

This Week

It is a short week, but potentially a significant one for monetary policy. Although the RBNZ will keep the OCR on hold, it is increasingly likely it will distance itself from its expectation it will keep the OCR "at or below the current level through until the latter part of 2010". Our full preview is available [here](#).

The economic outlook has improved considerably over the 6 weeks following the September MPS. The sheer volume of stronger than expected developments will see RBNZ reconsider both the economic outlook and the appropriateness of an OCR at 2.5%. Included in this stronger data are upward revisions to the global outlook, gathering momentum in house price inflation, stronger than expected Q2 GDP, inflation pressures unwinding slower than expected, and very sharp lifts in consumer and business confidence. However, the continued rise in the NZ dollar provides offset to the improvement in domestic demand.

We expect the RBNZ to remain on hold at the October OCR review, but drop the statement that it expects "to keep the OCR at or below the current level through until the latter part of 2010". Given recent developments, the day has come for the RBNZ to adopt a more realistic policy indication. This will be no easy task given markets' very aggressive expectations of OCR tightening. Ideally the RBNZ needs to allow itself more flexibility to respond to an environment as it evolves, while at the same time signalling that rate hikes are not imminent. One possibility would be to indicate the "OCR is likely to remain low until it is clear the economic recovery is sustainable". The RBNZ could choose to simply drop "below", but that would still leave a problem to address later on – and, given markets are pricing in a January hike, leave a non-credible phrase in place.

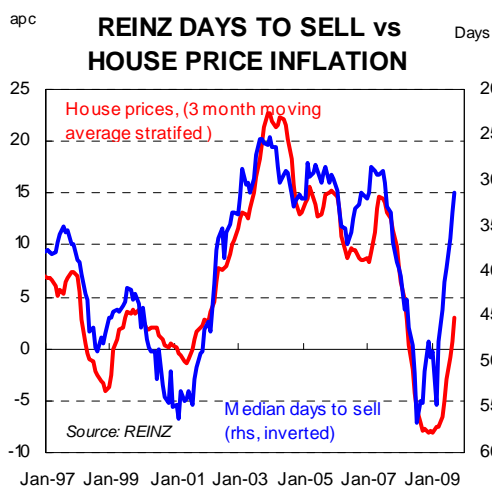
At present there are two schools of thought emerging on the RBNZ's eventual exit strategy from the very low OCR setting. One school of thought is the RBNZ will start early but lift the OCR gradually in 25bp steps (some people are forecasting hikes as early as January). Another possibility is holding off until solid confirmation of economic recovery is to hand but then unwinding some of the stimulus quickly.

We are in the latter camp. We expect the RBNZ to remain on hold until April 2010, with the view the RBNZ will want to confirm and be confident growth has become sustainable before lifting the cash rate. The April rate review is timed after Q4 GDP, Q1 CPI and business confidence are all known. We expect initial rate hikes to be aggressive (50 basis point steps) to promptly lift the cash rate off emergency settings before switching to 25bp increments. We envisage it would still take a year from April to get the OCR to a level consistent with interest rates having a neutral impact on the economy.

Click here for:

- [Foreign Exchange](#) • Bumpy ride for NZD, new high of 0.766 hit before easing back on USD recovery
- [Interest Rates](#) • Interest rates continue to lift ahead of this week's OCR announcement
- [Week Ahead](#) • RBNZ on hold but will soften expectation of keeping OCR low until late 2010
- [Week in Review](#) • Net migration continues at steady pace, short-term visitor arrivals up
- [Global Calendars](#) • Aust CPI key to RBA rate hike size; US Q3 GDP to be positive.

Chart of the week



- Two diametrically opposing challenges the RBNZ has to deal with are the continued rise in the NZD and the sharp lift in house prices.
- The high NZD is an issue the RBNZ can or will do little about (given USD and Pound weakness is much of the story).
- However, the housing market's recovery will be concerning the RBNZ: the relative lack of houses for sale is contributing to a noticeable rebound in house prices.
- Neither the RBNZ or the Government will be happy with this development. From an inflation perspective it risks triggering an earlier return of housing-related inflation. Furthermore, the economy needs to channel more resources into the productive sector rather than housing if it is to rebalance and become less dependent on foreign borrowing.

General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7465	0.7537	0.7189	0.5538	0.5550	UP	0.7400	0.7650
NZD/AUD	0.8152	0.8115	0.8272	0.7891	0.8970	DOWN	0.8050	0.8200
NZD/JPY	68.84	68.12	65.26	53.22	52.88	UP	68.50	70.00
NZD/EUR	0.5022	0.5033	0.4896	0.4260	0.4414	UP	0.4950	0.51
NZD/GBP	0.4573	0.4596	0.4488	0.3797	0.3530	UP	0.4500	0.4650
TWI	67.2	67.3	65.6	55.5	56.9	UP	67.00	68.00

^Weekly support and resistance levels * Current is as at 12pm Tuesday; week ago as at Tuesday 5pm

- The NZD had a bumpy ride last week, setting a fresh high for the year by nudging USD0.766 before going into reverse gear. A strong profit result from Apple, amidst a run of generally good US company reporting, contributed to the USD being on the back foot earlier in the week. The USD has subsequently sharply regained lost ground as speculation on the Federal Reserve's eventual exit strategy intensified.
- The RBNZ Governor unwittingly contributed to the lift in the NZD after some Select Committee comments he made were reported out of context. Radio NZ reported the Governor to have said the high value of the dollar is not necessarily an impediment to raising the Official Cash Rate to quell rising house prices. The comments lifted the NZD slightly further to 0.757 in NZ time and contributed in London trading to the NZD hitting its high for the week. A background of the euro pushing through USD1.50 and the Pound lifting on BoE comments also played a part in the NZD's high.
- At the start of this week the USD regained some ground as talk picked up about potential for the Federal Reserve to change the wording of its statement (i.e. backing away from keeping rates low for an extended period). Central bank exit strategies have come into prominence since the RBA began hiking.

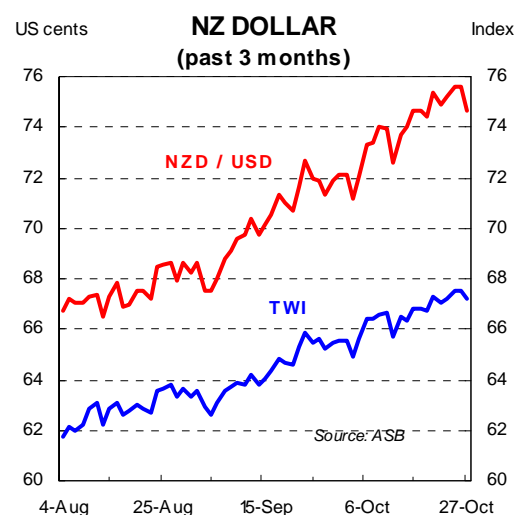
Short-term outlook:

Key data	Date	Time (NZST)	Market expects
NBNZ Business Outlook	28/10	3.00 pm	-
AU Q3 CPI	28/10	1.30 pm	0.9
RBNZ OCR Announcement	29/10	9.00 am	2.5%
Sep Trade Balance	29/10	10.45 am	-\$660 m

Potential currency movers from overseas this week: AU Q3 CPI (28th), US Durable goods orders (28th), EU Unemployment Rate (29th), US GDP (29th), US Personal Income (30th), US Chicago PMI (30th)

Medium-term outlook: [\[Last Quarterly Economic Forecasts\]](#)

- We continue to expect the NZD to appreciate further against the USD over the next 6-9 months. However, we have revised up our expected peak to USD 0.82. The story remains primarily one of USD weakness, also overlaid by some Downunder strength. We expect the USD to remain under pressure until the Federal Reserve starts to unwind its policy stimulus: the earlier that starts the sooner the NZD's rise is likely to be capped.
- The reasons for the expected USD weakness remain similar to the drivers in place since mid-March, namely:
 - US residents increase their offshore investment, encouraged by improvement in the global economy, with USD liquidity demand and safe-haven buying also no longer boosting the USD.
 - Diversification out of USD is expected to occur due to concerns about US government debt.
 - And, related, concern about the USD's future role as a reserve currency.
- The NZD is also likely to mildly outperform other major currencies in the ongoing environment of improving global growth prospects and rising commodity prices. Outright weakness in the Pound will continue to hold the NZD/GBP rate at very elevated levels. The Pound, like the USD, is being weighed down by debt concerns and the state of its financial sector – both of which have ramifications for the future growth rate of the economy.
- The buoyant Australian dollar is also likely to contribute to an overall strengthening of the NZD. The RBA is likely to continue lifting its cash rate back to a less stimulatory level. Rising interest rates there will lift the AUD. The NZD will be caught in the middle: weakening slightly against the AUD but up against other currencies.
- For more on the relative fundamentals driving the NZD see our Economic Note ["NZD: The Flighty Bird"](#).
- The September MPS made it pretty clear the RBNZ is unlikely to cut the OCR to try dampening the NZD. Direct FX intervention also appears unlikely (at the least, very risky) with the dominant driver of the high NZD being the weak USD.



Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	2.50	2.50	2.50	3.00	6.50	FLAT
90-day bank bill	2.80	2.80	2.79	3.02	7.06	FLAT/UP
2-year swap	4.86	4.70	4.27	3.68	6.39	UP
5-year swap	5.84	5.66	5.49	4.81	6.52	UP
11/11 gov't stock	5.30	5.16	4.85	4.39	5.72	UP
NZSX 50	3180	3253	3111	2686	2781	DOWN

* Current is as at 12pm Tuesday; week ago as at Tuesday 5pm

- US Treasury bond yields have been lifting over the week, as investors fretted about the ability of markets to digest \$US123 billion of bond issuance over the week. In addition, speculation that the Federal Reserve is preparing itself for policy normalisation has the market contemplating rate hikes potentially within the next six months. There is growing expectation that the Fed may drop the 'extended period' expectation from its statement in acknowledgement of the improving economic backdrop.
- Central bank speculation dominated NZ interest rate markets last week. As markets focus on the upcoming NZ OCR Review (this Thursday), the majority of economists brought forward the timing of the first rate hike, with the consensus currently sitting at April but the possibility of January being flagged by some. In addition, many now expect the RBNZ will drop the statement it expects the OCR will remain at or below current levels until the 'latter part of 2010'. Pre-announcement market jitters contributed to a rise in rates across the curve, possibly exacerbated by the exit of some offshore participants (note that Friday's trading was affected by lower than usual liquidity).

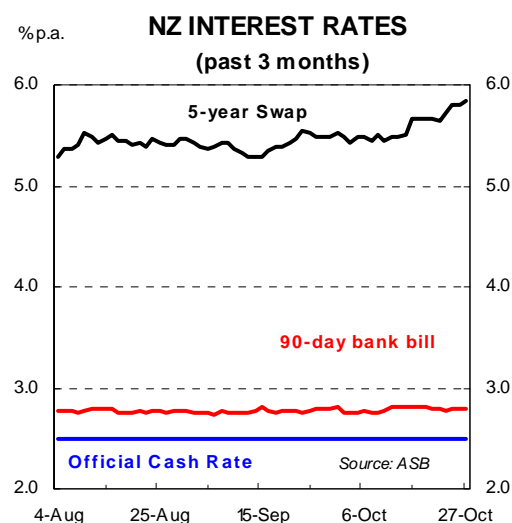
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Sep RBNZ Credit Aggregates	29/9	3.00 pm	-
Sep Building Consents	30/9	10.45 am	-

Comment: Highlight of the week will be the RBNZ OCR announcement on Thursday. We expect the Bank to keep the cash rate on hold at 2.5%: focus will be on the tone, particularly around the future outlook for the OCR. The Australian CPI will be watched closely by the market, with the risk of a stronger CPI potentially triggering a 50bp hike from the RBA in November.

Medium term outlook: [\[Last Quarterly Economic Forecasts\]](#)

- The RBNZ continues to hold the cash rate at 2.5%, although has now backed off its easing bias. The market did not see a strong easing bias as credible given the number of stronger than expected indicators of late. In September, the RBNZ continued to state it expected to hold the cash rate at or below current levels until the latter part of 2010. That stance is becoming increasingly untenable.
- The RBNZ's overall growth and inflation forecasts were unchanged at the September MPS, despite incorporating significantly stronger monetary conditions. The RBNZ sees more inflation pressure in the economy stemming from a less weak global outlook, a pick up in net migration supporting the housing market, and improved business confidence.
- Over the past few months, the continual flow of better than expected data will be hard for the RBNZ to ignore. World demand has stabilised and the outlook for 2010 continues to improve. Dairy prices have lifted off lows and have led Fonterra to revise up its forecast payout. Net migration continues at a robust pace, and continues to provide support to housing demand in a tight market. Housing supply has been slow to respond, resulting in a surprisingly strong lift in house prices over the past 6 months which is likely to make the RBNZ uncomfortable. Business and consumer confidence has surged pointing to an earlier recovery in growth than previously thought. Meanwhile, the downside risks to inflation have also abated.
- The next move in the OCR is up, it's just a matter of when. We expect the RBNZ will hike by April next year (previously June). The RBNZ has a substantial amount of policy stimulus to unwind, the first steps are likely to be bigger (i.e. 50 basis point moves).



NZ Data Preview: a look at the week ahead

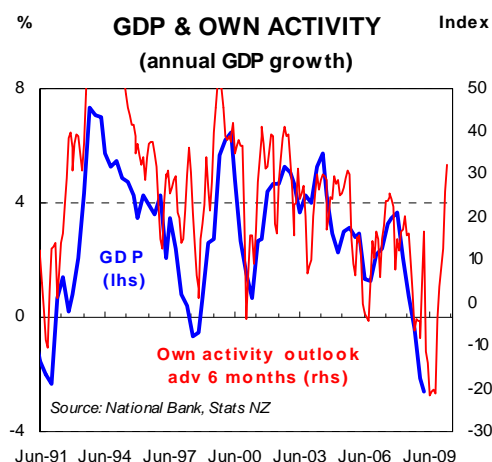
Data	Date	Time (NZST)	Previous	Market expects	ASB expects
NBNZ Business Outlook (Oct)	28/10	3.00 pm	+49.1	-	-
RBNZ OCR Review	29/10	9.00 am	2.5%	2.5%	2.5%
Trade Balance (Sep)	29/10	10.45 am	-\$725 m	-\$660 m	-500 m
RBNZ Credit Aggregates (household, yoy)	29/10	3.00 pm	+2.3%	-	-
Building Consents (Sep)	30/10	10.45 am	+1.7%	-	-

NBNZ Business Outlook - October

Previous: General Business Confidence + 49.1

Own activity Outlook + 32.2

Business confidence has recovered sharply over the past few months. The growing consensus is that the worst part of the recession is now behind us as the economy steadied itself over the second quarter of 2009. As a result we have revised up our near-term outlook for GDP growth, although the medium-term outlook remains subdued. A sense of relief may be leading the headline confidence figures to be overstating the underlying strength in the economy. More telling is the ongoing softness in investment and employment intentions despite the more optimistic outlook. This is consistent with an economic outlook that remains fragile.

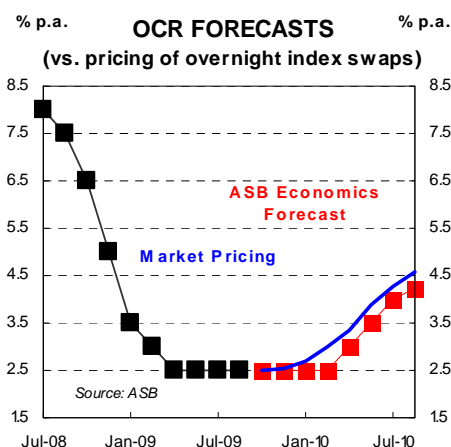


RBNZ OCR Review

Previous: 2.5% ASB(f): 2.5%

The economic outlook has improved considerably over the 6 weeks following the September MPS. The sheer volume of stronger than expected developments will see RBNZ reconsider both the economic outlook and the appropriateness of an OCR at 2.5%. There have been 5 key areas where data have performed stronger than expected, pointing to further improvement in the economic outlook and a greater degree of inflation pressure, including: the global growth outlook; housing market; Q2 GDP; Q3 CPI and; Q3 business confidence. The NZD, however, remains a significant headwind.

We expect the RBNZ to remain on hold at the October OCR review, but drop the statement that it expects "to keep the OCR at or below current levels until the latter part of 2010". Given recent developments, It is time to rewrite the policy outlook part of the statement.



Trade Balance - September

Previous: **-\$725 m** ASB(f): **-500 m**

Over the past 6 months the trade balance has corrected sharply, led by a dramatic drop in import demand coincidentally timed with seasonal strength in agricultural exports (aided by a post-drought recovery in dairy volumes).

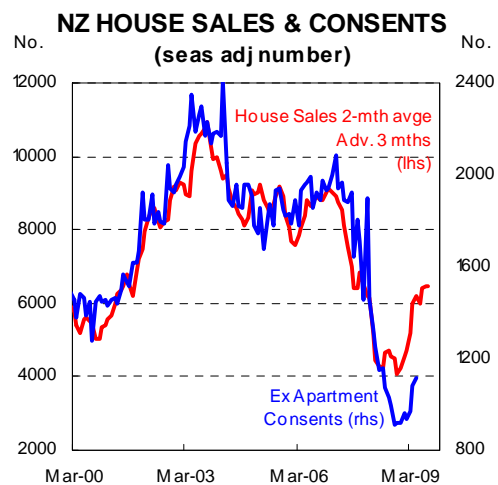
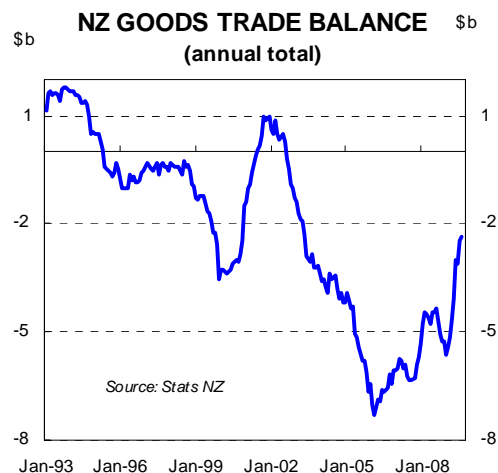
However, seasonal weakness has now caught up with agricultural exports, which has been exacerbated by weak commodity prices (particularly dairy). The underlying weakness in export demand has become more apparent, underscored by the surprising weakness in August's \$725 million deficit.

Export receipts are likely to remain weak in September. Meanwhile improving domestic demand will see import demand lift, although the rising NZ dollar will put downward pressure on import prices.

Building Consents - September

Previous: **+1.7% mom (total dwelling consents)**

Dwelling consent issuance has started to respond to the pick up in housing demand, although the number of consents issued remains very low. Housing demand has been supported by low interest rates and an increase in net migration. The recent lift in house prices should further encourage an increase in residential construction. House prices have been rising at an average rate of 1% per month over the past 6 months, and increased at an annualised pace of 10% over the 3 months to September.



NZ Data Review: weekly recap

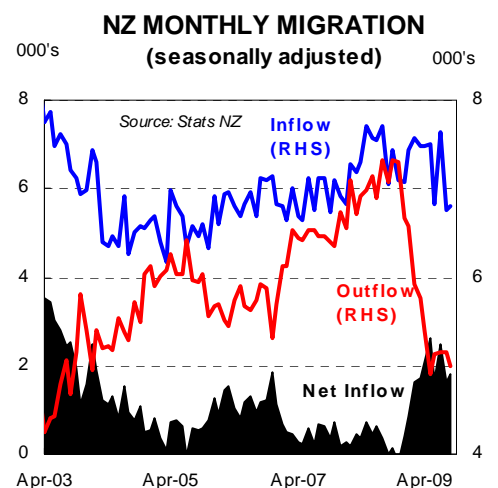
September International Travel and Migration

The net migration inflow remains steady, with NZ recording a net inflow of 1,800 people per month, bringing the annual inflow to 17,000 in the year to September. The steady pace over the past few months is consistent with our expectation that the annual inflow will peak around 22,000 early next year.

The rise in net migration continues to come from a low number of departures, with departures falling 3% in September. The decision for fewer New Zealanders to head offshore reflects the impact of the global financial crisis with fewer job opportunities available in Australia and the UK. However, with the recent recovery in the Australian economy this trend is likely to slow and we expect departures to slowly recover over the next year.

Arrivals remain steady, with a pick up in permanent and long term arrivals from Australia offsetting the fall in arrivals from the UK.

Short-term arrivals picked up 3.8% in September, and are now up 9% on year-ago levels. Once again, the boost stems from the surge in Australian visitors looking to spend their "Rudd Cheques" on NZ ski slopes. Also contributing to the recent lift, arrivals from Japan and China have picked up off lows over the past few months (although remain at very weak levels) perhaps as swine flu fears have abated.



Global Data Calendars

Note: Calendar 2 is in UK times. Add 12 hours for NZ times.

Calendar – Australasia, Japan and China

Date	Time		Econ Event	Period	Unit	Last	Forecast	
	NZST						Market	ASB/CBA
Wed 28 Oct	12.50	JP	Retail trade	Sep	m%ch	1.0	~	~
					y%ch	-1.8	~	~
	13.30	AU	CPI	QIII	q%ch	0.5	0.9	0.9
					y%ch	1.5	1.2	1.2
	13.30	AU	RBA trimmed mean	QIII	q%ch	0.8	0.7	0.7
					y%ch	3.6	3.2	3.2
13.30	AU	RBA weighted median	QIII	q%ch	0.8	0.8	0.7	
				y%ch	~	3.7	3.6	
14.00	AU	DEWR skilled vacancies	Oct	m%ch	1.2	~	~	
15.00	NZ	NBNZ business confidence	Oct	Index	49.1	~	~	
Thu 29 Oct	09.00	NZ	RBNZ official cash rate	Oct	%	2.50	2.5	2.5
	10.45	NZ	Trade balance	Sep	\$mn	-725	~	~
					12mth Ytd	-2,365	~	~
	10.45	NZ	Imports	Sep	\$bn	3.5	~	~
	10.45	NZ	Exports	Sep	\$bn	2.7	~	~
	12.50	JP	Industrial production	Sep	m%ch	1.6	~	~
					y%ch	-19.0	~	~
	12.50	JP	Corp service price	Sep	y%ch	-3.5	~	~
	13.00	AU	Conf. board leading index	Aug	%	0.7	~	~
	14.00	AU	HIA new home sales	Sep	m%ch	11.4	~	~
17.00	JP	Vehicle production	Sep	y%ch	-25.9	~	~	
Fri 30 Oct	~	JP	BoJ target rate	Oct	%	0.1	~	~
	10.45	NZ	Building permits	Sep	m%ch	1.7	~	~
	12.30	JP	Jobless rate	Sep	%	5.5	~	~
	12.30	JP	Job-to-applicant ratio	Sep	Ratio	0.4	~	~
	12.30	JP	Household spending	Sep	y%ch	2.6	~	~
	12.30	JP	National CPI	Oct	y%ch	-2.2	~	~
	12.30	JP	National CPI ex food, energy	Oct	y%ch	-0.9	~	~
	13.30	AU	Private sector credit	Sep	m%ch	0.1	0.2	0.2
					y%ch	2.5	2.0	2.0
	18.00	JP	Housing starts	Sep	y%ch	-38.3	~	~
18.00	JP	Construction orders	Sep	y%ch	-25.2	~	~	

Calendar – North America & Europe

Please note all days and times are UK time, not local release day/times

Date	UK time	Econ Event	Period	Unit	Last	Forecast	
						Market	CBA
Tue 27 Oct	11.00	UK CBI October distributive trades					
	13.00	US S&P/CS Composite-20	Aug	y%ch	-13.3	-11.5	~
	14.00	US Consumer confidence	Oct	Index	53.1	54.0	~
	14.00	US Richmond Fed manuf. index	Oct	Index	14.0	~	~
Wed 28 Oct	~	GE CPI – EU harmonised	Oct	m%ch y%ch	-0.5 -0.5	~	~
	12.30	US Durable goods orders	Sep	m%ch%	-2.4	0.7	~
	12.30	US Durable ex transportation	Sep	m%ch	0.0	0.8	~
	14.00	US New home sales	Sep	'000 m%ch	429 0.7	440 2.6	~ ~
Thu 29 Oct	08.55	GE Unemployment change	Oct	'000	-12.0	~	~
	08.55	GE Unemployment rate	Oct	%	8.2	~	~
	09.30	UK Net consumer credit	Sep	£bn	-0.3	~	~
	10.00	EZ Business climate indicator	Oct	Index	-2.1	~	~
	10.00	EZ CPI estimate	Oct	y%ch	-0.3	~	~
	10.00	EZ Unemployment rate	Sep	%	9.6	~	~
	12.30	CA Industrial product price	Sep	m%ch	0.5	~	~
	12.30	CA Raw materials price index	Sep	m%ch	3.7	~	~
	12.30	US GDP (annualised)	QIII	q%ch	-0.7	3.2	~
	12.30	US Initial jobless and continuing claims					
Fri 30 Oct	00.01	UK Gfk consumer conf. survey	Oct	Index	-16.0	~	~
	11.05	GE Retail sales	Sep	m%ch	-1.5	~	~
				y%ch	-2.6	~	~
	12.30	CA GDP	Aug	m%ch	0.0	~	~
	12.30	US Personal income	Sep	m%ch	0.2	0.0	~
	12.30	US Personal spending	Sep	m%ch	1.3	-0.4	~
	12.30	US PCE deflator	Sep	y%ch	-0.5	~	~
	12.30	US PCE core	Sep	m%ch	0.1	0.2	~
				y%ch	1.3	1.3	~
	12.30	US Employment cost index	QIII	q%ch	0.4	0.4	~
13.45	US Chicago purchasing manager	Oct	Index	46.1	48.5	~	
14.00	US Uni of Michigan confidence	Oct	Index	69.4	70.0	~	
14.00	US NAPM-Milwaukee	Oct	Index	58.0	~	~	

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