Westpac

Weekly Commentary

14 September 2009

Keeping up appearances

The Reserve Bank left the cash rate on hold at 2.50% last week as expected, and maintained the slightest trace of an easing bias.

The most significant change was that the explicit statement that "the OCR could still move modestly lower over the coming quarters" was removed, but they repeated that it was expected to remain "at or below" the current level until the latter part of 2010.

The RBNZ acknowledged the ongoing signs of recovery in the global and domestic economies, but as we warned, they regarded the recent gain in the New Zealand dollar as completely offsetting the other good news. Consequently, their GDP forecasts were little different from the June *Monetary Policy Statement*, and their interest rate track showed no change in the expected timing of rate hikes.

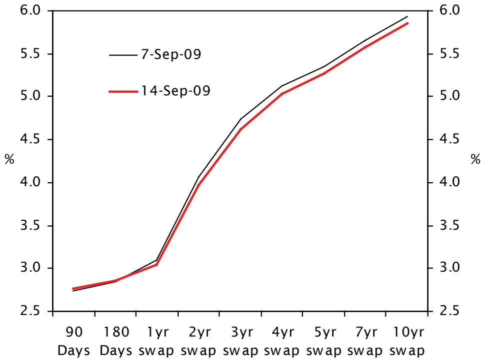
Given the RBNZ's concerns about the tightening in financial conditions, we think that the nod to an easing bias was solely aimed at tempering market pricing: if it had been removed completely, the market could have taken it as a green light to push the NZD and interest rates even higher. In that sense, it's really a cosmetic bias, since there isn't really a case for acting on it under current conditions.

Their wariness is understandable, given that market pricing is already running ahead of where the RBNZ would like it to be. Much has been made of the supposed clash of views as to the timing of the first rate hike – the market currently puts it in March 2010 – though this in itself isn't a big deal. Governor Bollard has commented that "markets don't do stability well", but a better way of putting it is that they don't do discontinuity well. The RBNZ's interest rate projections imply no action until late 2010, then a continuous series of hikes. The markets will always be inclined to price in a smooth path for interest rates, which inevitably means an earlier start for tightening.

That aside, there is a substantial divergence between where the market and the RBNZ see interest rates over the next few years. Why this level of disbelief? Part of the problem may be communication: the RBNZ have a tendency to muddle their views on monetary policy over the short to medium term with their concerns about the mix of growth over the longer term. For example, they have highlighted the risk of a return to debt-fuelled consumption that could prove to be unsustainable; but it's not at all clear how this is supposed to make the case for keeping rates low for an extended period.

We'll offer a couple of arguments in the RBNZ's favour. First, the recovery in the housing market in recent months is real but is not, as some have claimed, a resumption of the housing bubble. There is a risk of a renewed bubble if rates are kept low for too long, but for now the rumours of its rebirth are greatly exaggerated. According to the REINZ's new stratified house prices measure out today, prices have risen 5.9% since the lows in January, but they are still down 6.2% from their peak in November 2007. Similarly, house sales have bounced in recent months but are still running about 10% below their long-term trend. Growth in housing debt has slowed to a crawl. And this is with surging net migration and some of the lowest mortgage rates on record. We do expect a bit more life in house prices, given the definite lift in activity indicators (days-to-sell dropped further in August, down from 36 to 33

NZ Interest Rates



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

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seasonally adjusted) but neither the RBNZ nor we are expecting boom times to return.

Second, there is still a significant amount of slack in the economy, and will be for some time. Our upbeat growth forecasts would still only see GDP back to its pre-recession levels by the end of next year – never mind the shortfall relative to potential output, which would have continued to rise in that time. Recent business surveys show that some firms are starting to look at hiring again, but we'd be surprised if they were having difficulty in finding skilled workers, with the number of unemployed still on the rise. With so much spare capacity to be soaked up, a resurgence in inflation is simply not on the cards over the next couple of years.

For now, the divergence between market pricing and the RBNZ is not a major deal. But it could get very interesting by early next year: the market could be pushing hard for rate hikes based on the resumption of growth, while the RBNZ will be more concerned about the level of activity (and the exchange rate) and the degree of inflation pressure implied. The other significant release last week was the terms of trade for the June quarter. The 9% fall was the steepest quarterly drop since 1975. Export prices fell by 11.6%, led by a 24% drop in dairy prices. This was largely payback for their resilience through last year – the lag between contract and delivery can be as much as a year – so this was very much old news. Similarly, the recent pickup in dairy prices at auction is unlikely to be reflected in the terms of trade for several more quarters. Elsewhere, the details were largely a stronger NZ dollar story, though with a few surprises – oil prices were actually lower in NZD terms, which we put down as a timing issue.

The flipside of particularly weak export prices is that volumes were even stronger than expected, up 7% for the quarter. This was driven by a 24% rise in dairy volumes, as milk powder that was stockpiled at the end of last year continued to be sold down. Combined with a 1.9% drop in import volumes, we estimate that net exports added 2% to Q2 GDP. However, a lot of this is likely to be balanced out by a rundown in inventories. Our current forecast for production GDP (the generally preferred measure) is for a 0.4% decline.

Retail sales for July were also released today. Both core and total sales fell 0.5% m/m, weaker than expected. Higher car sales and cheaper petrol offset each other. Department store sales fell for a third month despite higher consumer confidence, likely reflecting the weaker labour market.

Fixed vs. floating: In the last couple of months we have seen borrowers gradually moving out of floating rates and returning to short-term fixed rates. These rates are the most favourable on offer, and will remain so for some time. But they're unlikely to remain at current levels once we see a more substantial shift by borrowers into these terms – in the same way that the extremely low long-term rates available prior to March didn't last for long once borrowers actually started taking them up. Borrowers should seriously consider fixing now, bearing in mind that they can reduce uncertainty about future cash flows by choosing a lower interest rate today and repaying more than the minimum amount.

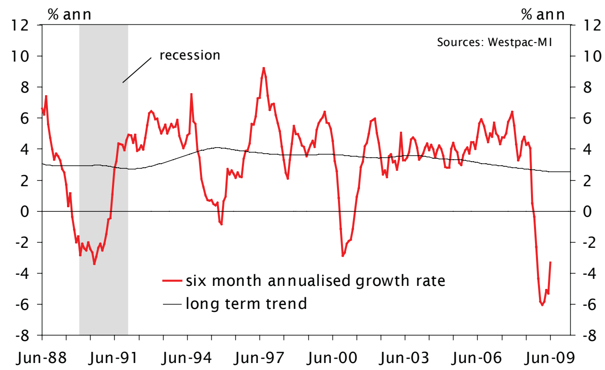
Key Data Previews

Aus Jul Westpac-MI Leading Index

Sep 16, Last: –3.3% annualised

- The annualised growth rate of the *Westpac–Melbourne Institute Leading Index*, which indicates the likely pace of economic activity three to nine months into the future, was –3.3% in June, up significantly on its February low point of –6.1% but still well below its long term trend of 2.6%.
- Most monthly components improved in June: the equity market surged strongly (ASX up 7.3% in the month); dwelling approvals posted another strong rise, up 7.7%mth; and US industrial production was up 0.5%mth – the first rise since October last year and after a string of large monthly falls. Against this, growth in the money supply moderated to 0.5% from 0.8% in June.
- The July read will also include updated quarterly data for Q2, which showed a sharp 7.6% fall in corporate profits but a jump in productivity as GDP outstripped hours worked.

Westpac-MI Leading Index

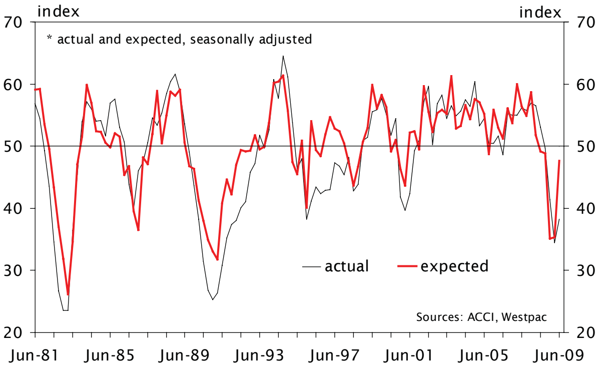


Aus Q3 Westpac–ACCI Survey of Industrial Trends

Sep 17, Last: Actual Composite Index: 38.3

- The Q2 Westpac–ACCI Survey showed a 3.9pt rise in the Actual Composite Index to 38.3 (highest since 2008Q4), partially reversing a 6.9pt fall previously. The Index implied a milder pace of manufacturing contraction, but remained below its decade average (52.3) for the fourth quarter. The Labour Market Composite net balance rose 8pts to –25, historically consistent with a deterioration in jobs growth through 2009H2 to around –1½%yr. The net balance reporting finance as 'harder to get' eased to 11% from a 34 year high of 40%.
- Amidst signs of global recovery and Australian domestic demand resilience, expectations improved solidly. The Expected Composite Index jumped 12.3pts to 47.6 (highest since 2008Q3) and general business sentiment surged 57pts to –4 (highest since 2007Q4).
- The Q3 survey was concluded in the week ended September 11.

*Westpac-ACCI composite indexes**

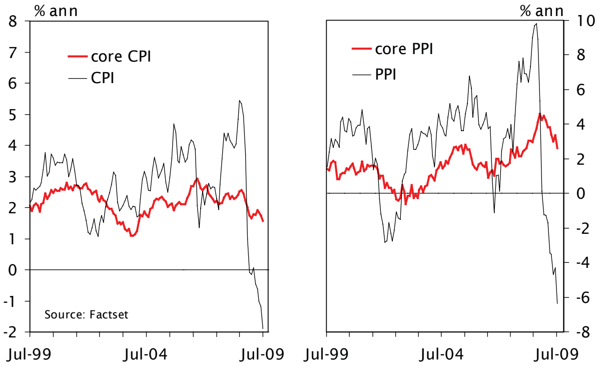


US Aug PPI and CPI – auto prices likely a factor

Sep 15, PPI headline Last: –0.9%, WBC f/c: 1.2%, Mkt f/c: 0.8%
Sep 16, CPI headline Last: flat, WBC f/c: 0.2%, Mkt f/c: 0.3%

- The PPI fell 0.9% in July, dragged lower by a 10% fall in gasoline prices and a 1.5% drop in food prices. The core rate fell 0.1%, thanks to falling auto prices (an early impact from the cash for clunkers scheme), a renewed negative for capital goods prices (including light trucks) and a small fall in apparel. August's renewed energy price spike will see the headline PPI rise sharply, although auto prices should print a further negative and this, along with subdued prices elsewhere, should deliver a flat core rate.
- Similar story for the CPI. Energy prices off 0.4%, food prices down 0.2% and the core rate up 0.1%, held the headline CPI to flat (despite a 0.3% rise in autos). In Aug, auto prices should fall due to cash for clunkers, holding the core rate to 0.0%, but gasoline prices are likely to spike, lifting the headline 0.2%.

US inflation

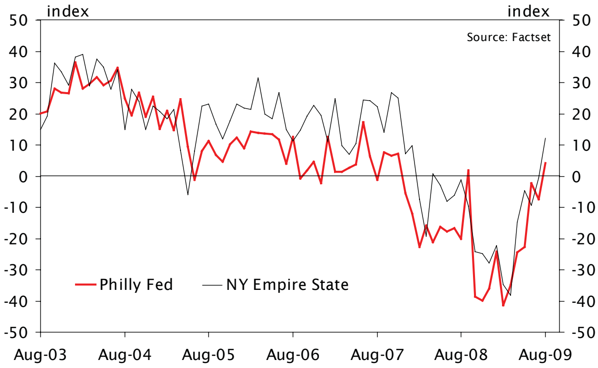


US Sep NY and Philly Fed surveys

Sep 15, New York Fed: Last: 12, WBC f/c: 18, Mkt f/c: 15
Sep 17, Philadelphia Fed: Last: 4.2, WBC f/c: 8.5 Mkt f/c: 8.0

- These surveys helped kick off the clichéd "green shoots of recovery" story that emerged in March-April, by turning sharply less negative – consistent with a slower pace of industrial contraction. Then in August, both rose above 0 (joining the Richmond Fed), indicative of industrial sector expansion.
- Without local agents it is difficult to forecast these surveys of just 100 bosses. However, with the ISM factory index in August (whose survey period overlaps with the regional Fed surveys for Sep) pushing sharply above the neutral 50 level, we expect both Empire and Philly to rise further.
- These outcomes would be broadly consistent with the economy expanding at around a 2-3% annualised pace in the third quarter.

US regional manufacturing surveys

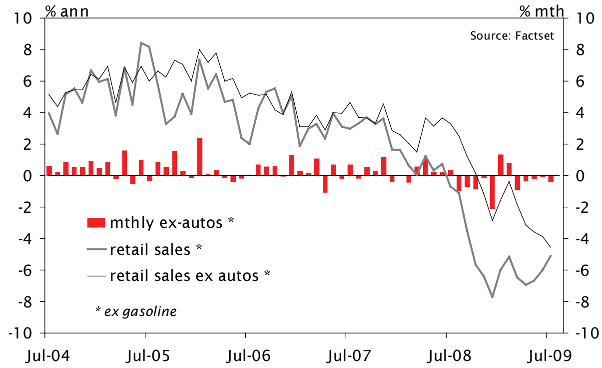


US Aug retail sales boosted by autos

Sep 15, Last: –0.1%, WBC f/c: 2.0%, Mkt f/c: 1.9%

- Retail sales fell 0.1% in July, with a smaller than expected 2.4% rise in auto sales offset by sluggish sales elsewhere, and falling gasoline prices.
- The "cash for clunkers" scheme was hailed a success, resulting in a 25% increase in auto unit sales in Aug, on top of 16% in July. That should drive a sharp headline gain in retail sales, supported also by the renewed upswing in gasoline prices.
- A big ticket purchase like a car tends to constrain spending elsewhere. But we have mixed evidence on chain store sales for Aug, with monthly data actually quite solid.
- Tying all this together we expect a 2.0% surge in headline retail, with upside risk, and a bounce in ex auto retailing from –0.6% in Jul to 0.5% in Aug.

US retail sales

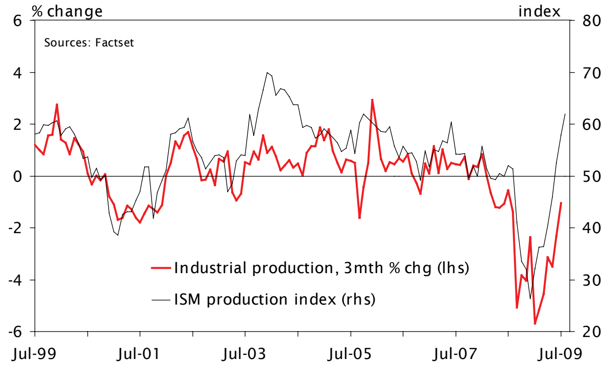


US Aug industrial production to post another gain

Sep 16, Last: 0.5%, WBC f/c: 0.5% Mkt f/c: 0.6%

- Since the beginning of last year, industrial production had just one monthly gain (in Oct 2008), prior to July's 0.5% rise. Although not as steep as the Oct gain, the July rise should prove to be sustainable: the beginning of an industrial recovery of sorts, after the steep contraction of the past year and a half.
- Survey evidence points to a sharp production gain. In particular, the ISM manufacturing index jumped from 57.9 to 61.9, a multi-year high. But that positive signal contrasts with the news that hours worked fell in Aug, including in the auto sector.
- Hence we are only forecasting another 0.5% gain in IP, but that would represent the first back to back gains in factory output since 2007 – and there is some upside risk if it turns out that increasing output doesn't require hours worked to rise at current low levels of output when there is plenty of spare capacity.

US industrial production rebounds

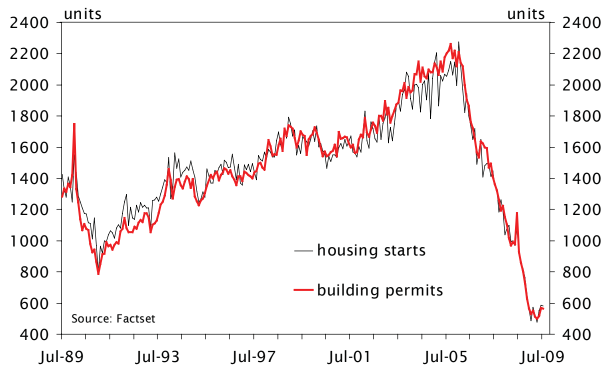


US Aug housing starts and permits

Sep 17, Starts: Last: –1.0%, WBC f/c: 4.0%, Mkt f/c: 2.1%
Sep 17, Permits: Last: –1.1%, WBC f/c: 4.0%, Mkt f/c: 2.5%

- On a range of indicators, housing has shown clear signs of turnaround after several years of tumbling prices and activity. Single family house starts have not posted a fall since January, surged nearly 18% in June and rose a further 1.7% in July; that strength looks to be sustainable with new home sales now up four months running including 9% gains in both June and July.
- In August, construction jobs fell by 65k (less than in June–July), and homebuilder confidence rose to its highest in over a year. These factors point to a further rise in single family house starts. Also multiple starts dropped a cumulative 40% in Jun–Jul, so an August multiples bounce would add to the headline starts rise.
- Permits should also post a headline rise, if multiples bounce after falling 26% in July.

US housing starts and permits



Key Data and Events

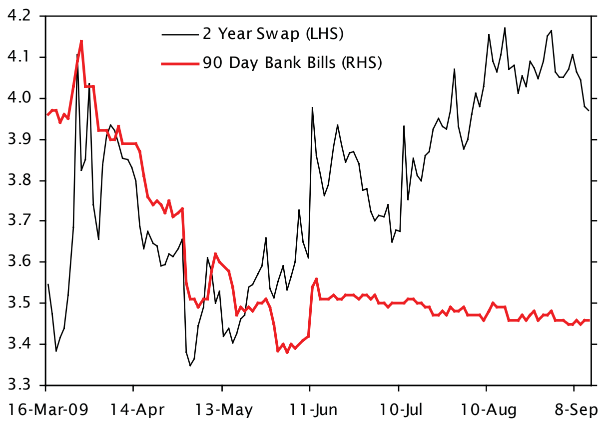
		Last	Market Median	Westpac Forecast	Comments
Mon 14 Sep					
US	Fedspeak	–	–	–	Lacker on financial regulation; Yellen on economic outlook.
Eur	Jul Industrial Production	-0.6%	-0.2%	-0.5%	German data known, down 0.9%.
Can	Q2 Capacity Utilisation	69.3%	65.5	–	Falling sharply as economy slides.
Tue 15 Sep					
NZ	Q2 Real Manufacturing Sales	0.2%	–	–	Business surveys suggest another quarter of production decline.
Aus	Q2 Dwelling Commencements	-4.0%	2.0%	-1.0%	Approvals up 6.5% in Q2 but previous plunge still dragging on starts.
	RBA Minutes of September Meeting	–	–	–	To be closely watched – how urgent is the desire to raise rates?
US	Aug PPI	-0.9%	0.8%	1.2%	Renewed energy price spike.
	Aug PPI Core	-0.1%	0.1%	0.0%	Auto price drag not to be reversed until Sep.
	Aug Retail Sales	-0.1%	1.9%	2.0%	Auto sales known up 25%, gasoline prices up (after seas adjustment).
	Aug Retail Sales Ex Auto	-0.6%	0.4%	0.5%	Monthly chain store data suggest ex auto gain.
	Sep NY Fed "Empire State" Index	12.0	15.0	18.0	High teens reading consistent with GDP growth in 2-3% range.
	Sep IBD-TIPP Economic Optimism	50.3	51.0	52.0	Increasing confidence the worst is now behind.
	Jul Business Inventories	-1.1%	-0.9%	-0.7%	Early clue to contribution of stocks to Q3 GDP.
Eur	Q2 Labour Costs %yr	3.7%	3.4%	–	Spiked late last year but easing again.
Ger	Sep ZEW Survey	56.1	60.0	70.0	Equity gains & economy out of recession – fuel for analyst confidence.
UK	Aug RICS House Price Balance	-8.1%	0.0%	–	Will a slim majority of surveyors assess house prices as rising?
	Aug CPI %yr	1.8%	1.4%	1.3%	Base effects helpful. BRC shop prices down sharply.
	Jul House Prices %yr	-10.7%	-9.5%	–	Lesser watched DCLG (govt) measure.
Can	Jul Auto Sales	-0.6%	5.0%	5.0%	Preliminary StatCan guidance is for a 5% rise.
	Q2 Labour Productivity	0.3%	0.8%	–	Slight uptrend in place as output fell faster than work effort up to Q1.
Wed 16 Sep					
Aus	Jul Westpac-MI Leading Index	-3.3%	–	–	Monthly inputs improved sharply in July but quarterly mixed for Q2.
US	Aug CPI	flat	0.3%	0.2%	Higher gasoline prices will lift the headline CPI but core prices should
	Aug CPI Core	0.1%	0.1%	0.0%	remain constrained, with auto prices likely negative.
	Q2 Current Account Balance $bn	-101.5	-92.0	–	Less dramatic improvement in trade deficit in Q2.
	Jul TIC Data $bn	90.7	–	–	Net long term TIC flows.
	Aug Industrial Production	0.5%	0.6%	0.5%	ISM survey suggests gain but auto hours worked fell, a downside risk.
	Sep NAHB Housing Market Index	18	19	20	Starts, permits, sales picking up.
Eur	Aug CPI (F) %yr	-0.2% a	-0.2%	-0.2%	Base effects driving annual rate higher in late 2009.
UK	Aug Unemployment chg	25k	25k	15k	Still growing but at a dramatically slower pace.
Can	Jul Manufacturing Sales	1.9%	2.5%	–	Aerospace boost in June; autos in July?
Thu 17 Sep					
Aus	Q3 WBC-ACCI Survey of Industrial Trends	38.3	–	–	+3.9pts in Q2 to highest since 4Q'08, implying milder mfg contraction.
	Aug Merchandise Imports AUDbn	16.7	–	–	Up 6.5% in Jul, translating to 4.2% sa; strengthening C goods uptrend.
	RBA Monthly Bulletin	–	–	–	Bulletin can include latest RBA research articles.
US	Aug Housing Starts	-1.0%	2.1%	4.0%	Both starts and permits fell in Jul due to volatile multiples component
	Aug Housing Permits	-1.1%	2.5%	4.0%	but single family trend is clearly rising.
	Initial Jobless Claims w/e 12/9	550k	555	540k	Watch for risk of distortion from Labor Day holiday.
	Sep Philadelphia Fed Index	4.2	8.0	8.5	Not as dramatic as Empire, but consistent with industrial expansion.
Jpn	Q3 BSI All-Industry Index	-22.4	–	–	Very deep sample, but lacks Tankan's venerable history.
	Jul Tertiary Activity Index	0.1%	0.5%	–	Activity rose in Q2, and should do so again in Q3, albeit narrowly.
	Bank of Japan Meeting	0.10%	0.10%	0.10%	We will be sitting here for a very considerable period of time.
Eur	Jul Trade Balance €bn	1.0	1.2	–	Back in surplus since April.
UK	Aug Retail Sales	0.4%	0.1%	0.0%	Private sector surveys imply weaker month for retail spending.
	Sep CBI Industrial Trends Survey	-54	–	–	Orders measure.
Can	Aug CPI %yr	-0.9%	-0.6%	–	Base effects to push ann rate higher a little in Aug, big time from Oct.
	Aug Leading Index	0.4%	0.6%	–	Has not posted a decline since April.
Fri 18 Sep					
Eur	Jul Current Account Balance €bn	-5.3	–	–	Trade surpluses not enough to bring current account back to surplus.
Ger	Aug PPI %yr	-7.8%	-7.2%	-6.8%	Base effects to start driving PPI annual rate higher again.
UK	Aug PSNCR £bn	0.2	14.5	–	Serious public finances deterioration under way.
	Aug Money Supply M4 %yr	14.5%	13.8%	–	Impact of quantitative easing not readily apparent in these data yet.
Can	Jul Wholesale Sales	0.6%	0.8%	–	June saw first rise since Sep last year.

New Zealand Economic and Financial Forecasts

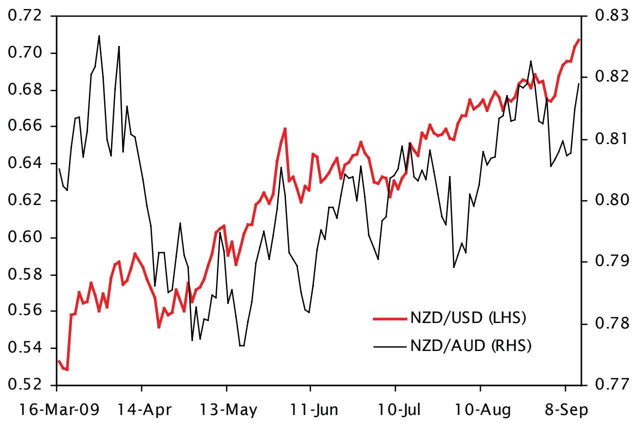
Economic Growth Forecasts	March years				Calendar years			
% change	2008	2009	2010f	2011f	2008	2009f	2010f	2011f
GDP (Production) ann avg	3.1	-1.0	-1.2	3.2	0.2	-2.1	2.6	3.6
Employment	-0.3	0.7	-1.3	1.1	0.9	-2.5	0.8	1.4
Unemployment Rate % s.a.	3.8	5.0	7.0	6.8	4.7	6.9	6.9	6.6
CPI	3.4	3.0	1.9	1.6	3.4	2.1	1.2	2.1
Current Account Balance % of GDP	-8.0	-8.5	-4.5	-5.5	-9.0	-4.7	-5.3	-6.3

Financial Forecasts	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Cash	2.50	2.50	2.50	3.00	4.00	5.00	5.50
90 Day bill	2.80	2.80	2.90	3.60	4.60	5.50	5.90
2 Year Swap	4.10	4.30	4.60	5.00	5.40	5.85	6.15
5 Year Swap	5.40	5.50	5.60	5.80	6.00	6.30	6.45
10 Year Bond	5.80	5.90	6.00	6.20	6.30	6.40	6.50
NZD/USD	0.63	0.67	0.69	0.71	0.74	0.73	0.72
NZD/AUD	0.79	0.81	0.81	0.82	0.83	0.85	0.84
NZD/JPY	56.7	62.3	66.2	70.7	76.2	77.4	78.5
NZD/EUR	0.45	0.47	0.48	0.49	0.50	0.50	0.49
NZD/GBP	0.39	0.40	0.40	0.41	0.40	0.39	0.38
TWI	59.2	62.4	64.0	65.9	67.8	67.8	67.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 14 September 2009

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.81%	2.77%	2.79%
60 Days	2.79%	2.75%	2.80%
90 Days	2.77%	2.78%	2.79%
2 Year Swap	3.97%	4.17%	4.17%
5 Year Swap	5.27%	5.41%	5.47%

NZ foreign currency midrates as at Monday 14 September 2009

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7056	0.6850	0.6764
NZD/EUR	0.4839	0.4779	0.4763
NZD/GBP	0.4233	0.4207	0.4089
NZD/JPY	63.700	63.700	64.190
NZD/AUD	0.8188	0.8125	0.8135
TWI	64.330	63.400	63.070

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2004	2005	2006	2007	2008	2009f	2010f
Australia							
Real GDP % yr	3.8	2.8	2.9	4.0	2.4	0.7	2.5
CPI inflation % annual	2.6	2.8	3.3	3.0	3.7	1.9	2.0
Unemployment %	5.4	5.1	4.8	4.4	4.3	5.9	7.3
Current Account % GDP	-6.1	-5.8	-5.3	-6.3	-4.6	-4.0	-4.9
United States							
Real GDP %yr	3.9	3.1	2.8	2.1	0.4	-2.8	1.4
Consumer Prices %yr	2.6	3.4	3.2	2.9	3.8	-0.8	1.1
Unemployment Rate %	5.5	5.1	4.6	4.6	5.8	9.4	11.1
Current Account % GDP	-5.7	-6.1	-6.0	-5.2	-4.9	-2.9	-2.7
Japan							
Real GDP %yr	2.3	1.9	2.8	2.2	-1.0	-5.8	1.5
Consumer Prices %yr	-0.1	-0.3	0.2	0.1	1.4	-1.1	-0.7
Unemployment Rate %	4.5	4.4	4.1	3.9	4.0	5.3	6.4
Current Account % GDP	3.3	3.6	3.9	4.8	3.2	2.6	2.9
Euroland							
Real GDP %yr	1.9	1.8	3.1	2.7	0.6	-4.1	0.2
Consumer Prices %yr	2.1	2.5	2.0	3.1	1.6	0.3	0.7
Unemployment Rate %	9.0	8.8	7.9	7.3	7.8	10.0	11.5
Current Account % GDP	0.0	-0.2	-0.5	0.0	-0.2	0.0	0.4
United Kingdom							
Real GDP %yr	3.0	2.2	2.9	2.6	0.7	-4.4	0.5
Consumer Prices %yr	1.3	2.1	3.0	2.1	3.5	1.0	1.2
Unemployment Rate %	2.8	2.8	3.0	2.5	3.1	5.5	7.0
Current Account % GDP	-1.9	-2.6	-3.0	-2.8	-2.3	-3.0	-3.0

Forecasts finalised 4 September 2009

Interest Rate Forecasts	Latest (Sep 14)	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Australia						
Cash	3.00	3.00	3.25	3.50	3.75	4.00
90 Day Bill	3.41	3.40	3.75	4.00	4.25	4.50
10 Year Bond	5.27	5.50	5.80	6.25	6.25	6.35
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.35	3.40	3.75	4.00	4.25	4.50
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.25

Exchange Rate Forecasts	Latest (Sep 14)	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
AUD/USD	0.8618	0.80	0.83	0.85	0.87	0.89
USD/JPY	90.280	90	93	96	99	103
EUR/USD	1.4582	1.40	1.42	1.44	1.46	1.49
AUD/NZD	1.2214	1.27	1.24	1.23	1.22	1.20