

New Zealand

UOB Economic Projections	2009	2010	2011F	2012F
GDP	0.5	0.4	2.0	3.7
CPI (average, y/y %)	2.2	2.3	4.5	2.7
Unemployment rate (%)	6.2	6.5	6.5	5.5
Current account (% of GDP)	-2.9	-2.3	-3.4	-4.2

- *Despite the recent sovereign downgrade by Fitch and S&P, economic data does suggest that the New Zealand economy has been expanding in recent months. We believe that the country will remain resilient into 2012.*
- *While the RBNZ will be cautious, keeping an eye on global developments, we think that it will likely move rates again early next year.*
- *We still see Kiwi being supported although we are cautious of potential downside risks amid a volatile environment.*

New Zealand Economy Recovers Albeit Slowly

The New Zealand economy grew 0.1% qoq in the second quarter, less than expected. Growth in both 1Q11 and 4Q10 was revised up to 0.9% qoq and 0.6% qoq respectively. As a result, annual growth for the year to Q2 eased to 1.5% from an upwardly revised 1.7% in Q1. Whilst the rebuilding and construction efforts of Canterbury have been delayed by continued aftershocks and some difficulties insuring projects, they are expected to start in late-2011 or early-2012, which should benefit both residential and business investment.

Besides, the economy will be boosted by the Rugby World Cup which is currently in full swing. Estimates by the RBNZ suggest that the event is expected to boost exports of services – the current working assumption is that visitors will contribute \$700 million to exports of services over the last two quarters of 2011. The external sector should also remain resilient, given that New Zealand is a major food exporter. Meat and dairy prices are high, boosting incomes and investment in the rural sector. This is why after near a decade of trade deficits, New Zealand's trade position has been a surplus for the past year.

Although the outlook for the New Zealand economy is reasonably strong, there are external risks to watch out for, which could weaken exports and hurt the country. At this juncture, we think that it is likely that the recovery will continue to strengthen but that growth will soon settle into a more subdued pace than previous years given the external risks. We are looking for 2011 growth to come in at 2.0%, before picking up pace thereafter.

A Prudent RBNZ Stays On Hold For Now

The RBNZ retained the OCR at 2.5% during the September

meeting. Whilst rates are still at emergency lows, the RBNZ's commentary on the domestic economy was relatively upbeat. Governor Allan Bollard acknowledged that the New Zealand economy has picked up more rapidly than was assumed in the June Statement. However, he had also highlighted that global economic and financial risks have increased.

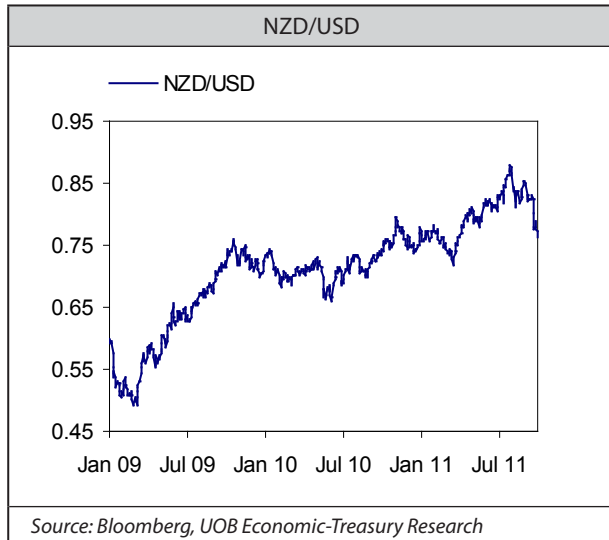
Hence, it is not surprising that the RBNZ has taken a more neutral stance at their most recent meeting. In the July statement, RBNZ Governor Bollard had said: "Provided current global financial risks recede and the economy continues to recover, the Bank sees little need for the March 2011 'insurance' cut to remain in place much longer". However, the key phrase in the September statement was: "If recent global developments have only a mild impact on the New Zealand economy, it is likely that the OCR will need to increase".

This shows that whilst it was prudent to hold at 2.50% given the risks associated with the global economy and markets; the cash rate will eventually need to be increased and that it could happen more quickly if the impact of global troubles are milder than anticipated. The RBNZ's last cut took place in March this year, where the OCR policy rate was slashed by 50bps to 2.5% on account of the February earthquake. This brings the cash rate back to the "emergency" lows, which is different from Australia and across the Asian countries.

Hence, whilst the possible increase in borrowing costs associated with the recent downgrades could imply that the RBNZ would be less likely to raise interest rates anytime soon; it would be true to say that the RBNZ has room to increase rates, and it would probably not want to fall behind the curve, especially given the positive momentum in the

New Zealand

economy. Unless the global economy worsens enough for them to warrant rates at current levels, we believe that it is possible that the RBNZ may begin moving rates upwards early next year.



Brace For Volatility And Downside Risks In The Kiwi

The NZD/USD pair had found itself on an appreciation path for most of this year, touching highs of 0.8843 in July, before falling to current levels. The recent rapid decline in the currency pair came on the back of the downgrade of New Zealand's sovereign credit rating. Fitch and S&P

announced their credit-rating downgrades for the country within hours of one another. Both agencies downgraded New Zealand's foreign-currency rating one level from AA+ to AA, while S&P also cut the country's local-currency rating from AAA to AA+.

Just like its Australian counterpart, an important issue to consider in the context of the NZD/USD is market risk appetite. As such, prices have the potential for big moves in either direction. Not surprising, given that the European debt crisis would spill over into broad global market risk aversion and onto commodity currencies. In any case, there is a good chance that the NZD will also fall significantly in line with the AUD and EUR.

On the interest rate front, expectations of a near-term RBNZ rate hike are low for now. But with yields continuing to play a critical role in currency markets, the NZD should still find support from being one of the highest yielding currencies within the G10 space. Furthermore, the high correlation between the antipodeans with Asian currencies may also reflect the increasing allocation of global FX reserves to these currencies.

We are looking for NZD/USD to hover around 0.730 by the end of this year. Whilst upside in the currency pair seems limited for now, we see the pair finding its way higher subsequently.