FOREX PROSPECTS

Sample Report

CONTENTS OF THE REPORTS

The primary monthly **Forex Prospects** reports that relate to the monthly subscription option contain our unique leading indicator analysis used for assessing near-term prospects for especially the NZD/USD but also for the NZD/AUD and NZD/JPY. They also contain an assessment of medium-term prospects for the NZD/USD (and NZD/JPY), summary hedging recommendations for the NZD/USD and some cursory comments on the NZD/GBP, NZD/EUR and NZD TWI. The twice monthly subscription option includes the primary monthly report and a second monthly report that updates the analysis of near-term prospects and the hedging recommendations for the NZD/USD.

Our assessment of exchange rate prospects is based on analysis of what actually drives them rather than the often half-baked combination of economic theory, mean reversion assumptions and wishful thinking that is behind most economists' currency forecasts. It is also presented in plain English. In the words of a client our "ability to put it in terms that everyone can understand is laudable".

The complementary report titled ***What really drives the NZD/USD*** presents in detail the framework we use to predict the major cycles in the NZD/USD. This report is stored on our website and can be accessed via the following link http://www.sra.co.nz/pdf/NZDUSD.pdf. The framework we have developed for assessing exchange rate prospects can also incorporate the impact of shocks like the international financial crisis as discussed in another complementary report (see http://www.sra.co.nz/pdf/NZDrevisited.pdf).

In the rest of this sample report we show examples of the leading indicator analysis we use for predicting the near-term prospects for the NZD/USD, discuss what drives the NZD/AUD and the NZD/JPY, present the framework we use for assessing the medium-term outlook for the NZD/USD, provide brief insights into our NZD/USD hedging recommendations and touches on how we incorporate the impact of shocks in our analysis of exchange rate prospects.

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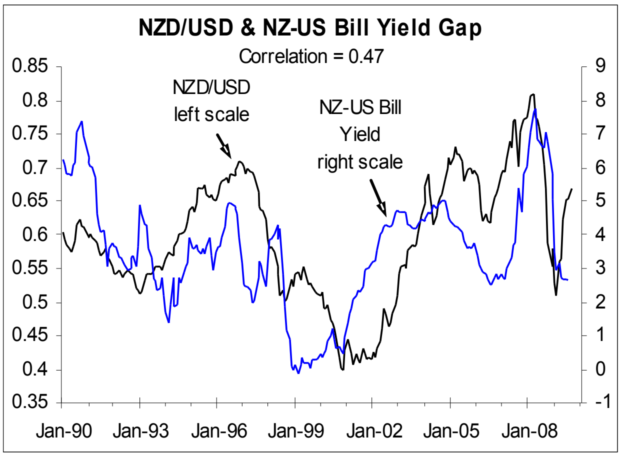
SPECIAL DISCLAIMER – exchange rate forecasting is inherently problematic because of the volatile nature of foreign exchange markets and the multitude of factors that can impact on the currency including unpredictable shocks. Consequently, while this report contains what we believe to be some of the best if not the best analysis of NZD prospects, especially in the case of the NZD/USD, this report is supplied on the basis of due care but no responsibility.

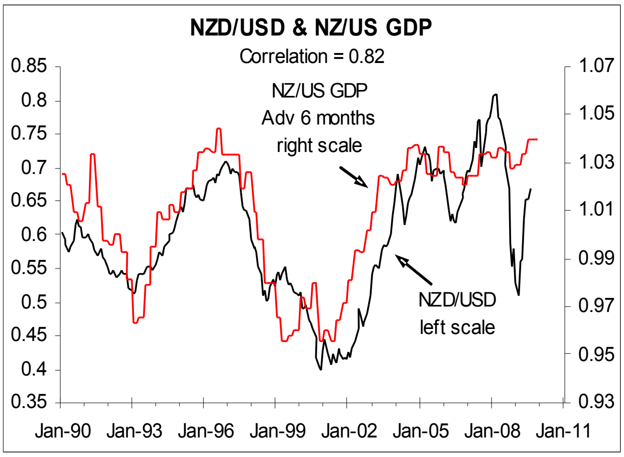
Understanding what drives the major cycles in the exchange rate

To be able to predict something we need to know what drives it. In the context of the exchange rate this means getting inside the heads of the major investors and traders and understanding the information that drives their thinking. Once we understand the economic fundamentals that drive their decisions then we have a starting point for making exchange rate forecasts.

The conventional wisdom is that interest rate differentials drive exchange rates but the report ***What really drives the NZD/USD*** we show that interest rates are of secondary importance. In summary, the left chart shows the relationship between the NZD/USD and the difference between the NZ and the US 90-day bill yield (bill yields being the benchmark short-term wholesale interest rates). As the left chart shows, the NZD/USD and the interest rate differential move in similar directions at times, but there are also a number of instances where they move in opposite directions. When we test the relationship mathematically using correlation calculations we find that the fit between the exchange rate and the interest rate differential is poor, at 0.47. A correlation of 1.0 is a perfect fit while one of 0.47 is like a failed mark.

By comparison, when we look at the relationship between the NZD/USD and the relativity between NZ and US economic activity (NZ/US GDP) in the right chart we find a much closer fit, with a correlation of 0.82 (something like an A mark). The right chart provides the best insight into what actually drives the major cycles in the exchange rate, although the impact of shocks like the international financial crisis also has to be taken into account. The financial crisis temporarily pushing the NZD/USD below the level justified by this key economic fundamental but normality is starting to return. Based on insights gained during 12 years spent travelling the world marketing NZ investments to major international investors we know the investors and traders like strong economies and retreat from weak ones. This is why relative NZ-US economic strength is the key driver of the major cycles in the NZD/USD.





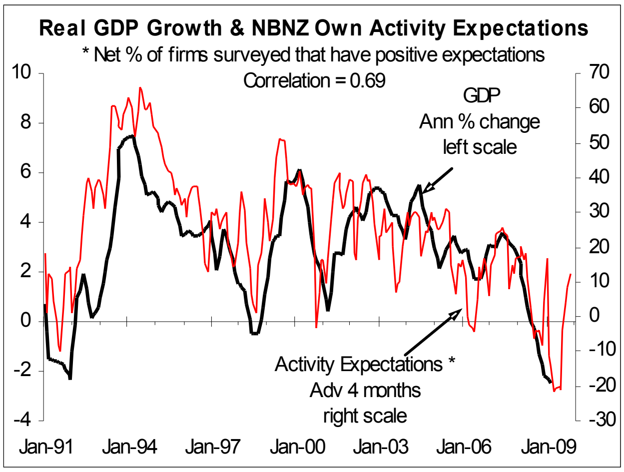
Picking relative NZ-US economic growth prospects is critical to assessing near-term prospects for the NZD/USD. But investors and traders don't wait for the quarterly GDP data to be released. They react constantly to the flow of news about growth prospects including the likes of confidence surveys, housing data and retail sales data. This is why the leading indicator analysis contained in the **Forex Prospects** reports is critical to assessing near-term prospects for the NZD/USD while the same leading indicator analysis is invaluable in assessing what will happen to the NZD/USD in the aftermath of a shock like the financial crisis. Based on our leading indicator analysis we were able to advise clients early this year that the NZD/USD would rebound while most economic forecasters were predicting that it would fall further.

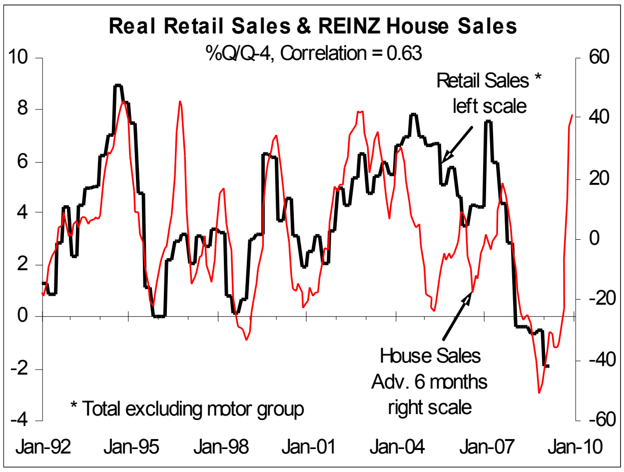
Leading indicator analysis is at the heart of picking currency movements

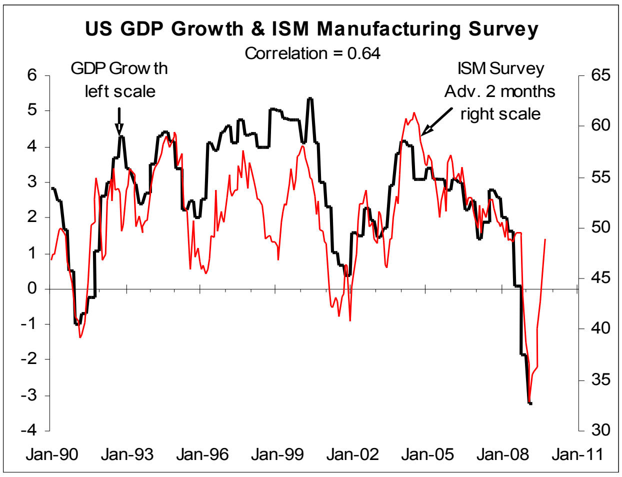
The four charts below give examples of some of the leading indicators we use to predict near-term economic growth in NZ and the US. The **Forex Prospects** reports contain many other leading indicators and, most importantly, our expert interpretation of the leading indicators and our understanding of how long it takes the likes of interest rates, exchange rates and migration to impact on economic growth.

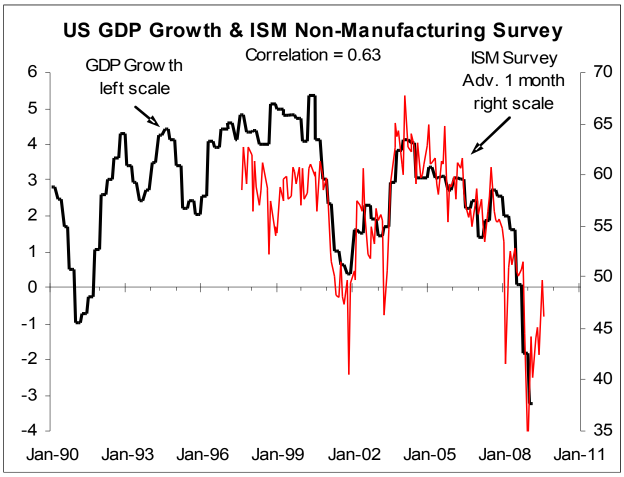
The top left chart shows the NBNZ survey of own activity expectations as a useful leading indicator of NZ GDP growth. The top right charts shows REINZ house sales as a useful leading indictor of growth prospects for NZ retail sales. The Raving titled ***Consumer spending will recover earlier than is***

generally expected further demonstrates the superiority of our leading indicator framework for assessing near-term growth prospects (see http://www.sra.co.nz/pdf/Consumer.pdf). The second two charts below show leading indicators of US economic growth, with leading indicator charts like these helping us get well ahead of the economists and ahead of the forex market in terms of assessing near-term prospects for especially the NZD/USD and the NZD/JPY that generally piggy-backs the behaviour of the NZD/USD.









Exchange rates don't all dance to the same tune – NZD/AUD and NZD/JPY

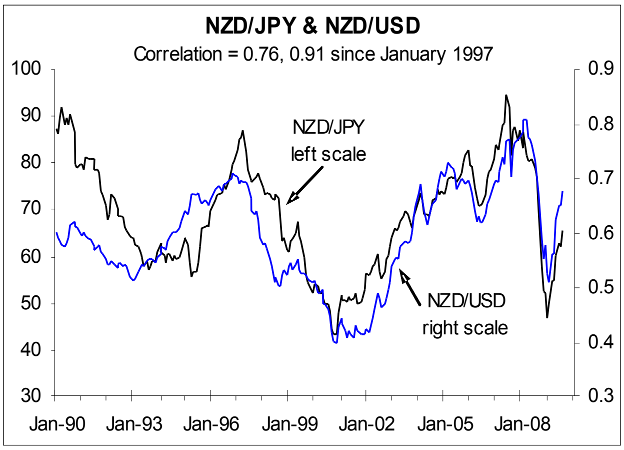
The most important economic fundamental for the major cycles in the NZD/USD is relative economic growth, but this is not the case for the NZD/AUD or the NZD/JPY. While we struggle to find any reliable relationship between economic fundamentals and the NZD/GBP or the NZD/EUR, which is why we don't pretend we can predict these two cross rates; we leave that job to the bank economists who seem willing to forecast anything even if they have no idea what really drives it.

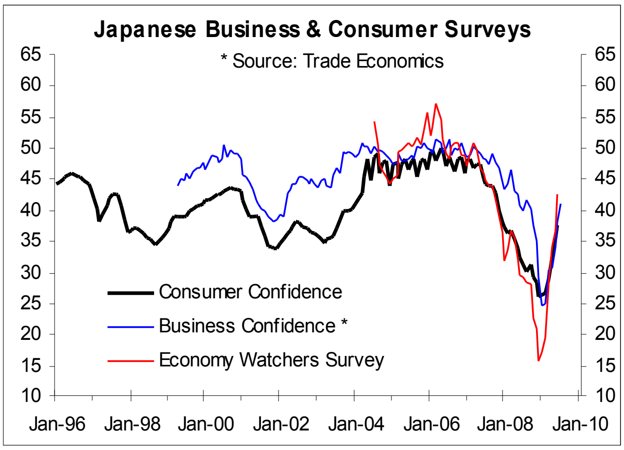
It seems reasonable to assume that the NZD/AUD will be driven by NZ versus Australia economic fundamentals, like the relative performance of economic growth, commodity prices and interest rates. But interest rate differentials have modest correlations with the NZD/AUD, relative commodity price performance have an even lower correlation in the post-float era, while relative economic growth also seems to have limited relevance to the major cycles in the NZD/AUD. Multiple factors are involved, but no amount of torturing the relative NZ-Australia economic data will provide a reliable explanation for the major cycles in the NZD/AUD.

Our analysis of the behaviour of NZD/AUD supported by our experience in dealing with major international investors and traders has taught us that NZ is treated as a "residual" market. Australia is a major market that gets constant, close attention by a large number of traders/investors, while NZ is a much smaller market with a more specialist following. But every now and then NZ will catch the attention of the pack for either good or bad reasons resulting in the NZD/AUD either rising or falling. If NZ indicators like consumer confidence and house prices surge more investors/traders get interested in NZ in part at the expense of Australia which generally results in the NZD/AUD appreciating. Equally, if NZ leading indicators dive some traders/investors will bailout of NZ and refocus back on Australia resulting in the NZD/AUD depreciating.

The behaviour of NZ leading indicators appear to be the major driver of cycles in the NZD/AUD but other factors play a part, including the likes of interest rates, Australian leading indicators, relative commodity price movements, so in the **Forex Prospects** reports we also take these factors into account in assessing near-term prospects for the NZD/AUD.

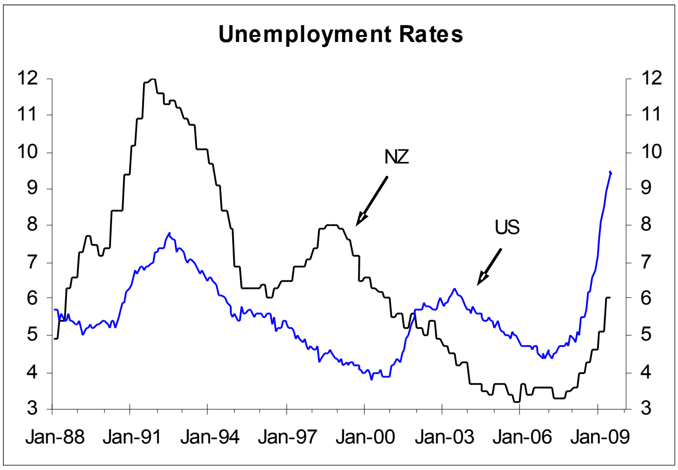
The NZD/JPY is another story again. The NZD/JPY does not dance to the tune of economic fundamentals which means any commentary on prospects for the NZD/JPY that is based on a discussion of economic fundamentals is a waste of time. The left chart below shows that for the last decade the NZD/JPY has piggy-backed the NZD/USD. We have dubbed the pretty close relationship between the NZD/JPY and the NZD/USD the “piggy-back” trade. It seems that when the traders drive the NZD/USD up or down they take the same position in the NZD/JPY. This means our leading indicator analysis of prospects for the NZD/USD is of most importance in assessing near-term prospects for the NZD/JPY, while our “big picture” analysis of medium-term prospects for the NZD/USD is of most importance to medium-term prospects for the NZD/JPY. We cannot guarantee that this relationship will remain intact forever so in the **Forex Prospects** reports we try and cover the basis by also looking at the impact of interest rates and Japanese leading economic indicators as shown in the right chart below.





Big picture analysis of medium-term prospects for the NZD/USD (and NZD/JPY)

Shocks aside, relative NZ-US economic growth should continue to be the main driver of the medium-term outlook for the NZD/USD (again, see the right chart on page 2). So, just as we focus most on leading indicators of economic growth for assessing near-term prospects for the NZD/USD, our “big picture” analysis of medium-term prospects for the NZD/USD focuses on medium-term relative NZ-US economic growth prospects. And the major role monetary policy plays in driving economic cycles.



Strong economic growth and recessions don’t happen by accident. A feature of both is the game central banks are playing. Periods of strong economic growth usually occur when central banks put their “go for growth” hats on while recessions usually happen when central banks put up a sustained fight against inflation although left field factors also often play a part in the timing and severity of recessions (e.g. the 2008-09 recession was a result of high interest rates and the financial crisis).

The unemployment rate is a key indicator of medium-term economic growth prospects but not in the way that most economists suggest.

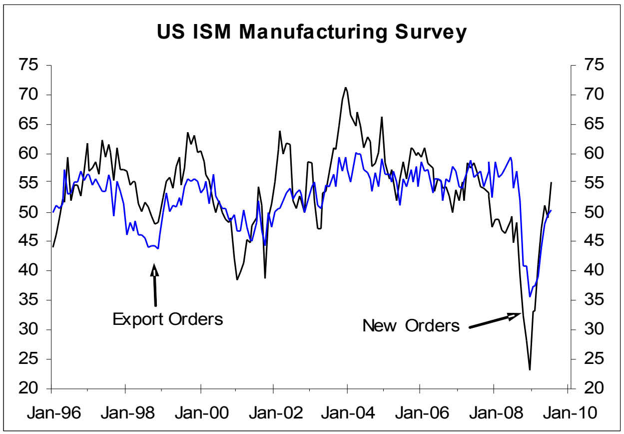
Economists generally expect the rising NZ unemployment rates to put a dampener on near-term growth prospects. The fallacy of this view was covered in the Raving titled ***Consumer spending will recover earlier than is generally expected*** (see http://www.sra.co.nz/pdf/Consumer.pdf). And if NZ economic growth recovers earlier than is generally expected it has implications for the exchange rate (i.e. it is why the NZD/USD has surged this year while most economists were picking that it would fall further). However, unemployment rates do have implications for medium-term growth prospects and therefore provide important insights in to medium-term prospects for the exchange rate.

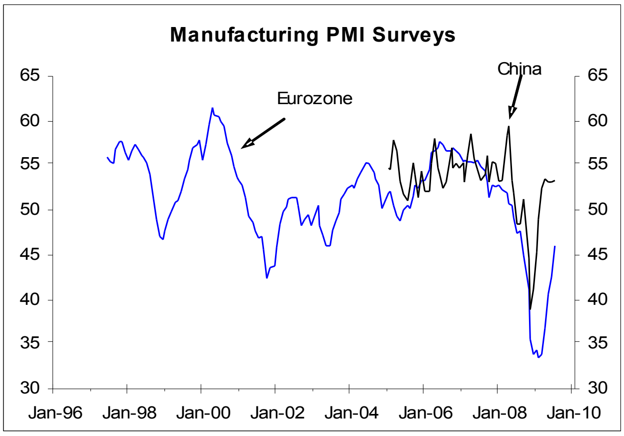
In the early-1990s and again in the late-1990s NZ had a much higher unemployment rate than the US. While many economists would view this as negative for growth it was actually a very positive sign for medium-term growth prospects. A high unemployment rate means labour cost inflation will be low and with labour costs the largest cost for most businesses it meant medium-term inflation prospects would remain favourable until the unemployment rate had fallen significantly. This in turn meant the RBNZ could run pro-growth monetary policy for an extended period. This is what happen, meaning NZ's economic growth significantly outperformed US growth over the subsequent few years, resulting in a large cyclical appreciation in the NZD/USD. However, the starting point now is one in which the US unemployment rate is significantly higher than the NZ rate meaning the US Fed will be able to be much more pro-growth than the RBNZ over the next few years, which in time should translate into a large cyclical rise in the USD relative to the NZD (i.e. large cyclical fall in the NZD/USD).

Shocks can have perverse impacts but leading indicator analysis is again valuable

We don't pretend to be able to forecast shocks, but when a shock arrives the leading indicators can again play an important part in assessing what will happen to the exchange rate as can our superior understanding of what drives economic cycles. The financial crisis is a case in point. It arrived at a time when the economic fundamentals that are normally most important to driving cycles in the NZD/USD were pointing to the potential of a significant cycle fall, which meant the exchange rate was vulnerable. But the shock had a somewhat perverse impact. The US was at the epicenter of the crisis and hence was at risk of experiencing worse economic fallout than NZ but the crisis fuelled "risk aversion" that meant NZ got treated like a debt-leper even more so than the US and the NZD/USD tumbled more than was justified by the economic fundamentals (i.e. especially by relative NZ-US economic growth). But this in turn meant the potential for the NZD/USD to rebound as the global crisis abated.

Earlier this year most economists predicted that a Tsunami was about to hit the NZ economy as a result of the crisis meaning the NZD/USD would head below US 50 cents. In February I wrote the Raving titled ***Positive news for economic growth in 2009*** that focused on three potential sources of positive surprise (see http://www.sra.co.nz/pdf/LifeAftertheCrisis.pdf), with one of these being a boost to global growth from the stock cycle. The role the stock or inventory cycle would play in delivering an earlier recovery in global growth that was generally expected was revisited in a recent Raving that used the international car market to explain how the stock cycle works (see http://www.sra.co.nz/pdf/StockcycleandCars.pdf). But in the **Forex Prospects** reports we have been reporting the relevant leading indicators that showed a sharp rebound unfolding in the manufacturing sectors of many countries largely as a result of the turnaround in the stock cycles (see the charts below). The use of leading indicators like those below again help us provide clients with superior insights into NZD/USD prospects even in the face of a shock.





NZD/USD Hedging Recommendations

Since mid-2008 we have been producing twice monthly **NZD/USD Hedging Strategy** reports that helped exporters and importers make more informed currency hedging decisions. Since launching this service we have been too busy doing especially contract property research to market the service, but based on positive feedback from clients of this service we decided it warranted a plug. The best way we saw of doing this was by amalgamating the hedging reports with the **Forex Prospects** reports that already have a sizeable client base, which has been achieved by the introduction of two options for subscribers of the **Forex Prospects** reports (i.e. a monthly option and a twice monthly option), and by incorporating the hedging recommendations into these reports.

The philosophy of the hedging recommendations is that exporters should have minimum levels of cover at around peak levels in the NZD/USD and maximum levels at around trough levels, while we fine-tune the recommendations with the help of the leading indicator analysis of near-term prospects for the NZD/USD. Obviously for importers we are trying to help them have maximum levels of cover when the NZD/USD it at peak levels and likely to fall significantly in the near-term, and minimum levels of cover when it is at around a trough level and likely to appreciate significantly in the near-term (that has been the story of 2009 so far). And we try and scale the recommendations up and down as the exchange rate moves through the cycle.

The framework is pretty simplistic and we don't provide advice on specific hedging strategies or instruments. We leave clients to look at these, potentially in consultation with their advisors, while our recommendations must be considered in the context of clients' treasury policies. We convert our views on prospects for the NZD/USD into broad-based hedging recommendations. By doing so we hope to help clients avoid being caught up in the pack mentality that can cost lots of dollars (e.g. the importers that put in place cover in early 2009 encouraged by the economists almost universally predicting that the NZD/USD would head well below US 50 cents just to find that it rebounded well above US 60 cents).