

DOOR OPEN

CONTENTS

Page 2: Economic overview

- The Reserve Bank followed through on its word and delivered an interest rate hike last week after little evidence of a moderation in the housing market. We are still taking a one-and-done view. However, current market pricing appears to understate the risk of a further hike and rates remaining elevated.

Page 3: Economic comment – implications from the global market correction

- Volatility in global financial markets over the past two weeks should be seen as a healthy correction and a reappraisal of risk. The fundamental outlook for the global economy is largely unchanged, but the period of excessively low volatility is likely to have ended.

Page 5: Interest rate strategy

- With the market now tuned to the prospect of higher rates, we expect market pricing to gradually increase the odds of a follow-up hike and remove the end of year easings currently priced in.

Page 6: Interest rate comment – offshore holdings of NZ Government bonds

- The proportion of offshore NZGB holdings is expected to rise further given their yield and credit quality attractiveness. While this will provide some support for the NZD, it also points to a further drying up of liquidity. Continued demand for NZGBs also suggests swap spreads could widen further in the near-term.

Page 9: Currency strategy

- Carry is back in vogue although NZD support looks to reflect JPY weakness. While we believe there is limited appetite to push the NZD up too far, the story looks to be one of slow grinds higher until we see something from offshore.

Page 10: Currency comment – commodity prices – tribulations and agitations

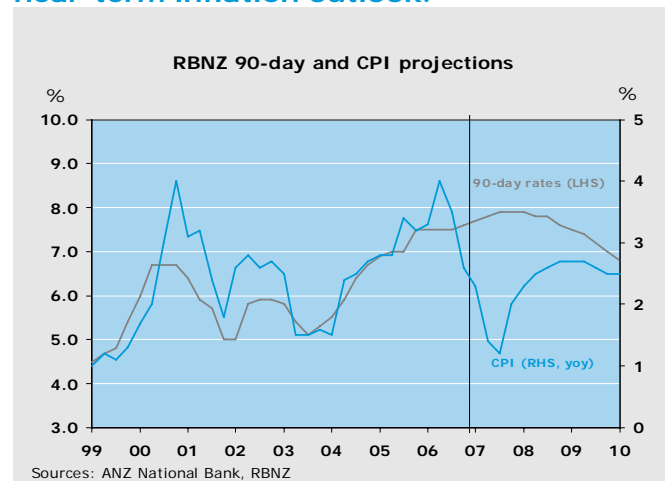
- Strength in commodity prices underpin fair value estimates for the NZD/USD around 0.63-0.65. Moreover, they imply any global induced weakness in the NZD will not be sustained, and the potential for the tradable sector to reflate may prove problematic for the Reserve Bank.

Page 11: Data timetable

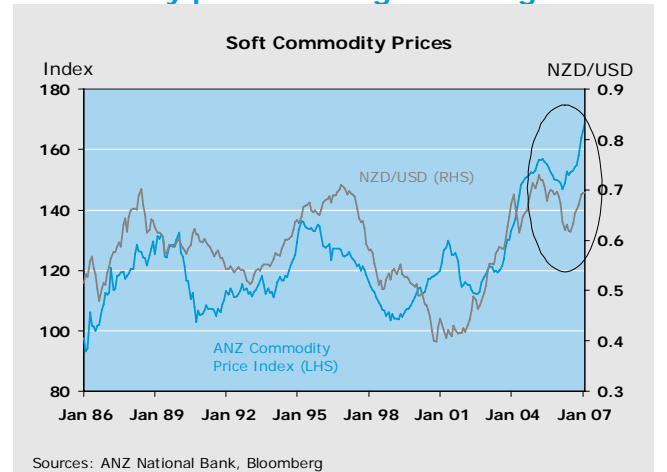
Page 13: Data watch

Page 14: Key forecasts

The Reserve Bank's 90-day projections include a follow up hike, despite a positive near-term inflation outlook.



Commodity prices hitting new heights.



ECONOMIC OVERVIEW

The Reserve Bank followed through on its word and delivered an interest rate hike last week after little evidence of a moderation in the housing market. We are still taking a one-and-done view. However, current market pricing appears to understate the risk of a further hike and rates remaining elevated.

What's ahead...

- NZ January Retail Sales (due Tuesday 1045 NZDT) is expected to show a modest increase in retail spending, with higher food prices inflating the food related spending numbers.
- NZ Q4 Manufacturing Survey (Wednesday 1045 NZDT) is expected to show subdued sales but a strong rebound in production.
- NZ Feb REINZ Housing Data (circa 15 March) should show activity remaining elevated.

What's the view

The Reserve Bank lifted the OCR by 25 basis points to 7.50 percent last week, as widely expected. In a sense, the Bank was forced to act after the ultimatum they delivered in January, where they warned that *"In the absence of clear indications of a moderation in housing and domestic demand, it is likely that further policy tightening will be required."* The Bank would have lacked credibility had they failed to deliver a hike given that the housing market has shown no evidence of this "moderation" and their 90-day projections have been revised up three times.

The Bank continues to see plenty of pressures on medium-term inflation, particularly from the robust housing market and the risk of further fiscal stimulus in 2008. Despite a benign near-term inflation profile, medium-term inflation is expected to remain high and elevated well into 2009 and early 2010. Last week's hike is seen as a pre-emptive move to reduce the risk of a rebound in growth, which the Bank views as unsustainable. While they see risks that the recent pick-up in economic activity could prove temporary, their judgement is that the lift in growth will be more enduring and they have therefore acted to quell it before it begins to impact further on inflation.

The Reserve Bank remains on a tightening bias with the door to a further hike open. You can't go past their 90-day rate projections, which explicitly included a follow-up hike and rates remaining elevated for some time. The market appears to be slowly absorbing this – once they looked beyond the references to supplementary instruments to slow the housing market – and has started to re-price the probability of a further hike, after this was effectively priced out after the *Statement*.

We are a little puzzled by the inclusion of references to supplementary instruments, which

appears to signal a reluctance to raise rates further. However, given there is limited potential for such mechanisms to be in place over coming months, we doubt they will heavily influence deliberations.

Looking at the broader growth picture – which requires a moderation – there are four avenues through which this could be achieved: interest rates, the currency, the global economy or credit. Of course all are inter-locked to some degree, and notably through how they influence wealth. The Governor looks wary of placing collateral damage on the business sector by raising rates aggressively, and equally wary of how close to a tipping point the housing market could be. The currency would need to rise more than 5 percent from this juncture to have any bite given where commodity prices reside. Wariness towards the carry trade is providing a cap. The global economy looks solid, with the US unemployment rate remaining low. This leaves credit, and its ample availability, as the available avenue that must give, and perhaps this was the message the Governor was implicitly alluding to.

Looking forward, we are still taking a one-and-done view. Each marginal push up in rates from this juncture carries a non-trivial risk of hitting that inflection point for the housing market. The step-back to December style language suggests the Governor does not want to be backed into a corner like January. However, we nonetheless have to recognise the risk profile for rates and we are not seeing anything than foretells of a housing shake-up – yet. Looking at the current market pricing, it seems to understate the risk profile for a follow-up hike, and is too early looking for an easing. There is only a 1/3 probability priced in for a hike by June and then easings beginning to be priced in by the end of the year. Although we see it as a big hurdle, further hikes are still a strong possibility and rates will at least stay elevated for some time. Given the importance the RBNZ is ascribing fiscal policy, it is difficult to imagine rates being cut until we are past the 2008 *Budget*.

Data last week...

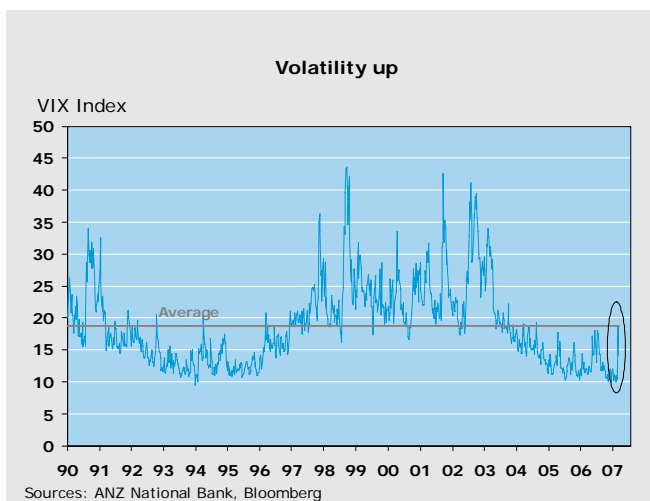
- **RBNZ March MPS.** The Reserve Bank hiked interest rates by 25bps to 7.50 percent as expected and, although the door was left open for further rate hikes, the statement was less hawkish than expected.
- **NZ Q4 Wholesale Trade.** Sales fell by 0.5 percent, while stocks rose by 0.6 percent.
- **ANZ Commodity Price Index (Feb).** World commodity prices rose by 1.6 percent. The NZD index rose by 1.9 percent.
- **NZ Q4 Overseas Trade Indices.** The terms of trade rose by 2.4 percent.
- **NZ Q4 Value of Building Work Put in Place.** Total real construction activity increased by 2.2 percent.
- **Global rate announcements.** The BoC, RBA and BoE all left their official interest rates unchanged, while the ECB increased rates.

IMPLICATIONS FROM THE GLOBAL MARKET CORRECTION

Volatility in global financial markets over the past two weeks should be seen as a healthy correction and a reappraisal of risk. The fundamental outlook for the global economy is largely unchanged, but the period of excessively low volatility is likely to have ended.

The global financial market volatility of the past two weeks has been the main focus in the business world. There is no agreement on the root cause of the global correction, although concerns have been mounting in the wake of the deterioration in the US sub-prime mortgage market and increased tensions with Iran. Weak US durable goods orders and the former Fed Chairman Alan Greenspan talking about a 'possible' recession by the end of the year only added to those concerns. The announcement by the Chinese authorities that they intend to clamp down on illegal securities operations and possibly introduce a capital gains tax on shares, which triggered a near 9 percent fall in the Shanghai A share index, was likely the straw that broke the camel's back. The fall in the Chinese equity market quickly spread to equity markets around the world and spilled over to other asset classes including bonds, currencies and commodities. From that point on, psychology, inertia and outright fear had a major say.

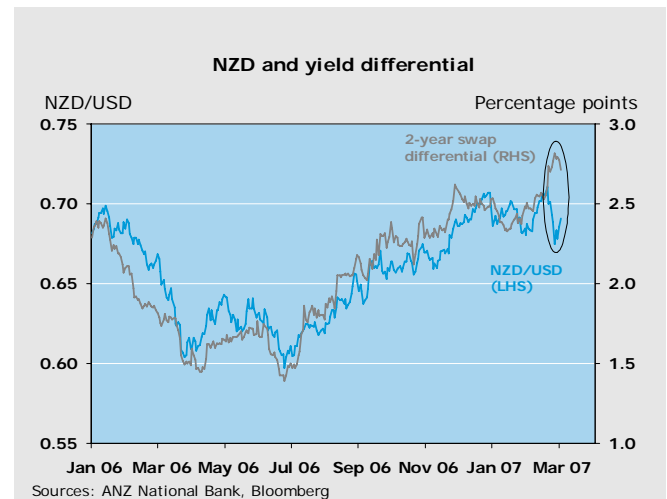
The initial reaction was a short-term wash-out of leveraged trading positions, including across currency carry-trades, interest rates, commodities and equities; and a rise in volatility.



In so far as the carry trade is concerned, the global market correction had little to do with the liability side of these speculative trades. Japanese and Swiss interest rates remain low and there is no evidence of a shift in investors' access to credit. The de-risking evident in global markets largely reflects a sudden shift in risk appetites and not a disruption to funding arrangements. The process

stabilises when asset prices become cheap enough to entice buyers back into the market, and there are signs that this has already started to occur with equity markets stabilising towards the end of last week.

For New Zealand, apart from the spillover into the NZD and equity market, there has been no sign of the market correction filtering through into soft commodity prices – the typical transmission mechanism from global unease. The RBNZ has welcomed the unwinding of the carry trade and increased risk aversion which has seen a decoupling of the NZD and yield differential, at least for the time being.



Moreover, when we step back and look at global economic conditions:

- Liquidity remains ample courtesy of low global interest rates.
- We continue to see robust growth across the G3, China, the Middle East and emerging markets.
- Fundamentals across emerging markets, including fiscal position and inflation, are far stronger relative to history and previous periods of dislocation.
- There is no evidence of a global financial contagion occurring. Specifically, there does not appear to have been large scale selling down of positions in 'healthy' markets to cover losses in expensive assets.

As such we do not believe that the correction will have a major negative impact on the real economy. While market volatility can expose weaknesses in the global financial system, we have little evidence of current volatility turning into a systemic global issue.

However, the one risk resides in the US sub-prime mortgage market. While this has been a growing part of the US mortgage market, it still remains less than 20 percent of total mortgages. The real

contagion here would be if financial institutions that incur losses in this sector are forced to alter behaviour in other 'healthy' markets, most importantly, the prime mortgage market. At this stage, the prime mortgage market looks to be in good order. Strong macroeconomic fundamentals are underpinning household credit more broadly despite a softening in US growth momentum in the past year. Low unemployment, stable and low interest rates, and continued access to credit have been a feature of economies that have successfully weathered the end of housing booms in recent years.

To date, we have seen limited evidence of changes in lending criteria or pricing in the prime market, or credit and swap spreads. While there has been some tightening in the latest Fed Loan Officers Survey over the past six months, this has been modest to date.

We note the strong corollary between recent action in the US sub-prime mortgage market currently and the stresses in the New Zealand finance company sector in mid-2006. The latter was generally confined to a narrow sector of the economy (motor vehicle retailing), was heavily localised, contained a strong microeconomic flavour and failed to extend into a more systemic issue.

If there is a wider theme to be mindful of around the globe – and particularly with risk appetites remaining strong, volatility is still historically low, and asset values elevated – it is a deteriorating path for productivity and rising unit labour costs. Unemployment rates across the Anglo-Saxon economies continue to ease or remain historically low (US, Canada, Australia, NZ). Productivity in each has more than halved, and unit labour costs are above 3 percent. As an indicator of pending profitability trends, the health of the cycle and the degree to which growth can remain strong without generating inflation, the messages are disconcerting.

Financial Market Implications

While the global market correction is unlikely to have a lasting negative impact on the global economy, it may signal the end of the low volatility environment we have been living in for the last three years. This transition to a more normal (though not high) volatility world where markets can and do move around in different directions may cause a modest widening of credit spreads and greater headwinds for equity markets, but it does not in itself signal a substantial shift in underlying macroeconomic conditions. At the margin, it does represent a modest tightening of financial conditions, but not sufficient to alter the policy or economic outlook.

For central banks this recent bout of market volatility, if contained, will be a welcome wake-up call for financial market participants, particularly speculators placing large positions on carry trades

in rates and currency markets. Hence, while central banks around the world will be keeping a watchful eye, they will largely look through the recent volatility in their policy assessments.

INTEREST RATE STRATEGY

With the market now tuned to the prospect of higher rates, we expect market pricing to gradually increase the odds of a follow-up hike and remove the end of year easings currently priced in.

Market themes...

- Payside pressure to continue with curves to normalise.
- Data and mortgage book paying to dominate.
- US sub-prime mortgage jitters to weigh on the long end.

Outlook...

After having sifted through and digested the Reserve Bank's confusing policy assessment delivered at last week's *Monetary Policy Statement*, the market has now come to terms with the Bank's main intended message: further hikes may be necessary if the housing market and domestic demand does not moderate. The post-MPS rally has now been almost completely pared back, with the market now pricing in a 20 percent chance of an April hike and a 36 percent chance of a June hike. Our core economic view is that the March hike is the last one, though if the economy continues to gain momentum then a hike in June is more likely. But given the Bank's concern over medium-term inflation risks, any easing is a long way off. We expect market pricing to increase the odds of a follow-up hike and push back the expected easings, which are currently priced for the end of the year.

With the dust now settled and the Reserve Bank's message taken on board by the market, it is a case of watching the dataflow. This week's retail sales and housing market data will help set the tone and direction. Retail sales data have been mixed to date, and we expect a modest increase in January, but certainly not an acceleration in growth that will worry the Bank. The housing market is the dominant concern, and February's housing market data expected at the end of this week is unlikely to show any signs of a moderating trend yet. But with the swaps yield curve holding up and fixed mortgages mostly above 8 percent, the housing market will eventually feel the effect.

Volatility in US Treasuries looks set to continue, and will dominate the long end of the local market. Flight-to-safety flows saw yields on US Treasuries fall over the past two weeks, but an easing of those flows as stability returned to global markets and stronger than expected US employment data has seen yields partially recover. However, concerns over the US sub-prime mortgage market will continue to weigh and hold US treasury yields down.

Gauges for NZ interest rates yields		
Gauge	Direction	Comment
RBNZ	↔/↑	March delivered. Case of wait and see for follow-up.
NZ data	↔	Retail sales and housing market data to gauge extent of domestic demand in Q1.
Fed Funds/front end	↓	Market still expecting mid-year cuts from the Fed.
RBA	↔/↑	RBA on hold but risk profile firmly pointed up.
US 10 year	↔/↓	Safe haven flows dried up but US sub-prime concerns remain.
NZ swap spreads	↔	Mortgage and corporate flows should see EFP's test wider
Flow	↔	Recent data and moves offshore favour the pay side.
Technicals	↔	NZ IRS markets have decoupled from global markets. NZD key.

Borrowing strategies we recommend at present

With global financial markets volatility diminishing, US Treasury Yields bouncing off the bottom of their recent range and the RBNZ delivering the anticipated 25 basis point hike in the OCR to 7.50% on Thursday, pressure remains firmly to the upside for the yield curve. Client's should look to utilise the inverted New Zealand yield curve between 3-5 years to deliver some savings over floating rates while protect themselves against the possibility of the New Zealand economy continuing to surprise in staying stronger for longer than was initially anticipated. Extendable swaps that take a view on the market can offer client's a pickup on ordinary swap pricing over the next couple of years.

Probability of 25bps increase as implied by market pricing

OCR dates	Last week	This week
Thu 26-Apr-07	28	20
Thu 7-Jun-07	36	36
Thu 26-Jul-07	36	36
Thu 13-Sep-07	28	44
Thu 25-Oct-07	28	32
Thu 6-Dec-07	20	20
Thu 24-Jan-08	20	8

Trading themes we favour at present

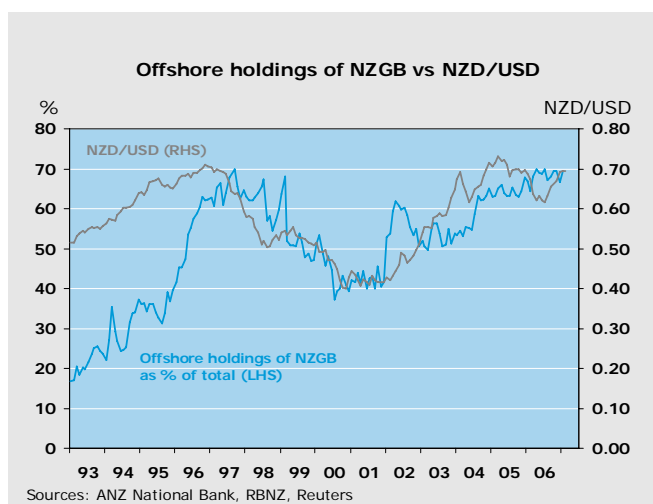
We favour receiving short dated NZ IRS vs AU IRS as 1-year spreads are too wide. On the bill curve we favour buying Jun 07's vs Dec 07.

OFFSHORE HOLDINGS OF NZ GOVERNMENT BONDS

The proportion of offshore NZGB holdings is expected to rise further, in line with growth in Asian and other central bank reserves, and given their yield and credit quality attractiveness. While this will provide some support for the NZD, limited supply and the long-term hold strategies of Asian central banks point to a further drying up of liquidity. Continued demand for NZGBs also suggests swap spreads could widen further in the near-term.

Offshore holdings of New Zealand Government Bonds (NZGB) currently stand at 69.1 percent, not far off the 70 percent high reached in September 1997. The fall in offshore interest in NZGBs over 1998 to 2000 was due to NZD denominated assets falling out of favour as the economy went into recession and the sovereign credit rating was downgraded. Offshore interest in NZGBs re-emerged after 2001, helped by a credit upgrade, the start of a period of strong growth performance and higher relative interest rates.

The proportion of offshore holdings has stabilised around current levels over the past year. Since the mid-1990s there has been a reasonable relationship between offshore holdings of NZGB and the NZD/USD (correlation of 0.75). This is not surprising given that foreign buyers of NZGB need to acquire NZD.



Part of the rise in the proportion of offshore NZGB holdings in the past few years can be attributed to the growing role of Asian central banks. In the aftermath of the 1997 Asian Crisis, Asian economies have been keeping their currencies low to run an export orientated strategy as a way to recover, racking up trade surpluses along the way. This resulted in their respective central banks accumulating FX reserves. Though not affected by the Asian Crisis, China has emerged as a major economic force, with its comparative advantage in

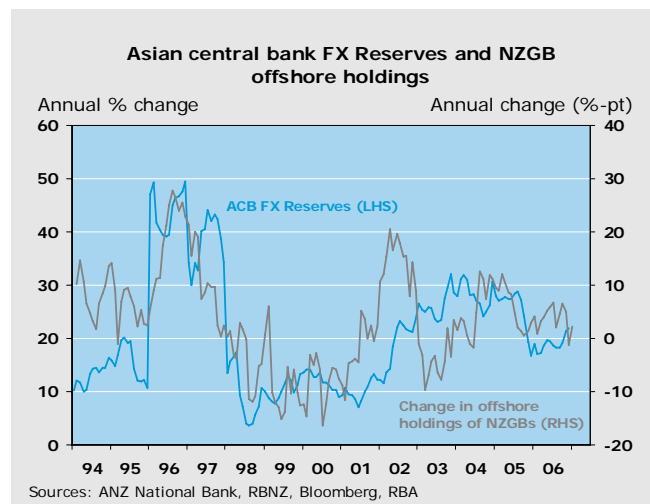
manufacturing, and has accumulated FX reserves totalling over US\$1 trillion.

Most of the Asian central bank reserves have been used to purchase USD denominated assets, largely US Treasuries (which has helped to push yields down). However, many Asian central banks have started to diversify their reserve holdings away from USD in recent years into other asset classes and currencies, including the NZD.

The attraction of NZGBs to Asian central banks is easy to understand:

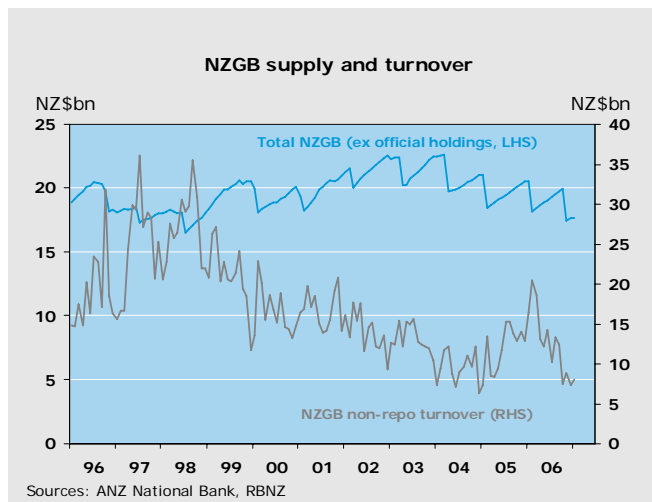
- Good credit rating, with AA+ (stable outlook) from S&P and Aaa from Moodys.
- Attractive yield differential compared to other similarly rated Sovereigns.
- Currency gains over the past few years.

Given New Zealand's strong fiscal position, good macroeconomic framework and a history of consistently running surpluses, New Zealand's sovereign credit rating will remain sound and is under no threat. Interest rates are set to remain at current high levels for some time, given the Reserve Bank's concern over medium-term inflation pressure. While the currency gains of the past are unlikely to be repeated, the yield and credit rating attractiveness will underpin demand. Offshore holders were not fazed by previous sharp declines in the NZD in 2004 and 2006 (when the NZD fell 10 cents against the USD), and we are unlikely to see offshore NZGB liquidation if the currency were to turn again – so long as interest rates do not move aggressively down.

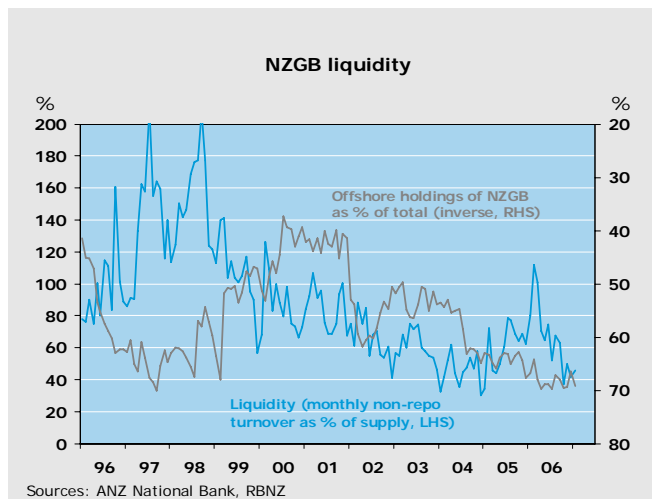


The yield and credit quality attractiveness is probably what prompted the Bank of Russia to look at diversifying its FX reserve (US\$300 billion) portfolio to include the NZD as well. Given the relatively small amount of NZGB supply, it does not take much of a shift in the Asian central banks' portfolio allocation towards NZD to see an upward shift in the proportion of offshore holdings.¹

¹ The total NZGB supply excluding official holdings is NZ\$17.65 billion. The estimated Asian central bank FX reserves total over NZ\$3 trillion.

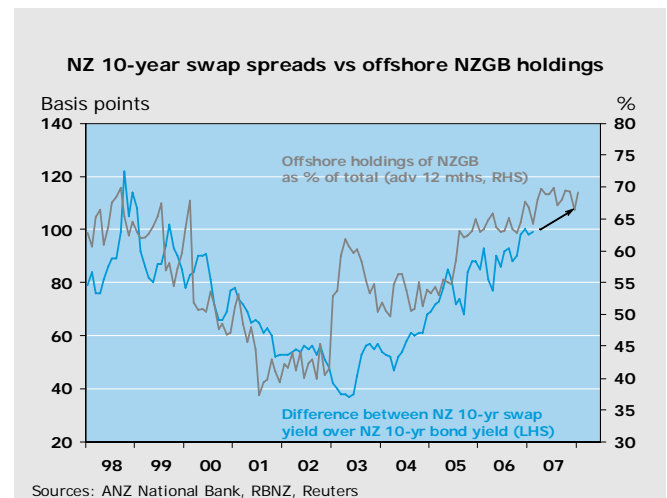


A higher proportion of Asian central bank holding (or any other offshore official holding) of NZGBs has important implications for liquidity in the local bond market. Unlike real money managers or hedge funds, Asian central banks tend to be “buy and hold” investors – they hold bonds until maturity, rather than actively trading them in the secondary market. Furthermore, they rarely allow their holdings to be used for repurchase agreements because their mandates typically do not allow for it. This explains the decline in NZGB turnover (excluding repo), which has been compounded by falling NZGB supply due to the NZ Government running strong surpluses and paying down debt.



The lack of liquidity in the NZGB market is a major issue. While this has recently been mitigated somewhat by the Reserve Bank reducing the need for banks to hold NZGBs as collateral in the inter-bank payment system and the introduction of a bond lending facility, these measures have not so far been sufficient to significantly improve liquidity in the local bond market. As a result, NZGBs have lost their appeal as a benchmark yield, with swaps yields starting to be used in their place. This has seen domestic funds allocating their portfolios away from NZGBs into swaps and corporate bonds, further affecting liquidity.

Demand for NZGBs also has an impact on swap spreads, which tend to be flow (as opposed to fundamentals_ driven in New Zealand. While mortgage bank hedging (close to 85 percent of the mortgage market is fixed) has been an important flow driver of swap spreads to date, the significant Uridashi and Eurokiwi maturity profile in the second half of this year is likely to have a more significant influence in the swap market than mortgage hedging. Whether spreads narrow or widen over the medium-term will depend on which flow dominates. If NZGB investors can find a suitable alternative, swap spreads could narrow significantly. But the continued demand for NZGBs from offshore suggests that swap spreads will continue to widen or at least remain sticky over this year as demand continues to outweigh supply.



Financial Market Implications

The implications we take from our analysis are:

- **Further modest rises in the proportion of NZGBs held offshore is expected.** Continued growth in Asian central bank reserves, portfolio diversification strategies by other central banks such as Russia's, and the attractiveness of NZGBs mean there will be continued offshore interest. In addition, there is also a large potential pool of reserves run by oil exporting economies that could find their way into NZGBs.
- **Continued offshore demand for NZGBs will provide some support for the NZD,** given the reasonably close correlation between the proportion of offshore holdings and the NZD/USD.
- **The supply of NZGBs will be restricted by the Government running strong surpluses, placing greater pressure on liquidity in the local bond market.** Falling supply, together with Asian central banks' “buy and hold” strategy, points to further drying up of liquidity. Unless this issue is addressed by the Debt Management Office, the local Government bond

market is in danger of losing its relevance as a meaningful yield benchmark.

- **Yield and a strong credit rating, rather than movements in the NZD, will influence the proportion of offshore holdings.** As long-term holders, Asian central banks will ride through currency cycles so long as the yield attractiveness and strong credit rating remain. The NZD has experienced two 10 cent moves down against the USD in 2004 and 2006 with limited effect on offshore holdings.
- **The demand for NZGBs suggests that swap spreads will continue to widen in the near-term as demand continues to outweigh supply.**

CURRENCY STRATEGY

Carry is back in vogue although NZD support looks to reflect JPY weakness. While we believe there is limited appetite to push the NZD up too far, the story looks to be one of slow grinds higher until we see something from offshore.

Market themes...

- All about carry as risk appetites improve.
- RBNZ hikes, and flags potentially another.
- USD/JPY up equals NZD the same.
- Base metals solid.
- US jobs data knocks rate cut view.

Outlook...

Another week and another market U-turn. It is once again all about carry, or so everyone says. Strong AUD data (GDP) and a hike from the RBNZ have confirmed the attractiveness of the antipodeans region, while the JPY has failed to kick on, with the USD/JPY up nearly 3 percent in the week. Equities have stabilised. Commodity prices have found a base. Everyone is back chasing yield.

While the NZD and AUD were generally supported last week, their failure to kick-on aggressively despite a strong GDP (AUD), rising base metal prices, and a hike from the RBNZ (with the door open to another) suggests some continued unease towards the carry trade. The bounce looks directly correlated to movements in the JPY, with the latest IMM data showing a massive pull-back in both JPY and CHF positioning. The way the NZD surged out of the dangerous 0.6720-0.6770 zone suggests a clear base has formed and the market now feels broadly neutral in terms of positioning.

For now, the NZD looks stuck in no man's land. Equities remain key. Global interest rates are not rallying enough to signal a change in global conditions or risk appetites, and neither are they high enough to dent the attractiveness of yield. So long as US Treasury's remain in the 4.5 to 5 percent range (the lower bound signalling risk, the upper a closing yield differential), the NZD is biased towards a slow grind up.

We expect domestic data (retail sales and housing market activity) to be broadly supportive over the week ahead. The NZ swaps market is pricing in a 20 percent chance of a hike for April, and while we agree on rates being on hold, this still looks a little light given the upcoming schedule.

The main focus over the coming week will remain offshore. US non-farm payrolls data on Friday night dented the market's rate cut view, and

attention now shifts to this week's US CPI data (due on Friday night). This is expected to record a 0.2 percent increase in core prices. With the market looking for rate cuts from the Fed and being disappointed by strength in the payrolls data, a strong CPI result could add insult to injury, and remind the market that the Fed's official bias remains towards further tightening.

Technically, the NZ dollar has broken through resistance at 0.6920, and this break will neutralise NZD bears. The kiwi has now all but completed a 61.8 percent Fibonacci retracement (0.6970) of its sell-off from February highs. This level should provide initial topside resistance, but we remain in the middle of a broad range.

NZD vs AUD: monthly directional gauges		
Gauge	Direction	Comment
Fair value	↓	Above the 0.85-0.88 zone.
Yield	↑	Yield differential has widened, swap differentials near record levels.
Commodities	↔	Base metals improving, but dairy strong.
Partial indicators	↔	Carry trade back on, uridashi issuance continues.
Technicals	↔	Consolidating in middle of broad range.
Sentiment	↑	NZ interest rates higher for longer, NZD the same.
Other	↓	Australian exporters are looking impatient.
On balance	↔	Broad consolidation.

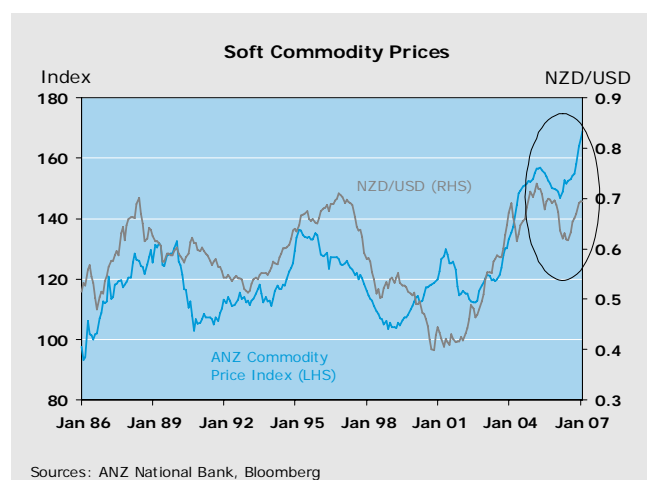
NZD vs USD: monthly directional gauges		
Gauge	Direction	Comment
Fair value – long-term	↓	Fair value 0.60. It may be higher given a structural shift in commodity prices.
Fair value – short-term	↔	NZD more fairly valued on commodity models.
Yield	↑	NZ yield more attractive.
Commodities	↔	Dairy prices providing insulation.
Risk aversion	↑	US sub-prime mortgages a concern, but risk aversion settling down.
Partial indicators	↔	Minor payrolls-led sell off in US rates. US CPI now key.
Technicals	↔	Testing Fibonacci resistance following break of 0.6920.
AUD	↔	GDP data solid, but AUD not following through.
Sentiment	↔	0.6920 break will neutralise bears.
Other	↔	Range defined 0.6720 – 0.7120.
On balance	↔	Carry vs USD bounce.

COMMODITY PRICES – TRIBULATIONS AND AGITATIONS

Strength in commodity prices underpin fair value estimates for the NZD/USD around 0.63-0.65. Moreover, they imply any global induced weakness in the NZD will not be sustained, and the potential for the tradable sector to reflate may prove problematic for the Reserve Bank.

New Zealand is on a winner. "Soft" commodity prices have surged to a historical high. Dairy prices are by-and-large underpinning the move, but when we look across the various segments, a host of others including forestry and aluminium prices are sitting above historical peaks.

The impact of strong commodity prices cannot go un-stated. Strong commodity prices are supporting rural land prices (which have doubled in five years), and have a huge flow-on effect for regional housing prices, giving the baby-boomer generation a retirement windfall. It is no coincidence that the "pace setters" and areas of the strongest excess demand in the New Zealand economy are in fact the rural aligned regions (refer our *Market Focus* of 20 November 2006).



Cyclical forces such as strong global growth and the Australian drought are major influences, but stripping out these, there looks to be a solid secular upward trend story. The first derivative of China's growth boom has been driven by industrialisation, and hence supportive of Australia's hard commodity basket. Australia's terms of trade have rocketed 40 percent over the past five years. Fast forward a few years and imagine China and other parts of Asia moving from industrialisation to consumerism and what that means for consumable commodities. Global consumer demand is growing at 2 to 3 percent while soft commodity supply is growing at under 2 percent.

This has six important implications.

- It reinforces our view that fair value for the NZD is far higher than the frequently quoted historical average. We are biased towards fair-value residing in the 0.63-0.65 range as opposed to the historically quoted 0.58 level, and recommend exporters and importers be conservative in setting hedge parameters. In fact, traditional commodity price metrics suggest the NZD/USD should be trading around 0.75 at present! Moreover, if New Zealand's terms of trade continue to improve, fair value will be biased up over time.
- It is difficult to get overly bearish on economic prospects given that a huge portion of export sector is being insulated from currency strength. Sure, there is some nervousness across the rural sector and land prices already capture the long-term "buy butter – sell DVDs/manufacturing goods view", but it would take a massive rout in commodity prices from these levels to materially dent prospects.
- High commodity prices point to a more elongated period of currency strength than built into our forecasts.
- Any "carry-trade run" on the NZD will not be sustained. We remain attuned to the risk of a sharp ride down the elevator for the NZD in a similar fashion to 2004. But such a ride will quickly reflate rural incomes and the economy if it does not coincide with a fall in commodity prices, allowing the sector to double-dip (strong prices, weak currency) such as in 2001. Weak commodity prices are not looking likely at this juncture.
- Strength in commodity prices – while welcome – may prove problematic for the Reserve Bank. Excess demand within the economy is a rural as well as housing phenomenon. The tradable sector will strengthen on currency weakness.
- There will be faster pass-through from a weaker currency when the NZD does turn. Previous currency cycles occurred when the tradable sector had excess spare capacity. This helped to dampen the initial pass-through from a weaker currency to prices. While some pockets of the export sector are battling under the high currency, our business discussions continue to emphasise strong appetites to hire, which we take as a signal of continued capacity constraints.

Financial market implications

Strength in commodity prices suggests rural sector unease, notably with land prices at elevated levels, will not persist indefinitely. As key pace-setters in the economy, continued strength or reflation from the rural sector will exacerbate pressure on the Reserve Bank and keep the bias for rates pointed up. Strength in commodity prices skews the risk profile on the currency towards elongated strength.

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
Mar 12	NZ	Food Prices (Feb) – mom	-	1.4%	10:45
	JN	Gross Domestic Product (4Q F) – qoq	1.3%	1.2%	12:50
		Gross Domestic Product (4Q F) – annualized	5.1%	4.8%	12:50
		GDP Deflator (4Q F) – yoy	-0.5%	-0.5%	12:50
		Domestic CGPI (Feb) – mom	0.0%	-0.2%	12:50
		Export Price Index (Feb) – mom	-	1.4%	12:50
		Import Price Index (Feb) – mom	-	2.8%	12:50
		Current Account Total (Jan)	¥1,020.0b	¥1,776.8b	12:50
		Adjusted Current Account Total (Jan)	¥2,010.0b	¥1,873.0b	12:50
		Trade Balance – BOP Basis	¥134.5b	¥1,218.9b	12:50
		Bankruptcies (Feb) – yoy	-	4.0%	17:30
		Consumer Confidence (Feb)	-	48.4	18:00
	AU	Home Loans (Jan)	1.0%	0.1%	13:30
		Investment Lending (Jan)	-	4.0%	13:30
	UK	PPI Input (Feb) – mom (s.a.)	0.7%	-2.0%	22:30
		PPI Output (Feb) – mom (n.s.a.)	0.2%	0.3%	22:30
		PPI Output Core (Feb) – mom (s.a.)	0.2%	0.2%	22:30
		DCLG House Prices (Jan) – yoy	9.6%	9.9%	22:30
Mar 13	US	Fed's Kroszner Speaks at Washington Economics Conference	-	-	05:20
		Monthly Budget Statement (Feb)	-\$117.5b	\$38.2b	07:00
	EU	ECB's Tumpel-Gugerell Speaks at Conference in Washington DC	-	-	10:00
		ZEW Survey (Economic Sentiment) (Mar)	4.5	6.8	22:00
	NZ	Retail Sales (Jan) – mom	0.2%	0.7%	10:45
		Retail Sales Ex-Auto (Jan) – mom	-	0.2%	10:45
	AU	NAB Business Confidence (Feb)	-	7	13:30
		NAB Business Conditions (Feb)	-	17	13:30
		ANZ Job Advertisements (Feb) – mom	-	-0.1%	13:30
	UK	Visible Trade Balance (Jan)	-£6,950	-£7,142m	22:30
		Trade Balance Non-EU25 (Jan)	-£4,300	-£4,308m	22:30
		Total Trade Balance (Jan)	-£4,600	-£4,894m	22:30
	GE	ZEW Survey (Economic Sentiment) (Mar)	3.2	2.9	23:00
		ZEW Survey (Current Situation) (Mar)	67.2	70.9	23:00
Mar 14	US	Treasury's Paulson Hosts Conference on Capital Markets in Washington	-	-	01:00
		Advanced Retail Sales (Feb)	0.3%	0.0%	01:30
		Retail Sales Less Autos (Feb)	0.3%	0.3%	01:30
		IBD/TIPP Economic Optimism		52.7	03:00
		Business Inventories (Jan)	0.1%	0.0%	03:00

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
Mar 14 cont.	UK	Leading Economic Index (Jan) – mom	-	0.1%	04:30
		Coincident Indicator Index (Jan) – mom	-	0.2%	04:30
		Jobless Claims Change (Feb)	-8.0k	-13.5k	22:30
		Average Earnings ex bonus (Jan) – 3m/yoy	4.0%	3.7%	22:30
		ILO Unemployment Rate (Jan) – 3mth	5.5%	5.5%	22:30
		Manufacturing Unit Wage Cost (Jan) – 3m/yoy	-	-0.2%	22:30
	NZ	Manufacturing Activity (4Q) – qoq	-	2.7%	10:45
AU	Westpac Consumer Confidence (Mar)	-	1.7%	12:30	
JN	Industrial Production (Jan F) – mom	-1.5%	-1.5%	17:30	
EU	Industrial Production (Jan) – mom	0.4%	1.0%	23:00	
Mar 15	US	Current Account Balance (4Q)	-\$203.0b	-\$225.6b	01:30
		Import Price Index (Feb) – mom	0.8%	-1.2%	01:30
	NZ	RBNZ's Bollard Speaking on the NZ Economy to the Wellington Regional Chamber of Commerce	-	-	07:30
	AU	Consumer Inflation Expectation (Mar)	-	23.3%	12:30
		Employment Change (Feb)	15.0k	-3.6k	13:30
		Unemployment Rate (Feb)	4.5%	4.5%	13:30
		Participation Rate (Feb)	64.8%	64.8%	13:30
	GE	Consumer Price Index (Feb F) – mom	0.4%	0.4%	19:00
	EU	ECB's Garganas Testifies in Greek Parliament	-	-	22:00
		Euro-Zone CPI (Feb) – mom	0.3%	-0.5%	23:00
Euro-Zone CPI – Core (Feb) – yoy		1.8%	1.7%	23:00	
Euro-Zone Labour Costs (4Q) – yoy		2.2%	2.0%	23:00	
Mar 16	NZ	Business NZ PMI (Feb)	-	56.0	00:01
	US	Producer Price Index (Feb) – mom	0.5%	-0.6%	01:30
		PPI Ex Food & Energy (Feb) – mom	0.2%	0.2%	01:30
		Empire Manufacturing (Mar)	17.3	24.4	01:30
		Net Long-Term TIC Flows (Jan)	\$60.0b	\$15.6b	02:00
		Philadelphia Fed	4.0	0.6	05:00
		Former Fed's Greenspan Speaks at Futures Industry Association	-	-	05:30
	AU	RBA Assistant Governor Edey Speaks	-	-	13:25
	UK	BoE's Sentence to Deliver Speech	-	-	07:00
	Mar 17	US	Consumer Price Index (Feb) – mom	0.3%	0.2%
CPI Ex Food & Energy (Feb) – mom			0.2%	0.3%	01:30
Industrial Production (Feb)			0.3%	-0.5%	02:15
Capacity Utilisation (Feb)			81.3%	81.2%	02:15
		University of Michigan Consumer Confidence (Mar)	89.5	91.3	03:00
EU	ECB's Stark Speaking in Santa Monica	-	-	23:30	

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: With the Reserve Bank's *Monetary Policy Statement* been and gone, the focus now is on data relating to Q1. Although Q4 GDP is expected to show a strong rebound, we remain unconvinced that this momentum will be sustained into the first half of this year. Reads on Q1 to date have been mixed and partial indicators released in the coming weeks will paint a clearer picture. This week's retail sales and housing market data will be closely watched for signs of the moderating trend that the Reserve Bank seeks.

Date	Data/Event	Economic Signal	Comment
Tue 13 Mar (10.45)	Retail Trade Survey (Jan)	Up	A modest rise in retail spending expected, though a big increase in food prices will inflate the food related spending numbers.
Wed 14 Mar (10.45)	Manufacturing Survey (Dec qtr)	Mixed	Manufacturing sales to be subdued due to a high NZD, but a rebound in production expected as firms rebuild stock levels.
circa 15 Mar	REINZ Housing data (Feb)	Steady	Housing market activity to again be solid although show limited evidence of acceleration.
Tue 20 Mar (10.45)	External Migration (Feb)	Steady	After an easing in recent migration gains, we expect annual migration to stabilise at around 14,000 per annum.
Wed 21 Mar (15.00)	Credit Card Billings (Feb)	Steady	A modest rebound expected after January's decline, but not strongly accelerating away.
Mon 26 Mar (10.45)	Merchandise Trade (Feb)	Imbalanced	An improvement in the monthly trade deficit is expected. Exports to be supported by higher commodity prices, although higher oil prices will add to imports.
Wed 28 Mar (10.45)	Building Consents (Feb)	Easing	We expect building consents to continue its recent easing trend.
Thu 29 Mar (10.45)	Balance of Payments (Dec qtr)	Large	We expect the current account deficit to post a slight improvement although still remain at an unsustainable level.
Thu 29 Mar (15.00)	Credit Growth (Feb)	Strong	Credit growth continues to show limited evidence of slowing. We expect another 1.0 percent month.
Fri 30 Mar (10.45)	Gross Domestic Product (Dec qtr)	Strong	Q4 GDP growth is shaping up to print at 1.0 percent after a weak result in Q3, driven by domestic demand with the net external sector subtracting from growth.
Fri 30 Mar (15.00)	National Bank <i>Business Outlook</i> (Mar)	-	-
Thu 5 Apr (15.00)	ANZ Commodity Price Index (Mar)	-	-
On Balance		Q4 strength but early signs of Q1 mixed.	Strong momentum end of last year. Still questions over 2007. Partial's relating to Q1 mixed to date, with the Reserve Bank's 0.8 percent GDP forecast looking on the high side at this stage.

NZ Economics

Cameron Bagrie
Chief Economist
+64 4 802 2212

Sean Comber
Economist
+64 4 802 2286

Philip Borkin
Economist
+64 4 802 2199

Khoon Goh
Interest Rate Strategist
+64 4 802 2357

Steve Edwards
Economist
+64 4 802 2217

Kevin Wilson
Rural Economist
+64 4 802 2361

SUMMARY OF KEY MARKET FORECASTS

NZ FX rates	Actual		Current	Forecast (end month)						
	Jan 07	Feb 07	12 Mar 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
NZD/USD	0.695	0.694	0.692	0.700	0.680	0.640	0.620	0.600	0.580	0.550
NZD/AUD	0.888	0.887	0.887	0.909	0.895	0.853	0.849	0.833	0.817	0.786
NZD/EUR	0.535	0.530	0.526	0.530	0.523	0.496	0.481	0.472	0.464	0.447
NZD/JPY	83.7	83.7	81.9	84.0	79.6	72.3	68.2	64.8	61.5	59.4
NZD/GBP	0.355	0.354	0.358	0.361	0.354	0.337	0.328	0.321	0.312	0.299
NZ\$ TWI	69.1	68.9	68.5	69.5	67.7	63.7	61.7	60.0	58.2	55.8
NZ interest rates	Jan 07	Feb 07	12 Mar 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
OCR	7.25	7.25	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50
90 day bill	7.70	7.74	7.85	7.80	7.70	7.60	7.60	7.60	7.60	7.60
10 year bond	5.93	5.96	5.85	5.80	6.00	6.10	6.10	6.00	6.00	5.90
International	Jan 07	Feb 07	12 Mar 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
US Fed funds	5.25	5.25	5.25	5.25	5.25	5.25	4.75	4.75	4.75	5.00
US 3-mth	5.36	5.35	5.34	5.32	5.40	5.00	4.60	4.75	4.90	5.25
AU cash	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25
AU 3-mth	6.39	6.35	6.36	6.30	6.40	6.40	6.40	6.40	6.40	6.40

KEY RATES

	9 Feb	5 Mar	6 Mar	7 Mar	8 Mar	9 Mar
Official Cash Rate	7.25	7.25	7.25	7.25	7.50	7.50
30 day bank bill	7.55	7.71	7.71	7.72	7.76	7.76
90 day bank bill	7.72	7.82	7.82	7.83	7.83	7.85
NZGB 07/09	6.56	6.64	6.66	6.68	6.66	6.69
NZGB 11/11	6.35	6.39	6.41	6.43	6.40	6.43
NZGB 04/13	6.14	6.14	6.15	6.17	6.14	6.16
NZGB 12/17	5.94	5.80	5.81	5.82	5.79	5.82
1 year swap	7.92	7.92	7.93	7.95	7.93	7.94
2 year swap	7.73	7.76	7.76	7.79	7.75	7.78
5 year swap	7.33	7.37	7.38	7.41	7.38	7.42
RBNZ TWI	68.2	67.4	67.2	67.4	67.1	68.0
NZD/USD	0.6852	0.6826	0.6793	0.6814	0.6792	0.6876
NZD/AUD	0.8785	0.8791	0.8776	0.8793	0.8754	0.8824
NZD/JPY	83.10	79.03	79.10	79.27	78.91	80.59
NZD/GBP	0.3498	0.3539	0.3525	0.3533	0.3518	0.3563
NZD/EUR	0.5256	0.5194	0.5183	0.5194	0.5157	0.5229
AUD/USD	0.7800	0.7765	0.7740	0.7749	0.7759	0.7792
EUR/USD	1.3036	1.3143	1.3107	1.3120	1.3170	1.3150
USD/JPY	121.28	115.78	116.45	116.33	116.18	117.21
GBP/USD	1.9586	1.9287	1.9271	1.9284	1.9308	1.9301
Oil	59.76	61.58	60.05	60.66	61.85	61.63
Gold	659.95	641.35	643.00	645.60	652.55	651.60
Electricity Price Index	3.36	6.57	6.65	6.60	6.58	6.71

Important Notice

Australia and New Zealand Banking Group Limited is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11005 357 522
10th Floor 100 Queen Street, Melbourne 3000, Australia
Telephone +61 3 9273 6224 Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited
ABN 11 005 357 522
Minerva House, PO Box 7, Montague Close, London, SE1
9DH, United Kingdom
Telephone +44 20 7378 2121 Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of NASD and SIPC)
6th Floor 1177 Avenue of the Americas
New York, NY 10036, United States of America
Tel: +1 212 801 9160 Fax: +1 212 801 9163

NEW ZEALAND by:

ANZ National Bank Limited
Level 7, 1-9 Victoria Street, Wellington, New Zealand
Telephone +64 4 802 2000

In Australia and the UK, ANZ Investment Bank ("ANZIB") is a business name of Australia and New Zealand Banking Group Limited, ABN 11 005 357 522 ("ANZ Bank"), which holds an Australian Financial Services licence no. 234527 and is authorised in the UK by the Financial Services Authority ("FSA"). In New Zealand, ANZ Investment Bank is a business name of ANZ National Bank Limited WN / 035976 ("ANZ NB").

This document is being distributed in the United States by ANZ Securities, Inc. ("ANZSI") (an affiliated company of ANZ Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZSI upon request. Any US person(s) receiving this document and wishing to effect transactions in any securities referred to herein should contact ANZSI, not its affiliates.

This document is being distributed in the United Kingdom by ANZ Bank for the information of its market counterparties and intermediate customers only. It is not intended for and must not be distributed to private customers. In the UK, ANZ Bank is regulated by the FSA. Nothing here excludes or restricts any duty or liability to a customer, which ANZ Bank may have under the UK Financial Services and Markets Act 2000 or under the regulatory system as defined in the Rules of the FSA. This document is issued on the basis that it is only for the information of the particular person to whom it is provided. This document may not be reproduced, distributed or published by any recipient for any purpose. This document does not take into account your personal needs and financial circumstances. Under no circumstances is this document to be used or considered as an offer to sell, or a solicitation of an offer to buy. In addition, from time to time ANZ Bank, ANZ NB, ANZSI, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this document (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this document. If you have been referred to ANZ Bank, ANZ NB, ANZSI or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request. The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable.

The views expressed in this document accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this document and are subject to change without notice. No part of the author's compensation was, is or will directly or indirectly relate to specific recommendations or views expressed about any securities or issuers in this document. The author's compensation will, be based upon, among other factors, the overall profitability of ANZ, including profits from investment banking revenues.

ANZ Bank, ANZ NB, ANZSI, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation. Where the recipient of this publication conducts a business, the provisions of the Consumer Guarantees Act 1993 (NZ) shall not apply.