# Weekly Commentary

21 September 2009

# Levelling out

Last week was mostly about putting the final pieces together for June quarter GDP, to be released on Wednesday.

We estimate that GDP fell by 0.2% in Q2. Having said that, we think that the economy was probably expanding again by the end of the quarter, and given the usual error bands around these estimates, it's possible that growth may have even been positive on a quarterly basis. Either way, leading indicators are increasingly pointing to growth in Q3. The substantial interest rate cuts over the last year, expansionary fiscal policy, a strong increase in net migration, the housing market upturn and a lift in energy output have arrested the decline in overall activity.

The margin of error around our forecast is greater than usual this time. High-level gauges like consumer confidence, electronic transactions, production, new orders and capacity utilisation indicators from the many business surveys all point to Q2 GDP coming in at a touch negative to flat. In contrast, indicators on a sector-by-sector basis collectively suggest mildly positive growth. To make life even harder, there's a technicality with unallocated and balancing items – normally a minor factor – which appear to have supported Q1 growth to the tune of around 0.4%. We have assumed that this will reverse in Q2, but we don't have a great deal of confidence about this.

Some of the detail of Q2 will look much like previous quarters of the recession, with declines in construction, manufacturing and wholesale trade. In construction, the scary economic landscape of 6-12 months ago saw investment plans delayed or cancelled and a slump in building consents at the time. Q2 will see the resulting drop in both residential and non-residential building activity. Manufacturing production is expected to post its fourth straight decline. Weaker domestic and foreign demand has seen producers cut back production and wholesale sales fall. It appears that a rundown of existing inventories, particularly for milk powder, drove the sales that did take place. The inventory run-down ties in with a strong contribution from net exports, as demonstrated in the recent terms of trade.

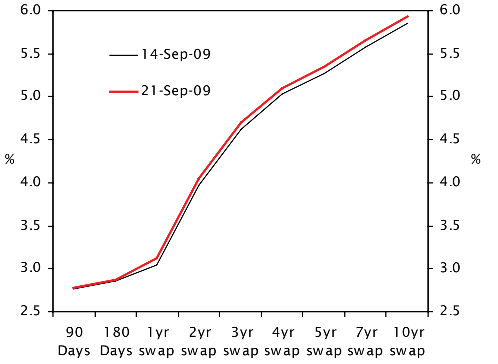
Among the sectoral positives for Q2, rising house sales will have lifted activity in the real estate and related services sectors. Energy-related sectors benefited from the first output from the Maari oil field and a rise in the share of relatively cheap hydro electricity generation. Government spending is also expected to make a positive contribution, adding to growth in the service sectors and helping to support domestic demand.

We suspect consumers eked out a small increase in real spending during the quarter, in what would be the first increase in 18 months. But our expectation that spending increased by 0.2%, if correct, is nothing to write home about when you consider the degree of monetary (lower interest rates) and fiscal (tax cut) stimulus that consumers received during the quarter.

As if GDP weren't enough, there is plenty of other significant data next week. We expect the current account deficit (Tuesday) to narrow from 8.5% to 6.6% of GDP for the year to June. This is still high by world standards, but would be the lowest for NZ since December 2004.

The speed of the improvement in the deficit is less dramatic than these figures suggest – last year's spike in imported fuel prices is now dropping out of the equation, and the investment income deficit could be unusually small thanks to a couple of one-off factors. The range of market forecasts for the deficit, from our

***NZ Interest Rates***




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

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6.6% to as high as 7.8%, in part reflects the degree of uncertainty around these factors. Notwithstanding this, though, the gradual trend improvement in the deficit remains intact.

Turning to more timely data, Fonterra announces its latest dairy payout estimate on Wednesday. A substantial upward revision is on the cards.

The Westpac McDermott Miller consumer confidence survey for June saw a collective sigh of relief that the economy had avoided the doomsday scenario that was feared at the peak of the global financial crisis. The September survey (Thursday) will reflect the recent flow of data confirming that the worst is behind us, balanced against the ongoing uncertainty around job prospects.

Finally, the August trade balance (Friday) is expected to move further into deficit as it hits a seasonal low point. Export prices are rising, but this is offset to some degree by the stronger exchange rate. Meanwhile, imports are rebounding fast, especially for motor vehicles, as domestic demand finds its feet again.

All up, Q2 increasingly looks like it was the trough in economic activity. The economic vibe is changing, with forward-looking indicators suggesting growth has resumed in Q3. Even so, this does not mean interest rate hikes are coming soon. The level of activity has fallen so far over the past 18 months that it will take time before the recovery generates any significant inflationary pressure. That means the OCR can remain low for some time yet.

***Fixed vs. floating:*** In the last couple of months we have seen borrowers gradually moving out of floating rates and returning to short-term fixed rates. These rates are the most favourable on offer, and will remain so for some time. But they're unlikely to remain at current levels once we see a more substantial shift by borrowers into these terms – in the same way that the extremely low long-term rates available prior to March didn't last for long once borrowers actually started taking them up. Borrowers should seriously consider fixing now, bearing in mind that they can reduce uncertainty about future cash flows by choosing a lower interest rate today and repaying more than the minimum amount.

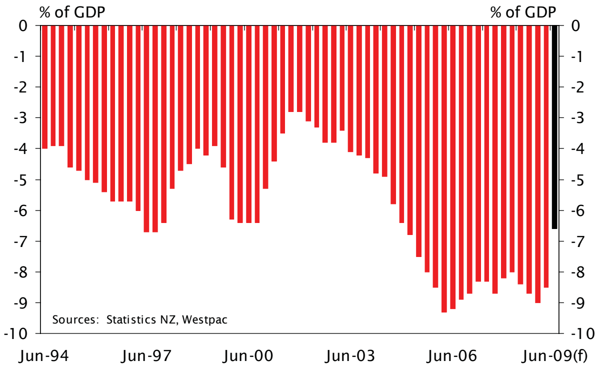
## Key Data Previews

### NZ Q2 current account deficit NZDm s.a.

**Sep 22, Last: –2,693, WBC f/c: –1,320**

- We estimate that the annual deficit narrowed from 8.5% to 6.6% of GDP in the June quarter. This is still high by world standards, but would be the lowest for New Zealand since December 2004.
- The trade balance is likely to have improved despite the stronger NZ dollar. Export volumes were very strong in Q2 as milk powder that was stockpiled at the end of last year was sold down, and the bumper ski season provided some respite for tourism earnings. Import volumes remained subdued even with vehicles rebounding from their Q1 lows.
- Investment income outflows continued to fall as a result of lower interest rates and falling profits for overseas-owned firms. A few one-off factors mean that the extent of the improvement in the deficit is likely to be exaggerated for Q2.

***NZ annual current account deficit***

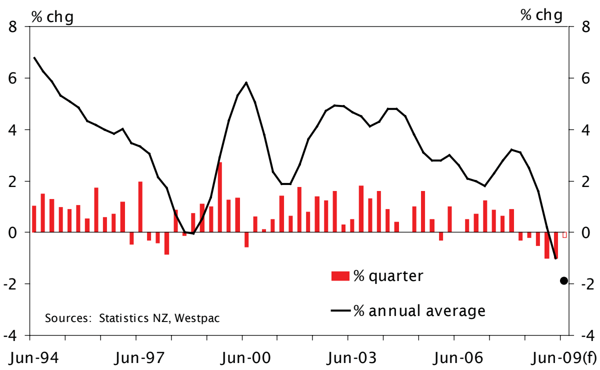



### NZ Q2 GDP

**Sep 23, Last: –1.0%, WBC f/c: –0.2%, Mkt f/c: –0.2%**

- The recession is nearing its end. There is a chance it ended in Q2 given our -0.2% estimate and the error bounds around this. We have settled on a forecast of -0.2% despite the detailed industry indicators pointing to a small positive result. This is due to a technicality with unallocated items and the seasonal adjustment balancing item. This and the forecast large sector movements this quarter bring a bigger-than-usual margin for error.
- High-level indicators like consumer confidence and production indicators from business surveys suggest a small negative to flat result.
- Manufacturing, construction, and wholesale trade are expected to fall, while real estate, energy, government spending and exports are forecast to rise. We expect a large inventory unwind that will set the stage for future growth as stocks are replenished when demand recovers.

***NZ GDP growth***

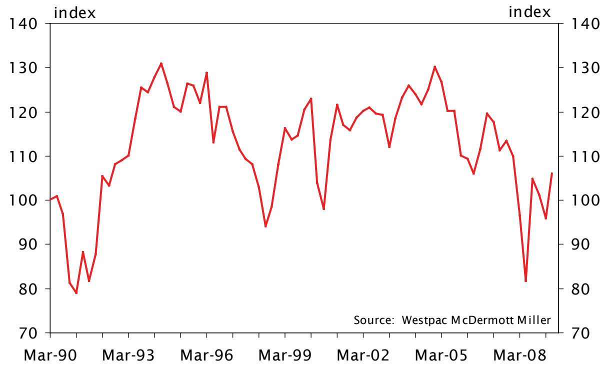


## NZ Q3 consumer confidence

**Sep 24 (10am), Last: 106.0**

- The Westpac McDermott Miller Consumer Confidence Index pushed back into positive territory in 2009Q2 as consumers once again heaved a collective sigh of relief. At the time, the Index was at 106.0 – an eighteen month high.
- Since June, the economic news internationally and locally has been far more appealing. On the global front, most commentators now agree that a turning point has been reached. The debate now lies largely around the shape and longevity of the recovery.
- In NZ, the economic data continue to trace out a gradual path of recovery. Business confidence has surged, the housing market is showing solid momentum in activity and prices, consumer spending has picked up pace, and Fonterra's last two auctions showed a massive 56% increase in whole milk powder prices.

*NZ Consumer Confidence*

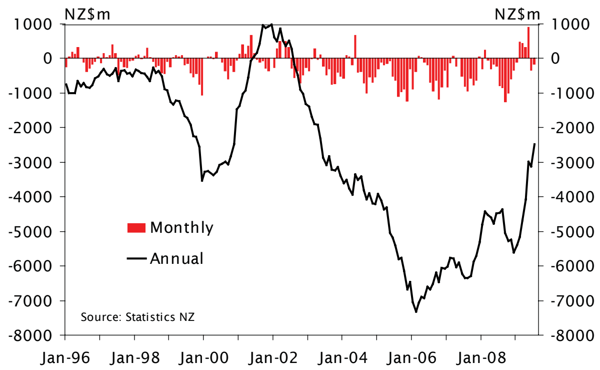



## NZ Aug merchandise trade NZDm

**Sep 25, Last: –163, WBC f/c: –350, Mkt f/c: –329**

- The merchandise trade balance rose sharply in late-2008 and early-2009, as import volumes fell and export price declines were offset by the falling exchange rate. For the past five months in a row, both imports and exports have exceeded the market expectation, as import volumes have rapidly recovered and export prices have risen. The balance between the two has seen the trade balance slipping downwards.
- Our forecast represents a continuation of the recent trends. The predicted deficit is the smallest for August since 2003, but in seasonally adjusted terms is larger than recent months.
- Imports are rebounding fast, especially for motor vehicles. Export prices are also rising fast, but this is offset to some degree by the rising exchange rate. It is too early for recent strength in spot dairy prices to show up as higher export receipts in the trade data.

*NZ merchandise trade balance*

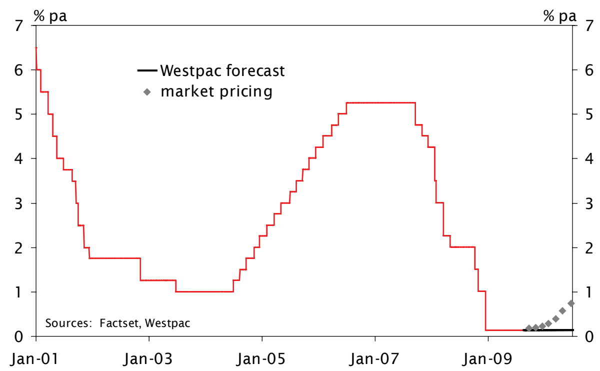



## US FOMC rate decision

**Sep 23, Last: 0-0.25%, WBC f/c: 0-0.25%, Mkt f/c: 0-0.25%**

- On Aug 12, the FOMC noted "improved" conditions in financial markets, and expected "a gradual resumption of sustainable economic growth", in response to the considerable fiscal and monetary stimulus already in place. Hence the Fed kept rates at 0-0.25% and made no adjustments to the size of the quantitative easing (asset purchase) program. However, to promote a smooth transition in markets, it was decided to gradually slow the pace of these transactions, with the program to be wound down by the end of October.
- We expect a similar outcome following the Sep 22-23 meeting, with no change to these policy arrangements likely. Despite rumours about a uber-hawkish minority on the FOMC, the commitment to maintain "exceptionally low levels of the federal funds rate for an extended period" should be reiterated.

*Fed funds target rate*

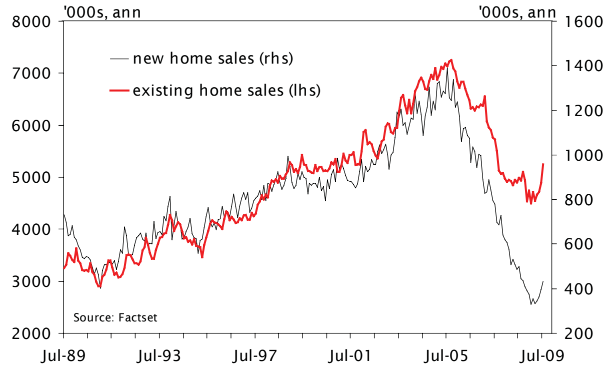


## US Aug existing and new home sales to post gains

**Sep 24, Existing home sales: Last: 7.2%, WBC f/c: 3.0%, Mkt f/c: 2.1%**
**Sep 25, New home sales: Last: 9.6%, WBC f/c: –2.5%, Mkt f/c: 1.6%**

- US housing is showing signs of strengthening on all indicators: starts, permits, prices, homebuilder sentiment and of course sales of both existing and new dwellings.
- In Jul, existing home sales surged 7.2% to be up nearly 17% from their Jan low. Even so they continue to lag behind pending home sales which purport to measure the same transactions (but earlier in the sale process), and which are up 21% since the start of the year. So we expect a further 2% gain, which would be the fifth consecutive monthly rise.
- New home sales soared nearly 10% in July making it four gains in a row. Inroads are being made into the stock of unsold new homes, at least in part due to the sharply lower prices and tax credits to encourage first home buyers. We expect a small fall in Aug to restore a more realistic pace of up-trend.

*US housing sales*

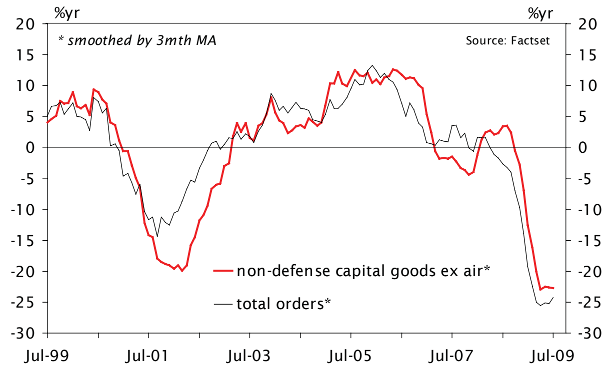



## US Aug durable goods orders to rise again

**Sep 25, Last: 5.1%, WBC f/c: 1.5%, Mkt f/c: 0.4%**

- Durable goods orders posted a renewed and sharp gain in July, boosted by defence (15%), autos (0.9%, with more to come in August thanks to 'cash for clunkers') and especially civilian aircraft orders, which more than doubled. The surprise, which adds a further positive note, was that core capital goods orders posted the mildest of declines (just –0.3%) in July, after back-to-back monthly gains in May-June worth a cumulative 8%.
- August orders should post a further but less impressive gain. The Aug ISM factory index orders component surged from 55 to 65; factory production rose 0.6%, with autos up again; business equipment output posted back-to-back gains in Jul-Aug. But, Boeing had fewer, less valuable orders in Aug, and auto orders will have fallen away sharply late month, after the 'cash for clunkers' program closed. Overall we expect Aug orders to rise 1.5%, ahead of a probable auto-driven fall in Sep.

*US durable goods orders*



## Key Data and Events

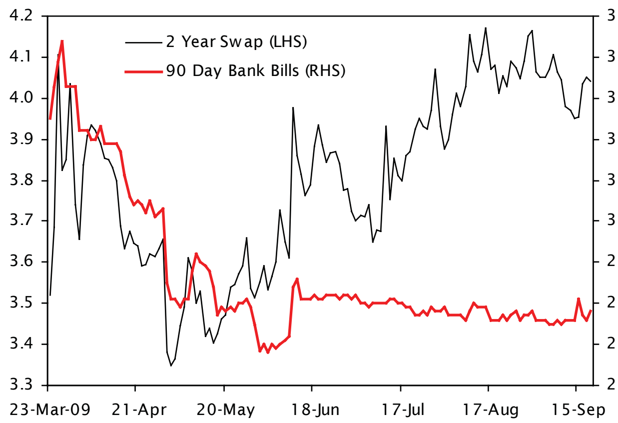
| | | Last | Market Median | Westpac Forecast | Comments |
|---|---|---|---|---|---|
| **Mon 21 Sep** | | | | | |
| NZ | Aug Credit Card Transactions | 1.0% | – | – | Moderate rise expected in August, as consumer confidence returns. |
| Aus | Aug Motor Vehicle Sales | -6.9% | – | -1.0% | Tax-break induced surge in business sales still unwinding. |
| US | Aug Leading Index | 0.6% | 0.7% | 1.0% | Equities, claims, permits, orders all +ve. Heading for 5th consec rise. |
| UK | Sep House Prices %yr | -3.1% | – | – | Tentative date for Rightmove index. |
| **Tue 22 Sep** | | | | | |
| NZ | Q2 Current Account NZDm s.a. | -2,693 | – | -1,320 | Weak import demand and falling investment income outflows. |
| US | Sep Richmond Fed Factory Index | 14 | 16 | 18 | The first to turn positive, back in May. |
| | Jul House Prices | 0.5% | 0.5% | – | Lesser watched FHFA series. |
| Can | Jul Retail Sales | 1.0% | 0.7% | 1.0% | Strong boost from auto sales. |
| **Wed 23 Sep** | | | | | |
| NZ | Q2 GDP %qtr | -1.0% | -0.2% | -0.2% | Contraction abating as policy starting to take effect. |
| US | FOMC Rate Decision | 0-0.25% | 0-0.25% | 0-0.25% | Firmly on hold despite reports some FOMC members want to hike. |
| Eur | Sep PMI Factory Advance | 48.2 | 49.7 | 49.0 | The Euroland economy looks like it is just expanding in Q3, by about |
| | Sep PMI Services Advance | 49.9 | 50.5 | 50.5 | 0.1%, so the PMIs should be hovering around 50+ to be consistent. |
| | Jul Industrial Orders | 3.1% | 2.0% | 2.5% | German orders known up 3.5%. |
| UK | Sep BoE Minutes | – | – | – | Interesting to see if any still voting for further QE extension. |
| | Aug BBA Mortgage Lending £bn | 38.2 | 40.5 | – | New bank mortgage lending has more than doubled since Nov 2008. |
| **Thu 24 Sep** | | | | | |
| NZ | Q3 Consumer Confidence (10am) | 106.0 | – | – | Monthly surveys suggest confidence remains buoyant. |
| Aus | RBA Financial Stability Review | – | – | – | Detailed assessment of the state of the financial system. |
| US | Initial Jobless Claims w/e 19/9 | 545k | 550k | 550k | Possible correction from possible distortion from Labor Day holiday! |
| | Aug Existing Home Sales | 7.2% | 2.1% | 3.0% | Pending home sales figures point to further gain in existing home sales. |
| | Fedspeak | – | – | – | Evans on asset prices and regulation. |
| Jpn | Aug Trade Balance ¥bn s.a. | 195 | 188 | – | Imports rose more than 3% in July as exports fell. Payback on the way. |
| Ger | Ifo Business Climate Index | 90.5 | 92.0 | 92.0 | Rising as outlook shifts from Armageddon to recession to sluggish growth. |
| **Fri 25 Sep** | | | | | |
| NZ | Aug Merchandise Trade NZDm | -163 | -329 | -350 | Imports rebounding fast, export prices rising, exchange rate rising. |
| US | Aug Durable Goods Orders | 5.1% | 0.4% | 1.5% | Business surveys strong, autos a positive, Boeing numbers down. |
| | Aug New Home Sales | 9.6% | 1.6% | -2.5% | Very strong up-trend, but due for a modest correction lower. |
| | Sep UoM Consumer Sentiment (F) | 70.2a | 70.5 | 71.0 | Equities solid and gasoline prices edging lower since prelim survey. |
| | Fedspeak | – | – | – | Gov Warsh in Chicago. |
| Jpn | Aug Bank of Japan Minutes | – | – | – | Expect cautious commentary on post-stimulus state of play. |
| | Aug Corp. Services Prices %yr | -3.4% | -3.5% | – | Collapse in int. freight rates is huge, but non-traded prices also weak. |
| Eur | Aug Money Supply M3 %yr | 3.0% | 2.7% | 2.7% | In Jul credit growth to private sector was slowest on record. |
| UK | Q2 Business Investment (F) | -10.4%a | -10.4% | -10.4% | Q2 is one of the weakest qtrs on record for capital spending. |
| **Sun 27 Sep** | | | | | |
| NZ | Daylight Savings Begins | – | – | – | Clocks go forward 1 hour. |

## New Zealand Economic and Financial Forecasts

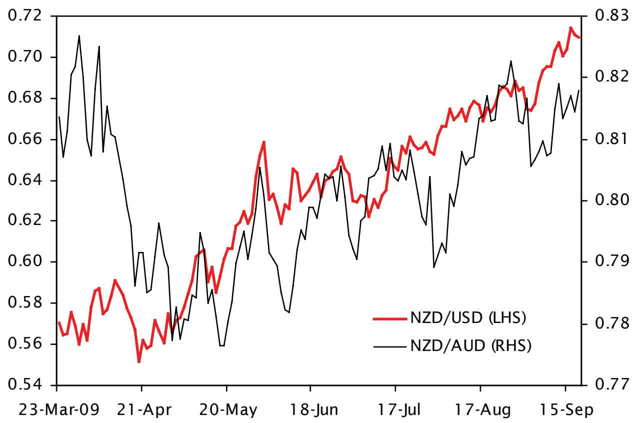
| Economic Growth Forecasts | March years | | | | Calendar years | | | |
|---|---|---|---|---|---|---|---|---|
| % change | 2008 | 2009 | 2010f | 2011f | 2008 | 2009f | 2010f | 2011f |
| GDP (Production) ann avg | 3.1 | -1.0 | -1.2 | 3.2 | 0.2 | -2.1 | 2.6 | 3.6 |
| Employment | -0.3 | 0.7 | -1.3 | 1.1 | 0.9 | -2.5 | 0.8 | 1.4 |
| Unemployment Rate % s.a. | 3.8 | 5.0 | 7.0 | 6.8 | 4.7 | 6.9 | 6.9 | 6.6 |
| CPI | 3.4 | 3.0 | 1.9 | 1.6 | 3.4 | 2.1 | 1.2 | 2.1 |
| Current Account Balance % of GDP | -8.0 | -8.5 | -4.5 | -5.5 | -9.0 | -4.7 | -5.3 | -6.3 |

| Financial Forecasts | Dec-09 | Mar-10 | Jun-10 | Sep-10 | Dec-10 | Mar-11 | Jun-11 |
|---|---|---|---|---|---|---|---|
| Cash | 2.50 | 2.50 | 2.50 | 3.00 | 4.00 | 5.00 | 5.50 |
| 90 Day bill | 2.80 | 2.80 | 2.90 | 3.60 | 4.60 | 5.50 | 5.90 |
| 2 Year Swap | 4.10 | 4.30 | 4.60 | 5.00 | 5.40 | 5.85 | 6.15 |
| 5 Year Swap | 5.40 | 5.50 | 5.60 | 5.80 | 6.00 | 6.30 | 6.45 |
| 10 Year Bond | 5.80 | 5.90 | 6.00 | 6.20 | 6.30 | 6.40 | 6.50 |
| NZD/USD | 0.67 | 0.70 | 0.72 | 0.74 | 0.76 | 0.74 | 0.74 |
| NZD/AUD | 0.84 | 0.84 | 0.85 | 0.85 | 0.85 | 0.86 | 0.86 |
| NZD/JPY | 60.3 | 65.1 | 69.1 | 73.3 | 78.3 | 78.4 | 80.7 |
| NZD/EUR | 0.48 | 0.49 | 0.50 | 0.51 | 0.51 | 0.50 | 0.50 |
| NZD/GBP | 0.41 | 0.42 | 0.42 | 0.42 | 0.41 | 0.40 | 0.39 |
| TWI | 62.8 | 65.1 | 66.6 | 68.0 | 69.3 | 68.5 | 68.6 |

*2 Year Swap and 90 Day Bank Bills*




*NZD/USD and NZD/AUD*




### NZ interest rates as at market open on Monday 21 September 2009

| Interest Rates | Current | Two Weeks Ago | One Month Ago |
|---|---|---|---|
| Cash | 2.50% | 2.50% | 2.50% |
| 30 Days | 2.81% | 2.77% | 2.78% |
| 60 Days | 2.83% | 2.77% | 2.80% |
| 90 Days | 2.79% | 2.75% | 2.76% |
| 2 Year Swap | 4.05% | 4.11% | 4.03% |
| 5 Year Swap | 5.35% | 5.37% | 5.35% |

### NZ foreign currency midrates as at Monday 21 September 2009

| Exchange Rates | Current | Two Weeks Ago | One Month Ago |
|---|---|---|---|
| NZD/USD | 0.7075 | 0.6932 | 0.6832 |
| NZD/EUR | 0.4817 | 0.4836 | 0.4769 |
| NZD/GBP | 0.4363 | 0.4244 | 0.4139 |
| NZD/JPY | 64.650 | 64.460 | 64.530 |
| NZD/AUD | 0.8175 | 0.8097 | 0.8188 |
| TWI | 64.550 | 63.950 | 63.470 |

## 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 | 0.7 | 2.5 |
| 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 | -6.3 | -4.6 | -4.0 | -4.9 |
| **United States** | | | | | | | |
| Real GDP %yr | 3.9 | 3.1 | 2.8 | 2.1 | 0.4 | -2.8 | 1.4 |
| 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 | 9.4 | 11.1 |
| Current Account % GDP | -5.7 | -6.1 | -6.0 | -5.2 | -4.9 | -2.9 | -2.7 |
| **Japan** | | | | | | | |
| Real GDP %yr | 2.3 | 1.9 | 2.8 | 2.2 | -1.0 | -5.8 | 1.5 |
| Consumer Prices %yr | -0.1 | -0.3 | 0.2 | 0.1 | 1.4 | -1.1 | -0.7 |
| Unemployment Rate % | 4.5 | 4.4 | 4.1 | 3.9 | 4.0 | 5.3 | 6.4 |
| Current Account % GDP | 3.3 | 3.6 | 3.9 | 4.8 | 3.2 | 2.6 | 2.9 |
| **Euroland** | | | | | | | |
| Real GDP %yr | 1.9 | 1.8 | 3.1 | 2.7 | 0.6 | -4.1 | 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 |
| **United Kingdom** | | | | | | | |
| Real GDP %yr | 3.0 | 2.2 | 2.9 | 2.6 | 0.7 | -4.4 | 0.5 |
| 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 4 September 2009

| Interest Rate Forecasts | Latest (Sep 21) | Dec-09 | Mar-10 | Jun-10 | Sep-10 | Dec-10 |
|---|---|---|---|---|---|---|
| **Australia** | | | | | | |
| Cash | 3.00 | 3.00 | 3.25 | 3.50 | 3.75 | 4.00 |
| 90 Day Bill | 3.35 | 3.40 | 3.75 | 4.00 | 4.25 | 4.50 |
| 10 Year Bond | 5.28 | 5.50 | 5.80 | 6.25 | 6.25 | 6.35 |
| **International** | | | | | | |
| Fed Funds | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 |
| US 10 Year Bond | 3.46 | 3.40 | 3.75 | 4.00 | 4.25 | 4.50 |
| ECB Repo Rate | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.25 |

| Exchange Rate Forecasts | Latest (Sep 21) | Dec-09 | Mar-10 | Jun-10 | Sep-10 | Dec-10 |
|---|---|---|---|---|---|---|
| AUD/USD | 0.8654 | 0.80 | 0.83 | 0.85 | 0.87 | 0.89 |
| USD/JPY | 91.38 | 90 | 93 | 96 | 99 | 103 |
| EUR/USD | 1.4688 | 1.40 | 1.42 | 1.44 | 1.46 | 1.49 |
| AUD/NZD | 1.2232 | 1.19 | 1.19 | 1.18 | 1.18 | 1.17 |