

# Weekly Commentary

17 August 2009

## A consumer comeback

Last week's data provided further evidence that consumers are finding their feet again, following a protracted retreat over the last two years.

Retail sales held their ground in June, following gains of 1.2% in the previous two months. Clothing sales slowed as expected in June, as unusually cold weather saw spending on winter woollies brought forward to May. However, appliance sales were up nearly 10%, which is likely to be a product of the pickup in housing market activity.

That left retail sales volumes up 0.4% for the June quarter, a welcome change after six consecutive quarterly declines. Rising net migration, an improving housing market, an increasing punch from prior interest rate cuts and the April tax cuts have all helped to arrest the decline in sales volumes. But retailers won't be jumping for joy just yet – sales remain at very low levels. On a per person basis, sales volumes have dropped 8.7% from their peak in early 2007.

The good news is that we expect growth off this low base. Electronic transaction data point to further resilience in spending in July, and consumer confidence surveys suggest this could be carried through to August as well. More significantly, the ratio of inventories to sales fell to record lows in Q2, as retailers continued to run down stocks, particularly motor vehicles and other durable goods. With sales now

turning up, along with expectations of more growth ahead, NZ – along with many other developed economies – is likely to benefit from the restocking phase of a classic inventory cycle. This is an important part of our forecast for a return to GDP growth in the second half of this year, and indeed it could well be stronger than we have allowed for.

The housing market continued to gain ground in July, with sales rising 7.4% (s.a) and prices holding steady both for the month and versus a year ago. The average number of days to sell dropped to 37, the lowest since December 2007, consistent with reports of a shortage of new listings on the market. Rising net migration is clearly offsetting some of the negative impacts of rising unemployment, high debt levels and higher fixed-term mortgage rates (although the more popular short-term fixed rates remain at historically low levels).

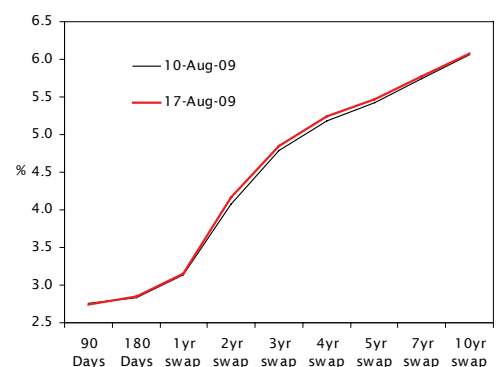
This month also marked the first release of the new 'stratified' house price index, which adjusts for changes in the composition of the houses being sold, giving a more accurate measure of house price movements. The upshot is that house prices last year fell by more than indicated by the simple median sales price – but by the same token, the recovery since then has been stronger.

One interesting snippet from the new series is that section prices, which

have generally followed the trend in actual house prices in the past, have been much weaker so far in 2009, down 20% on a year ago. This provides further support for our story of a rebound in residential investment through next year: if house prices are rising, but a key input (land) is getting relatively cheaper, it makes more sense to build.

The combination of rising consumer spending and housing activity is no accident, as we discussed in a recent Bulletin (*"The return of HEW?"*, 10 August). Households can withdraw equity by increasing debt against the existing housing stock; alternatively, they can inject equity by paying down debt, or by financing renovations at least partly from their own pockets. Our earlier research found that housing equity withdrawal (HEW) is strongly associated with housing turnover. One way this can occur is that

**NZ Interest Rates**



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

buyers top up their loans to buy other goods, especially durable items such as cars, appliances and furniture, at the same time as the house purchase.

During the housing market correction of the last two years, we estimate that homeowners switched from a peak equity withdrawal of \$5.6bn in the year to June 2007 to maximum injection of \$5.9bn in the year to March 2009 – a turnaround \$11.5bn. We estimate that 25-30% of HEW is spent, which points to around a \$3bn dollar drag on household spending over the two years to March 2009. No wonder that retail sales volumes fell so sharply in that time, with durable items bearing the brunt of the slowdown.

However, the strong rise in house sales and the stabilisation of house prices in recent months, aided by low interest rates,

suggest that the pace of home equity injection will start to ease. Indeed, on a quarterly basis this easing appears to be underway already, and a return to equity withdrawal next year can't be ruled out. And it's the change in HEW that matters for spending and economic growth: even if equity injection only dwindled to zero, we estimate this would support consumer spending to the tune of \$1.4-1.7bn over the next 18 months.

An economic recovery is certainly desirable, but a rapid return to home equity withdrawal would heighten the RBNZ's concerns about lop-sided, consumption-centric growth that could prove to be unsustainable. But as much as they would like to see a greater contribution from the export sector, their choices aren't getting any more palatable. The effect of lower interest rates on the NZ

dollar is far from straightforward, as there are many intervening factors (some of which are themselves affected by interest rates). On the other hand, the effect of lower interest rates on the domestic economy, and in particular the housing market, is indisputable.

**Fixed vs. floating:** Interest rates have bottomed and are likely to trend higher over coming years, although the RBNZ's intention to keep the OCR low suggests little pressure for short-term rates to rise any time soon. We recommend fixing for six months to one year, which remain easily the most favourable rates on offer. While a strategy of fixing for short terms creates more uncertainty about future cash flows, borrowers can reduce this uncertainty by repaying more than the minimum amount while interest rates are at the lower end of the cycle.

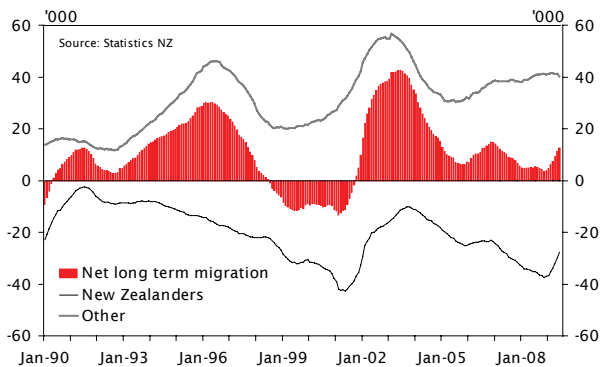
## Key Data Previews

### NZ Jul external migration ann.

Aug 21, Last: 12,500, WBC f/c: 14,300

- The trend in NZ net migration is rising sharply on the back of lower departures to Australia. We expect this momentum to continue for some months, underpinning the NZ economy and the housing market in particular.
- In June, we saw an unexpected drop in PLT arrivals of foreigners in the under-49 age brackets from a range of countries. For now, we are putting this down to monthly volatility.
- We expect annual net migration of around 14,300 in July, versus 12,500 in June. We are forecasting 25,000+ per annum by mid 2010, but this will depend crucially on the relative performance of the NZ and Australian economies.
- Weekly data suggest visitor arrivals remain relatively weak, which may be a swine flu impact, as well as the general economic malaise affecting our tourism markets.

Net migration

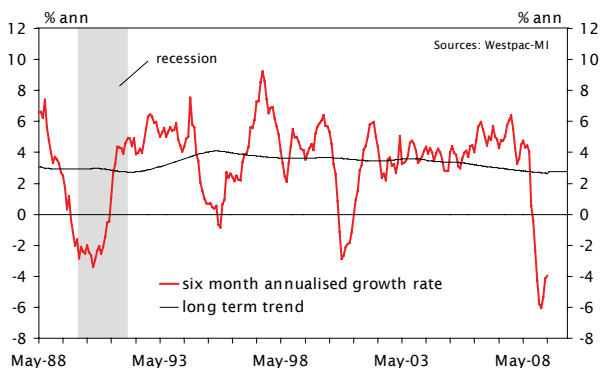


### Aus Jun Westpac-MI Leading Index

Aug 19, Last: -3.9% 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 -3.9% in May, up strongly on its February low point but still well below its long term trend of 2.6%.
- Most monthly components improved in June: the equity market rally continued, albeit at a slower pace (ASX up 3.6% in the month but up 10%+ since then); the money supply expanded 0.7%, down a touch on previous months; but dwelling approvals snapped back smartly, rising 9.3% in June after the surprisingly sharp 11% drop in May; and the slide in US industrial production moderated, down 0.4% in June after 1.2% drop in May and average monthly declines of 1.1% over the previous three months.

Westpac-MI Leading Index



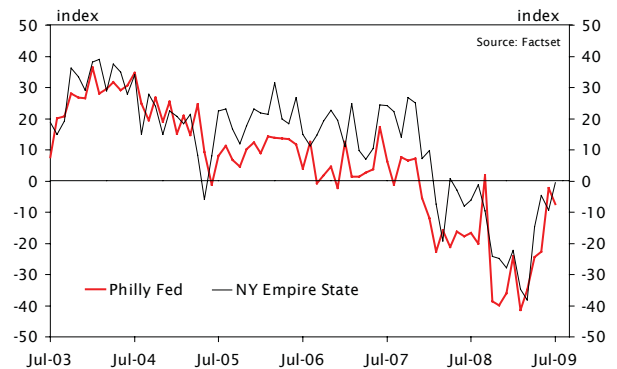
### US August NY and Philly Fed surveys

Aug 17, New York Fed: Last: -0.6, WBC f/c: 5.0

Aug 20, Philadelphia Fed: Last: -7.5, WBC f/c: -1.0

- These surveys helped kick off the cliched “green shoots of recovery” story that emerged in March-April, though the reality is that despite the recent higher readings (NY sharply higher in July, Philly in June), both remain at levels consistent with declining output, albeit at a much slower pace than in Q1. That compares with 3 consecutive months of industrial expansion recorded by the Richmond Fed survey.
- Without local agents it is difficult to forecast these surveys of just 100 bosses. However, based on previous patterns, we expect the Philly Fed to correct higher in Aug, to just shy of neutral 0, but the NY Fed to climb to a new high, above 0.
- These outcomes would be broadly consistent with the gradual stabilisation in factory output now apparent across a range of indicators.

### US regional manufacturing surveys



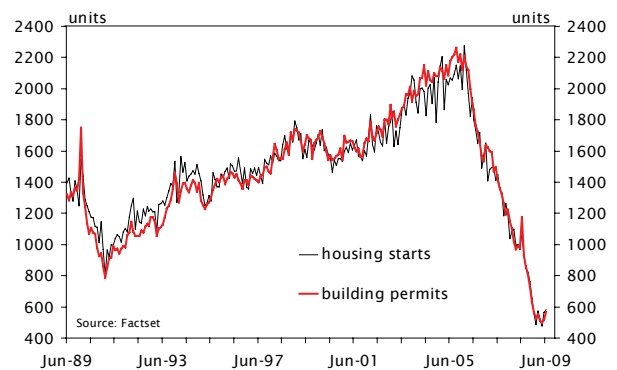
### US July housing starts and permits

Aug 18, Starts: Last: 3.6%, WBC f/c: 10.0%

Aug 18, Permits: Last: 8.7%, WBC f/c: 2.0%

- 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, and surged 14.4% in June; that strength looks to be sustainable with new home sales now up three months running including an 11% spike in June.
- In July, construction jobs fell by 76k, way down on the 100+ losses up until April, and homebuilder confidence rose to a 10 month high. These factors point to a further rise in single family house starts. Also multiple starts dropped 26% in Jun and have been extraordinarily volatile this year so far, so a July multiples bounce would add to the headline starts rise. In contrast, July permits might be constrained by a pull-back in multiples after a 19% June jump.

### US housing starts and permits



## Key Data and Events

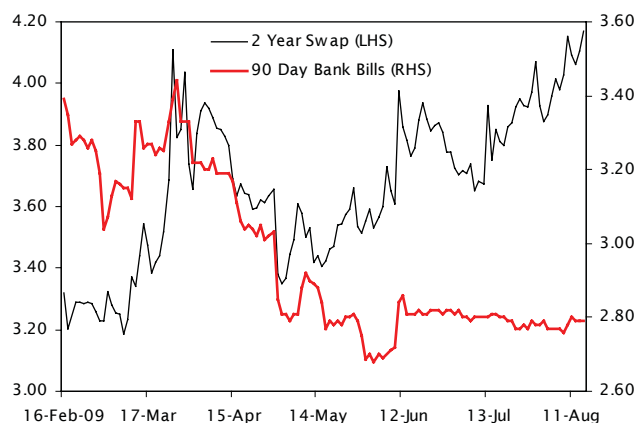
	Last	Market Median	Westpac Forecast	Comments	
<b>Mon 17 Aug</b>					
US	Aug Empire Manufacturing	-0.6	3.0	5.0	Expected to move into positive territory in August, a fresh cycle high.
	Jun TIC Data \$bn	-19.8	17.5	-	Net long term TIC flows.
	Aug NAHB Housing Market Index	17	18	-	Housing has shown clear signs of turnaround, lifting index to 10mth high.
Jpn	Q2 GDP %saar	-14.2%	3.9%	4.1%	Dramatic shift in net X cont. plus fiscal support drives return to growth.
Eur	Jun Trade Balance, €bn sa	0.8	1.3	-	In surplus for two months as imports fell faster than still weak exports.
UK	Aug Rightmove House Prices	0.6%	-	-	Index of England/Wales vendor asking prices firmed to -3.1%yr.
<b>Tue 18 May</b>					
Aus	Aug RBA Meeting Minutes	-	-	-	Statement dropped easing bias; to provide further colour to Aug SoMP.
US	Jul PPI	1.8%	-0.3%	-	Sharp deceleration on energy price base effects.
	Jul PPI Core	0.5%	0.1%	-	Upstream pressures meek with capacity utilisation at post war lows.
	Jul Housing Starts	3.6%	2.7%	10.0%	Recovery underway; new home sales up 3 mths; likely multiples bounce.
	Jul Building Permits	8.7%	2.3%	2.0%	July permits likely constrained by multiples pullback after June surge.
Eur	Aug ZEW Survey Economic Sentiment	39.5	43.0	-	Expectations fell in July for first time since Oct-08, impacted by ...
Ger	Aug ZEW Survey Economic Sentiment	39.5	45.0	-	... slippage in equities and pullback in optimism about global recovery.
UK	Jul CPI %yr	1.8%	1.5%	-	Sub-2% target with favourable base effects & less impact from £ fall.
Can	Jul CPI %yr	-0.3%	-0.8%	-	Turned negative due to gasoline base effects. Jun core CPI was 1.9%yr.
<b>Wed 19 Aug</b>					
NZ	Q2 Producer Output Prices	-1.4%	-0.5%	-0.5%	A stronger NZD to weigh on selling price.
	Q2 Producer Input Prices	-2.5%	-1.0%	0.5%	Electricity and fuel prices to drive costs higher.
Aus	Jun Westpac-MI Leading Index	-3.9%	-	-	Growth up strongly from Feb low but still well below 2.6% LR trend.
	RBA Asst Gov Edey Speaking	-	-	-	"Examining the Impact of the GFC on Retail Financial Services in Aust".
	Treasury Sec. Henry Speaking	-	-	-	"Implications of the Tax Review" to Australian Economic Forum.
	RBA Asst Gov Lowe Speaking	-	-	-	"Reforming Policy" to Australian Economic Forum.
Jpn	Jun All-Industry Activity Index	0.7%	0.3%	-	Loses impact with release time post Monday's GDP.
Eur	Jun Current Account Balance, €bn sa	-1.2	-	-	In deficit since March last year despite recent trade surpluses.
Ger	Jul Producer Prices %yr	-4.6%	-6.5%	-	Weakest since late-60s, but base effects should soon soften decline.
UK	Aug Bank of England Minutes	-	-	-	Extended QE program & noted "the trough in output is close at hand".
	Aug CBI Industrial Trends Survey	-	-	-	Jul results mixed with total orders slipping, but export orders less weak.
Can	Jul Leading Indicators	-0.1%	0.2%	-	Rate of decline has eased markedly last 2mths implying H2 stabilisation.
<b>Thu 20 Aug</b>					
Aus	Jul Merchandise Imports AUDbn	15.7	-	-	Rose 6.4% in Jun, translating to -0.1% sa, tempering trend decline.
	RBA Richards Speaking	-	-	-	"Australia's Housing Challenges" to Aust Economic Forum (14:00 AEST).
	Aug RBA Monthly Bulletin	-	-	-	Can include recent RBA Research articles.
US	Initial Jobless Claims w/e 15/8	558k	550k	-	Still at the tail end of Jul/Aug seasonal quagmire: interpret cautiously.
	Jul Leading Indicators	0.7%	0.7%	-	ECRI weekly index is pointing north.
	Aug Philadelphia Fed Index	-7.5	-2.0	-1.0	Stabilisation in factory output argues for further rise towards neutral.
UK	Jul Retail Sales	1.2%	0.4%	-	Strong June result had detail consistent with a hot weather boost.
	Jul Public Finances PSNCR £bn	19.0	-5.6	-	The black hole that is UK public finances.
Can	Jun Wholesale Sales	-0.3%	0.1%	-	May decline was 8th consecutive drop, but also the smallest fall.
<b>Fri 21 Aug</b>					
NZ	Jul External Migration ann.	12,500	-	14,300	Strong upward trend in net migration expected to reassert itself.
	Jul Credit Card Transactions	0.2%	-	-	Moderate rise expected in July, as consumer confidence returns.
US	Jul Existing Home Sales	3.6%	2.1%	-	Pending sales data points to a further rise.
	Fedspeak	-	-	-	Bernanke at KC Fed's annual Jackson Hole symposium.
Eur	Aug PMI Manufacturing, Advance	46.3	47.5	-	Both these surveys approaching neutral levels, indicating Euroland
	Aug PMI Services, Advance	45.7	46.5	-	economy still contracting in early Q3, but at a slower pace than Q2.

## New Zealand Economic and Financial Forecasts

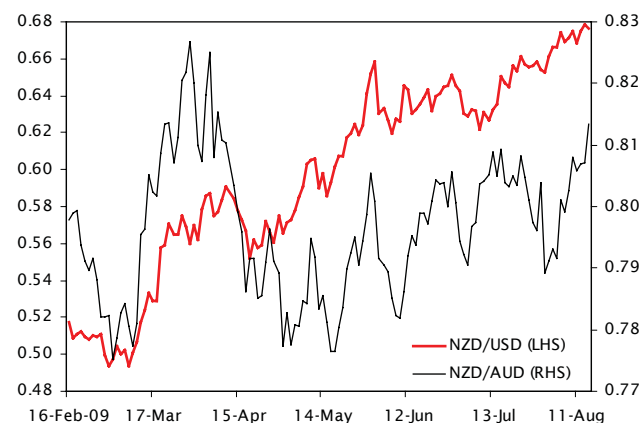
Economic Growth Forecasts	March years				Calendar years			
	2008	2009	2010f	2011f	2008	2009f	2010f	2011f
% change								
GDP (Production) ann avg	3.1	-1.0	-1.2	3.2	0.2	-2.1	2.6	3.6
Employment	-0.3	0.8	-1.5	1.6	0.9	-2.6	1.1	1.7
Unemployment Rate % s.a.	3.8	5.0	7.0	6.6	4.7	6.9	6.7	6.2
CPI	3.4	3.0	2.0	1.6	3.4	2.1	1.2	2.1
Current Account Balance % of GDP	-8.0	-8.5	-4.7	-5.7	-9.0	-4.9	-5.5	-6.5

Financial Forecasts	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Cash	2.50	2.50	2.50	2.50	3.00	4.00	5.00
90 Day bill	2.80	2.80	2.80	2.90	3.60	4.60	5.50
2 Year Swap	3.90	4.10	4.30	4.60	5.00	5.40	5.85
5 Year Swap	5.30	5.40	5.50	5.60	5.80	6.00	6.30
10 Year Bond	5.80	5.90	6.00	6.10	6.20	6.30	6.40
NZD/USD	0.69	0.63	0.67	0.69	0.71	0.74	0.73
NZD/AUD	0.80	0.79	0.81	0.81	0.82	0.83	0.85
NZD/JPY	66.9	58.0	63.0	66.2	70.7	76.2	77.4
NZD/EUR	0.47	0.45	0.47	0.48	0.49	0.50	0.50
NZD/GBP	0.40	0.39	0.40	0.40	0.41	0.40	0.39
TWI	63.7	59.4	62.6	64.0	65.9	67.8	67.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



## NZ interest rates as at market open on Monday 17 August 2009

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.79%	2.78%	2.80%
60 Days	2.80%	2.79%	2.80%
90 Days	2.75%	2.77%	2.80%
2 Year Swap	4.17%	3.90%	3.80%
5 Year Swap	5.47%	5.27%	5.28%

## NZ foreign currency midrates as at Monday 17 August 2009

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.6746	0.6664	0.6446
NZD/EUR	0.4754	0.4626	0.4573
NZD/GBP	0.4086	0.3939	0.3947
NZD/JPY	63.920	63.510	60.760
NZD/AUD	0.8130	0.7931	0.8032
TWI	62.940	61.690	60.660

## Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2004	2005	2006	2007	2008	2009f	2010f
<b>Australia</b>							
Real GDP % yr	3.8	2.8	2.9	4.0	2.3	0.2	1.8
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	-6.2	-4.3	-3.7	-4.8
<b>United States</b>							
Real GDP %yr	3.9	3.1	2.8	2.1	0.4	-2.9	1.2
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	9.5	11.1
Current Account %GDP	-5.7	-6.1	-6.0	-5.2	-4.9	-2.8	-2.5
<b>Japan</b>							
Real GDP %yr	2.3	1.9	2.8	2.1	-0.8	-6.6	1.5
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	2.4	2.5
<b>Euroland</b>							
Real GDP %yr	1.9	1.8	3.1	2.7	0.6	-4.9	-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
<b>United Kingdom</b>							
Real GDP %yr	3.0	2.2	2.9	2.6	0.7	-4.6	0.4
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 7 August 2009

Interest Rate Forecasts	Latest (Aug 17)	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10
<b>Australia</b>						
Cash	3.00	3.00	3.00	3.25	3.50	3.75
90 Day Bill	3.30	3.35	3.40	3.75	4.00	4.25
10 Year Bond	5.62	5.40	5.50	5.80	6.25	6.25
<b>International</b>						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	3.57	3.50	3.40	3.75	4.00	4.25
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00
<b>Exchange Rate Forecasts</b>						
AUD/USD	0.8298	0.86	0.80	0.83	0.85	0.87
USD/JPY	94.76	97	92	94	96	99
EUR/USD	1.4189	1.46	1.40	1.42	1.44	1.46
AUD/NZD	1.2301	1.25	1.27	1.24	1.23	1.22

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