

Weekly Commentary

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A weekly outlook for New Zealand, Australia and US markets

15 June 2009

Down so long, feels like up

The RBNZ left the cash rate unchanged at 2.50% last week, which was seen by financial markets and most domestic forecasters as the most likely outcome.

The RBNZ repeated the message from the April OCR review that further modest rate cuts are possible (though not their central view), and that the cash rate is expected to remain at or below the current level until the latter part of 2010.

The RBNZ noted that the economic outlook is weaker than in their March *Monetary Policy Statement*, and with substantial risks to the downside. But they now seem to be more convinced by the extent and sustainability of the 'green shoots' in the economy, in the form of a stabilisation in activity indicators offshore (particularly in Asia) and a pickup in housing and net migration in New Zealand. In fact, a large portion of the *MPS* was devoted to teasing out the extent and sustainability of the eventual recovery. This focus on the next cycle might seem premature to some, but it's consistent with the RBNZ's focus on activity and inflation pressures one to two years ahead.

Their interest rate projections were markedly different from the March *MPS*. The 90-day rate is expected to remain around the current level of 2.8% until late 2010 – they had said as much in the last two OCR reviews. The more notable change was that the following tightening cycle is projected to be extremely slow, with 90-day rates only reaching 4% by early 2012. This is clearly a message aimed at financial markets to keep a lid on

short-term wholesale rates, where recent OCR cuts have been most effective.

The recent tightening in financial conditions remains a bugbear for the RBNZ, although long-term interest rates came in for less attention than in April. The press statement noted that "although rising longer-term interest rates overseas are placing upward pressure on longer-term lending rates here, there is room for further reductions in shorter-term lending rates" – a statement that serves double duty as a nudge to banks to pass on more of the recent OCR cuts, and as a reminder to borrowers that short-term fixed mortgage rates are the cheapest point on the curve at the moment and are likely to remain so for some time.

The strength of the New Zealand dollar received more attention – although 'strength' is a relative concept, as the trade-weighted index is still a touch below its long-term average. The issue is whether currency markets have moved too far ahead of the recovery in the real economy, to the extent that a stronger currency could stifle a recovery in exports.

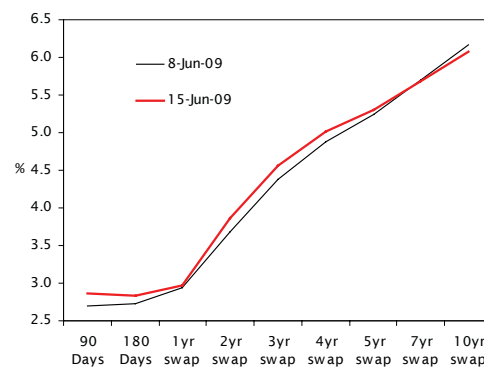
We'd argue that if the market is correct in anticipating a pickup in global demand, a higher currency won't provide a complete offset, whereas if market optimism is overdone then it will reverse of its own accord. The only problem would be if the currency remained strong while the global economy remained weak – an inconsistent mix that's unlikely to be sustained for long.

Yet it seems to be incorporated into the RBNZ's central view anyway: "The concern that a premature tightening in financial conditions could undermine the recovery is one of the reasons why we expect the OCR to remain around current levels until the latter part of next year."

The RBNZ's real fear, as detailed in an alternative scenario in the *MPS*, is that a stronger NZD presages a return to the economic imbalances of recent years: rising house prices driving an increase in household spending, while a stronger currency hammers the export sector. We think it's a valid concern – little has happened since the credit crisis to alter the relative appeal of debt-fuelled consumption versus saving and investment – and keeping interest rates at record lows for the foreseeable future certainly wouldn't help to address the balance.

The RBNZ believe they are done with the 'big picture' phase of the easing cycle,

NZ Interest Rates



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

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though they retain the option of further tactical rate cuts if needed. The difficulty they now face is communicating the message to the market that an improving economy doesn't equate to rate hikes. Rising unemployment and lower capacity utilisation mean that the RBNZ are a long way from having to worry about any substantial inflation pressures building in the domestic economy. Their forecasts see GDP running at more than 4% below potential over the next year, and even with strong growth in later years, the economy isn't expected to close this gap before 2012.

The market reaction to the MPS suggests

that this message will be a hard sell: two- to five-year swap rates rose by more than 30bp on the day. Markets are now pricing in up to 200bps of tightening by the end of next year, taking their lead from a similar trend overseas. Inevitably this will lead to calls for the RBNZ to 'do something', such as cutting rates again to send a message to the market. While we are leaning towards further cuts this year, we think they would need to be justified by the fundamentals. Lowering rates, simply to send a message that rates aren't going up, seems futile and potentially risky – it's just as likely to be viewed as something that will need to be unwound in the near future. The RBNZ would be better

served by maintaining their 'no hikes' message, and in the meantime trying to steer the public debate away from growth and back towards inflation – specifically, the lack of it.

Fixed vs. floating: With the RBNZ nearing the end of its easing cycle, short-term rates are unlikely to fall significantly further, while long-term rates will continue to anticipate the next tightening cycle. For those borrowers currently on floating rates who have been looking to time their re-entry into fixed rates, we recommend fixing now for six months to one year, which are easily the most favourable rates on offer.

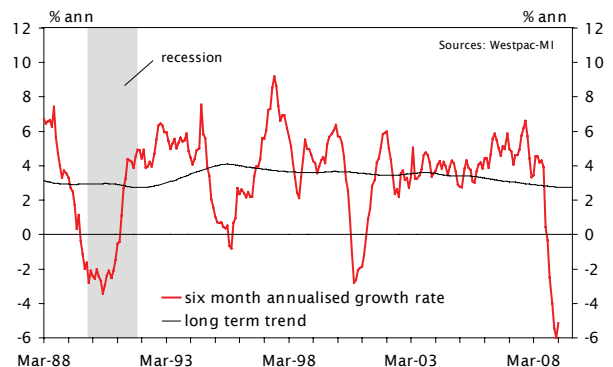
Key Data Previews

Aus Apr Westpac-MI Leading Index

Jun 17, Last: -5.1% 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 -5.1% in March, well below its long term trend of 2.8%.
- All monthly components improved in April: equity markets continued to rally (ASX up 5.5%); dwelling approvals also posted another solid 5.1% rise in the month; money supply growth rebounded with a 1.1% rise after a flat March; and even US industrial production registered a smaller decline, down just 0.5% compared to the 1.7% drop in March.
- The April Leading Index will also incorporate series from the Q1 national accounts. The better than expected positive result saw improvements in the components that feed into the Index with corporate profits down a milder 0.3% (vs -7.5% in Q4) and productivity rebounding after two quarterly declines.

Westpac-MI Leading Index

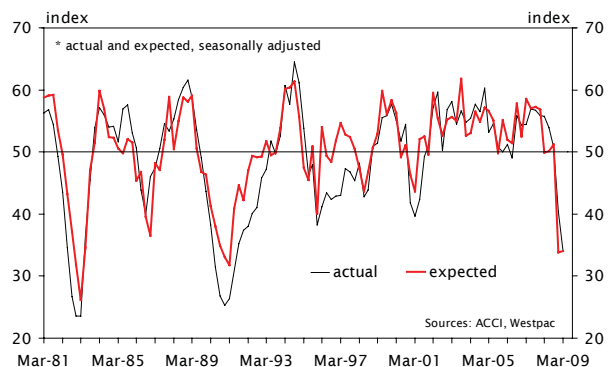


Aus Q2 Westpac-ACCI Survey of Industrial Trends

Jun 18, Last: Actual Composite Index: 34.0

- The Q1 Westpac-ACCI Survey showed a further fall in the Actual Composite Index to 34.0 (lowest since 1991Q2) from 40.4, consistent with a sharper contraction in manufacturing activity, amidst a backdrop of deteriorating global growth and trade, weak domestic demand and constrained finance. The Labour Market Composite net balance plunged 17pts to -33 implying a rapid fall in jobs growth through 2009. Perceptions of labour market tightness fell to a level consistent with a rise in unemployment above 8%. The net balance reporting finance as 'harder to get' remained at its highest since 1974. Business confidence (-61%) was steady at a more than 18 year low.
- The June quarter survey (concluded week ended June 12) will provide an important update on how conditions, expectations and confidence have fared in Q2 amidst emerging "green shoots" of a recovery in global demand.

Westpac-ACCI composite indexes*



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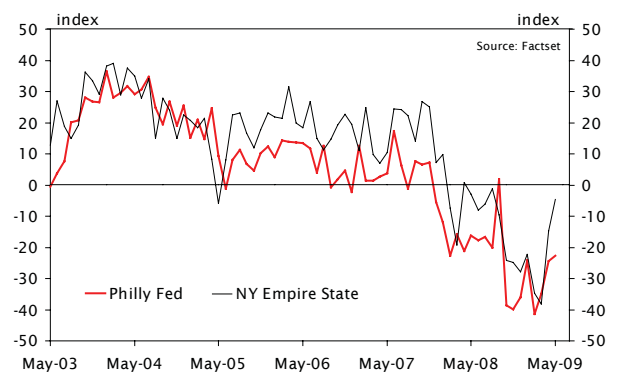
US June NY and Philly Fed surveys

Jun 15, New York Fed: Last: -4.5, WBC f/c: -8.0

Jun 18, Philadelphia Fed: Last: -22.6, WBC f/c: -15.0

- These surveys helped kick off the now ubiquitous “green shoots of recovery” story in March–April, though the reality is that despite the recent higher readings (sharply higher in the case of the NY Fed), both remain at levels consistent with declining output, albeit at a slower pace than in Q1.
- Without local agents on the ground it is difficult to forecast these regional surveys of just 100 business people. However, if they accurately reflect what we suspect is actually going on in the economy – i.e. it is still contracting, but at a moderating pace – then the most likely outcomes would be a modest pull-back in the NY Fed, but a further improvement in the Philly Fed index.
- These outcomes would be broadly consistent with the subdued May factory ISM (whose survey period overlaps with the regional June surveys), which rose from 40.1 to just 42.8.

US regional manufacturing surveys



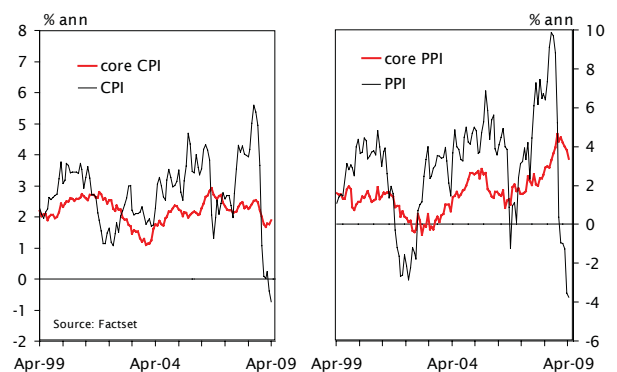
US May inflation indicators

Jun 16, PPI headline Last: 0.3%, WBC f/c: 0.9%

Jun 17, CPI headline Last: 0.0%, WBC f/c: 0.4%

- The headline PPI peaked at 9.9% yr in July 2008 but turned negative in Dec and was down -3.7% yr in April. The monthly PPI fell from Aug to Dec last year, but has been volatile around a flat trend so far this year. In May, an upswing in energy prices will push the PPI headline higher, but the core rate should be constrained to 0.1% by discounted auto prices. Our 0.9% PPI headline rise would see the annual rate fall to -4.3% yr.
- The annual CPI turned negative in March and April, and the monthly data resumed modest declines after a temporary spike in Jan–Feb. In May, a 20% jump in retail gasoline prices will be the key driver of the 0.4% rise we forecast for the headline CPI, while the core rate is expected to round to 0.2%, not up to 0.3% as it did in April. Auto price discounting should also be a feature.

US inflation



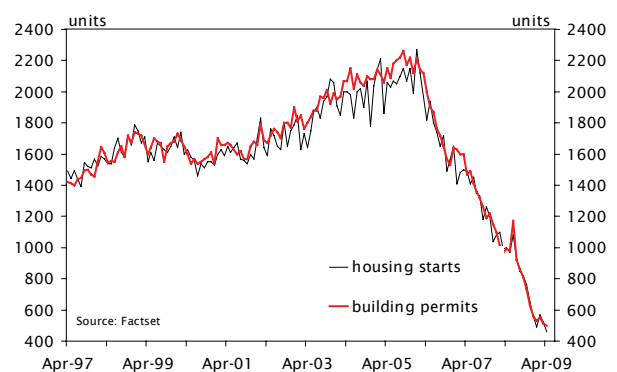
US May housing starts and permits

Jun 16, Starts: Last: -12.8%, WBC f/c: 6.0%

Jun 16, Permits: Last: -2.5%, WBC f/c: 2.0%

- On a range of indicators, housing has shown tentative signs of bottoming out after several years of tumbling prices and activity. Single family house starts have not posted a fall since January, although total starts fell in March and April due to steep falls on the multiples side, reversing a 66% Feb gain.
- Single family housing permits posted gains in Feb and April more than offsetting their Mar decline – further evidence of bottoming out. Indeed Apr’s single family permits annualised pace of 373k was a little higher than starts on 368k, suggesting a starts gain in May. Add in a multiples bounce for a 6% total starts rise.
- With homebuilder confidence rising sharply in April–May from its record lows in Q1, it follows that more permits to build may have been sought. We expect a 2% rise, though ongoing multiples volatility could distort the picture.

US housing starts and permits



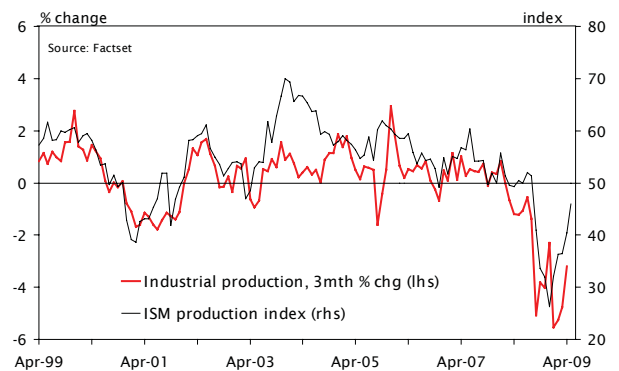
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US May industrial production to drop again

Jun 16, Last: -0.5%, WBC f/c: -1.0%

- Industrial production posted declines of between 1.0% and 2.2% between November and March, although in April the slippage moderated to 0.5%, consistent with survey evidence pointing to a slower pace of decline in factory output and indeed the broader economy.
- Indications ahead of the May result, however, suggest that the pace of industrial contraction probably steepened again. Hours worked in factories fell 2.1% last month, and primary industries and the utilities also recorded falling hours.
- That said, the May factory surveys generally showed an improved (but still negative) production reading, and factory orders, especially for durables, rose in April. These factors point to a decline in industrial production of around 1.0% in May.

US industrial production



Key Data and Events

		Last	Market Median	Westpac Forecast	Comments
Mon 15 Jun					
US	Jun NY Fed Empire State Index	-4.55	-4.60	-8.00	Probably too soon to be back in positive territory, so slippage in June.
	Apr TIC Data \$bn	55.8	57.5	-	Net long term TIC flows.
	Jun NAHB Housing Market Index	16	17	18	Most housing indicators are bottoming out at very weak levels.
	Fedspeak	-	-	-	Evans on financial crisis in Chicago
Can	Apr Manufacturing Shipments	-2.7%	-1.7%	-	Down 7 of the last 8 months.
	Apr Auto Sales	6.3%	flat	flat	StatCan guidance was for "essentially unchanged" April sales.
Tue 16 Jun					
Aus	RBA Minutes of June Meeting	-	-	-	How much is the RBA buying into the global recovery?
US	May PPI	0.3%	0.6%	0.9%	Energy prices rose sharply through May but core pressures should be soft especially given auto price discounting by the bankrupts.
	May PPI Core	0.1%	0.1%	0.1%	
	May Housing Starts	-12.8%	4.8%	6.0%	Volatility in permits and starts for multiple dwellings has actually masked mild uptrends in single family starts and permits.
	May Building Permits	-2.5%	0.4%	2.0%	
	May Industrial Production	-0.5%	-1.0%	-1.0%	Factory hours worked down sharply but surveys less weak.
Jpn	Bank of Japan Meeting	0.10%	0.10%	0.10%	Focus on unconventional measures with deflation entrenching itself.
Eur	May CPI (F) %yr	0.6%	flat	flat	Not usually revised. Core rate was 1.8%yr in April.
	Q1 Labour Costs %yr	3.8%	3.0%	3.5%	Easing from Q3 spike to 4.2%yr.
Ger	Jun ZEW Economic Sentiment	31.1	35.0	35.0	Less rapid gain given steadier stocks. Current measure still weak.
UK	May CPI %yr	2.3%	2.0%	2.0%	Base effects favourable. BRC data point to high st prices easing.
Can	Q1 Labour Productivity	-0.5%	-0.4%	-	Productivity downtrend began in H2 2007.
Wed 17 Jun					
Aus	Apr Westpac-MI Leading Index	-5.1%	-	-	At recessionary levels but all components improved in March.
	Q1 Dwelling Commencements	-11.9%	-3.0%	-3.0%	Starts slumped 19% over 2008H2. Approvals fell another 3.6% in Q1.
US	May CPI	0.0%	0.3%	0.4%	Gasoline prices rose quite sharply in May lifting the headline CPI, but the core rate is expected to round to 0.2% not up to 0.3% as in April.
	May CPI Core	0.3%	0.1%	0.2%	
	Q1 Current Account Balance \$bn	-132.8	-85.0	-80.0	The sharply lower trade deficit will drive the CAD narrowing.
	Fedspeak	-	-	-	Bernanke on financial literacy.
Eur	Apr Trade Balance €bn sa	-2.1	-1.5	-	Has been back in deficit since early 2008.
UK	Jun BoE Minutes	-	-	-	Decision to leave rates/QE program unchanged likely unanimous.
	May Unemployment ch '000	57.1k	60k	50k	Pace of monthly job shedding is well off Feb's 136k peak.
Can	May Leading Indicators	-1.1%	-0.6%	-	Down sharply for eight months running.
Thu 18 Jun					
Aus	Q2 WBC-ACCI Survey of Indust Trends	34.0	-	-	-6.5pts in Q1 to lowest since 91Q2, implying sharper mfg contraction.
	May Merchandise Imports AUDbn	16.2	-	-	Fell 6.3% in Apr, translating to -2.2% sa, maintaining downtrend.
	RBA Monthly Bulletin	-	-	-	Can include recent research articles.
US	Initial Jobless Claims w/e 13/6	601k	605k	590k	Pace of job shedding now clearly slowing.
	May Leading Index	1.0%	1.0%	1.0%	Equities, claims, permits, and others components solid in May.
	June Philadelphia Fed Factory Index	-22.6	-17	-15.0	Catch-up to other regional indices which improved more in May.
UK	May Retail Sales Volumes	0.9%	0.3%	-0.3%	Private surveys suggest April's warm weather boost reversed in May.
	May Public Sector Net Borrowing £bn	8.5	19.3	-	The UK's budget deficit is blowing out.
	May Money Supply M4 %yr	17.4%	17.3%	-	Some guide to effectiveness of BoE's attempts to refloat the economy
	Jun CBI Industrial Trends Survey	-56	-	-	Orders have been steady in 56-58 range since Feb.
Can	May CPI %yr	0.4%	-0.2%	-	The headline CPI annual rate is heading towards zero and the core rate has been at or below the 2% target midpoint all year so far.
	May CPI BoC Core Ex 8 %yr	1.8%	1.6%	-	
Fri 19 Jun					
Jpn	Bank of Japan Minutes (May)	-	-	-	Discussion on foreign bond collateral eligibility should be of interest.
Ger	May Producer Prices %yr	-2.7%	-3.6%	-3.0%	Base effects favourable but May energy price rises also a factor.
Can	Apr Retail Sales	0.3%	0.1%	0.1%	Flat auto sales, slightly higher gasoline prices and subdued core retail.

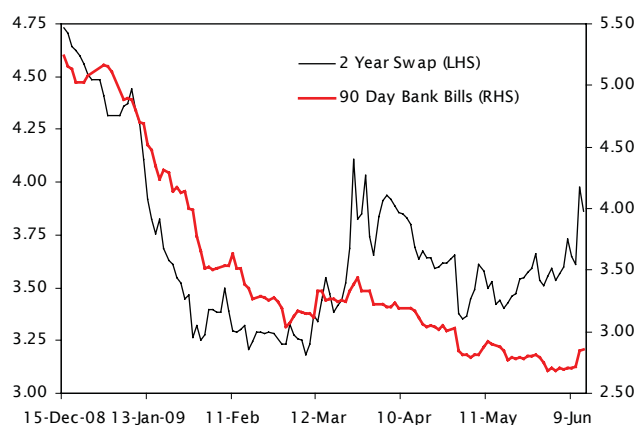
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New Zealand Economic and Financial Forecasts

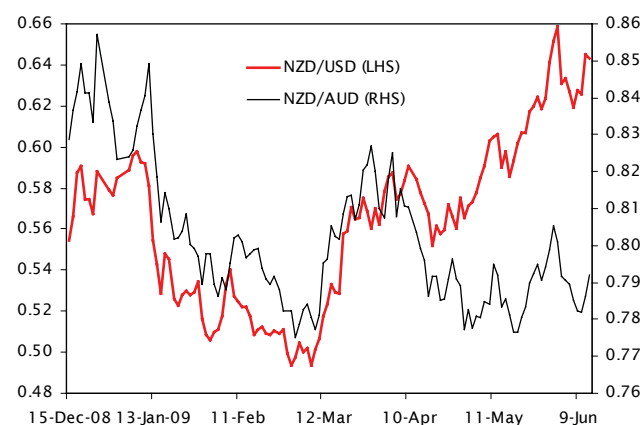
Economic Growth Forecasts	March years				Calendar years			
	2008	2009f	2010f	2011f	2008	2009f	2010f	2011f
% change								
GDP (Production) ann avg	3.1	-0.9	-2.3	2.1	0.2	-2.8	1.1	3.7
Employment	-0.3	0.8	-2.9	1.5	0.9	-3.7	0.6	2.2
Unemployment Rate % s.a.	3.8	5.0	7.6	6.4	4.7	7.3	6.9	5.4
CPI	3.4	3.0	1.5	1.2	3.4	1.3	1.1	1.2
Current Account Balance % of GDP	-8.0	-8.5	-5.0	-4.9	-8.9	-5.1	-4.9	-5.6

Financial Forecasts	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Cash	2.25	2.00	2.00	2.00	2.00	2.00	3.00
90 Day bill	2.50	2.30	2.30	2.30	2.30	2.50	3.40
2 Year Swap	3.60	3.70	3.90	4.10	4.30	4.50	4.70
5 Year Swap	4.50	4.60	4.70	4.80	5.00	5.20	5.40
10 Year Bond	5.40	5.50	5.60	5.70	5.80	5.90	6.10
NZD/USD	0.60	0.59	0.62	0.65	0.68	0.70	0.70
NZD/AUD	0.79	0.80	0.81	0.81	0.83	0.84	0.83
NZD/JPY	57.0	54.3	59.5	64.4	70.0	72.1	74.2
NZD/EUR	0.43	0.43	0.45	0.46	0.47	0.48	0.48
NZD/GBP	0.38	0.37	0.38	0.38	0.39	0.39	0.38
TWI	57.7	57.0	59.3	61.6	64.0	65.6	65.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 15 June 2009

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.86%	2.78%	2.84%
60 Days	2.86%	2.74%	2.84%
90 Days	2.86%	2.70%	2.84%
2 Year Swap	3.86%	3.55%	3.41%
5 Year Swap	5.31%	5.05%	4.69%

NZ foreign currency midrates as at Monday 15 June 2009

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.6379	0.6519	0.5855
NZD/EUR	0.4565	0.4608	0.4339
NZD/GBP	0.3888	0.3967	0.3861
NZD/JPY	62.850	62.970	55.750
NZD/AUD	0.7899	0.8054	0.7812
TWI	60.470	61.370	56.940

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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	2.3	-0.6	1.0
CPI inflation % annual	2.6	2.8	3.3	3.0	3.7	1.8	2.4
Unemployment %	5.4	5.1	4.8	4.4	4.2	6.3	8.5
Current Account % GDP	-6.1	-5.8	-5.3	-6.2	-4.3	-3.9	-5.7
United States							
Real GDP %yr	3.9	3.1	2.8	2.0	1.1	-3.1	0.7
Consumer Prices %yr	2.6	3.4	3.2	2.9	3.8	-1.4	1.1
Unemployment Rate %	5.5	5.1	4.6	4.6	5.8	9.3	10.6
Current Account %GDP	-5.7	-6.1	-6.0	-5.3	-4.7	-2.7	-2.9
Japan							
Real GDP %yr	2.3	1.9	2.8	2.3	-0.8	-7.5	1.1
Consumer Prices %yr	-0.1	-0.3	0.2	0.1	1.4	-1.1	-0.6
Unemployment Rate %	4.5	4.4	4.1	3.9	4.0	5.1	6.6
Current Account %GDP	3.3	3.6	3.9	4.8	3.2	2.5	2.4
Euroland							
Real GDP %yr	1.9	1.8	3.0	2.6	0.7	-4.7	-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	2.8	2.1	2.8	3.0	0.7	-4.5	-0.1
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	-6.0	-5.5

Forecasts finalised 5 June 2009

Interest Rate Forecasts	Latest (Jun 15)	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10
Australia						
Cash	3.00	2.50	2.00	2.00	2.00	2.00
90 Day Bill	3.32	2.60	2.30	2.30	2.30	2.30
10 Year Bond	5.55	5.00	4.75	5.00	5.50	5.75
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.79	3.50	3.25	3.75	4.25	4.75
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00
Exchange Rate Forecasts						
AUD/USD	0.8076	0.76	0.74	0.77	0.80	0.82
USD/JPY	98.53	95	92	96	99	103
EUR/USD	1.3973	1.38	1.36	1.39	1.42	1.45
AUD/NZD	1.2660	1.27	1.25	1.24	1.23	1.21

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