Westpac

Weekly Commentary

27 September 2010

Communication breakdown

GDP expanded at a disappointing rate of just 0.2% in the second quarter of 2010, much weaker than we or the market anticipated.

While there were some oddities and short-term factors in this quarter, none of these invalidate the notion that the pace of economic growth has slowed since late 2009.

On the production side, the biggest positive contribution came from construction, which experienced its strongest quarter of growth since 2003. Non-residential construction expenditure was up 9%, and "other construction" (roads and the like) was up 4.6%. But the biggest gain was expenditure on house building activity, which jumped a whopping 11.1%. We have long argued that the rate of homebuilding is unsustainably low relative to population growth, and predicted a substantial lift in residential investment. The lift in Q2 provided the first confirmation, but we believe there is further to go.

As expected, the autumn drought curtailed agricultural production, which was down 2.1%, and also hurt food processing, which contributed to a 4% decline in the manufacturing sector. The drought broke towards the end of the June quarter, so these sectors are likely to rebound smartly in the September quarter.

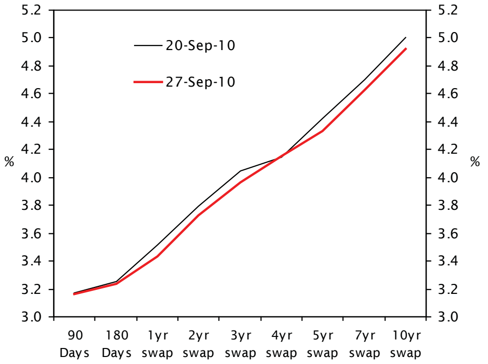
The biggest surprise was a 2.6% decline in communication services, compounding 2.2% declines in each of the preceding two quarters. This has a large effect on quarterly GDP, because real GDP is measured using 1995/96 prices, back when each minute of a toll call or a mobile phone call was much more valuable than today. Had this sector grown at its trend rate over the last three quarters, GDP would have been 0.9% higher. This would be a stunning upset for an industry where some form of Moore's Law applies: the communications sector has been the fastest-growing part of the economy for over two decades, averaging more than 2% *per quarter*. There's no reason to believe that the take-up of technology has abruptly gone into reverse.

It turns out that we are actually spending fewer minutes on landlines and mobile phones – Statistics NZ collects the data directly from providers. But this may be because people are instead turning to internet-based telecommunications such as Skype. Broadband penetration has greatly increased in the last year or so, enabling more people to switch technology. The trouble is that this isn't captured in the GDP figures, which are based on subscription numbers, not intensity of use. These types of issues are often dealt with when Statistics NZ conducts its annual revisions. But for now, we must caution that the past year's performance may not have been as woeful as the official figures suggest.

The decline in communications services was also apparent on the expenditure side of GDP. Private consumption rose by just 0.1% for the quarter, much weaker than we expected. Spending on consumer durables rose by 0.8%, but non-durables were flat and spending on services fell 0.6%. As well as the apparent decline in phone use, there was a 1.3% drop in accommodation and restaurants, whereas the same item rose 0.8% in the retail trade survey. These two measures tend not to diverge for long periods.

The reluctance of consumers to participate in the recovery was the rationale for the RBNZ's much more downbeat *Monetary Policy Statement* in September. While at face value the weak growth in consumption would seem to validate this view, the strength and weakness in spending is too selective to tell a general story about consumer caution. The strongest growth in the last year has been

NZ Interest Rates



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

Published by Westpac, PO Box 691, Wellington, ph: (04) 381 1413. For further information contact Brendan O'Donovan, Michael Gordon, Donna Purdue or Dominick Stephens. For email address changes contact natalie_denne@westpac.co.nz

in what are arguably the least essential areas: durables up 6.2%, and overseas travel up 10.6%. (Also, spending by overseas tourists in NZ is down 8.7% on a year ago, probably due to the rebound in the exchange rate over that time.)

The other major surprise in the figures was stockbuilding. There was a $530m rundown in inventories, which contributed -1.1 percentage points to expenditure GDP. The rundown in stocks of milk powder due to drought was well anticipated, and explains why export volumes held up. But there was also a substantial reduction in distribution stocks – perhaps many consumer durables were sold out of stocks, and did not actually provoke much production or imports. This is again cause to anticipate higher GDP growth in Q3, as stocks are unlikely to be run down at the same pace.

Net exports made a small positive contribution to growth, slightly better than we expected. Along with higher export commodity prices, that lifted the goods trade balance in the current account to a record high in seasonally adjusted terms. The drought meant that dairy export volumes were maintained by running down stocks; Fonterra has indicated that its stocks are now at very low levels.

We believe the stage is set for above 1% GDP growth in Q3 (even allowing for the fact that the issue with the communications sector is unlikely to be resolved that soon). More normal growing conditions will lift farm production and food processing, a low level of inventories will be a plus for production, and there is likely to be a pre-GST boost in consumer spending (we have always said that this would happen in the month before the GST hike, so it's no shock that it hasn't appeared in the data yet). The Canterbury earthquake will complicate matters – we expect a net impact of -0.3% – but the disruption to business was not as widespread as first feared, and the clean-up activity already under way will to be a positive for GDP.

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.

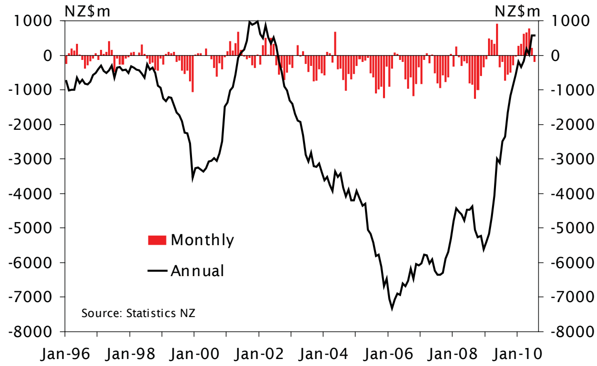
Key Data Previews

NZ Aug merchandise trade NZDm

Sep 29, Last: –186, WBC f/c: –590

- There was a monthly trade deficit for the first time this year in July and we expect the trade deficit to go further into negative territory in August.
- We expect the seasonal patterns which drove the trade balance negative in July to again be evident in the August data. Exports are set to decline further, both dairy and meat exports typically reach their seasonal lows around this time of the year.
- In contrast, imports are expected to continue to rise (again a seasonal pattern). While we think consumers continue to be cautious about spending there may be a temptation to bring forward purchase of big ticket items to beat the GST rise on the first of October. This may provide additional support to import growth in August as retailers ensure they have sufficient stocks on hand to meet any increase in demand.

NZ merchandise trade balance

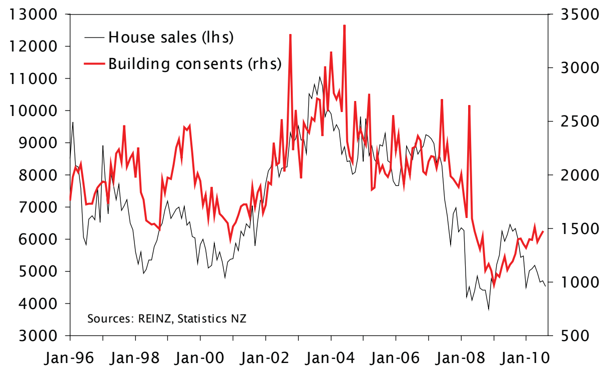


NZ Aug building consents s.a.

Sep 30, Last: 3.1%, WBC f/c: –3.0%

- Fears of changes to the taxation of property, falling population growth and rising interest rates have clearly had a cooling effect on the housing market (lower sales and prices) since last December. Still, our core view to date has been that these changes would not preclude a sizeable upturn in residential investment – i.e., the housing shortage would dominate.
- After showing promising signs through 2009, building consents hit a soft patch earlier this year. Growth has average just over 1% per month, compared with 2% through 2009. With conditions in the housing market remaining lacklustre we expect this weakness to have continued through August. We await a step-up in growth later this year as the rebuilding associated with the Christchurch earthquake gets underway.

Housing activity *(monthly, seasonally adjusted)*

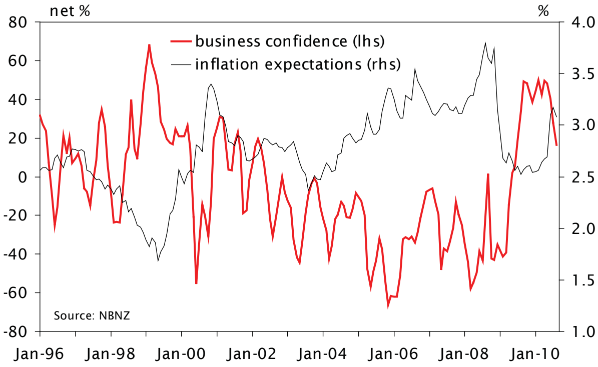


NZ Sep NBNZ business confidence

Sep 30, Last: 16.4%

- Business confidence fell to a one-year low in August, although the major activity indicators held up better. Evidence of a patchy recovery and uncertainty around upcoming tax changes suggests risks of a further decline in general confidence.
- The Canterbury earthquake had the curious effect of boosting consumer confidence in the region; we expect to see that come through in some aspects of the business survey as well, particularly in the construction sector.
- This survey will provide the last read on pricing intentions before the 1 October GST increase. The August survey found that half of retailers intended to raise prices in the next three months.

NBNZ Business Confidence

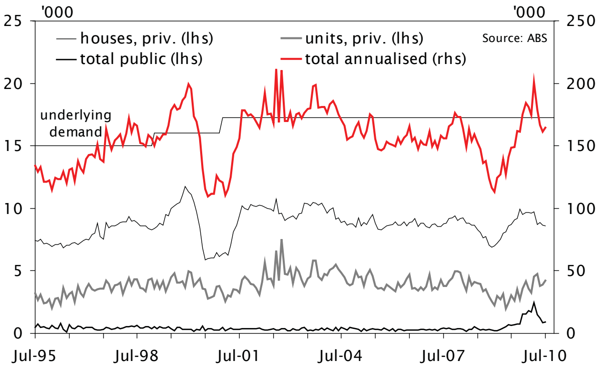


Aus Aug dwelling approvals

Sep 30, Last: 2.3%, WBC f/c: –1.5%, Mkt f/c: flat, Range: –3.0% to 3.0%

- Dwelling approvals rose 2.3% in July after sliding 19.7% over the previous three months. The bounce was led by a 7.7% rebound in 'units' with private sector house approvals basically flat. Public sector activity rose 2.1% but remained at relatively subdued levels after big boosts earlier in the year from a large round of social housing construction (totalling 19.3k dwellings vs the typical 3-4k a year).
- Private sector activity is now tracking new finance approvals for construction quite closely. These suggest activity is starting to stabilise but that there was some 'tail end' softness in August. Public approvals remain a wildcard with, we think, still a sizeable pipeline of projects still to come through. Overall we expect a small 1.5% fall in August, a negative but still mild enough to see a further softening in the trend decline.

Dwelling approvals

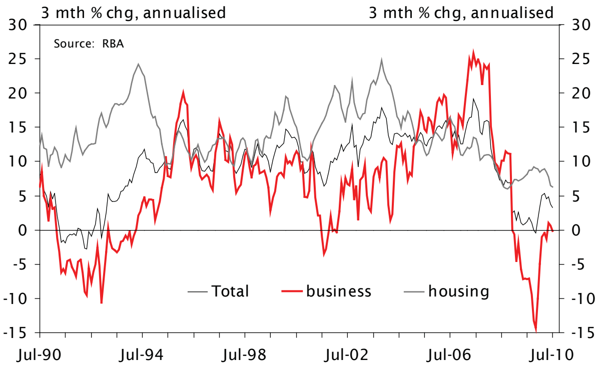


Aus Aug private credit

Sep 30, Last: 0.1%, WBC f/c: 0.3%, Mkt f/c: 0.3%, Range: 0.1% to 0.5%

- The credit cycle turned the corner at the end of 2009 as the business segment stabilised. However, the pace of growth remains modest. Indeed, the August data takes on greater significance following a soft spot over June and July – when growth was just 0.2% and 0.1% respectively.
- We continue to expect a gradual improvement in business credit to emerge given generally favourable fundamentals. This presumes that weakness in July (–0.4%) was either noise or temporary. We note that business confidence has rebounded after a brief bout of nervousness.
- Housing credit growth has slowed, to be 0.5% in July, down from 0.7% in January. The winding back of stimulus has clearly had an impact. But, with the RBA on the sidelines from June to September, we expect some temporary upside.

Credit growth off 2009 lows

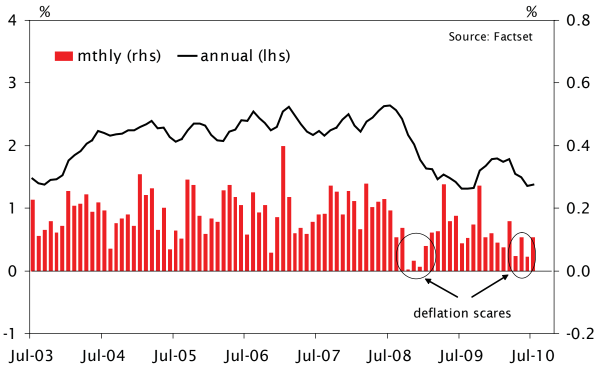


US Aug core PCE deflator

Oct 1, Last: 0.1%, WBC f/c: 0.0%, Mkt f/c: 0.1%

- Inflation has been drifting lower on most measures this year, driven at least in part by the wide output gap created by the deep recession of 2008 and 2009. The weak labour market, consumer resistance to price increases, discounting to gain market share and otherwise intense competition in many retail sectors are also factors at play.
- The core PCE deflator rose by less than 0.1% in 4 of the first 7 months of 2010; but in July it was up 0.11%.
- The core CPI rose by 0.046% in August which suggests the core PCE should correct lower from its above trend July outcome, so another flat core PCE is our forecast.
- The report will also include August personal income/spending numbers, likely to be close to their July growth pace, based on hours worked, earnings and retail data already to hand.

US core PCE deflator

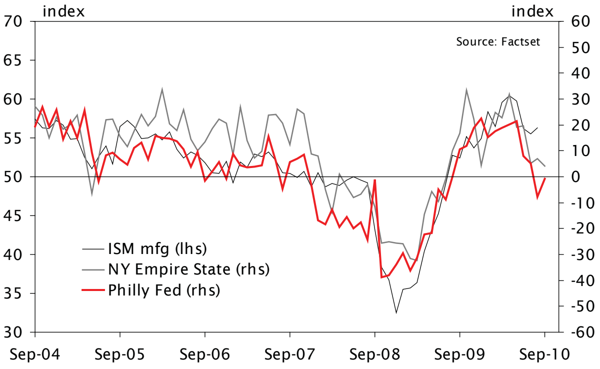


US Sep ISM factory report

Oct 1, Last: 56.3, WBC f/c: 54.5, Mkt f/c: 54.5

- The national factory ISM jumped to a new cycle high at 60.4 in April, but since then fell back to 55.5 in July, before bouncing a little in August to 56.3, due to stronger readings from production and jobs, although orders slipped further.
- The regional business surveys so far in September have been mixed – NY Fed had stronger readings for orders, shipments and jobs, whereas Philly Fed had weaker reads on orders and shipments (but jobs were up).
- Recent soft orders and industrial production data and the broader slowdown in economic growth now underway suggest that August’s 56.3 ISM reading was overstated, so we favour the signals from the Philly Fed as the better guide and expect the ISM factory index to correct lower to 54.5 in September.

US manufacturing surveys



Key Data and Events

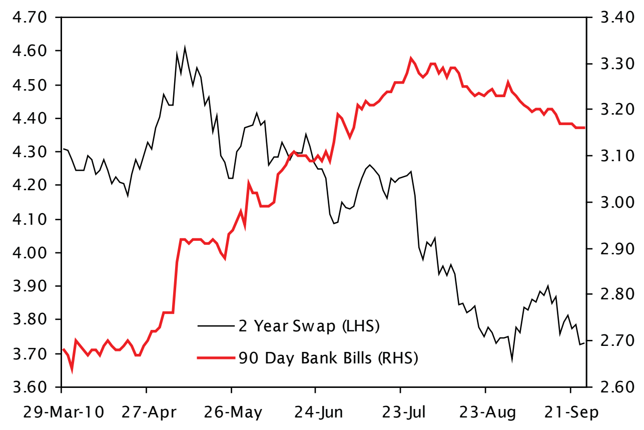
		Last	Market Median	Westpac Forecast	Comments
Mon 27 Sep					
US	Aug Chicago Fed National Activity Index	0.0	–0.5	–	Compiled using 80 previously released eco data series.
	Sep Dallas Fed Manufacturing Index	–13.5	–7.0	–6.0	Recently overstating factory sector weakness, may be to do with oil.
Jpn	Aug Corporate Services Prices %yr	–1.2%	–1.2%	–	Corporate cost control pervasive, pricing power just about zero.
	Aug Trade Balance ¥bn	610	522	–	Exports decelerating as G7 rebound loses steam, imports softening.
Eur	Aug M3 Money Supply %yr	0.2%	0.3%	–	Just back into positive territory but still very soft.
UK	Sep Hometrack House Price Survey %yr	1.5%	–	–	House prices are falling again pulling annual rates lower on all indices.
Tue 28 Sep					
US	Jul S&P-CS House Prices %yr	4.2%	3.1%	3.5%	FHFA data suggest prices will start falling again soon.
	Sep Consumer Confidence	53.5	52.3	51.0	Recent weekly confidence data softer.
	Sep Richmond Fed Manufacturing Index	11.0	6.0	6.0	Downtrend to continue to erode recent out-performance of Richmond
	Fedspeak	–	–	–	Lockhart in Tennessee.
Jpn	Sep Small Business Confidence	48.4	–	–	Sub 50 level indicates Nomura PMI may be headed the same way.
Ger	Oct GfK Consumer Confidence Survey	4.1	4.2	–	Labelled Oct but surveyed in early September.
	Sep CPI %yr Prelim	1.0%	1.3%	1.2%	Base effects and modest Sep gain to push annual rate higher.
UK	Q2 Total Business Investment (F)	–1.6a%	–1.6%	–	Revision of less interest given simultaneous release of GDP revision.
	Q2 GDP (F)	1.2a%	1.2%	1.2%	Still some prospect of further revision.
	Q2 Current Account £bn	–9.6	–8.2	–	Erratic and often revised series.
	Sep CBI Industrial Trends Survey	35	–	–	Reported sales index.
Wed 29 Sep					
NZ	Aug Merchandise Trade NZDm	–186	–	–590	Increasing imports to push trade balance further into negative territory.
US	Fedspeak	–	–	–	Plosser and Rosengren.
Jpn	Q3 Tankan Large Manuf. Conditions	1	7	7	This could well be a local maxima for manuf if our reading of the cycle
	Q3 Tankan Large Non–Manuf. Conditions	–5	–2	0	in the G7 is on the mark. Watch the capacity indicators closely.
Eur	Sep Business Climate Indicator	0.61	0.58	0.40	Modest slippage in Aug, PMI suggests will be steeper in Sep.
	Sep Economic Confidence	101.8	101.3	101.0	We expect first fall in four months.
UK	Aug Net Lending Sec. on Dwellings £bn	0.1	0.3	0.0	Loan approvals & household credit growth all likely to be weak.
Can	Aug Industrial Product Price	0.1%	0.2%	–	Commodity prices spiked in late Jul but fell in Aug.
	Jul House Prices %yr	13.6%	–	–	Teranet/National Bank index
Thu 30 Sep					
NZ	Aug Building Consents	3.1%	–	–3.0%	Weakness to persist. Apartments the wildcard.
	Sep NBNZ Business Confidence	16.4%	–	–	Will capture effects of SCF collapse and Canterbury earthquake.
Aus	Aug Dwelling Approvals	2.3%	flat	–1.5%	July's unit-led rise to reverse but trend downturn will still moderate.
	Aug Private Credit	0.1%	0.3%	0.3%	Looking for a firmer result following a 2 mth soft spot (see text box).
	RBA Financial Stability Review	–	–	–	Half yrly updated to confirm financial sector generally in sound shape.
US	Q2 GDP (% annualised)	1.6%a	1.6%	1.6%	Some revisions to components but these should be offsetting.
	Initial Jobless Claims w/e 25/9	465k	460k	465k	Labor Day holiday distortion now unwound.
	Sep Chicago Purchasing Manager	56.7	56.0	54.0	Industrial sector is losing momentum; Chicago will soon reflect this.
	Sep NAPM-Milwaukee	59	58.0	55	As above.
Jpn	Aug Industrial Production	–0.2%	1.1%	–	METI projection is decent, capex on a modest uptrend, exports weaker.
	Sep Nomura PMI	50.1	–	–	Wafer thin margin of expansion is under serious threat.
	Aug Retail Sales %yr	3.8%	4.7%		Held up by various fiscal incentives and modest income gains.
	Aug Housing Starts %yr	4.3%	10.2%	–	Forecast implies annualised level of 759k versus 772k in July.
	Aug Construction Orders %yr	–0.7%	–	–	Non-residential construction depressed, as it is in many countries.
Eur	Sep CPI Estimate %yr	1.6%	1.8%	1.8%	Base effects and expectations for higher Germ CPI point to acceleration.
Ger	Sep Unemployment Change	–17k	–20k	–	Recent strong growth and govt policy pushing unemployment lower.
UK	Sep GfK Consumer Confidence Survey	–18	–19	–20	Aug saw confidence improve but economy is slowing now.
	Sep Nationwide House Price %yr	3.9%	2.6%	–	Tentative date, due 27-30/9.
Can	Jul GDP	0.2%	–0.1%	–	GDP growth has slowed dramatically from solid Q1.
Fri 1 Oct					
Aus	Sep AiG PMI	51.7	–	–	Suggests manufacturing sector expanding, but Index –2.7ppts in Aug.
US	Aug Personal Income	0.2%	0.3%	0.2%	Hours worked and earnings data point to 0.2% rise.
	Aug Personal Spending	0.4%	0.4%	0.3%	Retail sales points to modest gain.
	Aug PCE Core	0.1%	0.1%	0.0%	Core CPI was flat in Aug.
	Sep Uni of Michigan Confidence (F)	66.6a	67.0	66.0	Weekly data suggest revision could be to downside.
	Sep ISM Manufacturing	56.3	54.5	54.5	Correction for unexpected Aug up-tick.
	Aug Construction Spending	–1.0%	–0.4%	–1.0%	Post tax rebate spending slump.
	Sep Total Vehicle Sales mn annualised	11.4	11.5	11.3	Sluggish.
	Fedspeak	–	–	–	Dudley.
Jpn	Aug National Consumer Prices %yr	–0.9%	–0.9%	–	The output gap is a major weight on the price level.
	Aug Unemployment Rate	5.2%	5.1%	–	Demographics are now a factor month by month as retirees increase.
	Aug Household Spending %yr	1.1%	1.4%	–	Volumes are holding up OK, test comes when incentives expire.
Eur	Sep PMI Manufacturing (F)	53.6a	53.6	53.4	Scale of downside in advance result suggests risk of further slippage.
	Aug Unemployment Rate	10.0%	10.0%	10.0%	German jobless rate steady in Aug.
UK	Q2 BoE Housing Equity Withdrawal £bn	–3.2	–2.9	–	Have not seen withdrawal since Q1 2008.
	Sep PMI Manufacturing	54.3	53.8	52.5	Weaker Euroland PMI may indicate further slippage in UK index.

New Zealand Economic and Financial Forecasts

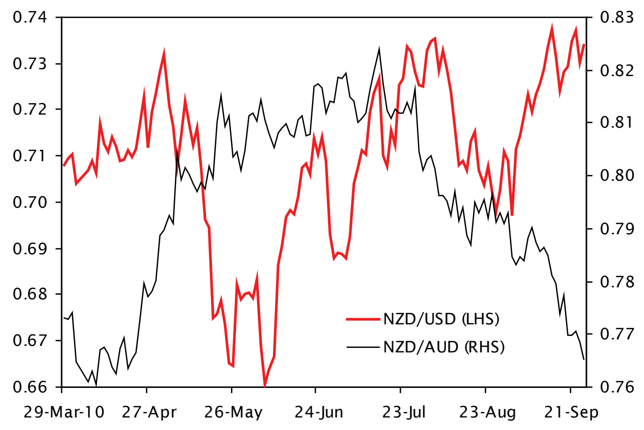
Economic Growth Forecasts	March years				Calendar years			
% change	2010	2011f	2012f	2013f	2009	2010f	2011f	2012f
GDP (Production) ann avg	-0.4	3.2	4.3	2.9	-1.7	2.5	4.7	2.9
Employment	-0.1	1.7	1.3	1.9	-2.4	2.0	1.6	1.8
Unemployment Rate % s.a.	6.0	5.9	5.9	5.1	7.1	6.1	5.8	5.3
CPI	2.0	4.9	2.1	3.1	2.0	4.8	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	0.74	0.76	0.77	0.76	0.76	0.76	0.76
NZD/AUD	0.77	0.78	0.79	0.80	0.82	0.82	0.82
NZD/JPY	62.9	64.6	65.5	68.4	72.2	76.0	79.0
NZD/EUR	0.55	0.55	0.56	0.58	0.59	0.59	0.59
NZD/GBP	0.45	0.47	0.48	0.47	0.46	0.45	0.44
TWI	66.9	68.0	69.1	70.1	71.1	71.6	71.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 27 September 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	3.00%	3.00%	3.00%
30 Days	3.14%	3.11%	3.09%
60 Days	3.19%	3.19%	3.15%
90 Days	3.17%	3.20%	3.26%
2 Year Swap	3.73%	3.90%	3.75%
5 Year Swap	4.33%	4.53%	4.22%

NZ foreign currency midrates as at Monday 27 September 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7355	0.7336	0.7109
NZD/EUR	0.5453	0.5699	0.5569
NZD/GBP	0.4649	0.4759	0.4578
NZD/JPY	62.010	61.340	60.580
NZD/AUD	0.7653	0.7849	0.7909
TWI	66.470	67.680	66.110

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 27)	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Australia						
Cash	4.50	5.00	5.00	5.25	5.25	5.25
90 Day Bill	4.84	5.30	5.40	5.50	5.50	5.50
10 Year Bond	5.05	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	2.61	2.50	2.50	2.75	3.00	3.25
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00

Exchange Rate Forecasts	Latest (Sep 27)	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
AUD/USD	0.9611	0.96	0.98	0.98	0.95	0.93
USD/JPY	84.32	85	85	85	90	95
EUR/USD	1.3488	1.35	1.38	1.37	1.31	1.29
AUD/NZD	1.3067	1.30	1.29	1.27	1.25	1.22