

NEW ZEALAND ECONOMICS MARKET FOCUS

19 September 2011

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KICKING FOR TOUCH

ECONOMIC OVERVIEW

The RBNZ chose the safe route by kicking things for touch last week and who can blame them! About the only certainty at present is uncertainty itself. In such circumstances we won't get caught up in intra-weekly noise, focusing rather on key anchors. Two of these for us are: we are in a low growth environment, and interest rates will move up only gradually. We're still of the view that the NZ economy looks better than most OECD peers, though we must be mindful of the risks. Q2 GDP data is expected to confirm solid momentum, but another current account deficit highlights our continued vulnerability to external shocks, notwithstanding the helpful impact of statistical changes.

EFFECTIVE MORTGAGE RATE UPDATE

Despite the OCR being on hold, the household sector is still getting further stimulus courtesy of a lower effective mortgage rate (EMR). We estimate that if the RBNZ were to stay on the sidelines until March next year, borrowers would receive the equivalent of close to a 25bp rate cut. Such passive stimulus, together with the RWC impact and high rural incomes, will lend considerable support to growth in the final quarter of this year. The flipside is that with the proportion of those on floating expected to rise further, the RBNZ will have a lot of policy traction when they feel the time is right to hike the OCR.

DATA PREVIEW

Despite the goods terms of trade hitting a new 37-year high, we expect the current account deficit to remain around 4 percent of GDP. Ongoing household deleveraging is likely to cap the magnitude of future deficits, but the high NZD, weaker global outlook and unbalanced nature of domestic expansion going forward suggests our external debt levels will remain elevated. June quarter GDP data is expected to confirm a reasonably solid quarter, reinforcing NZ's better economic momentum relative to OECD peers, but with wide sector divergences.

INTEREST RATE STRATEGY

Global financial market stability remains a pre-condition for RBNZ action, at least over the next few months. As such, we need to brace for more volatility in domestic markets as sentiment ebbs and flows in line with global developments. Subtle language changes by the RBNZ also suggest the first move will be 25bps rather than 50. This week's FOMC meeting and the Obama jobs package are the key "risk" events. In our view they are likely to be positively received – after all, they are stimuli. BY contrast, the longer Europe "muddles through", the worse the final outcome is likely to be, and that isn't good for anyone – NZ included.

CURRENCY STRATEGY

The failure of European politicians to come up with anything concrete over the weekend has EUR on the backfoot again. With the FOMC set to engage in "Operation Twist" this week, markets are expected to reward currencies where policymakers are active in providing stimulus. With the RBNZ kicking for touch, NZD will be at the mercy of global developments. A risk off environment to start the week will see NZD drift lower, but we expect it to remain well supported on dips, and end the week on a stronger footing based on our view that Q2 GDP will come in above market expectations.

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SUMMARY

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THIS WEEK'S EVENTS

SNZ Balance of Payments – 2011Q2 (Wednesday, September 21, 10:45am). We expect a quarterly deficit of \$0.95bn, with the annual deficit at 4.1 percent of GDP. See our preview on page 7.

SNZ International Travel and Migration – August (Wednesday, September 21, 10:45am). A net permanent and long-term outflow of 100 persons is expected. A 2 percent seasonally adjusted rise in visitor arrival numbers is envisaged.

RBNZ Credit Card Billings – August. We expect a 0.5 percent s.a. decline in billings. Billings on overseas cards should post a small rise.

SNZ Gross Domestic Product – 2011Q2 (Thursday, September 22, 10:45am). A 0.7 percent s.a. quarterly increase (1.9 percent y/y) is expected, with continuing sector divergences. See our preview on page 7.

WHAT'S THE VIEW

Now that the September Monetary Policy Statement is out of the way, it's time for some benchmarking. At present we know that:

- **The global economy is on a knife-edge.** In the past week we've seen the announcement of a coordinated approach by the world's major central banks to boost liquidity via swap lines, securing dollar funding for pockets of Europe, in effect offsetting tightened access to other markets. The glass half full interpretation would centre on this being proactive stuff from policymakers. Recall that swap lines across central banks were not installed until after the collapse of Lehmans in 2008. The glass half empty version centres on this action being taken because policymakers know the severity of the situation and are trying to

prevent something grave from turning into a real "event".

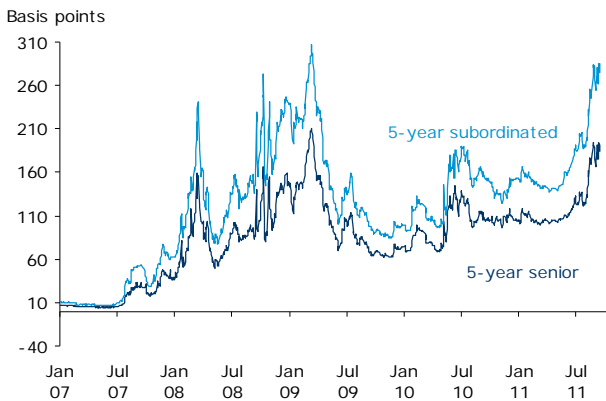
- **There is no quick fix.** History tells us never to underestimate policymakers' resolve, particularly when markets are demanding solutions, and the fabled central bank "puts" have tended to be delivered. It is untenable to think more steps will not be taken to mitigate extreme risks in the system. So brace for more concrete steps from policymakers, subject to political constraints. However, there are also key challenges here. Policymakers' arsenals are seriously diluted, and the tools at policymakers' disposal lack traction given structural headwinds. Repeatedly "*kicking the can down the road*" via central bank "puts" has inflated problems down the track. And global problems require truly global solutions. Politicians are the centre of attention here. It appears a clear application of game theory and the prisoners' dilemma: the optimal solution is co-operation but self-interest leads to an inferior outcome¹.
- **Reading between the lines the RBNZ appears very wary of a potential sharp deterioration in the global scene beyond what has already occurred.** As they've been privy to discussions with other central bankers we can assume the RBNZ know more than most.
- **Tail risks from a structural overhang of global debt looks set to remain for years to come which will contribute to the market mood oscillating from risk-on to risk-off.** The post financial crisis recovery was always going to be a long drawn-out affair. Risks will never be completely eliminated. Some degree of policy normalisation will have to take place against a fickle global backdrop. There were tail-risks in the system in July when the RBNZ suggested it would be reversing the March cut. There is a degree of risk central banks will need to simply accept. What is different at present is that we have crossed the threshold in terms of relevance as it is directly impacting a key channel, namely funding costs, which is New Zealand's Achilles heel.
- **We know pricing (funding wise) has gone up a long way, but as yet this is theoretical, with the market not really being tested.** There is no one-for-one connection between implied offshore funding costs and borrowing rates. Lower wholesale rates are offsetting somewhat. Borrowing costs have typically been more stable than implied funding costs and there likely remains

¹ This aspect of game theory was originally framed by Flood and Dresher, two US mathematicians in 1950.

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some scope to absorb a temporary increase in funding costs. The RBNZ should be wary of double-counting what rising funding costs could mean. We'll be providing an update on financial conditions next week, which is the cleanest way of quantifying the impact of each particular channel. Key to watch at present is deposit rates. If they start to move (up), its game on.

CDS spreads for "Big four" Australian Banks



Sources: ANZ, National Bank, Bloomberg

- **Monetary policy is still easing** in a passive sense with the effective mortgage rate still falling (refer page 6). The RBNZ is not standing still. Deferring prospective OCR hikes is actually easing policy, for the average interest rate on household borrowing at present is currently 6.2 percent, compared to a floating mortgage rate of 5.7 percent.
- **The local scene still looks pretty good.**
 - **Commodity prices remain buoyant.** The historical link with the business cycle needs to be acknowledged – and receding commodity prices (an assumed inevitability) looks a key part of the RBNZ's story. Yet supply issues continue to support key markets, with low inventory levels for dairy and the culling of livestock overseas due to higher grain prices likely to provide a pricing side offset to cyclically weaker demand. The structural demand story for our commodities remains positive. We're more optimistic than the RBNZ regarding prospects for commodity prices, but it's supply driven as opposed to demand.
 - **Domestic confidence is holding up** with last week's ANZ Roy Morgan consumer confidence report adding to the string of local resilience. The August NZ manufacturing PMI barely budged despite global measures heading south. Today's Westpac Consumer

Confidence report resonated with a similar tone.

- **When we eye the upcoming data calendar, we can see some real tensions between the global and local scene over the remainder of the year.** The former is heavily forward looking (i.e. a risk – but a big one), while the latter is more what we know – today. **This is why it would be folly to rule out the RBNZ hiking before the end of the year, though this faces hurdles.** We could express it another way. If the RBNZ hadn't cut rates in March, would they now be looking at reducing the OCR? We think not. **This merely illustrates that we need to be mindful of the level at which the OCR resides.**
- **The RBNZ is banking on a benign inflation outlook, affording them the flexibility to watch, worry and wait.** We're not so convinced. How the RBNZ can get inflation below 2 percent in 2012, failing a global meltdown, is beyond us! And in that latter situation the OCR will not be moving at all. Responding to one risk, namely the global scene, is not risk-free. With huge asymmetric risks in the financial system, brace for more inflation to grease the wheels of the economy, though we expect (hope!) the inflation genie will remain in the bottle. **Welcome to the world where policymakers, including central banks, face heightened tradeoffs within their reaction functions. The RBNZ will be no different.**

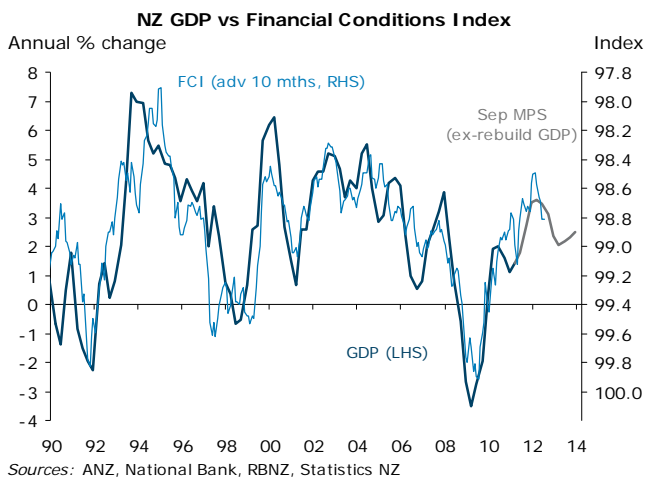
This combination makes life particularly difficult for crystal ball gazers like ourselves and the RBNZ. Last week the RBNZ chose the safe route, by kicking for touch, and who can blame them! About the only certainty at present is uncertainty itself. We see stabilisation and improvement in offshore funding markets as a prerequisite to a higher OCR and more stable economic environment, with the RBNZ unlikely to want to be hiking if funding costs are sharply elevated. Given the scale of Europe's challenges, it seems heroic to think things could be improving by year-end, though policymakers could yet pull a rabbit out of the hat.

In this situation the risk profile is clearly tilted towards a March 2012 OCR hike over December 2011. **Yet we strongly suspect inflation indicators will favour an end of 2011 start**, with upcoming data such as the Q3 unemployment rate, Q3 CPI and the next inflation expectations readings supporting this. However, tail-risks in the global scene will urge some chance being taken on the inflation trajectory.

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Yet we also need to acknowledge the possibility of a later start than March. If the global situation continues to deteriorate and "Rome is still burning" by December (and all our work is flagging more problems in Europe), we can put the case that the OCR will not be moving until mid 2012 or later! This may sound like your typical economist-speak covering all bases, but it is really a reflection of the complications brought on by the interaction of numerous shocks at the same time, and the reality of politics being front and centre.

We see little point ducking and diving at present trying to pin down the exact starting date for the hiking cycle, or offering precise economic predictions or prescriptions. There is simply too much going on, and we've written at length over the year about European sovereign debt challenges. The world will remain wobbly for years to come. Suffice to say we think the spirit of our interest rate and growth assessment is what matters. **And the messages here are simple. We are in a low trend growth environment that will be punctured by bouts of risk-on and risk-off. The bias for the OCR is up, but policy tightening will be slow and gradual, full of fits, stops and starts.** As such, the OCR endpoint is expected to be considerably below previous cycles, particularly if the NZD remains elevated and if funding pressures continue to drive a large wedge between the OCR and market interest rates.



Nevertheless, with the OCR set to remain low, interest rate sensitive sectors will need to be watched closely. August housing market data showed sales and days to sell strengthening, and while volumes are at benign levels, average days to sell (which gives a lead on house prices) has been quietly trending down to 40 days, their lowest since March 2010. Facing a pending construction boom in late 2012 the Bank can ill afford a complementary housing equivalent. We're still of the view that the balance sheet constraint limits the potential for housing to

accelerate strongly. But there are clearly risks here, particularly with supply tight in some areas such as Auckland and **more passive policy stimulus to come over the next 6 months or so.**

An area we continue to watch is the supply-side of the economy, with the comments in the September *MPS* consistent with concerns we have over truncated supply side capacity. Key to this is a diminishing margin of labour market slack, and while August job ads took a bit of a breather, lower numbers on the unemployment benefit tell a different real-time story. We'll wait till the September job ads figures before we make sweeping assessments. Internet ads suggest the August job ads weakness was a temporary lull.



Given recent global events this week's key Q2 activity data releases are likely to have less importance than usual. We expect a fairly large Q2 current account deficit, with an annual deficit in the low 4 percent range. Despite the terms of trade hitting a 37-year high, the consequence of living beyond our means is a large investment income deficit and high external debt, notwithstanding the impact of recent statistical changes. Ongoing deleveraging is expected to cap the extent of future deficits, but the lack of household saving remains an Achilles heel and key source of vulnerability.

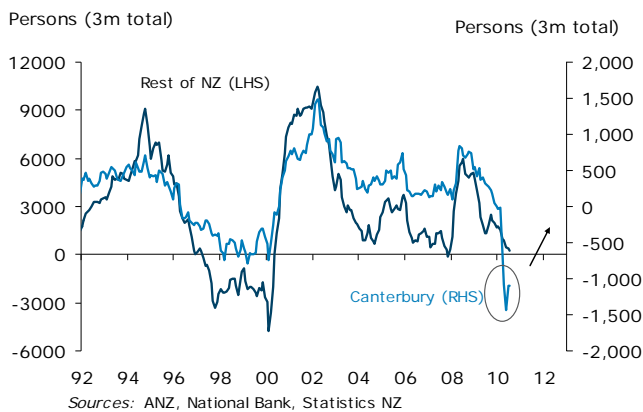
GDP for the June quarter should register respectable growth rates, but with strong sector divergences. Relative to the forecast consensus and the RBNZ we are slightly more optimistic, but this appears to reflect our more upbeat view on services sector, with agricultural sector activity benefitting from the mild autumn. We note, however, that activity in the consumption side of the economy will need to slow to make way for the rebuilding of Christchurch. While earthquake reconstruction work has been slow to get underway, it is a multi-year undertaking (equivalent to 10 percent of nationwide GDP and around 4 percent of

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nationwide capital stock) and represents a large call on resources nationwide.

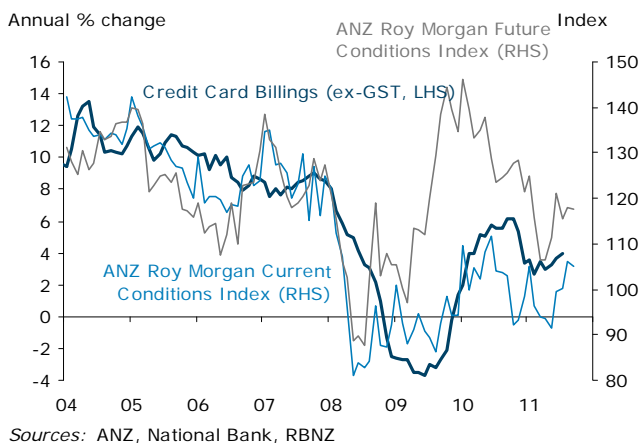
Migration data for August is expected to show another net outflow. With the NZ economy set to outperform most of our OECD counterparts, we expect a turnaround in net migration flows over the next few months to a sequence of net inflows. Visitor arrivals are anticipated to rise 2 percent, largely on account of a climb in Australian tourists coming for the snow. The next year or so is shaping up to be a key period for the tourism sector, and while the Rugby World Cup appears to be delivering a significant boost, we remain concerned over the tourism sector outlook beyond that.

Net Permanent and long-term immigration



August credit card billings are expected to take a breather after a frenetic few months. We have a strong suspicion people went into cautionary mode in August – a combination of the global scene but also recognition a major event was around the corner. September is shaping to be a ripper, particularly for overseas issued cards.

RBNZ credit card billings and confidence



RECENT LOCAL DATA

Westpac Consumer Confidence – 2011Q3.

Headline consumer confidence was unchanged at 112 in Q3. Current conditions ticked up to 105.7 (previously 103.9), whereas future conditions eased to 116.3 (117.4).

REINZ Housing Market Report – August. House sales rose a seasonally adjusted 5.2 percent (up 21.1 percent y/y). The median days to sale eased to 40 days (from 41.2), the lowest since March 2010. The REINZ house price index eased 0.1 percent (+0.7 percent y/y).

Food Price Index – August. Food prices fell 1.2 percent to be 6.6 percent higher than 12 months earlier.

Manufacturing Survey – 2011Q2. Manufacturing sales rose 2.1 percent q/q (up 8.2 percent y/y). Manufacturing volumes declined 0.7 percent q/q (+7.1 percent y/y), with meat and dairy manufacturing volumes down 1.2 percent q/q (+17.7 percent y/y). Other manufacturing volumes rose 0.3 percent q/q (+2.1 percent y/y).

ANZ Job Ads – August. Job ads fell 0.8 percent s.a. in August, with a 9.3 percent fall in newspaper advertising offsetting a 1.3 percent s.a. increase in internet listings. The ANZ composite jobs measure fell 4.5 percent s.a. in August.

RBNZ September 2011 Monetary Policy Statement.

“If recent global developments have only a mild impact on the New Zealand economy, it is likely that the OCR will need to increase. For now, given the recent intensification in global economic and financial risks, it is prudent to continue to hold the OCR at 2.5 percent”.

BNZ Business NZ Manufacturing PMI – August.

The seasonally adjusted New Zealand PMI index fell only slightly in August (from 53.2 to 52.9), remaining above its long-term average. All of the subcomponents except for employment (49.3) remained above 50.

ANZ Roy Morgan Consumer Confidence – September.

The ANZ-Roy Morgan Consumer Confidence measure dipped 0.7 points to 112.6. The Future Conditions index fell 0.6 points to 117.5, while the Current Conditions index fell 0.9 points to 105.2.

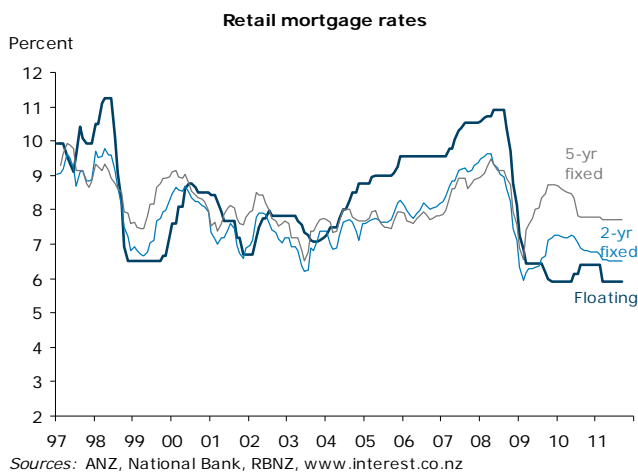
EFFECTIVE MORTGAGE RATE UPDATE

SUMMARY

Despite the OCR being on hold, the household sector is still getting further stimulus courtesy of a lower effective mortgage rate (EMR). We estimate that if the RBNZ were to stay on the sidelines until March next year, borrowers would receive the equivalent of close to a 25bp rate cut. Such passive stimulus, together with the RWC impact and high rural incomes, will lend considerable support to growth in the final quarter of this year. The flipside is that with the proportion of those on floating expected to rise further, the RBNZ will have a lot of policy traction when they feel the time is right to hike the OCR.

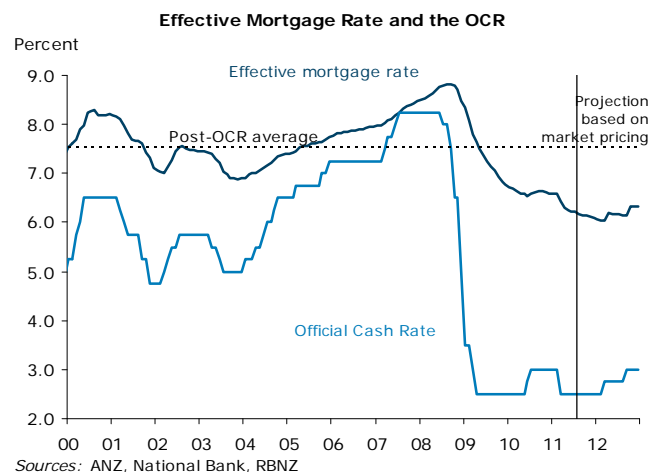
PASSIVE STIMULUS

The RBNZ has made it clear that they are in no hurry to raise the OCR given the uncertain global backdrop. This means mortgage rates will be fairly stable for a while, assuming funding costs don't blow out. However, **despite stability in mortgage interest rates, the actual interest rate paid by borrowers will continue to decline.** The OCR has been unchanged now for six months, after the 50bps March cut. Over this time, the effective mortgage rate (EMR), which is the weighted average of interest rates paid by borrowers, has declined by around 10bps.



We are getting this passive stimulus because of ongoing structural change in the New Zealand mortgage market. In 2008, only around 13 percent of mortgages by value were on floating rates. This has now risen to almost 60 percent, and is expected to continue rising. Floating rates were not popular a few years back because of the inverted nature of the mortgage curve, where floating rates were the most expensive. But with the mortgage curve now upward sloping, with floating the cheapest rate on offer, it is not surprising that more borrowers are gravitating towards them.

Though a record proportion are now on floating rates, there are still close to 40 percent on fixed rates, and it is the refinancing of these mortgages that are pushing the EMR lower. Over the next twelve months, some \$44bn of fixed rate mortgages will be due for renewal (61 percent of all fixed mortgage debt). These mortgages will be coming off a weighted average interest rate of 6.7 percent. By comparison, the current floating mortgage interest rate is 5.7 percent, and the once popular 2-year fixed rate is 6.4 percent, which is why the EMR will keep edging lower. Most borrowers have been gravitating towards floating mortgages, as they offer the lowest rates. With the RBNZ signalling that there will not be any OCR hikes until the global situation stabilises (and who knows when that will be!), and with only a gradual path of policy tightening likely thereafter, we can expect borrowers to continue to prefer floating.



To see how much further the EMR could fall, we assume that the path of the OCR will follow current market pricing, with a 25bp hike in March 2012 and another in September 2012, with a gradual path of policy tightening thereafter. In this instance the EMR will fall from its current 6.2 percent towards 6 percent by early next year. In other words, **by doing nothing until March next year, the RBNZ is effectively providing close to a 25bp rate cut.** Under our scenario, the EMR by the end of 2012 will still be below the level of early this year.

There are positives and negatives in this. Passive stimulus is appropriate considering the risk profile facing the NZ economy. With the proportion of borrowers on floating mortgages set to rise further, the RBNZ will have a lot of policy traction, giving them more confidence in the effectiveness of the OCR lever. But this is not without risk, particularly as low borrowing rates could ignite interest-rate sensitive sectors and the housing market. But it is a risk the RBNZ is willing to take at present.

DATA PREVIEW

SUMMARY

Despite the goods terms of trade hitting a new 37-year high, we expect the current account deficit to remain around 4 percent of GDP. Ongoing household deleveraging is likely to cap the magnitude of future deficits, but the high NZD, weaker global outlook and unbalanced nature of domestic expansion going forward suggests our external debt levels will remain elevated. June quarter GDP data is expected to confirm a reasonably solid quarter, reinforcing NZ's better economic momentum relative to OECD peers, but with wide sector divergences.

Current account – June 2011 quarter
(due Wednesday 21 September, 10.45am)

Current Account	ANZ	Market
Quarter	-0.95b	-0.67b
Annual	-8.26b	-7.91b
% of GDP	-4.1%	-4.0%

We are expecting a quarterly current account deficit of approximately \$1bn, with the annual deficit remaining stuck in the \$8.3bn zone. In seasonally adjusted terms this equates to a June quarter deficit of about \$2b.

Courtesy of the terms of trade being at a 37-year high, we expect a goods trade surplus of around \$2.7bn, with the annual goods balance climbing to 1.8 percent of GDP. Being the tourism offseason, the services deficit is expected to widen, and while the Rugby World Cup will see this component move into a large surplus over the remainder of 2011, the outlook beyond that inspires less optimism.

We expect an investment income deficit of \$3bn in June, with the annual deficit climbing to \$11bn. Investment income credits are expected to fall, with the stronger NZD offsetting modest gains on overseas equity markets. Investment income debits should strengthen as corporate profitability improves, albeit from a low base. Statistical changes are expected to deliver a net external debt of around 70 percent of GDP. While considerably lower than in 2009, it is still "high" compared to OECD counterparts.

Our core view assumes the deleveraging process has further to run, which is expected to cap the magnitude of future deficits despite the greater support to the spending side of the economy provided by low interest rates, the high NZD, and the boost to domestic spending from earthquake reconstruction. Looking forward, we expect annual current account deficits in the 3.5 to 4.5 percent range over the next 12 months, with the deficit heading towards 5 percent of GDP thereafter.

As such, the deficit is expected to remain in the "problematic but not alarming" zone, with little headway expected to be made in reducing our overseas indebtedness. This in part reflects tension between the need for the economy to deleverage but also to deploy capital towards rebuilding a substantial pool of destroyed domestic capital assets in Christchurch.

Gross Domestic Product – June 2011 quarter
(due Thursday 22 September, 10.45am)

GDP	ANZ	RBNZ	Market
QoQ	+0.7%	+0.6%	+0.5%
YoY	+1.9%	+1.8%	+1.7%
Ann. Ave.	+1.5%	+1.5%	+1.5%

We expect headline production GDP to increase by 0.7 percent in the June quarter, with sector differences apparent. Primary sector output is expected to increase by 0.5 percent, with our above-consensus Q2 pick assuming that the mild autumn will contribute to a strong quarter in agricultural production. Partly offsetting this will be falls in forestry and mining activity. We are positive on services sector activity, which is expected to climb 1 percent. Strong paid hours for the business services sector, robust retail activity and increasing house sales suggest more strength in the retail, transport and storage, and real estate and business services sectors. Activity in the goods sector is expected to be weak, declining by 1.4 percent. The major contributor is construction sector activity, which is expected to be very weak. Manufacturing and electricity sector activity should track sideways.

Sector divergences are also expected on the expenditure measure of GDP. Robust durable consumption is expected to underpin a solid increase in private consumption spending, although services consumption is expected to be more modest. Falls to residential investment and plant and machinery investment will contribute to a fall in private investment, despite other construction and transport equipment strengthening. Government consumption and inventory rebuilding will add to growth. However, net exports are set to make another negative quarterly contribution.

FINANCIAL MARKET IMPLICATIONS

A solid Q2 GDP print is expected to confirm that New Zealand entered a period of global fragility with better momentum than most. While still vulnerable to adverse global swings, such momentum should not be discounted.

INTEREST RATE STRATEGY

SUMMARY

Global financial market stability remains a pre-condition for RBNZ action, at least over the next few months. As such, we need to brace for more volatility in domestic markets as sentiment ebbs and flows in line with global developments. Subtle language changes by the RBNZ also suggest the first move will be 25bps rather than 50. This week's FOMC meeting and the Obama jobs package are the key "risk" events. In our view they are likely to be positively received – after all, they are stimuli. By contrast, the longer Europe "muddles through", the worse the final outcome is likely to be, and that isn't good for anyone – New Zealand included.

MARKET THEMES

- Last week's *MPS* placed heavy emphasis on global uncertainty, and dropped references to what had been hitherto described as "insurance" cuts in March. This gives the RBNZ more flexibility.
- The global sentiment tide continues to ebb and flow. Sentiment looks more "vulnerable" to improve this week, especially if Obama's jobs package and FOMC meeting initiatives are well received.
- Europe remains "fractured" literally and figuratively, and this is having a detrimental impact on markets. It is hard to see this changing.

REVIEW AND OUTLOOK

Although the September *MPS* came and went with very little market reaction, it was reasonably cautious and there were a number of key take-outs. The first and most obvious was **the removal of any references to the March cut, which the RBNZ had been referring to as an "insurance cut". By removing the reference, the Bank has removed the assumed need for the OCR to be moved higher immediately. It has also broken the link to a 50bp move.**

The second take out was **the Bank's substantially lower 90 day bank bill projections**, which now peak and stabilise at around 4.3% in the out years. **This is a clear endorsement of structural changes, and is consistent with the OCR not heading anywhere near historical levels**, as we have long argued. This has obvious ramifications for the term structure of interest rates, particularly with global interest rates likely to remain low for an extended period.

What happens offshore is critical to how policy will develop here – and in that regard we are mindful that Europe continues to go down the "muddle through" road. This is far from ideal, and carries significant risks, primarily via volatility and risk aversion. **But the big question hanging over markets is whether or not the Fed will engage in**

"operation twist" at this week's FOMC meeting. It would be a surprise if they don't do something to keep term rates depressed. But if they don't, ironically, any resultant negative sentiment may keep rates low too.

PREFERRED BORROWING STRATEGIES

It seems clear from the RBNZ's rhetoric that time is on the borrower's side, and that floating rates are likely to remain low for some time, possibly even into early 2012. Indeed, the RBNZ seem to be in no hurry to lift the OCR. We had been expecting them to place more emphasis on the domestic data flow, but it is clear from the *MPS* that future moves are contingent on global developments. Furthermore, with the US Federal Reserve likely to pursue policies (be it "operation twist" or lowering the level of interest payable on excess reserves), global rates are likely to remain low for some time. Along with the RBNZ's new downwardly revised OCR projections, this should keep downward pressure on local term swap rates. On the face of it, this does make paying for term more attractive. But term rates are still way above 3mth BKBM, and as such, we do not favour discretionarily adding to long term hedges unless they move lower yet, and we start to get more clarity that the global scene is stabilising. At the moment, if anything the global scene is getting worse. Of course, for hedge managers who need to keep within policy, lower long term swap rates does make paying fixed more palatable.

GAUGES FOR NZ INTEREST RATES

GAUGE	DIRECTION	COMMENT
RBNZ / OCR	↔	Tightening bias, but much depends on global scene.
NZ data	↔/↑	Confidence has held up well, Q2 GDP likely to be robust.
Fed Funds / front end	↔/↓	Markets expect something from FOMC, but not QE3.
RBA	↔/↑	Next move could be a cut.
US 10 year	↔	Markets hopeful the Fed will embark on "operation twist".
NZ swap curve	↔/↓	Flattening bias remains, exacerbated by global rates and revised RBNZ bill track.
Flow	↔/↑	Dependent on global themes, upside vulnerable this week.
Technicals	↔	2yr resistance in low 3.20s.

MARKET EXPECTATIONS FOR RBNZ OCR (BPS)

OCR DATES	LAST WEEK	THIS WEEK
Thu 27-Oct-11	+8	+2
Thu 8-Dec-11	+15	+9
Thu 26-Jan-12	+26	+17
Thu 8-Mar-12	+33	+28
Thu 26-Apr-12	+33	+35
Thu 14-Jun-12	+39	+37
Thu 26-Jul-12	Not forecast	+41

TRADING THEMES WE FAVOUR AT PRESENT

We continue to favour curve flattening trades. Although the curve has flattened substantially since the March rate cut, the global low rates environment and the RBNZ's lower 90 day bill projections suggest this has further to run. We also favour being short OIS over the December RBNZ meeting in the low 2.50s should it get there after this week's data flow.

CURRENCY STRATEGY

SUMMARY

The failure of European politicians to come up with anything concrete over the weekend has EUR on the backfoot again. With the FOMC set to engage in "Operation Twist" this week, markets are expected to reward currencies where policymakers are active in providing stimulus. With the RBNZ kicking for touch, NZD will be at the mercy of global developments. A risk off environment to start the week will see NZD drift lower, but we expect it to remain well supported on dips, and end the week on a stronger footing based on our view that Q2 GDP will come in above market expectations.

MARKET THEMES

- European situation remains main focus with Greek default imminent if nothing is done.
- FOMC set to deliver "Operation Twist" but full blown QE3 a step too far.
- NZ Q2 GDP release likely to provide NZD support.
- RBA board minutes could undermine AUD as they change tack.

REVIEW AND OUTLOOK

It feels like Groundhog Day as we continue to wait for any resolution of the European situation.

The positive boost to sentiment from the co-ordinated initiative by the ECB, BoE, SNB and BoJ in cooperation with the Fed to boost liquidity have faded with the failure of the European finance ministers to come up with anything concrete over the weekend to resolve the sovereign debt crisis. Focus is now turning to whether Greece is able to meet the conditions for receiving the second tranche of the bailout funds. With a growing expectation that Greece could default, this is not quite the resolution many hoped for but could give us more clarity going forward.

Unlike their European counterparts, US policymakers have been active in providing more support to their economy. This is partly behind recent USD strength. The FOMC is expected to engage in "Operation Twist" this week, selling shorted dated securities and purchasing longer dated ones. We think the hurdle for a full blown QE3 is too high, but the FOMC could also cut the interest rate paid on excess reserves. The policy toolkit may be running bare, but at least the Fed is willing to do what it takes, which we expect will put a floor under the USD against the major currencies.

The release of the RBA board minutes will be keenly anticipated for some hint that the RBA may be softening its monetary policy stance. Certainly Australian data has been coming off the boil

and the RBA now has some difficult choices to make as the dichotomy between the east and west coast economies tests policymakers. A softer tone in these minutes will undermine AUD, allowing NZDAUD to move up convincingly through 0.8000. **The release of NZ Q2 GDP data, which we expect to print above expectations, should provide support to the NZD.** On balance we expect NZD to start the week on the backfoot, but to remain well supported on dips and gain on positive domestic data to end the week.

NZD VS AUD: MONTHLY DIRECTIONAL GAUGES		
GAUGE	DIRECTION	COMMENT
Fair value	↔	Close to our fair value estimates.
Yield	↑	Opposing policy direction favours NZD.
Commodities	↔	Wary of cracks appearing here.
Partial indicators	↔/↑	Data still good in NZ.
Technicals	↔↑	Rangebound .7900 - .8050.
Sentiment	↔	Balanced.
Other	↔	Global sentiment big driver.
On balance	↑	Yield and undervaluation support NZD.

NZD VS USD: MONTHLY DIRECTIONAL GAUGES		
GAUGE	DIRECTION	COMMENT
Fair value – long-term	↓	Above structural fair value of 0.67.
Fair value – short-term	↔/↓	Still above our cyclical fair value estimates.
Yield	↑	Official rates to stay low but investable yields support.
Commodities	↔	So far so good.
Risk aversion	↓	European debt woes driving risk off sentiment.
Partial indicators	↑	NZ data still better, US data still bad.
Technicals	↔	Wide range continues .8150 - .8350.
AUD	↓	AUD undermined by data.
Sentiment	↑↓	Growth vs potential QE3 vs EU debt crisis = confusion.
Other	↓	USD making a comeback on lack of safe haven alternatives.
On balance	↔	Global issues remain the focus.

DATA EVENT CALENDAR

DATE	COUNTRY	DATA/EVENT	MKT.	LAST	NZ TIME
19-Sep	NZ	Westpac NZ Consumer Confidence - 3Q	--	112(a)	10:00
	NZ	Performance Services Index - AUG	--	53.9(a)	10:30
	UK	Rightmove House Prices (MoM) - SEP	--	-0.7%(a)	11:01
	UK	Rightmove House Prices (YoY) - SEP	--	-1.5%(a)	11:01
	EC	Construction Output SA MoM - JUL	--	-1.8%	21:00
	EC	Construction Output WDA YoY - JUL	--	-11.3%	21:00
20-Sep	US	NAHB Housing Market Index - SEP	15	15	02:00
	AU	Reserve Bank's Board Minutes - SEP	--	--	13:30
	GE	Producer Prices (MoM) - AUG	0.0%	0.7%	18:00
	GE	Producer Prices (YoY) - AUG	5.8%	5.8%	18:00
	GE	Zew Survey (Current Situation) - SEP	45.0	53.5	21:00
	EC	ZEW Survey (Econ. Sentiment) - SEP	--	-40.0	21:00
21-Sep	GE	ZEW Survey (Econ. Sentiment) - SEP	-45.0	-37.6	21:00
	NZ	ANZ Job Ads - AUG	590K	604K	00:30
	US	Housing Starts MOM% - AUG	-2.3%	-1.5%	00:30
	US	Building Permits - AUG	590K	601K	00:30
	US	Building Permits MOM% - AUG	-1.8%	-3.2%	00:30
	NZ	Current Account Balance - 2Q	-0.671B	-0.097B	10:45
	NZ	Current Account to GDP Ratio YTD - 2Q	-4.0%	-4.3%	10:45
	NZ	Net Migration SA - AUG	--	-220	10:45
	UK	Nationwide Consumer Confidence - AUG	47	49	11:01
	JN	Merchnds Trade Balance Total - AUG	-¥300.0B	¥70.0B	11:50
	JN	Adjusted Merchnds Trade Bal. - AUG	-¥22.1B	-¥130.5B	11:50
	JN	Merchnds Trade Exports YoY - AUG	8.0	-3.4	11:50
	JN	Merchnds Trade Imports YoY - AUG	14.3	9.9	11:50
	AU	Westpac Leading Index (MoM) - JUL	--	0.1%	12:30
	AU	DEWR Internet Skilled Vacancies MoM - AUG	--	-0.8%	13:00
CH	Conference Board Leading Economic Index - JUL	--	--	14:00	
NZ	Credit Card Spending SA (MoM) - AUG	--	1.0%	15:00	
NZ	Credit Card Spending (YoY) - AUG	--	7.3%	15:00	
UK	Bank of England Minutes - SEP	--	--	20:30	
UK	Public Finances (PSNCR) - AUG	£7.0B	-£5.6B	20:30	
UK	PSNB ex Interventions - AUG	£13.0B	£0.0B	20:30	
UK	Public Sector Net Borrowing - AUG	£11.4B	-£2.0B	20:30	
US	MBA Mortgage Applications - 16-SEP	--	6.3%	23:00	
22-Sep	US	Existing Home Sales - AUG	4.75M	4.67M	02:00
	US	Existing Home Sales MoM - AUG	1.7%	-3.5%	02:00
	US	FOMC Rate Decision - SEP	0.25%	0.25%	06:15
	NZ	GDP QoQ - 2Q	0.5%	0.8%	10:45
	NZ	GDP YoY - 2Q	1.7%	1.4%	10:45
	GE	PMI Manufacturing - SEP A	50.5	50.9	19:30
	GE	PMI Services - SEP A	50.5	51.1	19:30
	EC	PMI Composite - SEP A	49.8	50.7	20:00
	EC	PMI Manufacturing - SEP A	48.5	49.0	20:00
	EC	PMI Services - SEP A	51.0	51.5	20:00
	EC	Industrial New Orders NSA (YoY) - JUL	10.5%	11.1%	21:00
	EC	Industrial New Orders SA (MoM) - JUL	-1.2%	-0.9%	21:00
UK	CBI Trends Total Orders - SEP	-5	1	22:00	

Continued on following page

DATA EVENT CALENDAR

DATE	COUNTRY	DATA/EVENT	MKT.	LAST	NZ TIME
22-Sep	UK	CBI Trends Selling Prices - SEP	7	9	22:00
	CH	HSBC Flash China Manufacturing PMI - SEP	- -	49.9	22-25 SEP
23-Sep	US	Initial Jobless Claims - 17-SEP	420K	428K	00:30
	US	Continuing Claims - 10-SEP	3720K	3726K	00:30
	EC	Eurozone Consumer Confidence - SEP A	-18.0	-16.5	02:00
	US	Leading Indicators - AUG	0.1%	0.5%	02:00
	US	House Price Index MoM - JUL	0.2%	0.9%	02:00
	AU	Conference Board Leading Index - JUL	- -	-0.8%	12:00
	CH	MNI Flash Business Sentiment Survey - SEP	- -	- -	13:35
	UK	BBA Loans for House Purchase - AUG	33250	33417	20:30
	CH	Leading Index - AUG	- -	102.25	25-28 SEP

Key: AU: Australia, EC: Euro-zone, GE: Germany, JN: Japan, NZ: New Zealand, UK: United Kingdom, US: United States, CH: China.

Sources: Dow Jones, Reuters, Bloomberg, ANZ, National Bank. All \$ values in local currency.

Note: All surveys are preliminary and subject to change.

LOCAL DATA WATCH

Key focus over the next few weeks: Cognisant of downside global risks the RBNZ kicked for touch in the September *MPS*. This is a prudent strategy, although one not without risks. This week's Q2 GDP may be historical, but is expected to confirm domestic resilience, which should set the scene for a stronger second half of 2011. The next key read will be the NZIER QSBO in early October, which will give us an idea of how resilient the economy has been during the period of global volatility. While the timing of the first OCR hike is largely dependent on the global outlook, strong domestic momentum and a troublesome inflation trajectory suggest the OCR will need to move higher at some stage. Irrespective of when the OCR goes up, the spirit of our assessment is for a gradual path of policy tightening and historically low OCR endpoint.

DATE	DATA/EVENT	ECONOMIC SIGNAL	COMMENT
Wed 21 Sep (10:45am)	Balance of Payments – 2011Q2	Stable	A quarterly deficit of \$950m is forecast, with the annual deficit stable at 4.1 percent of GDP.
Wed 21 Sep (10:45am)	International Travel and Migration - Aug	Up	A net PLT migration outflow of 100 persons is expected. Visitor arrivals are expected to rise 2 percent on account of more snow.
Wed 21 Sep (10:45am)	RBNZ Credit Card Billings – Aug	Flat	The decline in Electronic Card Transactions suggests a flat outturn is in store. Billings from overseas credit cards look set to surge over September and October due to the Rugby World Cup.
Thur 22 Sep (10:45am)	Gross Domestic Product – 2011Q2	Resilience	We have pencilled in a 0.7 percent increase. Higher primary sector and services production will offset lower goods production.
Mon 26 Sep (10:45am)	Overseas Merchandise Trade - Aug	In the red	A trade deficit of \$300m is expected, with lower export commodity prices starting to weigh on export receipts.
Fri 30 Sep (10:45am)	Building Consents – Aug	Holding	A 2 percent increase in residential consents is envisaged. Some pullback is possible for non-residential consent values.
Fri 30 Sep (1:00pm)	National Bank Business Outlook - Sep	- -	- -
Fri 30 Sep (3:00pm)	RBNZ Credit Aggregates - Aug	Deleveraging	Low annual rates for household and business credit, with agricultural credit falling as farmers repay debt.
Mon 3 Oct (1:00pm)	ANZ Commodity Price Index – Sep	- -	- -
Tues 4 Oct (10:00am)	NZIER QSBO – 2011Q3	Solid	Domestic confidence to shake off the global gloom, with activity indicators pointing to solid growth and indicators of resource pressures warning of rising inflation pressure.
Tues 11 Oct (10:45am)	Electronic Card Transactions - Sep	RWC boost	We expect a 2.5 percent increase in retail Electronic Card Transaction (ECT) spending underpinned by sizeable increases for hospitality and services spending.
Thur 13 Oct (10:45am)	Food Price Index – Sep	Up	A slight reversal from last months fall is expected, with the 0.5 increase in food driven by higher meat and grocery prices.
Fri 14 Oct (10:45am)	REINZ Residential Sales - Sep	Up	We expect a 2 percent strengthening in house sales, with days to sale easing towards the high 30s. No change in prices is expected.
On Balance		Local vs global	Domestic gauges still resilient, but global concerns suggest some caution further out.

KEY FORECASTS AND RATES

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
GDP (% qoq)	0.5	0.8	0.7	1.1	1.5	0.7	1.0	0.9	0.8	0.7
GDP (% yoy)	1.1	1.4	1.9	3.1	4.2	4.1	4.4	4.2	3.4	3.4
CPI (% qoq)	2.3	0.8	1.0	0.8	0.7	0.6	0.8	0.7	0.6	0.8
CPI (% yoy)	4.0	4.5	5.3	5.0	3.3	3.1	2.9	2.8	2.7	2.9
Employment (% qoq)	-0.3	1.3	0.0	0.7	0.6	0.7	0.5	0.5	0.4	0.4
Employment (% yoy)	1.3	1.8	2.0	1.7	2.6	2.0	2.5	2.3	2.1	1.8
Unemployment Rate (% sa)	6.7	6.5	6.5	6.2	5.9	5.6	5.5	5.3	5.3	5.3
Current Account (% GDP)	-4.1	-4.2	-4.3	-4.2	-3.7	-3.9	-4.1	-4.4	-4.7	-4.8
Terms of Trade (% qoq)	0.8	0.8	2.3	3.0	1.0	-0.9	-0.8	-0.8	-0.8	-0.8
Terms of Trade (% yoy)	12.3	6.7	7.0	7.1	7.3	5.5	2.3	-1.4	-3.3	-3.1

	Dec-10	Jan-11	Feb-11	Mar-11	Apr-11	May-11	Jun-11	Jul-11	Aug-11	Sep-11
Retail ECT (% mom)	-0.9	2.4	-0.1	1.5	1.4	-0.7	1.1	0.3	-0.7	..
Retail ECT (% yoy)	4.4	5.7	6.2	6.6	10.0	6.8	9.0	8.0	8.4	..
Credit Card Billings (% mom)	-1.7	3.9	-0.5	-1.2	1.8	0.4	0.5	1.0	..	..
Credit Card Billings (% yoy)	2.4	6.2	5.9	2.1	6.6	5.5	4.6	7.3	..	..
Car registrations (% mom)	-8.8	1.3	-2.0	0.0	-5.5	3.6	-2.0	-1.0	6.5	..
Car registrations (% yoy)	6.4	6.8	2.8	-1.0	-10.5	-3.7	-9.5	-6.0	1.9	..
Building consents (% mom)	-18.7	9.0	-9.7	2.6	-1.1	3.1	-1.0	13.0	..	..
Building consents (% yoy)	-26.5	-14.6	-28.9	-26.0	-32.3	-21.9	-25.4	-15.7	..	..
REINZ House Price Index (% yoy)	-1.6	-2.6	-0.7	-1.8	-0.4	-0.7	0.0	0.5	..	..
Household Lending Growth (% mom)	0.1	0.1	0.1	-0.1	0.2	0.1	0.1	0.2	..	..
Household Lending Growth (% yoy)	1.6	1.5	1.5	1.2	1.2	1.2	1.2	1.2	..	..
ANZ Roy Morgan Consumer Confidence	112.2	117.1	108.1	101.4	101.4	103.3	112.5	109.4	113.3	112.6
NBNZ Business Confidence	29.5	..	34.5	-8.7	14.2	38.3	46.5	47.6	34.4	..
NBNZ Own Activity Outlook	34.5	..	36.6	14.7	29.5	39.7	38.7	43.7	43.3	..
Trade Balance (\$m)	-218	9	184	583	1158	554	197	129	..	..
Trade Balance (\$m ann)	1172	909	765	741	1238	1022	999	1314	..	..
ANZ World Commodity Price Index (% mom)	1.6	4.3	2.7	4.7	1.6	0.4	-1.2	-0.2	-1.2	..
ANZ World Commodity Price Index (% yoy)	12.1	16.3	20.3	23.5	19.8	19.6	20.6	22.2	22.1	..
Net migration (sa)	700	420	440	-530	-120	-320	-290	-220	..	..
Net migration (annual)	10451	8689	8249	6554	5508	4625	3867	2867	..	..

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

KEY MARKET FORECASTS AND RATES

	ACTUAL			Forecast (end month)						
FX RATES	Jul-11	Aug-11	Today	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
NZD/USD	0.879	0.854	0.824	0.88	0.91	0.92	0.93	0.93	0.93	0.92
NZD/AUD	0.799	0.798	0.801	0.80	0.81	0.82	0.83	0.82	0.82	0.82
NZD/EUR	0.610	0.594	0.603	0.60	0.61	0.61	0.61	0.60	0.60	0.60
NZD/JPY	67.54	65.48	63.41	66.0	68.3	69.0	67.0	67.0	67.0	68.1
NZD/GBP	0.536	0.526	0.524	0.53	0.55	0.54	0.55	0.53	0.53	0.53
NZ\$ TWI	74.2	73.0	72.3	74.1	75.9	76.3	76.7	75.8	75.8	75.7
INTEREST RATES	Jul-11	Aug-11	Today	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
NZ OCR	2.50	2.50	2.50	2.50	2.75	3.00	3.25	3.50	3.75	4.00
NZ 90 day bill	2.95	2.99	2.86	2.90	3.20	3.30	3.70	3.80	4.20	4.30
NZ 10-yr bond	4.93	4.52	4.46	4.50	4.40	4.50	4.60	4.80	4.90	5.00
US Fed funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
US 3-mth	0.26	0.33	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35
AU Cash Rate	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75
AU 3-mth	5.07	4.87	4.78	4.90	4.90	4.90	4.90	4.90	4.90	4.90

	16 Aug	12 Sep	13 Sep	14 Sep	15 Sep	16 Sep
Official Cash Rate	2.50	2.50	2.50	2.50	2.50	2.50
90 day bank bill	2.94	2.97	2.97	2.92	2.91	2.87
NZGB 04/13	3.01	2.99	2.99	3.00	2.95	3.02
NZGB 04/15	3.60	3.50	3.49	3.49	3.43	3.51
NZGB 03/19	4.35	4.28	4.26	4.27	4.19	4.27
NZGB 05/21	4.52	4.46	4.44	4.45	4.37	4.47
2 year swap	3.41	3.24	3.24	3.26	3.23	3.29
5 year swap	4.23	3.95	3.94	3.94	3.86	3.94
RBNZ TWI	71.4	71.6	72.0	71.8	71.3	72.0
NZD/USD	0.8322	0.8157	0.8236	0.8171	0.8137	0.8264
NZD/AUD	0.7944	0.7872	0.7944	0.7992	0.7970	0.7983
NZD/JPY	63.95	63.19	63.44	62.87	62.38	63.46
NZD/GBP	0.5083	0.5150	0.5191	0.5187	0.5161	0.5228
NZD/EUR	0.5768	0.6012	0.6018	0.5997	0.5928	0.5960
AUD/USD	1.0476	1.0362	1.0367	1.0224	1.0210	1.0352
EUR/USD	1.4428	1.3567	1.3685	1.3626	1.3726	1.3865
USD/JPY	76.84	77.47	77.03	76.94	76.66	76.79
GBP/USD	1.6371	1.5840	1.5867	1.5754	1.5766	1.5806
Oil (US\$/bbl)	87.82	87.25	88.19	90.24	88.81	87.97
Gold (US\$/oz)	1765.40	1855.30	1830.15	1833.80	1811.40	1812.15
Electricity (Haywards)	22.50	6.55	9.74	8.31	6.50	9.75
Baltic Dry Freight Index	1344	1876	1901	1927	1907	1814
Milk futures (USD)	147	147	147	147	147	147

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