Market Focus

New Zealand

25 March 2008

Open partnerships
Open possibilities

A TURNING POINT?

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ECONOMIC OVERVIEW

Our core macro view continues to be built around an economic adjustment that is elongated in length, as households de-leverage and rebuild savings. GDP data this week is expected to reinforce opening position capacity constraints. Most market interest will reside in indicators for Q1 and most notably consumer confidence, which is expected to weaken further.

What's ahead?

> **NZ February Credit Card data** (Tuesday 25 March 1500 NZDT). Based on last week's electronic card transaction data, we expect credit card billings to be flat.

> **NZ Q1 Westpac McDermott Miller consumer confidence** (Wednesday 26 March 0100 NZDT). Confidence to fall on the back of a higher cost of living, falling house prices and global uncertainty. We expect an index level of 105.

> **NZ Q4 2007 Balance of Payments** (Thursday 27 March 1045 NZDT). An export surge to see the current account improve, but the overall deficit still at an unsustainable level.

> **NZ February Trade Balance** (Thursday 27 March 1045 NZDT). High oil prices and dry weather to see another deficit for the month.

> **NZ Q4 2007 GDP** (Friday 28 March 1045 NZDT). A robust end to 2007 with growth of 0.6 percent expected, led by a surge in primary exports.

> **NZ February Credit Growth** (Friday 28 March 1500 NZDT). Household lending growth to continue easing in line with a cooling housing market.

What's the view?

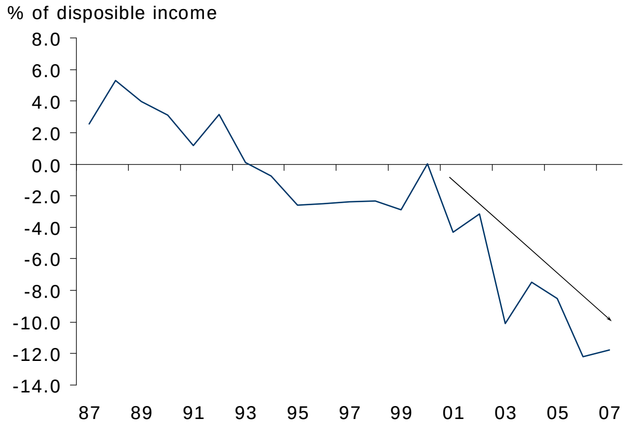
Last week was a quiet week domestically, with little new information. Electronic card transaction data points to a reasonably subdued retail sales result for February, with price increases in staples being offset by weak volumes. Soft monthly reads on net migration continue, with a mere net inflow of 170 in February. Looking at the 3-month annualised rate, annual growth is running at just over one thousand. Such softness will be another factor accentuating housing weakness although it will also exacerbate tightness in the labour market, particularly with out flows to Australia remaining strong. On a more encouraging note was the fact tourist numbers were up 5.3 percent in the month and 4.8 percent on the prior year.

Abstracting from recent data, recent (media) attention continues to be drawn to the dreaded "R" word. Whether NZ enters recession or not in 2008 is not the major issue in our view, particularly with the consensus now suggesting it will be of the "lite" variety with little change in the unemployment rate and relatively short-lived in duration and magnitude. (As an aside, we've never seen a recession like it). As commentators we need to be prudent and responsible in our assessment. There is a real danger that we talk ourselves into it. However, prudence also demands that we allude to risks and provide independent assessments.

The real issue in our minds is how long the period of weak growth extends, with our suspicion that any "adjustment" is set to last well into 2009. It may seem like the mouse on the exercise wheel, but to repeat from last week:

> As the credit cycle turns, the real economy must de-leverage in line with what is happening in the financial system. As this is largely a household balance sheet story, the de-leveraging is likely to be slow and elongated as precautionary savings are rebuilt. Given NZ's negative household savings rate as an opening position, and declining wealth in property, we are in no doubt such a rebuild is likely to extend over a lengthy period.

Household savings rate



Sources: ANZ National, Statistics NZ

> Productivity growth remains poor, restricting the ability of the supply side of the economy to help cushion the adjustment. But for productivity to pick up (freeing up resources and helping suppress inflation pressure, allowing lower interest rates), there is going to have to be an adjustment on the labour resources side. Herein resides the inconsistency. If productivity picks up (a positive for a recovery), labour will be the next leg of the "adjustment" and a recession "lite" will not cut it. The adjustment will be deeper, but eventual recovery quicker. Conversely, if productivity remains weak, then the labour market will support prospects to a degree at the trough, and the recession "lite" may well be the endgame but expressed over a very long time. But limited capacity from the supply-side means your demand side cannot grow solidly, and merely elongates the adjustment even beyond 2009. There is no free lunch when it comes to paying the piper!

> NZ's macro framework is not adjusting. The NZD remains elevated, supported by a weak USD, and the Reserve Bank has made it clear that a major growth sacrifice is required to tame inflation. Sure interest rates will eventually come down, although

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, particularly in regard to the credit cycle. To be fair we were a tad encouraged by how the NZD and rates market started to adjust over the past week as growth concerns aired. But both have a long way to go before we'd say financial conditions are easing, particularly considering what is happening in the credit sphere.

Will tax cuts and the dairy payout save us? Both are significant support factors, with growing expectations tax cuts may be implemented before this year's election. Yet even a tax cut of $2 billion is equivalent to only a 0.6 percent change in house prices. Not much when they are down 4 percent already! New Zealanders being New Zealanders they typically take the money and "leverage it" and it is the multiplier effect that is the real kicker, through property prices, spending, profits, employment, credit, property prices and so on. But what happens if the ability to leverage is curtailed by a turn in the credit cycle that manifests through altered lending appetites and guidelines? Leverage drives this economy, and the game has fundamentally changed on that front with a turn in the credit cycle.

Is there any good news? When nations enter adjustment phases there is unfortunately not much to crow about. No matter which quadrant of the economic cycle you reside, there is always going to be gripes. Economics is after all referred to as the dismal science! Booms are associated with a tight labour market, higher interest rates, and in New Zealand's case an overvalued exchange rate, a combination that squeezes the business sector.

At the top of the economic cycle inflation runs rife, placing pressure on company costs and earnings, and squeezing the disposable income of middle-to-low income families in particular. Savers see their wealth eroded in inflationary times. During the good times we spend too much, the current account deficit rises and housing becomes unaffordable. Spare a thought for those new home buyers who have been unable to get into the market because of stratospheric prices relative to incomes!

So before we all wrap ourselves in a pall of gloom, be mindful of some of the positive aspects that will follow from the adjustment that is pending. Inflation pressure will eventually recede in a weak growth environment. Interest rates do not need to remain at elevated levels when inflation is receding. Low inflation supports medium-term growth prospects by giving stable pricing signals. Weaker domestic growth and a lower currency (as the adjustment extends to fixing the current account deficit – an inevitable consequence in our view) will restore some much needed balance to growth. Houses become more affordable. Yields rise as prices fall. Bear markets eventually reach levels that represent value to investors. Tougher times mean firms' attention returns to driving productivity performance and doing things smarter.

Eventually, such forces underpin the next upswing. Those that have been cautious and patient late in the cycle invariably find value and get presented with opportunities. It's called a business cycle. We've been here before. Night follows day, and day follows night. The sun invariably comes up in the morning.

Now that we've got that off our chest, our attention turns to this week, with an action packed calendar.

GDP takes prime attention as the bellwether indicator for the economy. While we suspect the market will be quick to downplay any surprising "strength", with attention being drawn to weak 2008 momentum, we need to be cognisant of the fact that historical GDP figures are still very influential in determining the opening position for the output gap. A strong result will likely intensify the Reserve Bank's measures of capacity pressures.

We are expecting a result at the lower end of consensus, largely on our suspicion that export strength was taken out of stocks (particularly dairy), a development that will see stocks detract from growth in the quarter. Given the persistently high NZD and drought conditions weighing on milk production, we do not expect this export strength to be maintained into 2008. Nevertheless, the surge in exports in the December quarter will also help contribute to an expected reduction in the current account deficit, which we expect to print at 8.0 percent of GDP.

Rather than the Q4 indicators, we suspect the market will be more attuned to the read provided by the Westpac McDermott Miller consumer confidence survey given the implications it provides for future household spending. Confidence is expected to fall given increases in the cost of living through high prices for food and petrol as well as debt servicing costs. Falling house prices, global uncertainty and increased (negative) media attention on the state of the economy are also likely to weigh on confidence.

February trade, credit card spending and household lending growth data are also due this week, but given their second-tier nature, they are likely to only get fleeting attention. Another monthly trade deficit is expected given high imported oil prices, while credit card spending and lending growth are likely to be relatively soft.

Finally, the week ends with a speech by RBNZ Governor Bollard in Sydney. Interest will be high and looking for further clues to the outlook for monetary policy in the face of heightened uncertainty.

Recent data...

> **NZ Electronic Card Transactions (February).** Retail related electronic transactions value fell 0.1 percent, but core retail related transactions rose 0.6 percent.

> **NZ Net Migration (February).** A net gain of 170 people was recorded for the month. The annual net migration total, at 4,643 people, continues to ease.

LOOKING FOR A TURNING POINT? SOME MUSINGS

Markets remain volatile and we are being regularly asked what we are looking for to signal a sustainable turn. We offer no hard and fast rules, but rather some themes we continue to assess.

We are in no doubt the healing process across markets will be a normal market phenomenon during which asset prices adjust until buyers emerge. There are two primary preconditions to conditions stabilising and the floor being reached. Losses and exposures need to be declared and balance sheets improved. The macro (economic) environment needs to stabilise to ensure credit risk does not accentuate liquidity concerns. As this is largely a household balance sheet story, the de-leveraging could be slow as all the adjustment will happen via higher savings.

On top of this we are monitoring numerous secondary areas, including inflation pressure, politics and the responses adopted by financial intermediaries themselves.

Financial markets have been playing bungy-nomics, rising and falling regularly since August last year. Over that period we've seen massive swings in equity sentiment, along with signs of a clear turn in the credit cycle via heightened volatility, widening credit and swap spreads, and the same for the spread between interbank borrowing rates and cash rates.

From a fundamental perspective, credit is now looking extremely attractive based on the underlying fundamentals. Over the past week the market has taken additional liquidity provision by the US Federal Reserve, the bailout of Bear Stearns and the 75 basis points of additional interest rate cuts in a positive manner – albeit off panic driven extreme movements prior. We may well be on the cusp of another round of stability, although whether we are truly out of the woods remains uncertain.

We are in no doubt that the healing process will be a normal market phenomenon. At some juncture investors will identify high spreads and conclude that the risks are lower than the compensation offered in the marketplace. There is certainly no shortage of liquidity. Yet liquidity remains a function of cash, and willingness to put such cash to work. It remains a confidence game.

There are two preconditions to the healing process and confidence returning in a sustainable fashion. **Firstly, losses and exposures need to be disclosed, and eliminated from balance sheets.** Loss estimates vary, with some being at high as US$600 billion. Given US$190 billion of disclosures so far, we are potentially only a third of the way through it. The financial sector will stabilise once losses are cleared, balance sheets improve, and in some instances some firms possibly fail.

Second, macro conditions need to stabilise and confidence return to the market. This is essential for numerous reasons. Cash will not be put to work until confidence improves. Continued deterioration in the economic environment risks adding an additional layer of risk, namely pure credit and default risk in relation to the economic cycle placing further pressure on balance sheets. This is on top of liquidity considerations.

Ultimately the real economy must de-leverage in line with what is happening in the financial system. As this is largely a household balance sheet story the de-leveraging could be slow as all the adjustment will happen via higher savings. This means the real side of the economy in key OECD nations is likely to remain weak for a considerable period.

The nature of this credit event is also different. Historically, credit events have always been corporate-centric. This has typically seen the financial sector reallocate capital to the low beta asset, namely housing. This time around the major vulnerabilities (via low savings) appears to reside in the household sector across key OECD nations, and the past decade has seen a literal explosion in complicated derivative based structures used to manage the distribution of such debt. This has four important implications to think about. Firstly, as noted above, when households de-leverage it takes time, so you end up with a "U" or the feared "L" shaped outcome. Whether the US is in recession or not misses the point. Bottom line is that any recovery is likely to be a drawn out affair, and as noted on page 2, we believe the same applies to New Zealand. Secondly, central banks end up *"pushing on a string*", such as is the case with the Fed, necessitating very aggressive action. Thirdly, there are no historical benchmarks over how the financial sector will respond given the nature of the current episode. In regard to the latter point, it is crucial at this juncture. On the one hand, financial institutions - via altered lending standards - could quickly accentuate the economic cycle. On the other hand, maintaining the status quo in terms of risk appetites would be at odds with the credit cycle. Where the pendulum resides remains uncertain. In the meantime we have the central banks furiously injecting liquidity to make sure cash is circulating. Finally, how extensive, and cross entangled is the web given the massive growth we have seen in derivative-based structures?

The bottom line is that stabilising prospects could take some time and until both the preconditions discussed above have been met, we are likely to remain in an environment of heightened volatility.

There are also three other areas that we are closely monitoring.

First, inflation pressure. Surveyed measures of inflation expectations are rising across the OECD. Some central banks' response to current dislocation via the interest rate channel (on top of liquidity measures) does not come without medium-term inflation risks, particularly given the commodity backdrop. Earnings projections are looking increasingly prone to downgrades in a weak growth/sticky inflation environment. While the inflation card has often been the mechanism through which excessive debt levels are eroded, central banks are facing a very delicate balancing act as they assess their respective inflation mandates with ensuring the financial system functions effectively.

Second, politics. The adjustment (and adjustees) is ultimately being determined by the relative size and scale of offshore borrowing, or implicitly who runs a current account deficit. Two standard funding mechanisms are debt or equity. Debt funding just got a lot more expensive, which throws attention back towards equity funding or foreign direct investment, particularly those nations such as the US that are already progressing with currency realignments. It begs the obvious question – will strategic and political considerations interfere with what looks to be funding imperatives for major components of the economy? This is a delicate path to tread.

Third, the approach taken by financial institutions. The banking sector has historically – such as during the Russian debt default crisis – played a major role in defusing credit market trauma, hence the strong focus from the Fed in ensuring the financial system is working and liquidity provision is ample. To what degree and scope with which this can occur remains uncertain in the current environment.

What we do know is that the past decade has seen a growing portion of literature devoted to the credit channel of monetary policy, an implicit recognition of the role financial intermediaries play in the economic cycle.

Bernanke (yes, the current Fed Chairman) and Gerlter (1995) identified two legs – the balance sheet and the bank lending channel.[1] The balance sheet channel is where changes in interest rates (monetary policy) affect asset values, the cash flows of borrowers, creditworthiness and the external finance premium they face. The bank lending channel relates to outright supply of loans.

Both channels derive from the quality of balance sheets, hence aggressive attempts by the Fed via their recent dealer credit facility to improve financial intermediaries' loanable funds position. If the loans stop the endgame moves from the "R" to the "D".

Where to from here? While the Fed has clearly gone into overdrive in terms of the assistance being provided, we suspect at some juncture attention will turn to the approach taken by financial intermediaries themselves. One of the reasons the 1990/91 US recession was thought to be a long and drawn out process has been put down to "financial headwinds" arising from a shortage of capital (Bernanke and Lown, 1991).[2] The same could be said for New Zealand during the 1990/91 recession.

This could in turn raise questions in regards to financial intermediaries' attempts at balance sheet preservation or strengthening (particularly as a means of grasping opportunities that can present in such uncertain times), and the role of sovereign wealth funds in this area. Likewise for the actual cost of capital in the current environment, retained earnings as a means of strengthening balance sheets, and of course the balance between credit criteria and asset growth in what is a very uncertain economic environment.

Alas, no hard and fast rules, but lots to watch.

[1] Inside the Black Box: the Credit Channel of Monetary Transmission, *Journal of Economic Perspectives,* Vol.9, No.4.

[2] "The Credit Crunch," *Brookings Papers on Economic Activity, 1991:2*.

DATA PREVIEW

Current account – December 2007 quarter (due Thursday 27 March 10.45am)

	ANZ National	RBNZ	Market
Quarter	**-$3,499m**	-	-$3,505m
Annual	**-$13,877m**	-	-$13,889m
% of GDP	**-8.0**	-7.9	-7.9

Current account to show an improvement on the back of a surge in primary exports. But investment income deficit remains a drag. Further improvements in the current account expected, but higher debt servicing costs to weigh.

We are expecting the annual current account deficit to show an improvement from 8.3 percent of GDP in the September 2007 quarter to 8.0 percent in the December quarter. Our estimate is close to market expectations. Despite the expected improvement, the current account deficit remains at unsustainable levels.

The main driver of the expected improvement is from a surge in export values, courtesy of higher commodity prices and a large rise in primary export volumes. However, a large amount of the increase in volumes likely came from inventories, and will not be repeated over the coming quarters. Oil exports from the Tui oilfields also helped exports in the final quarter of last year.

The investment income balance will again act as a drag on the current account. Investment losses from global markets will push the credit side lower, while higher interest costs for overseas debt will offset expected lower profits from foreign owned NZ firms, leaving the annual investment income deficit steady at 7.2 percent of GDP.

Looking ahead, we expect further improvements in the current account position. Lagged effects from high commodity prices are yet to feed through, though this will be offset somewhat by lower primary export volumes due to dry weather conditions. The slowdown in domestic demand should also lead to lower import demand, helping the goods balance improve. However, the higher cost for overseas debt, as reflected by widening credit and swap spreads, mean that the investment income deficit will continue to weigh on the current account. Ultimately, a lower NZD is required to restore the current account towards more sustainable levels.

Financial market implications

Given the turbulence in global credit markets, increasing focus will be put on current account positions of various economies. Though moving in the right direction, NZ's current account deficit remains unsustainable. However, the financial market's attention is mainly focused elsewhere at this stage, so we do not anticipate much reaction in the rates and currency markets.

GDP – December 2007 quarter (due Friday 28 March 10.45am)

	ANZ National	RBNZ	Market
QoQ	**0.6**	0.7	0.8
YoY	**3.2**	3.3	3.4
Ann. Ave.	**3.0**	3.1	3.1

The GDP report will confirm the economy ended 2007 on a firm footing. Exports led the charge though this mostly came out of inventories, and will not be repeated in the March quarter. Indications are that momentum has stalled in early 2008.

We expect GDP growth of 0.6 percent for the December 2007 quarter, slightly below the market and RBNZ's forecasts. Nonetheless, it is still a firm end to 2007, taking annual average growth for the calendar year to 3.0 percent.

On the production side, the Tui oilfield will make a 0.1 percentage point contribution, with most of the industry groups making small positive contributions. The services sector will again contribute the most to growth despite a slowing housing market, as we suspect activity relating to the implementation of KiwiSaver is providing a lift to activity in the finance, insurance and business services sector.

Expenditure GDP growth is expected to be stronger than production, though this merely reverses the weaker expenditure print in the September quarter. We are expecting a 0.8 percent increase in expenditure GDP, with exports providing the largest contribution. However, much of the exports likely came out of inventories, resulting in stocks subtracting from growth. Investment growth is expected to be solid, largely due to non-residential investment, but this is largely a rebound following the previous quarter's weakness.

While momentum was reasonable towards the end of last year, indicators to date point to a stalling in activity over the early part of this year. Consumer spending likely went backwards in real terms, residential investment will decline based on where the housing market is heading, and the surge in exports in the December quarter will be partly unwound, as much of that came from inventories or were brought forward due to dry weather conditions. At this stage, it appears only government spending will be helping to prop up March quarter GDP growth.

Financial market implications

While largely historical, markets will nonetheless still pay attention as it does influence the RBNZ's view of how much (or lack of) slack there is in the economy. We suspect there will be a greater reaction to a weaker print compared to a stronger one, given the increasing focus the markets are placing on downside growth risks in the current environment.

GLOBAL WATCH

We present a table of global data outturns over the past week given the significance of the international backdrop at present. It was generally a quiet week across the globe this past week. Of note, was slightly weaker than expected European PMI data, while UK retail spending surprised on the upside. In the US, the big development was a further cut in the fed funds rate as expected. US data was mixed compared with market expectations, although appears to generally remain on an easing trend. Core PPI inflation was stronger than expected.

Country / Area	Indicator	Mkt	Actual	Last	Outturn vs market
US	Empire Manufacturing (Mar)	-7.4	-22.2	-11.7	Weaker
	Industrial Production (Feb)	-0.1%	-0.5%	0.1%	Weaker
	Capacity Utilisation (Feb)	81.2%	80.9%	81.5%	Weaker
	NAHB Housing Market Index (Mar)	20	20	20	In-line
	PPI Ex Food and Energy (Feb) – yoy	2.1%	2.4%	2.3%	Stronger
	Housing Starts (Feb)	995k	1065k	1071k	Stronger
	FOMC Interest Rate Announcement	2.25%	2.25%	3.00%	In-line
	Leading Indicators (Feb)	-0.3%	-0.3%	-0.4%	In-line
	Philadelphia Fed (Mar)	-19.0	-17.4	-24.0	Stronger
	Existing Home Sales (Feb) – mom	-0.8%	2.9%	-0.4%	Stronger
Europe	PMI Manufacturing (Mar A)	52.0	52.0	52.3	In-line
	PMI Services (Mar A)	52.0	51.7	52.3	Weaker
	PMI Composite (Mar A)	52.4	51.9	52.8	Weaker
UK	CPI (Feb) – yoy	2.5%	2.5%	2.2%	In-line
	Core CPI (Feb) – yoy	1.4%	1.2%	1.3%	Weaker
	Claimant Count Rate (Feb)	2.5%	2.5%	2.5%	In-line
	Jobless Claims Change (Feb)	-5.0k	-2.8k	-9.1k	(Weaker)
	Average Earnings inc Bonus (Jan) – 3m/yoy	3.8%	3.7%	3.8%	Weaker
	Retail Sales (Feb) – mom	-0.2%	1.0%	1.1%	Stronger
Asia Ex-Japan					
Singapore	Non-oil Domestic Exports (Feb) – mom	-2.0%	-0.4%	8.4%	Stronger
	CPI (Feb) – yoy	6.8%	6.5%	6.6%	Weaker
Philippines	Unemployment Rate (Jan)	-	7.4%	6.3%	-
Malaysia	CPI (Feb) – yoy	2.5%	2.7%	2.3%	Stronger
South Korea	GDP (4Q F) – qoq	-	1.6%	1.5%	-
Japan	Tertiary Industry Index (Jan) – mom	0.7%	0.7%	-0.9%	In-line
	All Industry Activity Index (Jan) – mom	0.1%	0.0%	-0.4%	Weaker
Australia	Westpac Leading Index (Jan) – mom	-	0.0%	-0.2%	-

INTEREST RATE STRATEGY

Despite a heavy local data calendar, flows will dictate direction. More volatility is expected given recent offshore moves, with the fortunes of NZ rates tied to the Aussie market.

Market themes…

> Extremely volatile movements driven by offshore.

> Fed cuts by "only" 75bps but more likely to come.

> Bear Stearns buyout and US Fed and government action turning sentiment around.

Outlook…

It was a week of volatility for the NZ rates market. A lack of domestic data always meant that offshore moves were going to dictate. Early optimism that the Fed's new liquidity measures would ease credit strains quickly evaporated with rumours a major US investment bank was in trouble. The Fed bailout and subsequent offer by JPM Chase to buy Bear Sterns failed to calm a jittery market initially. Some better than expected profit results from the big US investment banks and a 75bp cut by the Fed, while disappointing some who were expecting a 100bp easing, seemed to restore some confidence as did better than expected US home sales numbers and further action by the US government to allow the Federal Home Loan banks to increase their purchase of mortgage-backed bonds by US$150b.

So where to from here? It is fair to say that the local rates market will remain volatile this week. There is a heavy domestic data calendar this week with Q4 2007 GDP and current account, Q1 consumer confidence and February credit card and trade data. Though the GDP and current account data are dated, they will still provide the markets with some food for thought and confirm that the economy ended 2007 on a firm footing. Nonetheless, the market will be more focused on data relating to Q1. In this regard, the dataflow has been turning soft with electronic card transaction figures for February printing flat and net migration continuing to ease. Next week's NBBO survey will provide a much needed check on current business sentiment to see how activity is shaping up over the first half of this year.

The bias will be to the payside early in the week following offshore moves, but flows will ultimately dictate with liquidity likely thin. Mortgage paying and receiving due to upcoming bank bond issuances to dominate. We expect the 2-year swap yield to now trade within a new lower range of between 8.1 and 8.35 percent.

OIS pricing towards the RBNZ continue to shift towards further rate cuts. There is now a 30 percent chance of a cut by June, and a full rate cut priced in by September. The data calendar offshore is rather light given the shortened week, but US durable goods, income and spending data will be closely eyed, as will speeches by various Fed Governors. RBA Governor Stevens and RBNZ Governor Bollard's speeches will also be closely watched for signs of whether recent market turbulence means the peak of the respective cash rates has been reached. But as always, it could be corporate newsflow that results in the biggest reaction. The profit announcements by US financial institutions over the coming weeks will have the market on edge.

Gauges for NZ interest rates yields

Gauge	Direction	Comment
RBNZ	↔	Lack of inflation headroom means their hands are tied.
NZ data	↔	Q4 GDP to confirm strong end to 2007. Focus to be on Q1 data next week.
Fed Funds/front end	↓	75bp cut delivered, more likely to come still.
RBA	↔	Focus in Aussie market on RBA Governor speech this week.
US 10 year	↑	Safe haven flows unwinding on turnaround in sentiment.
NZ swap curve	↔	Parallel moves expected, flows will determine curve shape.
Flow	↔	Offshore moves will play a major role in flow.
Technicals	↔	The US moves need to become more sustainable before we get a clearer technical picture.

Borrowing strategies we favour at present

Our strategy remains unchanged – pay the 18 months to 2-year, and for those with existing portfolios and whose durations are beyond 3 years to 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	-7	-4
Thu 5-Jun-08	-23	-32
Thu 24-Jul-08	-47	-36
Thu 11-Sep-08	-107	-108
Thu 23-Oct-08	-107	-132
Thu 4-Dec-08	-183	-152
Thu 15-Jan-09	-183	-232

Trading themes we favour at present

We continue to 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

Firmer USD sentiment was a feature last week and attention will now be centred on the EUR/USD and whether a top is truly in place.

Market themes...

> USD finds support but can it kick-on?

> Aggressive action by the Fed stabilises sentiment.

> Commodities the next bubble to "adjust"?

Review and outlook...

Aggressive action by the Fed has acted to stabilise sentiment. We seem to now be entering the relief rally stage that has typified each of the two prior periods of credit dislocation. Typically we'd expect this to translate into renewed vigour towards the NZD given the relationship with US equities as a barometer, although it is fair to say that the last two periods of dislocation (Feb/Mar and December) did not see the same sort of aggressive downwards correction in the bird as we saw in August so the magnitude for the recovery bounce seems relatively limited.

More interesting last week was firming sentiment towards the USD, admittedly off lows against the EUR and JPY, so a fair degree of profit taking likely set in. Yet any signs of renewed support for the USD quickly transferred to commodities, reinforcing the huge speculative element that has now flowed into that asset class as well.

Our attention remains centred on the EUR/USD, as a proxy for the decoupling/recoupling debate, and the signal it sends for commodities in general. Last Friday was notable in that European PMI indicators softened while the US Philly Fed bounced, although the latter was off a low base. We'll be closely watching the tenor of both Euro-zone and US data, with the German IFO this week of particular interest. But at present with so much bad news priced into the US we suspect it could be the European region that surprises next, with negative implications for the EUR/USD.

Price action in the NZD/AUD continues to frustrate, once again squeezing up over the week, and against general economic trends within the two countries. Stepping back, the AUD's failure to kick-on in the current environment (and strongest commodity prices in fifty years), is perhaps the best indication that the market is reticent to take a firm view in the current environment of uncertainty and volatility, with both set to continue for a while yet.

This week's domestic data is relatively heavy, dominated by GDP at the end of the week. This looks set to provide a firm base under the bird, although as a lagging indicator we suspect the market will be inclined to discount and focus on Q1 momentum, and notably reads on consumer confidence (Wednesday), and business confidence (next Monday). In the meantime it looks to be a familiar story of drifting in response to what is happening offshore.

The 0.7890 to 0.7920 region remains crucial for the NZD/USD and a clear break through 0.7860 will signal deeper moves lower to follow. While resistance at 0.8215 remains in place, an eventual downside break is favoured. The NZD/AUD has almost retraced all of 2008's losses and now rests just below key resistance at 0.8830. Look for this level to hold this week.

NZD vs AUD: monthly directional gauges

Gauge	Direction	Comment
Fair value	↓	Growth differentials favouring AUD.
Yield	↓	Yield spreads narrowing
Commodities	↔	Commodities looking toppy all round. Who does it affect more?
Partial indicators	↔/↓	Better across the Tasman.
Technicals	↔	Resistance at 0.8830.
Sentiment	↑	AUD struggling given risk appetites and commodity volatility.
Other	↓	All eyes on commodities and equities.
On balance	↓	**Struggling AUD continues to frustrate weaker NZD/AUD view.**

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	↓	Still a key one to watch, particularly if the USD can firm some more.
Risk aversion	↔	Fed acted to stabilise
Partial indicators	↑	NZ domestic economy is soft, but US is dire.
Technicals	↔	0.7880/0.8215 range.
AUD	↔	Just can't kick-on.
Sentiment	↔/↓	Global players taking their toys home.
Other	↔	USD starting to firm? All eyes on the EUR/USD.
On balance	↔	**Risk side stabilising. Need more signs of USD kicking on, or NZ domestic situation to extend.**

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
25 Mar	**NZ**	**Credit Card Billings (Feb) - mom**	**-**	**0.1%**	**15:00**
26 Mar	**NZ**	**Westpac Consumer Confidence (Q1)**	**-**	**110.0**	**01:00**
	US	S&P/Case Shiller Composite-20 (Jan) - yoy	-10.5%	-9.1%	02:00
		Consumer Confidence (Mar)	73.5	75.0	03:00
		Richmond Fed Manufacturing Index (Mar)	-5	-5	03:00
		House Price Index (Jan) - mom	-	-0.2%	03:00
	GE	IFO – Business Climate (Mar)	103.5	104.1	22:00
		IFO – Current Assessment (Mar)	109.5	110.3	22:00
		IFO – Expectations (Mar)	97.8	98.2	22:00
	EC	Current Account (Jan)	-	-10.3B	22:00
		Industrial New Orders (Jan) - mom	0.2%	-3.6%	23:00
	JN	Trade Balance (Feb)	11.5B	-87.3B	12:50
27 Mar	**NZ**	**Current Account (Q4) - % of GDP**	**-7.9%**	**8.3%**	**10:45**
		Trade Balance (Feb)	**185M**	**-320M**	**10:45**
	US	Durable Goods Orders (Feb)	0.8%	-5.3%	01:30
		Durable Goods ex-transportation (Feb)	-0.3%	-1.6%	01:30
		New Home Sales (Feb)	578K	588K	03:00
		US Fed's Evans speaks in New York	-	-	05:00
		US Fed's Fisher speaks in Texas	-	-	05:00
		US Fed's Stern speaks in London	-	-	17:00
	AU	RBA Governor Stevens speech on recent financial developments	-	-	11:10
		Conference Board Leading Index (Jan)	-	0.2%	12:00
		Job Vacancies (Feb)	-	6.0%	13:30
		RBA Financial Stability Review	-	-	13:30
	UK	Total Business Investment (Q4 F) - qoq	1.7%	-0.5%	22:30
28 Mar	**NZ**	**GDP (Q4) - qoq**	**0.8%**	**0.5%**	**10:45**
		Money Supply M3 (Feb) - yoy	**-**	**8.9%**	**15:00**
	US	GDP Annualised (Q4 F)	0.6%	0.6%	01:30
		Personal Consumption (Q4 F)	1.9%	1.9%	01:30
		Core PCE (Q4 F) - qoq	2.7%	2.7%	01:30
		Initial Jobless Claims (w/e Mar 23)	370k	378k	01:30
		Continuing Claims (w/e Mar 16)	2,893k	2,865k	01:30
		US Fed's Pianalto speaks	-	-	05:00
		US Fed's Lockhart speaks in Tennessee	-	-	05:20
	UK	GDP (Q4 F) - qoq	0.6%	0.6%	22:30
		Current Account (Q4)	-18.0B	-20.1B	22:30

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
28 Mar cont	JN	Jobless Rate (Feb)	3.8%	3.8%	12:30
		Overall Household Spending (Feb) - yoy	2.4%	3.6%	12:30
		Tokyo CPI (Mar) - yoy	0.5%	0.4%	12:30
		Tokyo CPI ex-fresh food (Mar) - yoy	0.5%	0.4%	12:30
		National CPI (Feb) - yoy	0.9%	0.7%	12:30
		National CPI ex-fresh food (Feb) - yoy	0.9%	0.8%	12:30
		Retail Trade (Feb) - mom	-2.4%	0.8%	12:50
	NZ	**RBNZ's Bollard Speaks on Economy, Policy**	**-**	**-**	**13:05**
29 Mar	US	Personal Income (Feb)	0.3%	0.3%	01:30
		Personal Spending (Feb)	0.1%	0.4%	01:30
		PCE Deflator (Feb) - yoy	3.5%	3.7%	01:30
		PCE Core (Feb) - mom	0.1%	0.3%	01:30
		U of Michigan Confidence (Mar F)	70.0	70.5	03:00

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

NEW ZEALAND DATA WATCH

Key focus over the next four weeks: This week will confirm that economic activity ended 2007 on a firm note. But Q1 data looking soft so far and the dataflow over the next four weeks will continue to reflect this. However, Q1 CPI will reinforce the RBNZ's inflation concerns. Forward looking confidence surveys will provide crucial reads on economic prospects over the first half of this year.

Date	Data/Event	Economic Signal	Comment
Tue 25 Mar (1500)	Credit card billings (Feb)	Still flat?	Based on the electronic card transaction data, credit card billings likely to be flat.
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.
Thu 27 Mar (10.45)	Trade Balance (Feb)	On the improve	Dry conditions to have some impact on primary exports, but flat-lining retail sector should see consumer goods import growth slow. On balance we expect another deficit for the month.
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 *Business Outlook* (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 weakness. 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 reverses recent surprises on the downside.
Mon 21 Apr (10.45)	Net migration (Mar)	Lower	Stable arrivals but rising departures to see net migration continue to head lower.
Wed 23 Apr (10.45)	Electronic card transactions (Mar)	Easter effect	Early Easter this year to drag this reading lower.
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**	**0.2**	**0.1**	**0.2**
Employment (% yoy)	1.7	1.6	1.6	2.5	**1.5**	**1.0**	**1.4**	**0.6**	**0.5**	**0.6**
Unemployment Rate (% sa)	3.7	3.6	3.5	3.4	**3.5**	**3.6**	**3.8**	**4.0**	**4.1**	**4.1**
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	610	460	720	650	250	470	20	70	170
Net Migration (annual)	10682	10078	8966	8730	8309	7517	6588	5491	4799	4643

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

SUMMARY OF KEY MARKET FORECASTS

	Actual		Current	Forecast (end month)						
NZ FX rates	Jan-08	Feb-08	25-Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
NZD/USD	0.772	0.797	0.797	0.780	0.740	0.690	0.660	0.640	0.630	0.620
NZD/AUD	0.876	0.873	0.880	0.830	0.804	0.767	0.759	0.762	0.778	0.795
NZD/EUR	0.524	0.540	0.517	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	0.401	0.390	0.379	0.359	0.349	0.344	0.342	0.341
NZ$ TWI	71.2	73.0	71.5	69.6	66.6	63.0	61.6	60.9	61.2	61.7
NZ interest rates	Jan-08	Feb-08	25-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	8.92	8.80	8.20	7.60	7.00	7.00	7.00	7.00
10 year bond	6.28	6.40	6.46	6.50	6.20	5.80	5.40	5.30	5.30	5.20
International	Jan-08	Feb-08	25-Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
US Fed funds	3.00	3.00	2.25	1.75	1.50	1.50	1.50	1.50	2.00	2.50
US 3-mth	3.11	3.06	2.61	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	7.78	8.00	7.90	7.60	7.40	7.10	6.60	5.80

KEY RATES

	21 Feb	17 Mar	18 Mar	19 Mar	20 Mar	21 Mar
Official Cash Rate	8.25	8.25	8.25	8.25	8.25	n/a
90 day bank bill	8.87	8.82	8.86	8.88	8.92	n/a
NZGB 07/09	7.37	7.00	7.04	7.03	6.95	n/a
NZGB 11/11	7.10	6.66	6.67	6.68	6.58	n/a
NZGB 04/13	6.97	6.61	6.70	6.65	6.55	n/a
NZGB 12/17	6.45	6.27	6.40	6.47	6.43	n/a
2 year swap	8.57	8.17	8.22	8.26	8.20	n/a
5 year swap	8.15	7.85	7.90	7.94	7.84	n/a
RBNZ TWI	73.3	71.0	70.9	72.1	70.9	n/a
NZD/USD	0.7998	0.8058	0.8028	0.8143	0.7890	n/a
NZD/AUD	0.8702	0.8713	0.8726	0.8735	0.8783	n/a
NZD/JPY	86.43	77.70	77.87	81.06	78.78	n/a
NZD/GBP	0.4118	0.4004	0.4007	0.4048	0.3992	n/a
NZD/EUR	0.5433	0.5079	0.5088	0.5195	0.5139	n/a
AUD/USD	0.9191	0.9248	0.9200	0.9322	0.8983	n/a
EUR/USD	1.4722	1.5866	1.5779	1.5674	1.5354	n/a
USD/JPY	108.06	96.43	97.00	99.54	99.85	n/a
GBP/USD	1.9423	2.0124	2.0033	2.0118	1.9767	n/a
Oil	100.86	110.03	105.74	103.25	101.70	n/a
Gold	941.30	1023.30	1000.50	939.20	912.70	n/a
Electricity (Haywards)	17.20	14.56	16.52	16.36	15.59	n/a
Milk futures (US$/contract)	133	131	130	130	130	n/a
Baltic Dry Freight Index	6998	7913	7893	7801	7684	n/a

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