

HERE WE GO AGAIN

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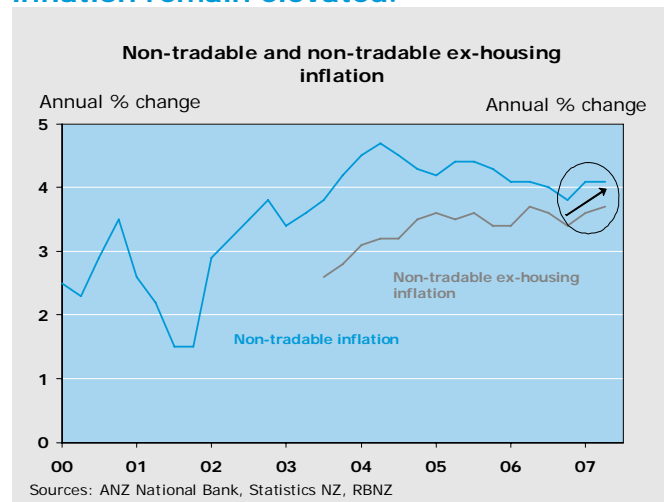
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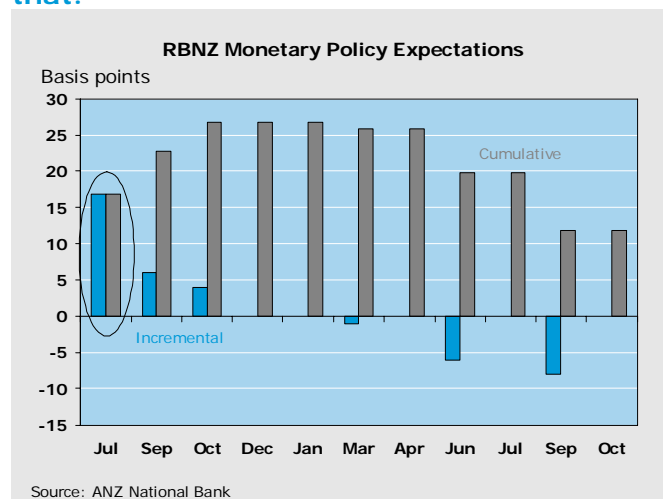
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Non-tradable and non-tradable ex-housing inflation remain elevated.



Markets are pricing in around a 70 percent chance of a hike this week and more after that.



ECONOMIC OVERVIEW

A stronger than expected inflation read in the June quarter looks set to force the Reserve Bank's hand, although strategic considerations may make it a close call. Australian CPI figures are the other key release this week.

What's ahead...

- RBNZ OCR *Review* (Thursday 0900 NZST). We feel that current market pricing for a July OCR hike may prove too tempting for the RBNZ and they will take the opportunity to raise rates.
- NZ June Overseas Merchandise Trade (Friday 1045 NZST). We are expecting a deficit as imports are pulled higher by the arrival of the HMNZS Canterbury.

What's the view

The obvious focus for markets this week is the Reserve Bank's OCR *Review* this Thursday. Like the majority of economists (11 out of 17), we believe the risk profile is now tilted towards a further late cycle hike. However, the decision to increase the OCR to 8.25 percent – the fourth hike this year, is shaping up as a much closer call than the three previous hikes.

We find the June quarter inflation data released last week hard to step away from. Although some of the key trends in the core inflation measures within the release are showing further movements south, non-tradable inflation and non-tradable ex-housing inflation – the area of inflationary pressure the Reserve Bank are ultimately trying to control – remain elevated at 4.1 percent and 3.7 percent respectively, and showed quarterly increases of 1.1 and 1.0 percent. Admittedly, both look to be stabilising in the quarter relative to March, but at uncomfortably high rates.

On the face of it, a hike looks a *fait accompli*. The June *Statement* was notable for the lack of inflation headroom and the June quarter inflation report came in above the Reserve Bank's expectations.

The economy at present is showing mixed signals. Retail sales in April were down, but up in May. June month credit card sales rose 1.9 percent, an incredibly strong increase. The consumer looks to be holding up frustratingly well despite the three OCR hikes to date this year. Dairy aligned regions continue to report strong activity, with all and sundry now expecting a payout close to \$6.50/kg milk solid. Time will tell. Migration flows continued to ease in data out last week, mitigating one potential housing and inflation risk. Non-dairy exporters are now feeling real pain from the high currency. Housing market activity is slowing. As a bank, we should know!

Stepping back, it seems strange to be calling a hike when financial conditions are this tight. Monetary

policy does, after all, work with a lag. But the reality is that last week's inflation figures are difficult to ignore and have reduced the Reserve Bank's flexibility. With the market now pricing in a hike, we suspect the path of least resistance from the Reserve Bank will be to follow through.

But the Reserve Bank is also facing strategic considerations. Last week was notable for the increased politicking surrounding both the high level of the NZD and the threat by the Minister of Finance to invoke Section 12 of the Reserve Bank Act. In addition, submissions into the inquiry into Monetary Policy also closed and deliberations due to start. All are subtle reminders that while the Reserve Bank has operational independence, that's where its independence ceases. If the decision is a line-ball call as far as the data interpretation is concerned (which we do not believe is the case), then such considerations – although technically irrelevant (and also a strong reason to hike and cement independence) – could swing the decision to no change.

Looking at other developments over the week, there are a couple of points of note. The USD remains weak, owing to subprime concerns and weakness in housing. Fast forward 12 months and we expect the same housing-related weakness to emerge here. Oil prices tested previous highs, swap spreads continued to widen, equities were up and down, bonds continued to rally on subprime woes, and China recorded strong growth and rising inflation. It's a combination that has us scratching our heads over the global economy – which looks strong at present, but not without risk. Historically, it has been a global event that has been the real "trigger" to weakness in the New Zealand economy, and New Zealand looks to be in a similar position to the early and mid 1990's when restrictive financial conditions sowed the seeds, but the "event" fostered the correction. At present we can't identify a trigger so it remains a story of vulnerability.

Turning to other points of interest this week, the key focal point is the Australian CPI data. Our Australian counterparts are expecting a 1.0 percent rise, but a core inflation read that will not trigger a pre-election hike from the RBA.

Recent data...

- **NZ CPI (Jun qtr)**. Headline inflation rose by 1.0 percent in the quarter, taking the annual rate to 2.0 percent. Tradable inflation rose 0.9 percent, and non-tradable inflation 1.1 percent.
- **NZ Electronic Card Transactions (Jun)**. Retail ECT sales rose 0.8 percent, while core retail ECT sales increased 1.3 percent.
- **NZ External Migration (Jun)**. The annual net migration inflow eased to 10,078 in June.
- **NZ Credit Card Billings (Jun)**. Credit card spending rose 1.9 percent, following a 0.5 percent increase in May.

MONETARY POLICY INQUIRY SUBMISSION

Our submission to the Finance and Expenditure Committee has three broad themes. The Monetary Policy Framework has served New Zealand well. Challenges the Reserve Bank is facing in curtailing inflation are increasingly looking supply-side phenomena. Going forward, we favour greater interaction between monetary, fiscal and broader policy, the monetary policy decision making process shifting to a committee, better information (statistics) for decision making, and a stronger focus on inflation expectations and the yield curve across the Reserve Bank's communication.

Monetary policy is not the only policy instrument that influences the economy. As noted in the Svensson Review, people typically ask too much of monetary policy. It also tends to become an easy target as a consequence. There are a host of other policy orientated stabilisation mechanisms that influence economic, interest rate and currency trends. These include tax, government spending, regulation, wider policy settings and local government. It is the interaction of all of these things that matters.

The benefits of a low inflation environment and price stability are well documented. IMF research shows that inflation in excess of 3 percent exerts a negative effect on growth for developed economies.

New Zealand has strong institutional arrangements that support the maintenance of price stability. This framework, which is built around the provision of a target for inflation, central bank independence and a high degree of transparency, cements low and stable inflation as a long-term policy aim. New Zealand's monetary policy framework is consistent with international best-practice.

New Zealand will invariably have higher interest rates relative to our trading partners, owing to a shortage of savings and a chronic current account deficit. New Zealand's continued reliance on foreign savings to fund consumption and investment has led to a deterioration in the country's external balances. Although the country's credit rating remains strong, the increasing vulnerability that a large current account deficit poses means a risk premium will always be demanded by foreign lenders to compensate for the additional risk they incur. Less reliance on foreign saving via increased domestic saving would see the risk premium subside.

Monetary policy, and New Zealand's economic framework, has had to deal with some challenging circumstances including China's integration into the global economy and

globalisation in general, an Asian crisis, droughts, events of 9/11, geopolitical conflict, massive swings in migration flows, electricity crisis, the outbreak of Severe Acute Respiratory Syndrome (SARS) and surging commodity prices.

New Zealand's monetary policy framework has served the economy well. Since the inception of inflation targeting with the signing of the first Policy Targets Agreement (PTA) in March 1990, inflation has been low and GDP growth more stable. The economy is currently recording the longest economic expansion since the 1960's. The annual rate of inflation has averaged 2.1 percent since inflation targeting was introduced. Inflation has been a tad higher since 2000, although broadly in line with our trading partners. Inflation expectations, in general, remain well anchored.

More recently, monetary policy has faced additional challenges. Excess demand has fuelled domestic inflationary pressures. Aggressive competition across financial intermediaries and massive growth in non-bank financial institutions has leaned against the Reserve Bank's efforts to slow the economy. Tight monetary policy settings are placing pressure on the tradable sector via a high currency. However, the Reserve Bank is not alone in addressing such challenges.

With hindsight, monetary policy could have been implemented differently. The Reserve Bank should have tightened policy earlier in the economic cycle. By their own admission, they probably paid too much attention to the currency, resulting in a more cautious tightening path.

But hindsight is a wonderful thing. The reality is that the Reserve Bank has faced some exceptional circumstances that have mitigated the potency of monetary policy. These are now unwinding. Monetary policy still works, just with longer lags. Few commentators foresaw current developments, and the Governor's rhetoric has repeatedly warned as to where the risk profile for rates resided. Other countries are showing similar strength in their currencies, a reflection of global forces in association with domestic considerations. While the New Zealand dollar is strong on a TWI basis, a large portion of this reflects weakness in the US dollar, which is sitting near historical lows.

Despite these challenges, monetary policy is working. New Zealand economic growth slowed from 4.5 percent in calendar 2004 to 2.2 percent in 2005 and 1.5 percent in 2006, well below our major trading partners. Monetary policy tightening since early 2004 has played a major part in this slowdown. **The main question at this juncture is why such a slowdown has not dampened inflation pressures.**

Some of the challenges the Reserve Bank is facing in curtailing inflation are increasingly looking to be supply-side phenomena. Productivity growth has deteriorated markedly.

Resources are not responding to pricing signals, suggesting policy frictions are restricting the free-flow of resources. Such challenges are forcing the Reserve Bank to lean more heavily on the demand-side of the economy in order to curtail inflation. This does not mean that improved supply-side capacity would lead to better monetary policy outcomes. However, better predictability regarding the supply-side certainly would.

As the world becomes more integrated, monetary policy becomes more challenging.

Globalisation provides direct trade benefits and has dampened general inflation pressure. Low global interest rates have dampened the monetary transmission mechanism by keeping longer-dated New Zealand rates low. As asset markets have become integrated, New Zealand assets are increasingly being priced according to global norms, and no longer at a massive discount. Wealth has been enhanced as a consequence. But as markets become more integrated, labour and capital move more readily, which is reflected in sizeable swings in the New Zealand dollar. The benefits of globalisation outweigh the costs.

Monetary policy can no longer work in isolation. The global environment is becoming less benign when looking at inflation trends. As globalisation continues, wider global forces will become of increasing importance in setting policy. Surfeit resources in the economy, apparent when New Zealand shifted to inflation targeting and which helped suppress general inflation pressure in the early years, are no longer available. Given the transmission mechanism from monetary policy to the economy is now more protracted, it is even more important that it is supported by other policy mechanisms.

Looking forward, other instruments and areas will need to work more readily in conjunction with monetary policy in order to more effectively stabilise output and achieve price stability. At present, monetary policy has been left to carry the inflationary burden. Ultimately it is the co-ordination across an array of policies that will be important.

While monetary and fiscal policies are generally well co-ordinated, we believe gaps exist across policy analysis in terms of how policy decisions are impacting on the supply-side of the economy, including productivity growth. The growing burden of regulation is a significant issue.

We do not believe the current monetary policy framework needs to be altered. We make six recommendations to help enhance what is already a successful framework:

- **Recommendation 1: Monetary policy needs assistance from other areas** including more co-ordination with Government spending and tax policies (including practices and

enforcement), broader economic policies, and local government. To support monetary policy, we recommend further improvements in regards to savings policy, further development in local capital markets, better enforcement in regards to housing's perceived and actual advantages (relative to alternate investments both domestic and offshore); and the establishment of an independent productivity commission, which aims to better understand how policy decisions could impact on productivity performance and the supply-side of the economy. In addition, we recommend an examination of the inflationary pressures emanating from non-market and less competitive sectors of the economy, with an eye to opening them up to competition and market-based pricing incentives.

- **Recommendation 2: A committee decision-making structure.** We recommend the implementation of a formal Monetary Policy Committee structure to be responsible for decisions relating to monetary policy, as opposed to the current single-decision maker model. The Governor considers a range of views in setting monetary policy, both from within the Reserve Bank and also externally through regular contacts with businesses. A committee structure could help to change possible perceptions that ultimately it is only the Governor's view that counts.
- **Recommendation 3: Better information for decision-making.** We recommend additional funding be directed towards the provision of more timely and accurate statistics, and particularly a monthly Consumers Price Index series and a quarterly income based measure of GDP.
- **Recommendation 4: A stronger focus on inflation expectations and the yield curve across the Reserve Bank's communication.**
- **Recommendation 5: Improved global linkages.** We recommend the fostering of greater linkages between the Reserve Bank and global counterparts in light of the growing importance globalisation is having on domestic trends.
- **Recommendation 6: We do not support the implementation of other ancillary policy instruments.** We do not believe floated stabilisation measures would enhance monetary policy outcomes. There is also a clear distinction between such instruments, and monetary policy being provided assistance from other areas as detailed in Recommendation 1. The distinction resides in putting in place the economic incentives (as opposed to potential distortions) that allow stakeholders to respond in an efficient manner.

If you would like a copy of our submission, please email Cameron Bagrie: bagriec@anz.com

INFLATIONARY READINGS

Inflationary indicators are mixed, although the most important gauges are nonetheless pointing to a hike.

There seems to be so much confusion at present over the extent of inflationary pressure within the economy, that we thought we should present an array of inflationary measures that are influential. These range from the headline CPI number to non-tradable (or domestically sourced) inflation and internationally comparable "core" measures such as the CPI ex-food and energy. There are also other measures of core inflation that get attention such as the 10 percent trimmed mean and weighted median measures, plus complicated models such as the exponentially smoothed and factor model measures, which the RBNZ calculate.

When we eye up the broad trends across these inflation indicators and the outlook, we are mindful of 8 points.

- **The most important inflationary indicators are pointing to a hike.** Non-tradable and non-tradable ex housing inflation gauges are more important than others purely because this is the sector of inflation and the economy the Reserve Bank controls. Non-tradable ex-housing inflation remains elevated. This is the type of slow-burn inflation that is slow to rise and hard to contain. It is also a proxy for inflation expectations and at elevated levels it raises the risks of feeding into wage expectations. Although quarterly growth, at 1.0 percent, was lower than in March – which we found mildly encouraging – annual growth has increased to 3.7 percent.
- **Care must be taken focusing on CPI ex petrol, government charges and food measures** when they are facing structural adjustments higher. i.e. you cannot strip out a one-off when it doesn't look to be a one-off.
- **There were nonetheless some encouraging signs in the June quarter inflation result,** with services inflation easing, and core measures showing signs of moderation.
- **However, both the RBNZ factor and exponentially smoothed core inflation indicators tend to move concurrently with the actual CPI.**
- **Irrespective of current inflation, it is medium-term inflation that is the Bank's central focus** and the core drivers are all pointed one way.
- **There are structural adjustments across a number of industries** (energy, food prices including bio-fuels) that will add further to inflationary pressure at a time the Reserve Bank has zero headroom. Strictly speaking

these should be looked through, but it is increasingly difficult to do when they are numerous, and come at a time when core inflation measures are still high.

- **The Reserve Bank clearly has limited inflation headroom.** The June *Monetary Policy Statement* highlighted the lack of inflation headroom the Bank currently faces. Their forecasts have inflation remaining near the top of the target band through to 2010. The Bank can ill-afford inflation becoming further entrenched given the large stimulus pending from commodity prices and fiscal policy.
- **Anecdotally, our travels around the country highlight a worrying inflation under-current.** No-one believes inflation will be at 2 percent in 18 months time, which tells us there is a degree of inflation stickiness in the system.

The upshot

We categorise ourselves as inflation and interest rate doves, but even we don't like the inflationary nuances we are seeing. While we believe inflation pressures will recede quickly as the tightening in financial conditions takes hold, the reality is that the Reserve Bank is now facing a risk profile where they will likely be forced to do more than they actually require, just to be sure.

Gauge	Inflation rate				Direction		Comment
	Sep 06 quarter	Dec 06 quarter	Mar 07 quarter	Jun 07 quarter	Current	Next six months	
Headline	3.5	2.6	2.5	2.0	↓	↑	Tradable pulling it lower but set to increase when the Q4 2006 drops out
- ex petrol	3.0	2.9	2.9	2.4	↓	↔	Petrol has led to increased volatility
- ex food, petrol & govt charges	2.7	2.5	2.7	2.1	↓	↔	A common measure of core inflation has eased but is this really an accurate measure of inflationary pressure?
Tradable	3.0	1.2	0.9	-0.5	↓	↓/↔	High NZD = cheaper imports
Non-tradable	4.0	3.8	4.1	4.1	↔	↔	Persistent
Non-tradable less housing	3.6	3.4	3.6	3.7	↑	↔	It's not just a housing phenomenon
Housing ex energy	4.9	4.4	4.7	4.7	↔	↔	Still elevated
Housing and household utilities	5.4	5.1	5.3	5.2	↔	↔	The resilience of the housing market still providing inflation pressure
Goods	3.3	2.0	1.6	1.3	↓	↓	The high NZD weighing
Services	3.8	3.6	4.2	3.1	↓	↑	Surprisingly soft Q2, but set to rise as cost pressures remain
Trimmed mean 10%*	3.0	2.6	2.4	2.0	↓	?	Easing, but the key is where it goes from here
Weighted median*	2.9	2.6	2.9	2.4	↓	?	Easing after strong increase in Q1
RBNZ factor model	2.9	2.6	2.6	2.5	↓	?	Gradually moderating
RBNZ exponentially smoothed	3.1	3.0	2.9	2.8	↓	?	Likewise

* Given the change in the CPI weighting system, these measures have taken a structural shift lower. We estimate that if these measures were based on the old weights, annual growth for the 10 percent trimmed mean and weighted median in the June 2007 quarter would have been 2.5 percent and 3.1 percent respectively (down from 3.0 and 3.7 percent respectively in the March quarter).

OCR PREVIEW (due 9:00am 26 July)

We expect the Reserve Bank to increase the OCR by 25 basis points to 8.25 percent this Thursday. We expect the tenor of the statement to highlight inflation risks, but once again remain silent on future policy moves.

The July OCR decision is shaping up as the hardest call the Governor has to make so far in the current tightening cycle. There are mixed signals now appearing which the Governor will need to weigh up.

The scientific approach to monetary policy will clearly be calling a hike:

- Indicators since the June *Monetary Policy Statement* are generally showing resilience. The signs of the required softening in activity are just not extensive enough.
- The upside scenario contained in the June *Monetary Policy Statement*, which incorporates a higher interest rate track, appears to be unfolding.
- Inflation was stronger in the June quarter and the June *Statement* was notable for the lack of inflation headroom.

Yet, the judgemental approach is urging caution:

- Financial conditions have tightened by more than the Reserve Bank's projections, even when accounting for the surge in commodity prices.
- Semi-political considerations (i.e. the sanctity of the monetary policy framework given the pending FEC inquiry) could weigh, although recent Government rhetoric is also a strong reason to hike to reinforce central bank independence.
- The housing market does look to be turning, and we can confirm this by looking at our own internal information.
- If the scientific approach to monetary policy was followed religiously, central banks would always end up over-tightening by 50 basis points each cycle! Data comes out with a lag.

On balance, we believe the RBNZ will hike:

- The strong Q2 non-tradable inflation has reduced the Reserve Bank's flexibility to play a watch and wait strategy.**
- The current market pricing will likely prove too tempting to pass up.**

We expect the accompanying statement to once again remain silent on future policy moves. This will be designed to prevent the NZD from extending too far, and give the Reserve Bank maximum flexibility to respond to the upcoming data. Comments about higher dairy prices and unease over upside risks to inflation will likely be tempered by acknowledgement that there are signs of softening activity and the pipeline tightening effect is still working its way through the economy. We also expect a renewed focus on inflation expectations – the core of all central bank's monetary framework.

Financial market implications

At the time of writing the market was pricing in close to a 70 percent chance of a rate hike for July, with a full 25bps hike priced in by October. Given that the swaps and futures market has already moved a long way since the Q2 CPI release, we think the market reaction to a hike will be muted. We expect the market to move to price in a slight chance of a follow-up move, in the order of 5bps.

If it hasn't already, a hike will see the NZD test 80 cents against the USD and provide ongoing yield support in the near-term.

But the end-game to a hike is slower growth and notably weaker housing activity. Weak housing activity is weighing on the USD, and we expect this theme to translate to the NZD from late in the year.

Indicators	Comment	Risk for rates
Resource pressures	A little tighter than what the RBNZ was expecting	↔/↑
Commodity prices	Continual surge in dairy prices see higher terms of trade than what RBNZ was expecting. Also presents an additional inflation risk.	↑
Confidence	Headline business and consumer confidence easing. But business own activity indicators still holding up reasonably well.	↔
Housing market	Early signs of softening in June but difficult to know if this will be sustained.	↔/↓
Global scene	Global growth looks to be evolving stronger than RBNZ expectations.	↑
Consumer spending	Essentially flat over April and May, but RBNZ was expecting consumption to hold up in the near-term anyway.	↔
Exchange rate	TWI 5½ percent higher than RBNZ projections.	↓
Inflation	Higher than RBNZ forecast, giving them even less headroom.	↑
Bottom line	Upside surprise to Q2 CPI the last straw	↑

INTEREST RATE STRATEGY

Payside pressure to remain heading into the OCR decision on Thursday. We expect 5bps to be priced in for September should the RBNZ hike in July. We suggest paying EFPs at current levels.

Market themes...

- Upside surprise to Q2 CPI likely the last straw for the RBNZ.
- Payside pressure to remain as market expects a rate hike but 2yr IRS to struggle past 8.5%.
- US subprime concerns back to the fore. This time there could be some legs to it.

Outlook...

Stronger Q2 CPI data upped the ante for a July rate hike and likely the last straw for the RBNZ. The market moved swiftly to fully price in a rate hike by October, and at one stage priced in as much as 19bps for July. Increased political rhetoric and talk by the Minister of Finance about using section 12 of the Reserve Bank Act to suspend the RBNZ's focus on inflation saw market pricing ease to 17bps.

We do not expect market pricing for July to sway too much heading into Thursday. The local data calendar is clear, and only major substantial fallout from the US subprime market woes is likely to see the RBNZ stand pat. As such, payside pressure is expected to remain for most of the week. But we expect resistance at 8.5 percent in the 2yr IRS to continue.

The market's focus will shift to the tone of the statement. We think the RBNZ will want to keep its options open, but still warn of inflation risks. Expect the market to price in around 5bps for September should the RBNZ deliver a hike this Thursday.

Globally, renewed US subprime concerns look to take centre stage once again. This time, there looks to be some legs to it with S&P downgrading a series of European debt pools, and St Louis Fed President Poole saying home building will be suppressed and foreclosures likely to rise. US home sales data and advanced Q2 GDP print are shaping up to be key releases for the US bond market this week. In Australia, Q2 CPI data hold the key as to whether the RBA stands pat in August or hike several months out from a Federal election.

Gauges for NZ interest rates yields		
Gauge	Direction	Comment
RBNZ	↔/↑	On balance, RBNZ set to hike this week. Market fully priced for a hike by October.
NZ data	↔/↑	Data mixed, but upside risk to inflation and consumer spending still holding up mean risk to rates still to the upside.
Fed Funds/front end	↔/↑	Fed downgrades US economic outlook but still sees upside risk to inflation. Look to be on hold for rest of the year.
RBA	↔/↑	Next move by RBA still up. This week's Q2 CPI data the key.
US 10 year	↔/↓	Subprime concerns back on the spotlight. US 10yr yields fall below key 5% level on safe haven flows.
NZ swap spreads	↔/↑	Swap spreads have hit their medium-term target. Expect them to widen on subprime concerns and demand for Govt bonds.
Flow	↔	Liquidity to be thin as investors take money off table.
Technicals	↔/↓	US at bottom end of the range on subprime concerns.

Borrowing strategies we favour at present

The market awaits Thursday's OCR release and until then pressure should remain on rates with the majority looking for another 25 basis point hike. Fixing in the 1 to 3-year part of the curve provides good insulation from further increases in the short term. Any dip in yields will allow borrowers restructuring opportunities. Building optionality into medium term strategies should be considered, to allow participation should rates fall in the medium term.

Probability of 25bps increase as implied by market pricing

OCR dates	Last week	This week
Thu 26-Jul-07	48	67
Thu 13-Sep-07	68	91
Thu 25-Oct-07	76	107
Thu 6-Dec-07	76	107
Thu 24-Jan-08	76	107
Thu 6-Mar-08	72	103
Thu 24-Apr-08	72	103

Trading themes we favour at present

The 2s10s curve is finding support at around the -78/80 level, which will limit moves lower in the 10's. EFPs are expected to push out and we suggest paying EFPs at current levels.

CURRENCY STRATEGY

Onward and upwards. Growing yield differentials and a USD that remains out of favour should see the NZD test 80 cents this week. Australian Q2 CPI will be an important piece to watch.

Market themes...

- Subprime and housing woes continue to weigh on the USD.
- Locally the RBNZ will be the focus, while offshore, the Australian CPI will be important.

Outlook...

The story is unchanged. A combination of poor sentiment towards the USD and ongoing yield related demand remain the dominant drivers of the NZD. Recent AUD strength has also played a role as the NZD, to a degree, rides in kanga's pouch.

Housing market weakness and further subprime woes continue to weigh heavily on the USD. Despite evidence that economic growth has rebounded and Fed rhetoric that they are yet to be convinced that recent soft core inflation reads will be sustained, markets continue to focus on the weak housing market and a break from this theme looks unlikely in the near-term.

The obvious local focus this week will be the Reserve Bank's OCR decision on Thursday. Politicking and sensitivity around the level of the kiwi, along with comments about invoking section 12 of the Reserve Bank Act has complicated the picture somewhat, and increased the pressure on the Governor. Ultimately though, given markets have effectively priced in a hike, we feel the Bank will take the opportunity to increase rates. The accompanying statement is likely to keep mum on the future direction of monetary policy in an attempt to dampen the impact on the currency. However, given the current environment of yield hungry investors, and the level of interest rate differentials, a hike should see the NZD remain well supported. A failure of the RBNZ to hike will obviously see support levels strongly tested.

As always, US housing and subprime themes will continue to be watched, although this week the Australia Q2 CPI will be the key offshore focus. Recent core inflation reads have been relatively benign and have given the RBA time to wait and assess. However, markets have been reasonably aggressive and have priced in the possibility that the RBA will hike rates, even before the Federal election this year. If core inflation was once again to print softly, expect markets to reassess this strategy and the AUD could come under pressure as a result. This could also weigh on the NZD.

On balance however, it is hard to go past a further grind upwards for the NZD and a test of 0.80 looks a strong possibility. The USD is really struggling and until weakness in the US housing market stabilises, the USD will remain out of favour.

With the USD index starting the week below previous long-term support at 80.40, the trend is firmly in the NZD's favour. The first main level of support for the NZD is at 0.7880, with the next level around 0.7850. These will come into play with a no change decision from the RBNZ. On the upside, 0.8000 will provide a psychological level of resistance. For the NZDAUD resistance around 0.9090 held last week and a test towards Fibonacci support at 0.8980 followed. These levels remain key this week.

NZD vs AUD: monthly directional gauges		
Gauge	Direction	Comment
Fair value	↓	Growth differentials favouring AUD.
Yield	↑/↔	RBNZ and Australian CPI will be key.
Commodities	↔	Still supportive of both.
Partial indicators	↓	Aussie ahead of us in the terms of trade cycle.
Technicals	↓	Still range bound. Key support not too far away.
Sentiment	↔	AUD/USD looks strong.
Other	↔	Yield still attractive for both Uridashi and eurokiwi. But maturity profile steepening.
On balance	↔	Range bound.

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	↓	Some sectors booming, but most struggling.
Yield	↑	8% clearly a buy trigger.
Commodities	↔	Higher commodity prices remain supportive but NZD over-priced on dairy alone.
Risk aversion	↓	Subprime looks to be getting legs.
Partial indicators	↓	Kiwi overvalued either way you look at it.
Technicals	↔	Move looks mature, but trend strong.
AUD	↑	Super strong all last week.
Sentiment	↔/↓	Market wary with NZD at extreme levels.
Other	↑	USD broke key support.
On balance	↔/↑	Trend is your friend.

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZST)
23 Jul	UK	Rightmove House Prices (Jul) – mom	0.6%	0.8%	11:01
	AU	Producer Price Index (2Q) – qoq	0.8%	0.0%	13:30
	JN	Supermarket Sales (Jun) – yoy	-	-0.6%	17:00
	EU	ECB's Stark Speaks at a Conference in Frankfurt	-	-	19:00
		ECB's Papademos Speaks at Event in Delphi	-	-	19:00
24 Jul	GE	Import Price Index (Jun) – mom	0.3%	0.3%	18:00
	JN	BoJ Governor Fukui to Speak at Financial Conference	-	-	19:30
	EU	Euro-Zone Current Account (May)	-0.2B	-4.0B	20:00
		PMI Manufacturing (Jul A)	55.5	55.6	20:00
		PMI Services (Jul A)	58.0	58.3	20:00
		PMI Composite (Jul A)	57.6	57.8	20:00
		Industrial New Orders (May)	1.2%	-0.4%	21:00
	UK	BoE Deputy Governor Gieve To Make Speech	-	-	23:30
25 Jul	EU	ECB's Papademos Speaks at Conference in Frankfurt	-	-	01:00
	US	Former Fed Chairman Greenspan Speaks on Commercial Real Estate	-	-	00:30
		Fed's Mishkin Speaks at ECB Conference on Globalisation	-	-	01:00
		Richmond Fed Manufacturing Index (Jul)	5	4	02:00
		Fed's Poole Speaks About Energy, Economy in Wilmington, Delaware	-	-	09:30
	JN	Merchandise Trade Balance Total (Jun)	¥955.0B	¥385.1B	11:50
		Adjusted Merchandise Trade Balance (Jun)	¥846.0B	¥788.5B	11:50
	AU	Conference Board Leading Index (May)	-	0.3%	12:00
		DEWR Skilled Vacancies (Jul) – mom	-	-0.8%	13:00
		Consumer Prices (2Q) – qoq	1.0%	0.1%	13:30
		RBA Trimmed Mean (2Q) – qoq	0.7%	0.5%	13:30
		RBA Weighted Median (2Q) – qoq	0.7%	0.5%	13:30
26 Jul	US	Existing Home Sales (Jun)	5.87m	5.99m	02:00
		Existing Home Sales (Jun) – mom	-2.0%	-0.3%	02:00
		Fed's Beige Book	-	-	06:00
		Fed's Geithner Speaks About Global Integration in Washington	-	-	08:45
	NZ	RBNZ Interest Rate Announcement	8.25%	8.00%	09:00
	JN	BoJ Board Member Noda to Speak at the Financial Conference	-	-	13:30
		BoJ Board Member Noda to Hold Press Conference	-	-	13:30
	GE	Ifo – Business Climate (Jul)	106.4	107.0	20:00
		Ifo – Current Assessment (Jul)	111.0	111.4	20:00
		Ifo – Expectations (Jul)	102.0	102.8	20:00
	EU	Euro-Zone M3 s.a. (Jun) – yoy	10.7%	10.7%	20:00

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZST)	
26 Jul cont.	UK	Nationwide House Prices (Jul) – mom	0.5%	1.1%	18:00	
		BBA Loans for House Purchase (Jun)	-	77,443	20:30	
27 Jul	US	Durable Goods Orders (Jun) – mom	1.9%	-2.4%	00:30	
		Durables Ex Transportation (Jun) – mom	0.5%	-0.4%	00:30	
		New Home Sales (Jun)	892k	915k	02:00	
		New Home Sales (Jun) – mom	-2.5%	-1.6%	02:00	
		Help Wanted Index (Jun)	27	27	02:00	
			Treasury's Paulson Given Closing Remarks at Treasury Tax Conference	-	-	04:45
		NZ	Tax Receipts, Revenues (Jun)	-	-	09:00
			Trade Balance (Jun)	-286m	9m	10:45
			Imports (Jun)	3,321m	3,340m	10:45
			Exports (Jun)	3,010m	3,350m	10:45
	JN	National CPI (Jun) – yoy	-0.2%	0.0%	11:30	
		National CPI Ex-Fresh Food (Jun) – yoy	-0.1%	-0.1%	11:30	
		National CPI Ex Food, Energy (Jun) – yoy	-	-0.3%	11:30	
		Retail Trade (Jun) – mom	0.1%	0.6%	11:50	
	GE	GfK Consumer Confidence Survey (Aug)	8.8	8.4	18:10	
28 Jul	US	GDP Annualised (2Q A)	3.2%	0.7%	00:30	
		Personal Consumption (2Q A)	1.6%	4.2%	00:30	
		GDP Price Index (2Q A)	3.4%	4.2%	00:30	
		Core PCE (2Q A) – qoq	1.4%	2.4%	00:30	
		University of Michigan Confidence (Jul F)	91.5	92.4	02:00	
		Fed's Lacker to Speak in Richmond on Early Childhood Education	-	-	03:10	

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

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

NEW ZEALAND DATA WATCH

Key focus over next four weeks: The focus this week is the Reserve Bank's *OCR Review*. Given current market pricing, we feel the Bank will take the path of least resistance and hike the OCR by 25 basis points to 8.25 percent. Once this is out of the way though, the focus will revert back to evidence of whether the economy is slowing enough to alleviate inflationary pressures. In this regard, the National Bank *Business Outlook*, labour market data, and retail sales data hold the key.

Date	Data/Event	Economic Signal	Comment
Thu 26 Jul (09.00)	RBNZ <i>OCR Review</i>	Hike	Given current market pricing for a July OCR hike, we feel this may prove too tempting for the Reserve Bank and they will take the opportunity to raise rates. Although it remains a close-call decision, particularly given the level and sensitivity surrounding the currency.
Fri 27 Jul (10.45)	Overseas Merchandise Trade (June)	Deficit	Expecting a deficit as imports are pulled higher by the arrival of the HMNZS Canterbury.
Mon 30 Jul (10.45)	Building Consents (June)	Up	Builders would have rushed to get consents in prior to the fee increases in July. This impact was felt in May and will also be seen in June.
Mon 30 Jul (15.00)	Credit Growth	Still strong	Monthly increases around 1 percent have been the norm over the past 24 months; we expect this to continue.
Tue 31 Jul (15.00)	National Bank <i>Business Outlook</i> (July)	-	-
Mon 6 Aug (10.45)	QES and LCI Surveys (Jun qtr)	Elevated	Business surveys indicate that firms are increasingly finding it difficult to find both skilled and unskilled staff. This suggests wage pressures will remain elevated for some time.
Tue 7 Aug (15.00)	ANZ Commodity Price Index (July)	-	-
Thu 9 Aug (10.45)	Household Labour Force Survey (Jun qtr)	Still tight overall	Employment is likely to have only grown by a small amount in the quarter after a strong increase in March. The unemployment and participation rates are expected to remain largely unchanged.
circa 13 Aug	REINZ Housing Report (July)	Slowing	There have been signs of easing in the previous two monthly reports. Given that the higher mortgage rates are likely to fully manifest in July, we expect further signs of slowing in this release.
Tue 14 Aug (10.45)	Retail Trade Survey (June)	Still robust	Credit card statistics suggest that consumer spending remains robust. We expect a modest increase for the month.
Wed 15 Aug (10.45)	Producer Price Index (Jun qtr)	Some regaining of margins	The level of the NZD will have resulted in subdued input prices. We expect firms to take the opportunity to claw back some of their lost margins.
Wed 15 Aug (10.45)	Capital Goods Price Index (Jun qtr)	Mixed	The high NZD will have had a downward impact on plant and machinery prices, although construction prices will remain elevated.
On Balance		Slowing	Housing looks to be leading the way but when will the rest follow?

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SUMMARY OF KEY MARKET FORECASTS

NZ FX rates	Actual		Current	Forecast (end month)						
	May 07	Jun 07	23 Jul 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09
NZD/USD	0.733	0.756	0.798	0.770	0.730	0.700	0.660	0.640	0.630	0.610
NZD/AUD	0.888	0.898	0.908	0.885	0.830	0.787	0.767	0.771	0.778	0.772
NZD/EUR	0.542	0.563	0.577	0.550	0.525	0.515	0.493	0.485	0.485	0.480
NZD/JPY	88.5	92.6	96.9	95.5	92.0	88.9	83.2	79.4	76.9	73.2
NZD/GBP	0.369	0.380	0.389	0.381	0.367	0.357	0.340	0.333	0.333	0.326
NZ\$ TWI	71.4	73.7	76.2	73.9	70.3	67.8	64.5	63.1	62.5	61.0
NZ interest rates	May 07	Jun 07	23 Jul 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09
OCR	7.85	8.07	8.00	8.25	8.25	8.25	8.25	8.25	7.75	6.75
90 day bill	8.09	8.32	8.49	8.50	8.40	8.40	8.40	8.40	7.70	6.80
10 year bond	6.18	6.73	6.89	6.90	6.70	6.70	6.70	6.90	6.80	6.80
International	May 07	Jun 07	23 Jul 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09
US Fed funds	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.75
US 3-mth	5.36	5.36	5.36	5.35	5.35	5.35	5.35	5.40	5.50	6.00
AU cash	6.25	6.25	6.25	6.25	6.25	6.50	6.75	6.75	6.75	6.75
AU 3-mth	6.36	6.44	6.44	6.40	6.40	6.70	6.90	6.90	6.90	6.90

KEY RATES

	20 June	16 July	17 July	18 July	19 July	20 July
Official Cash Rate	8.00	8.00	8.00	8.00	8.00	8.00
30 day bank bill	8.22	8.36	8.38	8.38	8.37	8.34
90 day bank bill	8.35	8.48	8.50	8.51	8.49	8.50
NZGB 07/09	7.27	7.68	7.74	7.77	7.78	7.79
NZGB 11/11	7.13	7.33	7.38	7.41	7.41	7.42
NZGB 04/13	7.04	7.20	7.24	7.28	7.26	7.28
NZGB 12/17	6.76	6.85	6.87	6.89	6.87	6.88
1 year swap	8.45	8.59	8.61	8.61	8.60	8.60
2 year swap	8.35	8.47	8.50	8.50	8.49	8.50
5 year swap	8.06	8.11	8.13	8.12	8.10	8.12
RBNZ TWI	73.9	75.6	75.9	75.7	75.7	76.0
NZD/USD	0.7591	0.7894	0.7923	0.7929	0.7915	0.7953
NZD/AUD	0.8965	0.9042	0.9066	0.9028	0.9019	0.9029
NZD/JPY	93.66	96.25	96.58	96.44	96.51	97.18
NZD/GBP	0.3820	0.3877	0.3889	0.3859	0.3855	0.3881
NZD/EUR	0.5652	0.5724	0.5747	0.5735	0.5736	0.5764
AUD/USD	0.8467	0.8730	0.8739	0.8783	0.8776	0.8808
EUR/USD	1.3430	1.3791	1.3787	1.3826	1.3798	1.3798
USD/JPY	123.38	121.93	121.90	121.63	121.93	122.19
GBP/USD	1.9874	2.0360	2.0371	2.0546	2.0530	2.0490
Oil	69.15	73.89	74.11	74.03	75.03	75.90
Gold	660.35	667.90	665.55	668.20	672.05	676.20
Electricity Price Index	7.59	7.48	7.31	7.27	7.11	6.97

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