

Weekly Commentary

11 October 2010

Back to reality

The disappointing pace of growth to date weighed on the September *Quarterly Survey of Business Opinion*, with headline confidence turning negative on balance for the first time since June 2009.

The main activity indicators within the survey fared a little better than headline confidence. Investment intentions were only slightly lower, while employment intentions actually rose (although surveyed employment over the last quarter was down). Actual and expected profits were both weaker. As always, the seemingly low levels for these indicators need to be put into context: many of them have been negative on average for decades. Both employment and investment intentions remain above their long-run averages – but admittedly, this far into a recovery, we would expect to see them well above these levels.

By sector, the starkest declines in confidence were seen in construction and manufacturing. The building industry is clearly in a deep malaise, and with good cause. The recovery in house sales and building consents has stalled since the start of this year; long lags in commercial construction mean that the sector is probably just now feeling the full force of the 2008-09 recession. The tax changes in the May Budget were a further blow, leaving property less attractive as an investment (at least at current yields).

We see the tax change as a necessary and

healthy development over the longer term. But for an economy that spent the best part of the last decade addicted to ever-rising property prices, the adjustment will continue to be painful. The current pace of home building remains below what is needed to meet population growth, but between weaker demand for housing as an investment and sharp increases in the cost of building materials, builders aren't confident enough about their margins to address this growing shortage.

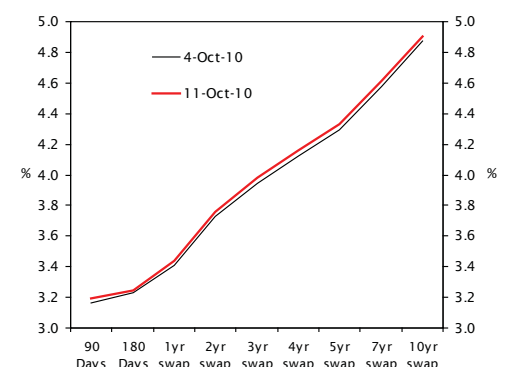
The decline in headline confidence in the manufacturing sector is not as easy to explain. The only marked change in the survey details compared to June was a sharp rise in reported and expected costs, leading to a renewed squeeze on profitability. That aside, manufacturers were if anything a little more optimistic about activity over the next quarter. This at least is understandable: the rip-roaring Australian economy is a key export market for our manufacturers, and the NZD/AUD exchange rate was once again approaching ten-year lows at the time the survey was held.

The economy-wide capacity indicators were little changed on balance. Ease of finding labour fell for the fifth straight quarter, with the manufacturing and service sectors finding it increasingly difficult to attract skilled workers. Capacity utilisation was only slightly lower, and remains near its average of the last decade.

Pricing intentions were always going to be a particular point of interest in this survey, given the impending GST increase on 1 October. Overall, intentions to raise prices were down from a net 32% to 20% since June, but there was a wide range of experiences across sectors. Pricing intentions fell furthest in the beleaguered construction sector, where weak demand has been the dominant effect on prices. Intentions were also down in manufacturing, although this sector is relatively highly weighted towards exports, which are less likely to be affected by GST.

In contrast, pricing intentions in the retail sector surged from 20% to 35% – the highest since the oil-driven spikes in 2006 and 2008. That increase is broadly consistent with what was seen ahead of the GST changes in 1986 and 1989, which were fully passed through to consumers (plus, in 1989 many retailers copped to

NZ Interest Rates



*Yield curve is yields on bank bills to 180 days, fixed interest rate swaps for 1 year onwards.

raising their prices before the GST hike, which wasn't apparent this time).

We are sticking with our assumption that the 2.2% price increase from the GST hike will be fully reflected in retail prices on balance. We already know that supermarkets and petrol stations passed it on fully and immediately – that accounts for about a third of retail spending. Elsewhere, we expect some retailers will try to absorb the hike, while some will use the opportunity to rebuild their margins (and have done so). In some cases such as electronics, the GST may be passed on through slower than usual price declines rather than outright price increases – but that will still be picked up in the CPI.

In broad-brush terms, the QSBO is consistent with GDP growth of 0.2% in Q3. That's not the final verdict though, as there are a number of factors to

consider. First, the survey doesn't cover the agricultural sector; even with the snowstorms in September, growing conditions were better in Q3 than in the drought-afflicted Q2. We also need to account for household spending that was brought forward to September to beat the GST hike – not hinted at in this survey, but clearly shown in September's Paymark data on credit and debit card transactions.

On the downside, the Canterbury earthquake will detract from Q3 GDP, through business disruptions and lost 'consumption' of housing. NZIER suggested there was no discernible impact from the quake in the survey, but also noted that the number of responses from the region was down by 20%. As with our consumer confidence survey, the sample may have been skewed towards those who were relatively unaffected by the quake, and were therefore able and willing to

respond.

All things considered, our initial estimate for Q3 GDP growth is 0.4% – but that is very much subject to change.

The QSBO is likely to reinforce the RBNZ's gloomier outlook on near-term growth prospects, as revealed in the September *Monetary Policy Statement*. One potential point of concern, though, is the absence of any signs of growing slack in the economy, hinting at weak potential as well as actual growth.

Fixed vs. floating: The RBNZ's change of heart suggests that floating rates will remain on hold for several more months; fixed-term rates could rise in that time, but only if there is a substantial turnaround in sentiment on the global economy. As a result, there is no urgency to fix right now.

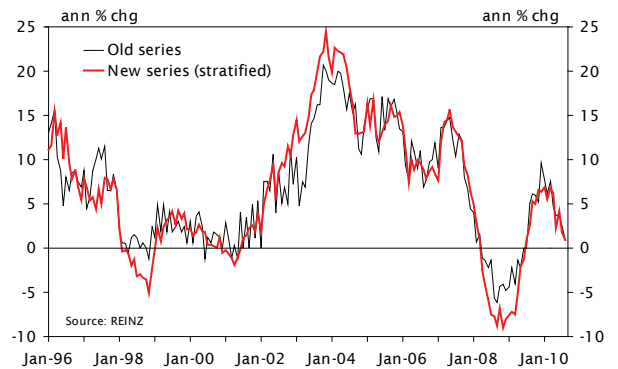
Key Data Previews

NZ Sep REINZ house price index

Oct 14, Last: 0.9% yr

- REINZ data for August revealed ongoing weakness in the housing market with sales reaching their lowest level since January 2009. Days to sell and prices managed to consolidate, but at current levels remain soft.
- Data from a major real estate firm in Auckland suggest that we can expect more of the same in September. For the time being at least, there are few sellers and even fewer buyers.
- That said, our view on the housing market is turning. There has been a large change in the interest rate outlook, and more recently there has been a small change in the outlook for population growth. Together these factors should provide some support to the housing market toward the end of the year. We expect house prices to stop falling in early 2011.

REINZ house prices

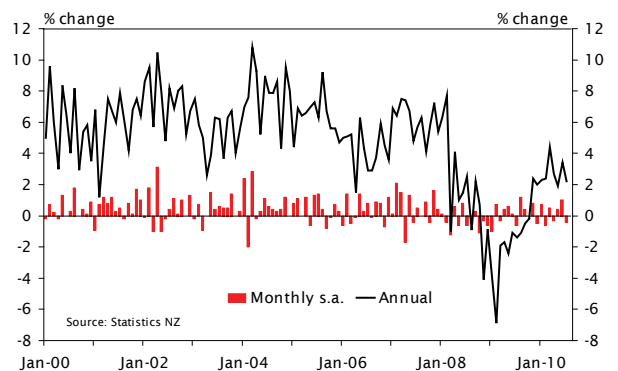


NZ Aug retail sales

Oct 14, Last: -0.4%, WBC f/c: 0.2%, Mkt f/c: 0.4%

- Retail spending unexpectedly fell in July, although most of the decline was confined to a few high erratic storetypes. The overall picture remains one of subdued growth.
- We estimate that core spending was close to flat again in August (down 0.1%). Food and fuel prices were broadly unchanged for the month, and electronic card transactions point to flat or weaker spending in most categories. A rebound in car sales, after a weak patch in July, appears to be the sole bright spot.
- As we expected, card transactions show that the pre-GST spending boost was largely limited to the final days before the 1 October increase. Early estimates suggest that this may have added 2-3% to sales in the September month.

NZ nominal retail sales

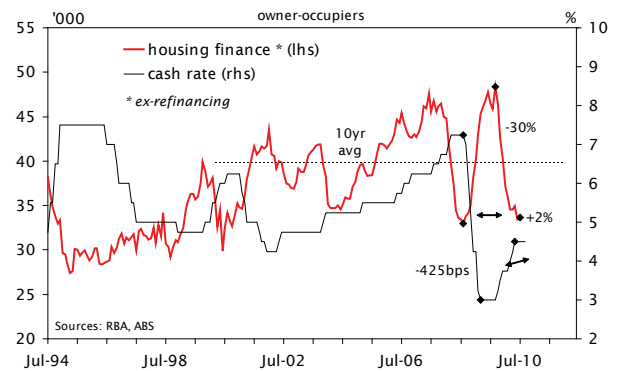


Aus Aug housing finance

Oct 11, Last: 1.7%, WBC f/c: 2.0%, Mkt f/c: 1.0%, Range: -3.0% to 2.5%

- Demand for housing finance has formed a base since April. We anticipate further confirmation in August, forecasting +2.0%.
- The RBA has been on the sidelines for five months, beginning in June. Also, 3 year fixed mortgage rates dropped to 7.15% in August, down from 7.5% in July and from an April peak of 7.8%. However, fixed rates rebounded in Sep to 7.45%. Other pluses are the rebound in Consumer Sentiment (from 102 in June to 113 in Sep) and labour market strength.
- This saw finance to owner-occupiers increase by 1.3% over the 3mths to July (although ex refinancing it fell by 2.5%). As for investors, finance dipped over June and July, falling by 6%. We're expecting the uptrend evident since the start of 2009 to resume in coming months.

Owner-occupier finance and the rate cycle

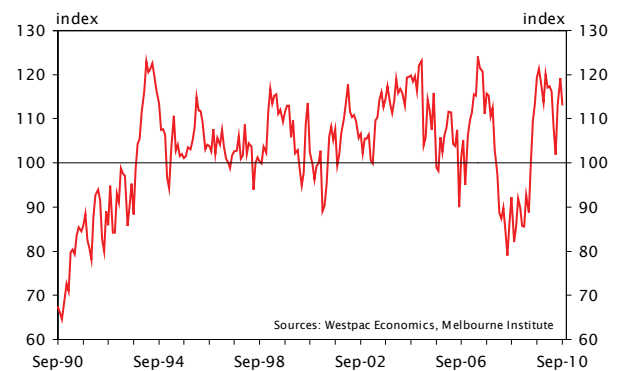


Aus Oct Westpac-MI Consumer Sentiment

Oct 13, Last: 113.2

- The *Westpac-Melbourne Institute Index of Consumer Sentiment* fell 5% in Sep despite a broadly positive run of economic news including the RBA's decision to leave rates unchanged. Some of this pull-back may have reflected over-optimism in Aug with the RBA's decision to leave rates on hold that month coming as more of a surprise. There also appeared to be a political element with the formation of a Labor minority government adding to a sharp fall in sentiment amongst Coalition voters.
- The Oct survey is in the field the week ended Oct 10. The economic news has again been positive with the RBA's surprise decision to leave rates on hold again, a strong rally in the AUD to within spitting distance of parity with the USD, and a bumper Sep jobs gain. Other economic data has been patchier and sentiment may also be weighed down by specific concerns about rising utilities costs and housing market softness.

Consumer sentiment



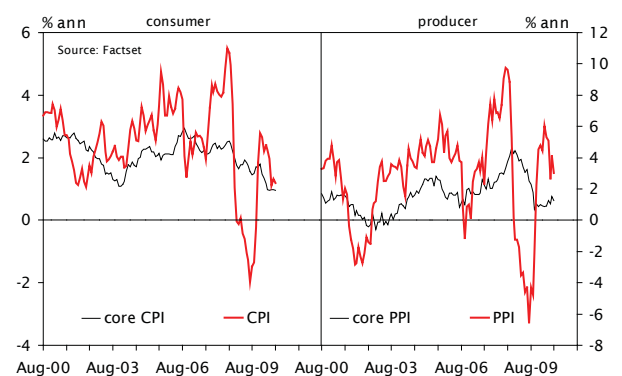
US Sep PPI and CPI: minimal core pressure

Oct 14, PPI Last: 0.4%, WBC f/c: -0.1%, Mkt f/c: 0.2%

Oct 15, CPI Last: 0.3%, WBC f/c: 0.1%, Mkt f/c: 0.2%

- US producer prices rose 0.4% in Aug. A 7.5% jump in gasoline prices was the main upside driver, but food prices fell 0.3% and core prices were up just 0.1%, constrained by a 0.4% fall in auto prices. Survey timing means the Sep PPI should capture the early month fall in energy prices, but food prices should rise. Another low core PPI is in prospect provided vehicle prices behave, so our Sep forecasts are -0.1% for headline PPI, +0.1% for the core.
- The CPI rose 0.3% in Aug, mainly due to a 2.3% rise in the energy component; food prices were up just 0.1%. The core was flat in Aug. This is the fourth month of eight so far this year that the core CPI has been flat or falling - further evidence that very accommodative monetary policy has thus far not aggravated inflationary pressures. Sep should see modest gasoline and food gains but another flat core rate, for a 0.1% headline rise.

US price inflation

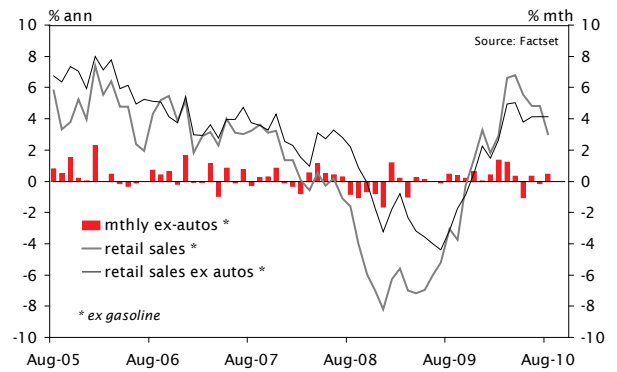


US Sep retail sales

Oct 15, Last: 0.4%, WBC f/c: 0.4%, Mkt f/c: 0.4%

- Retail sales rose 0.4% in Aug. Apparel, food and gasoline were the main drivers of the rise, offsetting falls in auto sales, furniture and electronics. Building materials sales, which had collapsed in May-July (part of the collateral damage from the end of the homebuyer tax credit) were flat. Ex auto sales rose 0.6%; core retailing (ex autos and gas) saw a 0.5% rise. Despite the rise in August retail trends remain weak: 3 month annualised sales were -2.2% for total retailing and -1.0% for core retail.
- Sep unit auto sales were up 2.4% so that could support the retail bottom line but this series has not fitted well with the retail auto component lately. Higher gasoline prices may add a little too. But retailer reports were on balance mixed to softer, suggesting that core retailing will post a soft but positive outcome.
- We expect a 0.4% headline; 0.2% ex auto; 0.2% ex autos/gas.

US retail sales



Key Data and Events

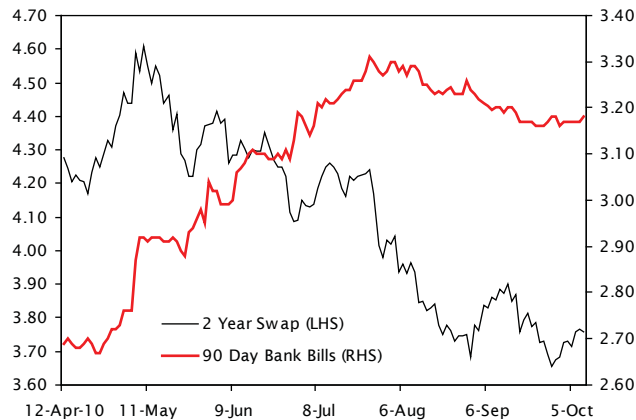
		Last	Market Median	Westpac Forecast	Comments
Mon 11 Oct					
Aus	Aug Housing Finance (no.)	1.7%	1.0%	2.0%	Owner-occupier demand forming a base while RBA on sidelines.
US	Fedspeak	-	-	-	NY Fed's Dudley in DC.
	Columbus Day	-	-	-	Public holiday.
Tue 12 Oct					
Aus	Sep NAB Business Survey	5	-	-	Conditions above trend but off highs. Forward orders weak last 2mths.
US	Sep NFIB Small Business Optimism	88.8	89.6	87.5	Most business surveys weaker in Aug-Sep so NFIB to correct lower.
	Oct IBD/TIPP Economic Optimism	45.3	44.5	44.5	Weekly confidence has been slipping from recent peak in early Sep.
	Sep 21 FOMC Meeting Minutes	-	-	-	More clarity - not that it's needed - about direction of the QE debate.
UK	Sep BRC Retail Sales Monitor %yr	1.0%	-	-	Same store sales accelerated from 0.5% yr to 1.0% yr in Aug.
	Sep RICS House Price net % balance	-32%	-36%	-	House prices seem to be falling back on all major measures now.
	Aug DCLG UK House Prices %yr	8.4%	8.1%	-	One of the lesser watched indices. Slowing from 10.6% yr May peak.
	Sep CPI %yr	3.1%	3.1%	3.2%	BRC shop price index suggests reacceleration.
	Aug Visible Trade Balance £bn	-£8.7	-£8.1	-	Modest factory output gain in Aug suggests exports subdued.
Wed 13 Oct					
NZ	Sep Food Prices	-0.1%	-	-0.5%	Falling due to seasonality, rising exchange rate, weak consumer.
Aus	Oct Westpac-MI Consumer Sentiment	113.2	-	-	Slipped in Sep but strong run of positive econ news heading into Oct.
US	Sep Import Price Index	0.6%	-0.2%	0.0%	Average energy prices little changed or lower but US\$ weaker.
Jpn	Aug Machinery Orders	8.8%	-3.9%	-	Losing out to German and Korean competitors on yen strength.
	Sep Bank Lending %yr	-1.9%	-	-	Demand for credit is low, outlook bleak.
Eur	Aug Industrial Production	0.1%	0.8%	1.0%	German IP known up 1.7% in Aug.
UK	Sep Claimant Count Unemployment chg	2k	4.5k	5k	Unemployment posting modest rises once again.
	Sep Consumer Confidence	61	59	-	Nationwide index. Recent peak 84 in Feb.
Can	Aug New House Prices	-0.1%	-0.1%	-	Yet another indicator pointing to renewed housing market decline.
Thu 14 Oct					
NZ	Sep REINZ House Prices %yr	0.9%	-	-	Market remains in lacklustre state.
	Aug Retail Sales	-0.4%	0.3%	0.2%	Flat food & fuel prices; car sales up but spending otherwise subdued.
Aus	Oct Westpac-MI Unemp. Expectations	102.0	-	-	Consolidating back at low levels. Positive jobs data helping.
	Oct MI Inflation Expectations	3.1%	-	-	Ticked up in Sep but has been trending lower since April.
US	Sep PPI	0.4%	0.2%	-0.1%	Energy prices lower at start of month, core prices settling around new
	Sep PPI ex food and energy	0.1%	0.1%	0.1%	lower trend at 0.1-0.2% provided vehicle prices didn't jump around.
	Aug Trade Balance \$bn	-42.8	-44.1	-46.0	Very volatile of late, but trend is towards wider deficit.
	Initial Jobless Claims w/e 9/10	445k	443k	455k	Claims finding a new trend around 450k.
	Fedspeak	-	-	-	Richmond Fed's Lacker.
Jpn	Sep Corporate Goods Prices %yr	flat	flat	-	Durables deflation, raw materials had a month of two halves.
Can	Aug Merchandise Trade Balance C\$bn	-2.7	-2.3	-	Have not seen a significant surplus since Feb.
Fri 15 Oct					
US	Sep CPI	0.3%	0.2%	0.1%	Gasoline price gains along with some upside risk on food to lift the
	Sep CPI ex food and energy	0.0%	0.1%	0.0%	headline but another very soft core CPI is likely.
	Sep Advance Retail Sales	0.4%	0.4%	0.4%	Some lift from auto sales and higher gasoline prices but core retailing
	Sep Retail Sales Less Autos	0.6%	0.3%	0.2%	to be subdued.
	Oct NY Fed Empire State Factory Index	4.1	6.0	0.0	Surveys to soften in line with our view economy losing momentum.
	Oct Uni of Michigan Confidence Prelim	68.2	69.0	67.0	Weekly indicators point to sentiment softening.
	Aug Business Inventories	1.0%	0.5%	0.4%	Weighed down by minimal growth in factory stocks.
	Fedspeak	-	-	-	Chair Bernanke at Boston Fed conf; also Lockhart in Atlanta.
	Sep Monthly Budget Statement \$bn	-47	-32	-	Budget deficit impacted by less fiscal stimulus, slower eco growth.
Eur	Sep CPI Core %yr	1.0%	1.0%	-	Core inflation has been within 0.8-1.0% yr all year.
	Aug Trade Balance sa €bn	-0.2	-0.8	-	Have not seen a surplus since April.
Can	Aug Manufacturing Sales	-0.9%	0.5%	-	Jun-Jul saw first back to back falls since late 2008.
	Aug New Motor Vehicles Sales	2.4%	-5.0%	-5.0%	StatCan guidance for a 5% fall.

New Zealand Economic and Financial Forecasts

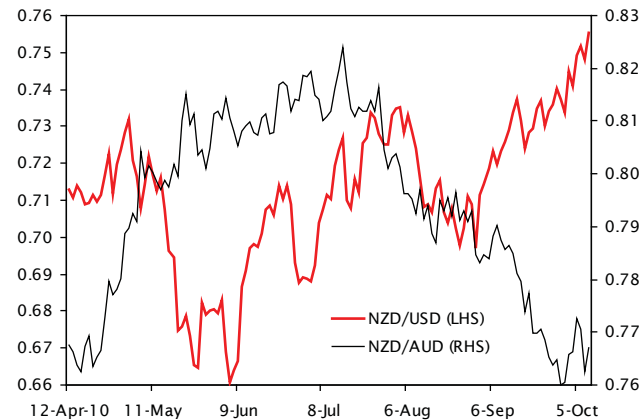
Economic Growth Forecasts	March years				Calendar years			
	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
% change								
GDP (Production) ann avg	-0.4	2.3	4.2	3.2	-1.7	2.0	4.3	3.1
Employment	-0.1	1.0	2.1	2.6	-2.4	1.3	2.6	2.2
Unemployment Rate % s.a.	6.0	6.4	5.8	4.4	7.1	6.7	5.6	4.7
CPI	2.0	4.3	1.7	2.7	2.0	3.9	1.9	2.5
Current Account Balance % of GDP	-2.4	-4.0	-5.6	-5.3	-2.8	-3.5	-5.4	-5.5

Financial Forecasts	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Cash	3.00	3.25	3.50	4.00	4.50	4.75	5.00
90 Day bill	3.20	3.50	3.90	4.40	4.90	5.10	5.30
2 Year Swap	3.80	4.00	4.30	4.80	5.20	5.50	5.70
5 Year Swap	4.40	4.60	4.90	5.30	5.60	5.80	5.90
10 Year Bond	4.90	5.00	5.10	5.30	5.60	5.70	5.80
NZD/USD	0.76	0.78	0.82	0.79	0.78	0.76	0.76
NZD/AUD	0.75	0.76	0.78	0.80	0.81	0.82	0.82
NZD/JPY	63.1	64.7	68.1	71.1	74.1	76.0	79.0
NZD/EUR	0.53	0.54	0.55	0.56	0.57	0.56	0.56
NZD/GBP	0.47	0.47	0.46	0.46	0.46	0.45	0.44
TWI	66.6	67.8	69.9	70.4	71.1	70.5	70.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 11 October 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	3.00%	3.00%	3.00%
30 Days	3.16%	3.12%	3.11%
60 Days	3.17%	3.17%	3.19%
90 Days	3.20%	3.17%	3.19%
2 Year Swap	3.76%	3.69%	3.88%
5 Year Swap	4.33%	4.29%	4.49%

NZ foreign currency midrates as at Monday 11 October 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7559	0.7359	0.7289
NZD/EUR	0.5402	0.5460	0.5747
NZD/GBP	0.4739	0.4643	0.4749
NZD/JPY	61.870	61.960	61.500
NZD/AUD	0.7641	0.7638	0.7865
TWI	66.930	66.540	67.740

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2005	2006	2007	2008	2009	2010f	2011f
Australia							
Real GDP % yr	2.8	2.9	4.0	2.2	1.2	3.5	4.0
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	3.2	3.2
Unemployment %	5.1	4.8	4.4	4.3	5.6	5.2	4.8
Current Account % GDP	-5.8	-5.3	-6.3	-4.5	-4.4	-3.0	-2.8
United States							
Real GDP %yr	3.1	2.7	2.1	0.0	-2.6	2.5	1.1
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.3	1.5	2.2
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.8	10.2
Current Account %GDP	-6.1	-6.0	-5.3	-4.7	-2.7	-3.2	-2.8
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	3.3	1.1
Consumer Prices %yr	-0.3	0.2	0.1	1.4	-1.3	-0.8	-0.4
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	5.1	5.0
Current Account %GDP	3.6	3.9	4.8	3.3	2.8	3.3	3.4
Euroland							
Real GDP %yr	1.8	3.2	2.9	0.3	-4.0	1.6	1.4
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.9	1.5	1.4
Unemployment Rate %	8.8	7.9	7.3	7.8	10.0	10.5	10.5
Current Account %GDP	-0.2	-0.1	0.1	-1.1	-1.0	-0.5	0.0
United Kingdom							
Real GDP %yr	2.2	2.8	2.7	-0.1	-5.0	1.4	1.1
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.8	2.8
Unemployment Rate %	2.8	3.0	2.5	3.1	5.0	4.5	5.0
Current Account %GDP	-2.6	-3.3	-2.7	-1.6	-2.4	-2.0	-1.5

Forecasts finalised 8 October 2010

Interest Rate Forecasts	Latest (Oct 11)	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Australia						
Cash	4.50	4.75	5.00	5.25	5.25	5.25
90 Day Bill	4.84	5.00	5.25	5.50	5.50	5.50
10 Year Bond	5.03	5.35	5.50	5.50	5.25	5.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.39	2.35	2.25	2.50	2.75	3.25
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00
Exchange Rate Forecasts						
AUD/USD	0.9893	1.02	1.03	1.05	0.99	0.96
USD/JPY	91.85	83	83	83	90	95
EUR/USD	1.3993	1.43	1.45	1.50	1.41	1.38
AUD/NZD	1.3088	1.34	1.32	1.28	1.25	1.23

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