Westpac

Weekly Commentary

16 November 2009

Peeking under the hood

The Reserve Bank's *Financial Stability Report*, its six-monthly health check of the financial system, highlighted the risks around New Zealand's economic recovery and shed some valuable light on a few important issues.

The international environment has come a long way since the last report in May. Most major economies have either resumed growth or are not far from it, confidence has improved, equities are soaring, and credit markets are back in action. The RBNZ notes that this turnaround has been partly fuelled by fiscal and monetary stimulus, which can't be kept in place forever. On the other hand, policymakers have pledged to keep this stimulus in place until it is clearly no longer needed – which raises interesting questions around how they will know when to start easing back.

New Zealand's economy has also begun to grow, and the improving global environment will support this progress. However, the RBNZ's concerns about imbalances loomed large again. The economy remains heavily reliant on overseas funding, and its exposure to international markets rose in the years leading up to the global financial crisis. The RBNZ noted that there has been some progress in reducing this vulnerability recently, but that the high NZD is not conducive to a lasting improvement in the current account deficit.

Governor Bollard noted that to assist the improvement in New Zealand's international debt position "we need to ensure there is no return to a debt-fuelled housing cycle, which would inevitably bring with it further exchange rate pressure and erosion of competitiveness", elaborating that "if necessary the RBNZ would act to prevent this debt build-up". That can only mean higher interest rates, regardless of whether they're induced by OCR hikes or by other measures such as tighter restrictions on bank lending.

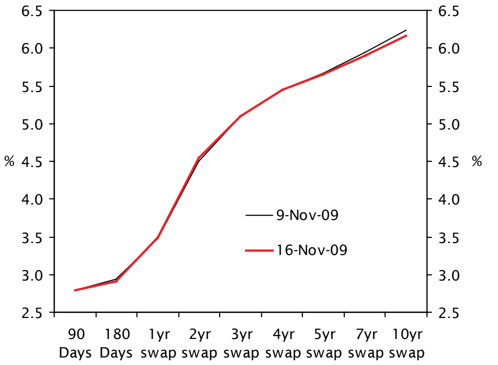
But before anyone jumps to the conclusion that the RBNZ has suddenly turned hawkish, we should emphasise that they still view the housing market as being relatively constrained. REINZ figures for October show that house sales are up 36% on a year ago, but they are still a touch below their long-run trend. And while prices are certainly getting up a head of steam (up 5.6% in the last four months), we see this as an inevitable result of temporary factors. Demand has been boosted by higher net migration and low interest rates, while supply is constrained by a slow response in building activity from levels that are already unsustainably low. But as these pressures start to ease through 2010, and as the potential for changes to the tax treatment of housing looms, we could see prices head lower again.

In addition, this week's retail figures hardly suggest that households are splurging out again on the back of their new-found housing wealth. Retail sales rose just 0.2% in the month of September, with 17 of the 24 storetypes recording either flat or weaker sales. Sales volumes for the September quarter were slightly more encouraging with a 0.1% gain, and excluding vehicles, which have taken a battering in the last year, sales were 0.5% higher. Even so, per capita sales volumes are down a whopping 8.7% from their 2007 peak.

Electronic card transactions for October also showed that consumers remain cautious, with a 0.2% fall in retail transactions. Consumer confidence may be at a four-year high according to the Westpac McDermott Miller survey, but mindful consumption still seems to be the order of the day.

Another important reason for the RBNZ remaining circumspect about the case for OCR hikes is that their new prudential liquidity policy for banks is also adding substantial upward pressure to borrowing rates. The policy requires banks to hold more liquid assets – most likely

NZ Interest Rates



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

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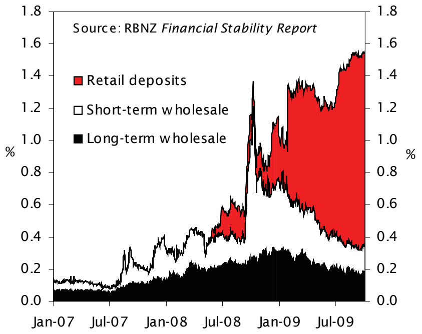
government bonds – to cover potential cash outflows over a one-week and a one-month period, and to limit the proportion of funding from short-term wholesale markets. These rules will become binding from April 2010, but banks have been working towards compliance with the new policy since it was first unveiled in October last year.

The impact on interest rates has already been dramatic, as banks have competed to attract more retail funding. This has seen term deposit rates, which in the past have shadowed the OCR, rise to 5% or more in the case of 'special' rates. A chart in the *Financial Stability Report* reproduced here shows that, under a reasonable set of assumptions, the average cost of new funding for banks has risen to more than 150 basis points over the OCR, compared to about 10 basis points before the financial crisis hit. Indeed, total funding is more expensive now than it was at the height of the crisis in October 2008, following the collapse of Lehmans, AIG and others. The cost of wholesale funding has eased significantly in the last year, but this has been more than offset by the rise in deposit rates.

Marginal cost of funds relative to OCR



Borrowers will be all too aware that this continues to flow through into higher mortgage rates, particularly for longer terms. But let's not forget that it has been a boon for savers too – not a bad way to address that saving/investment imbalance.

Fixed vs. floating: Six-month fixed mortgage rates have now risen – until now this was the only fixed term that had been left unscathed by rate increases. Now that it appears no point on the mortgage curve is 'safe', we could see borrowers seek to fix at whatever favourable rates are still on offer. With floating and one-year fixed rates around similar levels, there may not seem to be much advantage in fixing right now, but those who wait until they see the whites of the RBNZ's eyes before fixing are likely to face much less attractive options. Repaying more than the minimum amount and spreading the loan over a mix of terms can help to reduce overall risk regarding uncertain future interest rate changes.

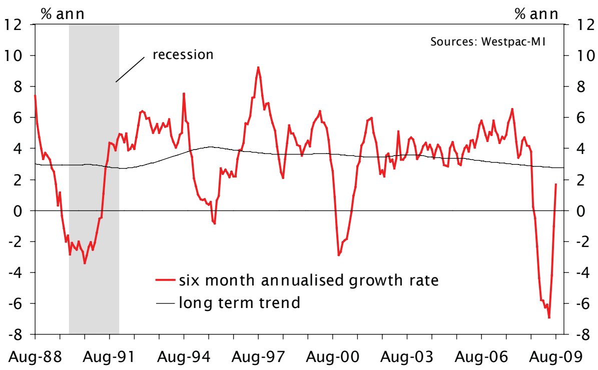
Key Data Previews

Aus Sep Westpac–MI Leading Index

Nov 18, Last: 1.7% 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 1.7% in August, up sharply on the –1% read in July and back in positive territory but well below its long term trend of 2.8%.
- Monthly components were mostly stronger in September: equity markets continued to rally strongly (ASX up another 5.9% in the month); dwelling approvals re-established their uptrend, rising 2.7% after a surprise dip in August; but the money supply contracted 0.2% (vs average +0.9%mth year to date). US industrial production posted a third successive rise, up another 0.7%mth in September.

Westpac-MI Leading Index

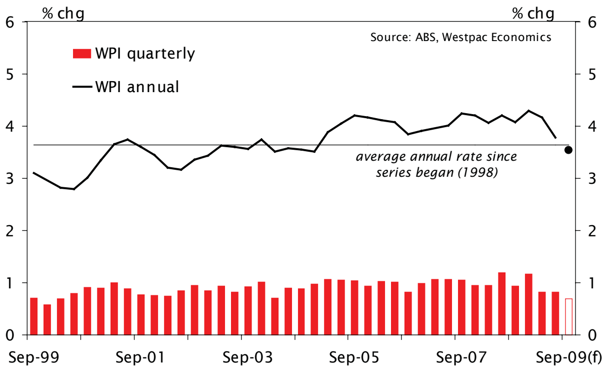


Aus Q3 wage price index

Nov 18, Last: 0.8%, WBC f/c: 0.7%, Mkt f/c: 0.7%, Range: 0.6% to 0.8%

- The wage price index (WPI) repeated Q1's 0.8%qtr result in Q2, the equal lowest since 2004Q1, and with a 1.2%qtr result from a year ago dropping out, annual growth fell to 3.8%yr from 4.2% (equal lowest since 2006Q3), approaching its historic average pace of 3.6%yr. Private sector growth fell to 3.5%yr from 4.1%yr, the weakest since 2004Q4, and back to its full history average pace. The broader measure including bonuses saw private sector growth ease to 3.6%yr from 3.7%.
- With wage growth historically responding to labour market developments with a lag, and the unemployment rate rising most rapidly through 2009H1, WPI growth should continue to ease in Q3. Quarterly business surveys also showed a marked slowing in labour cost pressures in Q3. We forecast a lower WPI result of 0.7%qtr, taking growth to 3.5%yr, below its historic average and at its lowest since 2002Q4.

Wage inflation slowdown continues … for now



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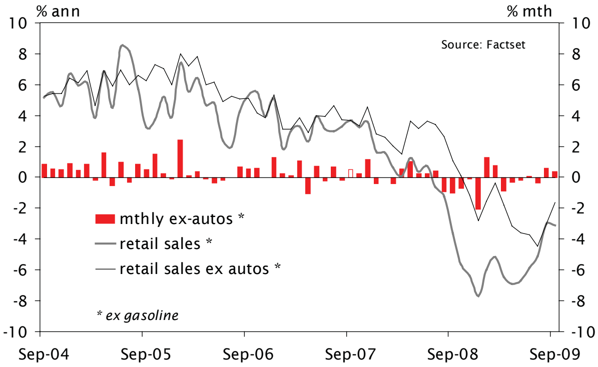
US Oct retail sales boosted by autos again

Nov 16, Last: –1.5%, WBC f/c: 1.2%, Mkt f/c: 0.9%

- Retail sales fell 1.5% in Sep, in the aftermath of the cash for clunkers scheme which saw auto sales plunge 10.4%. But there was some offset from higher gas station sales (prices rose 1% in the month), and moderately broad-based sales in other storetypes: ex autos & gas sales rose 0.4%, on top of a 0.6% rise in Aug.
- October data to hand include a 13% rebound in unit auto sales; fairly flat weekly chains store sales data but accelerating monthly chain store sales; further gasoline price gains; and somewhat weaker consumer confidence across a range of measures.
- Tying all this together we expect a solid 1.2% rise in total retail sales, although taking out the auto and gasoline components, core retailing probably rose just 0.3%.

US retail sales

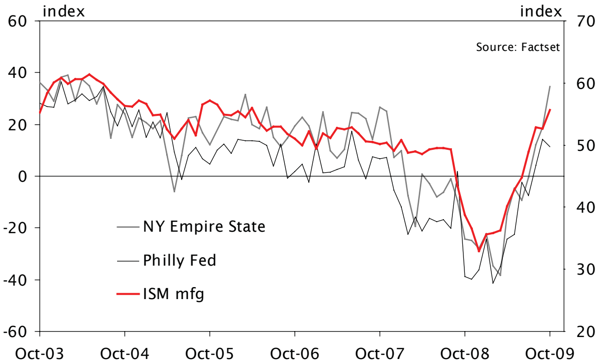


US Nov NY and Philly Fed surveys

Nov 16, New York Fed: Last: 34.6, WBC f/c: 38.0, Mkt f/c: 30.0
Nov 19, Philadelphia Fed: Last: 11.5, WBC f/c: 15.0, Mkt f/c: 12.0

- These surveys helped kick off the cliched "green shoots of recovery" story that emerged in March–April, by turning sharply less negative – consistent with a slower pace of industrial contraction. Since August, both rose above 0 (joining the Richmond Fed), indicative of industrial sector expansion, and the NY Fed in particular has been especially strong, hitting a five year high in October – consistent with rapid industrial expansion and 3–4% annualised GDP growth.
- Without local agents it is difficult to forecast these surveys of just 100 bosses. Maybe Mayor Bloomberg's re-election in NY is a factor this month? However, with the ISM factory index in Oct (whose survey period overlaps with the regional Fed surveys for Nov) pushing sharply higher, we expect both Empire and Philly to rise further as well.

US manufacturing surveys

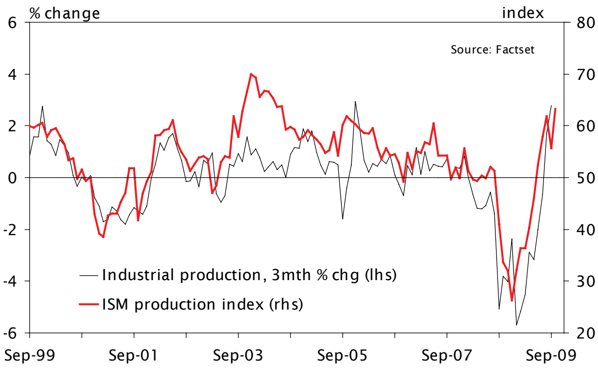


US Oct industrial production to post 4th rise in a row

Nov 17, Last: 0.7%, WBC f/c: 0.5%, Mkt f/c: 0.4%

- For nearly two years, industrial production had just one monthly gain (in Oct 2008), prior to the three monthly gains right through Q3 this year, reflecting surging auto output thanks to cash for clunkers and the reopening of Chrysler/GM plants post bankruptcy; rebuilding of depleted inventory in some sectors; and a modest increase in business investment in plant & equipment (in Jul–Aug but not Sep).
- Business survey evidence points to an Oct IP gain, with the production index of the ISM manufacturing index jumping to a 5 year high last month. However, we also know that factory hours worked fell 0.4% in Oct (despite a 2.5% gain in the auto sector). But productivity gains should offset that fall in hours.
- Hence we're forecasting a 4th straight gain, with a 0.5% Oct rise in IP likely to lift capacity utilisation from 70.5% to 70.9%.

US industrial production rebounds

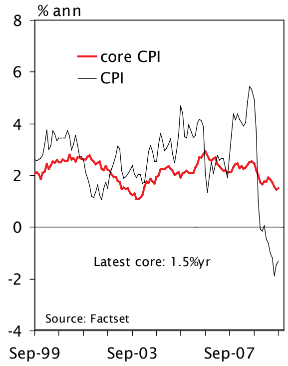


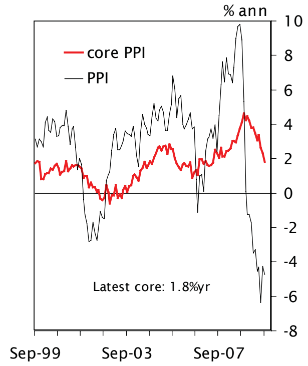
US Oct PPI and CPI – both to rise due to energy prices

Nov 17, PPI headline Last: –0.6%, WBC f/c: 0.4%, Mkt f/c: 0.5%
Nov 18, CPI headline Last: 0.2, WBC f/c: 0.3%, Mkt f/c: 0.2%

- The PPI fell 0.6% in Sep with gasoline prices down 5%, and electricity, clothing, residential gas, capital equipment (including truck) and food prices all falling as well. That was a relatively unusual confluence of price declines and some will reverse in the Oct data; we already know energy prices were higher. And because the PPI was collapsing this time last year, the annual PPI will jump by around 3 ppts to –1.8% yr.
- The CPI posted a 0.2% rise in Sep, with broad-based but soft gains across most components, except for minor declines in food, recreation and the high-weighted owners' equivalent rent (25% of the CPI), which helped prevent a steeper core CPI gain than 0.2%. Provided that component does not rebound, then the Oct rise in gasoline prices could lift the headline CPI by 0.3% but the core should be constrained to 0.1%.

US inflation



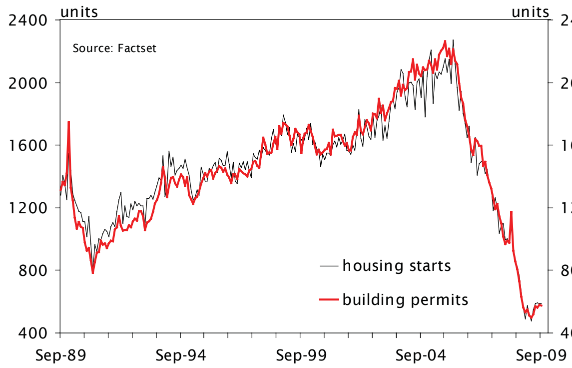


US Oct housing starts and permits

Nov 18, Starts: Last: 0.5%, WBC f/c: 2.5%, Mkt f/c: 1.4%
Nov 18, Permits: Last: –0.9%, WBC f/c: 0.0%, Mkt f/c: 0.9%

- On a range of indicators since about May this year, housing has shown clear signs of turnaround after several years of tumbling prices and activity. But since Jul–Aug, the starts/permits story has been a little less impressive, with the single family starts uptrend faltering, multiple starts volatility returning and single family permits showing signs of softening.
- In Oct, construction jobs fell by 62k (in line with the recent trend), hours worked fell 2.6%, and homebuilder confidence slipped for the first month in four. These signals are not weak enough for us to forecast a decline in starts because multiples are due to bounce. However a probable pull-back in multiples permits is likely to prevent a gain in total permits.
- Watch the Nov NAHB housing index on 17/11 for evidence of the impact from the extended first home buyer tax credit.

US housing starts and permits



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Key Data and Events

		Last	Market Median	Westpac Forecast	Comments
Mon 16 Nov					
US	Oct Retail Sales	–1.5%	0.9%	1.2%	Auto sales up 13%; chain store reports mixed/solid; gasoline prices up.
	Oct Retail Sales ex Autos & Gas	0.4%	0.3%	0.3%	Some signs of modest broad-based spending growth emerging.
	Nov NY Fed Empire State Factory Idx	34.6	30.0	38.0	Mayor Bloomberg back in? This survey often driven by local factors.
	Sep Business Inventories	–1.5%	–0.7%	–0.4%	Slower pace of decline consistent with stock-building cont'n to GDP.
	Fed Chair Bernanke	–	–	–	Eco Club of NY, economic outlook.
	Fedspeak	–	–	–	Kohn "Federal Reserve Policy Challenges" & Fisher on economy.
Jpn	Q3 GDP % saar	2.3%	2.9%	2.6%	Big swings in contribution of net X, inventories and investment.
Eur	Oct CPI (F) %yr	–0.1% a	–0.1%	–0.1%	Base effects will soon see (subdued) positive inflation again.
UK	Nov House Prices %yr	0.2%	–	–	Rightmove index. First positive annual pace since June last year.
Can	Sep Manufacturing Sales	–2.1%	1.7%	–	Aug decline on autos and aircraft.
Tue 17 Nov					
Aus	RBA Minutes, Nov Meeting (11:30am)	–	–	–	Provide more colour to policy of gradually lessening stimulus.
US	Oct PPI	–0.6%	0.5%	0.4%	Falling energy, truck and other prices in Sep will largely reverse in Oct
	Oct PPI Core	–0.1%	0.1%	0.2%	and deliver a stronger PPI.
	Sep Net Long Term TIC Flows $bn	28.6	30.0	–	Guide to nature and extent of funding of US current account deficit.
	Oct Industrial Production	0.7%	0.4%	0.5%	Manuf'g hours down 0.4% but strong productivity to deliver gain.
	Nov NAHB Housing Market Index	18	19	20	Extension of first home buyers' tax credit to help builder sentiment.
	Fedspeak	–	–	–	Lacker and Pianalto.
Jpn	Sep Tertiary Activity Index	0.3%	0.1%	–	A little anti-climactic when released after preliminary GDP estimate.
Eur	Sep Trade Balance sa €bn	1.0	–	–	Back in surplus for 5 mths running – car scrappage schemes a factor.
UK	Oct CPI %yr	1.1%	1.4%	1.6%	Base effects, fuel and weaker sterling to push CPI higher.
Wed 18 Nov					
Aus	Sep Westpac-MI Leading Index	1.7%	–	–	Back in positive territory for first time since Lehman's collapse.
	Q3 Wage Price Index	0.8%	0.7%	0.7%	Lagged unemploy't rise & low NAB survey measure; 3.5%yr vs 3.8% prev.
	Oct Merchandise Imports, nsa AUDbn	17.6	–	–	Up 13.9% in Sep = 6.4% sa, restoring uptrend despite value drag from A$.
	RBA Assist. Gov Debelle (Financial Mkts)	–	–	–	"Whither Securitisation?", Aust Securitisation Conference, 9am
US	Oct CPI	0.2%	0.2%	0.3%	Higher gasoline prices pose some risk to headline rate but pressures
	Oct CPI Core	0.2%	0.1%	0.1%	that lifted core rate to 0.164% in Sep will partly abate.
	Oct Housing Starts	0.5%	1.4%	2.5%	Probable bounce in multiple starts but softer new home sales and
	Oct Building Permits	–0.9%	0.9%	0.0%	builder sentiment will constrain underlying picture.
	Fedspeak	–	–	–	Bullard on the economy.
Eur	Sep Current Account Balance sa €bn	–1.3	–	–	Briefly back in surplus for one month in July.
UK	Nov BoE MPC Minutes	–	–	–	Was the decision to increase QE by £25bn unanimous?
	Nov CBI Industrial Trends Survey	-51	–	–	Orders measure slipped 3pts from –48 in Oct survey.
Can	Oct CPI %yr	–0.9%	0.1%	–	Inflation remains well below target but base effects mean headline
	Oct CPI BoC Core %yr	1.5%	1.7%	–	annual rates will rise more than 2ppts over next 4 months.
Thu 19 Nov					
Aus	RBA Monthly Bulletin	–	–	–	Can include research articles.
	RBA Assist. Gov Debelle (Financial Mkts)	–	–	–	Panel discussant, Financial Services Industry Executive Forum, 12pm
US	Initial Jobless Claims w/e14/11	502k	505k	500k	Claim could soon be hinting at positive payrolls growth, albeit temp.
	Oct Leading Index	1.0%	0.4%	0.6%	Heading for seventh consecutive positive reading.
	Nov Philadelphia Fed Factory Index	11.5	12.0	15.0	Strong Oct ISM has survey overlap period with Nov Philly Fed.
	Fedspeak	–	–	–	Plosser and Fisher.
Jpn	Sep All-Industry Index	0.9%	–0.1%	–	A little anti-climactic when released after preliminary GDP estimate.
UK	Oct Bank Mortgage Approvals	56k	–	–	Recovery in new approvals seems to have stalled recently.
	Oct Retail Sales Volumes	0.0%	0.5%	0.5%	Private retailer surveys suggest some growth, but ONS data yet to.
	Oct M4 Money Supply %yr	11.6%	9.9%	–	Growth has plunged from 18.7% yr in Feb.
	Oct PSNCR £bn	19.4	4.0	–	Public sector net credit requirement.
Can	Sep Wholesale Sales	–1.4%	1.0%	–	Aug weakness due to farm products and clothing.
	Oct Leading Index	1.1%	0.7%	–	Up four months running in June to September.
Fri 20 Nov					
NZ	Oct Credit Card Transactions	–1.0%	–	–	Expect strong bounce back from dip last month.
Jpn	Bank of Japan Meeting	0.10%	0.10%	0.10%	Now forecasting deflation out to the horizon.
Ger	Oct Producer Prices %yr	–7.6%	–7.5%	–7.3%	Base effects will push annual rate sharply higher from Nov.

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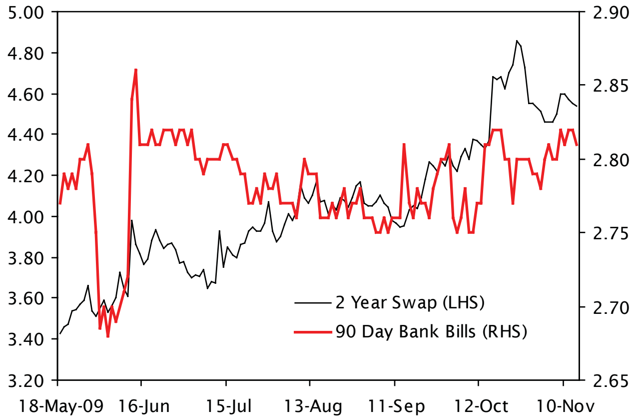
New Zealand Economic and Financial Forecasts

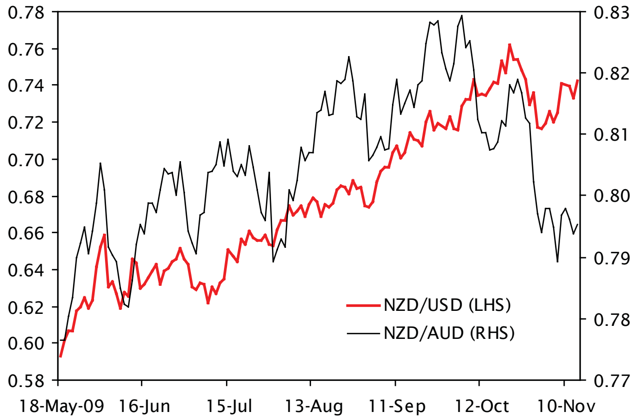
Economic Growth Forecasts	March years				Calendar years			
% change	2008	2009	2010f	2011f	2008	2009f	2010f	2011f
GDP (Production) ann avg	3.1	-1.1	0.0	3.8	0.0	-1.3	3.5	3.8
Employment	-0.3	0.7	-0.8	1.6	0.9	-2.1	1.0	1.8
Unemployment Rate % s.a.	3.8	5.0	6.7	5.3	4.7	6.7	6.3	5.5
CPI	3.4	3.0	2.4	2.8	3.4	2.5	2.4	2.8
Current Account Balance % of GDP	-7.9	-8.1	-2.5	-5.3	-8.9	-2.6	-4.0	-5.2

Financial Forecasts	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11
Cash	2.50	2.75	3.25	3.75	4.25	4.75	5.25
90 Day bill	2.90	3.20	3.70	4.20	4.70	5.20	5.70
2 Year Swap	4.70	5.10	5.40	5.70	5.90	6.10	6.20
5 Year Swap	5.80	6.00	6.10	6.20	6.30	6.40	6.50
10 Year Bond	6.00	6.10	6.20	6.30	6.30	6.40	6.50
NZD/USD	0.77	0.77	0.73	0.76	0.78	0.77	0.75
NZD/AUD	0.80	0.80	0.81	0.82	0.82	0.83	0.83
NZD/JPY	67.8	67.8	67.9	73.0	78.0	81.6	81.8
NZD/EUR	0.51	0.51	0.50	0.51	0.52	0.52	0.51
NZD/GBP	0.44	0.43	0.42	0.42	0.43	0.43	0.40
TWI	67.5	67.4	65.9	67.9	69.6	70.2	69.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 16 November 2009

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.80%	2.80%	2.80%
60 Days	2.80%	2.80%	2.78%
90 Days	2.80%	2.78%	2.82%
2 Year Swap	4.54%	4.51%	4.67%
5 Year Swap	5.66%	5.66%	5.64%

NZ foreign currency midrates as at Monday 16 November 2009

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7437	0.7168	0.7413
NZD/EUR	0.4981	0.4852	0.4973
NZD/GBP	0.4447	0.4376	0.4531
NZD/JPY	66.590	64.710	67.380
NZD/AUD	0.7961	0.7941	0.8087
TWI	66.170	64.570	66.480

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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	2.4	1.0	2.8
CPI inflation % annual	2.6	2.8	3.3	3.0	3.7	2.0	2.2
Unemployment %	5.4	5.1	4.8	4.4	4.3	5.7	6.4
Current Account % GDP	-6.1	-5.8	-5.3	-6.3	-4.6	-4.1	-4.7
United States							
Real GDP %yr	3.6	3.1	2.7	2.1	0.4	-2.5	1.6
Consumer Prices %yr	2.6	3.4	3.2	2.9	3.8	-0.5	1.3
Unemployment Rate %	5.5	5.1	4.6	5.8	9.2	10.5	10.8
Current Account %GDP	-5.7	-6.1	-6.0	-5.3	-4.9	-2.9	-2.5
Japan							
Real GDP %yr	2.3	1.9	2.8	2.2	-1.0	-6.0	1.1
Consumer Prices %yr	-0.1	-0.3	0.2	0.1	1.4	-1.2	-0.6
Unemployment Rate %	4.5	4.4	4.1	3.9	4.0	5.2	5.9
Current Account %GDP	3.3	3.6	3.9	4.8	3.2	2.6	3.0
Euroland							
Real GDP %yr	2.2	1.7	2.9	2.7	0.6	-4.0	0.7
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	-4.7	0.3
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 6 November 2009

Interest Rate Forecasts	Latest (Nov 16)	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Australia						
Cash	3.50	3.75	4.00	4.50	4.50	4.50
90 Day Bill	3.99	4.00	4.30	4.70	4.60	4.75
10 Year Bond	5.56	6.00	5.70	6.20	6.50	6.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.42	3.50	3.20	3.75	4.25	4.50
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.25

Exchange Rate Forecasts	Latest (Nov 16)	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
AUD/USD	0.9342	0.96	0.96	0.90	0.93	0.95
USD/JPY	89.54	88	88	93	96	100
EUR/USD	1.4930	1.51	1.51	1.47	1.50	1.51
AUD/NZD	1.2562	1.25	1.25	1.23	1.22	1.22

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