

Global uncertainty remains dominant theme

- Ongoing concerns about European debt crisis continue to weigh on global financial markets.
- Federal Reserve announces “Operation Twist” in response to weaker US growth outlook.
- We expect global uncertainty will keep the RBNZ on hold until March next year.

Market sentiment remained weak over September, weighed down by continued concerns over the European debt crisis. The lack of progress and any concrete resolution to the European debt crisis drove much of the volatility in financial markets. There was a great sense of uncertainty about the probability and scale of a sovereign debt default by Greece and the ability of the European financial system to withstand the fallout. Market perceptions of the risks were further obscured by speculation about a joint European solution to support Greece and the European banking system.

Added to the concerns about financial stability were signs of slowing growth in the Western economies. In particular, markets were alarmed by US payrolls data released at the beginning of September showing no growth in employment and the unemployment rate remaining high at 9.1%. In response to the soft US growth outlook, the Fed announced in late September it would increase the duration of its Treasury portfolio by shifting US\$400 billion of its holdings of short-term securities into longer-dated bonds. In addition, the Fed would reinvest the principal of maturing Agency securities back into Agency bonds instead of Treasury securities. The programme was widely dubbed as “Operation Twist” given the effect would be to twist the US yield curve. With the majority of mortgages and corporate lending being priced off long-term bond yields, the Fed is hoping Operation Twist would put downward pressure on long-term interest rates and hence encourage credit growth.

In NZ, data were on the softer side of market expectations. In particular, Q2 GDP highlighted the fact some pockets of weakness remain in the NZ economy, particularly in the construction, wholesale trade and communications sectors. However, growth indicators in recent business surveys indicate a gradual recovery in the underlying NZ economy remains in place. The downgrade to NZ’s credit rating by Fitch and Standard & Poors at the end of September added some uncertainty to the NZ outlook at the margin. For now, risks to the global economy are dominating the RBNZ’s outlook and we now expect the central bank will leave the OCR on hold until March next year in order to assess the effects on NZ economic activity.

Date	Instrument	30-Sep-11	Month %	Quarter %	Year %	5-Year %
Cash	NZ cash rate	2.50	0.00	0.00	-0.50	-4.75
	NZ 90-day bank bill	2.85	-0.09	0.19	-0.31	-4.76
	US 90-day bank bill	0.37	0.05	0.13	0.08	-5.00
	NZ - US 90-day bank bill	2.48	-0.14	0.06	-0.39	0.24
Fixed Interest	NZ 5-year gov't stock	3.39	-0.25	-0.61	-0.94	-2.76
	NZ 10-year gov't	4.46	-0.09	-0.65	-0.59	-1.27
	NZ 10-year swap	4.55	-0.32	-0.65	-0.30	-2.12
	AUS 10-year gov't	4.25	-0.14	-1.00	-0.75	-1.26
	US 10-year gov't	1.98	-0.19	-1.12	-0.50	-2.63
Equities	NZ - NZX50 (NZ\$)	2016	-0.9%	-5.0%	-0.3%	-28.4%
	AUS - All Ords (A\$)	4070	-6.9%	-12.7%	-12.2%	-20.4%
	JAP - Nikkei (¥)	8700	-2.8%	-11.4%	-7.1%	-46.1%
	UK - FT100 (£)	5128	-4.9%	-13.7%	-7.6%	-14.0%
	US - S&P500 (US\$)	1131	-7.2%	-14.3%	-0.9%	-15.3%
	WORLD - MSCI (US\$)	1104	-8.8%	-17.1%	-6.4%	-19.6%
	MSCI in NZD (NZ\$)	1445	1.9%	-10.0%	-9.8%	-31.4%
Exchange Rates	NZD/USD	0.764	-10.5%	-7.8%	3.8%	17.2%
Rates	NZD/AUD	0.785	-1.7%	1.7%	3.1%	-10.0%
	NZD/JPY	58.5	-10.5%	-12.1%	-4.9%	-23.8%
	NZD/GBP	0.490	-6.3%	-4.8%	5.5%	41.2%
	NZD/EUR	0.565	-4.5%	-1.1%	4.4%	10.2%
	NZ TWI	68.0	-6.7%	-4.5%	2.6%	3.5%
	EUR/USD	1.35	-6.3%	-6.8%	-0.5%	6.4%

Equity indices are the respective end-of-month closes. Interest rates and exchanges rates are at 5pm NZ.

Cash

The RBNZ left the OCR unchanged at the September MPS. In the accompanying statement, the RBNZ noted any increase in the OCR would be largely dependent on the global outlook. While the RBNZ remains optimistic on the domestic growth outlook, it has revised down its growth forecasts based on the weaker global outlook and a higher NZ dollar assumption.

With concern about the escalating debt crisis in Eurozone dominating RBNZ's outlook, we now expect the RBNZ will leave the OCR on hold until March next year. While there is much uncertainty about both the timing and size of the first OCR increase, for now we see a 50 basis point OCR increase in March as the most likely scenario. Beyond that, we continue to expect 25bp increases at the subsequent meetings until the OCR reaches a peak of 4%.

90-day bank bill yields remained volatile over September, reflecting continued funding pressures given the volatility in offshore markets.

Fixed interest

NZ Government bond yields continued to decline over September, largely following offshore movements. However, the downgrade to NZ's credit rating by Fitch and Standard & Poors at the end of September saw some reversal of these yield declines, as markets price in a greater amount of credit risk.

Continued risk aversion drove a decline in bond yields globally. With little in the way of progress in the resolution of the European debt crisis market sentiment remained subdued. Many of the larger European countries ratified the increase in the European Financial Stability Fund to €440 billion, but there is skepticism whether it will be enough.

Meanwhile, the tone of US data remained soft, particularly non-farm payrolls which showed no growth in employment. In response to the softening in US activity, the Fed announced "Operation Twist" in a bid to lower long-term interest rates to encourage credit growth.

Equities

After recovering from lows in late August, global equity markets resumed their declines in early September in response to weak US economic data and on-going fears about the European debt crisis. A commitment from German and French leaders to keep Greece in Eurozone supported some rebound in equity markets. Markets remained volatile in the final days of the month as European parliaments voted on approval of the expanded EFSF.

The Fed's announcement of 'Operation Twist' generally disappointed markets, given it would not involve expanding the Fed's balance sheet and hence did not represent extra stimulus. Instead, the Fed would replace short-dated securities with longer-term bonds in a bid to lower long-term interest rates.

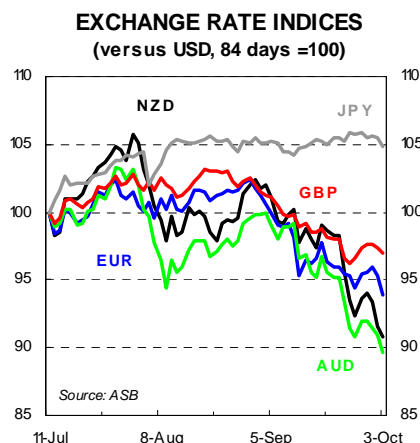
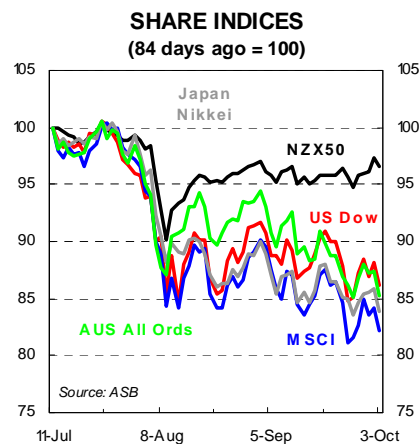
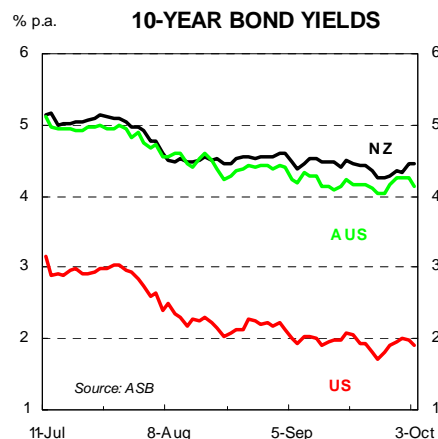
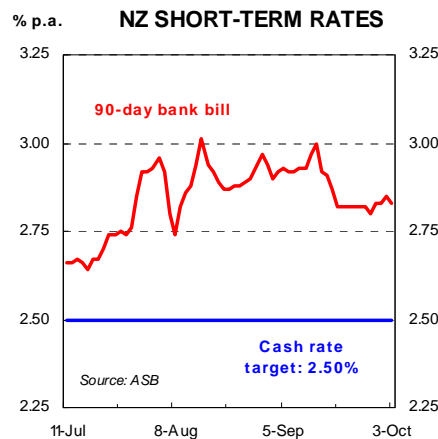
NZ equities also declined over September, although the drop in the NZSE50 was smaller relative to the global major market indices. This reflected the lower NZ dollar, which is seen as boosting profitability of listed exporters, and NZ's relatively limited exposure to the finance sector.

Exchange rates

The continued deterioration in market sentiment put downward pressure on the NZ dollar over September. The NZD/USD fell from a high of 0.8546 to its monthly low of 0.7608 by the end of the month, with downward pressure on the currency stemming from safe-haven flows into the US and Japan, weaker commodity prices, a softening in the RBNZ's tone at the September MPS and a downgrade to NZ's credit rating by Fitch and Standard & Poors.

Safe-haven demand for the US dollar and Japanese yen underpinned the appreciation in these currencies over September, reflecting repatriation of funds by US and Japanese investors back into their own country. The widening in the interest rate differential between the US and its G7 trading partners also made US investments more attractive from a yield perspective.

The euro declined on a trade-weighted basis, reflecting ongoing concerns over the European debt crisis and weak growth outlook in the region.



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