

Weekly Commentary

20 September 2010

Capitulation

The Reserve Bank delivered an astonishing about-face in last week's *Monetary Policy Statement*.

Only a matter of weeks ago it was anticipating respectable economic growth, warning that interest rates were still extraordinarily supportive, and cautioning businesses against raising prices under the cover of the upcoming GST hike. Now, the RBNZ expects the economy to run below potential for years to come, believes that only a gradual further tightening of policy is needed, and has simply assumed that second-round price effects won't happen because of weak demand.

The RBNZ had already warned of a more moderate pace and extent of tightening compared to its June forecasts. But we were staggered by how much its projections have changed: in June the 90-day rate was expected to peak at 6.1% by the end of 2012, now it only reaches 4.6% (though still rising) by that date. That is, the RBNZ has slashed 150 basis points from the end-point of its interest rate projections. To put this in perspective: between September and December 2008, the RBNZ reduced its interest rate track by 210bp for a year ahead, and 120bp for two years ahead – at a time when the collapse of Lehmans, AIG and others was threatening to drag down the entire global financial system.

Admittedly, the RBNZ had been at the optimistic end of the spectrum of market

views up until now. But it's hard to pin down what has happened in the last three months to warrant a change of this magnitude. It certainly had little to do with the global picture that has consumed much of the market's attention in recent months. Trading partner growth forecasts for 2011 were revised down from 4.0% to 3.5%, reflecting the murky outlook for the US and signs of slowing in China. But that doesn't seem to have led to any material change in the outlook for export volumes or commodity prices – in fact, the RBNZ's forecast for the trade balance has vastly improved since June, probably due to weaker growth in imports.

The RBNZ emphasised that both the economic forecasts and the decision to leave the OCR unchanged were agreed upon before the Canterbury earthquake. It did note that the reconstruction will add to GDP in 2011 and beyond and could drive up some prices, but judged that this is unlikely to have an impact on medium-term inflation.

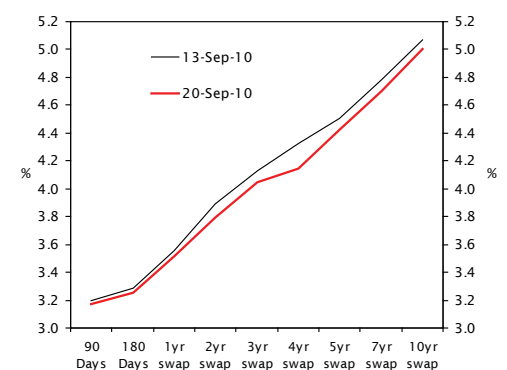
The domestic data has been soft over the last few months, which certainly warranted a shallower interest rate track compared to June. But the RBNZ has said that weaker data only accounts for about 60% of the change in their interest rate projections. The rest is down to a sea change in the RBNZ's perceptions of household behaviour – it has concluded that households are more concerned about house values, and

more focused on paying off debt, than previously thought.

It's difficult to find the basis for this change in judgement. Retail sales, household lending and building consents have grown only slowly; house prices have flattened out and sales remain weak. But these are not new stories in the last three months. It seems instead that the RBNZ has simply given up on waiting for signs of improvement and has backed away from its domestic recovery story.

With weaker domestic activity comes reduced inflation pressures. The RBNZ is now projecting annual inflation to settle around 2.2% over the medium term – and excluding the various government policy-related charges, underlying inflation is expected to be right in the middle of the 1-3% target band. It is also

NZ Interest Rates



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

assuming that inflation expectations will not only remain contained within the band, but will decline further, even as headline inflation approaches 5%. The RBNZ did acknowledge how uncertain – and important – this assumption is, by including an alternate track where inflation expectations spike higher over the next year, requiring much higher interest rates.

The RBNZ’s sudden conviction that consumers are withdrawing into their shells doesn’t stack up with the Westpac-McDermott Miller consumer confidence survey, which fell in the September quarter, but only back to around the levels reported at the beginning of the year. Indeed, it appears that consumers have weathered the recent spate of soft economic data and other upheavals

(including the failure of SCF and the Canterbury earthquake) reasonably well. Our reading is that consumers remain willing to spend, it’s just that the ability to spend has been constrained by slow employment and wage growth to date – a situation that neither we nor the RBNZ expect to last for long.

Nevertheless, we have taken the RBNZ at its word for now, and we expect the next OCR hike to be delayed until March. Since the RBNZ seems more focused on credit growth than actual activity, and on past wage and price inflation rather than expectations, it will take some time to restore their battered faith in the recovery story.

This week’s data calendar includes the

last of the major June quarter releases. We expect the annual current account deficit (Wed) to widen to 2.8% of GDP, with a improved quarterly trade surplus but rising investment income outflows. Our pick for a 0.6% rise in GDP (Thurs) is near the lower end of market forecasts; solid growth in retail and services was partly offset by weaker manufacturing and a short, sharp shock to agricultural output due to drought conditions earlier this year.

Fixed vs. floating: The RBNZ’s change 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.

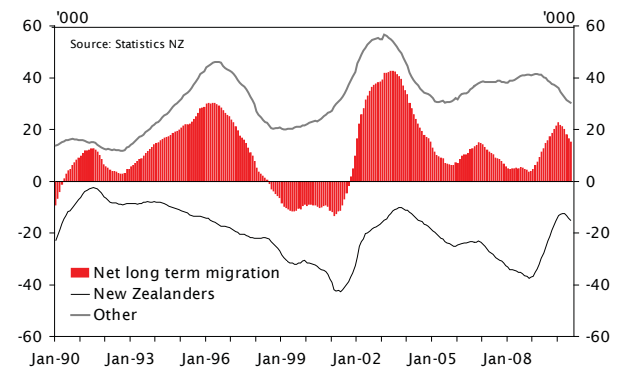
Key Data Previews

NZ Aug external migration ann.

Sep 21, Last: 15,200, WBC f/c: 14,300

- Net migration edged lower over the first half of 2010, as the number of foreigners arriving in NZ fell sharply, and the number of NZers heading for the exit edged up slowly. Given that foreign arrivals are administratively controlled, we always thought low arrivals would be temporary, but we expected departures to keep rising.
- Last month’s figures were a shock. Arrivals jumped from 6,200 to 7,300 (s.a.), and departures fell unexpectedly. As this was completely counter to recent trends, we suspended judgement on whether net migration had turned the corner or simply experienced a “black swan” month.
- This month is crucial for answering that question. Our formal forecast is consistent with a return to previous trends.

Net migration

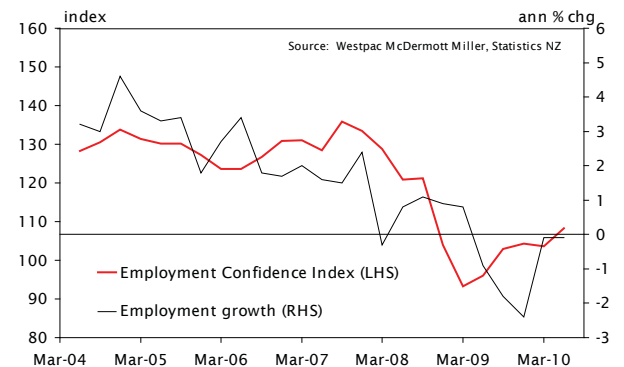


NZ Q3 employment confidence index

Sep 22, Last: 108.2

- Employment confidence rose in the June 2010 quarter, reaching its highest level in nearly two years as employees became less downbeat about their current employment situation and more optimistic about the future.
- Since June, economic conditions have weakened. Unemployment came in a lot higher than expected in Q2, business confidence has deteriorated, and consumers are feeling less optimistic.
- How much these factors weigh on employment confidence will play a critical part in determining the outlook for consumer spending in coming quarters.

NZ employment and confidence

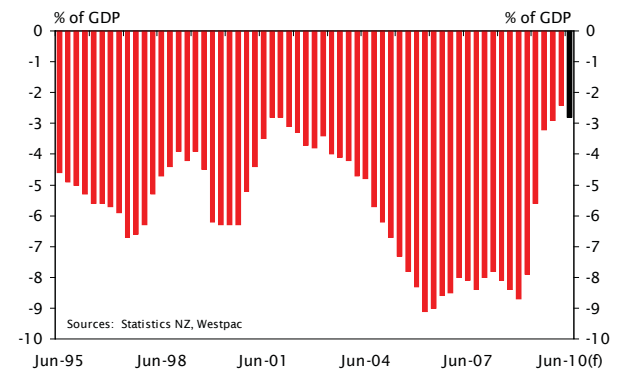


NZ Q2 current account deficit NZDm s.a.

Sep 22, Last: -1,320, WBC f/c: -1,290

- The annual current account deficit reached a 21-year low of 2.4% of GDP in March this year, which will almost certainly mark the low point in this cycle. We estimate that the deficit widened to 2.8% of GDP in the year to June.
- We expect the largest goods trade surplus on record, with rising export prices more than offsetting growth in import volumes. However, the investment income deficit has continued to widen as overseas-owned firms have returned to profitability.
- The expected increase in the annual deficit is partly due to base effects, with the impact of banks' tax provisions starting to drop out of the equation. Annual revisions to the accounts could nudge the deficit in either direction.

NZ annual current account deficit

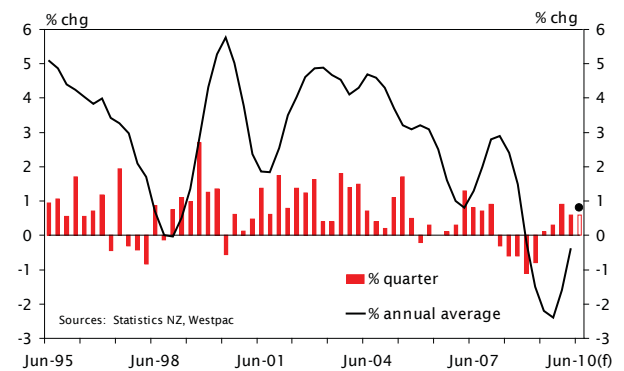


NZ Q2 GDP

Sep 23, Last: 0.6%, WBC f/c: 0.6%, Mkt f/c: 0.8%

- GDP expanded 0.6% in Q1, as the goods producing and export-oriented industries rebounded from recession. However, the service sectors remained torpid, and retail trade contracted.
- For Q2 we expect the same 0.6% growth rate, with the opposite composition. Indicators suggest the service sectors are now recovering vigorously, construction is tipped to have expanded 8%, and retail trade is expected to rise 1.2%. But the short, sharp drought will take its toll on agricultural production and related manufacturing. There was also a surprisingly sharp slide in non-agri manufacturing production.
- We expect 0.6% growth in expenditure GDP, led by healthy increases in residential investment and business investment. Reduced inventory investment and falling exports of goods are the main drags.

NZ GDP growth

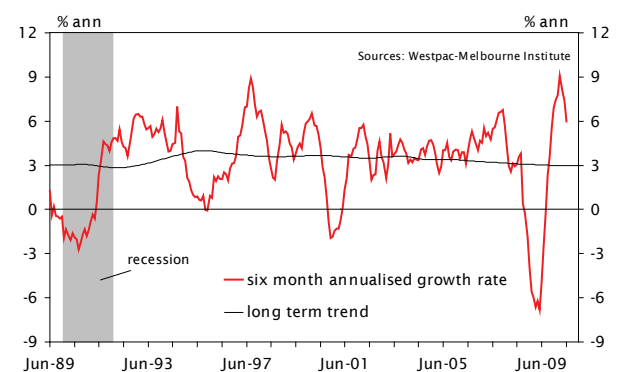


Aus Jul Westpac-MI Leading Index

Sep 22, Last: 6.0% annualised

- The *Westpac-Melbourne Institute Leading Index* continued to moderate in June with the annualised growth rate slowing to 6.0% from 7.4% previously and a remarkably high 9.1% read in March. Although this is an abrupt drop off, growth remains well above its long term trend of 3% indicating a continued above average pace of expansion heading into the 2010 H2.
- The Index's *monthly* components improved in July with the ASX rebounding strongly (+4.5%), dwelling approvals up 2.3% (the first rise since March), growth in the money supply rising from 0.5%*mth* to 0.9%*mth* and US industrial production up 0.6%*mth* vs 0.1%*mth* in June. The July Index will also incorporate updates for *quarterly* components which were a mixed bag for Q2 vs Q1: commodity prices and corporate profits were both up strongly, but overtime worked was steady and productivity growth slowed sharply as hours worked rose.

Westpac-MI Leading Index



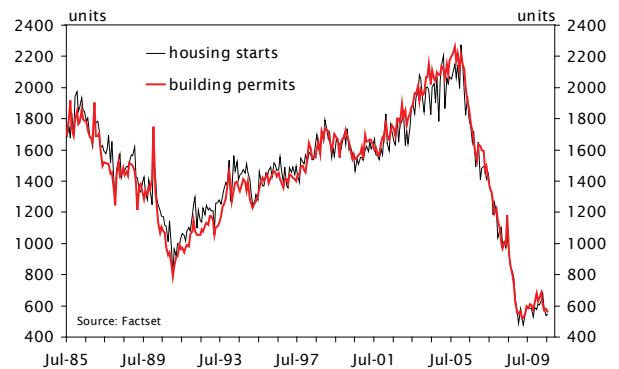
US Aug housing starts and permits – levelling off?

Sep 21, Starts: Last: 1.7%, WBC f/c: 3.0%, Mkt f/c: 0.7%

Sep 21, Permits: Last: -4.1%, WBC f/c: 0.0%, Mkt f/c: 0.2%

- Since the end of the tax rebate for home-buyers in April, new single family house building has contracted by about a quarter on both starts and permits, although the downside momentum has slowed.
- Housing starts rose 1.7% in July. But a 33% bounce in multiple starts (reversing June's 33% fall) masked the third straight fall in single family starts, down 4%. Permits fell 4.1% in July, much of that due to multiples. Even so, single family house permits were down 3.6%, their fourth fall in a row.
- Payrolls data showed decent gains in construction hours worked and jobs in August, but with sales at record lows in July any bounce will be muted or temporary. We expect a 3% rise in starts, all driven by multiples which still lag the recent rise in permits. We expect total permits were unchanged last month.

US housing starts and permits

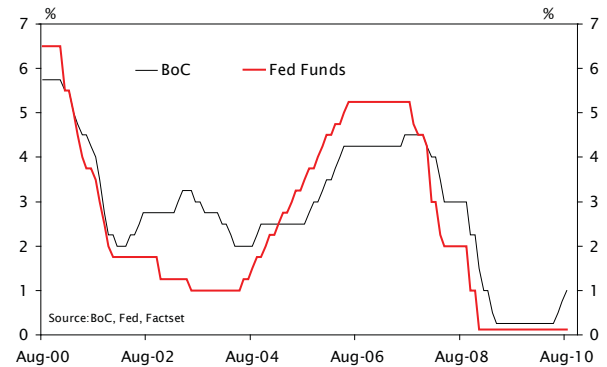


US FOMC: more QE hinted at, not yet delivered

Sep 21, Last 0-0.25%, WBC f/c: 0-0.25%, Mkt f/c: 0-0.25%

- At the Aug meeting the Fed indicated that it will reinvest the proceeds from maturing assets to prevent its balance sheet from shrinking and monetary conditions from tightening; however, the subsequent minutes revealed the Fed was still some way from actually embarking on a fresh round of quantitative easing.
- Fed Chairman Ben Bernanke in his keynote address at Jackson Hole in late August said that the Fed "is prepared to provide additional monetary accommodation through unconventional measures... if the outlook were to deteriorate significantly", and the latest Beige Book found "widespread signs of deceleration".
- But recent jobs, retail and survey news suggest the economy is not yet weak enough (i.e. contracting again) for further balance sheet expansion to be announced just yet, though the statement will emphasise further QE will be deployed if judged necessary.

Official rates



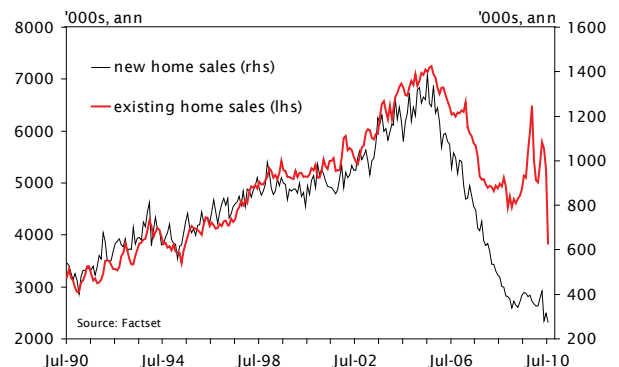
US Aug existing and new home sales

Sep 23, Existing home sales: Last: -27.2%, WBC f/c: 5.0%, Mkt f/c: 7.1%

Sep 24, New home sales: Last: -12.4%, WBC f/c: 5.0%, Mkt f/c: 6.9%

- Existing home sales plunged 27.2% in July, to be down just over a third on April, when the tax credit for home-buyers expired. The fall was not a complete surprise because pending home sales fell 31% in May-June but we had thought it would be spread over a few more months given a late extension to the tax credit which meant sale completions prior to September would still qualify. With pending sales up 5% in July, existing sales probably posted a similar August gain.
- New home sales fell 12.4% in July. The annualised sales pace of 276k in July is the lowest on records that go back nearly 50 years – more evidence that the tax rebate for homebuyers tended to pull activity forward into 2009 and early 2010 rather than actually stimulating extra sales. We expect a muted and possibly unsustainable 5% bounce in August.

US housing sales

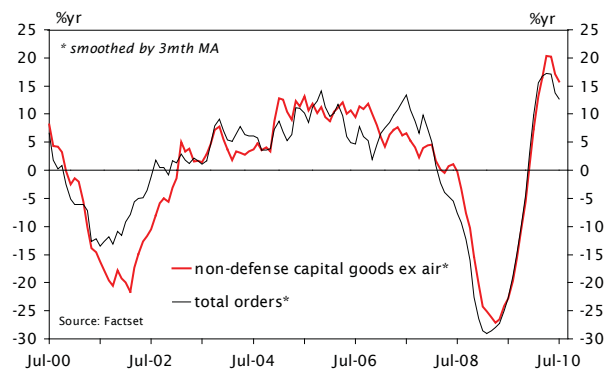


US Aug durable goods orders to recover somewhat

Sep 24, Last: -1.2%, WBC f/c: 1.0%, Mkt f/c: -1.0%

- Durable goods orders rose 0.4% in July but were exceptionally weak in the detail. A 76% jump in aircraft orders and 5% for autos prevented an overall orders decline, but ex-transport orders fell 4% and core capital goods orders plunged 7%, reversing gains in May and June. The report also showed a 1% fall in core capital goods shipments – the first drop since Jan – which suggests that business investment spending lost momentum early in Q3.
- Aug signals are soft but not dire, so Jul's weak components may bounce a little. The ISM factory new orders index fell 0.4pts to 53.1, its lowest since June last year (but still >50); and auto production dropped 5% but other manufacturing rose 0.5%. Boeing saw 130 July orders but just 10 in Aug, although the durables report did not fully reflect that July strength, so a further gain is likely. All up, we expect a 1.0% DGO rise.

US durable goods orders



Key Data and Events

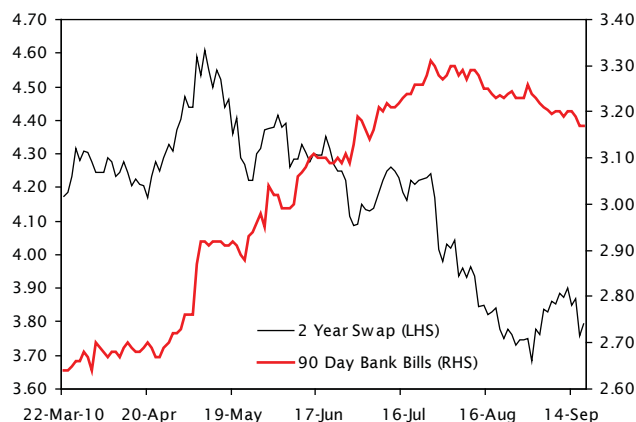
	Last	Market Median	Westpac Forecast	Comments	
Mon 20 Sep					
US	Sep NAHB Housing Market Index	13	14	13	No reason for builders to expect their sector to pick up soon.
UK	Sep Rightmove House Prices %yr	4.3%	-	-	Most UK house price measures suggest recent upward trend waning.
	Sep M4 Money Supply %yr	2.3%	-	-	Annual pace continues to trend towards zero from 18% in Feb 09.
Can	Jul Wholesale Sales	-0.3%	0.1%	0.5%	Seesawing up and down but recent trend barely flat.
Tue 21 Sep					
NZ	Aug External Migration ann.	15,200	-	14,300	Was last month's jump a rouge number or new trend?
	Aug Credit Card Transactions s.a.	-1.2%	-	-	Spending growth subdued and credit card share is falling.
Aus	RBA Minutes, Sep Meeting	-	-	-	Any hints on the urgency, or otherwise, to resume tightening cycle.
US	Sep Housing Starts	1.7%	0.7%	3.0%	Downtrend in single family starts and permits continues but is slowing
	Aug Building Permits	-4.1%	0.2%	0.0%	while multiples have been volatile about a weak trend. See text box.
	Sep FOMC Rate Decision	0-0.25%	0-0.25%	0-0.25%	Stronger hint that further QE is coming. See text box.
UK	Aug PSNCR £bn	-4.1	8.1	-	Public sector net credit requirement.
Can	Aug Consumer Price Index %yr	1.8%	1.9%	-	Headline and core rate at 1.6% yr both below 1-3% target midpoint.
Wed 22 Sep					
NZ	Q3 Employment Confidence Index	108.2	-	-	Recent economic events likely to weigh on confidence.
	Q2 Current Acct Deficit NZDm s.a.	-1,320	-	-1,290	Record trade surplus offsetting higher investment income outflows.
Aus	Jul Westpac-MI Leading Index	6.0%	-	-	Down on March peak but still pointing to above trend growth.
US	July House Price Index	-0.3%	-0.1%	-	Lesser watched FHFA index.
Jpn	Jul All-Industry Index	0.1%	1.0%	-	Domestic demand struggling, construction still a major drag.
Eur	July Industrial New Orders	2.5%	-1.4%	-1.0%	German orders fell 2.2% in July.
	Sep Consumer Confidence Advance	-11	-10	-11	Has been in an uptrend since debt crisis abated, but for how long?
UK	Sep BoE Minutes	-	-	-	Probably just the one dissenter in favour of modest retightening.
Can	Aug Leading Indicators	0.4%	0.3%	-	Trend monthly pace has slowed from 1+% earlier this year.
	July Retail Sales	0.1%	0.6%	-	Auto sales should provide some boost.
Thu 23 Sep					
NZ	Q2 GDP	0.6%	0.8%	0.6%	Strong construction & services, but drought to keep growth low.
US	Sep Initial Jobless Claims	450k	450k	465k	Recent downswing exaggerated by Labor Day holiday, we suspect.
	Aug Existing Home Sales	-27.2%	7.1%	5.0%	Pending sales suggest partial bounce.
	Aug Leading Indicators	0.1%	0.1%	0.0%	Has slowed from 1+% per month in late 2009.
Eur	Sep PMI Manufacturing Advance	55.1	54.5	54.0	Some surveys such as ZEW suggest that the outlook is for slower
	Sep PMI Services Advance	55.9	55.5	54.5	growth and at some point the PMIs will capture this.
UK	Aug BBA Home Loans Number	33,698	34,000	-	No evidence of upswing in home lending.
Fri 24 Sep					
US	Aug Durable Goods Orders	0.4%	-1.0%	1.0%	Partial recovery from excessive Jul declines in some of the detail.
	Aug New Home Sales	-12.4%	6.9%	5.0%	Volatile and heavily revised data series but dead cat bounce expected.
	Fed Chairman Bernanke	-	-	-	"Fixing Economics: Lessons from the Crisis".
	Fed's Lacker	-	-	-	Speaking on economic outlook, in Kentucky.
Ger	Sep IFO Business Climate	106.7	106.4	105.5	Uptrend since early last year is due to start turning.

New Zealand Economic and Financial Forecasts

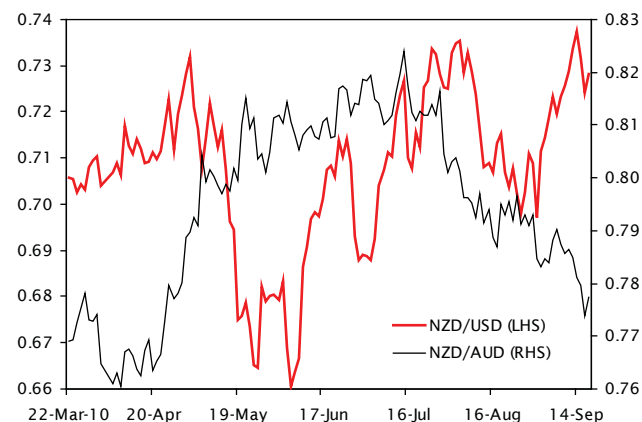
Economic Growth Forecasts	March years				Calendar years			
	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
% change								
GDP (Production) ann avg	-0.4	3.6	4.2	2.9	-1.6	2.8	4.7	2.9
Employment	-0.1	1.7	1.3	1.9	-2.4	2.0	1.6	1.8
Unemployment Rate % s.a.	6.0	5.9	5.9	5.1	7.1	6.1	5.8	5.3
CPI	2.0	4.9	2.1	3.1	2.0	4.8	2.0	2.7
Current Account Balance % of GDP	-2.4	-3.5	-5.0	-4.9	-2.9	-3.1	-4.8	-5.0

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	5.00	5.50
90 Day bill	3.30	3.50	3.90	4.40	4.90	5.40	5.90
2 Year Swap	3.90	4.20	4.60	5.00	5.40	5.80	6.10
5 Year Swap	4.50	4.80	5.20	5.50	5.80	6.10	6.30
10 Year Bond	5.10	5.30	5.50	5.60	5.80	6.00	6.20
NZD/USD	0.72	0.72	0.73	0.72	0.72	0.72	0.71
NZD/AUD	0.78	0.80	0.81	0.82	0.83	0.84	0.84
NZD/JPY	61.2	63.4	66.4	67.7	69.8	72.0	73.8
NZD/EUR	0.55	0.55	0.57	0.58	0.59	0.59	0.58
NZD/GBP	0.46	0.46	0.47	0.48	0.47	0.46	0.44
TWI	66.5	66.9	68.9	69.3	70.0	70.4	69.7

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 20 September 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	3.00%	3.00%	3.00%
30 Days	3.16%	3.09%	3.11%
60 Days	3.21%	3.20%	3.20%
90 Days	3.18%	3.21%	3.23%
2 Year Swap	3.80%	3.83%	3.75%
5 Year Swap	4.42%	4.49%	4.20%

NZ foreign currency midrates as at Monday 20 September 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7267	0.7233	0.7038
NZD/EUR	0.5564	0.5617	0.5536
NZD/GBP	0.4641	0.4699	0.4525
NZD/JPY	62.300	60.910	60.190
NZD/AUD	0.7749	0.7883	0.7955
TWI	66.910	67.070	66.100

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	2.3
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.7	9.9
Current Account %GDP	-6.1	-6.0	-5.3	-4.7	-2.7	-3.3	-3.0
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	-0.7	-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	1.5	1.3
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	1.4	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 10 September 2010

Interest Rate Forecasts	Latest (Sep 20)	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Australia						
Cash	4.50	4.50	4.75	5.00	5.00	5.25
90 Day Bill	4.79	4.80	5.00	5.25	5.25	5.50
10 Year Bond	5.12	5.20	5.30	5.40	5.40	5.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.74	2.75	2.75	3.00	3.25	3.50
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00
Exchange Rate Forecasts						
AUD/USD	0.9378	0.92	0.90	0.90	0.88	0.87
USD/JPY	85.74	85	88	91	94	97
EUR/USD	1.3060	1.30	1.32	1.28	1.24	1.28
AUD/NZD	1.2905	1.30	1.22	1.23	1.22	1.21

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