Investing Opportunities in New Zealand

October 2011

- *Short-term interest rates will begin rising again in the coming year*
- *Bond yields are likely to increase by less than global yields*
- *The currency is high in trade-weighted terms and may fall*

Economic growth resumed in 2009 but the earthquakes of the past year have disrupted economic activity. There has been a period of reduced economic activity in 2011 albeit without the year being as poor as had been feared. The rebuilding phase in 2012-2013 could be a time of relatively rapid economic expansion. Tax changes have boosted inflation in the past year but the availability of spare capacity and global competitive pressures should limit inflation pressures (see table of key forecasts).

Interest rate expectations have fluctuated over the past year. After moving downwards after the Reserve Bank of New Zealand's policy easing in March, expectations rose again due to the apparent resilience of economic activity. Most recently, global financial market turbulence has led to another downwards reassessment of future interest rates. Futures prices imply that short-term interest rates will rise towards 3.5% through the coming two years (see top chart). A rise of some magnitude is highly likely and if the economic environment unfolds in line with our projections, short-term interest rates would probably rise by more than current market pricing implies.

Bond yields have generally been stable around 6% since 2004 but the fall in global yields during recent months has led to a corresponding substantial decline in NZ yields. 10 year yields have now fallen back to their low point of 2008 (see middle chart). Even though NZ yields are lower than normal, global bond yields are so low that NZ bond spreads with other countries are actually wider than historical norms. A rebound in NZ yields is likely but only when financial market concerns ease and global yields are rising. NZ bond yields will probably rise by less than yields in most other countries and bond spreads will narrow accordingly.

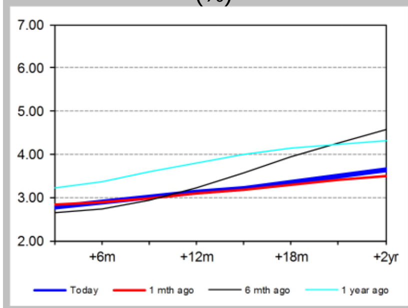
The New Zealand dollar has been very high this year in trade-weighted terms and is currently is close to the highs reached in 2006 and 2008 (see bottom chart). A very high terms of trade has been supporting the NZD with relatively wide interest rate differentials providing additional upwards impetus. The traditional downward influence from the persistent current account deficit has been reduced by capital inflows related to earthquake insurance payments but this impact will be transitory. To some extent, the very high trade-weighted index is a bit misleading as it reflects the low levels of the USD and GBP. A decline in the NZD index will probably occur when these two currencies begin to rise.

Equities have declined sharply during the past six months in line with global equities but have still provided a return of close to 10% in the past year. If global financial market turbulence subsides and domestic economic activity is boosted significantly by the required rebuilding efforts, the general environment should remain reasonably favourable for the corporate sector during the coming couple of years.

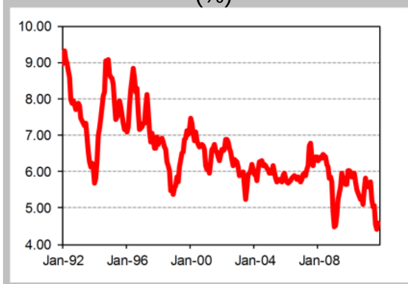
Key Forecasts

	Dec-12	Dec-13	Dec-14
GDP	4	2	1
CPI	2	2	2
OCR	4.50	6.00	6.00
10 year	6.00	6.00	6.00
USD/NZD	0.68	0.63	0.63
YEN/NZD	67	69	69
NZD/AUD	0.79	0.79	0.79

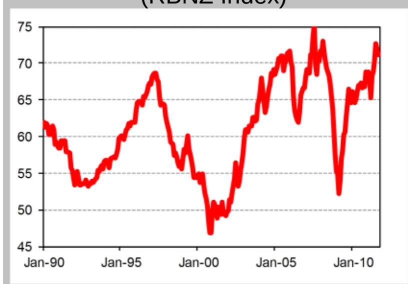
90 Day Future Strips
(%)



10 Year Bond Yields
(%)



Trade Weighted Exchange Rate
(RBNZ Index)



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