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RODNEY'S RAVINGS

Insights into NZD prospects

EXECUTIVE SUMMARY

In previous Ravings I have explained what really drives the NZD (<http://www.sra.co.nz/pdf/NZDUSD.pdf> and <http://www.sra.co.nz/pdf/NZdollarRaving.pdf>). Yesterday a Canadian business woman looking to move to NZ emailed me the following comments: "Thank you for your excellent report on the NZD/USD exchange rate. I've been following the CAD/NZD since February 2009 and until seeing your report I couldn't find anything that would even begin to explain the fundamentals. What you say makes sense, and you back it up." So in response to her kind comments and because many people are perplexed by the appreciating NZD I decided it was timely to revisit the issue of what really drives the exchange rate. This Raving looks more specifically at the impact of the financial crisis and why the NZD, especially the NZD/USD, has appreciated and why it is likely to appreciate further provided virus-infected pigs don't fall from the sky.

It is understandable if some exporters are ringing their hands in disgust at the appreciating NZD and believe it has no rational foundation. Such people may be inclined to dismiss this Raving. But I am not in the business of the rights and wrongs of an appreciating NZD, I set up Strategic Risk Analysis to help firms and individuals manage risks and opportunities emanating from the economy, be it related to major cycles in the exchange rate, the housing market or the economy more generally. If any firms or individuals are impacted significantly by the exchange rate and are serious about business or investment risk management they should feel naked if they don't have access to the best available analysis of exchange rate prospects (i.e. our monthly **Forex Prospects** reports – see <http://www.sra.co.nz/pdf/ForexProspectsSample.pdf> for a sample report). If you would like to find out more about these monthly reports and about the framework I have developed for helping clients understand why the exchange rate does what it does please get in touch. We are looking to run low cost independent seminars that present the framework while I also do in-house presentations of the framework to management teams for a fee. Feel free to contact me if you are interested in either of these.



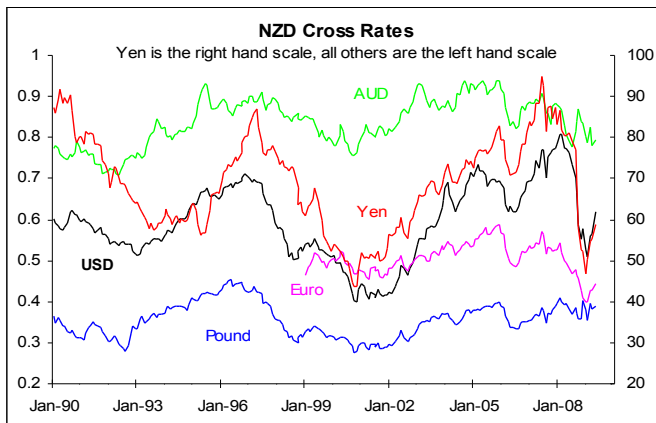
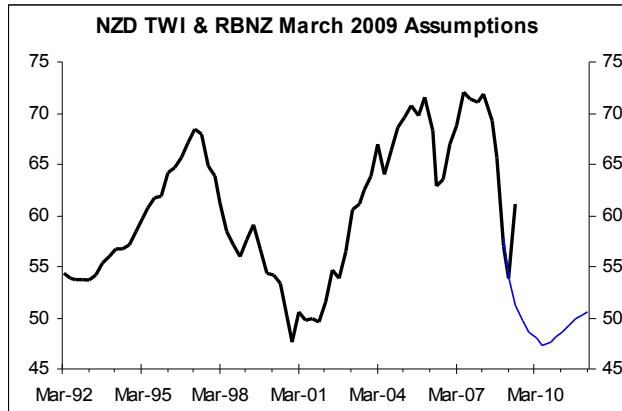
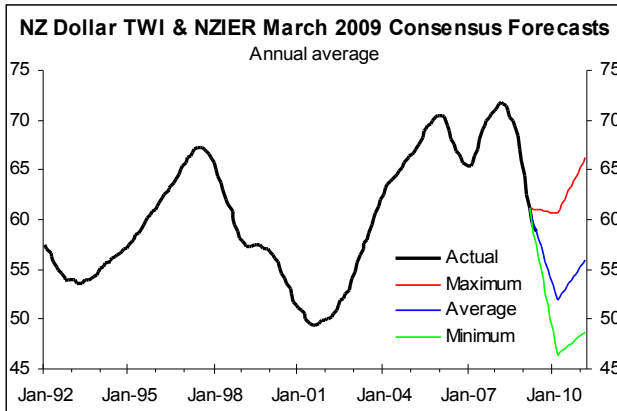
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Pitfalls in the consensus view of NZD prospects

Until the NZD surprised most people by appreciating strongly over the last three months (e.g. up 33% against the USD) the conventional view of economists was that a Tsunami was still coming NZ's way and that this would drive the exchange rate down further. The charts below present the related forecasts by economists in March 2009. The charts show forecasts for the NZD TWI, which is a measure of the value of the NZD against the USD, Euro, Yen, AUD and Pound Sterling. See the second left chart and the accompanying text for more info on the TWI.

The blue line in the left chart shows the consensus or average prediction for the NZD TWI by the 10 forecasters surveyed by NZIER in March 2009. The TWI was predicted to average 51.9 in the 2009/10 March year and 55.9 in 2010/11, which is puzzling in the context of the TWI having rebounded from a low of 51.1 on 3 March to 61.3 currently. The red line shows the highest predictions for the TWI by any of the 10 forecasters, so we weren't alone in predicting the NZD could rise but we seem to have been the only ones suggesting that it would surprise by rising this year. The most negative of the forecasters predicted that the TWI would average 46.4 in the year to March 2010 (the green line). In March 2009 the RBNZ assumed that the NZD TWI would head lower before starting to appreciate moderately in 2010 (see the blue line in the right chart below). With the TWI currently at 61.3 the RBNZ's assumptions now look a bit dubious.



The NZD TWI is based on the value of the NZD against the USD (0.299), the Euro (0.2741), the AUD (0.2057), the Yen (0.1489) and the Pound Sterling (0.0723). It is 50:50 weighted according to:

1. Each currency area's share of NZ's merchandise trade (exports plus imports), normalised to total 100 percent; and
2. Each currency area's share of the combined nominal GDP of the five currency areas.

The weights (in parenthesis above) are updated annually, most recently on 19 December 2008.

On 4 March I was one of several presenters at an NZ Institute of Accountants' session for CFOs. I was there to talk about the property market while one of the other presenters was from a major bank and presented the Tsunami view of NZ growth prospects that was the basis of the general expectation that the NZD would head lower. The Tsunami view was that NZ had yet to feel the full wrath of the international crisis but when this happened exports would tumble and the NZD would fall further. I managed to bite my lip at the time but in our March **Forex Prospects** reports for clients I wrote: "The NZD TWI has fallen below the level justified by the fundamental indicators that are normally associated with major cycles. This doesn't mean it can't fall further if the crisis takes a turn for the worse, but if NZ's growth prospects improve at least moderately this year and there are signs that the crisis is starting to heal then there is the potential for a moderate to significant rebound in the NZD TWI." But the potential of a rebound in the NZD was evident to me earlier than March. In the February client report I had observed that: "The NZD TWI remains a captive of the financial crisis and will probably ebb and flow with the crisis for some time to come."



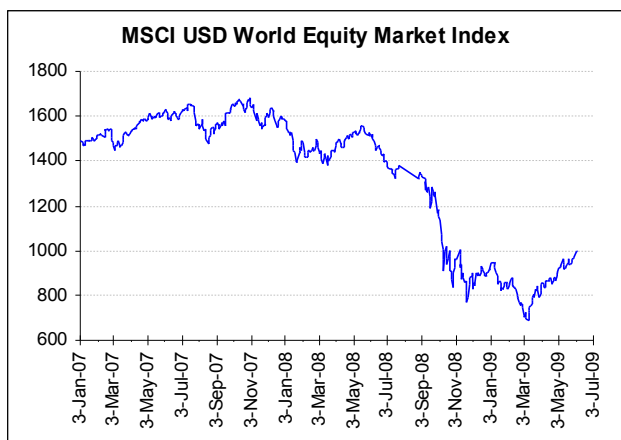
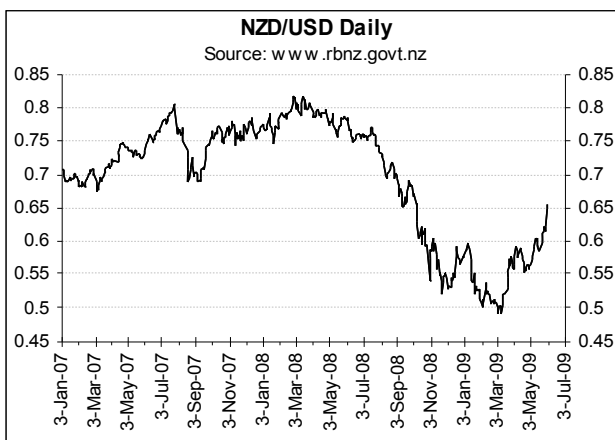
However, we cling to the idea that the NZ economy can escape the recession this year and as a result there could be a surprise rebound in the TWI at some stage. “

I didn't predict the arrival of the crisis although shocks like the crisis are incorporated into the framework I have developed for explaining what drives the exchange rate. This framework covers the impact of shocks, economic cycles, structural changes and random noise or volatility. In the courses I have presented on what drives the exchange rate for members of the Employers and Manufacturers Association (Northern) and the Canterbury Employers' Chamber of Commerce I explain the role of these four drivers. Thankfully when the financial crisis hit the NZD I was already advising clients that the exchange rate had downside risk for cyclical reasons but the focus of my exchange rate analysis shifted to assessing how the crisis would impact on the NZD and how this might fit in with the impact from the cyclical factors that normally drive the major cycles in the exchange rate. My novel approach is to analyse what really drives the exchange rate and use this as a basis for advising clients what the future might hold for the NZD.

The NZD and the financial crisis

Past Ravings have presented my general theory on what drives the major cycles in the exchange rate (see for example <http://www.sra.co.nz/pdf/NZDUSD.pdf> which focuses on the NZD/USD) and as the global financial and economic crisis fades the general theory will become of most importance again, except when shocks emerge from time-to-time. But for the moment the financial crisis is the major driver of the NZD and while this is the case what I have dubbed the “hypothermia” theory is the major consideration, but this still has to be dovetailed with consideration of the impact of the normal cyclical drivers.

The NZD is behaving much like a body does when subjected to cold, with distinct stages of hypothermia (see <http://en.wikipedia.org/wiki/Hypothermia> for info on the stages of hypothermia). In this context NZ is best viewed as a peripheral part of the body, like a pinky, while the US is the heart. In the first stage of hypothermia the body shivers and goose bumps form. This is like the NZD/USD initially falling in response to the emergence of the financial crisis in August-September 2007 (see the left chart). This mini-fall in the NZD was also mirrored in the world share market, with the latter performing the roll of a barometer for the global economy (see the right chart). But as stage one progresses the body will start feeling a warm sensation and the patient will start feeling better (this is the warm glow people who dip in ice water experience), which is reflected in NZD/USD rebounding to above US 80 cents by early 2008 and is mirrored in the rebound in the world share market in late 2007. As the temperature drops stage two of hypothermia sets in and the body responds by drawing blood away from the skin and peripheral parts of the body to protect the vital organs and core body temperature, which is like investors responding to the heightening of the financial crisis by deserting peripheral markets like NZ and taking money back to the US. This is when the really peripheral places like Iceland got frost bite. However, if the patient gets rescued before stage three and death set in the blood will return to peripheral parts of the body, which has its parallel in investors and traders returning to the NZD (and the world share market). It is no coincidence that the NZD/USD, the NZD TWI and the world share market have been highly correlated since the crisis started, with all being barometers of the crisis.



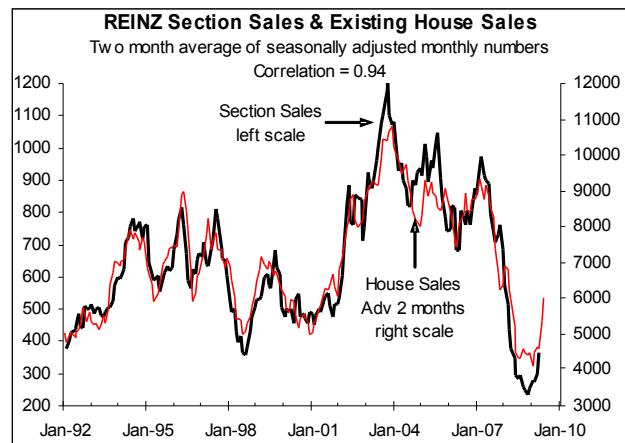
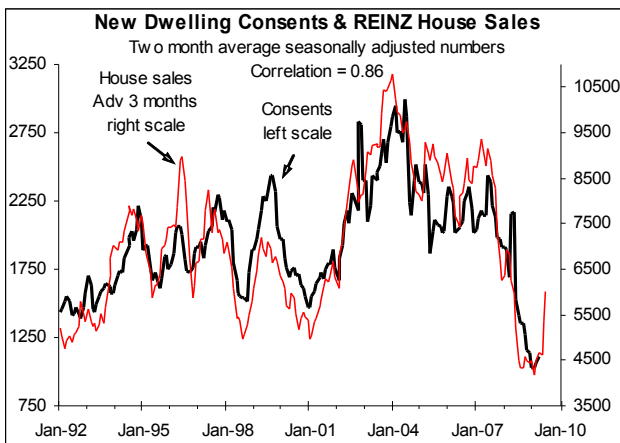
From another perspective the NZD is for the NZ economy what the share price is for a listed company. If an indebted company experiences a negative shock its share price gets smashed. The experience of Fisher & Paykel Appliances and Nuplex are prime examples of this. The parallel is that NZ has a large



external deficit so when the international crisis bared its teeth the NZD got smashed. But if signs emerge that a geared listed company is going to survive and eventually prosper again its share price generally surges, as we have seen with FAP and NPX. The parallel is that if the NZ economy is expected to survive the financial crisis and eventually return to something in the ballpark of normal growth the NZD can be expected to rebound sharply. So just as there are reasons why the NZD tumbled as a result of the escalation of the financial crisis, it was always likely to rebound sharply when signs of recovery emerged. The NZ economy has a large external deficit and it is only in the early stages of emerging from recession, but within the context of how the exchange rate normally behaves it also makes sense that the NZD is currently appreciating, especially against the likes of the USD, because on a relative basis NZ's near-term growth prospects are better than those of the US.

Critical to picking that the NZD would surprise everyone and rise this year was a better understanding of what would unfold in the local and the global economy as a result of both the crisis and the policy responses. My analysis earlier this year suggested that rather than the Tsunami being on its way it had already largely hit the NZ economy (e.g. export volumes had already been smashed, export prices had already fallen and the financial crisis had already delivered a credit crunch). This analysis was mainly contained in our pay-to-view monthly **Interesting Times** and **Forex Prospects** reports. But to show non-clients that I'm not telling porkies after the event I refer you to the Raving titled **Positive news for economic growth in 2009** that was released on 8 February and in which I argued there would be three major factors driving an economic recovery this year (see <http://www.sra.co.nz/pdf/LifeAftertheCrisis.pdf>). The sources of positive surprise I predicted were a housing recovery, a rebound in international trade volumes thanks to the stock/inventory cycle and the possibility of improved commodity prices.

The massive interest rate cuts, soon to be helped by net migration, are in the process of underwriting a V-shaped recovery in the NZ housing market. The red line in the left chart shows that the number of REINZ dwelling sales has started a sharp recovery with this line advanced or shifted to the right by three months as a leading indicator of the number of consents for building new houses (the black line). All going to plan there will be a sharp upturn in consents over the next few months with a hint of a recovery already evident. The right chart shows REINZ dwelling or existing house sales as a two month leading indicator of the number of REINZ section sales, with the latter starting to emulate the sharp upturn in house sales and giving support for my expectation that a sharp upturn in residential building is in the pipeline. So while most economists don't expect a recovery in housing until next year it is already underway!!!

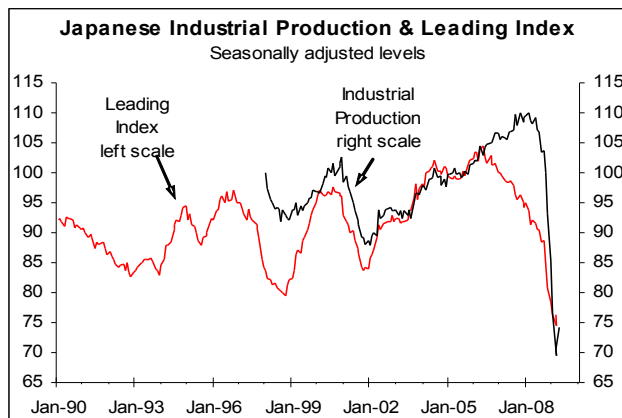
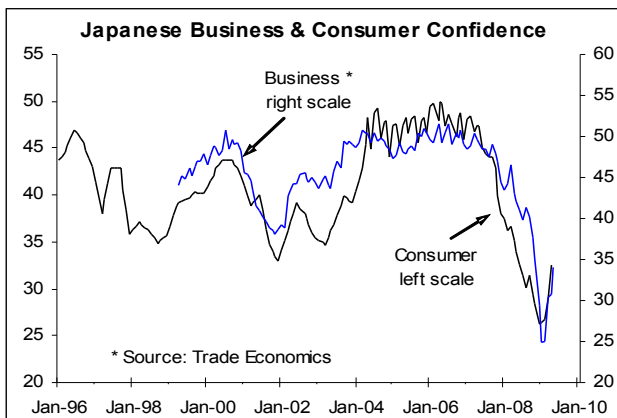
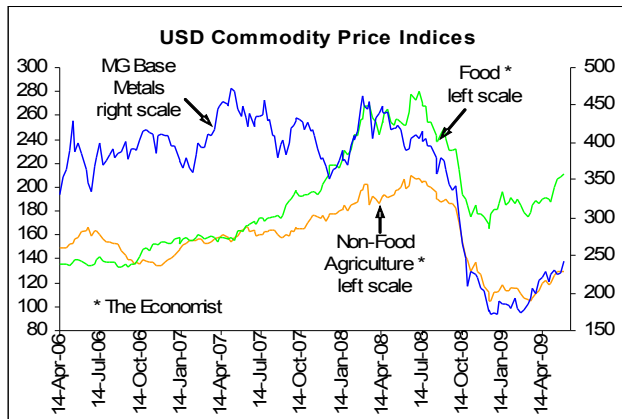
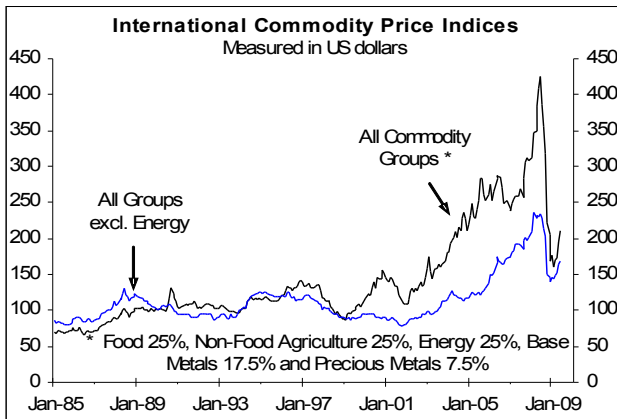
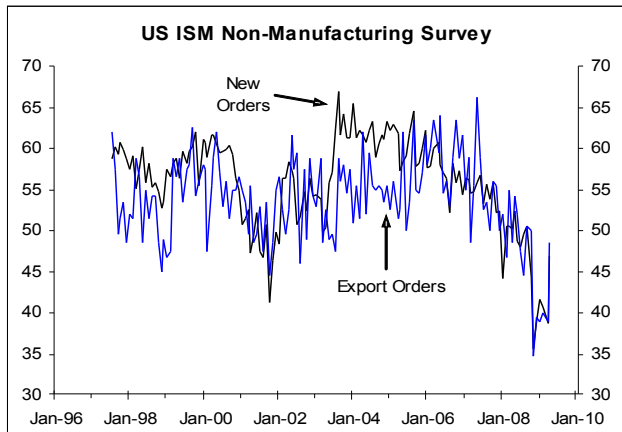
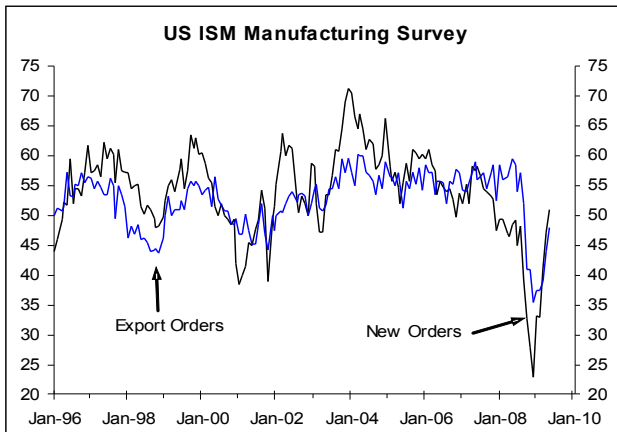


Having been head of research at two major share broking firms I am something of an old hand at understanding the relationship between the share market and the economy. The 45% increase in the world share market since it troughed in early March - see the right chart on the previous page - is telling us that investors all over the world can see reasons for being at least less negative about global growth prospects if not even a touch positive. The general response by many economists/commentators to the rise in share prices is that markets are "getting ahead of themselves", implying that reality wouldn't vindicate the rise in share prices and that share markets and expectations about global growth will come tumbling back down. But in general I'd back share markets over economists at picking what is going on 99.9% of the time. What is transpiring is that the economic indicators are starting to improve in line with what the share markets have been signalling. Put it this way: would you have more faith in the combined wisdom of the millions of investors all over the world who have their ears to the ground and money on the line or in economists?

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The key evidence emerging from the leading indicators that I have learnt to take lots of notice of is that international trade is in the process of experiencing what looks like being a V-shaped recovery. This is reflected in US export orders and total new orders surveys having rebounded sharply over the last couple of months in both the manufacturing and non-manufacturing sectors (see the first two charts below). It is reflected in international commodity prices showing the early signs of recovery (see the second two charts below). Japan is a prime example of an export-orientated country that has been smashed by the global crisis to the extent that Tsunami is a good description, but Japanese business and consumer confidence surveys are showing signs of a V-shaped recovery while Japanese industrial production experienced one of the largest monthly increases on record in April, largely driven by exports (see the bottom two charts).

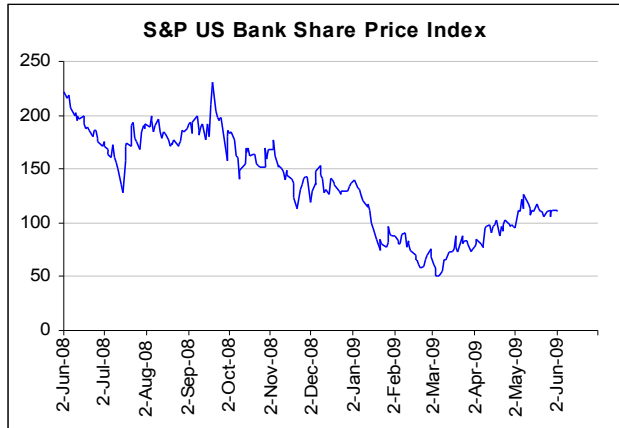
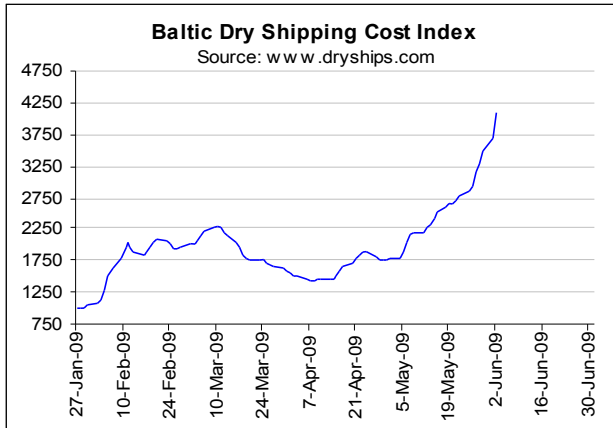


The stock or inventory cycle is at work. For a description of how the stock cycle works and why it would deliver a positive surprise this year see the Raving about why there would be positive surprises this year (<http://www.sra.co.nz/pdf/LifeAftertheCrisis.pdf>). The left chart below shows the rise in a shipping cost index for commodities like iron ore. It is surging, reflecting the stock cycle. But the "green shoots" are also emerging in financial markets and financial risk indicators, as partly reflected in the share prices of listed US banks (the right chart below). Measures of risk in the international debt markets have also fallen

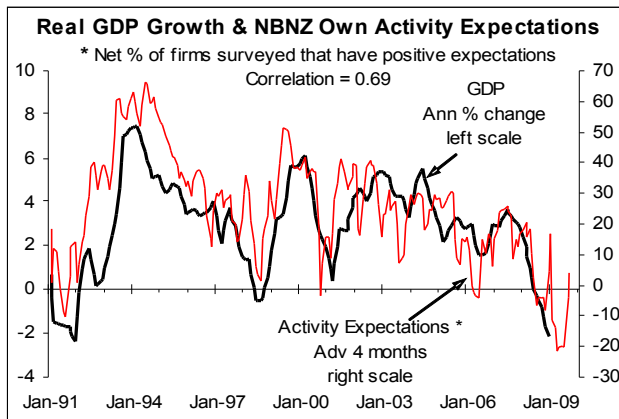
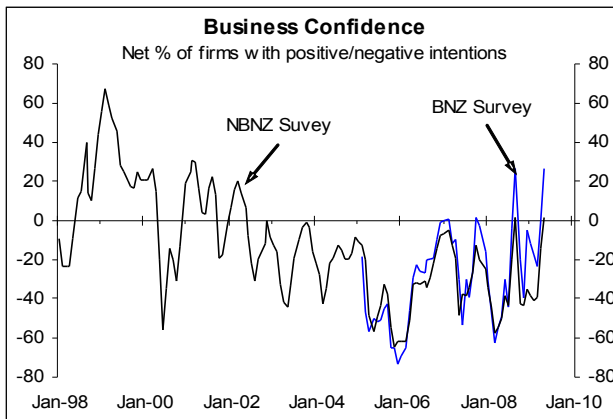
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significantly since peaking in February although they are still somewhat above the levels that existed prior to the bankruptcy of Lehman Brothers, a development that almost brought the international financial markets to their knees in September 2008. Long-term interest rates like the benchmark US 10-year bond yield have also started to increase, which is normal during economic recoveries.



When so many indicators are showing signs of recovery it is not a coincidence and reflects a change in the fundamental drivers of global economic growth. It partly reflects the fact that the plethora of stimulus packages launched around the world are starting to work, with this especially the case in China, but the stock cycle is also playing a major hand as it always does in the early stages of a recovery (and like normal most economists are assuming it away). But this is happening at a time that NZ leading indicators are not only improving (see the two charts below) but they are also improving relative to US leading indicators so at the moment the NZD has two friends (i.e. it is recovering from hypothermia and the normal cyclical drivers of the major cycles are in its favour). So I continue to warn clients and in this case non-clients also that the surprise this year could be the extent of the upside in the exchange rate.



It is understandable if some exporters are ringing their hands in disgust at the appreciating NZD and believe it has no rational foundation. Such people may be inclined to dismiss this Raving. But I am not in the business of the rights and wrongs of an appreciating NZD, I set up Strategic Risk Analysis to help firms and individuals manage risks and opportunities emanating from the economy, be it related to major cycles in the exchange rate, the housing market or the economy more generally. If any firms or individuals are impacted significantly by the exchange rate and are serious about business or investment risk management they should feel naked if they don't have access to the best available analysis of exchange rate prospects (i.e. our monthly **Forex Prospects** reports – see <http://www.sra.co.nz/pdf/ForexProspectsSample.pdf> for a sample report). If you would like to find out more about these monthly reports and about the framework I have developed for helping clients understand why the exchange rate does what it does please get in touch. We are looking to run low cost independent courses that present the framework while I also do in-house presentations of the framework to management teams for a fee. Feel free to contact me if you are interested in either of these (rodney@sra.co.nz).