

Market Focus

New Zealand

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KEY MACRO THEMES FOR 2010

Page 2: Economic overview

- > Tame core inflation reads has seen the market pull-back from prospects of a Q1 start to the tightening cycle, to be more in line with our view. Data outturns are pointing to increasing spending momentum, but housing market support is also fading. The economic picture is further clouded by prospects of material structural changes to the tax system. The recommendations of the Tax Working Group are now set to be debated, with potentially significant consequences for the property market. So while we remain comfortable saying momentum is building, the recovery is by no means self-fulfilling. In this environment, we expect the RBNZ to continue flagging a mid-year start to the tightening cycle as opposed to earlier.

Page 5: Economic comment – Key Macro Themes for 2010

- > In this article, we outline some of the key themes we see evolving over the year ahead that will have an influential role in New Zealand's economic prospects. While the economy is set to expand, we are not losing sight of the bigger picture. The economy still faces challenges that will cap the magnitude of growth over the next few years, as structural changes come to the fore.

Page 16: Interest rate strategy

- > The RBNZ is centre stage, but with an unchanged stance widely tipped, the NZ rates market will be more influenced by offshore developments. Further fallout from potential policy tightening in China and a regulatory backlash in the US seem likely.

Page 17: Currency strategy

- > Risk turned off across global markets as regulators in the US propose new rules for big banks, and strong China data sparked fears of further PBOC action. To date, these developments have been viewed as negative by the market, but should we be seeing it as a sign that things are in fact normalising?

Page 18: Data and event calendar

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ECONOMIC OVERVIEW

Tame core inflation reads has seen the market pull-back from prospects of a Q1 start to the tightening cycle, to be more in line with our view. Data outturns are pointing to increasing spending momentum, but housing market support is also fading. The economic picture is further clouded by prospects of material structural changes to the tax system. The recommendations of the Tax Working Group are now set to be debated, with potentially significant consequences for the property market. So while we remain comfortable saying momentum is building, the recovery is by no means self-fulfilling. In this environment, we expect the RBNZ to continue flagging a mid-year start to the tightening cycle as opposed to earlier.

What's ahead?

- > **Credit card billings – December month** (Tuesday 1500 NZDT). Based on the electronic card transaction data, we can expect a modest rise, though some of this will reflect higher spending on fuel.
- > **OCR Review** (Thursday 0900 NZDT). We are looking for the RBNZ to keep the OCR on hold at 2.5 percent, and largely reiterate their December stance of a mid-year start to the tightening cycle.
- > **Credit growth – December month** (Thursday 1500 NZDT). We expect household credit growth to remain subdued, growing by around 0.3 percent in the month.
- > **Building consents – December month** (Friday 1045 NZDT). We are looking for a lift in residential consents of around 5 percent. But commercial consents will continue to trend lower.
- > **Trade balance – December month** (Friday 1045 NZDT). Ongoing weakness in imports and a recovery in commodity prices for NZ's major exports should result in a smaller than normal deficit in December. We may even see a surplus in the month.

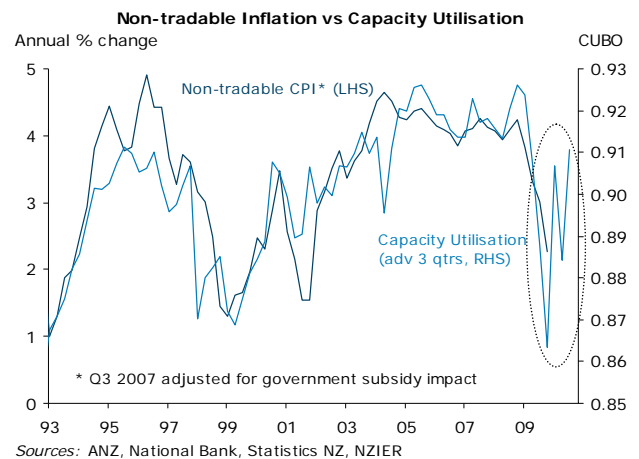
What's the view?

Three events dominated the week domestically: the December quarter CPI release, the tenor of economic data and the recommendations from the VUW Tax Working Group. All have implications for monetary policy, though over vastly different time horizons.

First, the CPI. The overall report was undoubtedly dovish with core measures well contained or essentially flat. In terms of the effect on the RBNZ, the CPI report has given them

time to continue assessing the dataflow. We still see a June start to the tightening cycle, and the hurdle to an earlier move is now quite high. However, we do not believe that the weakness seen across the core inflation measures are a true indication of price pressures in the economy. In some ways it was simply a reverse of the upside surprise in the September quarter. If we average through the September and December quarter non-tradable CPI reads, it comes in at 0.5 percent a quarter – a better reflection of underlying inflation trends in the economy in our view. Inflation has hardly been crushed as a result of the recession, but it does look to be contained.

There is still a large degree of uncertainty over the near-term outlook for non-tradable inflation. If last week's surprisingly strong capacity utilisation measure in the QSBO survey is read at face value, it points to a fairly quick re-emergence of domestic inflation pressures later this year. Likely ongoing volatility in non-tradable CPI in the coming quarters, as Government related charges are increased (i.e. ACC levy increases, local authority rates, emissions trading scheme and possibly tobacco tax increases), will only cloud the picture. For this reason, more focus should be placed on the inputs into the medium-term inflation drivers, as opposed to reacting to each quarterly CPI outturn. **As a result, we will be paying particularly close attention to labour market developments which are due in the first week of February.**

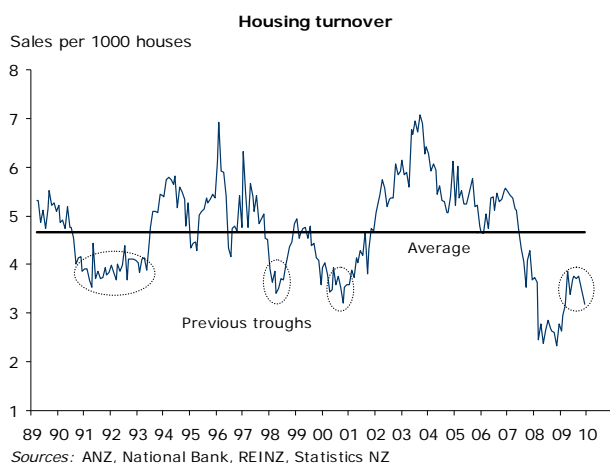


In terms of the economic data, retail sales figures for November suggest that consumers are starting to come out of their shell. While there is a base effect at work, the potential is for pent-up demand and ongoing strong net migration inflows to underpin further recovery in retail spending. Q4 retail volumes now look likely to be pretty stellar and consumption growth with it, giving a prospective lift in GDP of around 1 percent. On the face of it, this suggests that one of the RBNZ's noted uncertainties in December (the impact of stronger housing market activity on

spending) is now becoming a reality. We concur with the improving trend but would caution against too much excitement. Remember – retailing had been in recession for more than a year. To take away the punch-bowl at this stage is not only removing it before the party has really started to rock (as the analogy with monetary policy goes), it is to do so just after you've grabbed your first drink!

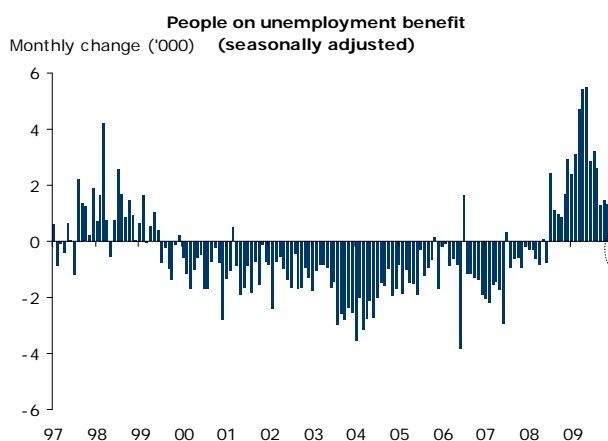
We continue to look for sustained evidence of a pick-up, and this means rebuilding momentum over subsequent quarters in the hard data, and for investment and employment activity starting to recover. Economic activity in the December quarter is looking good, but we need the same for March and June. Leading indicators such as the strong jump in consumer confidence for January are certainly pointing that way.

While retailing is picking up, the impetus from housing is fading. The number of houses sold has now fallen for three consecutive months (in seasonally adjusted terms), median days to sell have risen (marginally) and the stratified house price measure has been broadly flat over the last two months of 2009. To be fair, house sales volumes are well up on a year ago. But the key point is that it looks to have done its dash, although we'd like to see another couple of month's data in this regard as well. Weekly loan approvals for January certainly suggest further cooling. This is hardly consistent with a market that is kicking on, and it looks like rises in fixed mortgage rates have already started to bite. And we have yet to see a lift in the Official Cash Rate.

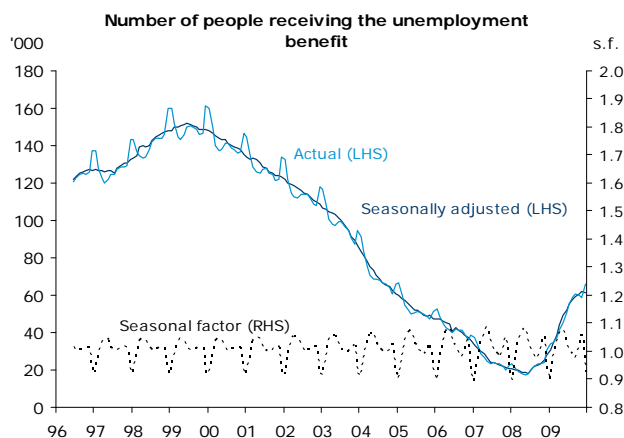


On the unemployment front, data on the numbers of people receiving the unemployment benefit suggests that things are potentially stabilising on the dole queue front. Despite a near 7,800 rise in the actual numbers of people receiving the unemployment benefit in December to 66,328, in seasonally adjusted terms it actually fell by 600, the first decline since June 2008.

It should be noted that the seasonal patterns have been unstable in this series (see chart below), so some caution is needed in relying too heavily on the seasonally adjusted numbers. But nonetheless, this points to the massive job losses seen last year as being past. The unemployment benefit numbers suggest to us that we will still get a rise in the official HLFS unemployment rate in the December quarter (data out on February 4). However, if this is the start of a turn in unemployment, then we could potentially be looking at a peak in the unemployment rate in the March quarter (data due in early May). This is part of the reason why we still like June as the start of the tightening cycle.



Sources: ANZ, National Bank, MSD



Sources: ANZ, National Bank, MSD

We are in no doubt such mixed data readings will be an ongoing feature over the coming months. We'll still be moving forward, but in a volatile and patchy sense.

Turning now to the Tax Working Group's report to the Government, major changes to the tax system have been recommended. We won't go into the details but a couple of observations are warranted. As the group notes, the tax system is broken, so the status quo is not an option. Various initiatives have been put on the table and property is at the heart of a number of them. The ball is now in the Government's court. There were some strong aspirations detailed in last month's *Budget Policy Statement* in terms of

making a step-change in economic performance. You don't take such "steps" by just tinkering. Some hard decisions are pending.

In so far as monetary policy is concerned, we have some observations.

- > You probably don't want monetary policy to be too far away from neutral (which we believe is 5 percent on the OCR at present) when structural changes are occurring. This doesn't mean you should rush to get there quickly either. Furthermore, anything directed at housing (which seems inevitable) is set to assist monetary policy somewhat. As the December *Monetary Policy Statement* noted, what policy action the Government takes "will affect how hard monetary policy has to work to achieve price stability and potentially where the burden of adjustment falls."
- > The fact that specific recommendations relating to residential investment property (such as removing tax depreciation on buildings and taxing returns based on a deemed risk-free rate, alongside a land tax) have been put on the table by the Tax Working Group and have not been rejected outright by the Government, means we should see some behavioural response occur even if final decisions are still some way off. This will make it difficult to get our heads around the data as structural and cyclical forces interact.
- > We have made a change to the profile of our OCR track. We are still sticking to a June start, kicking off with a couple of 50bp increases. But we now see a staggered tightening cycle where the RBNZ will get the OCR towards 4 percent in the first instance, followed by a pause to assess things, before embarking on another tightening cycle in mid 2011. A key assumption in our two part tightening cycle is that the Government will push through structural changes not only to the tax system, but in other areas as well in this year's Budget. This will complicate the economic picture.

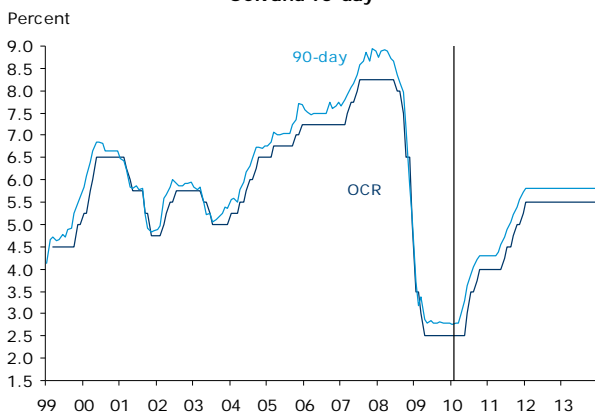
The January OCR Review takes centre stage in terms of the main events next week. We expect the assessment to reiterate December's stance, and douse any market expectations for an earlier move from mid-year. We also get December credit growth, building consents and merchandise trade data next week. Credit growth will stay subdued and show no signs of a pick-up in household or business credit. Building consents will see ongoing improvements in residential consents but weak commercial consents. And we are expecting a smaller than usual trade deficit in December courtesy of lower imports.

Internationally, December quarter CPI data is the main focus in Australia, while the FOMC decision will be keenly awaited by markets. We also get the first December quarter GDP reads out of the US and UK.

Recent local data...

- > **Consumers Price Index – December quarter:** Headline CPI fell 0.2 percent in the quarter, taking the annual rate of inflation to 2.0 percent. Non-tradable CPI rose by 0.1 percent and other core measures were soft.
- > **Retail sales – November:** Both headline and core retail sales rose by 0.8 percent. Fuel retailing and discretionary spending were the main drivers of the increase.
- > **ANZ Roy Morgan Consumer Confidence – January:** Confidence increased by 12.8 points to 131.4, the highest level since February 2007. Both the current conditions and future conditions readings rose strongly.

OCR and 90-day



Sources: ANZ, National Bank, Bloomberg

KEY MACRO THEMES FOR 2010

In this article, we outline some of the key themes we see evolving over the year ahead that will have an influential role in New Zealand's economic prospects. While the economy is set to expand, we are not losing sight of the bigger picture. The economy still faces challenges that will cap the magnitude of growth over the next few years, as structural changes come to the fore.

One of our key aims in writing this article is to alert our readers to some of the wider economic forces at work, including the inherent tensions that exist within the economic system, and to start thinking about the implications for their own businesses. Ultimately, it is the average rate of growth over a number of years that matter, as opposed to what GDP growth will be in a single year. The repercussions of the global financial crisis will continue to be felt for years. Therefore, we would encourage our readers to think about the macro themes we outline below within a five-year time horizon. The themes are:

- > **Rebalancing and the new normal.** The way things were pre-crisis was unsustainable. While the economy is recovering, there is still some way to go to address the imbalances that had build up in the previous decade, and it will take time.
- > **The economic cycle – a V, the Nike swish, bathtub with waves or the dreaded W?** History suggests a V, but structural forces are at play which means this time it will be different. Human behaviour, rather than pure economics, will determine the shape of the recovery path.
- > **From recovery to transition.** We are now in the recovery stage, and will enter the transition stage by mid-year, where policy support is gradually removed. But what other policy changes are introduced during the transition stage will determine the longer term growth outlook.
- > **The China factor.** A real positive medium to long-term development in NZ's favour.
- > **Looking for leadership.** The analysis has been done. Working groups and taskforces have reported back. The time has come for decisions to be made. Will the hard but necessary choices be made, or will populism and political expediency win the day?
- > **Key specifics for NZ over the year.** A list of some of the topical things to watch out for.

While the themes are by-and-large NZ centric, some of them, including the underlying principles, also apply globally. There is a degree of overlap

across the themes, and we do not profess to have all the answers. Anyone who comes up with a precise prescription of how 2010 will play out is likely to be pulling your chain. There are simply too many variables – both structural and cyclical – to accurately predict. On top of that, human behaviour is going to have a huge say (economists call this 'animal spirits').

From the outset, we should outline that our key baseline assumption is that the worst of the global economic and financial crisis has passed. However, the process of financial system repair is still ongoing and will take time. Significantly, we see the global economy embarking on not only a cyclical recovery, but also a period of structural change over 2010 and subsequent years. While the former will take priority as to when policymakers decide on the timing of their exit strategies from extraordinarily stimulatory policies (in particular whether the unemployment rate has stopped rising), we must not lose sight of structural aspects to this cycle if we are to learn from lessons of the past. We see a lot of pending tensions between the cyclical and structural forces over the year ahead, as many of our themes highlight.

Theme 1: Rebalancing and the new normal

Momentum within the NZ economy has been dominated by the spending side of the equation for the past decade. This reflects not only local specific factors (such as NZ's fixation with housing and relative insensitivity to high real interest rates), but is also symptomatic of the wider global picture. Excess savings in Asia have been channelled into savings deficit nations, mainly in the Anglo-Saxon world. For most of the first decade of this century leading up to the financial crisis, cash was not only abundant, it was also cheap. And NZ took full advantage of it.

We believe the debt-funded consumer-driven economic model that NZ ran has come to an end. While such pronouncements have proven premature in the past, we have reasonable confidence of this view this time. For one, we have the Reserve Bank Governor saying that it is untenable for NZ to go back to its borrow and spend habits of old. And he has the means to make sure we don't! In addition, policymakers globally are now taking note and the term "rebalancing" was used roughly 40 times in a 23 page communiqué from last September's G20 summit. Credit is no longer abundant or cheap despite record low official interest rates. There has been a material re-pricing of risk globally, and while short-term money markets have returned to pre-crisis levels, there is still a higher cost (premium) to raise long-term money. Policymakers require financial institutions to better match their claims and funding profile, and this has resulted in higher overall funding costs, which has been passed on to borrowers. Regulatory changes are coming thick and fast.

Looking at NZ's external position, it is clear that the economy has made considerable progress over the past year. The current account deficit has fallen from 8.7 percent of GDP in December 2008 to 3.1 percent in September 2009. New Zealand's net international liability position has stabilised at around 94 percent of GDP. The trade balance is back in surplus for the first time since 2003, courtesy of a sharp capitulation in imports. One-offs relating to structured tax transactions (equivalent to 1 percent of GDP) and a weak domestic economy have been the major drivers behind the improvements in the external position. But it does go some way to getting the economy on a more sustainable footing for robust growth over a number of years, as opposed to a flash-in-the-pan or bust-boom-bust style cycle.

But there is still some way to go. The household savings rate remains deeply negative (although we acknowledge the questionable quality of the statistics). Consumption as a share of GDP

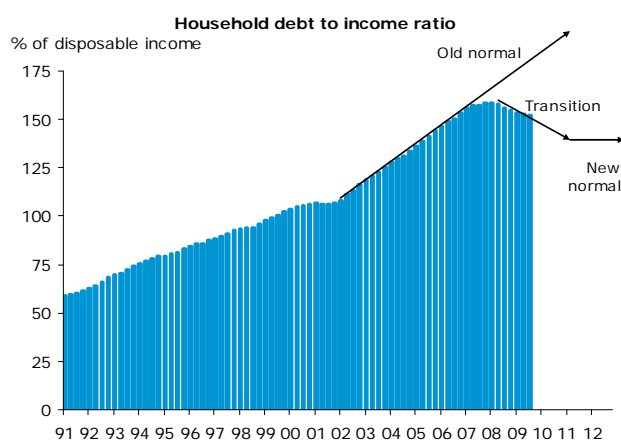
remains elevated. With recovery comes the inevitable temptation to go back to the ways of old. So while the current account deficit is considerably reduced, there remains the potential (or reality in most forecasts) for it to head higher again over 2010 as import demand picks up and profits by foreign owned firms recover. We, the Treasury and the Reserve Bank are expecting the current account deficit to move back above 5 percent of GDP in the next few years, which will likely mean that NZ's net external liability position will surge beyond 100 percent of GDP. While we do not know what the 'tipping point' is until we get there, it is clear that an ongoing deterioration in the net external liability position at that level is unsustainable, though like most we struggle to identify the cadaver that will stop it.

What we do know is that the whole rebalancing process will take a combination of several dynamics to occur.

- > **NZ's rebalancing process is symptomatic of a wider rebalancing process globally.** There is a lot of talk about rebalancing, but can policymakers walk the walk? Will the US shift from being the Freddy Mercury economy (as in we want it all and we want it now)? If pockets of Asia continue to accumulate excess reserves (relative to nominal GDP), then there will surely be savings deficiencies continuing in some shape or form on the other side in the West. If so, in deficit nations, policymakers will need to set policy accordingly (read: have interest rates higher than would otherwise be the case).
- > **Relative price signals must change.** Rising deposit rates in NZ are already helping to shift the incentive away from spending towards saving. Over time, current account deficit and highly indebted nations will face downward pressure on their currencies. Conversely, the currencies of surplus nations, Asia in particular, must rise. Some of the NZD cross rates are assisting with the rebalancing (such as the NZD/AUD), while others are not (NZD/USD). However, we have already seen China raise their reserve requirements this year, which we view as a precursor to allowing their currency to appreciate. All else equal, this should take some of the pressure off the USD to remain structurally weaker against the currencies of other OECD nations, including the NZD.
- > **We need to see structural changes across the NZ economy.** The tax system is at the forefront and we will be closely watching whether the Government adopts any of the recommendations from the Tax Working Group. But in so far as creating an environment built around more savings and a better investment culture, there are a host of other necessary changes. Examples include having another look

at Working for Families, improving the education system, and raising financial literacy, to name but a few. Introducing tax changes aimed at housing will do little unless matched by initiatives that give confidence in alternative investments. Making KiwiSaver compulsory would not go amiss. The bottom line is that mere tinkering will not do. Major structural changes are required to foster a fundamental change in behaviour.

Rebalancing is also about adjusting to a new normal. It is not normal to expect credit growth to expand at 2 to 3 times the rate of nominal GDP growth, nor is it normal to run excessive current account deficits indefinitely. Likewise, house prices cannot grow at double the rate of income growth. Such dynamics are ultimately explosive in terms of the pressure it places on the financial system via excessive leverage. And we should not forget what the global economy has just gone through. The Great Depression Mark 2 may have been averted courtesy of exceptional policy stimulus. But sooner or later economies will have to stand on their own two feet as they come off life support and the stimulus ceases. If the global financial crisis itself was about excessive leverage, we should not lose sight of the fact that there is still the same amount of debt in the system (perhaps even more) as before the crisis. It is just that the composition has been shifted from the private sector to the public sector in some instances.

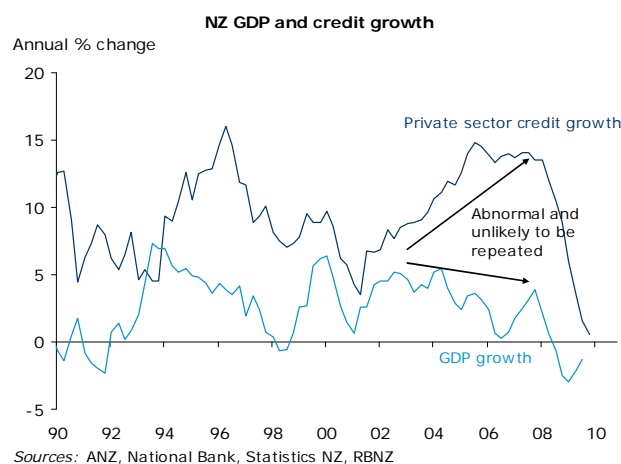


The ramifications of a new normal are significant.

- > **There is a new benchmark for credit growth**, which in the case of NZ, would broadly equate to the nominal growth rate of the economy (as a proxy for debt serviceability). **This will be a by-product of a new regulatory environment that attempts to better manage the booms and busts in the economic cycle.** The danger with regulation of course is that one absurdity is simply replaced with another as the law of unintended consequences prevails. Nonetheless, regulation

is set to play a powerful role going forward. A more subdued credit environment relative to an economy's underlying earnings growth will be the end result.

- > **Faced with more contained credit growth, this decade will be about yield and cash-flow, as opposed to being dominated by capital gains.** This is because there is less ability for that next purchaser to simply pay more because they can get the leverage. The rural sector and housing market should take note. Historical capital gains performance has been driven in part by accumulated leverage. Unless you think credit growth can continue to expand substantially in excess of nominal GDP, this game has come to an end. This does not mean there won't be any capital gains; there will be. It will merely be of a more muted variety with valuations reflecting cash-flow as opposed to anticipated capital gain realisations.

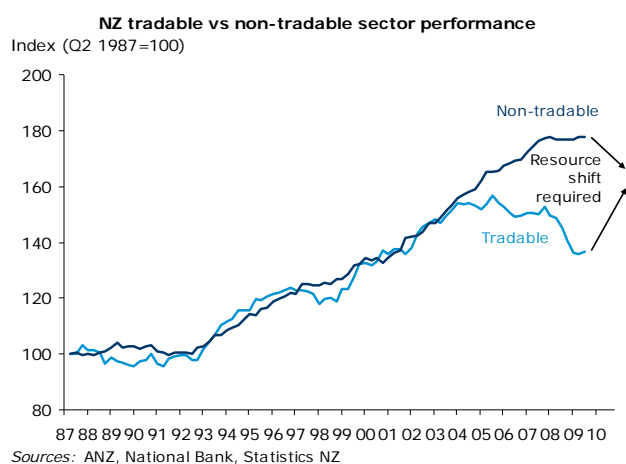


- > **Anticipated wealth, as a driver of consumer spending, will in turn be more contained.** Spending will increasingly be driven more by income growth rather than the wealth effect. RBNZ research¹ estimates that a 1 percent increase in real per-capita housing wealth is associated with a 0.2 percent increase in real per-capita consumption in the long run. The income elasticity is estimated to be 0.5. All else equal, this implies that in the absence of any real house price gains, consumer spending can be expected to grow at only half the rate of income growth, as opposed to in excess of it, as has been the case over the past decade.
- > **NZ is facing a lower trend growth rate over the next five years reflecting:**
 - o Some pay-back from consumption driven excesses of prior years.

¹ Veirman, E and Dunstan, A (2008) "How do housing wealth, financial wealth and consumption interact? Evidence from New Zealand", RBNZ Discussion Paper DP2008/05.

- o A structural resource shift as the economy rebalances away from the non-tradable sector towards the tradable sector. Capital will take time to reallocate. Bank behaviour (as allocators of capital) will take time to respond. Similarly, labour market dynamics will take time to adjust. The education system, for example, will not suddenly be spitting out fewer lawyers and more engineers.

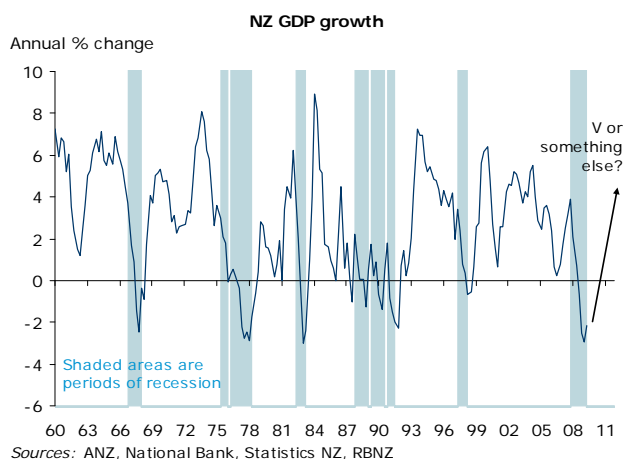
We fully expect the rebalancing process and the transition to a new normal to be both elongated and fraught with uncertainty (and at times with self-interest dominating). Global and local excesses took decades to build up. It will take time to purge.



De-leveraging remains a critical aspect for a host of nations undergoing rebalancing. The first leg of this is centred on restoring health to the financial system and the private sector. This involved a transfer of debt from private sector balance sheets to the public sector. But ultimately this will be transferred back to the private sector as the process of fiscal consolidation (i.e. reducing fiscal deficits or returning to surpluses) begins in a host of nations.

Theme 2: The economic cycle – a V, the Nike swish, bathtub with waves or the dreaded W?

There are solid reasons to bank on a V. After all, this has been the traditional experience. When you fall off a cliff like the global economy (and to a lesser extent for the NZ economy) did in 2009, the first legs of recovery are, of course, always consistent with a V. Upswings tend to be inversely proportional to downturns. We have seen year-on-year growth reaching 6 percent following the previous two recessions in NZ. Support is being provided via extraordinarily loose monetary policy. Pent-up demand is apparent in some areas, including residential construction, where a solution to the leaky home conundrum could unleash it further. Then there is the reality of more bums on seats, with the population growing at 1.2 percent annually, courtesy of strong net migration.



However, we have to be mindful of what a V shaped recovery means.

- > **There is the base effect to be mindful of.** A 15 percent lift in house sales in 2009 bears all the hallmarks of a V, as recovery followed the downturn. But the level is still 26 percent below the average level seen over the preceding four years. So even if a lot of industries experience what looks like a V in the first instance, there is still some way to go to get back to pre-recession levels. In short, the recovery has merely moved half-way up the other side.
- > **The recession has not opened up as much spare capacity in the economy compared to previous downturns.** Capacity utilisation, as measured by the QSBO, is already back above historical average levels. The peak in the unemployment rate this time, likely at around 7 percent, will be lower than the 7.9 percent reached following the Asian Crisis (although it has increased from a far lower base, and there is more idle capacity in terms of hours worked per person). On the inflation

front, it is becoming apparent that the downturn in 2008 and 2009 has merely taken the heat out of inflation as opposed to crushing it. If the economy is indeed embarking on a V shaped recovery with not as much resource slack compared to past cycles, this has important implications for how long monetary policy can remain supportive.

- > **A V implies policymakers are letting us go back to the old normal. The noises coming out of policymakers around the world suggest they will not be so inclined.** The G20 leaders have made it clear that we are not going back to *"banking as usual"*. The Reserve Bank Governor has been equally specific about NZ not returning to our borrow and spend habits of old. And it is not just the Official Cash Rate that will be used to make sure that it doesn't. New liquidity rules for banks which have been introduced are just the start. Greater regulation will be a fact of economic life, which will prevent the kinds of increases in credit growth and risk taking we saw pre-crisis. It may also slow innovation.
- > **Global forces are both assisting and derailing the V.** At the support end we have the growing importance of China (more on this in theme 4 below). Related to this, the long-run prognosis for NZ's terms of trade (broadly speaking, the relative price of soft commodities compared to manufactured goods) is good and is set to stay elevated compared to historical averages. This is because we see continued growing demand for soft commodities, where the ability to increase supply quickly is limited in the near term, while there is clear excess capacity globally for manufacturing goods. Conversely, the ongoing de-leveraging in the global financial system and the need for many governments to start addressing deteriorating fiscal positions (including in NZ) will continue to weigh on growth prospects for some time. Simply put, once the private sector has adequately de-leveraged, it will be the public sector's turn.

Human behaviour, rather than pure economics, will determine the shape of the recovery path. Economists have a notorious track record for understating both downturns and recoveries. The reason for this is simple: economists bank on the rational and most of the models they rely on assume linear relationships. In reality, the world can at times be irrational, and variables can and do interact in non-linear ways. There are tipping points at which behaviour in the form of investment and employment decisions stops and starts. Probably the most difficult task ahead of us at present is trying to predict the "behavioural aspect" within the economic cycle.

Economic trends are about combinations of economics, finance and human behaviour. The difficulty in the current instance is that you have an economy undergoing deep structural change as we adjust to a new normal. Human nature however, wants to go back and grasp the "old", as in the way things were pre-crisis. The problem is that the period in the lead-up to the global financial crisis was abnormal, characterised by excesses in risk taking, credit growth and double-digit asset prices, and unlikely to be repeated again.

We see such behavioural tensions every day.

One scribe notes the process of learning as similar to watching a teenager learn from a mistake: faced with two choices, the path chosen is likely to be the one that is most fun and least painful. And so it applies to the general economy in terms of how we "learn". Across the corporate world we see business leaders recognising that a step-change is required if NZ's medium-term positive potential is to be unlocked. But that requires a sacrifice up front in terms of earnings, and we all know how conditioned the market, and hence CEO behaviour, can become to hitting those near-term benchmarks. The existing level of government services is unsustainable given the income (tax) base. But where is the hurry to forge ahead with the hard decisions when you are judged in the court of public opinion? **Hence, the tendency to push against the inevitable or take the easy solution.**

We will be keeping a close eye on a number of gauges to see whether behavioural changes are taking place.

Measures of lending standards (the QSBO and NBNZ Business Outlook now contain questions related to access to credit) and changes to loan-to-value ratios are one. There was a huge credit accelerator dynamic at the top of the economic cycle, and the reciprocal decelerator was at work during the crisis. The credit decelerator continues to dominate for now. But the credit accelerator/decelerator dynamic, and the consequential flow on for the credit channel of monetary policy, could quickly change. Of course, forthcoming regulatory changes will mitigate this to some extent. But at some stage the financial system will go looking for more volume driven growth. Other measures we will monitor include yields on commercial and residential property investment, and expectations of future house price gains. The adjustment from double digit rates to one closer with income growth may be difficult for some, and there are likely to be disappointments as people get used to the new reality.

The one uncertainty is whether the process of learning occurs voluntarily (orderly) or it gets forced upon us, which leads to a disorderly adjustment. The whole behavioural aspect that is inherent in every economic cycle will have a huge say.

Theme 3: From recovery to transition

We think about current events as involving 5 distinct stages. The first stage was the old normal, specifically the 2002 to 2007 period, where growth was driven by excessive leverage and risk taking, which led to asset price bubbles and artificial wealth-induced spending. Stage 2 saw the inevitable purging that followed such excesses over 2008 and 2009. **Stage 3 is the healing or recovery process that we are currently going through**, helped by aggressive policy action. Faced with the possibility of the Great Depression Mark 2, kitchen sink style economics came to the fore, and by that we mean the kitchen sink was literally thrown at it. As the G20 noted in September, *"it worked"*.

Stage 3 will continue to dominate for the first half of 2010. A mild inventory-led recovery will be the main driver in the first instance. But in the absence of a substantial pick-up in final demand, which is conditional on stabilisation/improvement in the labour market, the final conditions for a sustained recovery are not yet in place. Ensuring that conditions for a durable and sustained recovery are in place will no doubt dominate policymakers' reaction functions in the first part of this year. That means stimulus and continued support will remain in place for some time. But already, we have seen some policymakers move to reduce stimulus earlier, including the Reserve Bank of Australia and the People's Bank of China. But for those nations that suffered deep recessions, the economic priority is to ensure that the recovery is on a solid footing and can be self sustained. NZ is not in that space just yet.

At some point in 2010 (we believe the mid-year to the 2nd half) we will enter stage 4, which we refer to as the transition. The subsequent stage is the endgame, where decisions in the transition phase will determine our growth outlook.

Transition will involve two distinct dynamics. The first is taking the patient off life support, or the so-called exit strategies. There is still a lot of uncertainty over the exact timing, but H2 2010 seems reasonable at present for nations that suffered deep recessions, with the interaction between fiscal and monetary policy key to watch. The second is introducing structural changes to prevent a repeat of the financial crisis but also aimed at changing economic performance. This is where leadership (theme 5) and foresight across policymakers, in setting the scene for subsequent decades, will come to the fore as differentiators.

It is becoming increasingly clear that regulation and/or direct intervention will play a strong role, especially in preventing the build up of asset bubbles (although these are noted as being

difficult to identify). Ignore the warnings from policymakers at your peril. **There is likely to be considerable overlap between the recovery and transition dynamics mentioned above, and we struggle to see policymakers getting the timing or execution "perfect"**. The past week being an example as the anti-bank feeling grows and politicians feel obliged to deliver a policy response. Each policy solution in 2009 has created an exit conundrum. There are levers to pull by different policymakers. In our view, there is a huge risk of a double-dip style recession. This is not a slur on policymakers, rather based on the simple observation that there are simply too many variables to expect such a transition to occur in an orderly fashion.

With the movement from recovery to transition, investment attention will turn to points of differentiation as opposed to simply chasing trends. In fact, concerns over Greece's deteriorating fiscal position are already bringing traditional dynamics like sovereign risk to the fore. We expect more of the same. During the transition stage, we see equities shifting from their cyclical bull run of late to a secular bear market.

During the transition phase, the trend rate of growth will be lower. This is not just a reflection of growth payback, but rather due to timing lags as resources respond to different price signals. It is fine to say NZ is shifting to a more balanced growth model, but it will take time for the likes of the education system to churn out a workforce which is aligned to this, and for capital to reallocate to different sectors.

The transition stage will also see a change in expectations between cash-flow and capital gains. In the absence of leverage to drive asset prices higher, valuations will increasingly be driven by cash-flow and yield. To be fair, they have always been critical in a number of areas. But in some, they took a back seat. This will be the case no more. Residential property investors and the rural sector should take note. Your "old normal" of leverage driven capital gains will not be repeated in the "new normal". But as noted in theme 2, it will no doubt take a while for "behaviour" to adapt.

Theme 4: The China factor

One major positive medium-term development in NZ's favour is China and the outlook for the Asian region.

NZ's exports to China have been growing strongly, and now account for nearly 9 percent of total merchandise exports, compared to below 3 percent a decade ago. Last year, China took over 10 percent of NZ's total dairy and fisheries exports and almost 30 percent of wood related exports. China's industrialisation still has further to run. It may now be the second largest economy after the US, but its average per capita income is still relatively low. China has the ability to grow at 8 percent per annum for many years to come.



Sources: ANZ, National Bank, Statistics NZ

NZ's economy is complimentary to China's in that it produces what China wants, and does not compete head on with it.

Indeed, NZ stands to benefit from China's increasing demand for high-quality agricultural products. China is facing serious water shortage problems in its northern plains. This means it will become difficult for China to maintain the current scale of agricultural production in the future. Meanwhile, China's affluent middle and upper class, with a per capita income of US\$7,000 and above, is emerging rapidly. Our estimates put the number at about 130 million, larger than the Japanese population. This income group will demand more proteins and high quality agricultural and fishery products, which will help keep soft commodity prices elevated.

NZ, with its free trade agreement with China, is well positioned to capitalise on this opportunity. This is one area where NZ is ahead of other countries clamouring to piggy back off China's strong growth. A flip side of the global rebalancing that needs to occur is that China needs to rely more on domestic demand to drive its future growth, rather than persevering with its export-led model. The Chinese authorities are aware of this, and steps are being taken to address it. But it will be a gradual process, and just as the household savings rate of Anglo Saxon countries have been declining for the past two decades, the same will

occur for Chinese household savings rate. With a high starting point for Chinese savings (estimated at 25 percent of income), this has the potential to provide ongoing support to domestic demand for some time (and hence import demand), much to the benefit of NZ. The tourism and education sectors also stand to continue benefiting from rising income in China.

Apart from the direct demand implications for NZ's exports, a further area of benefit will be from China's foreign direct and portfolio investment outflows.

There are still strict capital controls in place in China, but the authorities are gradually liberalising their capital account, though at a very slow pace. But the policy direction is clear, and more capital can be expected to flow out of China in search of opportunities around the world. We have already seen recent investments by Chinese companies in high profile NZ companies. This trend will continue.

This story is not about China alone. It is about prospects for the entire Asian region (excluding Japan). Indonesia and India are two other fast growing developing economies that will be beneficial for NZ. Growth in NZ's traditional OECD trading partners over the next decade is expected to be around 2½ percent. Asia has the capacity to grow at more than triple that rate. It does not take a genius to work out where we need to hitch our wagon. This is where progress on free trade agreements across the region and closer economic integration is critical. NZ is already ahead of the game in this respect, with free trade deals already in place with China, ASEAN, and the Gulf Cooperation Council, with progress being made to negotiating a Trans-Pacific Partnership that will include the US.



Vulnerabilities must be acknowledged and there will be bumps in the road ahead. China's investment share of GDP (at around 45 percent) portends a capacity and infrastructure overhang, and a high degree of poor performing loans. The long-term demographic picture is poor, as the effects of China's "one child policy" start to bite. At

some stage, China – and the region – will have a “bad” year. The region faces inflation challenges over 2010. Policymakers have already responded by tightening monetary policy and we expect more of the same. Containing inflation expectations and pressures across the region will be a key challenge, particularly given the tension between economic (sustainable growth) and social (jobs) objectives. However, this is more than matched over the medium-term by the basic maths behind rapidly growing per capita incomes and huge foreign reserves to absorb any near-term blips.

Theme 5: Looking for leadership

2010 is shaping up as one of the most critical years in NZ’s economic history. The scene has been set with the Government talking about aspirations to catch up with Australia, and about laying the groundwork for a step-change in economic performance. The various working groups and taskforces that have been set up have largely reported back with their recommendations. The analysis has been done. The time has now come for decisions to be made and implemented.

There are four key areas to watch.

- > **The process of fiscal consolidation.** The Government’s *Half-year Economic and Fiscal Update* projected underlying deficits of 2 to 4 percent of GDP over the next five years. At present we believe that around half the projected deficits are structural (i.e. permanent) and half are cyclical that will eventually correct when the economy recovers. Just as households are facing different spending choices, so too is the Government, and this includes local government as well. Thankfully NZ’s fiscal position is in a far stronger state relative to peers such as the United States and United Kingdom. Nonetheless, this does not diminish the need to return the fiscal position back into surplus. Failure to curb the growth in government spending today will merely burden the next generation with more debt and potentially higher taxes. Particularly as the demographic bulge starts to hit. This will involve structural changes across the delivery of key government services (think the number of government departments, education facilities – do we need 80 plus polytechnics?). **It will also involve shifting the burden to households, which will still be de-leveraging themselves.** Someone asked us the other day about who would pay for the leaky building problems. Our answer: ultimately we will, for we fund the coffers of central and local government.
- > **The balance between monetary policy and fiscal policy.** Monetary policy has become inherently more complicated as the world becomes increasingly integrated and labour becomes even more mobile. The OCR will no doubt remain the primary policy instrument at the RBNZ, with new initiatives on the regulatory front also assisting. But it is at this juncture, monetary policy needs mates. We fully expect some of the recommendations that came out of the Tax Working Group to be acted upon, particularly in the areas related to residential investment property. This should greatly assist the RBNZ in terms of both the timing and magnitude of the tightening cycle. On the

global stage, we see deficit governments that are prepared to embark on the process of fiscal consolidation earlier as assisting monetary policy, allowing interest rates to remain lower than would otherwise be the case. This looks to be the case in NZ.

- > **Look for further progress in unlocking NZ's mineral wealth (reputedly worth \$170 billion) and other growth-wins such as oil exploration.** Strong growth over the past decade led to touchy-feely style initiatives supplanting economic priorities. This has changed given the growth outlook. The economic imperative for any government at present is growth and jobs: these are the benchmarks they will be judged in the court of public opinion. Hence, we expect substantial progress in some key areas, despite obvious concerns from some pockets.
- > **Foresight versus populism.** The Government is committed to delivering a step-change in NZ's economic performance. Yet radical change has all but been ruled out. The two appear incompatible. On the global stage, we have the group of 20 industrialised nations committing to the principles of competitiveness, anti-protectionism etc. Yet as events of the past week testify (especially in the US), there is growing populist demand for politicians to act, particularly against the banking system. Some change is inevitable, and indeed needed. But the risk is that in responding to populism, the goose that lays the golden egg gets cooked. The process of credit facilitation and creation is a critical part of the modern economy. Common-sense and analytics need to determine policy responses as opposed to populism. The latter is now emerging as a significant risk, particularly if it leads to a bout of protectionism.

How we get a step change improvement in economic performance and reduce the fiscal deficit is where there are a lot of disagreements. Typically, the debate turns into one about who loses or pays, such as the impact of additional ACC levies for motorcyclists. There is a failure to appreciate that someone else is also impacted, and in the case of motorcyclists, the motor vehicle owners and others who are subsidising them. In the end, not everyone can be winners, and policy cannot be designed to ensure that no one loses. But it is typically small self-interest groups that grab the emotive headlines. The Government should also not be afraid to leverage off its balance sheet further in order to address national infrastructure deficits. But this is on the proviso that there are clear corresponding proactive savings initiatives in other areas and less core government spending.

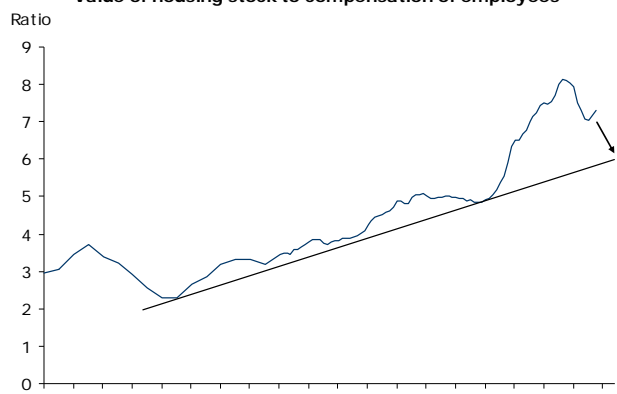
2010 is not going to be a year across political circles for making easy choices. You can't talk about a step-change in growth and then rule out the recommendations of the Productivity Taskforce as being too radical. If we see "popular" decisions being made, then we cannot expect to see meaningful improvements. But if we see the tough decisions being made, then we will have more confidence about NZ's future prospects.

Theme 6: Key specifics for NZ in 2010

There are a host of issues everyone will be eyeing in 2010. The following list is intended to be a non-exhaustive list in relation to some of the more topical ones we see.

- > **The global surprise in 2010 is Japan or Europe and not the US.** The US has clear economic challenges, but it has flexibility across product and goods markets that allow resources to reallocate. Japan and Europe have structural rigidities that have us more concerned. In addition, Japan faces a huge demographic and government debt challenge. Greece's fiscal difficulties are only the start for Europe. Watch Spain and the others. **With this, the other surprise of 2010 may well be a rally in the USD.**
- > **Falling land prices.** NZ continues to face a house price adjustment given the multiple to income (a factor of 7). We are now leaning towards a W shaped cycle for housing. But ultimately it must be a land price adjustment. For sure, there are shortages of land in key pockets such as Auckland. But across the nation there is no shortage of land and the ripple effects of the credit decelerator are only now unfolding. The rural sector will not be immune either, despite stronger NZD commodity prices. They still do not provide anywhere near a decent return on equity.

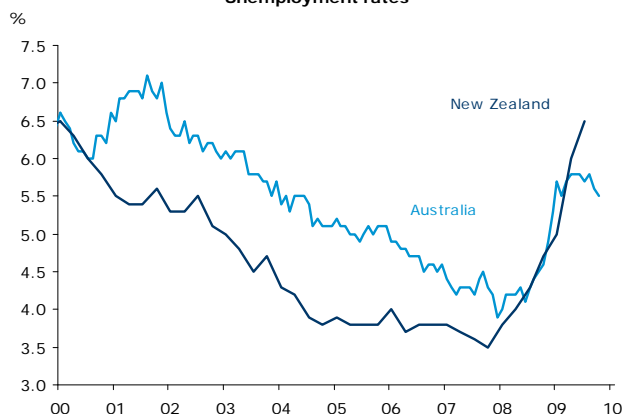
Value of housing stock to compensation of employees



Sources: ANZ, National Bank, Statistics NZ, QV

- > **Stemming the tide.** The Australian unemployment rate is currently 5.5 percent and falling. NZ's is 6.5 percent and rising. Enough said. Net migration will weaken in 2010 as more NZ'ers go to the "lucky country". Unless we see concrete steps on the policy front (leadership on the tax front), this will only get worse.

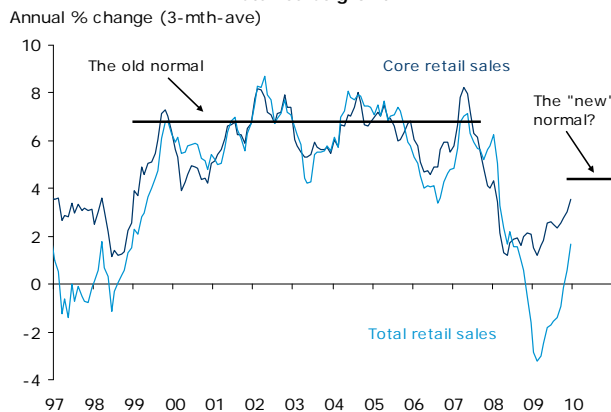
Unemployment rates



Sources: ANZ, National Bank, Bloomberg

- > **Labour market divergences.** We expect the labour market to remain weak into early 2010. But already divergences are opening up and if there is one issue that is likely to confuse all and sundry, it will be the outlook for jobs. Employment intentions have picked up, yet with hours worked per person at record lows, there is the potential to meet increased labour demand simply by working the existing workforce harder. But we are also noting anecdotes of skill shortages, and worry about this being exacerbated by a pending uplift in migration to Australia. The capacity "losses" in key trades and infrastructure (e.g. medical profession) could take years to rebuild. There needs to be a policy response.
- > **The household behavioural response.** After a period of excess, household spending took a breather in 2009. With emerging signs of recovery in consumer confidence and consumer spending evident, we hope that NZ households have learnt the lessons of the 2003-2007 period. There are some positive signs out there, but discipline will need to be exercised. A key component to this will be to the extent to which the housing market (the RBNZ's perennial bugbear) remains under control, in an environment when net immigration is high and borrowing rates are relatively low.

Retail sales growth



Sources: ANZ National, Statistics NZ

> **The exit strategy for the RBNZ. There are three issues.**

- **In regards to timing, we continue to favour a mid-year start.** There appears to be a reasonable balancing act between side-ranging nuances from demand and supply-sides of the economy. Clearly the economy has less spare capacity than initially thought. However, the recovery to date remains patchy and narrow. It is at this juncture that stimulatory monetary policy must look for its exit strategy as synonymous with the path of least potential regret.
 - **Be assertive when you need to move.** For credibility as much as for other reasons, we believe the RBNZ needs to deliver at least one 50 basis points move early in the tightening cycle. To do otherwise would appear to go against the lessons of 2 of the preceding 3 upswings when monetary policy ended up behind the curve (the early 1990's and 2004, with 2000 the exception).
 - **The neutral OCR is lower**, reflecting a structural shift in the pricing of risk around the globe which increases the cost of funds and keeps the yield curve steep. Structural changes that will keep the spread between the OCR and lending rates wide include the RBNZ's new liquidity rules, as well as a reversal of the downward trend in lending margins to offset slower volume growth. At present we see the neutral OCR being closer to 5 percent as opposed to the commonly perceived or talked about 6 percent.
- > **The NZD/AUD eventually gives way and hits 0.75.** This has been on the cards for some time given fundamental economic differences, notably the terms of trade. But a widening NZ-Australia interest rate differential and the reality of a stubborn USD means NZ's rebalancing process must ultimately be borne more against our largest trading partner.

The bottom line

We've turned the corner but more work still needs to be done. Armageddon has been averted, but de-leveraging will remain a key dynamic influencing performance over 2010. There will be much to confuse everyone as we eye improvements, but off a low base in some instances. There is a new normal. The economy still needs to rebalance. At some stage in 2010 we will enter the transition stage, which will involve the odd pocket of turbulence. Early indications for this year suggest we may be hitting that stage already. 2010 will progressively be about points of differentiation, and leadership will come to the fore. Do we take the hard or populist decisions?

If 2010 is a tough year, then we'll be euphoric over prospects for the subsequent five. A tough year will tell us the message is sinking in. Balance sheets are being repaired. Savings rates are lifting. Resources are shifting from housing to more productive investment. We are making the hard decisions. However, if we set the world on fire in the coming twelve months – with domestic consumption and property at the forefront – and momentum associated with the Rugby World Cup carries us through 2011 (provided we do not exit in the quarter finals or earlier!), then we'd put strong odds on a double-dip in 2012.

The years ahead provide opportunities for NZ to make progress towards achieving better economic performance. Everybody will need to do their part. Governments alone cannot do this, but their direction will be crucial. More focus will need to be directed towards improving skills, directing saving towards productive investment, and living within our means so that future generations are not burdened. There are no easy choices. Banks, businesses and households are all facing behavioural changes as we adjust from the abnormal to the new normal. The only uncertainty is whether we embrace it voluntarily or not.

INTEREST RATE STRATEGY

The RBNZ is centre stage, but with an unchanged stance widely tipped, the NZ rates market will be more influenced by offshore developments. Further fallout from potential policy tightening in China and a regulatory backlash in the US seem likely.

Market themes...

- > Weak NZ inflation report has market paring back rate hike expectations.
- > Global rates rally as risk aversion returns, not helped by proposed tougher regulation for big US banks.

Review and outlook

It was a week of two halves. The first part was dominated by domestic data, with NZ Q4 CPI the key event. A dovish read overall led to a rally in the rates market, leading to a paring back of expectations of the timing of the tightening cycle. March has now all but been priced out, with a full hike priced in for April. The degree of the rally suggested many participants had been positioned in anticipation of a stronger read. The ugly Q3 print last year was no doubt still fresh in the market's mind. We did see some pullback following stronger retail sales and consumer confidence data. The mixed data is making for a choppy environment as the market continues to struggle with the starting point and magnitude of the tightening cycle.

Offshore events dominated the second part of the week. Risk aversion returned, as weak US earnings results, strong Chinese data raising fears of further policy tightening by the PBOC, and proposed tough financial regulations for US banks all sparked selling of risk assets. The flight to safety led to a rally in global rates, with the NZ market following suit.

In Australia, comments by RBA board member Graham Kraehe were very hawkish but were largely ignored by the Australian market, even on top of strong motor vehicle sales, high consumer confidence and another increase in the TD inflation gauge. When asked if the risk was that too much policy tightening would choke off a recovery, Kraehe replied that *"the risk is more to cost pressure and inflation than it is to the demand side"*. He was also confident about the China growth story even though more generally the market is concerned that China's expansion may be an asset bubble and that moves to tighten policy there may see the slowdown flowing back to the Australian resources sector.

We have seen very little activity in the fixed rate mortgage market which is not surprising

following on from the summer holiday break. Corporate flow has been light although enquiries about forward start swaps have increased. Offshore receiving picked up prior to the CPI data, and a few uridashi issues have been done. We suspect speculative longs will carry long positions into next week's OCR.

Borrowing strategies we favour at present

Rates will move higher this year. But a steep yield curve looks set to stay for some time, negating some of the benefit of fixing. We continue to favour the use of caps as a way to hedge interest rate risk, while enjoying lower floating rates while they last.

Gauges for NZ interest rates

Gauge	Direction	Comment
RBNZ / OCR	↔	Q4 CPI gives the RBNZ some breathing space. Mid-year still looks likely.
NZ data	↔/↑	Mixed generally, with soft CPI but strong retail.
Fed Funds / front end	↔/↑	How long will "an extended period" remain?
RBA	↑	Market now looking for a February move.
US 10 year	↓	Safe haven bids return with a vengeance following equity weakness.
NZ swap curve	↔/↑	Flattening pressure undone following CPI data.
Flow	↔	Very little mortgage or corporate flows.
Technicals	↔/↓	4.4%-4.5% range in the 2-year heading into the RBNZ.

Market expectations for RBNZ OCR (bps)

OCR dates	Last week	This week
Thu 28-Jan-10	+1	+2
Thu 11-Mar-10	+12	+4
Thu 29-Apr-10	+37	+29
Thu 10-Jun-10	+73	+59
Thu 29-Jul-10	+105	+95
Thu 16-Sep-10	+143	+125
Thu 28-Oct-10	+162	+151

Trading themes we favour at present

Given volatility in the economic data, expect similar chopiness in the rates market to continue. This means a period of trading the ranges is in order, while being mindful that the ranges could move quick swiftly.

CURRENCY STRATEGY

Risk turned off across global markets as regulators in the US propose new rules for big banks, and strong China data sparked fears of further PBOC action. To date, these developments have been viewed as negative by the market, but should we be seeing it as a sign that things are in fact normalising?

Market themes...

- > Risk off the table as the market regulators design a new world. IMM positioning show NZ and AUD markets are long.
- > Greece still weighing on the euro.
- > Equities/commodities correlation returns.

Review and outlook...

The benign NZ Q4 CPI was the domestic focus this week but behind the scenes, the real economy showed it has found its legs with both retail sales and consumer confidence showing above expected activity. The ANZ Roy Morgan consumer confidence reading printed a 3 year high.

The currency market was solely focused on developments in the regulatory front, with talk by US President Barack Obama about curbing the trading risk taken by banks, and also steps taken by Chinese regulators in turning off the credit tap, negatively impacting on risk appetite. The AUD was not helped by reports that the Henry tax review is recommending a new mining tax for Australian miners. In addition, the US earnings reporting season got off to a bad start with more disappointments than positive surprises. With risk being taken off the table across all markets, the NZD and AUD was sold hard.

The Chinese authorities have easily maintained growth above their desired 8 percent target. The problem is they have over stimulated their economy, with inflation at 1.9 percent uncomfortably high, with a risk of further inflation pressures as the output gap in China closes. The tightening in credit growth by the Chinese regulators has been felt mainly in the commodity currencies. The implications are two-fold. Firstly, tighter policy in China takes the heat off antipodean central banks to move aggressively. Secondly, if this is as good as it gets for the Chinese economy (hitting capacity constraints), then the top looks to have been reached for the commodity block.

Needless to say, despite ongoing signs of recovery in NZ, and ongoing strength in the Australian economy and the prospect of another rate hike by the RBA in February, both the antipodean currencies have moved sharply lower purely on offshore developments.

Given that even NZ no longer needs a government guarantee to borrow term cash abroad, and the narrowing spread to Libor, you could easily argue that the antipodean countries could be seen as a safe haven in an uncertain world. But US bonds and the USD remain the primary safe haven destination of choice by global markets.

The elephant in the room remains the euro. Despite reassurances from Greece towards its fiscal position, the market is far from convinced, with worries towards others. This is leading to a default USD bid, further dragging on the NZD.

NZD vs AUD: monthly directional gauges		
Gauge	Direction	Comment
Fair value	↔	Within the range.
Yield	↓	Yield favours Australia.
Commodities	↔	Softs and hardes are weakening.
Partial indicators	↔/↓	Both economies improving, but Aussie much faster.
Technicals	↔	Range trade. Resistance above 0.80 now.
Sentiment	↔	Both tarred with the same brush as focus turns to global economy.
Other	↔/↑	IMM positioning weighing more on AUD.
On balance	↔/↓	Yield story too hard to ignore.

NZD vs USD: monthly directional gauges		
Gauge	Direction	Comment
Fair value – long-term	↔/↓	Above long-term average.
Fair value – short-term	↔	In line with cyclical fair value.
Yield	↔	RBNZ expectations pared back.
Commodities	↔/↓	Commodities turning.
Risk aversion	↔	Rising but how does this affect NZ?
Partial indicators	↔	RBNZ main focus next week.
Technicals	↔/↓	0.7050 still key support level and if broken opens up for tests of 0.69 and
AUD	↔	Impacted negatively by China story.
Sentiment	↔/↓	Turning off risk currencies?
Other	↔	Watch the regulatory backlash.
On balance	↔/↓	Support levels to be tested.

DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
25-Jan	NZ	Business NZ Performance of Services Index	-	56.0	10:30
	AU	Produce Price Index- 4Q - qoq	-	0.1%	13:30
	AU	Produce Price Index- 4Q- yoy	-	0.2%	13:30
	JN	BOJ Monetary Policy Meeting			17:00
26-Jan	US	Existing Home Sales - Dec	6.07m	6.54m	04:00
	NZ	Credit Card Spending - sa - mom	-	0.8%	15:00
	JN	BOJ Target Rate	0.1%	0.1%	
	UK	Nationwide HPI – Jan-mom	-	0.4%	
	UK	Nationwide HPI – Jan-yoy	-	5.9%	
	GE	IFO – Business Climate - Jan	95.2	94.7	22:00
	GE	IFO – Current Assessment - Jan	91.3	90.5	22:00
	GE	IFO – Expectations - Jan	99.1	99.1	22:00
	EC	ECB Euro-Zone Current Account – sa - Nov		-4.6b	22:00
	UK	GDP – 4Q - qoq	0.4%	-0.2%	22:30
	UK	GDP – 4Q - yoy	-2.9%	-5.1%	22:30
	UK	BOE King Testimony to UK Lawmakers			22:45
27-Jan	US	S&R/CaseShiller 20 City HPI - sa – Nov - mom	-	0.4%	03:00
	US	S&R/CaseShiller 20 City HPI - Nov - yoy	-5.0%	-7.3%	03:00
	US	Consumer Confidence - Jan	54.0	52.9	04:00
	AU	Consumer Prices - 4Q- qoq	-	1.0%	13:30
	AU	Consumer Prices - 4Q-yoy	-	1.3%	13:30
	JP	BOJ Monthly Report			18:00
28-Jan	US	Fed's Open Market Committee Meets			03:00
	GE	CPI – EU Harmonised – mom - Jan	-0.4%	0.9%	
	GE	CPI – EU Harmonised – yoy - Jan	0.9%	0.8%	
	US	New Home Sales – Dec	370k	355k	04:00
	US	FOMC Rate Decision	0.25%	0.25%	08:15
	NZ	RBNZ Official Cash Rate	2.5%	2.5%	09:00
	GE	Unemployment Rate – sa - Jan	8.2%	8.1%	21:55
	EC	Business Climate Indicator - Jan	-1.10	-1.22	23:00
	EC	Euro-Zone Indust. Confidence - Jan	-15	-16	23:00
	EC	Euro-Zone Consumer Confidence - Jan	-15	-16	23:00
	EC	Euro-Zone Economic Confidence - Jan	92.5	91.3	23:00
	EC	Euro-Zone Services Confidence - Jan	-3	-3	23:00
29-Jan	US	Durable Goods Orders - Dec	1.6%	0.2%	02:30
	US	Initial Jobless Claims – Jan 24	435k	482k	02:30
	NZ	Merchandise Trade Balance - Dec	-	-269m	10:45
	NZ	Merchandise Trade Imports - Dec	-	3.34b	10:45

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
29-Jan Cont.	NZ	Merchandise Trade Exports - Dec	-	3.07b	10:45
	NZ	Building Consents - Dec	-	1.2%	10:45
	NZ	Governor Bollard Speaks in Christchurch	-	-	12:00
	JN	Jobless Rate - Dec	5.3%	5.2%	12:30
	JN	Household Spending – yoy - Dec	1.6%	2.2%	12:30
	JN	National CPI – yoy - Dec	-1.7%	-1.9%	12:30
	JN	National CPI Ex Food, Energy – yoy - Dec	-1.2%	-1.0%	12:30
	JN	Industrial Production – mom - Dec	2.5%	2.2%	12:50
	JN	Industrial Production – yoy - Dec	5.7%	-4.2%	12:50
	UK	GfK Consumer Confidence - Jan		-19	13:01
	AU	Private Sector Credit - yoy - Dec		0.8%	13:30
	EU	Euro-Zone M3 -sa - yoy- Dec	-0.6%	-0.2%	22:00
	EU	Euro-Zone Employment Rate - Dec	10.1%	10.0%	23:00
	EU	Euro-Zone CPI Estimate – yoy - Jan	1.2%	0.9%	23:00
30-Jan	US	GDP QoQ (Annualised) – 4Q	4.5%	2.2%	02:30
	US	Core PCE (annualised) QoQ – 4Q	1.3%	1.2%	02:30
	US	Employment Cost Index – 4Q	0.4%	0.4%	02:30
	US	Chicago PMI - Jan	56.5	58.7	03:45
	US	U. of Michigan Confidence - Jan	73.0	72.8	03:55

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

NEW ZEALAND DATA WATCH

Key focus over the next four weeks: The economic data has been mixed to date, and we expect this to be the case for some time. Beyond the January OCR decision, the main focus will be on labour market developments, and indications of momentum in consumer spending.

Date	Data/Event	Economic Signal	Comment
Thur 28 Jan (09.00)	OCR Review	The exit strategy	We expect the RBNZ to by-and-large stick to their December script that rates look set to move higher from mid 2010.
Thur 28 Jan (15.00)	Credit Growth (Dec)	Lacking a pick-up	Household lending growth to continue to be soft, while corporate sector deleveraging continues. Overall credit growth to show no pick-up in business investment as yet.
Fri 29 Jan (10.45)	Overseas merchandise trade (Dec)	Further improvements	The annual trade balance looks set to improve further courtesy of still weak imports. This sets the scene for further improvements in the Q4 current account.
Fri 29 Jan (10.45)	Building consents (Dec)	Mixed	Residential building consents are expected to continue trending up but non-residential activity to remain subdued.
Mon 1 Feb (15.00)	ANZ Commodity Price Index (Jan)	Better	Irrespective of the monthly result the trend in the series shows a strong lift in export prices. This is a critical part of the economy's rebalancing process and also allowing the rural sector to work through excesses in a reasonably orderly fashion.
Tue 2 Feb (10.45)	Quarterly Employment Survey and Labour Cost Index (Dec qtr)	Subdued	We expect labour cost readings to remain contained given spare capacity within the labour market, and the normal lagged response to real economic activity.
Thu 4 Feb (10.45)	Household Labour Force Survey (Dec qtr)	Ongoing capacity gaps	We expect the unemployment rate to lift to 6.8 percent. Employment is expected to be flat to negative and insufficient to soak up entrants into the labour force. Hours worked are expected to come in positive (0.3 percent) as firms respond to better economic momentum by lifting hours per FTE (which have dropped to an all time low).
Thu 4 Feb (10.45)	Visitor arrivals and net migration (Dec)	More bums on seats	Migration rebounding strongly in 2009. December's figures are expected to continue the trend although most interest will be on 2010 and what a booming Australian economy means for those people that deferred plans in 2009.
Wed 10 Feb (10.45)	Electronic Card Transactions (Jan)	Improvement	The trend in ECT has been on a gradual grind up and we expect this to extend into 2010.
Circa 15 Feb (10.00)	REINZ House sales and prices (Jan)	Stating to wobble?	Volumes tailed into 2009 but the market (prices) remained tight owing to a lack of listings. January will give a key read on whether momentum in the housing market is starting to fade.
Tue 16 Feb (10.45)	Producers Price Index (Dec qtr)	Still margin pressure	Volatility caused by the Fonterra payout movements mean not too much should be read into the headline numbers. Margin pressure should still be evident among most sectors.
Wed 17 Feb (15.00)	NBNZ Regional Trends (Dec qtr)	How strong?	We will get an indication of how Q4 GDP could shape up from the Regional Trends release.
Thu 18 Feb (15.00)	ANZ Roy Morgan Consumer Confidence (Feb)	Still perky?	After a good start to the year, we will see whether confidence stays high once consumers get their credit bills in the mail.
Wed 24 Feb (15.00)	RBNZ Survey of Expectations (Mar qtr)	Steady	We were surprised at the previous quarter's rise, and are looking for a steady print for this release.
On Balance		Improving but not racing away	Growth momentum continues to accelerate but off a low base.

SUMMARY OF KEY ECONOMIC FORECASTS

	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
GDP (% qoq)	-0.9	-0.9	0.2	0.2	0.9	0.5	0.6	0.6	0.5	0.7
GDP (% yoy)	-2.5	-3.0	-2.1	-1.3	0.5	1.8	2.2	2.6	2.2	2.4
CPI (% qoq)	-0.5	0.3	0.6	1.3	-0.2	0.2	0.7	0.9	0.8	0.5
CPI (% yoy)	3.4	3.0	1.9	1.7	2.0	1.9	2.0	1.6	2.7	3.0
Employment (% qoq)	0.7	-1.4	-0.4	-0.7	-0.1	0.0	0.1	0.3	0.4	0.5
Employment (% yoy)	0.9	0.7	-0.9	-1.8	-2.5	-1.2	-0.7	0.3	0.8	1.3
Unemployment Rate (% sa)	4.7	5.0	6.0	6.5	6.8	7.0	7.1	7.1	7.0	6.9
Current Account (% GDP)	-8.7	-7.9	-5.6	-3.1	-1.8	-1.3	-1.7	-2.4	-2.5	-2.5
Terms of Trade (% qoq)	-1.0	-2.7	-9.4	-1.2	3.8	3.0	1.9	0.5	0.2	-0.2
Terms of Trade (% yoy)	1.8	-5.0	-13.5	-13.7	-9.6	-4.3	7.6	9.5	5.7	2.5

KEY ECONOMIC INDICATORS

	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09	Jan-10
Retail Sales (% mom)	0.6	0.6	0.0	-0.5	1.2	0.2	0.1	0.8	..	..
Retail Sales (% yoy)	-1.7	-2.4	-1.1	-1.4	-1.1	-0.5	-0.2	2.4	..	..
Credit Card Billings (% mom)	2.4	-0.3	0.1	0.3	1.2	-0.7	0.2	0.8	..	..
Credit Card Billings (% yoy)	-1.6	-2.3	-2.0	-1.9	0.0	-2.3	-0.3	1.6	..	..
Car Registrations (% mom)	-1.4	-2.1	6.0	7.0	-3.6	8.1	0.9	2.2	5.9	..
Car Registrations (% yoy)	-41.0	-33.3	-29.6	-16.4	-18.3	-16.8	-16.8	2.4	0.3	..
Building Consents (% mom)	10.9	2.6	-9.4	5.3	2.9	7.3	10.7	1.1	..	..
Building Consents (% yoy)	-56.6	-23.3	-24.1	-16.8	-8.4	-12.2	27.5	21.3	..	..
REINZ House Price (% yoy)	-1.4	-2.2	0.0	0.0	5.1	6.1	6.0	5.2	9.6	..
Household Lending Growth (% mom)	0.2	0.4	0.1	0.3	0.3	0.3	0.3	0.2	..	..
Household Lending Growth (% yoy)	2.5	2.5	2.3	2.4	2.3	2.3	2.6	2.8	..	..
ANZ-Roy Morgan Consumer Confidence	104.6	105.8	103.4	107.8	112.3	120.0	125.9	121.5	118.6	131.4
NBNZ Business Confidence	-14.5	1.9	5.5	18.7	34.2	49.1	48.2	43.4	38.5	..
NBNZ Own Activity Outlook	-3.8	3.8	8.3	12.6	26.0	32.2	30.5	33.7	36.9	..
Trade Balance (\$m)	322	906	-331	-178	-717	-562	-495	-269	..	..
Trade Balance (\$m annual)	-4070	-2994	-3110	-2491	-2360	-1669	-1171	-846	..	..
ANZ World Commodity Price Index (% mom)	2.6	2.8	0.2	1.0	4.4	6.8	4.7	10.5	2.6	..
ANZ World Commodity Price Index (% yoy)	-29.4	-28.1	-27.9	-28.5	-22.7	-13.0	-1.5	17.4	30.0	..
Net Migration (sa)	2020	2480	1650	2480	1640	1860	2140	1780	..	..
Net Migration (annual)	9176	11202	12515	14488	15642	17043	18560	20021	..	..

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

SUMMARY OF KEY MARKET FORECASTS

NZ FX rates	Actual		Current	Forecast (end month)						
	Nov-09	Dec-09	22-Jan-10	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
NZD/USD	0.731	0.716	0.712	0.720	0.710	0.690	0.680	0.670	0.650	0.650
NZD/AUD	0.794	0.793	0.790	0.783	0.780	0.775	0.782	0.788	0.793	0.823
NZD/EUR	0.490	0.490	0.504	0.493	0.480	0.483	0.482	0.479	0.471	0.478
NZD/JPY	65.3	64.1	64.1	65.5	62.5	62.1	62.6	63.0	61.8	63.1
NZD/GBP	0.440	0.440	0.439	0.439	0.428	0.421	0.412	0.404	0.389	0.382
NZ\$ TWI	65.2	64.6	64.96	64.9	63.5	62.9	62.7	62.4	61.3	62.1
NZ interest rates	Nov-09	Dec-09	22-Jan-10	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
OCR	2.76	2.76	2.50	2.50	3.00	3.75	4.00	4.00	4.25	4.75
90 day bill	2.80	2.78	2.78	2.80	3.60	4.20	4.30	4.30	4.70	5.20
10 year bond	5.88	5.90	5.70	5.50	5.50	5.60	6.00	6.20	6.40	6.50
International	Nov-09	Dec-09	22-Jan-10	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
US Fed funds	0.25	0.25	0.25	0.25	0.25	0.25	0.75	1.25	1.75	2.00
US 3-mth	0.26	0.25	0.25	0.25	0.30	0.35	0.85	1.35	1.85	2.10
AU cash	3.50	3.75	3.75	4.00	4.25	4.50	4.75	4.75	4.75	5.25
AU 3-mth	4.03	4.28	4.22	4.40	4.80	4.90	5.00	5.00	5.10	5.60

KEY RATES

	22 Dec	18 Jan	19 Jan	20 Jan	21 Jan	22 Jan
Official Cash Rate	2.50	2.50	2.50	2.50	2.50	2.50
90 day bank bill	2.77	2.77	2.78	2.78	2.77	2.77
NZGB 11/11	4.26	4.19	4.20	4.16	4.12	4.05
NZGB 04/13	4.96	4.86	4.87	4.84	4.82	4.77
NZGB 12/17	5.74	5.69	5.69	5.68	5.70	5.67
NZGB 05/21	6.03	5.96	5.96	5.96	6.00	5.97
2 year swap	4.55	4.56	4.55	4.46	4.48	4.43
5 year swap	5.53	5.41	5.41	5.37	5.39	5.34
RBNZ TWI	64.6	66.5	66.7	66.4	65.7	64.96
NZD/USD	0.7041	0.7348	0.7388	0.7305	0.7196	0.7119
NZD/AUD	0.8012	0.7994	0.7996	0.7951	0.7903	0.7896
NZD/JPY	64.33	66.75	66.85	66.67	65.82	64.09
NZD/GBP	0.4385	0.4511	0.4502	0.4476	0.4425	0.4391
NZD/EUR	0.4928	0.5118	0.5135	0.5139	0.5110	0.5039
AUD/USD	0.8788	0.9192	0.9240	0.9187	0.9105	0.9016
EUR/USD	1.4289	1.4358	1.4387	1.4214	1.4081	1.4128
USD/JPY	91.37	90.84	90.49	91.27	91.47	90.01
GBP/USD	1.6057	1.6288	1.6410	1.6322	1.6261	1.6209
Oil	73.48	77.96	78.25	78.98	77.42	75.84
Gold	1084.65	1132.95	1137.55	1134.15	1113.60	1094.6
Electricity (Haywards)	6.62	5.20	6.81	6.61	6.34	..
Milk futures (US\$/contract)	131	..	123	121	120	..
Baltic Dry Freight Index	3063	3295	3208	3158	3170	..

NEW ZEALAND DISCLOSURE INFORMATION

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

Qualifications, experience and professional standing

Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

Professional indemnity insurance

The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

Other interests and relationships

When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

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The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

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- Providing cash;
- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

Auditing

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Money or property held by the Bank for a specific purpose communicated to the Bank (e.g. the purchase of an interest in a security) may not be used by the Bank for its own purposes and will be applied for your stated purpose. No member of the Bank's staff may use any money or property deposited with the Bank, for their own purposes or for the benefit of any other person. In the absence of such instructions, money deposited with the Bank may be used by the Bank for its own purposes, provided it repays the money to you upon demand (or where applicable, on maturity), together with interest, where payable.

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