Market Focus
New Zealand
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MORE "LIKELY" THAN NOT?

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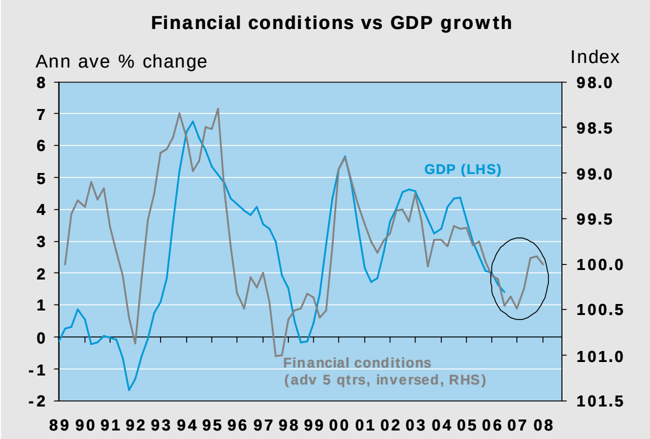
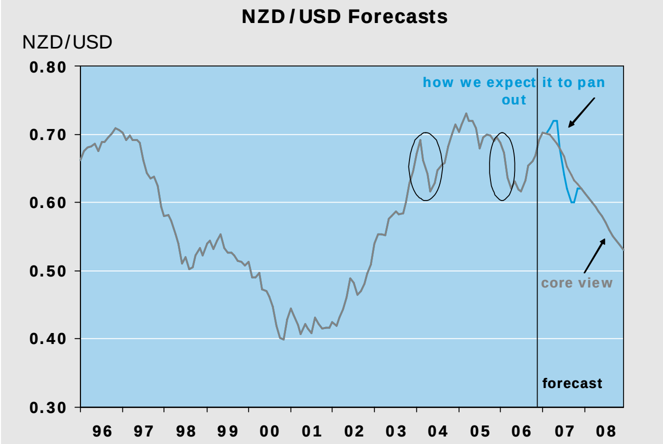


Sources: ANZ National Bank, Statistics NZ

We continue to see a major move in the NZD around mid-year



Sources: ANZ National Bank, Reuters

ECONOMIC OVERVIEW

Nuances from the Reserve Bank regarding strength in the economy have to be respected, and on this front a hike in March is likely. However, we remain wary of extrapolating Q4 2006 performance into 2007, and see little point joining the hordes calling a hike until we determine if this upturn is indeed sustained.

What's ahead…

- NZ building consents issued for December (Tuesday 1045NZDT) are expected to show a technical rebound from weakness in November.
- NZ December credit growth (1500NZDT Tuesday) is expected to rise 1% m/m.
- NZ merchandise trade for December (Wednesday 1045NZDT) is expected to show sluggish exports under a high NZD, but imports ex-fuel to remain high.
- December net migration (Friday) expected to show another 1,000+ number.
- The US Fed's FOMC interest rate decision (0815NZDT Thursday 1 February). Interest rates are expected to remain on hold at 5.25 percent and the hawkish bias to remain.

What's the view

The Reserve Bank left rates unchanged last week but sent a clear warning to the market that if a moderation (as opposed to a sustained slowdown) in the housing market and domestic demand did not occur, then further interest rate hikes would be required. The Bank is increasingly concerned at the pick-up in the housing market and domestic demand, and what this implies for inflation.

While we concur with the Reserve Bank's inflation unease, we are a little perplexed by aspects of the stepped up rhetoric from December, which implies medium-term inflation pressure has intensified vis-à-vis the December 2006 *Statement*. While there is certainly a strong under-current, the Reserve Bank's updated inflation forecasts should show less medium-term pressure on inflation, courtesy of the key role being played by inflation expectations and a better opening position for non-tradable inflation and the output gap. The Bank's Q4 growth forecast needs to be revised up markedly to generate the same degree of medium-term pressure.

The nuances from the Reserve Bank have to be respected with regard to forecasting inflation as opposed to growth, with the Bank having a consistent bias towards overstating the latter. On the face of it, a rate hike looks fait accompli. There are pockets of strength in the economy. Lower petrol prices, higher international dairy prices, ample liquidity, migration flows, and fiscal policy add a degree of solidity to the outlook. Remarks by the Governor on Friday noting that to avert a rate hike requires the housing market to moderate, have added fuel to the fire. The housing market is on notice and when we look at the upcoming housing related data (building consents, credit growth, and January REINZ report), we see little relief. The Reserve Bank is now facing a clear credibility test heading into the March *Monetary Policy Statement* given the use of the term "likely". How often can you continue to cry wolf?

Yet against this backdrop we find it difficult to go past the material tightening in financial conditions that has occurred, and the close relationship this bears with the economic cycle (refer page 4). We remain very wary over extrapolating Q4's rebounding growth signals into 2007. Isn't the rural sector on anyone's radar? The significant role assigned to the housing market by the Governor on Friday is a dangerous precedent. Monetary policy is a blunt instrument and cannot target one sector in isolation. If the Bank feels it is so far away from its desired policy settings, there is no point hiking just once. An additional 50 basis points at this point of the cycle could well spell crunch for the economy. This is not like Australia where you get huge mileage in a 25 basis point move. Most people are on fixed rates in New Zealand. The RBNZ needs to be unequivocal in its view if it is to follow through.

So for now we expect monetary policy to remain unchanged, and we have pushed out the expected start of the easing cycle by a year to recognise the environment we are in (see page 6). While we admittedly feel a tad uncomfortable with our view for no change, we see little point or value joining the hordes at this late juncture. You are either one of the first to make the call or not at all, and there is no point sitting on a crowded fence!

In the meantime it will be a case of watching the data. Any strength in the Q4 HLFS (employment) report will solidify the sustained upturn view. The National Bank *Business Outlook* report on firms' own activity expectations (due 28 February) is likely to be persuasive in determining whether the upturn is indeed sustained or not. Strength in either will see us cross the line.

Our instincts are simply that 2007 feels like the reciprocal of 2006. The market early last year was talking down growth prospects (the recession) and barking for cuts. This year the economy is reputedly off to the races and hikes are required. But when you step back and look at the big picture, a 1½ to 2 percent economy implies a flat line.

Data last week…

- **RBNZ *OCR Review*.** The Bank left rates unchanged at 7.25 percent but noted that in the absence of a moderation in the housing market and domestic demand, they are set to hike interest rates.
- **NZ credit card billings** rose 3.2%m/m in December, after a 1% decline in November.
- **Australian CPI.** Q4 CPI fell 0.1 percent (+3.3 percent apc) and various core measures eased, suggesting the RBA has time on its side.

REGULATION – THE ROLE OF THE REFEREE

We look at some of the wider economic costs of adverse regulation, and offer recommendations for the future.

ANZ – in conjunction with Dr John McDermott (Associate Professor, Victoria University) – recently launched a new *Policy Issues* series that will tackle some of the hard issues New Zealand is facing and that will need addressed if we are going to close the gap in incomes that exists with our major trading partners. New Zealand's per capita income is 12 percent below the OECD average, and 22 percent below Australia's. It goes without saying that the only way to close that gap is through doing things better and smarter than our competitors.

Typically we see a great deal of comment and criticism directed at various areas such as regulation, education, the energy sector, roading, tax, exports, foreign direct investment, and health to name a few. Yet such comment frequently falls short of offering solutions or educating the public about some of the implicit trade-offs involved. Policy-making is neither black nor white. It is about weighing up options. Everyone needs to be aware of the trade-offs that are implicitly being made on our behalf when decisions are taken. Our *Policy Issues* series is intended to add to the debate in an informed and apolitical manner.

The first edition has been released, and focuses on regulation – an issue that frequently permeates through our discussions with businesses.

Key points include:

- **Regulation is an important part of any modern economy.** Regulation can overcome the existence of externalities and market failures.
- **Yet poor regulation hinders economic performance, just as poor refereeing spoils a rugby game.** Good regulation should have no detectable influence on economic performance, just as a good referee has no influence on the game itself.
- **There is conflicting survey evidence over the extent of regulation in New Zealand.** The growing burden that additional compliance costs are placing on business features repeatedly across New Zealand surveys and anecdotes. Yet the World Bank report on ease of doing business concludes that New Zealand is one of the best places in the world to do business.
- **On balance, survey evidence suggests New Zealand has relatively fewer regulatory distortions than most other countries but this says nothing about the absolute level of distortions.** When it comes to enhancing opportunity and creating future prosperity, it is the level of absolute distortions that matter, not relative distortions. If we can find any evidence of distortions we should strive to eliminate them to maximise our growth potential.
- **Identifying the economic costs of poor regulation is difficult** because we do not know the counterfactual. The cost of poor regulation is investment that never takes place. As a general principle, regulatory barriers that create economic distortions will result in the misallocation of resources.
- **We test for the adverse impact of distortions** in two forms. First, whether general uncertainty hinders investment in capital equipment. Second, whether the regulatory environment creates any visible misallocation of resources in specific investments and how this impacts growth.
- **We found evidence of distortionary impacts at the macroeconomic level.** We provide statistical evidence that rising uncertainty has an adverse impact on investment. We also found a negative relationship between the relative price of capital goods and economic fluctuations, but only in the plant, machinery and equipment sector not in the non-residential construction and transportation sectors.
- **The key to good regulation resides in demonstrating and articulating the benefits relative to the costs.** This is where we believe the major gaps currently reside. Our analysis has demonstrated some of the adverse consequences of regulatory distortions.
- **The paper has five high level recommendations.** All new and revised regulation should require <u>quantitative cost-benefit analysis</u> with a particular emphasis on the costs. An <u>independent body</u> should be charged with undertaking such analysis. There needs to be a better <u>articulation</u> of the goals and strategies to the public including such cost-benefit analysis. Where distortions can be demonstrated there should be an <u>ex-post review</u> of existing regulations that may have led to those distortions. Our research has highlighted a negative impact in the electricity distribution and control apparatus (i.e. energy), and insulated wire and cable (i.e. telecommunications) industries. The <u>negative impact of uncertainty</u> on growth needs greater recognition within policymakers' reaction function.

If you would like a copy of the paper please email bagriec@anz.com

FINANCIAL CONDITIONS UPDATE

Our financial conditions index successfully picked the upturn in growth seen in late 2006, and is likewise suggesting a tailing off in prospects over 2007.

We monitor a *Financial Conditions Index* – as opposed to a conventional *Monetary Conditions Index*. It includes a wider array of variables to recognise the different channels through which monetary policy influences the economy, such as:

- The NZD, augmented by where commodity prices reside in the cycle and the impact that costs are having on export performance.
- The 90-day bank bill rate, which the RBNZ influences through the OCR.
- The 2-year swap rate to recognise that most mortgage lending is undertaken for 1 to 2 years, which gives monetary policy long lags.
- The 10-year bond rate.
- The equity market index as a proxy for corporate wealth and liquidity.
- House prices to proxy household wealth, in recognition that most of NZ households' wealth is tied up in housing.
- Private sector credit growth as a proxy for the credit channel of monetary policy and to recognise the growing role that financial intermediaries are playing in the monetary transmission process.
- The stock of monetary aggregate relative to the size of the economy to capture the role of liquidity.

Our index is calibrated so that there is a 4:1 ratio between the internal (e.g. interest rates) and external (e.g. currency) variables. The weights on the domestic variables are also heavily skewed towards the 90-day and 2-year swap rates, with smaller roles for the 10-year bond rate, equity market, house prices, credit growth and monetary aggregate ratio.

Reflation is a recent theme emerging, and one that the Reserve Bank appears to be buying into. This theme has gained ground with partial indicators for Q4 such as REINZ housing market data, retail sales and business confidence all suggesting GDP growth will rebound relatively strongly in Q4.

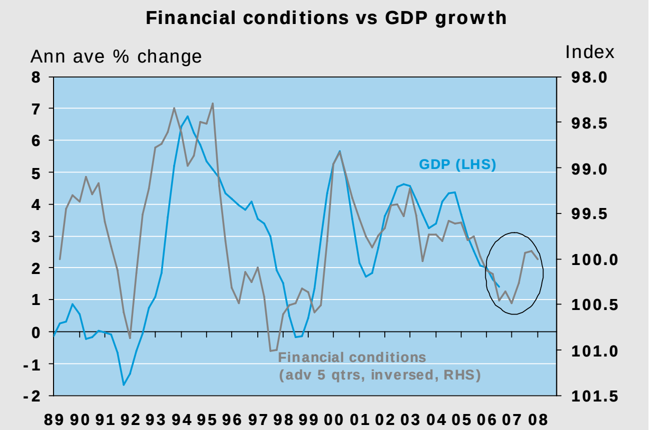
A key question for the Reserve Bank is whether this strength will be sustained well into 2007. For the Reserve Bank to hike rates in March, they need to be certain that growth is truly accelerating beyond Q4 in a sustained fashion.

The interest rate market is certainly buying into the sustained reflation theme, with a 80 percent probability of a hike priced in by March and 120 percent probability by April. Oil prices, migration, job security, fiscal spending and commodity prices are adding solidity to the reflation theme.

The current pick-up in the indicators is certainly in line with the loosening in financial conditions – as measured by our *Financial Conditions Index* – seen over mid-2006, courtesy of the currency which fell to a low of 0.60 against the USD and lower longer dated yields on the back of falling global rates.

More recently, financial conditions have tightened. The run-up in the currency and higher wholesale interest rates have seen financial conditions tighten in Q4 last year and almost certainly in Q1 this year. Tightening has occurred in spite of rising commodity prices, the strength in the equity market and continued liquidity.

Our measure suggests the recent run of economic strength will ultimately not be sustained beyond early 2007, as the rebounding currency starts to take its toll. We remain equally mindful of a certain endogeneity across inputs. When financial conditions get sufficiently tight, you can easily see a circle where conditions tighten, asset values ease, liquidity tightens, financial conditions tighten and the spiral is in motion.



Sources: ANZ National Bank, Statistics NZ

Financial Market Implications

The pick-up in activity late last year is consistent with looser financial conditions in mid-2006 courtesy of the run-down in the currency and lower longer dated interest rates. But current financial conditions remain tight and the recent run-up in the currency will certainly weigh on the economy as 2007 progresses. A continued pick-up in growth is far from clear. But the question is whether the Reserve Bank has the patience to wait.

INTEREST RATE STRATEGY

Expect payside pressure to come out in the 2-year in light of this week's data, which is expected to print on the strong side. Strength in Australia should cause further inversion of the curve as the long end is driven by global moves.

Market themes…

- Pay side pressure through the front end of the swaps curve.
- Further inversion through bond and swap curves.
- NZD supported on dips.

Outlook…

Last week the Reserve Bank all but hiked interest rates. The market reaction was aggressive, with an 80 percent chance of a March hike now priced in. The market latched on to the last paragraph of the statement: "*In the absence of clear indications of a moderation in housing and domestic demand, it is likely that further policy tightening will be required. The situation will be reassessed in the light of a full review of our economic forecasts at the March Monetary Policy Statement.*"

While our core economic view is that the Reserve Bank will leave interest rates unchanged for the rest of this year and well into next year (see page 6), it's a position we feel very nervous about. Neither hikes nor no move feel an intuitively correct position to have. But from a market perspective, it is all about when the Reserve Bank will hike and whether they will follow it up with another hike. The tenor of the data due this week will certainly validate the market's pricing. Building consents data for December out tomorrow will show a rebound from the surprisingly weak November reading. Credit growth numbers also due out tomorrow will show strength in mortgage growth, though the Reserve Bank would have already had access to this data prior to the January *Review*. The consumption import numbers from Wednesday's merchandise trade data will be sliced and diced for hints of consumer demand in January. And migration data out on Friday will see another solid increase, adding further near-term demand pressure. To us, the Q4 HLFS employment data (due 8 February), Q4 retail sales (due 15 February) and National Bank *Business Outlook* (due 28 February) will be key.

It is with these pressures in the shorter dated swaps that we see further curve inversion. Mortgage flows will continue to weigh on front dated swaps in the event of policy tightening. NZD related issuance is expected to keep the offer in the mid-curve particularly in the 5 year. New Zealand yields are clearly on the radar with a supported NZD and the fact that rate moves in the Australian market are now seemingly off the table for now.

Gauges for NZ interest rates yields

Gauge	Direction	Comment
RBNZ	↑	80 percent of a March moved priced. Likely to stay heavy.
NZ data	↔	Data over next six weeks, particularly Q4 HLFS, Q4 retail sales and *NBBO* key for RBNZ.
Fed Funds	↔	Recent data printing stronger. Bias is for test of 5 percent for US 2 year.
RBA	↔	Rate hikes seemingly off the table.
US 10 year	↑	Stronger data sees 10yr notes teat higher levels.
NZ swap spreads	↑	Our longer term view for swap spreads to narrow. Shorter term risks point wider.
Flow	↔	Payside pressure continues.
Technicals	↔	Testing new support levels after January *Review*.

Borrowing strategies we recommend at present

The Reserve Bank's no change decision last week and the current market pricing leave us comfortable with last week's borrowing strategy. Hence, there is no change to our view that borrowers should continue to pay the 3-5 year part of the curve. Those with more dovish outlooks for interest rates through 2008 are encouraged to look at option based strategies that provide some downside potential.

Probability of 25bps increase as implied by market pricing

OCR dates	Last week	This week
Thu 8-Mar-07	60	80
Thu 26-Apr-07	60	120
Thu 7-Jun-07	80	136
Thu 26-Jul-07	80	136
Thu 13-Sep-07	76	136
Thu 25-Oct-07	60	136
Thu 6-Dec-07	52	136

Trading themes we favour at present

With an 80 percent chance of a March hike, we favour taking some shorts off these levels.

INTEREST RATE UPDATE

Our latest interest rate profile has a flat-lined OCR track right to late 2008, which would be an exceptional cycle across central banks. While we are not (yet) joining the hike camp, the Reserve Bank's wariness has to be accommodated in some form. Moreover, unease surrounding the 2008 *Budget* will likely leave no scope for lower rates for an exceptionally long period.

Given the clear discomfort the Reserve Bank is still feeling over the medium-term inflation outlook, there seems two possible interest rate outcomes. Either crunch the economy through successive hikes, then ease (policy normalisation). Or, look for an exceptionally long period of high rates.

The favourable near-term inflation outlook has certainly bought the Reserve Bank more time to wait and digest upcoming data and to carry out a full economic assessment for their March *Monetary Policy Statement*, before deciding on the appropriate course of action. But the Reserve Bank's January language was unequivocally hawkish and a March hike is certainly in play. The market is now in the crunch and ease camp, with most expecting hikes in 2007, and cuts by early 2008.

The spectre of a fiscal loosening in 2008 clearly has the Reserve Bank on tenterhooks in terms of the need for a hike. But for the market, it is the timing of when monetary policy could start to normalise that is at issue. Expansionary fiscal and monetary policy in early 2008 just seems incongruous with medium-term inflation pressure. We find it difficult to defend the start of an easing cycle late this year or H1 2008.

Yet as noted on page 2, we remain more circumspect on the path for interest rates. We are very coy about the need for a new tightening cycle, with growth sitting at between 1½ to 2 percent and inflation below 3 percent, even if it is a late-cycle insurance policy. For this to happen, the Reserve Bank will need to be convinced that a strong sustained economic recovery is underway, and not just partial data pointing to a rebound in Q4 2006 or Q1 2007. Either that or the Governor has had enough of the insolence the housing market is showing. To us, the evidence that the economy is reflating strongly is inconclusive (see page 4).

A key change in our eyes from the Reserve Bank's previous statements is the view that they require a *"return to a moderating trend"* in the housing market and domestic demand, rather than a *"sustained slowdown"* that was previously mentioned. Effectively the Reserve Bank now only requires growth to slow or the trend to ease in these sectors rather than a level shift to occur. This change in language may be subtle, but it suggests some tolerance could be exercised by the Reserve Bank in terms of the upcoming dataflow.

This leaves us more attuned to the extended period of high rates as opposed to the crunch and ease scenario. Three years of interest rate stability by the Reserve Bank would be a remarkable interest rate cycle but not without precedent. Across other central banks, only the BOJ would have had a longer period of stable rates.

Our new interest rate forecasts are explicitly a reflection of the risks facing monetary policy. It is a remarkable interest rate forecast in that it has monetary policy on hold for three years. Yet it is an interest rate profile we feel we have to show, given the Reserve Bank's concerns about medium-term inflation pressure, and the clear risk profile for rates.

Length of time official interest rates on hold

Central Bank	Period from [1]	Average number of days on hold	Longest period on hold (days)
RBNZ	**March 1999**	**201**	**417 (and counting). 1,099 days if on hold until late 2008**
RBA	August 1990	191	595
Fed	January 1990	213	581
BOE	May 1997	143	455
ECB	June 2000	200	914
BOC	January 1997	171	323
BOJ	March 1990	468	1,984
Norges Bank	January 1991	170	758

NZ Interest Rate Forecasts

	OCR	90-day bank bills	2-year swap rate	3-year swap rate	5-year swap rate
Mar-06	7.3	7.6	7.0	6.8	6.7
Jun-06	7.3	7.5	7.0	6.9	6.7
Sep-06	7.3	7.5	7.3	7.2	6.9
Dec-06	7.3	7.6	7.5	7.3	7.1
Mar-07	**7.3**	**7.7**	**7.6**	**7.5**	**7.2**
Jun-07	**7.3**	**7.6**	**7.5**	**7.4**	**7.2**
Sep-07	**7.3**	**7.4**	**7.4**	**7.4**	**7.2**
Dec-07	**7.3**	**7.4**	**7.3**	**7.2**	**7.1**
Mar-08	**7.3**	**7.4**	**7.1**	**7.0**	**6.9**
Jun-08	**7.3**	**7.4**	**7.0**	**6.9**	**6.9**
Sep-08	**7.3**	**7.4**	**6.7**	**6.7**	**6.7**
Dec-08	**7.2**	**7.1**	**6.4**	**6.4**	**6.6**
Mar-09	**6.7**	**6.6**	**6.1**	**6.3**	**6.5**
Jun-09	**6.2**	**6.1**	**6.0**	**6.2**	**6.5**
Sep-09	**5.7**	**5.7**	**6.0**	**6.3**	**6.6**
Dec-09	**5.5**	**5.6**	**6.0**	**6.3**	**6.6**

[1] Period when official interest rates started or in the early 1990s when central banks began inflation targeting.

CURRENCY STRATEGY

The NZD remains biased to the upside given the clear hike rhetoric from the RBNZ. Strength from this juncture will only be capped by global forces.

Market themes…

- No move from the RBNZ, as expected, but the term "likely" in reference to a hike has seen the market cement expectations for one in March and potentially April.
- Pressure on AUD courtesy of a low CPI. Time is on the RBA's side.
- US data continues to firm and the USD too.
- CPI looks to have given the BOJ more time.

Outlook…

No move from the RBNZ but a zealous stance towards inflation and the strong possibility of a hike in March has knee-capped any potential for the kiwi to ease.

The strong stance from the RBNZ, coupled with a weak Australian CPI and similar softness in Japanese inflation figures, means the NZD looks to have upside risk painted all over it. Given this combination – and the extent of the sell-off in the NZ swaps market with the 2 and 3 year up 12 and 10 basis points, respectively – it is perhaps surprising that the extent of the NZD's gains were largely limited to a 1 cent rise against the AUD. Given implied market positioning (with short NZD/AUD a highly recommended trade across investment banks early in the year), sentiment permeating from the respective central banks, and carry trade unwind in the AUD/JPY, the NZD/AUD looks vulnerable to further squeezes topside.

Against the other majors, kiwi's prospects still look capped. Bearish sentiment towards the US economy is dissipating. With data printing consistently better than expectations this year, and with the negative sentiment towards the USD. US 2 year bonds are now closing in on the psychologically important 5 percent barrier, and the US dollar index is close to key resistance around 85.50.

Internationally, the focus this week will be on the Federal Reserve's interest rate announcement on Thursday morning (NZDT). We expect the Fed to leave interest rates unchanged and deliver a hawkish statement, further reinforcing the sentiment in US interest rate markets, and limiting the topside on the NZD/USD. Non-farm payrolls on Friday night is also expected to reinforce the recent positive run of US data.

The carry trade is still a major driver of the NZD/JPY cross, with plenty of real money flows looking for a home. The prospect of comment on carry trades (and yen weakness) from the G7 meeting on 9/10 February may limit NZD/JPY topside over the weeks ahead.

Any topside in the NZD/USD is likely to run into heavy resistance around the 0.7040 level, support is seen at 0.6920 and 0.6880. The NZD/AUD is facing decent resistance at 0.9050, and short term support at 0.8960.

NZD vs AUD: monthly directional gauges

Gauge	Direction	Comment
Fair value	↓	Fair value 0.85-0.88.
Yield	↑	RBA patient, RBNZ not.
Commodities	↔	Hard continue to outshine soft but lower oil helping NZ.
Partial indicators	↓	Australian economy just looks to have a broader base.
Technicals	↔	0.9050 strong resistance.
Sentiment	↔	Hard to see NZD strength being sustained but absence of sellers when RBNZ in play.
Other	↑	Liquidity still plentiful. Risk of a cleanout of short NZD/AUD positions.
On balance	↔/↑	**Looks vulnerable to topside squeezes.**

NZD vs USD: monthly directional gauges

Gauge	Direction	Comment
Fair value – long-term	↓	Fair value 0.60. It may be higher given a structural shift in commodity prices.
Fair value – short-term	↔	NZD more fairly valued on commodity models.
Yield	↔	Rising US rates helping cap but RBNZ in play.
Commodities	↔	Dairy prices are insulating the dairy sector but meat prices looking suspect.
Risk aversion	↑	Low.
Partial indicators	↔	Both economies have similar imbalances.
Technicals	↔	Short term support 0.6920, USD Index 85.50 key.
AUD	↓	Vulnerable to further carry liquidation
Sentiment	↔	Are we back to chasing the tallest pygmy?
Other	↔	Mixed messages from falling oil prices but could easily spillover.
On balance	↔	**Topside being protected by US curve re-pricing.**

CURRENCY UPDATE

If there is some encouragement to be taken from the RBNZ's aggressive nuances, it is that the end-game is slower growth and the NZD will not sustain current levels in such circumstances. While we've softened our easing profile for the NZD over the coming months, and the path in the near-term looks a lottery, tactically we remain attuned to a major move around mid-year.

Last week's correct call on the RBNZ feels like a hollow victory, with their explicit reference to a likely hike a lot more hawkish than we had envisaged. The Governor's patience with the housing market in particular looks to have run out.

Given these nuances, and changes to our interest rate profile as noted on page 6, we have taken a good hard look at our currency view.

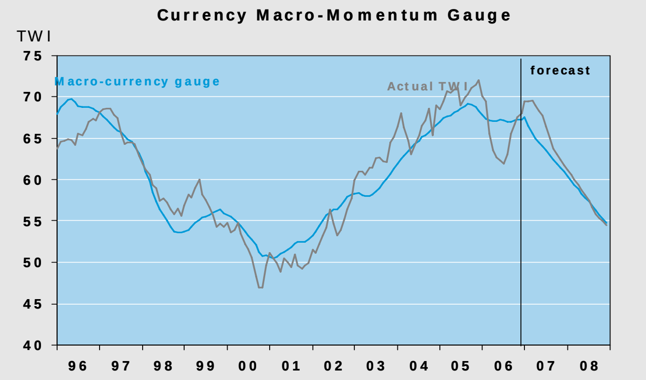
Most of the changes centres around the June quarter, where we have raised our forecasts noticeably, in recognition of the hike risk. We now see the NZD/USD residing around 0.68 (0.62 previously) and the NZD/AUD 0.90 (0.82 previously) – both levels we suspect are on the high side. Beyond that we have resisted making major changes. We still foresee an easing profile over 2007, with a year end target for the NZD/USD of 0.62 (0.60 previously). Tactically, we suspect all the action will occur around mid-year.

Five themes shape our currency view.

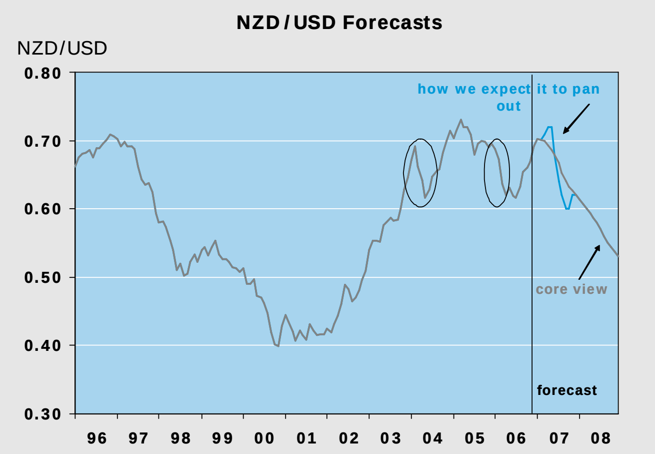
- **The NZ economy will slow**. Speculation of 2 percent plus growth over 2007 doesn't wash given the material imbalances in the economy and the desire of the central bank. Either financial conditions are tight enough or the RBNZ is prepared to do more. We know from our macro-momentum gauge (refer *Market Focus* 11 December) that ultimately it is growth as opposed to yield that matters for the NZD. The NZD is typically in a declining trajectory when growth is moderating. The Reserve Bank will not let the economy reflate at this juncture and the danger is a late cycle hike(s) acts as a tipping point for the housing market. We know from recent US experience how quickly things (housing) can turn and the currency (USD) with it. NZ households carry a debt servicing burden that is 50 percent higher than US equivalents.

- **The economy has the potential to turn sharply, and the NZD with it.** We know from early 2000, and late 2005 that the NZ economy tends to turn very aggressively in response to late cycle rate moves. The economy contracted in June 2000 and December 2005. The "lag" between hikes and the economy was generally contemporaneous in both instances. We suspect the NZ economy will likely be on a recessionary knife-edge if 50 basis points of hikes eventuate at this juncture of the cycle.

With a household debt servicing ratio of 13 percent, the housing market is exceptionally vulnerable, even in a low unemployment environment. The NZD/USD has had two 10 cent moves over three months in the past three years. While our core NZD/USD trajectory is for a sliding trend, tactically we are biased towards a move up to 0.72, although global forces look to be capping this at present. A marginal NZD seller is likely to be mindful of the downstream impact of late cycle hike(s), and a sizeable easing around mid-year as the growth portrait deteriorates. If the RBNZ does hike rates, we will pencil in a negative GDP outturn for the June quarter (in a similar fashion to the call we made in late 2005 for the December 2005 quarter), which will manifest in partial indicators around July, August and September. While we are now centred on Q3 for the timing of an aggressive turn, Q2 looks equally likely.



Sources: ANZ National Bank, Reuters

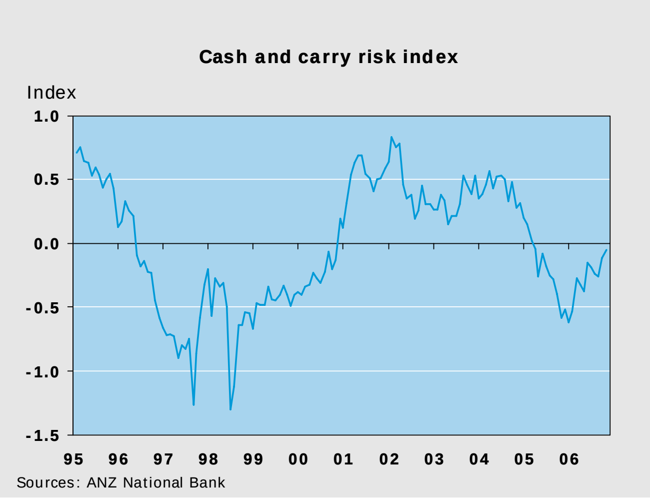


Sources: ANZ National Bank, Reuters

- **We see the timing of pending Uridashi maturities** as being a significant factor around Q3 as they will likely coincide with flagging perception towards the economy in a similar fashion to early 2006. August and October this year are monster months with $3.5 billion and $3.9 billion of maturities pending respectively. A large portion may in fact be rolled. Yet the speculative market will find it difficult to ignore the sheer potential size of the flow.

- **We are strongly biased towards the NZ economic resilience story repeating elsewhere, which will eventually necessitate a closing yield differential.** Low unemployment and an abundance of liquidity have been the mainstays of New Zealand's resilience. When we look at the US and Australia we see similar characteristics, and remain strongly biased (although not our central track) towards the surprise of 2007 being how far global interest rate settings in the other nations move up. Commodity prices have played a role for New Zealand as well, but more so in Australia given the 39 percent surge in their terms of trade over the past four years. While migration has been a differentiating factor in New Zealand's case, we see that as more than being compensated for by a materially higher household debt servicing burden, and tighter financial conditions.

- **We remain very wary of the global perception towards the carry trade.** A weaker CPI may have bought the BOJ more time but the outlook for rates remain up if the Japanese recovery story continues to be sustained. Our cash-and carry risk index (refer *Market Focus* of 27 November 2006) has been negative for 20 months although it has moved back to broadly neutral territory. Low levels of risk aversion remains a key supporting factor although we wonder how long this will continue if US yields start to test 5 percent given the tenor of data. If there is a lesson from recent action in the oil market it is how easily perception can change.



The upshot

If there is some encouragement to be taken from the RBNZ's aggressive nuances last week, it is that the end-game is slower growth and the NZD will not sustain current levels in such a circumstance. While we've softened our easing profile for the NZD over the coming months, tactically we remain attuned to a major move around mid-year.

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
29 Jan	JN	Retail Trade (Dec) – mom s.a.	-	0.0%	12:50
		Retail Trade (Dec) – yoy	-0.6%	-0.2%	12:50
	AU	National Australia Bank's 4th Quarter Business Confidence	-	-	13:30
30 Jan	**NZ**	**Building Consents (Dec) – mom**	**-**	**-12.0%**	**10:45**
		Money Supply M3 (Dec) – yoy	**-**	**15.5%**	**15:00**
	JN	Jobless Rate (Dec)	4.0%	4.0%	12:30
		Overall Household Spending (Dec) – yoy	-1.2%	-0.7%	12:30
		Industrial Production (Dec) – mom	0.4%	0.8%	12:50
		Industrial Production (Dec) – yoy	4.3%	4.9%	12:50
		Vehicle Production (Dec) – yoy	-	7.4%	17:00
	AU	NAB Business Survey	-	6	13.30
	UK	Nationwide House Prices (Jan) – mom s.a.	0.8%	1.2%	20:00
		Nationwide House Prices (Jan) – yoy	10.0%	10.5%	20:00
		Mortgage Approvals (Dec)	125K	129K	22:30
		Net Consumer Credit (Dec)	1.0B	1.0B	22:30
	GE	Consumer Price Index (Jan) – yoy	2.0%	1.4%	-
		CPI – EU Harmonised – mom	0.2%	0.9%	-
		CPI – EU Harmonised – yoy	2.2%	1.4%	-
	EU	ECB's Papademos speaks at a conference in Athens	-	-	20:25
		Bloomberg Euro-zone Retail PMI (Jan)	-	52.1	22:00
31 Jan	US	Consumer Confidence	109.3	109.0	04:00
	NZ	**Overseas Merchandise Trade Balance (Dec)**	**-$415m**	**-$785m**	**10:45**
		Imports (Dec)	**$3,270m**	**$3,640m**	**10:45**
		Exports (Dec)	**$2,900m**	**$2,850m**	**10:45**
	JN	Labour Cash Earnings (Dec) – yoy	0.6%	0.2%	14:30
		Overtime Earnings (Dec) – yoy	3.4%	3.2%	14:30
		Housing Starts (Dec)– yoy	9.3%	4.0%	18:00
		Annualised Hosing Starts (Dec)	1,292m	1.358m	18:00
		Construction Orders (Dec) – yoy	8.0%	9.2%	18:00
	AU	Private Sector Credit (Dec) – mom	1.0%	1.1%	13:30
		Private Sector Credit (Dec) – yoy	-	-	13:30
	GE	Unemployment Rate (Jan) – s.a.	9.7%	9.8%	21:55
		Euro-Zone Consumer Confidence (Jan)	-6	-6	23:00
		Euro-Zone Industrial Confidence (Jan)	5	6	23:00
		Euro-Zone Unemployment Rate (Dec)	7.6%	7.6	23:00
		Euro-Zone CPI Estimate (Jan) – yoy	2.1%	1.9%	23:00
	UK	GfK Consumer Confidence Survey (Jan)	-9	-8	23:30

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
1 Feb	US	MBA Mortgage Applications (Jan 27)	-	-8.4%	01:00
		ADP Employment Change (Jan)	140K	-40K	02:15
		GDP Annualised (Q4 A)	3.0%	2.0%	02:30
		Personal Consumption (Q4 A)	4.2%	2.8%	02:30
		GDP Price Index (Q4 A)	1.5%	1.9%	02:30
		Employment Cost Index (Q4)	1.0%	1.0%	02:30
		Construction Spending (Dec) – mom	0.0%	-0.2%	04:00
		FOMC Interest Rate Decision	5.25%	5.25%	08:15
	NZ	**Tax Receipts, Revenue (Dec)**	**-**	**-**	**09:00**
	JN	Vehicle Sales (Jan) - yoy	-	-7.2%	18:00
	EC	PMI Manufacturing (Jan)	56.2	56.5	22:00
	UK	PMI Manufacturing (Jan)	51.7	51.9	22:30
2 Feb	US	Personal Income (Dec)	0.5%	0.3%	02:30
		Personal Spending (Dec)	0.7%	0.5%	02:30
		PCE Deflator (Dec) – yoy	2.2%	1.9%	02:30
		PCE Core (Dec) – mom	0.2%	0.0%	02:30
		PCE Core (Dec) – yoy	2.3%	2.2%	02:30
		Initial Jobless Claims (Jan 28)	315K	325K	02:30
		Pending Home Sales (Dec) – mom	0.8%	-0.5%	04:00
		ISM Manufacturing (Jan)	51.8	51.4	04:00
		ISM Prices Paid (Jan)	47.0	47.5	04:00
		Total Vehicle Sales (Jan)	16.6m	16.8m	-
		Domestic Vehicle Sales (Jan)	12.7m	12.7m	-
	EU	ECB's Trichet and Noyer speak at a conference with African Banks	-	-	05:30
		Euro-Zone PPI (Dec) – mom	0.0%	0.0%	23:00
		Euro-Zone PPI (Dec) – yoy	4.1%	4.3%	23:00
	NZ	**Visitor Arrivals (Dec)**	**-**	**0.6%**	**10:45**
	JN	Monetary Base (Jan) – yoy	-21.0%	-20.0%	12:50
	AU	Trade Balance (Dec)	-1,000m	-$843m	13:30
		Exports (Dec)	-	$18,026m	13:30
		Imports (Dec)	-	$18,869m	13:30
3 Feb	US	Change in Non-Farm Payrolls (Jan)	145K	167K	02:30
		Unemployment Rate (Jan)	4.5%	4.5%	02:30
		Change in Manufacturing Payrolls (Jan)	-11K	-12K	02:30
		Average Hourly Earnings (Jan) – mom	0.3%	0.5%	02:30
		Average Hourly Earnings (Jan) – yoy	4.2%	4.3%	02:30
		Average Weekly Hours (Jan)	33.9	33.9	02:30
		University of Michigan Confidence (Jan)	97.7	98.0	04:00

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

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

NEW ZEALAND DATA WATCH

Key focus over next four weeks: With the Reserve Bank signaling last week that further interest rate increases were likely in the absence of a moderation in the housing market and domestic demand, data over the next four weeks is key in the lead up to the March *Monetary Policy Statement*.

Date	Data/Event	Economic Signal	Comment
Tue 30 Jan (10:45)	Building consents issued (Dec)	Holding up	A technical rebound expected from the surprising weakness in November. Trend to be modestly positive, but not accelerating away.
Tue 30 Jan (15:00)	Credit growth (Dec)	Up	Demand for household credit to remain strong, with another 1 percent increase expected. The Reserve Bank would already have access to this data for their January *Review*, so will not be 'new' information to them.
Wed 31 Jan (10:45)	Merchandise trade (Dec)	Still imbalanced	Exports to be sluggish under a high NZD, but imports ex-fuel to remain high. Headline imports to be dragged lower by falling oil prices. Keep and eye out for consumption good imports.
Fri 2 Feb (10:45)	External Migration (Dec)	Still strong	We're still a favorite destination for migrants, and strong labour market convincing more New Zealanders to stay home rather than seek greener pastures offshore. Another 1,000+ number expected.
Mon 5 Feb (10:45)	LCI and QES (Dec qtr)	Wages up	Wage growth expected to be strong with labour market still tight and demand for labour holding. Annual wage inflation rate may have peaked, but will stay high for some time.
Thu 8 Feb (10:45)	HLFS (Dec qtr)	Steady	Modest employment growth expected in line with confidence surveys, but unemployment rate to remain unchanged. We see upside risk to employment growth, partly as a technical pullback from September quarter weakness.
Thu 8 Feb (01:00)	ANZ Commodity Price Index (Jan)	-	-
Tue 13 Feb (10:45)	Capital Goods Price Index (Dec qtr)	Mixed	Construction prices are expected to continue rising while the high NZD should see plant and machinery prices fall.
Wed 13 Feb (10:45)	Producers Price Index (Dec qtr)	Payback	Firms expected to claw back some of their lost margins, but overall margins still under significant pressure overall.
Thu 15 Feb (10:45)	Retail Trade (Dec qtr)	Up	Anecdotal evidence suggests that consumers spent plenty this Christmas. Discounting should see a solid volume increase in the quarter.
Thu 22 Feb (15:00)	Credit card billings (Jan)	Steady	Some pull-back can be expected after the strong growth recorded in December.
On Balance		**Confirming strong Q4 2006**	**Growth still one sided and in need of rebalancing.**

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SUMMARY OF KEY MARKET FORECASTS

	Actual		Current	Forecast (end month)						
NZ FX rates	Nov 06	Dec 06	29 Jan 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
NZD/USD	0.669	0.692	0.6967	0.700	0.680	0.640	0.620	0.600	0.580	0.550
NZD/AUD	0.866	0.880	0.9002	0.909	0.895	0.853	0.849	0.833	0.817	0.786
NZD/EUR	0.520	0.524	0.5391	0.530	0.523	0.496	0.481	0.472	0.464	0.447
NZD/JPY	78.5	81.0	84.65	84.0	79.6	72.3	68.2	64.8	61.5	59.4
NZD/GBP	0.350	0.352	0.3552	0.361	0.354	0.337	0.328	0.321	0.312	0.299
NZ$ TWI	66.7	68.1	69.6	69.5	67.7	63.7	61.7	60.0	58.2	55.8
NZ interest rates	Nov 06	Dec 06	29 Jan 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
OCR	7.25	7.25	7.25	7.25	7.25	7.25	7.25	7.25	7.25	7.25
90 day bill	7.61	7.66	7.68	7.70	7.50	7.40	7.40	7.40	7.40	7.40
10 year bond	5.72	5.78	6.06	6.00	6.00	6.20	6.10	6.20	6.40	6.50
International	Nov 06	Dec 06	29 Jan 07	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
US Fed funds	5.25	5.25	5.25	5.25	5.25	5.25	4.75	4.75	4.75	5.00
US 3-mth	5.37	5.37	5.36	5.40	5.40	5.00	4.60	4.75	4.90	5.25
AU cash	6.25	6.25	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
AU 3-mth	6.39	6.38	6.39	6.40	6.40	6.30	5.80	5.60	5.80	6.00

KEY RATES

	26 Dec	22 Jan	23 Jan	24 Jan	25 Jan	26 Jan
Official Cash Rate	n/a	n/a	7.25	7.25	7.25	7.25
30 day bank bill	n/a	n/a	7.55	7.54	7.51	7.52
90 day bank bill	n/a	n/a	7.66	7.68	7.67	7.68
NZGB 07/09	n/a	n/a	6.44	6.44	6.51	6.54
NZGB 11/11	n/a	n/a	6.26	6.27	6.33	6.35
NZGB 04/13	n/a	n/a	6.10	6.10	6.15	6.18
NZGB 12/17	n/a	n/a	5.95	5.96	5.98	6.00
1 year swap	n/a	n/a	7.80	7.81	7.88	7.89
2 year swap	n/a	n/a	7.62	7.63	7.72	7.75
5 year swap	n/a	n/a	7.26	7.27	7.33	7.36
RBNZ TWI	n/a	n/a	69.5	69.5	69.6	69.6
NZD/USD	n/a	n/a	0.6988	0.6991	0.6989	0.6963
NZD/AUD	n/a	n/a	0.8861	0.8926	0.8971	0.8998
NZD/JPY	n/a	n/a	85.03	85.05	84.22	84.59
NZD/GBP	n/a	n/a	0.3532	0.3528	0.3555	0.3544
NZD/EUR	n/a	n/a	0.5401	0.5367	0.5392	0.5388
AUD/USD	n/a	n/a	0.7886	0.7832	0.7791	0.7738
EUR/USD	n/a	n/a	1.2939	1.3027	1.2962	1.2923
USD/JPY	n/a	n/a	121.68	121.65	120.50	121.49
GBP/USD	n/a	n/a	1.9784	1.9818	1.9660	1.9646
Oil	n/a	n/a	53.26	53.61	54.24	53.49
Gold	n/a	n/a	646.40	644.90	647.30	645.40
Electricity Price Index	n/a	2.85	2.89	2.94	2.95	2.91

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