Westpac

Weekly Commentary

19 July 2010

The inflation lowdown

The Consumer Price Index increased just 0.3% in the June quarter of 2010, the third – and last – successive quarter of low inflation.

There were lumps and bumps on either side: an increase in tobacco excise added 0.2% to inflation, while a fall in food prices knocked a similar amount off the index. But the underlying story is clear. Inflation has been hobbled by the combined effect of last year's recession and the strong rebound in the exchange rate.

Domestic inflation has risen a little in response to the economic recovery. Housing-related inflation, in particular, is picking itself up off the floor. Construction and property maintenance inflation accelerated, and rents continued to rise at 0.5%, compared to 0.3% a year ago. The strong exchange rate kept tradables inflation low, although not quite to the extent we expected. Food prices fell sharply, but car prices rose 2.4% and appliances were up 1.2%.

The headline measure will have been comforting to the RBNZ, but the details less so. The shortfall relative to their forecast of 0.5% in the March Monetary Policy Statement was probably due to subsequent information on food prices. Meanwhile, non-tradables inflation picked up to 0.6% for the quarter, exceeding their expectations.

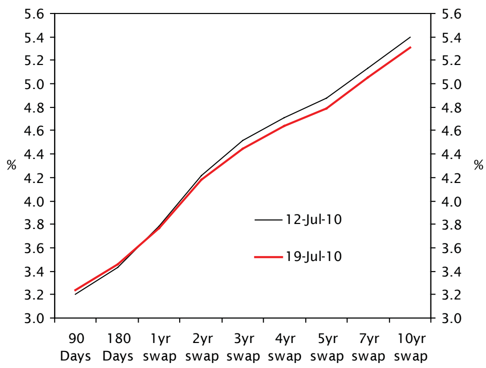
It's worth reflecting on the annual inflation rate, which is currently at 1.8% and has been at or below 2% for the last five quarters. Last year featured the most severe recession in a generation, and the most rapid exchange rate appreciation, both of which are having their maximum impact on annual inflation right about now. This is rock bottom for New Zealand inflation. Meanwhile, deflation has become the watchword overseas; there are a few central banks that would love to have core inflation as high as 1.8%!

What's more, the June quarter was the calm before the storm. The economic recovery is due to feed through to higher inflation in the second half of 2010 and into 2011. Simultaneously, a wide range of Government charges and taxes – the ETS, an increase in GST, and more tobacco excise hikes – are set to add around 3 percentage points to inflation over the next year. This will push annual inflation to 5.1% by June 2011, which is highly likely to feed through to higher inflation expectations and faster wage growth. The second-round effect of higher inflation could cause quite a headache for the RBNZ in 2011 and 2012.

That said, recent news could well prompt a less strident tone from the RBNZ at its next OCR review on 29 July. GDP and inflation have both turned out slightly lower than the RBNZ's forecasts, the exchange rate has risen since June, and second-tier data has generally undershot expectations. But while they'll certainly acknowledge the weaker flow of data, we don't expect any knee-jerk reaction. It would be utterly inappropriate to keep the OCR at 2.75%, given the inflation outlook. That's why the RBNZ has articulated such a clear plan to return the OCR to a more normal level over the next couple of years.

Last week's other data releases showed that the weak consumer/strong producer dynamic of this recovery remains firmly in place. House sales fell an estimated 6% in seasonally adjusted terms in June, the second month of decline after a brief respite in the early part of this year. Sale prices rose slightly, but not enough to offset the drop in May. The housing

NZ Interest Rates



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

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market has been notably subdued since late last year, when talk of changes to the tax treatment of property turned serious, and the clarity provided by the May Budget has been cold comfort at best.

Retail sales rose just 0.4% in May, with ex-auto sales down 0.2%. The main contributions to growth came from a steady uptick in supermarket sales (despite a fall in food prices over the month) and a 7.5% jump in vehicle sales. The car market was hit early and very hard by the recession, and while it has seen one of the more substantial recoveries – registrations were up 36% y/y in June – sales are still a long way below their pre-recession levels.

The mix of sectors that saw a decline in sales suggests that the foul weather in the second half of the month may have been a factor (in which case the odds for a reversal in June don't look good). Clothing and footwear sales were up 2.8%, but cafes and restaurants were down 2%, recreational goods fell 1.3%, and "other retailing" (including gardening supplies) fell 3.1%.

With credit and debit cards transactions pointing to a slight increase in the June month, we estimate that Q2 retail sales were up just 0.2% in nominal terms. However, within the CPI there were some sizeable price declines for some of the major retail items such as food, appliances and fuel – and even more so in seasonally adjusted terms. That leaves us with an estimated 1.0% rise in real sales, with cars making the greatest contribution. We estimate that ex-auto sales were up a more modest 0.7%.

This would be a significant improvement on the 0.2% rise in Q1. However, it would still leave sales volumes per capita just 1% higher over the last year, following an 8.7% plunge during the recession. Retailers will be reporting tough times for a while yet.

Fixed vs. floating: Last month, as was widely anticipated, the RBNZ kicked off what we expect to be an extended tightening cycle. Nevertheless the decision to fix or float remains finely balanced. Floating rates remain lower than short-term fixed rates at the moment, but they are likely to rise faster as the RBNZ increases the OCR. Fixing, if even for a short term, has the advantage of greater certainty around cash flows, at a time when floating rates could be rising rapidly. Repaying more than the minimum amount, and spreading the loan over a mix of terms, can also help to reduce the overall risk around uncertain future interest rate changes.

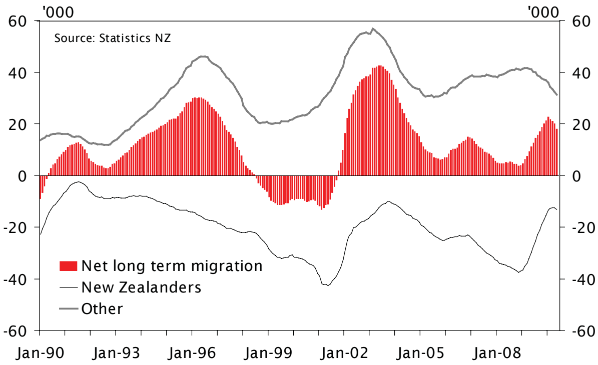
Key Data Previews

NZ Jun external migration ann.

Jul 21, Last: 17,970, WBC f/c: 16,900

- Monthly seasonally adjusted net migration has plunged from 1,700 in Dec 2009 to 250 in May 2010. This has mainly been due to fewer foreigners arriving, and partly due to more New Zealanders leaving (although the latter trend has been far weaker than we anticipated).
- We forecast a net inflow of 500 s.a. for June. Low foreign arrivals must be temporary, as Immigration NZ operates a quota system. However, we do expect net migration to remain fairly low as NZer departures continue to rise.
- Weak net migration is one factor behind the housing market's current weakness.

Net migration

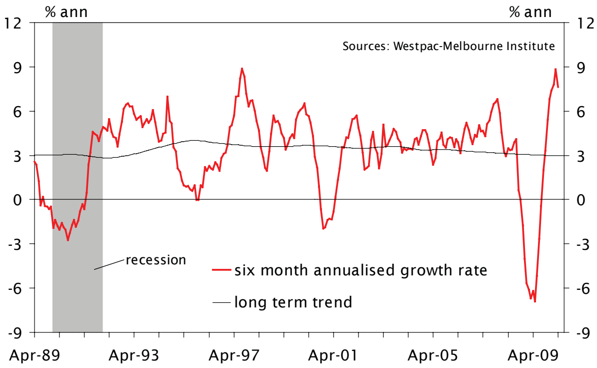


Aus May Westpac–MI Leading Index

Jul 21, Last: 8.7% annualised

- After ten consecutive months of strong acceleration, the *Westpac–Melbourne Institute Leading Index* recorded a slight moderation in April. That said, at 7.6%, the annualised growth rate in the index was still strong and well above its long run trend of 3%, implying an above trend pace of expansion through the second half of 2010.
- The Index's monthly components were again mixed in April, with two sharply weaker (ASX down 7.9% and dwelling approvals down 6.6%) but money supply growth stepping up a notch from 0.3%mth to 0.9%mth and US industrial production rising 1.3%mth vs 0.6%mth in April.

Westpac-MI Leading Index

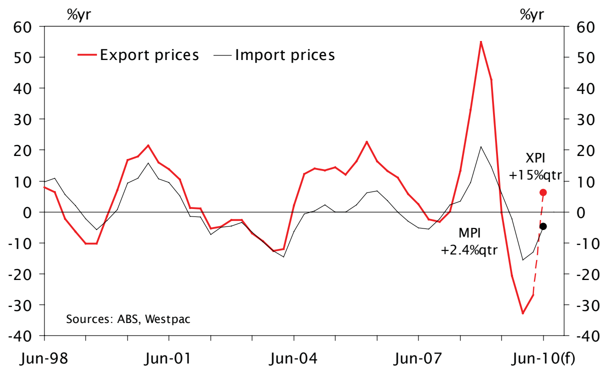


Aus Q2 international trade price indexes

Jul 23, Export: Last: 3.8%, WBC f/c: 15.0%, Mkt f/c: 12.0%
Import: Last: 0.3%, WBC f/c: 2.4%, Mkt f/c: 1.0%

- Q1 export prices rose 3.8%qtr after a year of falls. A base metals led 4.6% rise in USD commodity prices in Q1 was augmented by a 0.5% AUD/USD dip. With the import weighted AUD TWI near stable (+0.1%), core import prices rose 0.2%, and with a 3.0% rise in food & beverage prices partially offset by a 0.5% dip in mineral fuels, total import prices rose 0.3%qtr, giving a solid terms of trade gain.
- Q2 sees the export price lift from new qtrly iron ore contract prices. The USD commodity price index surged 18.6%qtr led by ex-base metals non-rural commodities and with a 2.4% AUD/USD dip giving a valuation lift for non-commodity export prices, we look for a strong 15.0%qtr jump in the XPI. A 1.1% fall in the MTWI implies a 1.5% rise in the core MPI. An expected 8.0% rise in mineral fuels lifts the total MPI forecast to +2.4%qtr, well short of the XPI, for a 12.3%qtr ToT jump.

International trade price inflation

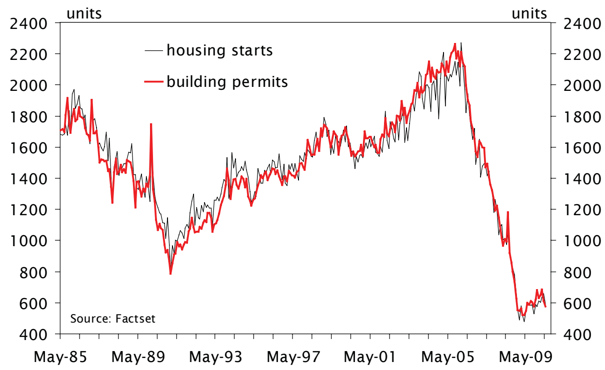


US June housing starts and permits – further steep falls

Jul 20, Starts: Last: –10.0%, WBC f/c: –8.0%, Mkt f/c: –2.2%
Jul 20, Permits: Last: –5.9%, WBC f/c: –8.0%, WBC f/c: 0.2%

- Since the expiry of the tax credit for home buyers at the end of April, US housing data across sales, builder sentiment and activity have nose-dived.
- Starts and permits fell 10% and 6% respectively in May, but that was small-fry compared to the 33% in fall in new home sales that month. If new homes aren't being sold, then builders are going to stop constructing them.
- That means that starts and permits must have further to fall. We are forecasting 8% drops in both but certainly would not rule out double digit % declines, especially if the volatile multiples components fully reverse their 33%/10% jumps in May.

US housing starts and permits

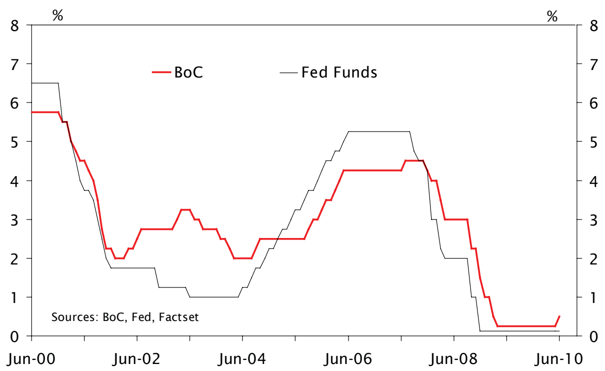


Bank of Canada – further hike but cautious statement

Jul 20, Last: 0.50%, WBC f/c: 0.75%, Mkt f/c: 0.75%

- The BoC began retightening monetary policy at the June 1 window, but noted that "this decision still leaves considerable monetary stimulus in place... any further reduction of monetary stimulus would have to be weighed carefully against domestic and global economic developments".
- Economic data since then have included very strong jobs growth, some evidence, though not convincing, of slower housing activity, and soft inflation. The US economy has shown signs of moderating growth.
- With rates still very low, there is nothing there to prevent the BoC from nudging rates up a further quarter point. We expect them to continue retightening later this year, before pausing at 1.0% or a little higher when evidence that the US economy is slowing sharply becomes more compelling.

Bank of Canada

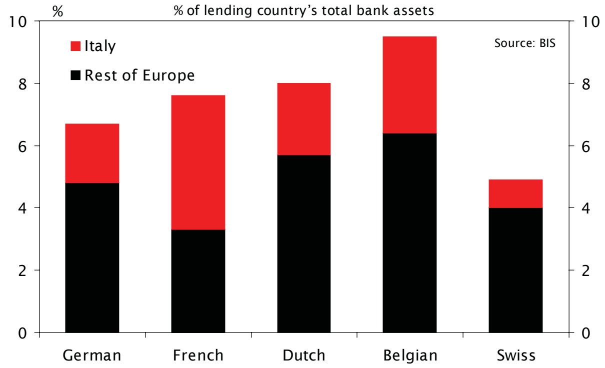


Europe: CEBS stress test results

Jul 23

- The Committee of European Banking Supervisors is conducting an EU-wide stress test of the overall resilience of the European banking sector and individual banks' ability to absorb possible future shocks related to economic growth, interest rates, credit markets and sovereign debt.
- Aggregate and individual bank results will be published on July 23, along with the methodology. Apart from an adverse scenario involving a 3ppt deviation of GDP vs official forecasts, and deteriorated sovereign market conditions relative to May, we don't know how much stress is really being tested for.
- On the day, markets will need to judge whether the tests were strict enough, as well as reacting to the news that some banks' balance sheets aren't strong enough to withstand the shocks tested for. Presumably European authorities will also need to present a credible remediation plan for those banks ASAP.

Foreign bank claims on weak euro area



Key Data and Events

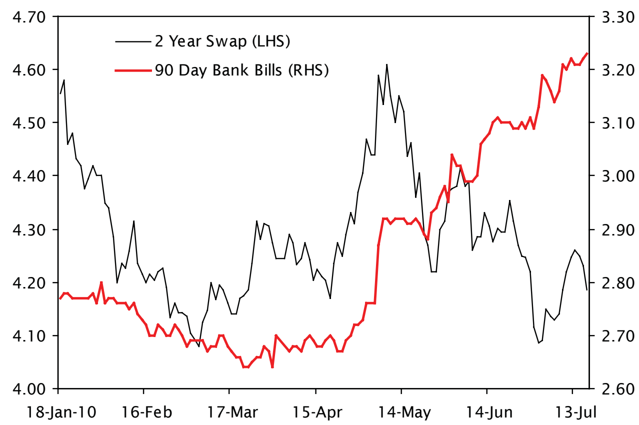
		Last	Market Median	Westpac Forecast	Comments
Mon 19 Jul					
US	Jul NAHB Housing Market Index	17	16	15	Builders worried about collapse in post tax credit home sales.
Eur	May Current Account Balance €bn sa	-5.1	–	–	Brief return to surplus in March not sustained.
Tue 20 Jul					
Aus	Jul RBA Board Minutes	–	–	–	Hints re inflation risks, growth risks both domestically and globally.
	RBA Governor Stevens Speaking	–	–	–	"Some long-run effects of the financial crisis", Sydney, 1pm
US	Jun Housing Starts	-10.0%	-2.8%	-8.0%	The scale of home sale slump since the tax credit wound up suggests
	Jun Building Permits	-5.9%	0.2%	-8.0%	further weakness for new building activity in months ahead.
	Fedspeak	–	–	–	Gov Tarullo testimony on financial regulation.
Ger	Jun Producer Prices %yr	0.9%	1.1%	–	Base effects and weaker euro pushing PPI higher.
UK	Jun Major Banks Mortgage Approvals, no.	51k	52k	–	Stabilised after falling from recent 61k peak in late 2009.
	Jun Public Finances (PSNCR) £bn	12.0	16.0	–	Intense interest in these numbers from July when the early impact of
	Jun Public Sector Net Borrowing £bn	16.0	13.0	–	the June 22 emergency budget will start to flow through.
	Jun M4 Money Supply %yr	2.8%	2.9%	–	Continues to decelerate from 17.7% yr peak early last year.
Can	Jul Bank Canada Rate Decision	0.50%	0.75%	0.75%	Further quarter point hikes to come until US economy clearly softens
Wed 21 Jul					
NZ	Jun External Migration ann.	17,970	–	16,900	Foreign arrivals have been very low.
	Jun Credit Card Transactions s.a.	1.9%	–	–	Spending is rising gradually, but credit card share is slipping.
Aus	May Westpac-MI Leading Index, ann'lsd	7.6%	–	–	Monthly components ASX and dwellings approvals down sharply in May.
US	Fed's Bernanke	–	–	–	Semi-annual testimony – Fed's monetary policy report.
Can	May Wholesale Sales	-0.3%	0.4%	–	One of the less robust activity indicators of late.
Thu 22 Jul					
US	Initial Jobless Claims we 17/7	429k	445k	–	July data always distorted by seasonal adjustment problems.
	Jun Existing Home Sales	-2.2%	-9.9%	-15.0%	Pending data suggest 30% sales slump due in coming months.
Jpn	May All-Industry Activity Index	1.8%	-0.4%	–	Tertiary and IP underwhelming; construction unlikely to carry the day.
Eur	Jul PMI Manufacturing Advance	55.6	55.1	56.0	Weaker euro providing support to European factory exports.
	Jul PMI Services Advance	55.5	55.0	55.0	Concern about sovereigns, banks, budget cuts to hit service sector
	May Industrial New Orders	0.6%	-0.1%	-0.3%	German orders known down 0.5%.
	Jul Consumer Confidence Advance	-17	-17	-18	Confidence no longer gaining but yet to plunge on budget cut concerns.
UK	Jun Retail Sales W/Auto Fuel	0.6%	0.5%	–	Both CBI and BRC surveys point to gain in sales; also World Cup boost.
Can	May Retail Sales	-2.0%	0.5%	0.5%	Auto sales probably flat, ex auto due a bounce.
	BoC Monetary Policy Report	–	–	–	More detail behind Tuesday's decision and guidance re outlook.
Fri 23 Jul					
Aus	Q2 Export Price Index %qtr	3.8%	12.0%	15.0%	Jump in iron ore saw 18.6% USD commod. price leap + AUD fell 2.4%.
	Q2 Import Price Index %qtr	0.3%	1.0%	2.4%	Core prices +1.5% with MTWI -1.1% and mineral fuels +8.0%.
Eur	Committee of Euro Banking Supervisors	–	–	–	Bank balance stress test results, aggregate and individual bank basis.
Ger	Jul IFO – Business Climate	101.8	101.5	101.0	Stopped rising Q2; decline expected ahead despite weak euro.
UK	Q2 GDP Adv	0.3%	0.6%	0.6%	Growth accelerated in Q2 but that will likely be the peak for the year
	Jun BBA Loans for House Purchase, no.	36.7k	37.0k	–	Also down from late 2009 peak at 63.0k.
Can	Jun CPI %yr	1.4%	0.9%	–	Headline inflation has been consistently below 2% this year and the
	Jun BoC Core %yr	1.8%	1.9%	–	core rate is back below 2% (midpoint of BoC 1–3% target range).

New Zealand Economic and Financial Forecasts

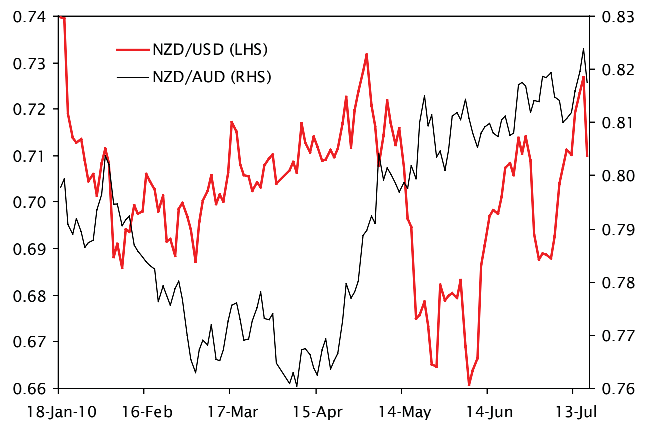
Economic Growth Forecasts	March years				Calendar years			
% change	2009	2010	2011f	2012f	2009	2010f	2011f	2012f
GDP (Production) ann avg	-1.5	-0.4	4.1	4.2	-1.6	3.4	4.4	3.4
Employment	0.7	-0.1	2.1	1.8	-2.4	2.7	1.8	1.3
Unemployment Rate % s.a.	5.1	6.0	5.3	5.0	7.1	5.5	5.0	4.9
CPI	3.0	2.0	5.1	2.7	2.0	4.8	2.6	3.1
Current Account Balance % of GDP	-7.9	-2.6	-3.3	-4.4	-2.9	-3.0	-4.4	-4.4

Financial Forecasts	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Cash	3.25	3.75	4.25	4.75	5.25	5.75	6.00
90 Day bill	3.70	4.20	4.70	5.20	5.70	6.10	6.20
2 Year Swap	4.80	5.20	5.50	5.90	6.20	6.40	6.50
5 Year Swap	5.70	5.90	6.10	6.30	6.50	6.60	6.70
10 Year Bond	6.00	6.10	6.20	6.30	6.30	6.40	6.50
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	0.78	0.75
NZD/JPY	65.5	70.3	74.5	76.5	77.7	80.3	82.8
NZD/EUR	0.57	0.58	0.59	0.60	0.61	0.58	0.56
NZD/GBP	0.49	0.49	0.49	0.50	0.50	0.47	0.44
TWI	68.7	70.4	71.9	72.5	72.9	70.7	69.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 19 July 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.75%	2.75%	2.75%
30 Days	2.99%	2.96%	2.94%
60 Days	3.11%	3.02%	3.00%
90 Days	3.24%	3.16%	3.10%
2 Year Swap	4.19%	4.14%	4.30%
5 Year Swap	4.79%	4.85%	5.04%

NZ foreign currency midrates as at Monday 19 July 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7088	0.6879	0.7075
NZD/EUR	0.5488	0.5486	0.5668
NZD/GBP	0.4627	0.4545	0.4761
NZD/JPY	61.400	60.380	63.820
NZD/AUD	0.8175	0.8194	0.8113
TWI	66.770	65.950	67.960

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	3.0	3.5
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	3.4	3.1
Unemployment %	5.1	4.8	4.4	4.3	5.6	5.1	4.9
Current Account % GDP	-5.8	-5.3	-6.3	-4.4	-4.1	-3.4	-3.0
United States							
Real GDP %yr	3.1	2.7	2.1	0.4	-2.4	2.7	2.8
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.2	1.3	2.4
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	-4.6	-2.7	-0.3	-2.4
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	3.1	1.4
Consumer Prices %yr	-0.3	0.2	0.1	1.4	-1.3	-1.1	-0.2
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	4.8	4.5
Current Account %GDP	3.6	3.9	4.8	3.3	2.8	4.2	4.6
Euroland							
Real GDP %yr	1.8	3.1	2.8	0.5	-4.0	0.6	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	0.5	1.3
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.5	2.0
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 9 July 2010

Interest Rate Forecasts	Latest (Jul 19)	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Australia						
Cash	4.50	4.75	5.00	5.00	5.25	5.50
90 Day Bill	4.83	5.00	5.20	5.20	5.50	5.75
10 Year Bond	5.12	5.40	5.70	5.70	5.80	5.80
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.375
US 10 Year Bond	2.92	3.20	3.40	3.50	4.00	4.20
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00

Exchange Rate Forecasts	Latest (Jul 19)	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
AUD/USD	0.8670	0.88	0.90	0.92	0.90	0.88
USD/JPY	86.62	91	95	98	102	105
EUR/USD	1.2916	1.26	1.28	1.29	1.25	1.21
AUD/NZD	1.2232	1.22	1.22	1.21	1.20	1.19