

DEFERRED ACHIEVEMENT

NZ Economics Team:

Cameron Bagrie

Chief Economist
Telephone: +64 4 802 2212
E-mail: bagrie@anz.com

Khoon Goh

Senior Economist /
Interest Rate Strategist
Telephone: +64 4 802 2357
E-mail: gohk@anz.com

Philip Borkin

Economist
Telephone: +64 4 802 2199
E-mail: borkinp@anz.com

Steve Edwards

Economist
Telephone: +64 4 802 2217
E-mail: edwards1@anz.com

Kevin Wilson

Rural Economist
Telephone: +64 4 802 2199
E-mail: wilsonk1@anz.com

Page 2: Economic overview

- > The dreaded "R" word is now being bandied about. We prefer to characterise the adjustment NZ is undertaking as a period of deferred achievement. While much attention will focus on near-term prospects, the more important issue in our eyes is how long the adjustment lasts. We are facing a trough in the economic cycle extending into 2009, given weak productivity growth and the need for household de-leveraging.

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- > Prices continue to trend up for a broad range of commodities but prices for NZ pastoral products remained steady. Agriculture's contribution to the economy in 2007/08 is still significant but will be less than expected in mid 2007. While the farm gate milk price outlook remains very good, it is back to the drawing board for Fonterra's capital restructuring.

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- > Financial conditions are largely unchanged from February but remain at very restrictive levels. Our index is pointing towards sub-1 percent growth in the year ahead.

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- > The dataflow in Europe and Asia is still printing largely above expectations, though exports out of China were well shy of expectations. Employment growth in Australia remains strong, while consumer spending in the US contracted, another sign that the US economy may already be in recession.

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- > Lack of domestic data means the local rates market is at the mercy of offshore developments. Volatility expected as global credit crisis deepens. Receivers to have the upper hand.

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- > The USD continues to be pummelled. Given widespread expectations of more aggressive cuts from the Fed and likely close attention being paid to earnings figures of financials, the greenback remains vulnerable. Stepping back, "surplus" nation currencies are being supported, while "deficit" nations struggle and remain volatile. We expect this to continue.

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ECONOMIC OVERVIEW

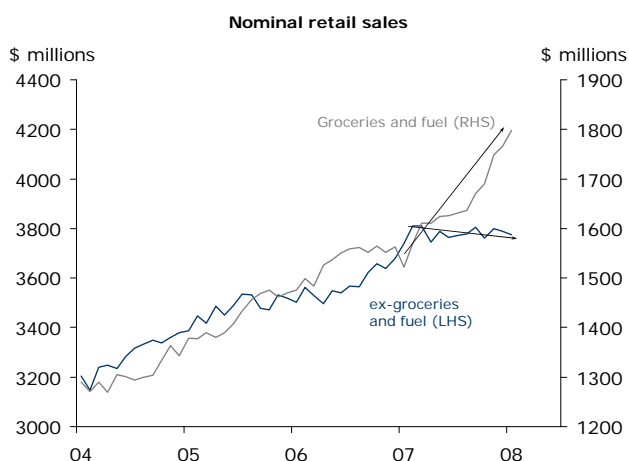
The dreaded “R” word is now being bandied about. We prefer to characterise the adjustment NZ is undertaking as a period of deferred achievement. While much attention will focus on near-term prospects, the more important issue in our eyes is how long the adjustment lasts. We are facing a trough in the economic cycle extending into 2009, given weak productivity growth and the need for household de-leveraging.

What’s ahead?

- > **NZ February Electronic Card Transaction** (Wednesday 19 March 1045 NZDT). Another soft print expected though higher food and petrol prices to hold the total number up.
- > **NZ February Migration data** (Thursday 20 March 1045 NZDT). More exodus to Australia mean this number could potentially turn negative.

What’s the view?

The economy continues to show clear signs of rapidly waning momentum. There is no doubt that the housing market is at the forefront of the slowdown, with last week’s real estate figures showing house sales down 32 percent from a year ago and house prices now 4 percent off its late 2007 peak. Given the combination of rising supply, receding migration, higher credit costs and altered risk appetites, the outlook contains a lot more downside risk, particularly on the price front.



But household incomes are also getting squeezed from higher costs for staples such as food and petrol. Grocery prices are up 9 percent from a year ago and petrol prices have hit a new high of \$1.779/ltr last week for 91 Octane, a 14 percent increase from a year ago. We can be thankful that the Government has decided not to proceed with the annual inflation indexation of the petrol tax levies, for that would have pushed pump prices even higher from 1 April. The effect on consumer spending from these higher prices is obvious. Retail spending on non-grocery and fuel items has effectively been flat since early last year,

while spending on groceries and fuel continue to increase, though out of necessity rather than want. Consumer spending will remain subdued in the coming months. A strong labour market and fiscal stimulus will provide some support, but at this stage it is being dwarfed by other factors.

However, we also need to be cognisant of the fact that economic activity ended 2007 on a firm note. The final pieces of the December 2007 quarter GDP jigsaw was received last week and suggests a reasonably robust 0.6 percent growth rate, with the expenditure figure likely higher. Strong growth at the end of 2007 reinforces the positive and inflationary output gap, necessitating weak growth in 2008.

Data, confidence and anecdotes are clearly pointing to a significant souring in activity. Our National Bank *Business Confidence* survey for February was the first concrete read on this turn in sentiment. The anecdotes that we have been hearing since are mostly negative. The latest Colmar Brunton poll points to a significant fall in consumer confidence, with a net 25 percent pessimistic over the year ahead – a 19 month low.

The prevailing mood out there is such that the dreaded “R” word is now being bandied about. It is a term we do not like to use. Certainly, indicators for 2008 at present indicate growth in the first half of the year is flat at best and we may well be entering a technical recession already. Given tightening lending standards, higher credit costs, not to mention a high NZD and the potential for negative net migration, the outlook for the second half of the year is no better. For now, we prefer to characterise the adjustment the economy is entering as a stage of deferred achievement, in a similar manner to high school kids, whom in the modern era, never fail.

As commentators we have a responsibility to allude to changes in the economic cycle. We have been noting for months that things were not right. Ticks in the negative column continue to rise and escalate in intensity when looking at areas such as credit, a theme that has consistently pervaded our commentary. If it has been hard to read such pessimism, it has been no better to write it.

Yet at this juncture, there is also a danger we encircle ourselves in pending doom and the outcome becomes self fulfilling. After all, if households and businesses believe a material slowdown is about to occur, they will become more cautious on the spending, investing and hiring front, which in turn leads to the slowdown they were expecting. Strictly speaking, we suspect the train has already left the station on the growth stakes, and we fully expect to see some real ugliness over the coming months as the data lags the anecdotes. But touch-wood, it is of the “recession lite” variety, given the strong base effect and good opening position of the economy via a low unemployment rate and strong end to last year. However, if we are to see more credit dislocation globally spreading across our shores, then all bets are off.

Stepping beyond the talk of pending doom in 2008, we believe there are more important issues to think about. Key in this regard is how long momentum will likely remain weak. It is the rate of growth expressed over a number of years that is ultimately more important than that expressed over one. Alas, we are wary about prospects in 2009 as well.

- > The consolidation we are entering is a period of household de-leveraging. Unlike the corporate sector, the de-leveraging process for households tends to be a long drawn out affair. We have noted some useful comparisons between the 1997/98 recession and now. Yet the comparisons fail to appreciate one dynamic – 1997/98 was largely a corporate adjustment and de-leveraging period. The economy went in hard, adjusted quickly as businesses cut investment, inventories, employment and costs to improve cashflow and restore balance sheets. Private consumption growth slowed, but troughed at 2 percent! Hardly an adjustment at all for households. On the other hand, household de-leveraging is much more consistent with the 1990/91 downturn, which was a far more drawn out affair. Unlike the 1997/98 experience, it is household balance sheets that enter this cycle in need of repair and consolidation. To do this, households have only one lever to pull, namely reduced spending. Restoring household balance sheet health will take time.
- > Productivity growth remains poor, restricting the ability of the supply side of the economy to help cushion the adjustment. Indeed, it is one of the reasons why inflation is sticky and preventing the Reserve Bank from easing as an insurance option. Last week's release of official productivity statistics for the business sector of the economy make for grim reading. Statistics NZ describes productivity growth since 2000 as "subdued". We think this is being too kind. Average labour productivity growth since 2000 is half the historical growth rate, and well down from the 2.6 percent achieved over the 1990s. We shudder to think what those numbers would look like if the government sector were to be included in the measurement.

Productivity growth (5-year compound annual rate)



Sources: ANZ National, Statistics NZ

- > NZ's macro framework is not adjusting. The NZD is being elevated by a weak USD, as pygmy trading resumes. The Reserve Bank has made it clear that a major growth sacrifice is required to tame inflation. Implicitly, they are waiting for indicators of inflation to turn before they will cut rates. But once they do, they will move policy back to neutral very aggressively. We suspect the Reserve Bank will struggle to reflate the economy as the reverse of what we have seen over the past few years unfolds. Yes, there must be a better way to run policy, but the stark reality is that when you have an inflation problem, tough love is required. And the Reserve Bank has made it clear that, as inflation targeters, they are prepared to deliver it.

Technically, the NZ economy may indeed be on the brink of a recession (oops, we mean in a stage of deferred achievement). But the more important aspect is that weakness is likely to continue for some time as household de-leveraging unfolds and NZ's policy framework lags behind. Time to batten down the hatches.

In terms of what's coming up on the domestic and international calendar, it is all quiet on the local front with only February's electronic card transaction and migration data out. The former will show ongoing soft consumer spending, with the headline number once again supported by higher food and petrol prices. Net migration could potentially turn negative, and we will be keeping a close eye on whether the outflow to Australia stabilises or continues to trend higher. The main event offshore is the FOMC interest rate decision on March 19 (NZ time). A 75bp cut is now widely expected. Monetary policy aside, we will get more data on US housing starts, housing market sentiment and industrial production. Key releases in Europe include the various PMI readings to get an indication of whether activity there is starting to feel the effects of the US slowdown/recession. CPI, labour data and retail sales are key releases out of the UK.

Recent data...

- > **NZ Terms of Trade (December quarter).** Terms of trade rose 2.9 percent to its highest level since the March 1974 quarter.
- > **NZ REINZ Housing Market Report (February).** House sales down 2.5 percent (sa), house prices fell for the third consecutive month and days to sell jumped from 40 days to 45 (sa).
- > **NZ Food Price Index (February).** Food prices rose 0.8 percent, taking the annual increase to 5.2 percent.
- > **NZ Retail Sales (January).** Both total and core retail sales grew by 0.3 percent. Supermarket and grocery store sales contributed to most of the increase.
- > **NZ Manufacturing Survey (December quarter).** Headline manufacturing sales rose by 8.3 percent, led by dairy and meat. Manufacturing volumes rose 3.4 percent.

RURAL UPDATE

Prices continue to trend up for a broad range of commodities but prices for NZ pastoral products remained steady.

The lack of rainfall continues to dominate day-to-day issues within the pastoral sector. The pincer of no rain and a relentless reduction in potential growing days is closing steadily.

Agriculture's contribution to the economy in 2007/08 is still significant but will be less than expected in mid 2007.

While the farm gate milk price outlook remains very good, it is back to the drawing board for Fonterra's capital restructuring.

Rationalisation of the meat industry is gaining momentum. A task force has been established with Sir John Anderson as chairman. The two co-operative meat companies are being pushed by shareholders to act.

Increases in the prices of a broad range of commodities continue. The increase in the indicative fertilizer price over 12 months is frightening. Rock phosphate has gone from US\$45/tonne in April 2007 to US\$190/tonne in January 2008. Rock phosphate is a major ingredient for the production of super phosphate, a pillar of agricultural production in NZ. Most other commodity prices also increased over the month but to a lesser extent.

Prices are being driven partly by demand but it is reported that speculators betting on a correction to an ever weakening USD and equity funds broadening their portfolios have become large players.

Prices for NZ pastoral agricultural commodities remained steady over the past month. Benchmark wholesale UK lamb and US beef prices improved following a usual seasonal pattern but retail prices show mixed trends. Indicative UK beef and pork prices have firmed but lamb is unchanged. US prices are marginally up on 12 months ago. Venison is holding at a higher level.

Quoted prices for Oceania dairy commodities are 5 to 25 percent off the highs of September/October 2007 but have been steady over the past month.

International grains have firmed again. Wool continues to climb in USD terms. But that is mostly due to the weaker USD against major wool buyer domestic currencies. Indicative European fruit prices are steady to marginally up on the equivalent week in 2007.

The dry is still widespread. Rainfall has shifted several regions into a recovery mode but plant recovery is not instantaneous. It takes time, more rain and mild temperatures to build up grass and crop covers required for winter and early spring feeding of livestock. The potential number of grass growing days before winter is steadily decreasing. The pincer of no rain and a relentless reduction in potential growing days is closing steadily. We need an extended mild

moist autumn! Of course the fine weather is a boon to the fruit industries (apples, kiwifruit and grapes). La Nina has kicked in for Southern Oscillation Index watchers.

Pastoral Drought Situation (11 March)		
OK	Recovery	Still serious concerns
Northland	Bay of Plenty	Waikato
Mid-Canterbury	Gisbourne	Wairarapa
	Hawke's Bay	Taranaki
	Nelson	Manawatu
	South Otago	Marlborough
	Southland	South Canterbury
		North Otago

Implications

National annual dairy production likely to be down by five percent.

- > Milk production in the 2007/08 season in the Waikato is commonly down over 10 percent and up to 20 percent on the previous year. The number of herds being dried off early is escalating rapidly. Similar results and action is happening in the Bay of Plenty, Taranaki, Manawatu, Marlborough and Nelson.
- > Total production in the mid and lower South Island is likely to be higher than last year with assistance from new conversions. But individual results are variable depending on the management strategy adopted to deal with the dry (put in more feed or go to 16 hour milking or once a day, etc). Westland has had a good summer after a shaky start in the spring

The lamb kill is disrupted (again).

- > An extra 775,000 lambs were processed in January 2008 compared to January 2007. Not helpful to company marketing teams. Do the lower lambing percentage in spring 2007 and an advanced kill point to a market shortfall later in the season or early spring 2008?

Agriculture's contribution to the economy in 2007/08 is still significant but less than expected in mid 2007.

The boost expected from dairy will be less than forecast and further offset by another very fair result from the sheep and beef sector.

The gloss is off projected profitability of dairy farms.

- > Anecdotal evidence indicates dairy farm working expenses (before any extraordinary feed purchases due to the drought) are up 20 to 30 cents/kg milk solids (7 to 10 percent) with another similar increase expected next year. Wages, unit

feed costs, grazing, tradesmen, fuel, and rates are all costing more. The interest rate paid on total debt will also be up 50 to 100 bps in many instances. The combined increases will lift the average break even payout to over \$5/kg ms and could well be closer to \$5.25 (includes depreciation).

- > The cash result of dairy farms in drought areas may only be similar to last year.

Sheep and beef farm profits modest at best and more likely to be a loss.

- > The average mid season prime lamb price to date is around \$2/head higher than last season but store lambs are down by \$5 to \$15/head. The extended and extensive drought was one factor in the store lamb price. Another (and long-term, a bigger factor) is changing land use. There are two effects at play – conversion of traditional lamb finishing farms to dairy or a switch by finishing farms to dairy support units. Both are real concerns for farmers on harder hill country who have limited alternatives. Processors are also being faced with some big decisions about capacity.
- > Prime and manufacturing beef prices are also running 5 to 10 percent lower than last season, squeezing margins for both breeders and finishers.
- > Fine wool returns are up 10 to 15 percent depending on micron count, time of sale and how much had been sold forward on contracts. But crossbred wool languishes.
- > Cost structures are also rising in a similar manner to dairying. The end result is some sheep and beef farms staring at a second or third consecutive cash loss and with reduced capital stock in drought districts. A most uncomfortable position to be in.

Fonterra Road Shows

Fonterra have completed a very extensive series of meetings by directors with shareholders.

Milk Price

The directors are confident the 2007/08 payout will have a seven at the front. The next official forecast for the 2007/08 season will be released after the Board meeting in April. Indicative numbers suggest that the 2007/08 payout may include another gain on foreign exchange hedging in the order of \$0.30 to \$0.40/kg ms.

The first forecast for 2008/09 is announced in May. The forecast was anticipated to be in the range of \$5.50 to \$6.50/kg ms.

Capital Restructuring

The board/management are again reviewing all alternatives for capital restructuring as at least two of the three planks for restructuring still exist, i.e. capital for growth and the redemption risk.

Remaining a co-operative with shares tradable only between suppliers (the LIC model) was suggested at the meetings. Shareholders could hold up to 1.2 times milk supply as shares (similar to the current arrangement) to assist liquidity of those shares. Redemption by the co-operative would only be under exceptional circumstances (not defined).

Redemption Risk

Redemption is obviously a (growing?) concern for the co-operative and has to be addressed. Tradable co-operative shares obviously substantially reduce the redemption risk.

Calculation of the milk price

The proposal is to establish a public market and a new pricing model. The public market will be visible and independent and sell five milk commodities (skim, whole and butter milk powders; butter and anhydrous milk fat). The market will provide clearer signals to shareholders and buyers about the trends in dairy commodity prices.

The public market will operate monthly by an unnamed independent US company. Twenty percent of the five NZ produced products will be offered and sold in USD. The exchange rate for the transaction will be declared.

The public market price information will feed into a new Fonterra revenue model along with the undisclosed prices of the other four commodities. A "make allowance" will be deducted and the result is a base milk price. The "make allowance" will include depreciation, a cost of capital charge and be subject to independent review. The new pricing model will also be used by Fonterra to calculate the transfer pricing for added value products.

The proposal is a big step from the 'behind closed doors' way that internationally traded dairy commodities are currently priced. Open markets are considered to be more efficient. Will 20 percent of NZ production (simplistically 4 percent of internationally traded products) be a large enough pool to establish a true price for the other 96 percent?

Rationalisation in the Meat Industry

Meat and Wool New Zealand announced the establishment of a task force to consider "strategies for advancing New Zealand's red meat industry". The task force is chaired by Sir John Anderson.

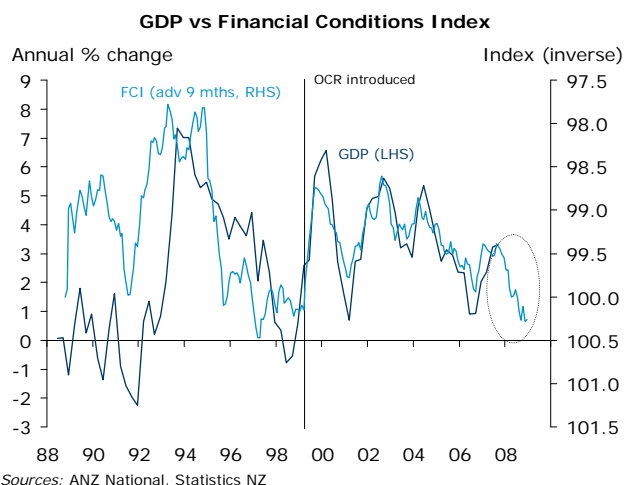
Sheep farmers have been voting, both with their feet and at the governance level for the two meat processing/marketing co-operatives. Willingness at the grass roots to consider a merger/amalgamation of at least the two co-operatives appears to be gaining momentum. The commercial and organisational challenge cannot be underestimated. Capital structures are one part of the jigsaw that will have to be considered.

FINANCIAL CONDITIONS UPDATE

Financial conditions are largely unchanged from February but remain at very restrictive levels. Our index is pointing towards sub-1 percent growth in the year ahead

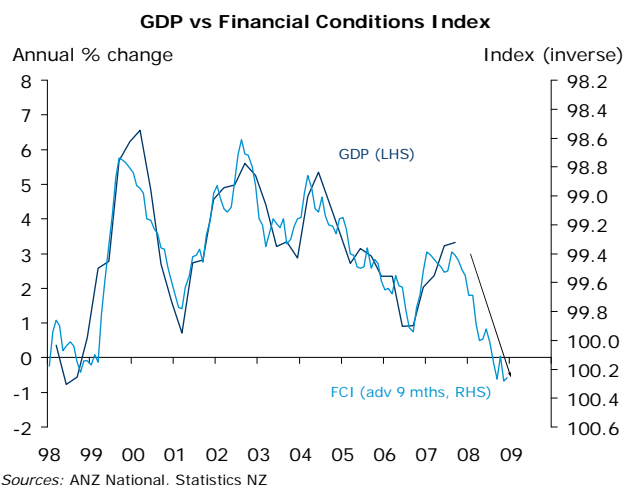
Regular readers will be familiar with our Financial Conditions Index¹, which we monitor and provide periodic updates in this publication. Unlike the conventional Monetary Conditions Index, our Financial Conditions Index includes a wider array of variables to recognise the different channels through which 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, as of mid-March, is largely unchanged from February. But given the volatile movements in financial markets lately, this could easily change by month's end. Falling equity and house prices, widening US 2-year swap spreads and a rise in the 90-day rate was offset by a lower currency on a TWI adjusted basis and lower 2-year swap rates.



Financial conditions at current levels are pointing towards a marked slowdown in growth. It is a given that Q4 2007 GDP, due for release next week, will be robust. But as we have been saying for some time, momentum look to have eased off early this year. The question is how deep the slowdown will be. Our index is consistent with sub-1 percent growth (in annual percent change terms when looking at history since 1989). But the correlation between our Financial Conditions Index and GDP growth is best since 1999 when the OCR was introduced, replacing the old MCI regime. Looking at it from that shorter time frame suggests the growth rate could be much worse.

¹ 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).



And we may yet see further tightening in financial conditions, given that asset prices in NZ continue to come under downward pressure. The equity market continues to head lower with growing concerns over earnings, and house prices are now in decline and set to fall further. Financial conditions are set to tighten more via the wealth channel.

Indicators	Comment	Impact on activity
Currency, adjusted for the terms of trade	TWI down from February levels but still restrictive.	↓
Interest rates	2-year swap yields down but 90-day up.	↓
US 2-year swap spread	Spreads continue to widen.	↓
Equity market index as a proxy for corporate wealth and liquidity	Equity market keep falling.	↓
House prices as a proxy for household wealth	House prices now starting to fall.	↔/↓
Private sector credit growth	Credit growth is slowing, though off a high rate.	↔
Liquidity	Liquidity remains abundant but is off its peak.	↔/↑
Overall conditions	Still very tight	↓

We have now formally revised our economic forecasts for GDP growth down to 1 percent (on an annual average basis) for calendar 2008. We fully expect to see at least one negative quarter in 2008. The longer financial conditions stay at current levels, the higher the odds of a more severe and elongated adjustment.

GLOBAL WATCH

We present a table of global data outturns over the past week given the significance of the international backdrop at present. The dataflow in Europe and Asia is still printing largely above expectations, though exports out of China were well shy of expectations. Employment growth in Australia remains strong, while consumer spending in the US contracted, another sign that the US economy may already be in recession.

Country/ Area	Indicator	Mkt	Actual	Last	Outturn vs market
US	Wholesale Inventories (Jan)	0.5%	0.8%	1.1%	Stronger
	Trade Balance (Jan)	-59.5B	-58.2B	-57.9B	Stronger
	Import Price Index (Feb) – mom	0.8%	0.2%	1.6%	Weaker
	Advance Retail Sales (Feb) - mom	0.2%	-0.6%	0.4%	Weaker
	Retail Sales ex-autos (Feb) - mom	0.2%	-0.2%	0.5%	Weaker
	Initial Jobless Claims (w/e Mar 9)	357k	353k	353k	Weaker
	Continuing Claims (w/e Mar 2)	2835k	2835k	2828k	In-line
	CPI (Feb) - mom	0.3%	0.0%	0.4%	Weaker
	CPI ex food and energy (Feb) - mom	0.2%	0.0%	0.3%	Weaker
	U of Michigan Confidence (Mar P)	69.3	70.5	70.8	Stronger
	Europe	ZEW Economic Sentiment (Mar)	-42.0	-35.0	-41.4
Eurozone Industrial Prod (Jan) - mom		0.4%	0.9%	0.0%	Stronger
Eurozone Labour Costs (Q4) - yoy		2.6%	2.7%	2.5%	Stronger
Eurozone CPI (Feb) - mom		0.3%	0.3%	-0.4%	In-line
Eurozone core-CPI (Feb) - yoy		1.7%	1.8%	1.7%	Stronger
UK	PPI Input (Feb)	1.6%	1.7%	2.6%	Stronger
	Industrial Production (Jan)	0.1%	-0.1%	0.0%	Weaker
	Manufacturing Production (Jan)	0.1%	0.4%	-0.2%	Stronger
	RICS House Price Balance (Feb)	-54.7%	-64.1%	-54.8%	Weaker
	DCLG UK House Prices (Jan)	7.5%	8.0%	8.4%	Stronger
	Total Trade Balance (Jan)	-4600m	-4102m	-4094m	Stronger
Asia Ex-Japan					
<i>China</i>	Exports (Feb) - yoy	19.2%	6.5%	26.6%	Weaker
	CPI (Feb) - yoy	7.9%	8.7%	7.1%	Stronger
	Retail Sales (Feb) - yoy	19.0%	20.2%	16.8%	Stronger
	Industrial Production (Feb) - yoy	16.9%	15.4%	18.5%	Weaker
<i>Singapore</i>	Industrial Production (Jan) - mom	1.7%	9.9%	-2.7%	Stronger
	Retail Sales (Jan) - yoy	5.1%	7.8%	2.5%	Stronger
<i>Philippines</i>	Exports (Jan P) - yoy	7.0%	6.4%	21.4%	Weaker
<i>South Korea</i>	Unemployment Rate (Feb)	-	3.0%	3.0%	-
<i>India</i>	Industrial Production (Jan) - yoy	8.0%	5.3%	7.7%	Weaker
	Japan				
Japan	Machine Orders (Jan) - mom	2.6%	19.6%	-3.2%	Stronger
	M2+CD Money Supply (Feb) - yoy	2.1%	2.3%	2.1%	Stronger
	GDP (Q4 F) - qoq	0.6%	0.9%	0.9%	Stronger
	Domestic CGPI (Feb) - mom	0.3%	0.4%	0.2%	Stronger
	Total Current Account (Jan)	1249.0B	1235.8B	1697.2B	In-line
	Consumer Confidence	37.7	36.4	37.9	Weaker
Australia	Employment Change (Feb)	15.0k	36.7k	21.4k	Stronger
	Unemployment Rate (Feb)	4.2%	4.0%	4.1%	Stronger

INTEREST RATE STRATEGY

Lack of domestic data means the local rates market is at the mercy of offshore developments. Volatility expected as global credit crisis deepens. Receivers to have the upper hand.

Market themes...

- > "R" word now being used for NZ economy.
- > Data playing second fiddle to credit developments.
- > US markets now primed for 75bp cut from Fed.

Review and outlook...

With rate hikes now seemingly off the table, the focus in the NZ rates market is on the start of the inevitable easing cycle. The RBNZ has indicated that the OCR will remain where it is for a significant time. Clearly, inflation remains a concern, which food price data for February and another rise in petrol prices to an all time high reinforcing this concern. Yet, February's housing market data showing falling house prices for the third month in a row, falling house sales and a jump in the number of days to sell a house, also reinforce the downside growth risks ahead. January retail sales were soft when excluding core staples such as groceries and fuel. Consumer confidence has taken another step lower. With the housing market heading south and annual house price inflation set to record a fall next month, we expect consumers to pare back on discretionary spending as the wealth effect turns negative.

The market will start to be more attuned to the dataflow over the coming months. One forecaster has recession as their core view now. Q1 GDP data due at the end of the month will likely show a robust end to 2007 economic activity, but the market's focus will increasingly be on the forward looking indicators for signs of whether the downside growth risks that the RBNZ highlighted in their Monetary Policy Statement is evolving. Our expectation is that the economic data relating to Q1 will turn consistently soft. But the market may not be prepared to rally just yet as Q1 inflation numbers look to be slightly higher than the RBNZ's latest projections, judging by recent rises in food and petrol prices.

Nonetheless, current OIS pricing has no further chance of a hike priced in, with a full rate cut by September, which is where we have penciled in the start of the easing cycle. Receiving interest is growing but the carry cost from a high 90-day bank bill rate due to the cash squeeze is limiting any moves lower in swap yields. The strategy therefore remains one of trading the ranges with the 2-year swap yield to stay within a 8.25 to 8.45 percent range.

With the global focus still very much on the credit crisis, we expect this theme to dominate in the week ahead. Markets are now expecting the Fed to cut rates by 75bp this week, and continue to take the Fed funds rate down to 1.5 percent. Restoring some confidence back into markets will take some doing

following the Bear Stearns bailout, and even a buyout by JPM Chase may not be enough.

Gauges for NZ interest rates yields		
Gauge	Direction	Comment
RBNZ	↔	Lack of inflation headroom means their hands are tied.
NZ data	↔/↓	ECT and migration data this week to reinforce softening NZ dataflow.
Fed Funds/front end	↓	75bp cuts now expected by the markets at this week's FOMC meeting.
RBA	↔/↑	RBA Governor sees inflation going to 4 percent. Risk of hike still on the table.
US 10 year	↓	Bond yields still going lower on flight-to-safety flows.
NZ swap curve	↔	Expected to flatten as local accounts look to extend duration through 7 and 10-years.
Flow	↔	Participants to stay on the sidelines. Flows will dominate.
Technicals	↔	How the global credit crisis unfolds will determine the next technical move.

Borrowing strategies we favour at present

Our strategy remains unchanged. Pay the 2-year and shorten duration. If weaker NZ economic data intensifies, the mid-points of the curve should outperform as investors look to obtain duration that covers multiple potential rate cuts. Our preference remains to keep borrowing short, no longer than two years.

Probability of 25bps increase as implied by market pricing

OCR dates	Last week	This week
Thu 24-Apr-08	-2	-7
Thu 5-Jun-08	-6	-23
Thu 24-Jul-08	-38	-47
Thu 11-Sep-08	-90	-107
Thu 23-Oct-08	-90	-107
Thu 4-Dec-08	-166	-183
Thu 15-Jan-09	-166	-183

Trading themes we favour at present

We favour receiving in the 3-5 year part of the curve as the 2-year is expensive given the carry cost from the elevated 90-day rate.

CURRENCY STRATEGY

The USD continues to be pummelled. Given widespread expectations of more aggressive cuts from the Fed and likely close attention being paid to earnings figures of financials, the greenback remains vulnerable. Stepping back, "surplus" nation currencies are being supported, while "deficit" nations struggle and remain volatile. We expect this to continue.

Market themes...

- > USD unloved.
- > Commodities continue to surge.
- > USD/JPY sub 100 and EUR/USD +1.56.

Review and outlook...

We had it all over the past week. Co-ordinated funding injections across an array of central banks, more concern towards "financials" in the US, roaring movements up in commodity prices, dollar-yen through 100, and euro-dollar through 1.56. Out of it all we know that perception towards the USD remains perilous and the NZD is vulnerable to wide springs, trading broadly in line with movements in the S&P VIX.

For now, equities remain the global risk barometer and the coming week will see considerable attention focused on earnings reports from numerous financials.

Looking at the USD, we need to see a deterioration in the tenor of Eurozone data for sentiment towards the USD to firm and stabilise. Movements across commodity markets also continue to confuse in the current environment. While speculative behaviour and a weak USD are pushing commodities higher, the Baltic Dry Freight Index has risen by 5 percent so far in March after dropping 26 percent in February, although it did track down last week (refer bottom of page 14). Bottom line is that the demand picture is holding up, but signals are still mixed. The decoupling/recoupling debate needs to swing from the former to the latter before the NZD will lose ground in a sustainable fashion. Commodities in general and the EUR/USD remain two bellwethers we continue to watch.

We noted last week that current account deficits were implicitly back on the radar. The week was notable for the relative strength being shown across surplus countries vis-à-vis deficit nations, with the NZD underperforming on the TWI basis and notable weakest against the Euro and Yen. We expect such an undertone to remain. Bottom line is that deficit nations are likely to be prone to a massive deterioration in growth sentiment as higher international borrowing costs and wider credit spreads filter through to debt laden pockets of the economy. NZ looks particularly vulnerable in this regard. Given the massive change in economic momentum we are seeing at present, the NZD may well be primed for another move down the elevator in Q2, in a similar fashion to Q1 2006.

NZD volatility has increased. Often a whippy intraday market, particularly in a defined range, can signal a trend change. We are now monitoring 0.7880 and 0.8215 levels for break outs to result in a fast 350 point moves in either direction. NZDJPY cross major support at 79.80/80.00 is significant and break would suggest a down tread has begun.

NZD vs AUD: monthly directional gauges		
Gauge	Direction	Comment
Fair value	↓	Growth differentials favouring AUD.
Yield	↓	Yield spreads narrowing
Commodities	↔	Commodities looking topy all round. Who does it affect more?
Partial indicators	↔/↓	Better across the Tasman but weakening there as well for now.
Technicals	↔	0.8500-.8750 range
Sentiment	↓	Kiwi should be more disliked in this environment.
Other	↓	All eyes on commodities and equities.
On balance	↓	AUD lost its shine but still brighter than Kiwi.

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. Current account becoming an issue.
Yield	↑	Yield differentials still at phenomenal levels.
Commodities	↓	One to watch this week as meltdown could occur here.
Risk aversion	↓	Increasing.
Partial indicators	↑	NZ domestic economy is soft, but US is dire.
Technicals	↔	0.7880/0.8215 range
AUD	↑	AUD looks better than USD.
Sentiment	↔/↓	Global players taking their toys home.
Other	↔/↑	USD disliked.
On balance	↔/↓	USD story but risk aversion rising. NZD looking more vulnerable each week.

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
17 Mar	JN	Tertiary Industry Index (Jan) - mom	0.7%	-0.6%	12:50
		Leading Economic Index (Jan F)	-	30.0%	18:00
		Coincident Index (Jan F)	-	22.2%	18:00
	EC	Eurozone Employment (Q4) - qoq	-	0.3%	23:00
18 Mar	US	Current Account (Q4)	-183.8B	-178.5B	01:30
		Empire Manufacturing (Mar)	-7.4	-11.7	01:30
		Net Long-term TIC Flows (Jan)	60.0B	56.5B	02:00
		Total Net TIC Flows (Jan)	85.0B	60.4B	02:00
		Industrial Production (Feb)	-0.1%	0.1%	02:15
		Capacity Utilisation (Feb)	81.2%	81.5%	02:15
		NAHB Housing Market Index (Mar)	20	20	06:00
	AU	RBA Board Minutes published	-	-	13:30
	JN	Tokyo Department Store Sales (Feb) – yoy	-	-1.6%	18:30
		Nationwide Department Store Sales (Feb) – yoy	-	-2.1%	18:30
	UK	CPI (Feb) – mom	0.8%	-0.7%	22:30
		CPI (Feb) – yoy	2.5%	2.2%	22:30
		Core CPI (Feb) – yoy	1.4%	1.3%	22:30
		Retail Price Index (Feb) - mom	0.8%	-0.5%	22:30
		Retail Price Index ex mort payments (Feb) - yoy	3.7%	3.4%	22:30
19 Mar	US	PPI ex-food and energy (Feb) - mom	0.2%	0.4%	01:30
		PPI (Feb) - mom	0.3%	1.0%	01:30
		Housing Starts (Feb)	995K	1012K	01:30
		Building Permits (Feb)	1,020K	1,061K	01:30
		FOMC Rate Decision	2.50%	3.00%	07:15
	AU	Dwelling Starts (Q4)	-	1.3%	13:30
		Imports (Feb) - mom	-	6.0%	13:30
	UK	BoE Minutes released	-	-	22:30
		Average Earnings incl bonus (Jan) - yoy	3.8%	3.8%	22:30
		Unemployment Rate (Jan)	5.2%	5.2%	22:30
		Manufacturing Unit Wage Cost (Jan) - yoy	-	1.4%	22:30
	EU	Eurozone Trade Balance (Jan)	-0.4B	-2.1B	23:00
20 Mar	GE	Producer Prices (Feb) - mom	0.3%	0.8%	20:00
		PMI Manufacturing (Mar A)	54.0	54.3	22:00
		PMI Services (Mar A)	51.8	52.2	22:00
	EU	PMI Manufacturing (Mar A)	52.0	52.3	22:00
		PMI Services (Mar A)	52.0	52.3	22:00
		PMI Composite (Mar A)	52.4	52.8	22:00
	UK	Retail Sales (Feb) - mom	-0.2%	0.8%	22:30

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
20 Mar cont		M4 Money Supply (Feb P) - mom	0.9%	1.4%	22:30
21 Mar	US	Jobless Claims (w/e Mar 16)	360K	353K	01:30
		Continuing Claims (w/e Mar 9)	2837K	2835K	01:30
		Philadelphia Fed (Mar)	-18.0	-24.0	03:00
		Leading Indicators (Feb)	-0.3%	-0.1%	03:00
24 Mar	JN	BSI Large All Industry (Q1) - qoq	-	0.5	12:50
		BSI Large Manufacturing (Q1) - qoq	-	5.2	12:50
	UK	Rightmove House Prices (Mar) - mom	-	3.2%	13:01

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: While Q4 GDP is looking robust, we will get further data relating to Q1 activity, which are expected to show a sharp moderation in domestic demand – particularly those related to housing. The NBBO survey at the end of the month will provide a crucial read on whether the fall in confidence over February was sustained.

Date	Data/Event	Economic Signal	Comment
Wed 19 Mar (10.45)	Electronic Card Transactions (Feb)	Still flat?	Electronic card transaction data starting to provide a good lead for retail sales. Following a soft January, particularly for core retail related transactions, some recovery could be expected although overall story one of softness. Food and petrol prices to inflate the overall number.
Thu 20 Mar (10.45)	External Migration (Feb)	Flat	There is now a real risk of a net outflow of migrants. Arrivals drifting slightly lower but departures increasing at faster rate, mainly to Australia.
Tue 25 Mar (15.00)	Credit card billings (Feb)	Still flat?	Likely to show retail sales still largely flatlining.
Wed 26 Mar (01.00)	Westpac McDermott Miller consumer confidence (Q1)	Easing	Confidence to head lower given the headwinds households are facing in the form of higher food and petrol prices, and higher debt servicing costs.
Thu 27 Mar (10.45)	Balance of Payments (Q4)	Improving but still imbalanced	Dairy price effect and Tui oilfield to provide an improvement to the current account, but the level of the deficit still high and the economy still reliant on offshore capital.
	Trade Balance (Feb)	On the improve	Dry conditions to have some impact on primary exports, but flatlining retail sector should see consumer goods import growth slow.
Fri 28 Mar (10.45)	Gross Domestic Product (Q4)	Strong end to 2007	Economic activity was robust at the end of last year, with exports leading the charge. But things looking very different early this year, with a step change lower in activity in Q1.
Fri 28 Mar (15.00)	Credit Growth (Feb)	Slowing	Housing lending to continue slowing, in line with the cooling housing market.
Mon 31 Mar (10.45)	Building Consents (Feb)	Falling trend	Consent issuance to continue trending lower, as it plays catch-up to falling house sales.
Mon 31 Mar (15.00)	National Bank <i>Business Outlook</i> (Mar)	-	-
Thu 3 Apr (15.00)	ANZ Commodity Price Index (Mar)	-	-
Tue 8 Apr (10.00)	NZIER QSBO (Q1)	Negative	Confidence expected to show a sharp drop, in line with the NBBO survey. Key to watch is whether indicators of resource pressure eased.
circa 11 Apr	REINZ housing report (Mar)	On the down	Further downward pressure on house prices, with the annual house price inflation rate expected to move into negative territory. House sales may show a slight rebound but days to sell to head higher.
Mon 14 Apr (10.45)	Retail sales (Feb)	Ongoing softness	Following fairly soft January retail sales, we expect the underlying trend to remain one of softness. Higher food and petrol prices to again inflate the headline number.
Tue 15 Apr (10.45)	CPI (Q1)	Too high for comfort	Higher food and petrol prices to see annual inflation remain above the RBNZ's target band. Key focus is on whether non-tradable inflation surprises on the downside again.
On Balance		Sub-trend growth	More partial data for Q1 to show soft activity, but inflation to remain problematic.

SUMMARY OF KEY ECONOMIC FORECASTS

	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09
GDP (% qoq)	1.2	0.8	0.5	0.6	0.1	-0.1	0.2	0.2	0.4	0.5
GDP (% yoy)	2.4	3.2	3.3	3.2	2.0	1.1	0.8	0.4	0.7	1.3
CPI (% qoq)	0.5	1.0	0.5	1.2	0.8	0.8	0.9	0.8	0.5	0.7
CPI (% yoy)	2.5	2.0	1.8	3.2	3.5	3.2	3.6	3.2	2.9	2.8
Employment (% qoq)	1.2	0.6	-0.3	1.1	0.2	0.1	0.1	0.1	0.1	0.1
Employment (% yoy)	1.7	1.6	1.6	2.5	1.5	1.0	1.4	0.5	0.4	0.4
Unemployment Rate (% sa)	3.7	3.6	3.5	3.4	3.5	3.6	3.8	4.0	4.1	4.2
Current Account (% GDP)	-8.2	-8.1	-8.3	-8.0	-7.6	-7.0	-6.7	-6.8	-6.9	-6.9
Terms of Trade (% qoq)	1.5	0.4	3.7	2.9	1.1	-0.2	-1.2	-1.0	-0.8	-0.8
Terms of Trade (% yoy)	4.5	2.3	8.4	8.8	8.3	7.7	2.7	-1.3	-3.1	-3.6

KEY ECONOMIC INDICATORS

	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08
Retail Sales (% mom)	1.1	-0.4	0.2	0.2	1.1	-0.5	1.8	0.1	0.3	..
Retail Sales (% yoy)	6.7	4.8	5.7	6.3	4.1	5.8	7.2	5.4	6.3	..
Credit Card Billings (% mom)	1.1	1.7	0.1	0.9	2.0	-0.6	1.2	0.4	0.1	..
Credit Card Billings (% yoy)	5.9	8.9	7.9	8.6	9.4	7.7	9.5	7.6	8.6	..
Car Registrations (% mom)	6.0	-4.8	7.0	1.1	-6.6	5.7	-3.6	-2.6	5.4	-3.6
Car Registrations (% yoy)	-2.5	-1.5	7.0	10.9	0.1	4.7	2.3	1.4	1.7	1.9
Building Consents (% mom)	5.2	12.3	-15.9	4.7	-9.2	-5.4	1.2	-3.9	3.3	..
Building Consents (% yoy)	3.6	32.9	-4.5	-2.1	-15.2	-16.5	-4.3	-6.3	-4.5	..
REINZ House Price (% yoy)	14.8	12.1	10.4	12.9	12.3	8.0	6.7	4.5	4.0	..
Household Lending Growth (% mom)	1.0	1.2	0.8	0.9	0.8	0.8	0.8	0.7	0.7	..
Household Lending Growth (% yoy)	13.5	13.5	13.5	13.4	13.0	12.8	12.6	12.2	11.8	..
Roy Morgan Consumer Confidence	122.1	121.0	121.1	122.4	121.3	122.0	121.9	126.6	121.2	116.0
NBNZ Business Confidence	-48.3	-37.2	-38.5	-33.8	-26.5	-12.9	-19.6	-24.9	..	-43.9
NBNZ Own Activity Outlook	7.8	14.8	12.4	16.7	17.2	20.3	15.7	18.2	..	2.4
Trade Balance (\$m)	8	-518	-808	-947	-572	-774	-621	33	-320	..
Trade Balance (\$m annual)	-5900	-6226	-6340	-6336	-6282	-5883	-5685	-5306	-4801	..
ANZ World Commodity Price Index (% mom)	2.6	6.3	4.6	1.4	0.4	1.8	0.8	0.0	-1.4	0.9
ANZ World Commodity Price Index (% yoy)	21.1	29.8	35.1	36.3	35.7	37.8	35.9	30.9	27.4	26.7
Net Migration (sa)	420	600	470	730	670	250	470	10	60	..
Net Migration (annual)	10682	10078	8966	8730	8309	7517	6588	5491	4799	..

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)						
	Jan-08	Feb-08	17-Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
NZD/USD	0.772	0.797	0.812	0.780	0.740	0.690	0.660	0.640	0.630	0.620
NZD/AUD	0.876	0.873	0.868	0.830	0.804	0.767	0.759	0.762	0.778	0.795
NZD/EUR	0.524	0.540	0.518	0.506	0.490	0.469	0.465	0.464	0.474	0.488
NZD/JPY	83.2	85.5	80.3	79.6	74.0	70.4	69.3	69.1	69.3	70.1
NZD/GBP	0.392	0.406	0.403	0.390	0.379	0.359	0.349	0.344	0.342	0.341
NZ\$ TWI	71.2	73.0	71.8	69.6	66.6	63.0	61.6	60.9	61.2	61.7
NZ interest rates	Jan-08	Feb-08	17-Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
OCR	8.38	8.40	8.25	8.25	8.00	7.50	7.00	6.75	6.75	6.75
90 day bill	8.75	8.82	8.85	8.80	8.20	7.60	7.00	7.00	7.00	7.00
10 year bond	6.28	6.40	6.36	6.50	6.20	5.80	5.40	5.30	5.30	5.20
International	Jan-08	Feb-08	17-Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
US Fed funds	3.00	3.00	3.00	1.75	1.50	1.50	1.50	1.50	2.00	2.50
US 3-mth	3.11	3.06	2.76	2.00	1.75	1.75	1.75	2.00	2.50	3.00
AU cash	6.75	7.00	7.25	7.25	7.25	7.25	7.25	7.25	6.75	6.00
AU 3-mth	7.35	7.99	7.89	8.00	7.90	7.60	7.40	7.10	6.60	5.80

KEY RATES

	14 Feb	10 Mar	11 Mar	12 Mar	13 Mar	14 Mar
Official Cash Rate	8.25	8.25	8.25	8.25	8.25	8.25
90 day bank bill	8.81	8.91	8.92	8.89	8.92	8.92
NZGB 07/09	7.32	7.10	7.10	7.13	7.12	7.12
NZGB 11/11	7.05	6.75	6.75	6.78	6.78	6.78
NZGB 04/13	6.92	6.69	6.69	6.72	6.72	6.72
NZGB 12/17	6.40	6.30	6.33	6.36	6.36	6.36
2 year swap	8.55	8.40	8.42	8.39	8.36	8.35
5 year swap	8.11	8.03	8.07	8.05	8.02	8.02
RBNZ TWI	72.5	71.1	70.9	72.0	71.6	72.3
NZD/USD	0.7863	0.7947	0.7906	0.8032	0.8084	0.8168
NZD/AUD	0.8711	0.8541	0.8618	0.8635	0.8593	0.8646
NZD/JPY	85.02	81.30	80.44	82.79	81.17	82.18
NZD/GBP	0.4007	0.3936	0.3941	0.3997	0.3979	0.4021
NZD/EUR	0.5396	0.5165	0.5147	0.5231	0.5188	0.5234
AUD/USD	0.9027	0.9305	0.9174	0.9302	0.9408	0.9447
EUR/USD	1.4571	1.5387	1.5360	1.5355	1.5583	1.5605
USD/JPY	108.13	102.30	101.75	103.08	100.41	100.61
GBP/USD	1.9625	2.0188	2.0061	2.0094	2.0317	2.0312
Oil	93.28	105.12	107.90	108.73	109.86	110.03
Gold	905.90	975.00	972.10	974.90	984.90	993.20
Electricity (Haywards)	13.81	11.41	11.38	12.37	12.41	15.38
Milk futures (US\$/contract)	134	128	128	130	131	131
Baltic Dry Freight Index	7212	8624	8560	8346	8092	7972

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