

Weekly Commentary

23 August 2010

Minding inflation

It's a longer than usual gap between *Monetary Policy Statements*. With few significant data releases before the September review, the market took what it could from the RBNZ Governor's speech last week.

The RBNZ still sees the economy in recovery mode, even though growth is not expected to be outstanding and the downside risks are all too apparent. Annual inflation has been steady around the middle of the 1-3% target band so far in the recovery. However, as economic activity returns to its potential, inflation pressures are expected to build again and rates will need to be normalised.

The inflation picture for the next year or so will be complicated by a range of government policy-related price increases, which will see annual inflation approach 5% by the middle of next year. The RBNZ has scope to look through these one-off effects on the price level, but there is the danger that higher inflation comes to be seen as the norm, and filters through into wage and price setting (note that this will be the third breach of the top of the target band in five years). The RBNZ is "hopeful" that it won't need to raise rates to lean against a ratcheting-up of inflation pressures, but it will continue to monitor the situation, and warned businesses and other groups against pushing through additional price hikes under the cover of the upcoming GST hike.

For the most part, the speech was a repeat of what the RBNZ has already said in recent statements. However, it did emphasise that the RBNZ is giving the benefit of the doubt that higher inflation expectations won't be acted upon in wages and prices. That seems to imply a demotion of Tuesday's inflation expectations survey as a useful inflation indicator. The previous quarter's survey saw expectations rise to 2.8% for two years ahead (which is beyond the direct impact of most of the impending policy changes), and we wouldn't be surprised if it heads a little higher.

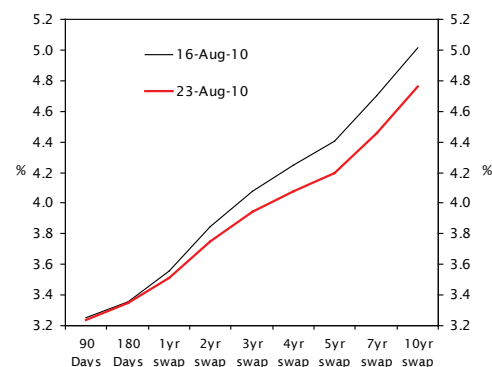
Wholesale interest rates fell after the speech, with the market apparently reading it as a signal that the RBNZ is reluctant to raise the OCR further. Given the global backdrop lately, it's not surprising that the market would be looking for the downside risks in everything, but even so that conclusion seems a bit of a stretch.

The RBNZ's forecast for inflation to remain "comfortably inside the target band in the second half of our forecast horizon" is a conditional one, which relies on the RBNZ delivering the rate hikes that they have projected. In the June *MPS* those projections pointed to a peak OCR of close to 6%; the July review hinted at something less. But we would be staggered if the RBNZ has taken its projections

down to anything like the 4% peak that the market is now pricing. An extended series of rate hikes is still the base case; the message of the speech was that the RBNZ doesn't want to have to raise rates even more than it has already flagged.

On the data front, net migration inflows rebounded to a seasonally adjusted 970 in July, the highest since March. We had been puzzled by the weakness of foreign arrivals in recent months, and while the bounce in July was a pleasant change, it simply serves to highlight the volatility of this series. There was also a sharp drop in the number of Kiwis heading overseas, though we don't think this marks a change in the trend. The strong Australian labour market will continue to draw Kiwis across the Tasman in coming months, keeping overall net migration at a lower level than in previous cycles.

NZ Interest Rates



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

Visitor arrivals rose a seasonally adjusted 1.4% rise in July, taking the annual total above 2.5 million for the first time. In contrast, short-term departures of NZ residents fell 1.0%, continuing the theme of subdued spending by NZ households.

Producer prices recorded another large gain in Q2, with inputs up 1.4% and outputs up 1.1%. The new information content in this release is limited, not just because it comes a month later than consumer prices, but because the drivers are already well recognised: higher world prices for our key commodity exports such as milk, meat, wood and oil. The implications for general inflation are limited – these items are a tiny fraction of NZ consumers’ spending, while they make up a large proportion of our production. Low CPI inflation and high

PPI inflation simply reflects a relative price shift, albeit one that bodes well for NZ’s near-term economic outlook.

Finally, on Friday Fonterra said that it is maintaining its payout forecast for the current season of \$6.90-7.10/kg – a relief given recent speculation that it may be lowered. That said, if world prices and the NZ dollar remain around current levels for the rest of the season, the risks to the payout are now to the downside (whereas they were substantially to the upside just a few months ago). However, Fonterra sees scope for prices to improve later in the season.

Our own view is that dairy prices will stabilise or improve over the next few months, but a bumper Australasian growing season will eventually weigh on

prices. However, our difference in view amounts to a tradeoff between prices and volumes. We expect dairy farmers’ incomes in the 2010/11 season to be within \$500m of the \$9.8bn achieved in the record 2007/08 season.

Fixed vs. floating: The gap between fixed and floating rates has narrowed significantly – partly because financial markets are questioning the RBNZ’s resolve to return the OCR to normal levels. Borrowers who believe that the economy is simply wobbling along the path to recovery, and therefore that the RBNZ will continue to normalise the OCR in the next few years, will find today’s 2-3 year fixed rates very attractive. Those who believe that markets are presaging a return to recession will be more attracted to floating rates.

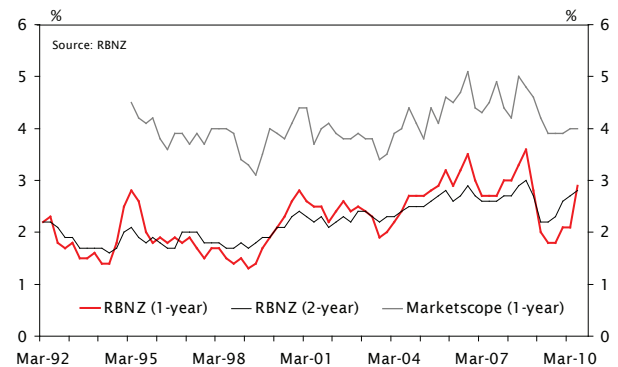
Key Data Previews

NZ Q3 RBNZ survey of inflation expectations

Aug 24, 2yr ahead: Last: 2.8%, WBC f/c: 2.9%

- 2-year-ahead inflation expectations dipped during the recession, but have since returned to 2.8%. That is slightly uncomfortable for a central bank that is charged with keeping inflation between 1% and 3%. To make matters worse, inflation will soon jump to 5% as a consequence of hikes to GST, ACC levies and tobacco excise, along with the introduction of the ETS.
- In a recent speech, RBNZ Governor Bollard effectively demoted this survey from the ranks of useful inflation indicators. He said that although surveyed inflation expectations could spike temporarily higher, in the long term inflation expectations shouldn’t be affected by high headline inflation. Rather than focusing on the survey, the RBNZ will watch for signs that expectations are being acted upon in wage and price setting behaviour.

NZ inflation expectations

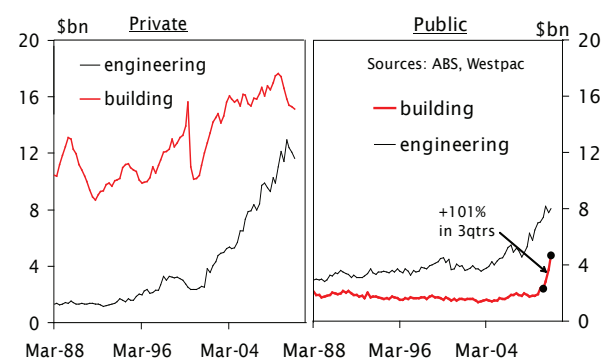


Aus Q2 construction work done

Aug 25, Last: 1.9%, WBC f/c: 3.5%, Mkt f/c: 2.8%, Range: 1.0% to 7.0%

- We’re forecasting a sizeable 3.5% rise in total construction work done in the June quarter. However, the potential for surprise is great given strong cross currents.
- New private residential construction is forecast to jump – possibly by as much as 10%. Starts rebounded 27% over 2009H2 but work done has fallen by 4% over the three quarters to 2010Q1. It’s time for some catch-up. Private infrastructure activity is also forecast to climb, up 8% (\$850mn), after three quarters of decline, as work on the \$43bn Gorgon project gets underway.
- Public construction is forecast to lose altitude after a burst of spending. Activity is up 36% over the last year and up 58% over the last two years. While the level of work will remain high, we expect a fall of 3% (maybe more) in Q2.

Construction work

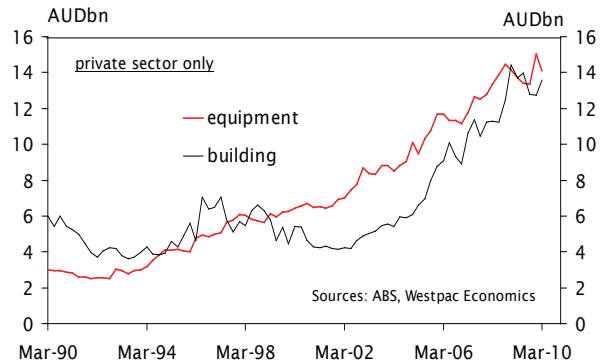


Aus Q2 CAPEX

Aug 26, Last: -0.2%, WBC f/c: 4.0%, Mkt f/c: 2.2%, Range: 1.5% to 4.5%

- The survey of private CAPEX expenditure is also forecast to report a sizeable rise in Q2, up 4%. However, we are mindful of the divergence between the CAPEX and the national accounts in Q1 - what impact this will have on Q2 is unclear.
- Notably, CAPEX reported building & structures spending up 6.7% in Q1 but the national accounts showed building work down 0.6% and infrastructure work down 3.9% - go figure. We expect a rise in this segment, driven by the Gorgon project.
- Equipment spending has been whipped around by temporary government tax breaks. Spending was brought forward into Q4 (up 12.5%) from Q1 (down 6.0%). We expect a 4% rebound in Q2. Imports of capital goods advanced for the 4th consecutive quarter and vehicle sales rose a little after a sharp pull-back.

Real capital expenditure (CAPEX survey)



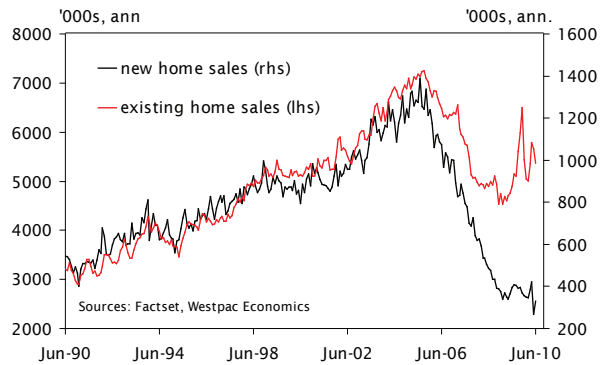
US July existing & new home sales

Aug 24, Existing home sales: Last: -5.1%, WBC f/c: -12.0%

Aug 25, New home sales: Last: 23.6%, WBC f/c: -12.0%

- Housing data have mostly slumped since the tax credit for homebuyers finally expired in April. Single family home starts and permits have contracted by a quarter and homebuilder sentiment dropped to its weakest since March 2009.
- Sales data have been less clear-cut: new home sales plunged 37% in May but recovered two fifths of that loss in June (24% bounce); existing home sales, which still qualified for the credit provided they completed by June (then extended to Sep), were down 7% in May-June but pending sales plunged 31% in late Q2 which will eventually be reflected in the existing sales.
- So existing home sales are likely to post a sizeable double digit fall in July. The new home sales' bounce in June looks inconsistent with the services sectors were more circumspect, with the 2nd est. of \$45bn, up 2% on the corresponding est. last year.

US housing sales

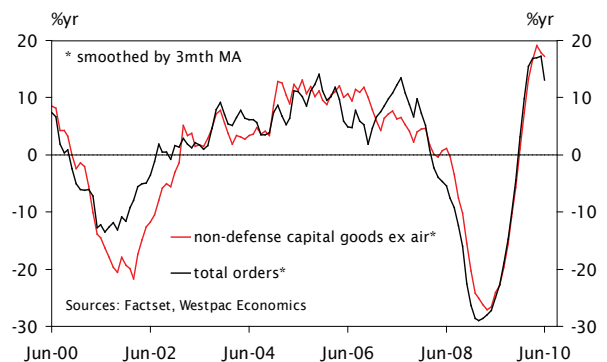


US July durable goods orders to rise, due to aircraft

Aug 25, Last: -1.2%, WBC f/c: 5.0%

- The 1.2% durables fall was largely driven by transport, with civilian aircraft down by a quarter despite solid gains in Boeing data. However ex transport orders fell 0.9% and ex defence was down 1.0% so there was underlying softness in the report, consistent with other evidence that the US economy will slow further in H2 2010. One "bright" spot was a 0.2% rise in core capital goods orders in June, on top of a 4.7% rise in May.
- Boeing saw 49 June orders but 130 in July. Boeing data don't always track Commerce Dept figures but at some point we must see a huge rebound well in excess of 100%. Elsewhere, signals are mixed: the ISM factory survey new orders index fell from 58.5 to 53.5, its lowest since June last year; but factory output jumped 1.1% in July (much of that autos). So total durable orders should post a solid gain, but ex the other data so could be revised lower - or else July sales will plunge again.

US durable goods orders



Key Data and Events

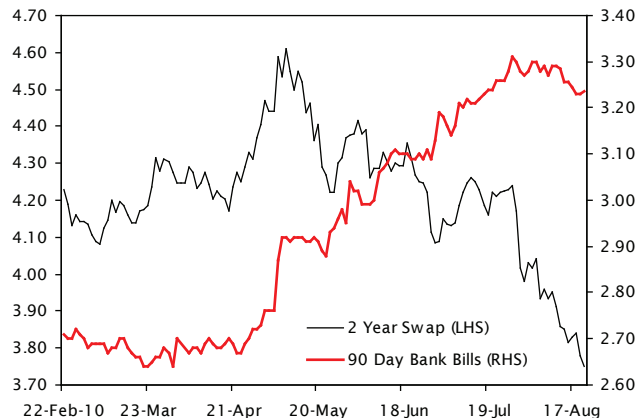
		Last	Market Median	Westpac Forecast	Comments
Mon 23 Aug					
US	Jul Chicago Fed activity index	-0.63	-	-1.00	Derived from 80+ data releases many of which softened in July.
	Q2 mortgage delinquencies %	10.1%	-	-	Tentative date – data due 23-27/8.
	Fedspeak	-	-	-	Chicago Fed president Hoenig the dissenter.
Eur	Aug PMI factory advance	56.7	56.4	56.0	Resumption of downtrend as economy slows from Q2's rapid pace.
	Aug PMI services advance	55.8	55.5	55.0	Services also likely to soften into H2 2010.
	Aug consumer confidence advance	-14	-13	-14	Concerns about Greece, budget cuts are waning.
Tue 24 Aug					
NZ	Q2 RBNZ 2yr inflation expectations	2.8%	-	2.9%	Could be polluted by upcoming GST hike; RBNZ will pay no heed.
US	Jul Richmond Fed manufacturing index	16	12	8	Further downside as the economy slows in H2 2010.
	Jul existing home sales	-5.1%	-13.9%	-12.0%	Pending sales suggest further steep falls to come.
	Fedspeak	-	-	-	Kansas City Fed president Evans.
Eur	Jun industrial new orders	3.2%	1.5%	2.0%	May solid despite German orders flat; Germany up 3.2% in June.
UK	Jul BBA home loans, number	34.8k	-	34.0k	Major bank data showed a small fall in new loans by number.
Can	Jun retail sales	-0.2%	0.3%	0.4%	Auto sales up, gasoline sales down, mixed sales elsewhere.
Wed 25 Aug					
Aus	Q2 construction work done	1.9%	2.8%	3.5%	Housing upswing & Gorgon kicks-in, but public to fall.
US	Jul durable goods orders	-1.2%	3.0%	5.0%	Aircraft/autos to be strong but surveys suggest softness elsewhere.
	Jul new home sales	23.6%	flat	-12.0%	June bounce to be revised away or July to fall steeply.
	Jun house prices	0.5%	-	-	Lesser-watched FHFA index.
Jpn	Jul corporate services prices %yr	-1.0%	-1.0%	-	Cost constraint high, pricing power low, equals services deflation.
	Jul trade balance ¥bn sa	456	398	-	Strong yen damping usual sensitivity of the surplus to MTP growth.
Ger	Aug IFO business climate index	106.2	105.5	107.5	Solid German GDP news and recent renewed euro weakness to help.
UK	Aug house prices %yr	6.6%	-	-	Tentative date for Nationwide index, due 25-31/8.
	Aug CBI retail survey	33	-	15	July survey captured World Cup spending, discounting.
Can	Jun house prices %yr	13.6%	-	-	Teranet/National Bank index.
Thu 26 Aug					
Aus	Q2 private CAPEX	-0.2%	2.2%	4.0%	Equipment to rebound + Gorgon boost.
	2010/11 CAPEX intentions, AUDbn	103.9	-	-	Upbeat on mining boost. 2nd est implied 19% growth.
US	Initial jobless claims w/e 21/8	500k	485k	510k	Labour market is weakening again as Q3 GDP growth stalls.
	Fed's Jackson Hole annual conference	-	-	-	Aug 26-28.
Eur	Jul money supply M3 %yr	0.2%	0.4%	-	June saw first positive annual growth since last October.
Ger	Sep GfK consumer confidence	3.9	4.0	-	Labelled Sep but surveyed early Aug.
Fri 27 Aug					
US	Q2 GDP, 2nd est. % annualised	2.4%	1.4%	1.2%	Some risk of sub 1% annualised in Q2 – and Q3 will be slower!
	Aug Michigan consumer sentiment	69.6	70.0	70.0	Modest upward revision given recent signals from weekly conf. data.
	Fed's Jackson Hole symposium	-	-	-	Reliable guide to the monetary policy anxieties of the day.
Jpn	Jul unemployment rate %	5.3%	5.3%	-	Jobs-to-applicants ratio grinding higher, still at ice-age levels.
	Jul real household spending %yr	0.5%	1.6%	-	To lose ground in second half as fiscal incentive impact wanes.
	Jul national consumer prices %yr	-0.7%	-0.9%	-	That output gap needs a fence around it and a warning sign.
	Aug Tokyo consumer prices %yr	-1.2%	-1.1%	-	Services -0.8%; Goods -1.3%; Durables -5.8%; Agri +1.6% in July.
Ger	Jul retail sales	-0.3%	-	-	Down in 3 of last 4 months despite recent upward revision to June.
	Aug CPI %yr prelim	1.2%	1.2%	-	Euro reappreciation and pull-back in oil prices factors at play.
UK	Q2 business investment	7.8%	-	-	Q1 saw first rise since mid 2008.
	Q2 GDP first revision	1.1% a	1.1%	1.1%	Some risk of modest downward revision.

New Zealand Economic and Financial Forecasts

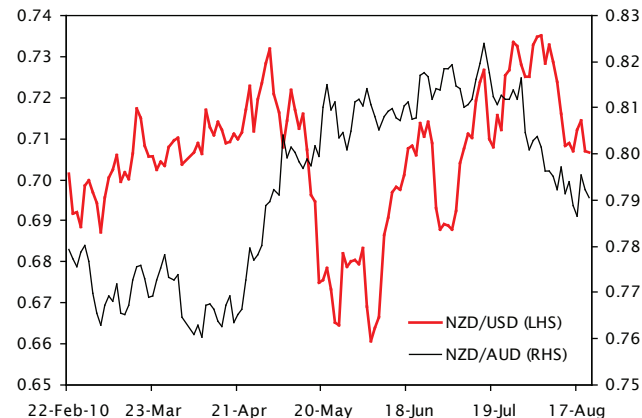
Economic Growth Forecasts	March years				Calendar years			
	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
% change								
GDP (Production) ann avg	-0.4	3.5	4.1	3.3	-1.6	2.9	4.4	3.4
Employment	-0.1	1.7	1.5	1.7	-2.4	1.9	1.9	1.6
Unemployment Rate % s.a.	6.0	5.8	5.6	5.1	7.1	6.2	5.6	5.2
CPI	2.0	4.7	2.7	3.2	2.0	4.7	2.4	3.3
Current Account Balance % of GDP	-2.4	-3.3	-4.8	-4.9	-2.9	-3.0	-4.6	-5.0

Financial Forecasts	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Cash	3.25	3.50	3.75	4.25	4.75	5.25	5.75
90 Day bill	3.50	3.70	4.20	4.70	5.20	5.70	6.10
2 Year Swap	4.10	4.40	4.80	5.20	5.60	6.00	6.30
5 Year Swap	4.80	5.00	5.30	5.60	5.90	6.20	6.40
10 Year Bond	5.30	5.50	5.70	5.90	6.00	6.20	6.30
NZD/USD	0.70	0.72	0.75	0.75	0.74	0.73	0.72
NZD/AUD	0.80	0.80	0.82	0.83	0.84	0.84	0.84
NZD/JPY	61.6	65.5	70.5	72.8	74.0	75.2	76.3
NZD/EUR	0.53	0.54	0.56	0.58	0.59	0.59	0.59
NZD/GBP	0.45	0.46	0.47	0.48	0.48	0.47	0.46
TWI	65.6	67.1	69.7	71.1	71.4	71.2	71.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 23 August 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	3.00%	3.00%	2.75%
30 Days	3.13%	3.12%	3.00%
60 Days	3.22%	3.20%	3.09%
90 Days	3.24%	3.27%	3.26%
2 Year Swap	3.75%	3.93%	4.23%
5 Year Swap	4.20%	4.51%	4.82%

NZ foreign currency midrates as at Monday 23 August 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7050	0.7288	0.7268
NZD/EUR	0.5549	0.5510	0.5628
NZD/GBP	0.4544	0.4584	0.4707
NZD/JPY	60.320	62.580	68.040
NZD/AUD	0.7958	0.7953	0.8119
TWI	66.190	67.130	68.040

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	3.3	3.5
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	-4.4	-4.1	-2.9	-2.1
United States							
Real GDP %yr	3.1	2.7	2.1	0.0	-2.6	2.6	2.5
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.1	1.1	2.2
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	-4.7	-2.7	-3.2	-2.7
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	3.5	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	0.8	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	1.1	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 6 August 2010

Interest Rate Forecasts	Latest (Aug 23)	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Australia						
Cash	4.50	4.50	4.50	4.75	5.00	5.00
90 Day Bill	4.72	4.75	4.75	5.00	5.25	5.50
10 Year Bond	4.91	5.20	5.30	5.30	5.30	5.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.375
US 10 Year Bond	2.61	3.20	3.40	3.50	3.60	3.80
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00
Exchange Rate Forecasts						
AUD/USD	0.8857	0.88	0.90	0.92	0.90	0.88
USD/JPY	85.59	88	91	94	97	100
EUR/USD	1.2698	1.31	1.33	1.34	1.30	1.26
AUD/NZD	1.2571	1.26	1.25	1.23	1.20	1.19

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