been dismal over the past two years, and multifactor productivity growth has eased from 2.5 percent per annum over the 1992-2000 period to 1.1 percent over 2000-2005. Productivity performance needs to improve if economic growth is to recover without a reacceleration in inflation. The challenge to policy-makers is to deliver a policy platform that raises the supply-side capacity of the economy and shifts attention to growing as opposed to dividing the pie. Politics may deliver a new broom in this regard.

3. The RBNZ is on hold but will remain very nervous (as will we).

A more restrictive monetary policy stance may be required if the slowdown does not alleviate inflation pressure sufficiently, or the economy goes on a sustained recovery. Our core view is that interest rates will stay on hold, and we are coy about reading too much into indicators pointing towards the economy reflating. New Zealand's economic indicators are notoriously volatile and the economy is not reflating just as it was not headed into recession in early 2006. But the risk profile for interest rates will be firmly on the upside in the near-term as the Reserve Bank looks to a potential late cycle insurance policy, which ironically would merely reinforce the need for an aggressive easing cycle at some stage down the track. With the neutral 90-day interest rate residing around 6 percent, even returning rates to the perceived neutral zone at some stage leaves us natural strategic receivers of the 2-5 year part of the curve. We remain equally mindful that the NZ economy does tend to turn aggressively (and the interest rate market with it). While the 2008 *Budget* obviously presents a further challenge to our easing profile late in the year, a year is still a long time in monetary policy cycles and circles. Pushing the easing cycle out to 2009 – beyond the realms of the 2008 *Budget* – would imply a period of interest rate stability no other

central bank has undertaken apart from the Bank of Japan.

4. The game of chicken between the currency and interest rates will continue for the first part of this year before we see a major currency move mid-year.

The NZD is high because the economy is perceived to be reflating, and the RBNZ has put a hike back on the table. The carry trade and yield continues to dominate. All are themes that are likely to persist for a while yet, which suggests a firm NZD. Against this backdrop, we expect the reflation theme to become a mirage (particularly given the impact the recent run-up in the currency is having). Perception towards the carry trade will become dented as global interest rates continue to move up, and the outright yield gap closes (initially from the foreign side). The latter is likely to significantly impact on a sizeable Uridashi maturity profile in the September quarter. Any whiff of the above combination and the NZD is set for a ride and a half down in a similar fashion to early 2006. Currencies move in cycles and we see no reason the NZD will not eventually follow its historical pattern of spending 3 years undervalued following three to four years of being exceptionally high.

5. Economic imbalances leave the economy very vulnerable, and in serious need of adjustment.

For now our forecasts are stock standard with a benign economic trough and an orderly rebalancing of growth – in effect the holy grail of economic adjustments. But if there is one thing we know from history it is that economic adjustments are anything but orderly. The economy is vulnerable to unexpected shocks that could derail the economy. The current account deficit (9 percent of GDP) remains precarious, the household dis-saving rate (17.5 percent) disconcerting, asset classes (notably property) overvalued, and household gearing is high. What these shocks might be is anyone's guess. Yet we only need to look at geopolitical uncertainty, oil prices, and global imbalances to appreciate that significant risks are apparent. Historically New Zealand has been knocked for six when such shocks emerge, particularly given our stage in the economic cycle. Investment quality will count at this juncture of the cycle.

6. Liquidity is aplenty, which will mitigate the downside risks.

There is an abundance of capital looking for a home. Both domestically (banking sector) and globally (excess saving from Asian and oil-exporting economies), liquidity is ample. While this presents an added complication for central banks around the world as asset and commodity prices become more volatile, it is difficult to become overly bearish on economic prospects when the liquidity tap is likely to remain firmly open.

7. A helping hand from abroad.

There are three global themes we believe are specific to NZ at present.

- First, strong global growth, particularly in China, will sustain commodity prices at high

levels. This dampens some of the economic risk facing the New Zealand economy, and suggests the overshoot in the currency detailed in point 4 will be mild by historical standards. The first derivative of China's growth boom has been surging hard commodity prices and we expect the second derivative (through rising incomes as opposed to industrial production) to be positive New Zealand's soft basket.

- Second, we are siding with the Fed over its view for the US economy. We are reminded of the bearish economic sentiment that engulfed New Zealand in early 2006, inversion in the yield curve, weak currency and subsequent recoveries in all. The key lessons from New Zealand's experience are that economies do not keel over when liquidity is ample and the labour market remains strong. The housing market quickly reflate when the yield curve inverts. This more bullish view of the US, and hence global economy, leaves us with a more bearish bias towards US and global interest rate settings (once again following the NZ monetary policy experience) and reinforces our bearish view of the NZD.
- Thirdly, given the risk profile for global interest rates is to the upside, we expect New Zealand's yield curve to progressively normalise, and the RBNZ to gain additional policy traction through this avenue.

8. Corporate sector focus: costs, costs, costs. Slowing economic growth and more recently the high NZD has hit the revenue line and rising costs (especially wages) are inflating the expenditure side. A tight labour market environment and poor labour productivity performance over the past two years has hampered the corporate sector's ability to contain rising wage costs. As an indicator of corporate profits we note that the corporate tax take is 3.0 percent down on a year ago, while business investment is 5.2 percent below last year's levels. Expect the corporate sector's focus this year to be on cost containment. Precisely when this flows-through to the workforce remains the million dollar question.

9. Households to start sharing the economic burden as the year progresses. The slow-down that manifested over 2006 was largely borne by businesses with households being insulated via a strong labour market. Labour's share of income has rocketed to a 15 year high. The corporate sector's focus on costs will see less demand for labour, leading to gradually higher unemployment. This turn in the labour market is the missing ingredient transferring the economic slowdown from the corporate sector to households and delivering the sustained slow-down the Reserve Bank is seeking. While we expect the unemployment rate to remain low, the household sector still looks vulnerable to even a mild turn in job prospects given the stretched nature of the

household balance sheet, and notably high debt servicing ratio.

10. Let's not forget the positives. New Zealand's major commodity prices have moved to a higher structural plane. China and India will become of increasing importance to New Zealand over the coming years. New Zealand's macro framework is working a treat. We are starting to see smarter investment offshore. Signs of stronger growth are met by higher interest rates and currency. The reverse also applies and such movements iron out the peaks and troughs, leading to more stable outcomes. Significant investment in infrastructure and exploration is being made. New Zealand has some pockets of mineral wealth.

Of course there are numerous judgments that underpin these views. Current imbalances are unsustainable and need to adjust. We expect these imbalances to weigh heavily. The neutral 90-day interest rate is around 6 percent. Fair value for the NZD/USD resides between 0.62-0.64. As imbalances are purged the economy could be expected to revert to its potential growth rate, thought to be around 3 percent. Economies and financial markets tend to mean-revert to such anchors.

But what if our judgements of these anchors prove to be wrong? There are certainly some anchors such as the economy's potential growth rate and the neutral interest rate level that we are becoming increasingly queasy about. For instance, if the economy's potential growth rate is now lower at 2.5 percent, growth could be weaker for longer and the Reserve Bank would have to keep rates higher for longer to purge excess demand. Equally, if the neutral 90-day interest rate is above 6.0 percent, interest rates are likely to stay higher for longer.

A lower potential growth rate would have material implications for asset valuations all-round. Increasingly, central bank officials in the US, Australia and Canada are debating whether the potential growth rate in their respective economies are in fact lower than originally thought. Such debate is largely absent in New Zealand at the moment, but may generate increasing policy attention this year.

With regards to economic adjustments, our judgement is that it will be an orderly rebalancing process. But what if it is more abrupt, as history and the Iceland experience last year show is a real possibility? Or what if the current imbalance does prove to be sustainable in a world awash with capital?

These are important areas of analysis we plan to comment on in our *Market Focus* throughout the year. Ultimately it is the qualitative risk profile that accompanies the quantitative assessment that matters, and how the risk profile changes as the year progresses.

INTEREST RATE STRATEGY

The market is split over next week's January OCR Review decision. The dataflow this week will be key, though we suspect it will lack the smoking gun that will force the RBNZ's hand. The market will remain on edge heading into Wednesday's CPI data release.

Market themes...

- Market paring back probability of January hike but still see good chance of a move by April.
- Higher global interest rates on the back of surprise BOE decision, stronger US data.
- Lower oil prices to deliver inflation relief, and buy the RBNZ more time.

Outlook...

The market remains divided over prospects for a further move from the Reserve Bank. While the tenor of domestic data was pointing towards a hike at the end of last year, weaker than expected Q3 GDP data and historical downward revisions have forced a rethink. Economic growth has slowed to below 1½ percent, and the RBNZ's 2.1 percent annual GDP forecast for the March 2007 year is now looking optimistic. But in our mind, the major developments that will convince the RBNZ to keep interest rates unchanged, if the run of mixed domestic data were not enough, is the reassessment of global interest rate prospects and the sharp decline in world oil prices.

Domestic pump prices have fallen by 5 cents/ltr and if sustained, will shave 0.1 percentage points off Q1 CPI. The higher NZD over recent weeks will also add downward pressure on tradable inflation. Higher global interest rates have resulted in the NZ yield curve flattening, helping the RBNZ's efforts after working against it for most of last year. Given uncertainty over how sustained the economic momentum is after the weaker Q3 GDP data, the near-term relief from lower petrol prices and higher longer-dated yields courtesy of global developments make it easier for the RBNZ to stand pat. However, a firm tightening bias will remain to hold the curve up.

Based on our view that the RBNZ will not hike next week, we see value in going long out to 6 months, and paying the 2-year IRS. The front end of the curve is expected to hold in the event of a no change decision, as the market will still look to price in a hike at some stage this year. However, even if the RBNZ does hike, paying the 2-year IRS provides protection from a selloff in the front end.

Gauges for NZ interest rates yields		
Gauge	Direction	Comment
RBNZ	↑	RBNZ's projected 90-day tuck is higher than the market at present
NZ data	↔	Domestic data printing mixed. This week's CPI crucial.
Fed Funds	↔	Sectors outside of housing still robust
RBA	↑	Odds for a rate hike getting shorter.
US 10 year	↑	Market reassessing prospects for US economy.
NZ swap spreads	↓	Risks point wider with offshore demand for bonds.
Flow	↔	Lack of liquidity with market staying on the sidelines ahead of next week's OCR decision.
Technicals	↔	Tight ranges limiting technical picture.

Borrowing strategies we recommend at present

Domestic strength coupled with rising global yields has aided a further sell off in the NZ yield curve. Much attention will be paid to Thursday's Q4 CPI figure leading into the RBNZ announcement next week. We feel borrower's should continue to pay the 3 - 5 year part of the curve and should not risk the chance of further rate increases whilst waiting for better levels. Given the current situation and risks of higher rates, borrowers of the view that rates may come off sharply in two years time, should consider a suitable interest rate strategy, with some form of optionality to provide flexibility in the latter years.

Trading themes we favour at present

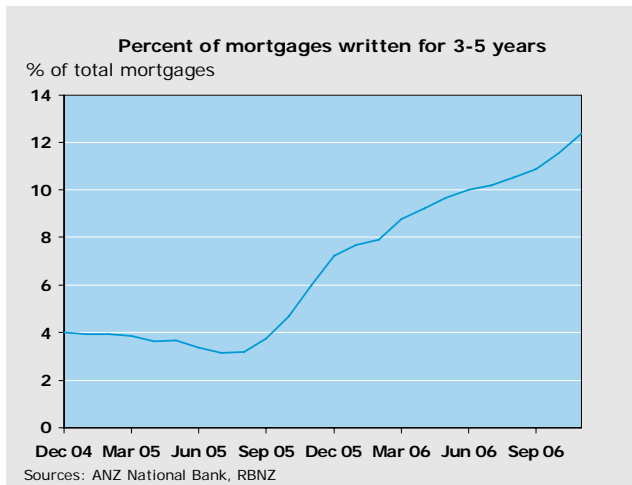
We see value in going long out to 6 months and paying in the 2 year.

DOING YOUR WORK

The Reserve Bank will take some comfort from rising international interest rates, which is giving them additional policy traction along the yield curve.

Amongst the hurly-burly of domestic considerations as to whether the Reserve Bank should hike or not, a key issue has been looked over, namely the important role being played by international interest rates.

Low international interest rates – and the corresponding impact on NZ longer dated yields – have been a key source of frustration to the Reserve Bank. The inverted NZ yield curve has dampened the efficacy of monetary policy as borrowers simply shifted further out the curve. The percentage of mortgages (in value terms) being written for 3-5 years duration has risen from 4 to 12 percent over the past 2 years.



The Reserve Bank has made explicit references to such influences in the past; ranging from the difficulties, to noting the positive impact in the July *OCR Review* that "rising foreign interest rate trends (at that time) were working to support domestic monetary policy settings". This positive impact turned decidedly frustrating through September and towards the end of the year as global interest rates fell markedly.

The last two weeks have seen a noticeable change in foreign interest rate sentiment. The BoE surprised markets with a 25 basis point hike. Signs of stabilising growth across indicators in the US has seen the yield on the US 2 year bond increase from a low of 4.5 percent in early December to 4.9 percent at present.

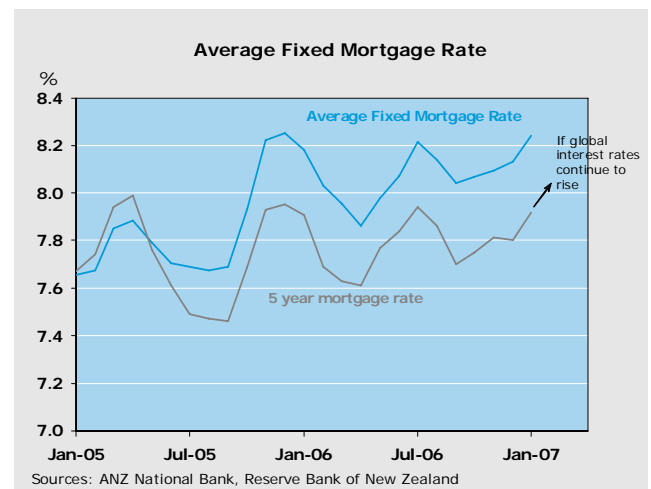
The impact on the NZ curve has been noticeable. Even the front end of the NZ curve (up to 2 years) has not been immune. The NZ 2 year swap rate post the December *Monetary Policy Statement* was oscillating around 7.5-7.55 percent. Post bearish global interest rate sentiment, the range jumped to 7.6-7.65 percent. Admittedly, stronger domestic economic data will have played a role post the *Statement*, although a weak Q3 GDP result should have seen this reverse. The impact has been more

marked further out the curve, where there has been a steady 15 basis point rise in 3 to 5 year yields.

Such upward forces have been quick to flow through to fixed mortgage rates. Average fixed mortgage rates (written) are generally 20 basis points higher across the board than the average written in November.

While such a move is generally small, the impact is nonetheless material from a monetary policy perspective.

Higher 3 to 5 year fixed lending rates, which now generally reside around 8 percent, have dampened consumers' ability to duck for cover in the face of rising short-term rates.



Moreover, it is the forward looking trends that the Reserve Bank needs to be mindful of. The BOE has set the tone, with two surprise moves indicating little patience. The Fed continues to warn of inflation risks, the RBA the same, the ECB has ratified market expectations for a further move in March, and even the BoJ is expected to move over the coming months.

Our own view is that the outlook for global interest rates carries considerably more upside risk than down.

Our suspicion going forward is that global interest rate settings, after being a source of frustration for the Reserve Bank over the past 2 years, will gradually begin to work in its favour.

The risk at this juncture is that the Reserve Bank loses patience and we potentially end up with a double bout of policy tightening, both at the front-end and courtesy of rising global rates, further out the curve as well.

CURRENCY STRATEGY

The NZD looks topy at present given our core view that the RBNZ will not raise rates at the end of the month and global interest rates are starting to move up. Yet it is difficult to see a significant decline until we see the NZ economy start to roll. This looks a mid-year story at present.

Market themes...

- Yield related support to the USD re-emerges.
- Carry trade back in favour after some nervousness to start to the year.
- Oil down.

Outlook...

We have shifted to a mildly bearish bias towards the NZD. While we suspect the magnitude of the move will not be large there are two forces at work over the coming weeks that suggest the NZD has more downside risk than up.

- We do not believe the RBNZ will raise rates at the January *OCR Review* (although we remain very wary of where non-tradable inflation could print in this week's inflation report). While the interest rate market has slowly pared back the probability of a hike over the past week from a near certainty to a 50-50 call, currency sentiment appears to be looking for a rate hike to be a done deal, which is still reflected in a sizeable net long position. We currently ascribe a 30 percent probability to a hike, compared with 40 percent pre-Christmas, with lower petrol prices and a weaker than expected GDP result late last year simply too hard to ignore.
- Global interest rate sentiment is turning, notably in the US. There has been a steady stream of better than expected data in the US – non-farm payrolls were sharply higher, and jobless claims came in below expectations, and better than expected trade data has seen estimates of Q4 GDP revised higher. The housing market, previously an area of concern, has also shown signs of stabilising in recent weeks. US futures markets have shifted the timing of the first rate cut being fully priced in from July to December over the past few weeks. We would not be surprised to see this bearish sentiment extend further.

Certainly the carry trade remains a key focal point. The BoJ's decision this week is likely to be key. The market is divided and so are we, but it just seems a question of time before rates move up, whether it is this month or next month. While we remain a way off a yield differential where the NZD typically struggles (such as sub 90 in the NZ-Aus 2 year swap and sub 190 in the same vis-à-vis the US), and an abundance of global liquidity is implying a narrower rate paradigm, it is the change in yields that is equally important for sentiment, and the NZD at current levels looks vulnerable to a change in sentiment. IMM long positioning in the NZD has been pared back, but at \$1.5 billion, it remains historically chunky.

From a technical perspective, the NZD/USD looks stuck in the 0.6750-0.6950 range and we expect the downside of this range to be probed over the coming weeks. But to see a further sustained break will likely require a massive re-rating towards New Zealand growth prospects and the RBNZ to remove the threat of a hike down the track. Neither look likely at present and we suspect that any dip will be met by yield related support.

NZD vs AUD: monthly directional gauges

Gauge	Direction	Comment
Fair value	↓	Fair value 0.85-0.88.
Yield	↓	Too much factored in for RBNZ and too little for RBA.
Commodities	↔	Hard continue to outshine soft but lower oil helping NZ
Partial indicators	↓	NZ domestic economy remains resilient, but Aus looks better given massive jobs growth.
Technicals	↔	Topside capped at 0.8880. Initial resistance at 0.8790, and then 0.8760.
Sentiment	↔	No mans land.
Other	↑	Liquidity still plentiful. AUD positioning looks extreme.
On balance	↓↔	Mildly bearish with the RBNZ not set to deliver

NZD vs USD: monthly directional gauges

Gauge	Direction	Comment
Fair value – long-term	↓	Fair value 0.60. It may be higher given a structural shift in commodity prices.
Fair value – short-term	↔	NZD more fairly valued on commodity models.
Yield	↓	RBNZ supportive but US curve still too inverted.
Commodities	↔	Dairy prices are insulating the dairy sector but meat prices looking suspect
Risk aversion	↑	Low.
Partial indicators	↔	Both economies have similar imbalances.
Technicals	↔	Looks at 0.6950-0.6750 range at present
AUD	↔	Just keep prodding but not progressing.
Sentiment	↔	Are we back to chasing the tallest pygmy?
Other	↔	Watch the BoJ for sentiment towards carry
On balance	↓↔	RBNZ to hold and continued re-rating towards the Fed imply downside probing

THE YIELD SURPRISE FACTOR

When we look at expectations towards the RBNZ, RBA and Fed, the former looks too hawkish, and the latter two understate the upwards risk profile for rates. Re-rating could see the NZD give up recent froth.

Last week was notable for the “surprise” hike from the BOE. The move, and subsequent market reaction, served to reinforce three key themes.

- Yield remains the key driver within the currency market, with the GBP lifting 2 big figures post the hike. The move similarly carried over to other perceived yielders including the NZD.
- Central banks can and do surprise markets from time to time, and the market is not always right. This does not mean the market is wrong – the market after all has clear economic incentives to listen to central bank speak. But the market – in its chase for the pot of gold at the end of the rainbow (the kahuna trade) does inevitably tend to push the probability of an outcome too far.
- It is the change in expectations towards the yield differential as well as the absolute level that matters. Perception towards the NZD has generally turned decidedly bearish when the NZ-Aus 2 year swap differential falls below 90 bp, and the NZ-US differential sub 190 bp.

Against this backdrop it is interesting to note where the market currently resides. There is a definite hike view being taken towards the RBNZ, a guarded view towards the RBA, and continued expectations of easing from the Fed in 2007 (although these have been pared back of late). With a cash rate of 0.25 percent there seems only one way for the BoJ to go, and that's up.

Admittedly, the RBNZ opened the door to a hike in December. Yet subsequently, oil prices have fallen sharply and the tenor of data has been mixed,

being generally strong in mid December, yet a weak GDP result emerged (0.3 percent versus the RBNZ's expectations of 0.7 percent), taking annual growth to a meager 1.5 percent.

Moreover, on a relative basis, market pricing just doesn't sit right. New Zealand is, after all, the nation with one of the highest official rates in the Western world and hence tightest financial conditions. The currency is amongst the most overvalued, and households look most vulnerable given a double-digit debt servicing ratio compared to single digits in the US and Australia. What makes the NZ economy so bullet-proof? Commodity prices have played a role, but more so in Australia given the 39 percent surge in their terms of trade over the past four years. Liquidity? Well there is an abundance of that everywhere!

We note the dichotomy between RBNZ speak and easings being priced into the market in 2006, and what transpired. A similar picture appears to be panning out in the US, with Fed rhetoric maintaining a tightening bias yet the market pricing in easings over 2007.

When we look at things on a relative basis, it seems peculiar to imagine a scenario where the NZ-Aus or NZ-US yield differential widens further from current levels. This does not mean it may not happen, and the RBNZ could certainly hike again given their repeated warnings. Yet such a scenario looks to be fully factored into the market. The scenario – which the market is not yet buying into – is that the RBA ends up following the path of the RBNZ in late 2005, and the Fed is correct in its economic assessment of inflation risks.

Our baseline scenario of no move from the RBNZ later this month, and continued re-pricing towards the RBA and Fed, is likely to see the NZD give up some of its recent froth.

RBA Meeting	Rate	P (+25bps)	RBNZ Meeting	Rate	P (+25bps)
<i>Current Rate</i>	6.25		<i>Current Rate</i>	7.25	
Wed 7 Feb 07	6.36	44%	Thu 25 Jan 07	7.37	48%
Wed 7 Mar 07	6.39	57%	Thu 8 Mar 07	7.46	82%
Wed 4 Apr 07	6.40	60%	Thu 26 Apr 07	7.49	96%
Wed 2 May 07	6.45	79%	Thu 7 Jun 07	7.49	97%
Wed 6 Jun 07	6.46	83%	Thu 26 Jul 07	7.54	118%
Wed 4 Jul 07	6.47	86%	Thu 13 Sep 07	7.51	104%
Wed 8 Aug 07	6.47	87%	Thu 25 Oct 07	7.44	75%
Fed Meeting			BOJ Meeting		
<i>Current Rate</i>	5.25		<i>Current Rate</i>	0.25	
Wed 31 Jan 07	5.24	-2%	Thu 18 Jan 07	0.44	76%
Wed 21 Mar 07	5.24	-6%	Wed 21 Feb 07	0.48	90%
Wed 9 May 07	5.23	-8%	Tue 20 Mar 07	0.50	100%
Thu 28 Jun 07	5.19	-26%	Tue 17 Apr 07	0.57	127%
Tue 7 Aug 07	5.12	-52%	Tue 15 May 07	0.57	127%
Tue 18 Sep 07	5.05	-78%	Tue 12 Jun 07	0.57	127%
Wed 31 Oct 07	5.02	-91%	Tue 10 Jul 07	0.67	167%
Tue 11 Dec 07	4.90	-139%			
Wed 30 Jan 08	4.80	-181%			

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
15 Jan	UK	Producer Prices - Inputs s.a. (Dec) - mom	0.3%	0.1%	22:30
	UK	Producer Prices - Outputs n.s.a. (Dec) - mom	0.1%	0.0%	22:30
	EU	Euro-zone Industrial Production (Nov) - mom	0.8%	-0.1%	23:00
16 Jan	CA	New Motor Vehicle Sales (Nov) - mom	3.0%	-1.6%	02:30
	NZ	NZIER December Quarterly Survey of Business Opinion	-	-19	10:00
	JP	Domestic Capital Goods Prices (Dec) - mom	0.0%	-0.1%	12:50
		Export Prices (Dec) - mom	-	-1.0%	12:50
		Import Prices (Dec) - mom	-	-2.2%	12:50
		Industrial Production (Nov F) - mom	0.7%	0.7%	17:30
		Capacity Utilisation (Nov F)	-	107.2	17:30
	UK	RICS House Price Balance (Dec)	45%	47%	13:01
		CPI (Dec) - mom	0.4%	0.3%	22:30
		Core CPI (Dec) - yoy	0.6%	0.3%	22:30
		Bank of England's Sentence speaks on Monetary Policy in London	-	-	-
	GE	ZEW Economic Sentiment Survey (Jan)	-10.5	-19.0	23:00
17 Jan	US	Empire Manufacturing Survey (Jan)	19.6	23.1	02:30
		ABC Consumer Confidence (w/e 15 Jan)	-	-5	11:00
	CA	Bank of Canada Interest Rate Announcement	4.25%	4.25%	03:00
	NZ	CPI (Dec qtr) - qoq	-0.1%	0.7%	10:45
		Food Prices (Dec) - mom	-	0.1%	10:45
		Non-Resident Holdings of Government Securities (Dec)	-	-	15:00
	AU	Westpac Leading Index (Nov) - mom	-	0.5%	12:30
	JP	Current Account Balance (Nov)	¥1939.3b	¥1514.6b	12:50
		Consumer Confidence – Households (Dec)	47.0	48.7	18:00
		Machine Orders (Dec F) - yoy	-	-2.4%	19:00
	UK	ILO Unemployment Rate (Nov)	5.5%	5.5%	22:30
		Average Earnings Inc. Bonus (Nov) – yoy	4.2%	4.1%	22:30
	EU	European Central Bank's Stark speaks in Tuebingen	-	-	08.25
		Euro-zone CPI (Dec) - mom	0.4%	0.0%	23:00
		Euro-zone Core CPI (Dec) - yoy	1.6%	1.5%	23:00
18 Jan	US	MBA Mortgage Applications (w/e 13 Jan)	-	16.6%	01:00
		Producer Prices (Dec) - mom	0.5%	2.0%	02:30
		Producer Prices – ex Food and Energy (Dec) - mom	0.1%	1.3%	02:30
		Net Long Term Capital Flows (Nov)	\$82.5b	\$82.3b	03:00
		Industrial Production (Dec)	0.1%	0.2%	03:15
		Capacity Utilisation (Dec)	81.7%	81.8%	03:15
		NAHB Housing Market Index (Jan)	33	32	07:00

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
18 Jan cont.	US	Fed Beige Book released for the 30-31 January FOMC meeting	-	-	08:00
		Fed President Yellen speaks on the Economy in Arizona (non-voter)	-	-	08:50
		Fed President Poole speaks on Government-Sponsored Enterprises (voter)	-	-	12:45
	JP	Bank of Japan Interest Rate Announcement	0.5%	0.25%	-
		Tertiary Industry Index (Nov) - mom	0.0%	2.1%	12:50
		Leading Economic Index (Nov F)	-	20.0%	18:00
		Band of Japan Monthly Report	-	-	19:00
	EU	European Central Bank Monthly Report	-	-	22:00
19 Jan	US	Fed President Pinalto speaks on the Regional Economy and Economic Outlook in Ohio (non voter)	-	-	02:00
		CPI (Dec) – mom	0.5%	0.0%	02:30
		CPI ex Food and Energy (Dec) – mom	0.2%	0.0%	02:30
		Initial Jobless Claims (w/e 14 Jan)	310k	299k	02:30
		Housing Starts (dec)	1560k	1588l	02:30
		Leading Indicators (Dec)	0.2%	0.1%	04:00
		Fed Chairman Bernanke testifies before the Senate Budget Committee	-	-	04:00
		Philadelphia Fed Index (Jan)	2.5	-2.3	06:00
	NZ	Retail Sales (Nov) - mom	-0.1%	0.3%	10:45
	AU	Export Prices (Dec qtr) - qoq	-	1.9%	13:30
		Import Prices (Dec qtr) - qoq	-	1.9%	13:30
	UK	Retail Sales (Dec) - mom	0.5%	0.3%	22:30
	CA	Bank of Canada Monthly Policy Report	-	-	03:00
20 Jan	US	Fed President Lacker speaks on the Economic Outlook for 2007 in Richmond (non voter)	-	-	02:00
		University of Michigan Confidence (Jan P)	92.3	91.7	04:00
		Fed President Hoenig speaks on the Economy in Kansas (voter)	-	-	07:15
	CA	Wholesale Sales (Nov) - mom	0.6%	-0.2%	02:30

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

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

NEW ZEALAND DATA WATCH

Key focus over next four weeks: This week sees an important run of data leading up to the Reserve Bank's January *OCR Review*. Business confidence, CPI and retail sales figures out this week are expected to maintain the Reserve Bank's inflation wariness, but provide insufficient justification to pull the trigger and hike rates at the January *Review*.

Date	Data/Event	Economic Signal	Comment
circa 15 Jan (15:00)	REINZ Housing Market data (Dec)	Resilience	Activity in the housing market likely to continue the theme of recent months with strong growth in house sales, the number of days to sell a house remaining at historically low levels, and annual house price growth above 10 percent.
Tue 16 Jan (10:00)	NZIER QSBO (Mar qtr)	Up but not above-trend	Headline confidence and own activity to follow the National Bank <i>Business Outlook</i> lead and head up. Capacity utilisation should come off from the previous quarter's surge but stay historically high. While trading indicators are likely to pick-up, we suspect the overall level will still be suggesting sub-trend growth.
Wed 17 Jan (10:45)	CPI (Dec qtr)	Headline easing but core sticky	Headline to be flat, taking the annual inflation rate down but non-tradable to stay elevated.
Fri 19 Jan (10:45)	Retail sales (Nov)	Down but not out	A small fall in headline retail sales expected, but core spending to increase.
Wed 24 Jan (15:00)	Credit card billings (Dec)	Up	Credit cards expected to have been given a good workout over the holiday shopping season. Strong m/m increase expected, especially after the 0.9 percent decline in November.
Thu 25 Jan (09:00)	OCR January <i>Review</i>	No change	Market split 50:50 on the decision. We don't see sufficient justification for the Reserve Bank to go.
Tue 30 Jan (10:45)	Building consents issued (Dec)	Holding up	A technical rebound expected from the surprising weakness in November. Trend to be modestly positive, but not accelerating away.
Tue 30 Jan (15:00)	Credit growth (Dec)	Up	Demand for household credit to remain strong, with another 1 percent increase expected.
Wed 31 Jan (10:45)	Merchandise trade (Dec)	Still imbalanced	Exports to be sluggish under a high NZD, but imports ex-fuel to remain high. Headline imports to be dragged lower by falling oil prices.
Fri 2 Feb (10:45)	External Migration (Dec)	Still strong	We're still a favorite destination for migrants, and strong labour market convincing more New Zealanders to stay home rather than seek greener pastures offshore. Another 1,000+ number expected.
Mon 5 Feb (10:45)	LCI and QES (Dec qtr)	Wages up	Wage growth expected to be strong with labour market still tight and demand for labour holding. Annual wage inflation rate may have peaked, but will stay high for some time.
Thu 8 Feb (10:45)	HLFS (Dec qtr)	Steady	Modest employment growth expected in line with confidence surveys, but unemployment rate to tick up slightly.
Thu 8 Feb (01:00)	ANZ Commodity Price Index (Jan)	-	-
On Balance		Steady as she goes	Growth still one sided and in need of rebalancing.

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SUMMARY OF KEY MARKET FORECASTS

NZ FX rates	Actual		Current	Forecast (end month)						
	Nov 06	Dec 06	15 Jan 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
NZD/USD	0.669	0.692	0.691	0.690	0.620	0.600	0.580	0.560	0.530	0.530
NZD/AUD	0.866	0.880	0.882	0.885	0.816	0.800	0.795	0.778	0.736	0.746
NZD/EUR	0.520	0.524	0.535	0.523	0.477	0.465	0.457	0.448	0.431	0.438
NZD/JPY	78.5	81.0	83.2	79.4	70.1	67.2	63.8	60.5	56.2	57.2
NZD/GBP	0.350	0.352	0.353	0.356	0.323	0.316	0.307	0.299	0.285	0.288
NZ\$ TWI	66.7	68.1	68.7	67.9	61.4	59.6	58.0	56.2	53.3	53.8
NZ interest rates	Nov 06	Dec 06	15 Jan 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
OCR	7.25	7.25	7.25	7.25	7.25	7.25	7.00	6.50	6.00	5.50
90 day bill	7.61	7.66	7.71	7.70	7.50	7.40	7.00	6.50	6.10	5.60
10 year bond	5.72	5.78	5.90	6.00	6.00	6.20	6.10	6.20	6.40	6.50
International	Nov 06	Dec 06	15 Jan 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
US Fed funds	5.25	5.25	5.25	5.25	5.25	5.00	4.50	4.50	4.50	4.50
US 3-mth	5.37	5.37	5.30	5.25	5.00	4.75	4.60	4.60	4.60	4.60
AU cash	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25
AU 3-mth	6.39	6.38	6.44	6.40	6.40	6.40	6.40	6.40	6.40	6.40

KEY RATES

	12 Dec	8 Jan	9 Jan	10 Jan	11 Jan	12 Jan
Official Cash Rate	7.25	7.25	7.25	7.25	7.25	7.25
30 day bank bill	7.65	7.60	7.61	7.61	7.61	7.61
90 day bank bill	7.64	7.73	7.73	7.73	7.74	7.71
NZGB 07/09	6.48	6.60	6.58	6.57	6.53	6.49
NZGB 11/11	6.20	6.34	6.32	6.30	6.29	6.27
NZGB 04/13	5.96	6.10	6.08	6.07	6.08	6.07
NZGB 12/17	5.75	5.91	5.89	5.88	5.89	5.89
1 year swap	7.74	7.85	7.85	7.84	7.84	7.82
2 year swap	7.52	7.62	7.62	7.62	7.62	7.61
5 year swap	7.12	7.22	7.21	7.21	7.22	7.22
RBNZ TWI	67.7	68.0	68.6	68.7	68.8	68.8
NZD/USD	0.6895	0.6851	0.6923	0.6907	0.6903	0.6903
NZD/AUD	0.8782	0.8797	0.8843	0.8860	0.8852	0.8852
NZD/JPY	80.50	81.08	82.32	82.42	83.26	83.26
NZD/GBP	0.3514	0.3552	0.3564	0.3569	0.3548	0.3548
NZD/EUR	0.5199	0.5272	0.5309	0.5329	0.5352	0.5352
AUD/USD	0.7851	0.7788	0.7829	0.7796	0.7798	0.7798
EUR/USD	1.3263	1.2996	1.3039	1.2962	1.2898	1.2898
USD/JPY	116.75	118.35	118.91	119.33	120.61	120.61
GBP/USD	1.9619	1.9289	1.9426	1.9353	1.9457	1.9457
Oil	61.26	56.29	56.08	55.65	51.91	51.91
Gold	630.38	609.10	613.60	612.60	611.30	611.25
Electricity Price Index	3.40	2.14	2.32	2.50	2.63	2.59

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