

Weekly Commentary

18 October 2010

Realty bites

Last week's data provided more evidence of the renewed weakness in household activity since the start of this year.

House sales fell further in September, to be down 33% on a year ago. Part of that reflects the Canterbury earthquake early in the month, which left sales in Christchurch City down 62% on a year earlier. But even after making an adjustment for earthquake effects, we estimate that national sales would have fallen by 2.7% in seasonally adjusted terms. After a strong pickup in 2009, housing turnover has fallen back to near its 2008 lows.

The September manufacturing PMI eased from 49.3 to 49.2, the second month below the 50 mark that signifies growth. Anecdotes suggest that export-oriented manufacturers are faring better – especially those who sell into the strong Australian market, with the NZD/AUD exchange rate back towards ten-year lows. That implies those who produce for the domestic market are finding things particularly tough. Weak demand for carpet, furniture and appliances would be one consequence of the slowdown in housing turnover.

Retail sales were flat in August, and even that was flattered by a rebound in vehicle and fuel sales after a downward blip in July. The 0.6% fall in core sales was spread across most categories, with the largest negative contributions coming from durable goods such as hardware and appliances.

The weakness of the August figures tells us nothing about consumer behaviour ahead of the 1 October GST increase; electronic card transactions data for September has already shown that the spending boost was largely limited to the days before the tax hike, as we expected. Retail transactions were up 1.5% for the month, although that also reflects the disruption to business from the Canterbury earthquake. We estimate that the GST effect, on its own, was worth about 3% of monthly sales. We also estimate that car registrations were up about 3% for the month (vehicle sales generally aren't captured in card transactions). Outside of the GST effect, though, spending appears to have been broadly flat for another month.

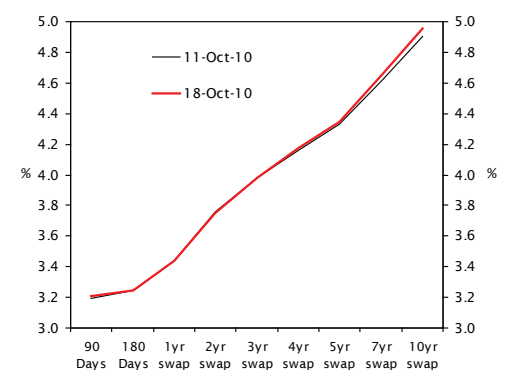
At Thursday's release of the Crown financial accounts for the year to June, the discussion neatly drew the link between the state of the housing market and consumer spending. Tax revenue remains well down on pre-recession levels, partly because of a dramatic shift in household behaviour away from debt accumulation and towards saving in the last few years.

In the year to June 2007, we estimate that households 'withdrew' about \$5bn of housing equity – that is, housing debt rose more than the value of net additions to the housing stock. But as higher mortgage rates began to cool the housing market, the rate of withdrawal soon followed

(equity withdrawal is highly correlated with housing turnover). That process accelerated during the 2008 recession, and by early 2009 it had turned around to a \$6bn annual equity injection. (Note that this doesn't just refer to people paying down debt, but also putting more of their own money into new homes or alterations – which is still a form of saving.) That meant an \$11bn hit to household cashflows, which came through in – among other things – a sharp drop in the level of retail sales.

This tells us a lot about what happened in the domestic economy during the recession, but not so much about recent trends. The shift in the *level* of spending was complete by early 2009; from that point on it was no longer a drag on the rate of *growth*, and indeed, consumer spending did rebound in the second half

NZ Interest Rates



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

of 2009. A shift to a positive savings rate doesn't preclude growth in household spending, as long as incomes are growing at the same time.

The renewed weakness in spending since the start of this year coincides with a second downward leg in the housing market, as a result of higher mortgage rates and, perhaps more importantly, concerns about changes to the tax treatment of property. While we think those tax changes will be beneficial in the long term, consumption growth is likely to stay relatively subdued during the adjustment phase.

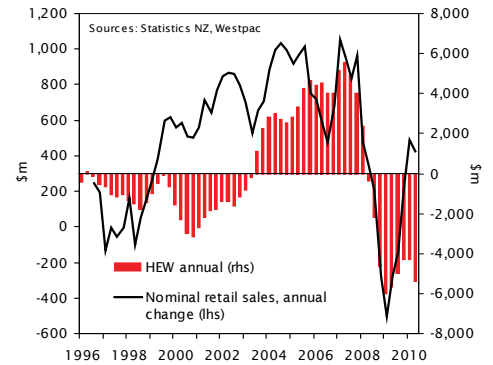
We do expect some signs of improvement in the housing market by early next year. Mortgage rates and net migration trends have turned more favourable in recent months; in time, this will show up first as stronger sales, and eventually in prices.

However, don't get too excited: "improvement" in this context will probably mean a shift from gently falling to flat prices, whereas in the last decade these factors might have meant the difference between single-digit and double-digit annual house price inflation.

The 1.1% rise in consumer prices in the September quarter largely reflected the usual seasonal influences – food, local body rates and alcohol excise – as well as the introduction of the Emissions Trading Scheme. Annual inflation of 1.5% will not faze the RBNZ, nor will the upcoming spike in inflation due to the GST increase; rather, its concern will be about how ongoing perceptions of inflation respond to this temporary spike.

Fixed vs. floating: The RBNZ's change

Housing equity withdrawal and retail sales



of heart 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.

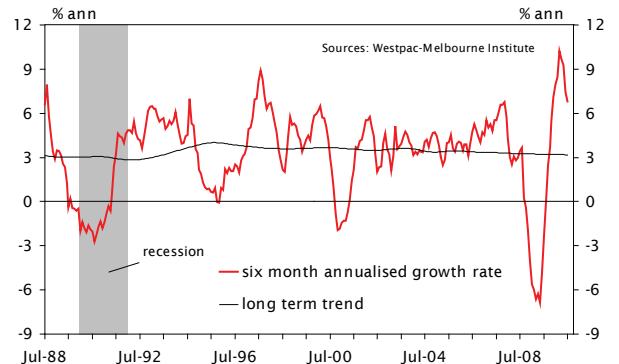
Key Data Previews

Aus Aug Westpac-MI Leading Index

Oct 20, Last: 6.8% annualised

- The *Westpac-Melbourne Institute Leading Index* continued to moderate in July although at 6.8% the annualised growth rate remains well above its long term trend of 3.2%. Although this points to an above average pace of expansion heading into the second half of 2010, it suggests the growth pulse may have passed its peak.
- The Index's monthly components were all weaker in August with the ASX retracing 2% of a its 4.5% rebound in July, dwelling approvals falling a hefty 4.7% after a surprise 0.1% gain in the previous month, growth in the money supply edging down to 0.7%*mt*h from 0.9%*mt*h, and US industrial production posting a disappointing 0.2%*mt*h rise after a solid 0.6%*mt*h gain in July.

Westpac-MI Leading Index



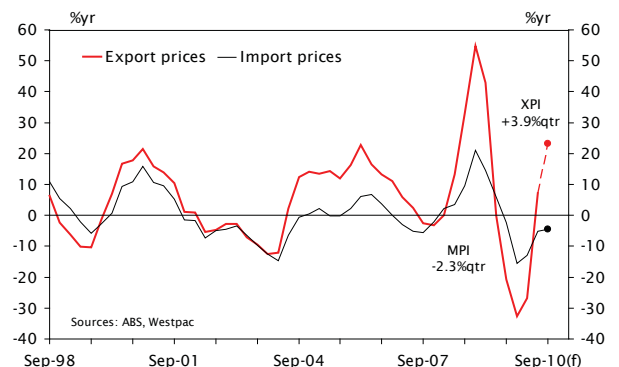
Aus Q3 international trade price indexes

Oct 22, Export: Last: 16.1%, WBC f/c: 3.9%, Mkt f/c: 4.0%

Import: Last: 1.9%, WBC f/c: -2.3%, Mkt f/c: 0.0%

- Q2 export prices saw a record rise of 16.1%*qtr*, lifting annual growth to 7.1%*yr*, the highest since 2009Q1. An iron ore and coal (the bulks) led 19.0% surge in USD commodity prices was reinforced by broader price support from a 2.4% AUD/USD fall. With the import weighted AUD TWI -1.1%, core import prices rose 1.1%, but with stronger gains in food and beverages (1.6%) and mineral fuels (6.5%), total import prices rose 1.9%*qtr*, giving a quarterly surge in the terms of trade.
- Q3 sees a further export price lift from quarterly iron ore and coal contract prices. The USD commodity price index rose a further 8.1% led by bulks and rurals, but with the 2.6% AUD/USD rise a valuation drag, we f/c a lesser 3.9%*qtr* rise in the XPI. A 1.4% rise in the MTWI implies a 1.1% fall in the core MPI. A f/c 9.0% fall in mineral fuels cuts the MPI f/c to -2.3%*qtr*, with the XPI rise implying a rough 6.3%*qtr* ToT jump.

International trade price inflation

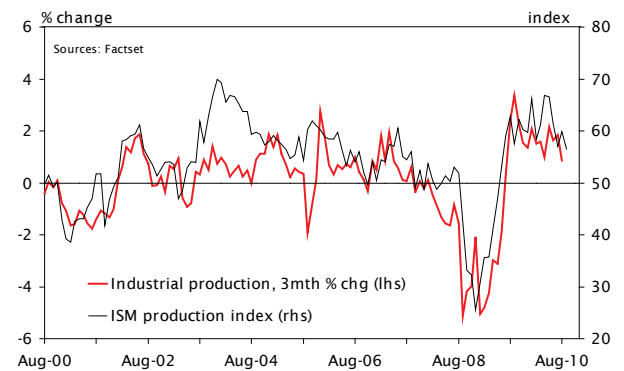


US Sep industrial production may have stalled

Oct 18, Last: 0.2%, WBC f/c: 0.0%, Mkt f/c: 0.2%

- US industrial production rose 0.2% in Aug. A 5% pull-back in auto production and a further 1.5% fall in utility output was offset by a 0.5% rise in ex auto factory output. July's 1.0% rise in IP was revised back to 0.6% but the sector was clearly still expanding in the first two months of Q3.
- Sep signals are biased to the downside. Hours worked in factories fell slightly in Sep and the production index of the national factory ISM was the lowest for the year so far (though still implying a gain). Durable goods orders fell 1.5% in Aug, suggesting weaker production in Sep. Mining indicators suggest lower output. However utility output probably rose.
- Tying these together, we expect flat industrial production in Sep, which would be the equal softest (with Feb 2010) outcome since the middle of last year.

US industrial sector



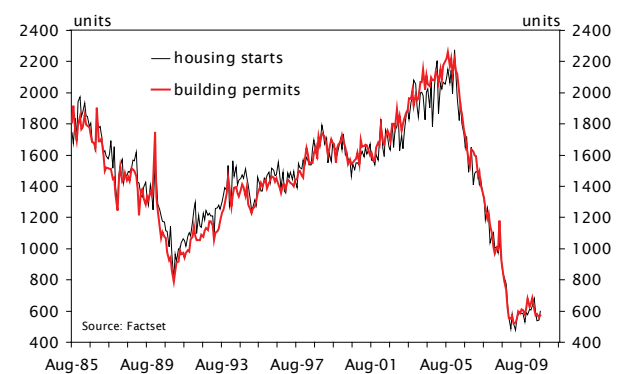
US Sep housing starts and permits – levelling off?

Oct 19, Starts: Last: 10.5%, WBC f/c: -5.0%, Mkt f/c: -3.0%

Oct 19, Permits: Last: 2.1%, WBC f/c: -3.0%, Mkt f/c: 0.7%

- 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 the downside momentum slowed in Aug.
- Starts rose 10.5% in Aug. A further 32% surge in multiple starts (on top of June's 33% fall) explained more than half of that rise; single family starts rose 4.3%, their first gain in four months. Permits rose 2.1% in Aug, all of that due to multiples. Single family house permits were down 0.7%, their fifth fall in a row.
- Payrolls data showed a 1% fall in construction hours worked and 21k fewer building jobs in Sep, and with sales near record lows in Aug and single family permits still falling, the Sep starts data will be weak, compounded by a pull-back in multiples. The forecast permits fall will be led by multiples.

US housing starts and permits



Key Data and Events

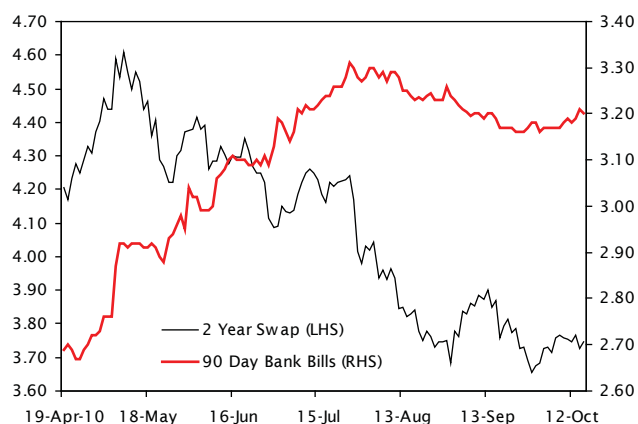
		Last	Market Median	Westpac Forecast	Comments
Mon 18 Oct					
Aus	Sep New Motor Vehicle Sales	0.3%	-	1.0%	Industry figs show sales firmed in Sep led by passenger and SUVs.
US	Aug TIC Data \$bn	61.2	-	-	Net long term flows.
	Sep Industrial Production	0.2%	0.2%	0.0%	Factory hours worked down 0.3% in Sep.
	Oct NAHB Housing Market Index	13	14	13	Housing market is at best bottoming out post tax rebate plunge.
	Fedspeak	-	-	-	Lockhart on economy and policy.
Jpn	Aug Tertiary Activity Index	1.6%	-0.5%	-	Non-manufacturing conditions are probably close to their peak.
Tue 19 Oct					
Aus	Oct RBA Board Meeting Minutes	-	-	-	Keen focus as rates on hold in Oct after sig more hawkish Sep mins.
US	Sep Housing Starts	10.5%	-3.0%	-5.0%	Starts and permits were boosted by multiples in Aug but underlying picture remains weak. See text box.
	Sep Housing Permits	1.8%	0.7%	-3.0%	
	Fedspeak	-	-	-	Evans, Dudley, Lockhart, Fisher and Kocherlakota.
Eur	Aug Current Account €bn	-3.8	-	-	Euroland has not seen sustained surpluses since 2007.
Ger	Oct ZEW Analyst's Survey	-4.3	-7.0	-10.0	Economic sentiment falling sharply but current index still rising.
UK	Oct CBI Industrial Trends Survey	-17	-19	-	Total orders index.
Can	BoC Rate Decision	1.00%	1.00%	1.00%	With US economy close to stalling, BoC hikes are firmly off agenda.
Wed 20 Oct					
Aus	Aug Westpac-MI Leading Index	6.8%	-	-	Slowing but still way > 3.2% trend; mthly components softer in Aug.
US	Fed Beige Book	-	-	-	If assessment is weaker than in previous BB, more QE is done deal.
	Fedspeak	-	-	-	Duke, Plosser and Lacker.
Ger	Sep Producer Prices %yr	3.2%	3.8%	-	Base effects less of an upward driver, euro gains now pushing PPI lower.
UK	Oct BoE MPC Minutes	-	-	-	Are the arguments in favour of further QE gaining momentum?
	Sep PSNB £bn	15.3	14.5	-	Public sector net borrowing.
	Sep M4 Money Supply %yr	1.9%	1.5%	-	Down from near 18% yr in Feb last year.
	Treasury Spending Review	-	-	-	New gov't's four year spending plans - big cuts to be confirmed.
Can	Aug Wholesale Sales	-0.1%	0.5%	-	Down in five of the past six months.
	BoC Monetary Policy Report	-	-	-	More detail behind this week's decision and guidance re output.
Thu 21 Oct					
NZ	Sep External Migration ann.	14,507	-	13,860	Expect recent improvement in net foreign arrivals to continue.
	Sep Credit Card Transactions s.a.	0.5%	-	-	Boosted by purchases brought forward to beat the GST hike.
US	Initial Jobless Claims w/e 16/10	462k	455k	455k	Non-farm payrolls survey week.
	Sep Leading Indicators	0.3%	0.3%	0.1%	Index barely growing now after surging in late 2009.
	Oct Philadelphia Fed Index	-0.7	1.8	-2.0	Business surveys will continue to hover close to contractionary levels.
Jpn	Aug All-Industry Activity Index	1.0%	-0.4%	-	New information on the construction and public sectors.
Eur	Oct PMI Factory Advance	53.7	53.2	53.0	We expect third consecutive monthly decline.
	Oct PMI Services Advance	54.1	53.7	53.5	We expect a second decline, but less steep than in Sep.
	Oct Consumer Confidence Advance	-11	-11	-	European consumers mood has been in uptrend since early 2009.
UK	Sep Major Bank Mortgage Approvals no.	45k	44k	-	Trending lower since Nov last year.
	Sep Retail Sales incl Fuel	-0.5%	0.3%	0.4%	CBI survey very strong but BRC suggested sales losing momentum.
Can	Sep Leading Index	0.5%	0.2%	-	Still growing but at less than half the pace of earlier this year.
Fri 22 Oct					
Aus	Q3 Export Price Index %qtr	16.1%	4.0%	3.9%	Rural & bulks-led 8.1% USD commod price rise offset by 2.6% AUD rise.
	Q3 Import Price Index %qtr	1.9%	0.0%	-2.3%	Core prices -1.1% with MTWI up 1.4%, reinforced by mineral fuels -9.0%.
US	Fedspeak	-	-	-	Hoenig and Plosser.
Ger	Oct IFO Business Climate Index	106.8	106.5	107.0	Expectations faltering but current index still rising.
Can	Sep CPI %yr	1.7%	1.9%	-	Headline and core (1.6% yr in Aug) both below 1-3% target midpoint.
	Aug Retail Sales	-0.1%	-0.1%	-0.5%	Likely to be weighed down by auto sales.

New Zealand Economic and Financial Forecasts

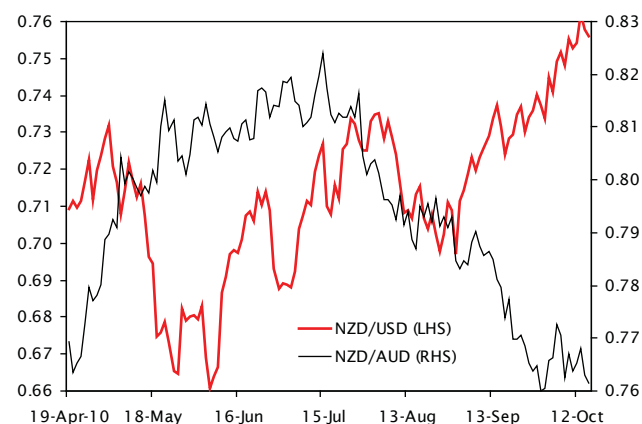
Economic Growth Forecasts	March years				Calendar years			
	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
% change								
GDP (Production) ann avg	-0.4	2.3	4.3	3.0	-1.7	2.0	4.2	3.0
Employment	-0.1	1.5	2.3	1.3	-2.4	1.7	2.9	1.2
Unemployment Rate % s.a.	6.0	6.2	5.0	5.0	7.1	6.4	5.0	4.9
CPI	2.0	4.3	1.8	2.5	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	3.80	4.00	4.30	4.80	5.20	5.50	5.70
5 Year Swap	4.40	4.60	4.90	5.30	5.60	5.80	5.90
10 Year Bond	4.90	5.00	5.10	5.30	5.60	5.70	5.80
NZD/USD	0.76	0.78	0.82	0.79	0.78	0.76	0.76
NZD/AUD	0.75	0.76	0.78	0.80	0.81	0.82	0.82
NZD/JPY	63.1	64.7	68.1	71.1	74.1	76.0	79.0
NZD/EUR	0.53	0.54	0.55	0.56	0.57	0.56	0.56
NZD/GBP	0.47	0.47	0.46	0.46	0.46	0.45	0.44
TWI	66.6	67.8	69.9	70.4	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 18 October 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	3.00%	3.00%	3.00%
30 Days	3.17%	3.14%	3.14%
60 Days	3.18%	3.16%	3.19%
90 Days	3.21%	3.17%	3.17%
2 Year Swap	3.75%	3.73%	3.80%
5 Year Swap	4.35%	4.29%	4.42%

NZ foreign currency midrates as at Monday 18 October 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7550	0.7408	0.7283
NZD/EUR	0.5404	0.5412	0.5581
NZD/GBP	0.4723	0.4678	0.4659
NZD/JPY	61.470	61.750	62.550
NZD/AUD	0.7624	0.7664	0.7774
TWI	66.810	66.540	67.100

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	3.5	4.0
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	5.2	4.8
Current Account % GDP	-5.8	-5.3	-6.3	-4.5	-4.4	-3.0	-2.8
United States							
Real GDP %yr	3.1	2.7	2.1	0.0	-2.6	2.5	1.1
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.3	1.5	2.2
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.8	10.2
Current Account %GDP	-6.1	-6.0	-5.3	-4.7	-2.7	-3.2	-2.8
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	3.3	1.1
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	1.6	1.4
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.9	1.5	1.4
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	1.4	1.1
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.8	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 8 October 2010

Interest Rate Forecasts	Latest (Oct 18)	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Australia						
Cash	4.50	4.75	5.00	5.25	5.25	5.25
90 Day Bill	4.77	5.00	5.25	5.50	5.50	5.50
10 Year Bond	5.15	5.35	5.50	5.50	5.25	5.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.56	2.35	2.25	2.50	2.75	3.25
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00
Exchange Rate Forecasts						
AUD/USD	0.9903	1.02	1.03	1.05	0.99	0.96
USD/JPY	81.41	83	83	83	90	95
EUR/USD	1.3970	1.43	1.45	1.50	1.41	1.38
AUD/NZD	1.3117	1.34	1.32	1.28	1.25	1.23

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