

Quarterly Forecasts

Fasten your seatbelt

ECONOMICS

16 Oct. 07

- Global uncertainty has risen sharply as credit markets focus on risk rather than on returns.
- The NZ economy, whilst growing moderately, is still well placed to weather any global shock.
- Inflation pressures “remain intense”, meaning high interest rates lingering for a while yet.

In our May Quarterly we touched on the market jitters seen in late February and early March. We noted how a shift in investor sentiment can easily knock the NZ dollar down sharply, and that emerging problems in the US sub-prime mortgage market were a potential risk to the pricing of credit and the housing market.

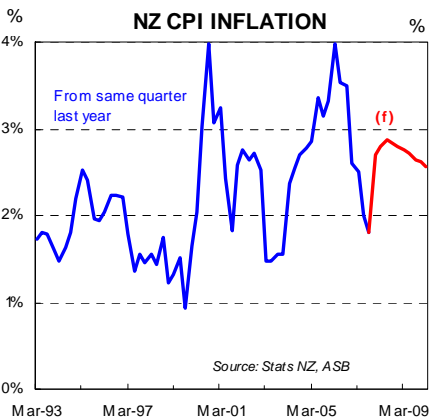
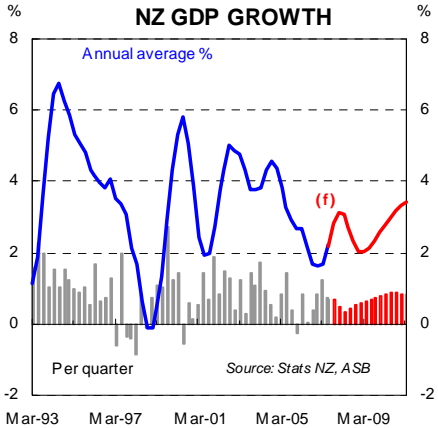
Those two issues came to a head in abrupt fashion in August. The epicentre for the recent financial shockwave was the US sub-prime mortgage market. Though problems have continued to surface at regular occasions, complacency was blown out of the water by signs the problems were filtering through to financial markets. For example, two US hedge funds owned by an investment bank declared they were effectively worthless through high exposure to exotic financial products derived from sub-prime mortgage securities.

The problem quickly snowballed into a credit crunch as US financial institutions became reluctant to extend credit to other financial institutions out of fear counterparties could turn out to be holding similar ‘toxic waste’. Funds reliant on borrowing to fund investments found they had to liquidate their holdings, spreading the fallout wider. Fear took over, and in numerous asset and commodity markets investors tried to go out the exit door simultaneously. The NZD dropped sharply during this period as investors chasing NZ’s high interest rates rushed to take their money home: years of ignoring risk in favour of returns was turned on its head.

Global financial markets remain jittery, though the general panic that prevailed in August has died away to wariness. Encouragingly, a degree of risk taking has been creeping back into markets. However, the past 5 years or so of cheap credit and underpricing of risk have now gone.

Locally the RBNZ recently talked much about the uncertainty of the global environment, that being the biggest development since its July OCR increase. However, the RBNZ’s September economic forecasts painted a more ‘hawkish’ outlook. A dominant influence on the forecasts was the considerably-lower NZD outlook in the wake of August’s plummet. The flow-on effect on the RBNZ’s view forward is much stronger growth (a whisker below 3% over the next 3 financial years) and higher inflation (at 3% through to the end of 2008). Ironically, the global turmoil both triggered heightened inflation concerns via the NZD but also raised uncertainties about the global economy’s fortunes that for now counterbalance the fresh inflation concerns.

The RBNZ’s economic outlook reinforces to us that the rate outlook still has some (very modest) upside risk over the remainder of 2007. We have maintained our view that the RBNZ is unlikely to cut interest rates until late 2008. In contrast, for a brief period there was speculation the OCR would be cut early next year. That is not out of the question, but in our view requires the global economy to take a nasty turn downwards. In the meantime, make sure your baggage is safely stowed and your seatbelt is fastened tightly. There is no guarantee yet that we are safely through the global market turbulence, and the economic impact of it isn’t yet clear.



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Remembering risk – Part 2

Financial market volatility comes back – courtesy of US housing

In our last Quarterly Forecasts we discussed the brief market turmoil in late February and early March triggered by the slump in the Chinese sharemarket and emerging problems in the US sub-prime mortgage market.

We noted that the brief drop in the NZD back then on flaring risk aversion was a reminder of what can happen if investor sentiment abruptly changes. We also talked about the risk that rising US mortgage defaults spilled over into wider credit problems. We would like to claim incredible foresight about the more recent financial market turmoil, but we have been as surprised as anyone at the abruptness of recent events.

US mortgage woes spread to financial markets

Rising US sub-prime mortgage defaults and financial difficulties for US mortgage companies have continued, but until recently were seen as an isolated problem.

However, that complacency changed upon revelations that hedge funds attached to a major US investment bank had made huge losses. The hedge funds lost money through debt-funded (i.e. leveraged) investments in exotic financial instruments backed by sub-prime mortgage securities. The extent of the losses sparked fears over what potential losses other financial institutions and investors were sitting on.

Avoiding risk became investors' sole focus

As a consequence, banks and buyers of commercial paper (short-term funding instruments) became unwilling to extend credit out of fear borrowers were tainted by holding similar loss-inducing assets. Moreover, US banks were less willing to lend to each other for the same reason.

As one investment vehicle after another ran into funding difficulty, they became forced to sell assets. And so the impact spread, becoming a panic affecting numerous different markets around the globe.

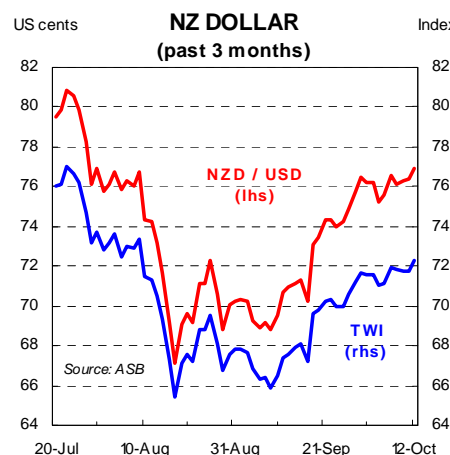
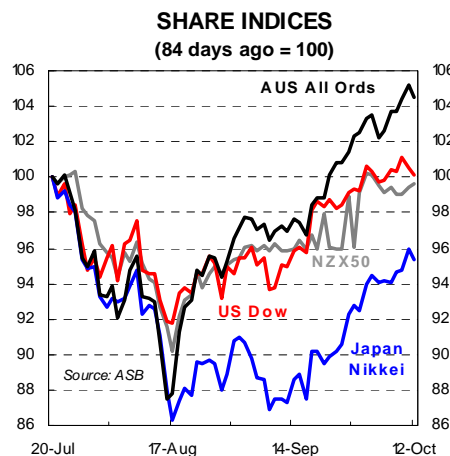
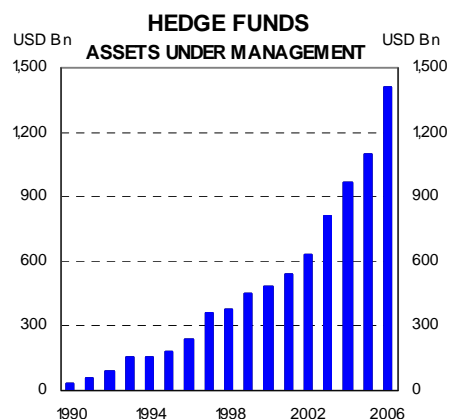
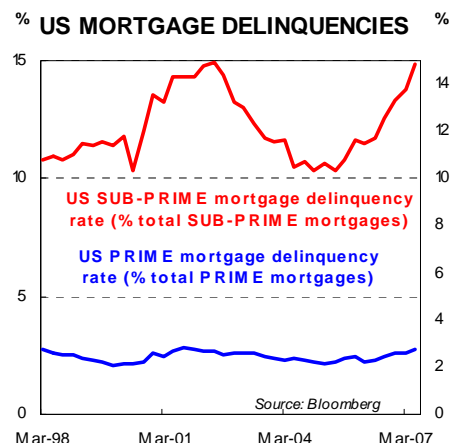
After several years of focusing heavily on returns and discounting risk, the pendulum has swung to the other extreme.

The main impact on NZ was a lower NZD

The impact to date on NZ was mainly through a sharp drop in the NZD in August. 'Carry trades', investments in high-yielding NZ dollar assets funded by borrowing cheap yen, got unwound abruptly to avoid or contain losses.

For some local finance companies the nervousness in credit markets compounded difficulties in obtaining funding.

A degree of risk taking and provision of credit has crept back into global markets, particularly as the Federal Reserve has acted swiftly to cut lending rates and make it easier to obtain emergency funding. As a result the NZD has recovered, particularly against the USD and the (still weak) yen.



Creaming it

Dairy prices offsetting high NZD

The New Zealand dollar has displayed impressive strength over 2007, and is now trading around USD0.75 – 0.77. This strength is expected to continue in 2007, providing a head wind for some exporters. However, for dairy farmers the pain from a high dollar looks like it will be more than offset by high global prices over the next few seasons. USD dairy prices are up over 100% over the last year.

Dairy is New Zealand's largest export industry, and Fonterra processes the vast majority of New Zealand's milk production (an estimated 95%). Fonterra is also New Zealand's largest company, representing more than 20% of total New Zealand exports and around 3% of the country's Gross Domestic Product.

Consequently, dairy incomes will receive a strong boost

Fonterra has a payout forecast of \$6.40 per kg of milk solids for this season, up nearly \$2 on the final payout for the year ended May 31 2007 of \$4.46.

Every 10 cent per kg/ms lift in the payout adds roughly \$120 million to rural incomes. This calculation is based on last season's NZ production of 1.2 billion kg of milk solids.

New Zealand has a small domestic dairy market – 95% of all milk produced is exported. Prices for all the main dairy export products have risen dramatically over the 2006/7 season. Prices are now trading at record high spot prices, as shown to the right. This increase in USD prices has more than offset the strengthening local currency.

That boost will flow through dairy regions

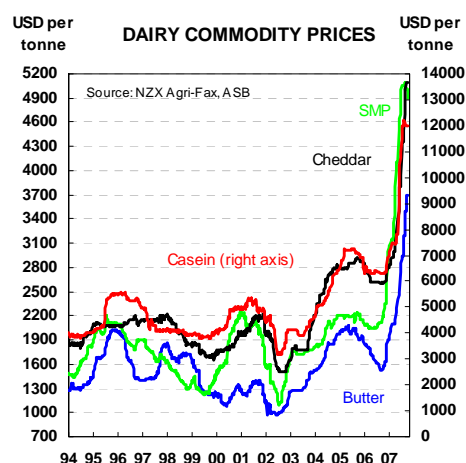
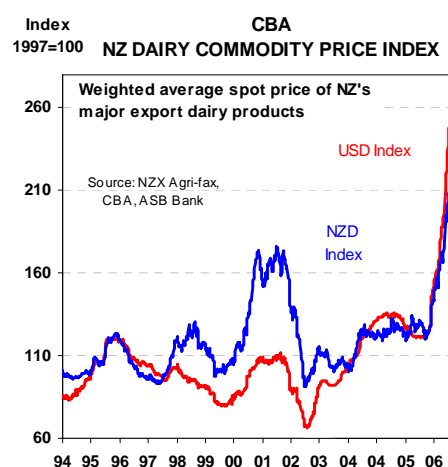
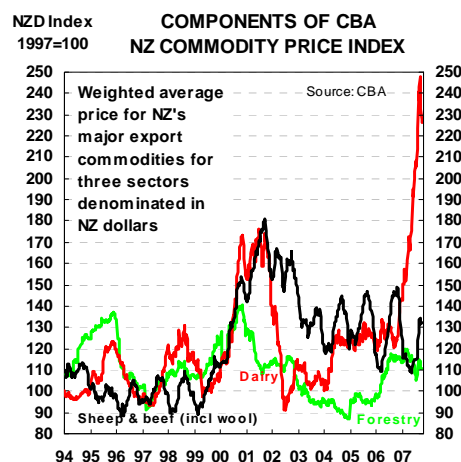
Dairy intensive areas of New Zealand should benefit from the increase in dairy farmers' incomes. Indeed, retail sales and consumer confidence data for the dairying regions are already reflecting the payout improvements that have been forecast.

However, on a cautionary note, the RBNZ's November 2006 Financial Stability report showed that debt relative to profit has grown significantly over the last few years. It is reasonable to expect some balance sheet repairs to take place over the next 12 months on the back of the higher incomes. The RBNZ has also commented that "parts of the export sector outside the dairy industry will continue to face challenging conditions due partly to the New Zealand dollar."

Dairy is part of the rebalancing of the economy

The RBNZ has repeatedly stated "the exchange rate is at levels that are both exceptionally high and unjustified on the basis of New Zealand's medium-term fundamentals." Non-dairy exporters would agree.

The dairy sector's continued strength is an important part of the rebalancing that needs to take place in New Zealand. The sector is well positioned to generate strong export earnings growth in the year ahead, and the related earning inflows are part of the process of reducing New Zealand's current account deficit to a more manageable level over the long-term.



International economies

US housing market weakness will be prolonged

The US subprime mortgage market and its ripples through the US housing and global credit markets loom as the large unknown for the health of the global economy.

Weakness in the US housing market will be prolonged. The market was already well oversupplied with homes for sale, into which increasing numbers of overstretched homeowners are now being forced to sell. Furthermore, credit has unsurprisingly dried up for those with a blemished credit history.

The longer the US housing slowdown is prolonged, the more likely it is that US consumer demand will slow the economy.

US growth will soften a touch

It is still too early to see what impact credit market troubles could have on the US economy. Conceivably, US growth in 2008 could be half to one percent lower due to housing and credit issues, nearer 2%.

However, the Federal Reserve appears prepared to act decisively to keep US financial markets functioning. To date it has cut the Federal Funds rate 50bps and the discount rate (at which the Fed will directly lend money to banks) by 100bps.

There has been some easing of credit market tensions, but the smooth functioning of the US economy will depend on a quick return to an efficient allocation of credit.

But global growth is less dependent on the US

It is important to remember that the US economy's significance in driving global growth has waned. The risks from a weak US economy are not quite what they were several years ago when the US was the consumer of last resort:

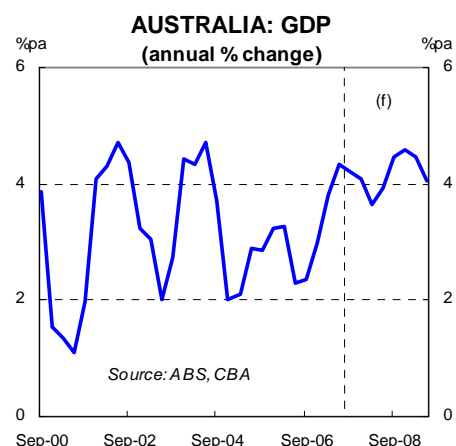
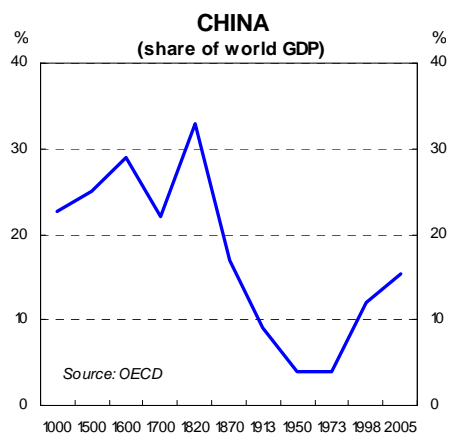
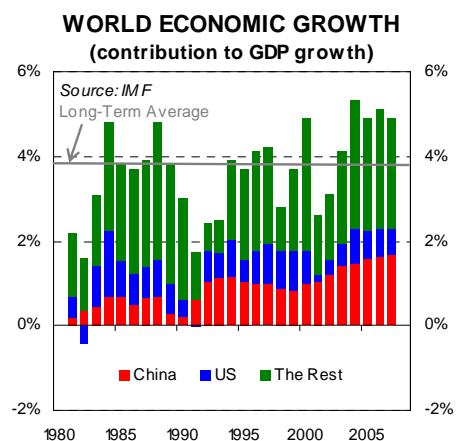
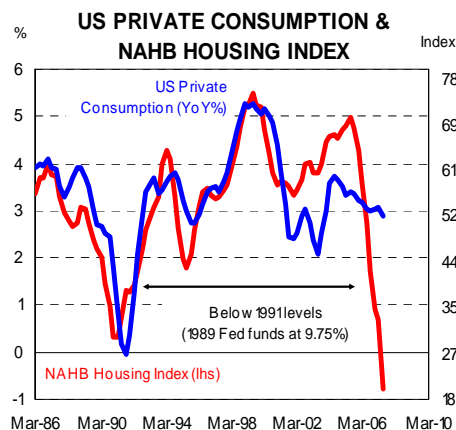
- Chinese economic growth now accounts for about 30% of global *growth*, even though the *size* of its economy is half that share of the global economy;
- Both the Chinese and Indian economies are heavily driven by internal, rather than external, demand;
- Trade within Asia is becoming increasingly important to that region.

Commodity prices are key to how NZ fares

From New Zealand's perspective a key issue will be whether NZ's export commodity prices are impacted by any slowing of global demand.

And a potential anchor for NZ manufactured exports is the Australian economy, which will be steaming ahead around 4% over the next couple of years.

A slower global economy might dent hard commodity prices, but Australia would still likely maintain strong levels of mining activity given the extent to which the resource sector is struggling to keep up with current demand.



The New Zealand Economy

The recent economic spurt is cooling

The NZ economy's rebound in late 2006 and early 2007 is now showing signs of petering out. Significantly higher interest rates in 2007 are now having evident impact.

Nevertheless, annual average growth in calendar 2007 will reach 3% on the back of the earlier spend-up and a boost from oil extraction. 2008 growth, of around 2%, is likely to show the brunt of tighter monetary conditions before greater export momentum aids improvement to back above 3%.

Key recent economic developments are:

Housing is softening

- House price growth has slowed and the level of house prices has steadied in recent months;
- Sales turnover has headed down noticeably in recent months;
- House price expectations in the ASB Housing Confidence survey have softened from their recent peak, indicating a degree of wariness about the longevity of the latest pick-up;
- Net migration inflows have slowed to a below-average level, arguing for housing demand to be moderate;

Spending and confidence are off their peaks

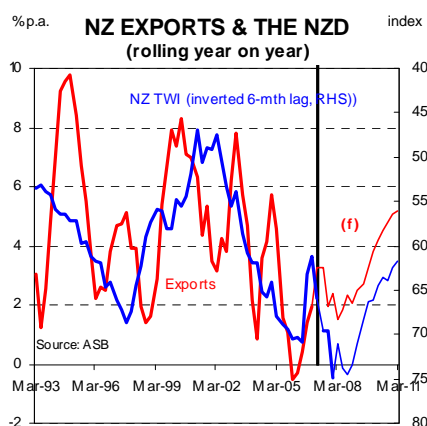
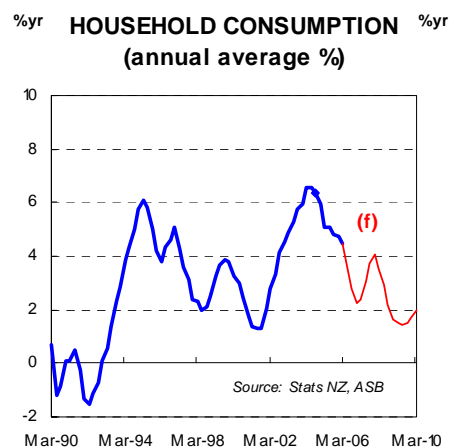
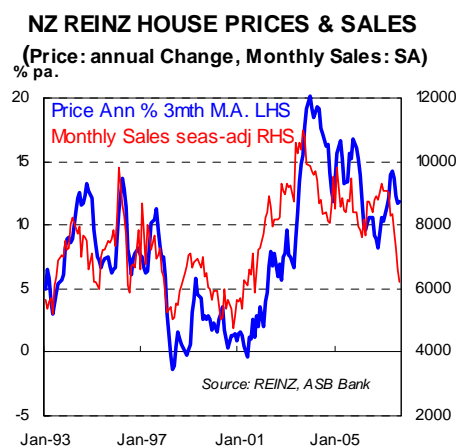
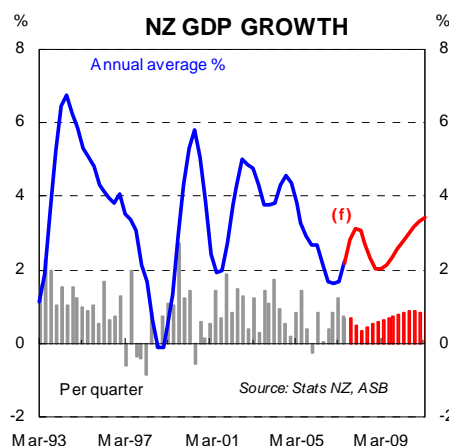
- Retail spending growth has now slowed noticeably after the Q1 spend-up, with luxury/leisure items affected;
- Business confidence has again become more cautious, though the decline in the NZD is being seen as a positive for manufacturers and exporters;
- Consumer confidence is lower than at the start of the year, though has held up very well recently in the face of financial market and finance company worries;
- Consumer goods imports have taken a step back after a period of strength.
- Capital equipment imports have been strong, though boosted by 'one-offs' such as port cranes;

Economy has a backstop in dairy incomes,...

What we envisage happening over the next year is a baton change as the economy's growth engines become more balanced between domestic and external demand, in contrast to years of domestic-driven growth.

Whilst there are ominous clouds brewing offshore, there are also over the horizon a few positives offering rays of sunshine.

For one, the increased dairy payout will bring in an estimated \$2.6 billion extra in dairy income over the next year, with the likelihood that dairy incomes hold onto that windfall for another year.



The New Zealand Economy (cont'd)

...a tight labour market, potential for fiscal stimulus

There is also the fact that even though economic growth has slowed, the labour market has remained very tight: wage growth is strong and job security is relatively high thanks to the two-decade low in the unemployment rate.

Even if the global economy did look set for a hard landing, NZ is still well positioned to react. High interest rates mean plenty of scope to cut rates to boost the economy. Moreover, on the fiscal front a key restraint to further stimulus has been high inflation pressures: to the extent a weaker global economy reduces inflation pressures there is added room for future fiscal stimulus.

Persistent inflation pressures a growth handbrake

Ultimately, it is still-persistent inflation pressures that are the constraint on NZ ability to grow faster: spare capacity is all but used up. A number of indicators point to only a slow unwinding of current pressures:

- Capacity utilisation remains stubbornly high;
- Labour shortages have intensified over the past year;
- Non-tradables inflation has started to accelerate in both the housing components and the non-housing areas (predominantly services).

Supply side response is muted

The other part of the inflation picture is growth in the economy's ability to supply. And on that front the news looks unhelpful. Labour force growth will be slower over coming years than it was through the economic boom. That means businesses will have greater reliance on other means to boost production.

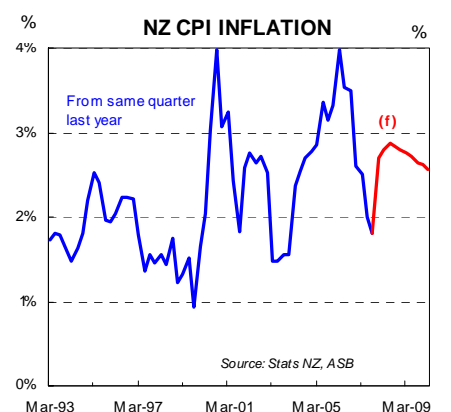
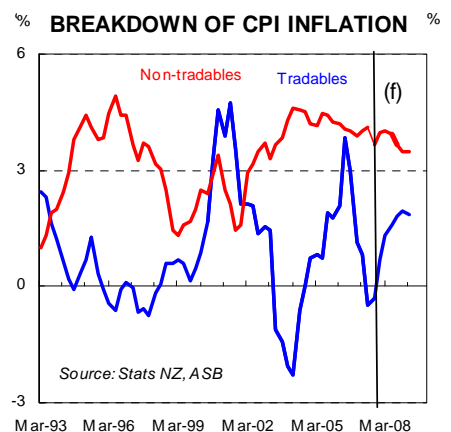
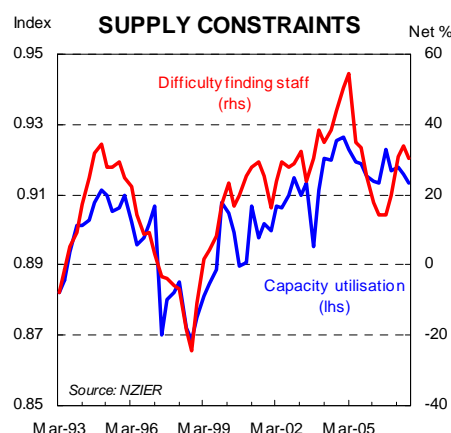
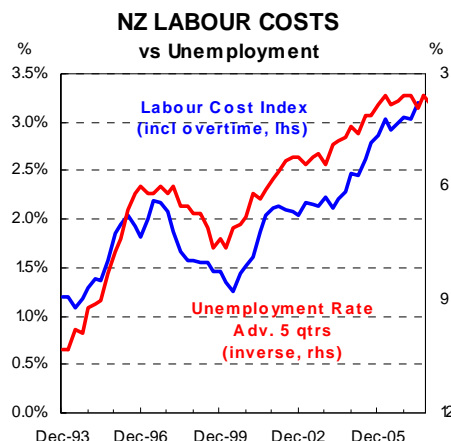
Yet, investment in productive capacity is tapering off. More worryingly, productivity growth has been trending down since 2000, according to official figures. These factors are contributing to a low economic speed limit in the short term.

The RBNZ is left with little inflation leeway

The inflation outlook, despite the slowing of growth over the past couple of years, is still one of inflation sitting near the top of the 1% to 3% target band over 2008.

Slower domestic demand will only have a modest impact in lowering non-tradables inflation: the tight labour market means that service sector inflation will remain stubborn.

Globally, fuel and food prices are creeping up. Moreover, a lower NZD will eventually lead to higher consumer prices for wider imported goods.



Interest rates and exchange rates

Interest rate cuts are unlikely soon

Despite the RBNZ recently focussing much on the shift in the global environment, its forecasts show very little headroom to tolerate further developments that could boost inflation further. And, the Q2 GDP figures were a touch on the strong side of RBNZ expectations.

To us these factors emphasise that the RBNZ is unlikely to be cutting interest rates anytime soon. Moreover, there is still a small risk that the RBNZ lifts rates further – particularly if the impact of this year's interest rate increases proves to be short-lived.

Though global environment brings added uncertainty

The great uncertainty, of course, is the extent to which the US housing market and credit concerns flow on to affect the global economy. A hard landing for the rest of the world would see the RBNZ respond eventually to prop the local economy up. However, at this stage we see that as a risk but not the most likely outcome.

The degree of evident inflation pressure suggests to us that interest rates will be on hold until late 2008, at which point we expect the RBNZ will have inflation sufficiently contained. But keep an eye on those storm clouds just over the horizon.

NZD has been very volatile

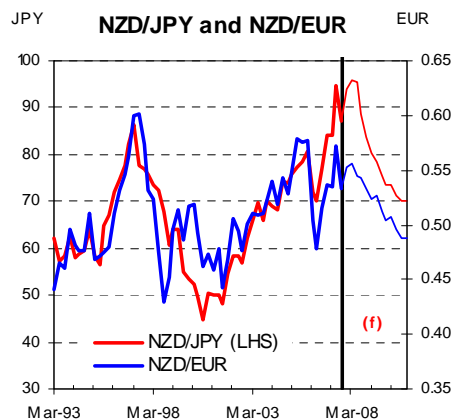
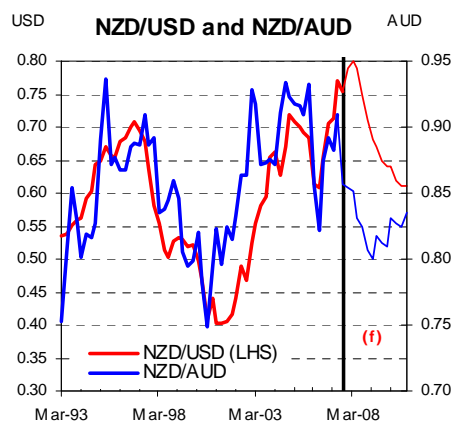
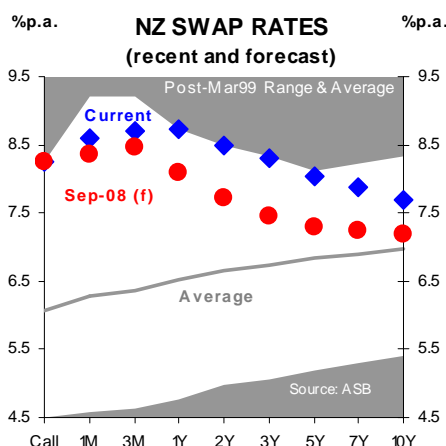
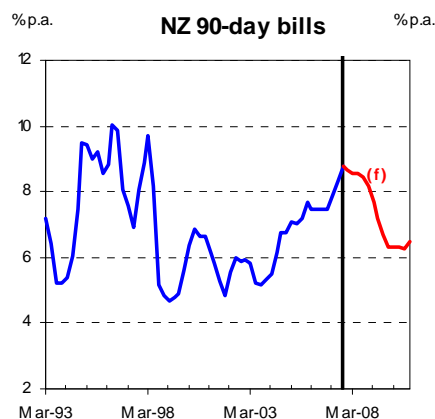
The NZ dollar is one of the uncertainties at present. It rose dramatically as investors focussed on the return yielded by ever higher interest rates, peaking in July at USD0.811. But signals that the RBNZ was done brought the NZD off its peak, and global risk aversion saw it tumble back below USD0.67 in a matter of weeks.

The NZD has since rebounded considerably as a degree of risk-taking has come back – and as the USD itself has weakened. But, volatility is likely to be a key feature over the rest of 2007 – something to be wary of.

NZD could hold up in the short term, but likely to underperform in 2008

The NZD could well keep lifting in the short term, in part a reflection of USD weakness rather than NZD strength. However, going forward the NZD is biased to eventually underperform other key currencies. Even though risk appetites for trades such as leveraged buying of the NZD are returning, the extent of such activity will be curtailed.

Over the next year the NZD outlook will revert to being heavily driven by the direction of monetary policy. As the RBNZ gradually relaxes next year we see scope for the NZD to begin falling slightly on a broad basis.



ECONOMIC FORECASTS

ASB economic forecasts		Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Mar-09	Mar-10	Mar-11
					<< actual	forecast >>					
NZ GDP nominal	AA%	3.9	4.3	4.6	6.0	6.2	6.2	5.8	4.4	5.1	5.3
NZ GDP real	AA%	1.7	1.6	1.7	2.2	2.8	3.1	3.1	2.0	2.8	3.4
private consumption	AA%	2.8	2.3	2.4	3.0	3.7	4.0	3.5	1.5	2.0	3.2
dwelling construction	AA%	-3.4	-2.7	-2.1	2.2	3.7	4.6	5.8	-1.5	1.4	4.0
other investment	AA%	1.2	-2.3	-3.3	-0.9	1.7	4.3	4.0	2.3	4.8	5.3
exports	AA%	1.4	1.9	3.2	3.3	2.0	2.4	1.5	2.5	4.2	5.2
imports	AA%	-2.3	-2.5	-1.2	1.6	4.7	6.4	5.6	2.0	4.1	5.7
NZ GDP real	A%	1.0	2.1	2.5	3.2	3.5	3.2	2.3	2.2	3.1	3.5
NZ GDP real	Q%	0.4	0.8	1.2	0.7	0.7	0.5	0.4			
NZ CPI	Q%	0.7	-0.2	0.5	1.0	0.5	0.7	0.6			
NZ CPI	A%	3.5	2.6	2.5	2.0	1.8	2.7	2.8	2.8	2.6	2.2
NZ house prices (QV index)	A%	10.1	9.7	11.7	14.0	12.9	9.6	5.4	-0.5	1.1	2.4
NZ dwelling consents (no.)	A%	-6.1	-11.5	0.2	7.6	5.0	3.0	-4.0	0.0	6.0	6.0
NZ non-residential consents (\$)	A%	-8.3	-11.4	21.0	22.7	13.9	8.9	1.4	4.5	10.0	10.0
NZ unemployment (sa%)	Qtr	3.8	3.7	3.7	3.6	3.8	3.8	4.0	4.0	4.3	4.3
NZ private sector wages (LCI)	A%	3.2	3.2	3.0	3.2	3.0	2.8	2.9	2.7	2.6	2.7
NZ current account (\$b)	Yr	-14.0	-14.0	-13.5	-13.6	-13.2	-12.4	-11.5	-10.0	-10.7	-11.7
as a % of GDP	Yr	-9.2	-9.0	-8.3	-8.2	-7.8	-7.2	-6.6	-5.6	-5.6	-5.9

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

FINANCIAL FORECASTS

ASB interest rate forecasts	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Mar-09	Mar-10
(end of quarter)			<< actual	forecast >>					
NZ cash rate target	7.50	8.00	8.25	8.25	8.25	8.25	8.25	7.50	6.00
NZ 90-day bank bill	7.92	8.4	8.8	8.7	8.6	8.6	8.5	7.7	6.3
NZ 3-year swap rate	7.85	8.3	8.2	8.0	7.8	8.2	8.1	7.5	6.4
NZ 10-year gov't stock	5.93	6.7	6.3	6.4	6.4	7.6	7.5	7.1	6.6
ASB foreign exchange forecasts	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Mar-09	Mar-10
(end of quarter)			<< actual	forecast >>					
USD per NZD	0.713	0.770	0.754	0.79	0.80	0.79	0.75	0.68	0.64
GBP per NZD	0.363	0.385	0.372	0.39	0.39	0.38	0.38	0.35	0.34
AUD per NZD	0.883	0.909	0.857	0.85	0.85	0.83	0.83	0.80	0.83
JPY per NZD	84.1	94.8	87.2	94	96	96	89	80	74
EUR per NZD	0.534	0.572	0.5	0.55	0.56	0.54	0.54	0.52	0.51
TWI	69.7	74.8	71.0	73.8	74.5	73.4	71.0	66.4	64.0

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