Westpac

Weekly Commentary

15 November 2010

Currency concerns

Last week the Reserve Bank released its *Financial Stability Report (FSR)*, a six-monthly health check on the financial system.

The RBNZ noted that the global economic recovery continues to support NZ's economy and financial system, although the momentum has slowed in many developed nations. Our own recovery has been "tepid" to date, with households and businesses focusing on reducing debt levels, while high export commodity prices have been providing more support. Banks are holding more capital and have moved towards more stable forms of funding, partly in response to new regulations.

While the *FSR* is intended to be a broad overview of long-running developments in the financial system, the subsequent questioning and commentary inevitably focused on more immediate issues. Of relevance to current monetary policy, there were two notable points. Firstly, Governor Bollard stated that markets "have interpreted some of the recent data over the last couple of weeks as stronger than we believe it is", citing employment and retail figures in particular.

The RBNZ has already expressed concern about the Household Labour Force Survey as a gauge of the labour market (see Box D in the September *Monetary Policy Statement*). The fall in the unemployment rate from 6.9% to 6.4% in the September quarter prompted a sharp rise in the NZ dollar and wholesale interest rates, despite the market being well aware of the extreme volatility in this measure recently.

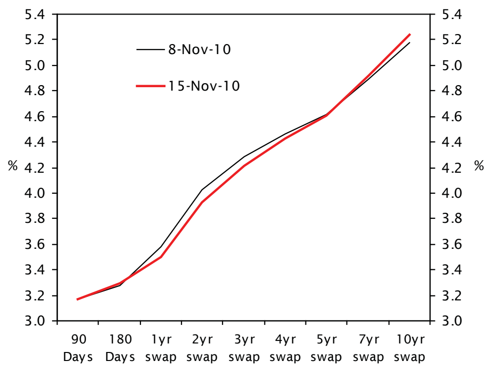
Aside from that, though, we're scratching our heads as to what data the market might be reading too optimistically. There was no market response to last week's electronic card transactions figures, our first solid indicator of consumer spending in the wake of the 1 October tax changes. The 0.9% rise in spending in October reflects two opposing forces: a fallback in volumes after some purchases were brought forward to September to beat the GST hike; and the price impact of the GST hike itself (a complete passthrough would amount to a 2.2% rise in the retail price).

To separate the two effects we would have to make a host of assumptions, in particular around the 'counterfactual' of what would have happened to sales in the absence of the tax changes. But broadly speaking, the lower the counterfactual, the more of the October spending rise that we can pin on the higher GST rate being passed through. Given recent trends and anecdotes, a weak counterfactual seems more plausible than a strong one.

The extent of GST passthrough has been a point of contention for two reasons. First, a low degree of passthrough would be seen as a sign of a weak retailing sector, to the extent that businesses feel unable to raise their prices. Second, from the RBNZ's point of view, it will affect the degree to which longer-term expectations of inflation might become 'polluted' by the impending spike in the headline inflation rate. The greater the GST passthrough, the greater the risk that higher inflation becomes embedded to people's expectations.

The other timely issue raised by the *FSR* was the recent rise in the exchange rate, and the possibility of a policy response. The RBNZ made the usual point that a higher exchange rate, if sustained, would warrant a lower interest rate track than otherwise. But the issue of FX intervention was inevitably raised as well, with the RBNZ emphasising that intervention is not a magic bullet and that there are limited circumstances in which it is likely to have any impact.

NZ Interest Rates



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

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By and large, the higher NZ dollar has mirrored the slide in the US dollar, as the market has focused on the quantitative easing (QE) measures recently announced in the US. As a point of comparison, the NZD remains well below its long-run average against the Australian dollar, though it has risen from its lows in the last two weeks.

The impact of a higher NZD, and the appropriate policy response if any, depend on what else is happening at the same time. At an extreme, a fall in the US dollar could simply lead to everything being repriced in US dollars by the same amount – so our export and import prices would rise in USD terms, completely offsetting the move in the exchange rate. In practice it's highly unlikely to be a 1:1 adjustment, although the impact of QE is already apparent in 'hard' commodity prices such as oil, gold and copper. We'll have to wait and observe the price response in 'soft' commodities, which make up the majority of New Zealand's exports.

While the Fed's latest monetary policy measures are unconventional, their implications for markets are not. Just as with policy interest rates, it is not just the current level of QE, but also expectations, that matter. The US dollar has already fallen significantly in anticipation of an announcement of QE. Now that it's being carried out, that doesn't necessarily mean that the US dollar will continue to slide: its future path will depend on how long this easing is expected to be left in place, and on whether furthers measures are likely to be announced. This in turn will depend on how the indicators of US activity and inflation pan out over coming months.

So while the speed of the recent rise in the NZD will be distressing to exporters, we need to caution – as always – against extrapolating from short-term movements in the exchange rate. Further USD weakness is not preordained even with the Fed pumping more money into the financial system; and if QE is truly effective, it may eventually result in a higher USD and a lower NZD.

Fixed vs. floating: The RBNZ's more cautious stance 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.

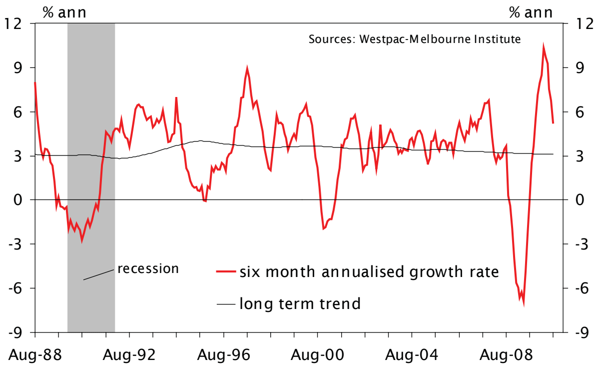
Key Data Previews

Aus Sep Westpac–MI Leading Index

Nov 17, Last: 5.3% annualised

- The *Westpac–Melbourne Institute Leading Index* continued to moderate in August with the six month annualised growth rate easing from 6.8% in August to 5.3% in September. This is still comfortably above the long term trend of 3.1% but the slowdown from March's peak growth rate of 10.3% has been very rapid. The raw index has dipped in two of the last three months and a flat result for September could even result in the six month growth rate dropping below the long run trend.
- The Index's monthly components were mixed in September. The ASX bounced strongly, gaining 4.1% in the month. Dwelling approvals continued to slide though, registering another large 6.6% fall following the 4.8% drop in August. Growth in the money supply was also soft, with a 0.4%mth rise after average gains of 0.8% over the previous six months. US industrial production was also soft down 0.2%mth, registering the first monthly fall since June 2009.

Westpac-MI Leading Index

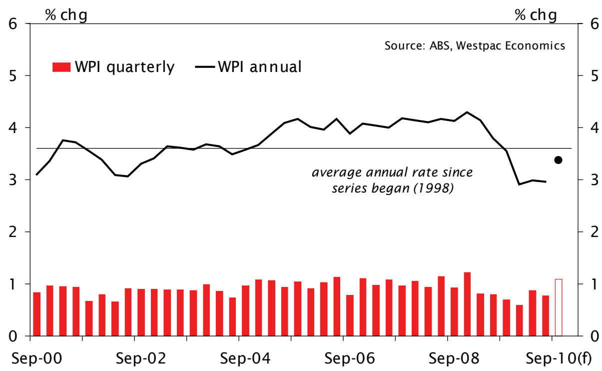


Aus Q3 wage price index %qtr

Nov 17, Last: 0.8%, WBC f/c: 1.1%, Mkt f/c: 1.1%, Range: 0.7% to 1.2%

- With unemployment trending down from 5.8% end-Q3 2009 to 5.3% end Q1 2010, the private sector WPI is accelerating, maintaining the rise in the quarterly pace from 0.6% in Q4 to 0.8% in Q1 in Q2, lifting the annual rate to 2.8% from 2.6% (vs 3.5% LR avg). But a slower public sector WPI (1.0%qtr vs 1.1% prev) contained the aggregate WPI to 0.8%qtr, 3.0%yr.
- Wage inflation responds to labour market tightening with a two quarter lag, so with unemployment trending down from 5.5% end-09 to 5.2% end-Q2 2010, the quarterly WPI is forecast to accelerate in Q3. Q3 will additionally be boosted by Fair Work Australia's decision to lift the minimum wage 4.8% (vs no increase prev year) from 1 July. The quarterly NAB business survey data on labour costs also points to an acceleration in Q3. We forecast a 1.1%qtr rise in the Q3 WPI, lifting annual growth to 3.4% (still below 3.6% LR avg, but highest annual since Q3 2009).

WPI stronger with lower U & min. wage rise

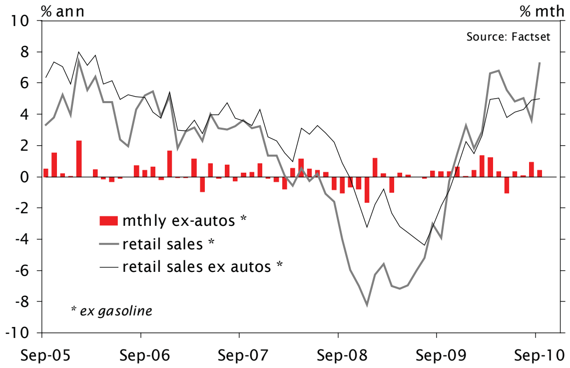


US Oct retail sales

Nov 15, Last: 0.6%, WBC f/c: 0.9%, Mkt f/c: 0.7%

- Retail sales rose 0.6% in Sep, and Aug was revised up from 0.4% to 0.7%. Ex autos and gasoline sales rose 0.4% and Aug was revised up by 0.4 ppts to 0.9%. The breakdown showed modest but broad-based gains across most storetypes except clothing and department stores. 3 month annualised sales of 2.4% for total and 2.7% for core sales were the healthiest since June and like much subsequent data, must have added to some FOMC members' reticence to embark on further quantitative easing.
- Oct unit auto sales were up 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. Retail hiring was strong in Oct but annual chain store sales growth slowed.
- We expect a 0.9% headline; 0.6% ex auto; 0.5% ex autos/gas.

US retail sales

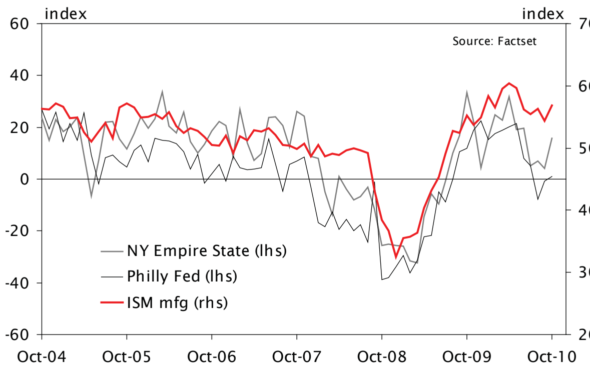


US Nov NY and Philly Fed surveys

Nov 15, New York Fed: Last: 15.7, WBC f/c: 10.0, Mkt f/c: 14.0
Nov 18, Philadelphia Fed: Last: 1.0, WBC f/c: 4.0, Mkt f/c: 5.0

- All the major and most minor business surveys, national and regional, pointed to renewed acceleration in industrial growth since Q3, after the relatively short-lived mid year slowdown which saw some regional surveys point to contracting activity.
- With recent retail, jobs, GDP, and to a lesser extent consumer confidence and housing data also showing an improved tone, the latest business survey uptrend may still have some life. That view is reflected in our forecast pull-back in the NY Fed factory index (expected down 6 pts after surging 12 pts in Oct) and a further 3 pt gain in the somewhat lagging Philly survey.
- We do however remain concerned about the US economic outlook in 2011 and these surveys may be among the first indicators to turn sharply lower in coming months.

US manufacturing surveys

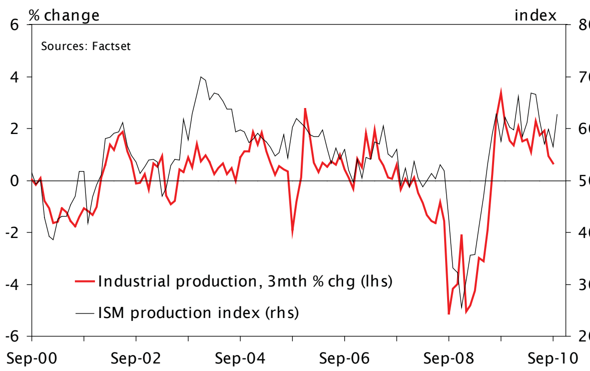


US Oct industrial production may have stalled

Nov 16, Last: –0.2%, WBC f/c: 0.5%, Mkt f/c: 0.3%

- US industrial production fell 0.2% in Sep, the first fall in IP since mid 2009. The fall was led by the factory sector down 0.2%, with broad-based declines outside of autos. A sharpish further fall in utility output was offset by higher mining output. Capacity utilisation at 79.4% fell below 80% for the first month since May.
- Oct signals are much more favourable. Hours worked in factories rose 0.3% in Oct and the production index of the national factory ISM jumped 6.2 pts to 62.7 (highest since May). Mining output should keep growing given the surge in commodity prices but utility output likely remained soft due to warmer weather for the time of year.
- Tying these together, we expect a 0.5% industrial production rise in Oct, about in line with trend prior to Sep's fall in IP.

US industrial sector

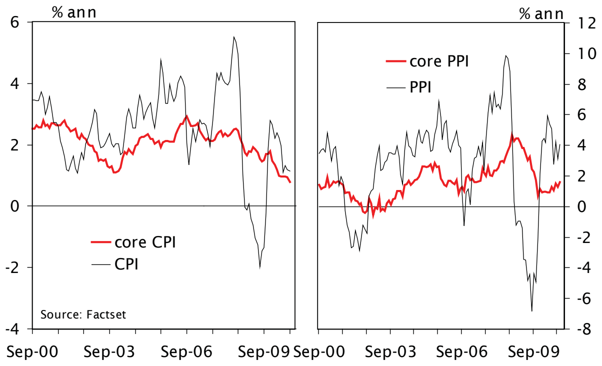


US Oct PPI and CPI: the QE impact on inflation

Nov 16, PPI: Last: 0.4%, WBC f/c: 1.0%, Mkt f/c: 0.8%
Nov 17, CPI: Last: 0.1%, WBC f/c: 0.4%, Mkt f/c: 0.3%

- The PPI was up 0.4% in Sep, reflecting a 0.5% rise in energy prices and steeper food price gains, but the core rate was again subdued at 0.1%. Oct should see much steeper energy and food price gains for a 1.0% headline but a still subdued core (0.1%).
- Sep consumer energy prices gained 0.7% and food prices were up 0.3%, but the core CPI was flat (apparel and vehicle prices falling, rents flat), constraining the overall CPI to a modest 0.1% rise. This was the fifth month of nine 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. But the recent USD depreciation in anticipation of the Fed's QE2 means higher gasoline, food and clothing costs (due to higher commodity prices), so we expect a higher 0.4% Oct CPI headline and an above trend 0.1% core rate.

US price inflation

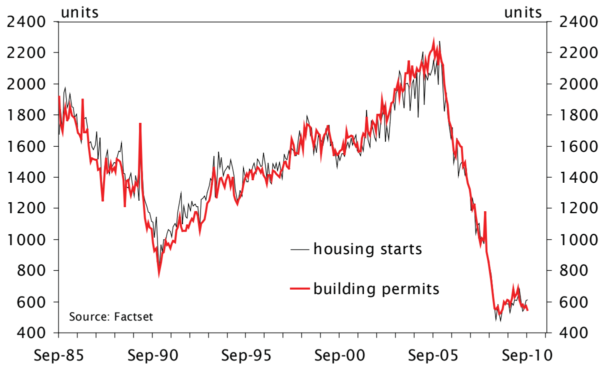


US Oct housing starts and permits – bottoming out?

Nov 17, Starts: Last: 0.3%, WBC f/c: 0.0%, Mkt f/c: -1.6%
Nov 17, Permits: Last: -5.6%, WBC f/c: 6.0%, Mkt f/c: 4.2%

- Since the home-buyer tax rebate ended in Apr, new single family house building contracted by about a quarter on both starts and permits, although early signs of a bounce – maybe dead cat – emerged late in Q3.
- Starts rose 0.3% in Sep: single family up 4.4%, their second consecutive rise. But multiples fell nearly 10%. A 14% multiples fall also weighed against housing permits in Sep, which fell 4.2%, but single family permits rose 0.5%, their first positive since March.
- Payrolls data showed renewed construction hiring in Oct, but sluggish Sep permits and further multiples downside risk could see Oct starts constrained to flat. However permits are due to bounce, particularly if multiples turn around.

US housing starts and permits



Key Data and Events

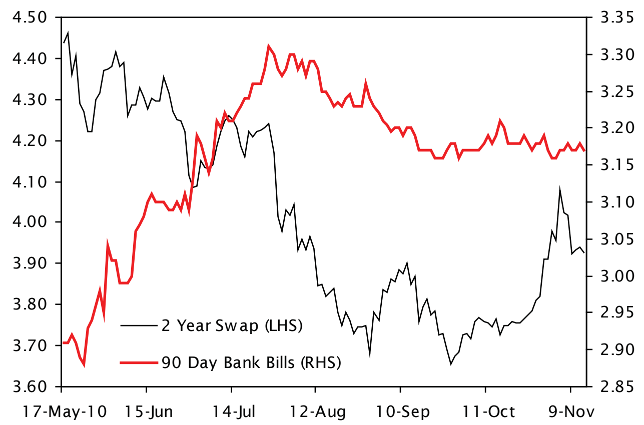
		Last	Market Median	Westpac Forecast	Comments
Mon 15 Nov					
Aus	Oct Motor Vehicle Sales	0.9%	–	-3.0%	Industry figures suggest sales weakened on seasonally adjusted basis.
US	Oct Retail Sales	0.6%	0.7%	0.9%	Auto unit sales posted a solid 4% rise; retail hiring was solid in Oct;
	Oct Retail Sales ex autos	0.4%	0.4%	0.6%	but chain store sales growth slowed.
	Nov NY Factory Index	15.7	14.0	10.0	Partial pull-back from Oct's 12 pt jump.
	Sep Business Inventories	0.6%	0.8%	0.5%	Clue to direction of revision to Q3 GDP growth.
	Fedspeak	–	–	–	Lacker on the labour market.
Jpn	Q3 GDP %saar	1.5%	2.5%	2.3%	Inventories, PCE and housing pluses; net exports a negative swing.
Eur	Sep Trade Balance €bn	-1.4	1.0	–	In deficit since May.
	EC Autumn Forecasts	–	–	–	Tentative date for latest update of Euro Comm's eco forecasts.
UK	Nov House Prices %yr	2.9%	–	–	Rightmove index of asking prices, peaked at 6.1% yr in Feb 2010.
Tue 16 Nov					
Aus	Nov RBA Board Meeting Minutes	–	–	–	Detail behind "early, modest tightening" for inflation risks from ToT boom.
US	Oct Producer Prices	0.4%	0.8%	1.0%	Big spike in energy and some food commodity prices to lift headline
	Oct PPI Core	0.1%	0.1%	0.1%	but core pressures still subdued.
	Sep TIC Data $bn	128.7	–	–	Net long term flows.
	Oct Industrial Production	-0.2%	0.3%	0.5%	Factory hours worked up 0.3%.
	Nov NAHB Housing Market Index	16	17	15	Builder confidence jumped 3 pts in Oct, we expect slight pull-back.
Jpn	Sep Tertiary Activity Index	-0.2%	-0.5%	–	Finishing Q3 with a whimper. Q4 likely to be even weaker.
Eur	Oct Core CPI %yr	1.0%	1.0%	1.0%	Oct headline flash was 1.9% yr, half of which due to food and energy.
Ger	Nov ZEW Analysts' Survey	-7.2	-6.0	-10.0	Headline eco sentiment has been in downtrend for a year now.
UK	Sep House Prices %yr	8.3%	–	–	DCLG (government) measure. Peaked at 10.7% yr in May.
	Oct CPI %yr	3.1%	3.1%	3.2%	Shop price data suggest some acceleration.
Can	Sep Manufacturing Sales	2.0%	-0.9%	–	Aug boosted by reopening of auto factories.
Wed 17 Nov					
Aus	Sep WBC-MI Leading Index 6mth ann'lsd	5.3%	–	–	Above trend but slowing sharply and most components soft in Sep.
	Q3 Wage Price Index %qtr	0.8%	1.1%	1.1%	U downtrend + boost from min. wage rise; lifts annual to 3.4% (v 3.0%).
US	Oct Consumer Price Index	0.1%	0.3%	0.4%	Some pressure from gasoline prices and pass through of food price
	Oct CPI Core	0.0%	0.1%	0.1%	pressures and weaker USD on imports. But still subdued core prices.
	Oct Housing Starts	0.3%	-1.6%	0.0%	Some downside risk from multiples to starts, also single family permit
	Oct Housing Permits	-5.6%	4.2%	6.0%	data soft in Sep, suggests weak starts in Oct, but permits may bounce.
	Fedspeak	–	–	–	Lockhart on economy; Bullard on future of the GSEs; also Rosengren.
UK	Nov BoE MPC Minutes	1:7:1	–	–	Was there still a vote for further QE?
	Oct Unemployment chg	5.3k	6.0k	8.0k	Aug-Sep saw first back to back rises in claimants since Sep-Oct 2009.
Thu 18 Nov					
NZ	Q3 Producer Input Prices	1.4%	0.3%	–	May dip below CPI due to lower commodity prices over quarter.
	Q3 Producer Output Prices	1.1%	0.6%	–	Subdued on low domestic inflation and export prices.
Aus	RBA Deputy Governor Battellino Speech	–	–	–	Speaking to CEDA Western Australian Luncheon, Perth (16:05 AEDT).
US	Initial Jobless Claims w/e 13/11	435k	441k	450k	Payrolls survey week. Also includes Veteran's Day – possible distortion.
	Oct Leading Index	0.3%	0.5%	–	Appears to be accelerating again after mid-year slowdown.
	Nov Philadelphia Fed Factory Index	1.0	5.0	4.0	More firmly back in positive territory.
	Fedspeak	–	–	–	Warsh on financial mkts; Plosser on asset bubbles; Kocherlakota on policy.
Eur	Sep Current Account €bn	-7.5	–	–	Surpluses have been rare since early 2008.
UK	Oct PSNB £bn	15.6	8.9	–	Public sector net borrowing.
	Oct Money Supply M4 %yr	1.0%	–	–	Downtrend from 17.7% yr in Feb 2009 continues.
	Oct Retail Sales (incl fuel)	-0.2%	0.4%	0.4%	Some pickup in private surveys. Pre VAT hike spending?
Can	Oct Leading Index	-0.1%	0.1%	–	Sep saw first negative since April last year.
	Sep Wholesale Sales	1.2%	-0.1%		Aug saw solid rise boosted by machinery and equipment.
Fri 19 Nov					
US	Fedspeak	–	–	–	Fed chair Bernanke at ECB conference on lessons from the crisis.
Jpn	Sep All-Industry Activity	-0.4%	-0.6%	–	New information on public sector and construction activity.
Ger	Oct Producer Prices %yr	3.9%	4.1%	–	Base effects now neutral, acceleration now due commodity prices, euro.

New Zealand Economic and Financial Forecasts

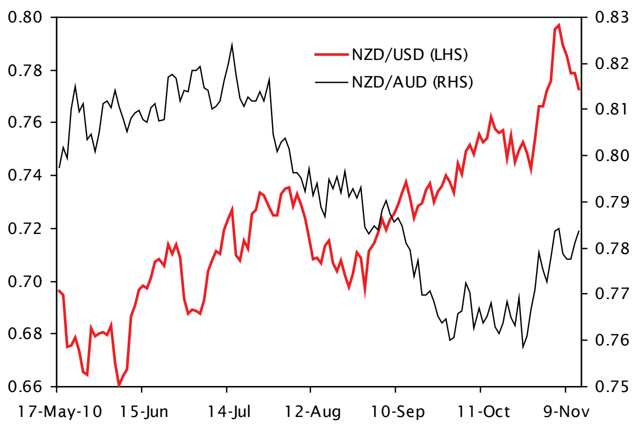
Economic Growth Forecasts	March years				Calendar years			
% change	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
GDP (Production) ann avg	-0.4	2.3	4.3	3.0	-1.7	2.0	4.2	3.0
Employment	-0.1	1.5	2.3	1.3	-2.4	1.7	2.9	1.2
Unemployment Rate % s.a.	6.0	6.2	5.0	5.0	7.1	6.4	5.0	4.9
CPI	2.0	4.3	1.8	2.5	2.0	3.9	1.9	2.4
Current Account Balance % of GDP	-2.4	-4.0	-5.2	-5.3	-2.8	-3.6	-5.0	-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	4.10	4.40	4.70	5.00	5.30	5.50	5.70
5 Year Swap	4.70	4.90	5.10	5.40	5.60	5.80	5.90
10 Year Bond	5.20	5.30	5.40	5.50	5.60	5.70	5.80
NZD/USD	0.80	0.81	0.84	0.80	0.78	0.76	0.76
NZD/AUD	0.78	0.79	0.80	0.81	0.81	0.82	0.82
NZD/JPY	66.4	67.2	69.7	72.0	74.1	76.0	79.0
NZD/EUR	0.56	0.56	0.56	0.57	0.57	0.56	0.56
NZD/GBP	0.50	0.49	0.47	0.47	0.46	0.45	0.44
TWI	70.1	70.4	71.6	71.3	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 15 November 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	3.00%	3.00%	3.00%
30 Days	3.15%	3.12%	3.14%
60 Days	3.17%	3.16%	3.15%
90 Days	3.17%	3.17%	3.20%
2 Year Swap	3.93%	3.91%	3.75%
5 Year Swap	4.61%	4.53%	4.34%

NZ foreign currency midrates as at Monday 15 November 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7747	0.7663	0.7560
NZD/EUR	0.5653	0.5507	0.5404
NZD/GBP	0.4801	0.4771	0.4729
NZD/JPY	63.850	61.740	61.550
NZD/AUD	0.7843	0.7753	0.7616
TWI	69.040	67.780	66.840

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	3.3	3.7
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	2.7	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	-2.5
United States							
Real GDP %yr	3.1	2.7	2.1	0.0	-2.6	2.6	1.0
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.3	1.6	2.3
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.7	10.1
Current Account %GDP	-6.1	-6.0	-5.3	-4.7	-2.7	-3.2	-3.2
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	3.3	1.5
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	1.7	1.2
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.9	2.0	1.6
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	1.8	1.3
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	3.0	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 5 November 2010

Interest Rate Forecasts	Latest (Nov 15)	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Australia						
Cash	4.75	4.75	4.75	5.00	5.00	5.00
90 Day Bill	5.05	5.00	5.00	5.25	5.25	5.25
10 Year Bond	5.34	5.25	5.30	5.50	5.50	5.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.78	2.35	2.25	2.50	2.75	3.00
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00

Exchange Rate Forecasts	Latest (Nov 15)	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
AUD/USD	0.9877	1.02	1.03	1.05	0.99	0.96
USD/JPY	82.43	83	83	83	90	95
EUR/USD	1.3704	1.43	1.45	1.48	1.39	1.35
AUD/NZD	1.2749	1.28	1.27	1.25	1.24	1.23