Westpac

Weekly Commentary

16 August 2010

Falling prices encourage spending

June retail sales data confirmed our view that the consumer has not been as subdued as many thought. Still, with more forward looking indicators suggesting that the recovery momentum elsewhere is waning, our OCR track remains unchanged.

We continue to expect the RBNZ to deliver consecutive 25bps hikes in September and October, before pausing through December and January.

Nominal retail sales growth came in above market expectations in June, on both the month and quarter measures. However, the big story was not in nominal sales but in real sales (i.e., volumes). Sales volumes lifted a hefty 1.3% in the quarter, the strongest quarterly growth since March 2007, and well above the 0.2% growth recorded in the March quarter. In a nutshell, lower prices in some key categories gave consumers more bang for their buck. But while the sharp rise in sales came as a surprise to the market, it was not a surprise to us.

The rest of the market appears to have assumed that the retail price deflator through the quarter would be similar to the 0.3% rise in the CPI. However, our line-by-line review of the deflators revealed a substantial fall in prices for some of the key retail components of the CPI – particularly food, appliances and fuel. That view was vindicated with the release of the retail data, with retail prices falling 0.8% in seasonally adjusted terms, giving us the 1.3% rise in volumes (very close to our forecast of a 1.2% rise).

'Discounting' is the usual refrain from analysts in response to any fall in retail prices – implying that retailers are continually having to slash prices in order to stay afloat. But looking at the details, we're not convinced that discounting is much of a factor.

The most significant price falls were in fresh food, which was partly due to weather effects; the rate of discounting at supermarkets and grocery stores tends to be fairly constant over time. Fuel was down only in seasonally adjusted terms – the June quarter rise of 2.4% was less than in past years. Lower prices for durables (department stores, furniture and appliances) could arguably be attributed to discounting, but even then it wasn't across the board. The biggest price falls were electronics (which are in trend decline) and imported items in general, which may still be experiencing some pass-through from the rise in the NZ dollar in the last year. We'd agree that many of these price declines are unsustainable, but not because of desperate retailers slashing their margins.

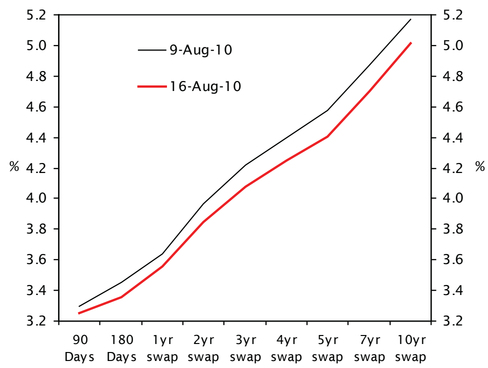
The greatest boost to sales volumes came from a 4% rise in vehicle sales, on top of a 4.3% increase in the March quarter. Car sales have been one of the strongest performing sectors in the recovery to date. But they were also hit the hardest by the recession, as households cut back on large purchases and finance company collapses reduced access to credit. Other areas showing strong volume growth included supermarkets (up 0.8%), department stores (+1.2%), appliances (+3.4%), clothing (+3.4%), and accommodation (+5.4%).

On balance, we expect these data to be positive for the market, to the extent that it may see some analysts revise up their June quarter GDP forecasts. For now we're comfortable with our forecast of 0.7% GDP growth, which incorporates a 0.7% rise in private consumption. Retail volumes were strong, but non-retail spending is unlikely to have seen the same kind of real growth (since the CPI tells us this is where prices tended to rise).

The implications for the RBNZ are effectively balanced – real spending surged, but precisely because prices fell. We continue to expect a 25bp hike in the September *MPS*, although a pause before long to assess the situation is increasingly likely.

Indeed, other news over the course of the week has generally been on the soft side.

NZ Interest Rates



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

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In particular, international developments suggest that the global recovery momentum continues to wane, notably in the US and China. The cautious tone from the US Federal Reserve at the August FOMC added to market nerves and set off another round of risk aversion through the week, with equity markets declining and the NZD falling.

Back home, the July REINZ housing market was undeniably weak. In seasonally adjusted terms, sales managed to consolidate through July lifting 1.2%, but at current levels remain 27% lower than a year ago. In raw terms, the 4,411 sales in the month were the lowest number of sales for July in 10 years. Days to sell also lengthened to 45, the highest since March 2009, while the stratified house price index fell 1.2%.

Meanwhile, the BNZ – BusinessNZ Performance of Manufacturing Index (PMI) fell 6pts in July, to sit just under the critical 50pt level at 49.9 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). The decline was driven by new orders, which fell almost 10pts in the month and now sits in contractionary territory. The production, employment, and finished stocks components also declined, but at current levels remain consistent with modest expansion. Overall, the decline in the PMI is consistent with the story we are seeing globally where recovery momentum is waning. Further deterioration in the manufacturing sector, combined with the obvious weakness in the construction sector, would clearly dampen the prospect of above trend growth in 2011.

This week's data calendar is very light. Q2 producer prices are due on Thursday but will likely go by largely unnoticed by the market. However, net migration on Friday should garner more attention. Monthly seasonally adjusted net migration has slowed sharply through 2010, from 1,800 in January to just 70 in June as foreign arrivals track well below seasonal norms and NZ departures pick up the pace. While we expect the recent soft patch in foreign arrivals to reverse in coming months, the down trend in NZ departures is now well and truly entrenched. As a result, we have revised down our forecasts for annual net migration over the coming year. We now expect a trough of around 5,000 in April 2011, compared to a trough of 10,000 previously.

Fixed vs. floating: The gap between fixed and floating rates has narrowed significantly in recent months – partly because financial markets are questioning the RBNZ's resolve to return the OCR to more normal levels. Borrowers who believe that the economy is simply wobbling on the path to recovery, and therefore believe that the RBNZ will continue to normalise the OCR in coming years, will find today's 2-3 year fixed rates very attractive. Those borrowers who believe that markets are presaging a return to recession will be more attracted to floating rates.

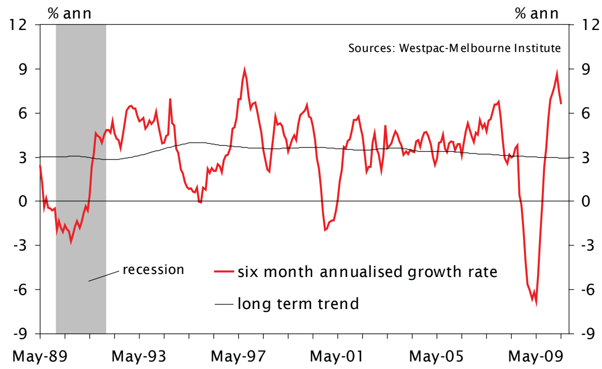
Key Data Previews

Aus Jun Westpac–MI Leading Index

Aug 18, Last: 6.7% annualised

- The *Westpac-Melbourne Institute Leading Index* registered a second consecutive moderation in May. At 6.7% the annualised growth rate in the Index is still remarkably high, implying above trend growth near term. Growth in the Coincident Index, a companion measure of current activity, also rose sharply, pointing to an above trend pace of expansion in Q2. However, the moderation in the Leading Index since March suggests this growth pulse will peak from around the middle of the year.
- The Index's monthly components were all softer in June, with the ASX down another 2.9% (despite a rally late in the month), dwelling approvals falling a further 3.3%, growth in the money supply slowing from 0.9%mth to 0.4%mth and US industrial production edging up just 0.1%mth after a big 1.3%mth gain in May.

Westpac-MI Leading Index

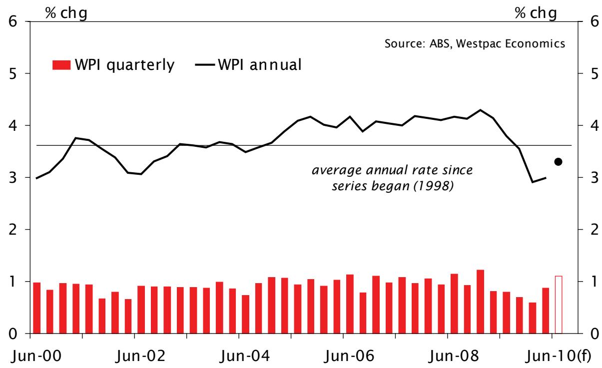


Aus Q2 wage price index %qtr

Aug 18, Last: 0.9%, WBC f/c: 1.1%, Mkt f/c: 0.9%, Range: 0.7% to 1.2%

- With the trend unemployment rate peaking in mid-09 at 5.8% and falling to 5.5% at end-09, the wage price index (WPI) commenced a reacceleration in Q1, rising 0.9%qtr (strongest since 2008Q4) after a 0.6%qtr rise previously. Annual growth rose to 3.0% from a 2.9%yr trough, but remained well below its 3.6%yr historical average. The private sector WPI also began a reacceleration from a low base.
- With wage inflation historically responding to labour market developments with around a two quarter lag, and the trend unemployment rate falling from 5.8% end-Q3 to 5.3% end-Q1, a further WPI acceleration is expected for Q2. The qtrly NAB business survey data on labour costs also suggests an acceleration in wage inflation in Q2. We forecast a 1.1%qtr rise in the Q2 WPI, which would lift annual growth to 3.3%yr (highest since 2009Q3) from 3.0%yr.

Wage inflation acceleration to continue Q2

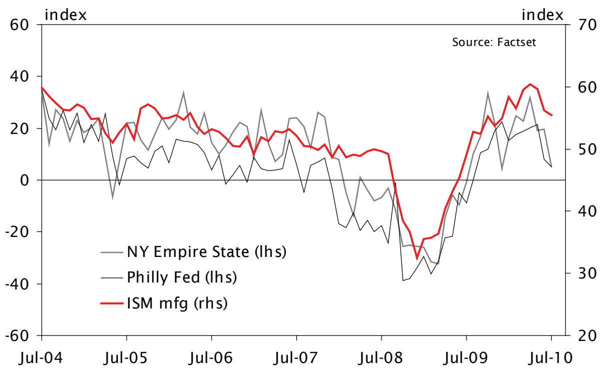


US Aug NY and Philly Fed surveys

Aug 16, New York Fed: Last: 5.1, WBC f/c: 0.0, Mkt f/c: 8.3
Aug 19, Philadelphia Fed: Last: 5.1, WBC f/c: 3.0, Mkt f/c: 7.0

- Most of the major and minor business surveys, national and regional, pointed to slower industrial growth late in Q2 and in July, supporting our once out of consensus view that US economic growth will slow in the H2 2010 – a view that has now been adopted by the Fed and seems to be mainstream.
- With recent retail, jobs, housing and consumer confidence data also pointing in that direction, the business surveys should slip further in coming months, as the slowdown impacts industry.
- That view is reflected in our lower August forecasts for both the NY and Philly surveys. Given that our GDP growth forecasts for Q3 and Q4 are 0.8% and 0.4% annualised respectively (i.e. not much above nil growth), a temporary dip back below 0 for the NY Fed and even the (less volatile) Philly Fed would not surprise.

US manufacturing surveys

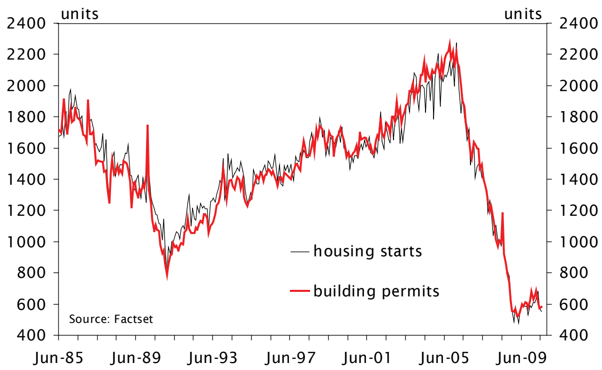


US Jul housing starts and permits – signs of levelling off

Aug 17, Starts: Last: –5.0%, WBC f/c: 3.0%, Mkt f/c: 2.0%
Aug 17, Permits: Last: 2.1%, WBC f/c: –3.0%, Mkt f/c: –0.7%

- Since the April expiry of the buyer tax credit, US housing data across sales, builder sentiment and activity have nose-dived, though June saw a partial rebound in new home sales.
- Single family house permits fell three months running in April-June (down around 23%), while starts were down in May-June (by around 20%). In June, the total starts fall of 5% was exacerbated by a 22% plunge in the multiples component, whereas total permits rose 2% due to a 20% multiples spike.
- The new sales rebound suggest some sort of floor in activity is being reached. We expect starts and permits for single family dwellings to be about flat, but a fall in multiple permits and a rise in multiple starts to drive the direction of the change in total permits and starts.

US housing starts and permits

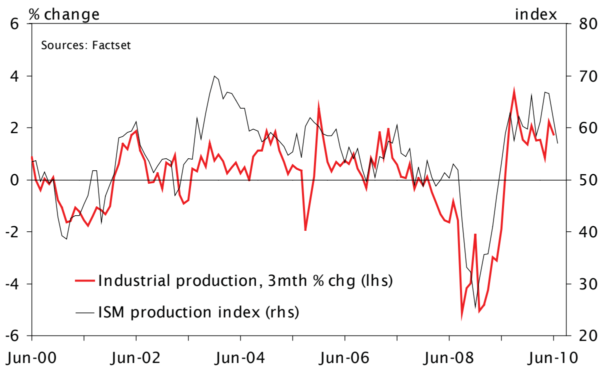


US Jul industrial production

Aug 17, Last: 0.1%, WBC f/c: 0.5%, Mkt f/c: 0.5%

- US industrial production rose 0.1% in June. Manufacturing output was down 0.4% – further evidence that the factory sector has started to see growth moderate – but another sharp rise in utility output prevented an overall IP decline.
- As noted in our August regional Fed survey preview box earlier, evidence is mounting that the industrial sector should see growth moderate later this year. But it won't be a smooth path, and the July IP data are a case in point.
- The July payrolls report showed that factory hours worked rose 0.9% and suggest mining output bounced (there may be some impact from the Gulf oil spillage fallout). These positives will be partially offset by a possible pull-back in utility production, but we still expect a solid 0.5% IP rise in July.

US industrial sector



Key Data and Events

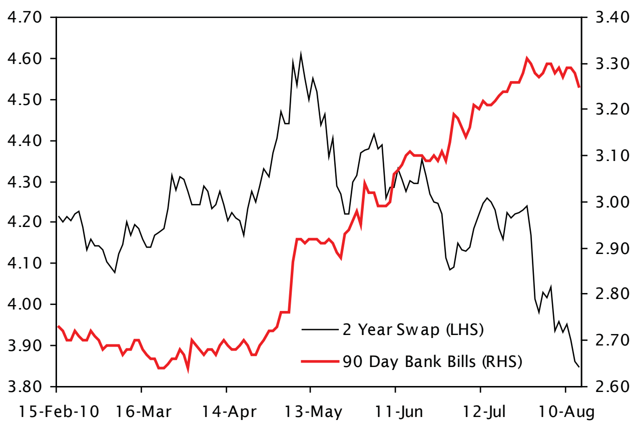
		Last	Market Median	Westpac Forecast	Comments
Mon 16 Aug					
Aus	Jul Motor Vehicle Sales	-1.2%	–	-3.0%	End of tax-break boost to business demand offsets rising cons spend.
US	Aug NY 'Empire' Fed Survey	5.1	8.3	0	Further evidence economy is losing momentum.
	Aug NAHB Housing Market Index	14	15	13	More evidence that housing is slowing again post tax rebate.
	Q2 Mortgage Delinquencies %	10.1%	–	–	Tentative date – data due 16-27/8.
Jpn	Q2 GDP %saar	5.0%	2.3%	3.2%	Consensus has ratcheted lower in recent days.
	Jun Tertiary Activity Index	-0.9%	-0.1%	–	Unlikely to garner much attention when competing with GDP.
Eur	Jul CPI %yr (F)	1.7%a	1.7%	1.7%	Core rate was just 0.9% yr in June.
Tue 17 Aug					
Aus	Aug RBA Board Meeting Minutes	–	–	–	Superseded by SoMP which retained above-trend '11 & '12 growth f/c.
	RBA Governor Stevens Speaking	–	–	–	"The Role of Finance", Perth 6:00pm (20:00 AEST).
US	Jul PPI	-0.5%	0.2%	0.1%	Early month survey timing should miss most of Jul's energy price gain
	Jul PPI Core	0.1%	0.2%	0.0%	and core rate to remain subdued provided vehicle prices don't spike.
	Jul Housing Starts	-5.0%	2.0%	3.0%	A bounce in multiples will mask levelling out in single family starts,
	Jul Building Permits	2.1%	-0.7%	-3.0%	while permits will be weighed down by a fall in multiples.
	Jul Industrial Production	0.1%	0.5%	0.5%	Factory hours up 0.9% but some offset from weaker utility output.
Eur	Jun Current Account €bn	-5.8	–	–	Deficit now firmly entrenched.
Ger	Aug ZEW Economic Sentiment	21.2	20.0	17.0	Analyst expectations have fallen for three months now.
UK	Jul CPI %yr	3.2%	3.1%	3.2%	BRC shop price index suggested little change in annual CPI pace.
Can	Jun Manufacturing Sales	0.4%	-0.5%	–	Have not fallen since Aug last year, but downside risks building.
Wed 18 Aug					
Aus	Jun Leading Index 6mth ann'lsd	6.7%	–	–	Well above trend but suggests growth pulse will peak from mid-year.
	Q2 Wage Price Index %qtr	0.9%	0.9%	1.1%	Trend U 5.3% end-Q1 v 5.8% end-Q3 = WPI acceleration to 3.3%yr.
UK	Aug BoE MPC Minutes	–	–	–	Any more dissenters in favour of modest policy retightening?
Thu 19 Aug					
NZ	Q2 Producer Input Prices	1.3%	–	1.0%	Rising prices for raw materials.
	Q2 Producer Output Prices	1.8%	–	0.9%	Dominated by the rising price of exported dairy & forestry products.
US	Initial Jobless Claims w/e 14/8	484k	478k	475k	With no special factors at play, claims suggest job market is softer.
	Aug Philadelphia Fed Survey	5.1	7.0	3.0	More evidence that US economy is losing momentum.
	Jul Leading Indicators	-0.2%	0.1%	-0.1%	We expect first back to back declines since early 2009.
	Fedspeak	–	–	–	Bullard on the economy.
Jpn	Jun All-Industry Activity Index	0.2%	-0.3%	–	New info on construction and public sector activity.
Ger	Jul PPI %yr	1.7%	3.3%	3.5%	Base effects particularly strong in July.
UK	Jul Retail Sales with fuel	0.7%	0.3%	0.0%	Jul BRC retail report suggested post World Cup sales slump.
	Jul PSNCR £bn	20.9	0.9	–	Public sector net credit requirement.
	Jul Money Supply M4 %yr	3.0%	2.0%	–	Jun data saw first reacceleration in annual pace since July last year.
	Jul Major Bank Mortgage Approvals	48k	–	–	Some loss of momentum in mortgage market.
	Aug CBI Industrial Trends Survey	-16	-14	–	Total orders index.
Can	Jul Leading Index	1.0%	0.7%	–	Have not posted a decline since Apr last year, but risks of fall building.
	Jun Wholesale Sales	-0.1%	0.3%	–	April-May's back to back falls first since early 2009.
Fri 20 Aug					
NZ	Jul External Migration ann.	16,500	–	13,785	Net migration is plunging as more head to Aust and fewer arrive.
	Jul Credit Card Transactions	1.0%	–	–	Some unwind from June when 2011 RWC tickets were purchased.
Can	Jul CPI %yr	1.0%	2.0%	–	Jun BoC core rate was 1.7% yr.
Sat 21 Aug					
Aus	Federal Election	–	–	–	

New Zealand Economic and Financial Forecasts

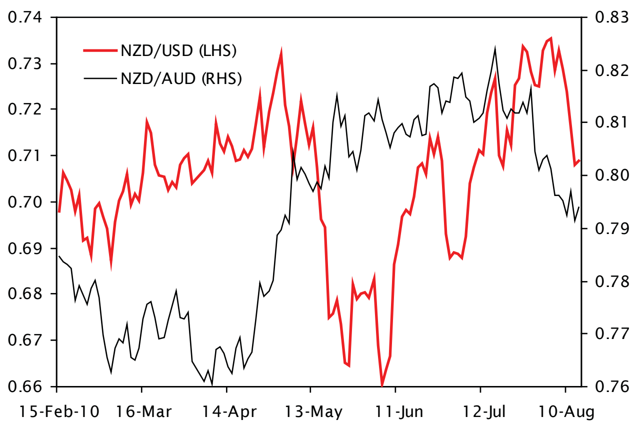
Economic Growth Forecasts	March years				Calendar years			
% change	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
GDP (Production) ann avg	-0.4	3.5	4.1	3.3	-1.6	2.9	4.4	3.4
Employment	-0.1	1.7	1.5	1.7	-2.4	1.9	1.9	1.6
Unemployment Rate % s.a.	6.0	5.8	5.6	5.1	7.1	6.2	5.6	5.2
CPI	2.0	4.7	2.7	3.2	2.0	4.7	2.4	3.3
Current Account Balance % of GDP	-2.4	-3.3	-4.8	-4.9	-2.9	-3.0	-4.6	-5.0

Financial Forecasts	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Cash	3.25	3.50	3.75	4.25	4.75	5.25	5.75
90 Day bill	3.50	3.70	4.20	4.70	5.20	5.70	6.10
2 Year Swap	4.20	4.40	4.80	5.20	5.60	6.00	6.30
5 Year Swap	4.90	5.00	5.30	5.60	5.90	6.20	6.40
10 Year Bond	5.40	5.50	5.70	5.90	6.00	6.20	6.30
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	0.84	0.84	0.84
NZD/JPY	63.4	67.3	71.4	72.8	74.0	75.2	76.3
NZD/EUR	0.55	0.56	0.57	0.58	0.59	0.59	0.59
NZD/GBP	0.47	0.47	0.48	0.48	0.48	0.47	0.46
TWI	67.5	69.0	70.6	71.1	71.4	71.2	71.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 16 August 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	3.00%	3.00%	2.75%
30 Days	3.14%	3.08%	2.97%
60 Days	3.22%	3.20%	3.09%
90 Days	3.26%	3.28%	3.23%
2 Year Swap	3.85%	4.03%	4.19%
5 Year Swap	4.41%	4.68%	4.79%

NZ foreign currency midrates as at Monday 16 August 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7063	0.7329	0.7100
NZD/EUR	0.5532	0.5563	0.5500
NZD/GBP	0.4527	0.4613	0.4644
NZD/JPY	60.860	63.400	61.440
NZD/AUD	0.7908	0.8031	0.8175
TWI	66.230	67.710	66.860

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	3.3	3.5
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	5.1	4.8
Current Account % GDP	-5.8	-5.3	-6.3	-4.4	-4.1	-2.9	-2.1
United States							
Real GDP %yr	3.1	2.7	2.1	0.0	-2.6	2.6	2.5
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.1	1.1	2.2
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.8	10.0
Current Account %GDP	-6.1	-6.0	-5.3	-4.7	-2.7	-3.2	-2.7
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	3.5	1.1
Consumer Prices %yr	-0.3	0.2	0.1	1.4	-1.3	-0.7	-0.2
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	5.1	4.8
Current Account %GDP	3.6	3.9	4.8	3.3	2.8	3.3	3.4
Euroland							
Real GDP %yr	1.7	3.0	2.8	0.6	-4.1	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	1.1	1.0
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.5	3.0
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 6 August 2010

Interest Rate Forecasts	Latest (Aug 16)	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Australia						
Cash	4.50	4.50	4.50	4.75	5.00	5.00
90 Day Bill	4.73	4.75	4.75	5.00	5.25	5.50
10 Year Bond	5.05	5.20	5.30	5.30	5.30	5.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.375
US 10 Year Bond	3.85	3.20	3.40	3.50	3.60	3.80
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00

Exchange Rate Forecasts	Latest (Aug 16)	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
AUD/USD	0.8932	0.88	0.90	0.92	0.90	0.88
USD/JPY	86.17	88	91	94	97	100
EUR/USD	1.2767	1.31	1.33	1.34	1.30	1.26
AUD/NZD	1.2646	1.22	1.22	1.21	1.20	1.19