

Weekly Commentary

14 June 2010

One down ...

In a week chock full of data, the key event was the RBNZ's 25 basis point OCR hike. The accompanying statement made it clear this should be seen as the first step in an extended series of rate hikes: "we have decided to begin removing some of the monetary policy stimulus that is currently in place".

The debate from here on will be around when and how much: "The further removal of stimulus will be reviewed in light of economic and financial market developments".

The RBNZ's projection for 90-day interest rates showed the cash rate rising to 5.5-6.0% over the next few years. That's not quite consistent with a 25bp hike at every review date for the next couple of years - but it's not far off. The RBNZ is now confident that the economy is normalising, which implies that monetary policy settings should do the same. There's an element of rebalancing going on, so the recovery isn't being felt in all parts of the economy: household spending and credit growth are still subdued, and firms' stated intentions to increase investment are not yet being acted upon. But on the plus side, the growth outlook for our major trading partners has continued to improve, and export commodity prices have reached new highs. This boost to export earnings is expected to eventually flow through to income growth in other parts of the economy.

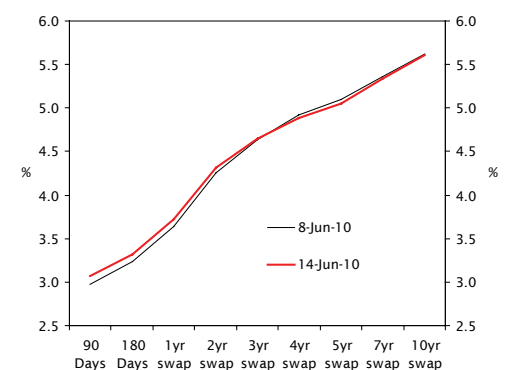
The market was perhaps surprised by the RBNZ's relative comfort about the recent financial market ructions related to Europe's sovereign debt woes - though it had said as much in the *Financial Stability Report* last month. While the RBNZ highlighted this as a substantial downside risk, the only impact on its central projections was in terms of the 'knowns': a downward revision to already-weak growth forecasts for Europe, and a rise in bank funding costs that the RBNZ assumes will be sustained.

The other reason for raising rates now is the inflation outlook. Recent government policies - the GST increase, the Emissions Trading Scheme, and several rounds of tobacco excise hikes - will add 2.8 percentage points to the inflation rate at their peak early next year. As a consequence, the RBNZ expects annual inflation to reach 5.3% in June 2011, then moderate to around 2.7% in the latter years of their forecasts. The initial spike can be ignored, but the risk is that high inflation could feed into wage- and price-setting behaviour over the medium term, causing an ongoing inflation dynamic. Once inflation expectations become embedded they can be difficult to squeeze out, and the RBNZ's own survey indicates that medium-term inflation expectations have already risen back towards the upper end of the 1-3% target range. The RBNZ appears to have adopted a cautious approach, running more

with hawkish monetary policy as a hedge against the possibility of higher inflation expectations. This was expressed in their forecasts, which featured higher interest rates, a higher exchange rate, and higher bank funding costs, all of which cause lower economic growth and lower inflation once the effect of GST and other policy changes have washed out. That may well prove to be a prudent decision.

Other data over last week set a generally disappointing tone. In Tuesday's Q1 Quarterly Survey of Manufacturing, manufacturing sales declined 2.7%, mainly due to a 10.3% decline in dairy and meat product manufacturing. Ex-meat-and-dairy manufacturing sales were up only 1.3%, and production was probably flat. Building work put in place rose 0.7% in Q1, again slightly weaker than expected. Residential building work pick up by a modest 2.0%,

NZ Interest Rates



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

while the shake-out in non-residential construction continued with a further 0.8% decline. We are still finalising our Q1 GDP forecast, but these data point in the direction of a significant downward revision to our current forecast of 0.8%.

The Q1 Terms of Trade rose by a phenomenal 5.9%, as last year's booming dairy prices finally hit the official figures. Another rise in Q2 is expected to propel the terms of trade to a new three-decade high. The Overseas Trade Index showed that import volumes were weaker than expected at 2.8%, while export volumes rose 3.0%, suggesting net exports will make a solid contribution to Q1 GDP growth. This was further confirmation of the weak consumer / strong export dynamic that has characterised the NZ economy throughout 2010.

The weak consumer was in evidence yet again when May electronic card transactions rose only 0.2%, while April retail sales data confirmed a decline in spending following the pre-Easter spending boost in March. Meanwhile food prices fell by 0.7%, a large enough surprise to have us revising down our Q2 CPI forecast from 0.5% to 0.4%. It looks as though the strong exchange rate is being passed through relatively quickly into lower consumer prices.

This week is a little less busy on the data front. We expect ongoing weakness in the housing market to show up in the REINZ's sales and price figures on Tuesday. And, Wednesday's Westpac McDermott Miller Consumer Confidence survey will be an interesting test of how consumers have interpreted the Budget.

Fixed vs. floating: Last week, as was widely anticipated, the RBNZ kicked off what we expect to be an extended tightening cycle. Nevertheless the decision to fix or float remains finely balanced. Floating rates remain lower than short-term fixed rates at the moment, but they are likely to rise faster as the RBNZ increases the OCR. Fixing, if even for a short term, has the advantage of greater certainty around cash flows, at a time when floating rates could be rising rapidly. Repaying more than the minimum amount, and spreading the loan over a mix of terms, can also help to reduce the overall risk around uncertain future interest rate changes.

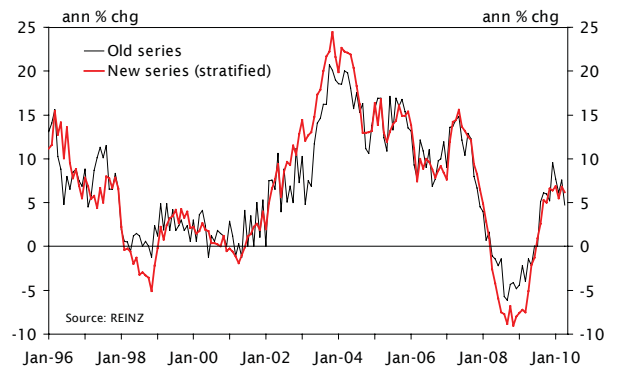
Key Data Previews

NZ May REINZ house price index

Jun 15, Last: 6.2% yr

- The April REINZ report indicated a lacklustre housing market, with house sales still 4.3% below the December 2009 level, prices declining, and days to sell lengthening.
- With at least some of the recent weakness likely related to tax uncertainty surrounding Budget 2010 (which was released on May 20), we expect the May housing data to reveal a similar subdued picture.
- Looking forward, the tax changes in the Government's 2010 Budget were a clear negative for house price growth in the short term. Thus, while there could be a surge in sales over coming months as people reorganise their affairs to reflect their changed tax position, we do not anticipate an improvement on prices.

REINZ house prices

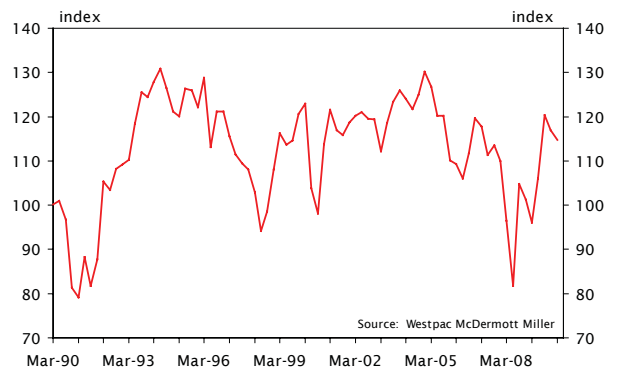


NZ Q2 consumer confidence

Jun 16, Last: 114.7

- Consumer confidence moved modestly lower in the March 2010 quarter, but at 114.7 remained at a high level. A reassessment of future conditions drove the decline, while consumers' assessment of current conditions actually improved.
- Economic news has been a bit of a mixed bag in recent months, but on the whole we expect the good to outweigh the bad.
- On the upside, unemployment has fallen sharply, high business confidence points to further improvements in the labour market, Fonterra has indicated a near-record payout for farmers in 2011, and the Government's 2010 Budget included \$15bn of income tax cuts over the next four years.
- On the downside inflation is spiking, and the near term outlook for house prices is weaker.

NZ Consumer Confidence

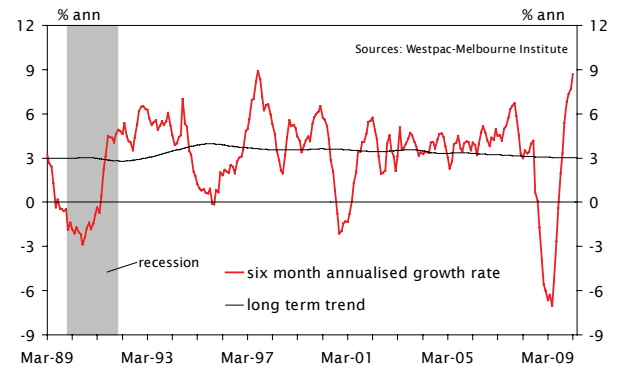


Aus Apr Westpac-MI Leading Index

Jun 16, Last: 8.7% annualised

- The *Westpac-Melbourne Institute Leading Index* continued riding high in March. The annualised growth rate in the index – a guide to the likely pace of activity over the following three to nine months – was 8.7%, a long way above its long term trend of 2.8%.
- Despite a rapid deterioration in financial markets since May, the Index’s monthly components were still fairly mixed in April. Equity markets registered a mild fall, the ASX down 1.4% after a 5.1% bounce in March (it has fallen another 8.8% since then); dwelling approvals slumped 14.8% but this was just a partial unwind of March’s 16.8% jump; money supply growth fell back from the fairly rapid 1.5% registered in March to a more subdued 0.4% in April; but growth in US industrial production picked up from 0.2%*mt* to 0.8%*mt*.

Westpac-MI Leading Index



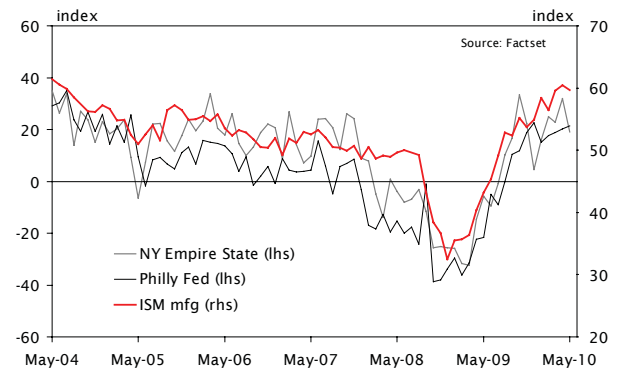
US Jun NY and Philly Fed surveys

Jun 15, New York Fed: Last: 19, WBC f/c: 24, Mkt f/c: 20

Jun 17, Philadelphia Fed: Last: 21, WBC f/c: 17, Mkt f/c: 20

- Both these regional Fed factory surveys surged in the second half of 2009, the NY index peaking at 33 (highest since 2006) in Oct and Philly at 23 (highest since 2005) in Dec. Since peaking, they pulled back a touch, then recovered in April back to levels just shy of those late 2009 highs. However in May the NY index fell nearly 13 pts whereas Philly rose a further point.
- The softer NY Fed index could be an early indication that we are in for a period of slower industrial growth, as the impact on activity of fiscal stimulus and inventory building wanes. The Richmond and Dallas Fed factory indices also moderated in May. Hence we expect the Philly index to moderate in June.
- However the scale of the NY Fed index’s May decline, and its inherent volatility, suggests that it will bounce in June, but leave in place a downtrend that will continue in H2 2010.

US manufacturing surveys



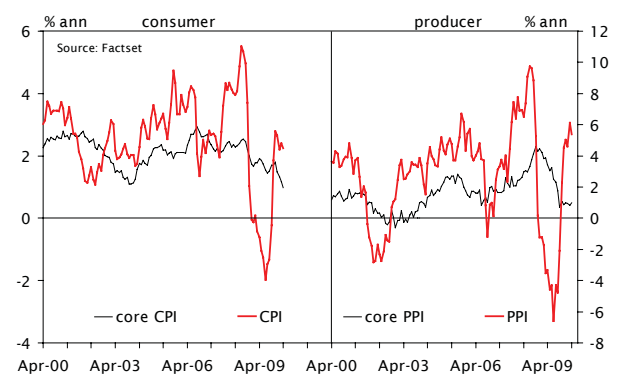
US May PPI and CPI

Jun 16, PPI headline: Last: -0.1%, WBC f/c: -0.9%, Mkt f/c: -0.5%

Jun 17, CPI headline: Last: -0.1%, WBC f/c: -0.1%, Mkt f/c: -0.2%

- The PPI headline has recently been boosted by sharp food price gains (due to recent weather damage to crops) on top of persistent energy price rises and volatility in new auto and truck prices (a big driver of swings in the core rate). But in April food and fuel prices began to reverse, although the core rate was held at 0.2% by higher auto prices. In May, fuel prices dumped and we expect that to drag the headline PPI down by almost 1%.
- Despite pressure from some components of the PPI, there has been minimal pass-through to retail prices, as evidenced by flat to negative headline/core CPI outcomes this year. Anecdotally, consumer goods firms say they have no pricing power and are wearing higher costs via narrower margins. In May, lower gasoline prices should weigh on the headline CPI again and the third consecutive flat core rate is expected.

US price inflation



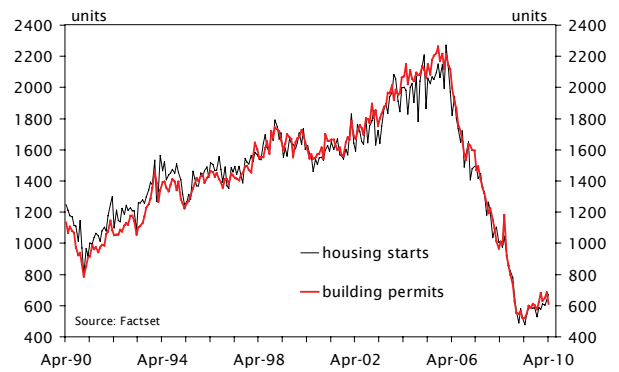
US May housing starts and permits

Jun 16, Starts: Last: 5.8%, WBC f/c: -5.0%, Mkt f/c: -3.7%

Jun 16, Permits: Last: -10.9%, WBC f/c: 0.0%, Mkt f/c: 2.5%

- Housing starts jumped 6% in Apr, led by single family homes (multiples fell sharply), but housing permits fell 11%, more than eliminating permits' previous lead over starts – perhaps a sign that the end of the tax credit for homebuyers in April is already impacting on future construction activity.
- Assuming that is the case, then we expect a sizeable fall in starts in May, of around 5%, with more declines to come into mid-year, depending on the extent to which the tax credit pulled activity forward. The May decline would be steeper were it not for a likely bounce in the volatile multiples component.
- Housing permits likely have further to fall too, though the size of the April pull-back means May could see temporary stability particularly if the multiples component bounces.

US housing starts and permits

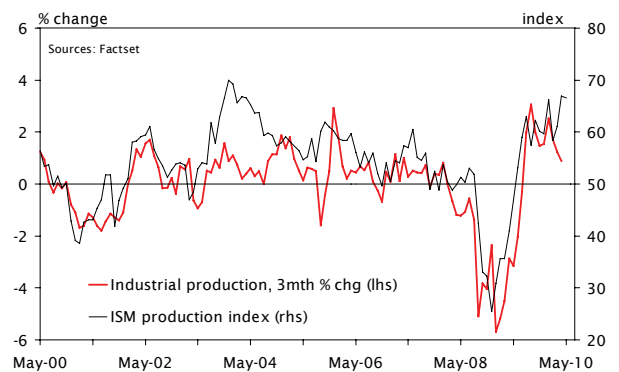


US May industrial production

Jun 16, Last: 0.8%, WBC f/c: 1.2%, Mkt f/c: 0.8%

- US industrial production rose a solid 0.8% in April, and the factory sector was even stronger at 1.0% – the difference due to an ongoing contraction in utility output following the very cold weather earlier in the year.
- The factory ISM for May showed marginal slippage in the production index but it remained at a very high level (66.6), in contrast to slippage in many of the regional factory surveys. April orders data were mixed outside of the transport sector which was solid. Hours worked in the factory sector were up an impressive 1.4% in May.
- These factors point to a rise in industrial production in excess of 1% but the orders and regional survey wobbles hint at some downside risks, sufficient to prevent us from forecasting a rise in output faster than the gain in factory hours worked.

US industrial sector: expansion mode



Key Data and Events

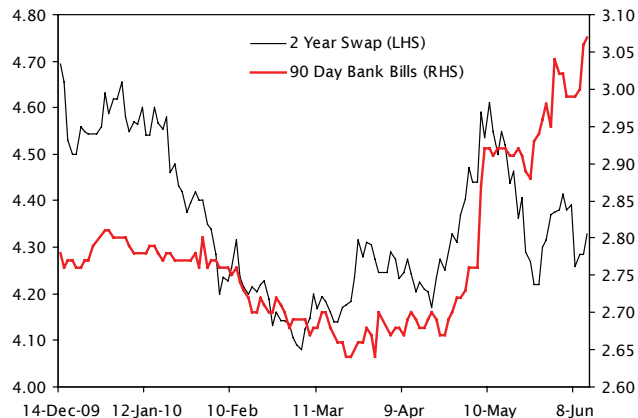
	Last	Market Median	Westpac Forecast	Comments	
Mon 14 Jun					
Aus	Queen's Birthday Holiday	-	-	-	Public holiday in ACT, NSW, NT, Qld, Tas, Vic and SA.
Jpn	Apr Industrial Production (F) %yr	31.8	-	-	Initial weaker: also includes capacity utilisation measure.
Eur	Apr Industrial Production	1.5%	0.5%	0.6%	German IP known up 0.9% in April.
Can	Apr Auto Sales	-4.2%	-5.0%	-5.0%	Guidance for Apr from StatCan is a 5% fall.
Tue 15 Jun					
NZ	May REINZ House Prices %yr	6.2%	-	-	Uncertainty around tax changes still influencing market.
Aus	RBA Deputy Governor Battellino Speaking	-	-	-	Sydney (12:30 AEST) to Financial Executives International of Australia.
	Jun RBA Board Meeting Minutes	-	-	-	On hold "near term" amidst global uncertainty; focus on int'l outlook.
US	May Import Prices	0.9%	-1.3%	-2.0%	Plunging oil prices to drive import prices lower.
	Jun NY Fed Factory Index	19.1	20.0	24.0	Bounce from sharp May plunge but still well off its peak.
	Apr Net Long Term TIC Flows \$bn	140.5	30.0	-	Guide to extend/composition of current account deficit funding.
	Jun NAHB Housing Market Index	22	21	20	Homebuilder confidence waning as buyer tax credit impact fades.
Jpn	BoJ Policy Decision	0.10%	0.10%	0.10%	First meeting under Prime Minister Kan.
Eur	Apr Trade Balance sa €bn	0.6	1.5	-	Consistently in surplus since September last year.
Ger	Jun ZEW Economic Sentiment	45.8	42.0	40.0	Analysts are surely even more concerned about prospects for 2010.
UK	May RICS House Price Balance %	17%	15%	-	Bottomed at 9% in March: fewer surveyors expect higher prices.
	May CPI %yr	3.7%	3.5%	3.5%	Base effects and BRC shop price index point to lower annual rate.
	Apr House Prices %yr	9.7%	10.0%	-	Lesser watched DCLG measure.
Can	Q1 Productivity	1.4%	1.3%	-	Strong GDP growth but jobs have been rising too.
Wed 16 Jun					
NZ	Q2 Consumer Confidence	114.7	-	-	Indicators a mixed bag, but overall should support confidence.
Aus	Apr Leading Index 6m ann'lsd%	8.7%	-	-	Riding high in March but components became more mixed in April.
	Q1 Dwelling Commencements	14.5%	7.0%	5.0%	Already up 27% over 2009H2 but still 12% below Q1 approvals.
US	May Producer Prices	-0.1%	-0.5%	-0.9%	Sharp oil price declines to weigh on headline PPI, while core will
	May PPI Core	0.2%	0.1%	0.0%	continue to be impacted by auto and truck price volatility.
	May Housing Starts	5.8%	-3.7%	-5.0%	April decline in permits suggests pull-back in post tax credit activity
	May Housing Permits	-10.9%	2.5%	0.0%	will be fairly immediate.
	May Industrial Production	0.8%	0.8%	1.2%	Hours worked in factories up 1.4% in May. Business surveys solid.
Eur	May CPI (F) %yr	1.6%a	1.6%	1.6%	Core rate was just 0.8% yr in April.
	Q1 Labour Costs %yr	2.2%	2.1%	-	Sharp deceleration in H2 2009.
UK	May Unemployment Change	-27k	-20k	-25k	Recent declines reflect return to GDP growth but jobs still falling too.
	May Consumer Confidence	74	72	-	Tentative date for Nationwide index.
Thu 17 Jun					
US	May Consumer Price Index	-0.1%	-0.2%	-0.1%	Gasoline prices drifted lower in May and with core CPI expected to be
	May Core CPI	0.0%	0.1%	0.0%	flat for third month running headline CPI should fall again.
	Initial Jobless Claims w/e 12/6	456k	450k	450k	Initial claims downtrend appears to have stalled.
	Q1 Current Account Balance \$bn	-115.6	-121.8	-	Trade deficit widening again but income & other flows not yet known.
	Jun Philadelphia Fed Index	21.4	21.0	17.0	Delayed replication of NY Fed's May decline.
	May Leading Index	-0.1%	0.4%	-	April saw first LEI decline since April last year.
Eur	Jun ECB Monthly Report	-	-	-	Not usually market mover but these are interesting days!
UK	May Retail Sales incl fuel	0.3%	0.1%	-	Somewhat lacklustre since Jan-Feb volatility.
	Jun CBI Industrial Trends Survey	-18	-15	-	New orders measure. May was well improved on previous readings.
Can	Apr Wholesale Sales	1.4%	0.3%	-	March rise reversed Feb fall.
Fri 18 Jun					
Ger	May PPI %yr	0.6%	0.8%	-	April saw first positive annual % gain since Feb last year.
UK	May Mortgage Approvals, Major Banks	47k	50k	-	Down from recent peak of 62k in Nov last year.
	May PSNCR £bn	8.8	20.5	-	Last figures ahead of June 22 "lifechanging" budget.
	May M4 Money Supply %yr	3.3%	3.2%	-	Slowed from Feb 2009 high of 17.7% yr.
Can	May Leading Index	0.9%	0.7%	-	Has not posted a decline since April last year.

New Zealand Economic and Financial Forecasts

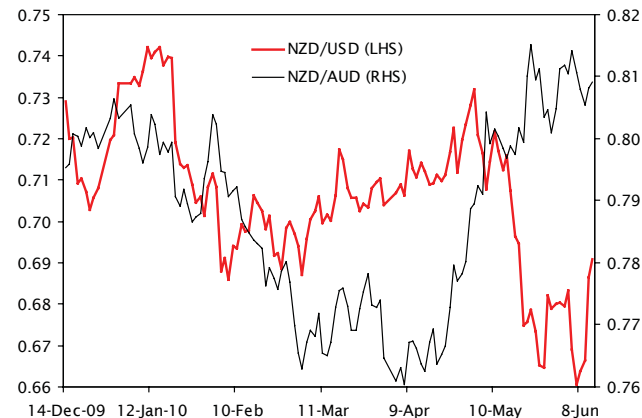
Economic Growth Forecasts	March years				Calendar years			
	2009	2010f	2011f	2012f	2009	2010f	2011f	2012f
% change								
GDP (Production) ann avg	-1.4	-0.3	4.1	4.2	-1.6	3.4	4.4	3.4
Employment	0.7	-0.1	2.1	1.8	-2.4	2.7	1.8	1.3
Unemployment Rate % s.a.	5.1	6.0	5.3	5.0	7.1	5.5	5.0	4.9
CPI	3.0	2.0	5.1	2.7	2.0	4.9	2.6	3.1
Current Account Balance % of GDP	-7.9	-2.6	-3.3	-4.4	-2.9	-3.0	-4.4	-4.4

Financial Forecasts	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Cash	3.25	3.75	4.25	4.75	5.25	5.75	6.00
90 Day bill	3.70	4.20	4.70	5.20	5.70	6.10	6.20
2 Year Swap	4.80	5.20	5.50	5.90	6.20	6.40	6.50
5 Year Swap	5.70	5.90	6.10	6.30	6.50	6.60	6.70
10 Year Bond	6.00	6.10	6.20	6.30	6.30	6.40	6.50
NZD/USD	0.72	0.74	0.76	0.75	0.74	0.73	0.72
NZD/AUD	0.82	0.82	0.83	0.83	0.83	0.84	0.84
NZD/JPY	65.5	70.3	74.5	76.5	78.4	79.6	80.6
NZD/EUR	0.58	0.60	0.63	0.64	0.64	0.63	0.62
NZD/GBP	0.50	0.51	0.53	0.53	0.53	0.52	0.51
TWI	69.1	71.2	73.8	74.0	74.0	73.9	73.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 14 June 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.75%	2.50%	2.50%
30 Days	2.96%	2.72%	2.64%
60 Days	3.03%	2.86%	2.80%
90 Days	3.08%	2.98%	2.92%
2 Year Swap	4.32%	4.37%	4.52%
5 Year Swap	5.06%	5.23%	5.37%

NZ foreign currency midrates as at Monday 14 June 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.6905	0.6800	0.7074
NZD/EUR	0.5698	0.5524	0.5722
NZD/GBP	0.4743	0.4676	0.4867
NZD/JPY	63.340	61.920	65.410
NZD/AUD	0.8111	0.8049	0.7988
TWI	67.260	65.980	68.030

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	2.3	1.3	3.0	3.5
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	3.3	3.1
Unemployment %	5.1	4.8	4.4	4.2	5.6	5.1	4.8
Current Account % GDP	-5.8	-5.3	-6.3	-4.4	-4.1	-3.4	-3.0
United States							
Real GDP %yr	3.1	2.7	2.1	0.4	-2.4	2.7	2.8
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.2	1.3	2.4
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.7	9.9
Current Account %GDP	-6.1	-6.0	-5.3	-4.9	-2.9	-3.2	-2.4
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	3.3	2.0
Consumer Prices %yr	-0.3	0.2	0.1	1.4	-1.3	-1.1	-0.2
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	4.8	4.5
Current Account %GDP	3.6	3.9	4.8	3.3	2.8	4.0	4.3
Euroland							
Real GDP %yr	1.8	3.1	2.8	0.5	-4.0	0.8	1.2
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.9	1.0	1.2
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	2.9	2.6	0.5	-4.9	0.7	1.4
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.5	2.0
Unemployment Rate %	2.8	3.0	2.5	3.1	5.0	5.0	5.0
Current Account %GDP	-2.6	-3.3	-2.7	-1.6	-2.4	-2.0	-1.5

Forecasts finalised 4 June 2010

Interest Rate Forecasts	Latest (Jun 14)	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Australia						
Cash	4.50	4.75	5.00	5.00	5.25	5.50
90 Day Bill	4.90	5.00	5.20	5.20	5.50	5.75
10 Year Bond	5.40	5.60	5.90	5.90	6.00	6.00
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.375
US 10 Year Bond	3.24	3.40	3.50	4.00	4.20	4.50
ECB Repo Rate	1.00	1.00	1.00	1.00	1.25	1.50
Exchange Rate Forecasts						
AUD/USD	0.8513	0.88	0.90	0.92	0.90	0.88
USD/JPY	91.73	92	95	98	102	105
EUR/USD	1.2119	1.22	1.22	1.18	1.18	1.16
AUD/NZD	1.2329	1.22	1.22	1.21	1.20	1.19

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