Weekly Commentary

26 July 2010

Walking the path

We expect another 25bp hike at Thursday's OCR review, with a slightly more subdued assessment compared to the June *Monetary Policy Statement*.

Since June the economic news has generally been on the weaker side of expectations – not hugely so, but the shortfalls have been widespread. In terms of the major data releases (which we can compare directly to the RBNZ's forecasts), two have undershot slightly and one was stronger.

March quarter GDP grew by 0.6% against the RBNZ's forecast of 0.8%, with the difference likely coming from a subdued consumer. Top-down indicators to date suggest that the June quarter will also fall short of the RBNZ's previous forecast of 1.1%. Together, that suggests a starting point for the economy with less inflation pressure than expected.

June quarter CPI was also lower than forecast, taking the annual inflation rate down to 1.8%, although the RBNZ will take some mixed messages from the details. Food prices have fallen, and the strength of the NZ dollar over the last year is still being passed through to the prices of many tradable goods. However, non-tradables prices (in particular housing-related costs) rose by more than the RBNZ expected.

On the plus side, the export sector continues to benefit from high commodity prices and solid demand growth. That saw the current account deficit narrow to 2.4% of GDP, much lower than the RBNZ forecast of 3.3% (with about half of the surprise coming from the trade surplus). So all together, the data points to a continued rebalancing of the economy, with the contrast between weak consumption and strong production even greater than thought.

On top of these, more recent data has pointed to subdued retail spending, a soft housing market, and slowing net migration inflows (the latter perhaps contributing to the first two). Business confidence has dipped recently, but it remains at levels that are consistent with recovery.

Financial developments since June have been mixed. The NZD trade-weighted index has averaged about 3% higher than the RBNZ assumed, but global credit market conditions have been steadily improving. The June OCR hike was not fully reflected in short-term mortgage rates, and fixed-term rates for two years or more have actually fallen outright.

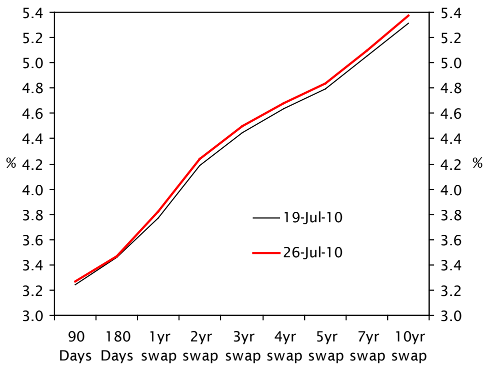
The RBNZ's statement is likely to be peppered with references to the weaker developments since June. However, we think that the 'bias' paragraph – the crucial part of the message, at least from the market's point of view – will be left largely intact. In June that paragraph read:

"Given this outlook and as previously signalled, we have decided to begin removing some of the monetary policy stimulus that is currently in place. The further removal of stimulus will be reviewed in light of economic and financial market developments."

Keeping the first sentence would hark back to the June *MPS* projections, which pointed to the OCR rising from a low of 2.5% to a more 'neutral' level of 5.5-6.0% over the next two years. The RBNZ has spent many months making the case that interest rates will need to be normalised as the economy improves. There is nothing in the recent data that would warrant a change to the end-point of that plan, though it perhaps argues for less front-loading of hikes.

The phrase "removal of stimulus" will definitely be retained – the RBNZ is aiming to deflect criticism by portraying rate hikes as taking the foot off the accelerator

NZ Interest Rates



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

This publication has been prepared by the Wellington, Sydney and London Economic Departments

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

rather than hitting the brakes.

Finally, the last sentence of the paragraph was fairly non-committal for a central bank projecting 300 basis points or more of hikes over the next two years. We think it was meant to imply "don't automatically assume another hike in seven weeks", and that seems like a reasonable message to convey this time as well – even if a follow-up hike is more likely than not.

Interest rate markets have fully factored in a 25bp hike next week, and pricing for the next year is broadly in line with the RBNZ's June projections – a touch lower if anything. We expect that a 25bp hike with an unchanged 'bias' would see a modest rise in wholesale interest rates – no more than 5bps. The NZD remains beholden to sentiment in global equity markets, so the OCR decision is unlikely to have a sustained impact.

This week's data releases are likely to paint a mixed picture, but one that can be shoehorned into the 'rebalancing' story. Business confidence (Wed) eased from its highs in May, and a less formal survey by BNZ suggested a sharp fall in June (though this may be more highly weighted towards the property market). Recent indicators point to tough conditions for retailing and construction, but steady gains in manufacturing.

Merchandise trade (Thurs) is expected to record a June surplus for the first time since 2002, despite the autumn drought now weighing on the volume of dairy exports. Imports continue to grow steadily but slowly, with the higher exchange rate still dampening prices compared to a year ago.

Finally, housing consents for June (Fri) are expected to recover from a nearly 10% drop in May, which may have been partly due to trading day effects. Apartment consents are already at rock-bottom levels, so the risk is always for a sharp bounce in any given month.

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.

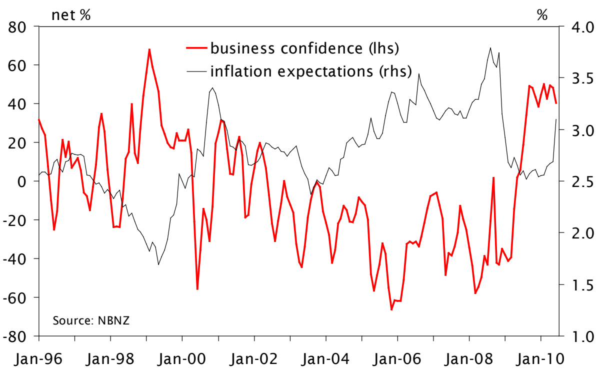
Key Data Previews

NZ Jul NBNZ business confidence

Jul 28, Last: 40.2%

- Business confidence fell in June, though it was still within the elevated range it has maintained for the last year. Both general confidence and own activity expectations were the lowest since last December.
- Recent sectoral indicators suggest that a further dip in confidence is likely on balance. Retail and construction remain subdued and dairy prices have fallen in the last month. However, manufacturing output appears to be growing steadily.
- Anxiety about government policy changes may be a factor in some sectors. The Emissions Trading Scheme came into effect on 1 July, and an increase in the GST rate to 15% looms in October (as do income tax cuts, however).

NBNZ Business Confidence

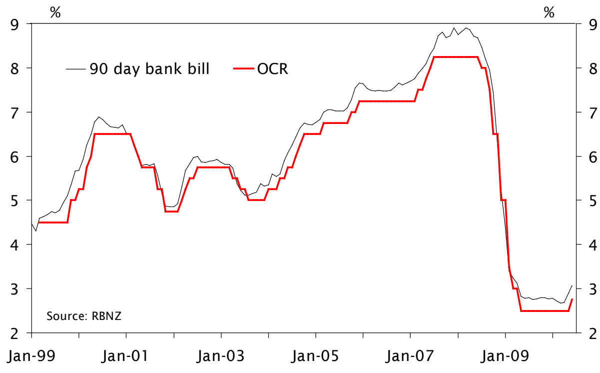


NZ RBNZ OCR review

Jul 29, Last: 2.75%, WBC f/c: 3.00%, Mkt f/c: 3.00%

- We expect another 25bp hike at next Thursday's OCR review, with a slightly more subdued statement compared to June.
- Recent economic data has been on the soft side of expectations, but not enough to divert the RBNZ from its stated intention to normalise interest rates over the next couple of years.

NZ OCR and 90 day rate

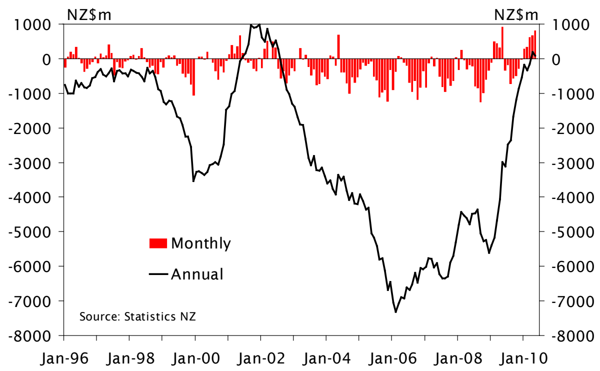


NZ Jun merchandise trade NZDm

Jul 29, Last: 814, WBC f/c: 100

- The trade balance has been resoundingly positive for many months. Exports have grown in line with the resurgence in global trade, but NZers have been cautious in both consumption and investment, meaning only modest import growth.
- The autumn drought is now having a significant effect on the volume of dairy product exports, and export prices fell slightly in June. We anticipate fairly weak export receipts for the month. Meanwhile, imports are anticipated to continue growing steadily and slowly.
- The monthly trade balance will soon turn negative in response to the normal seasonal patterns. However, the annual trade balance is forecast to exceed +$1bn by the end of this year.

NZ merchandise trade balance

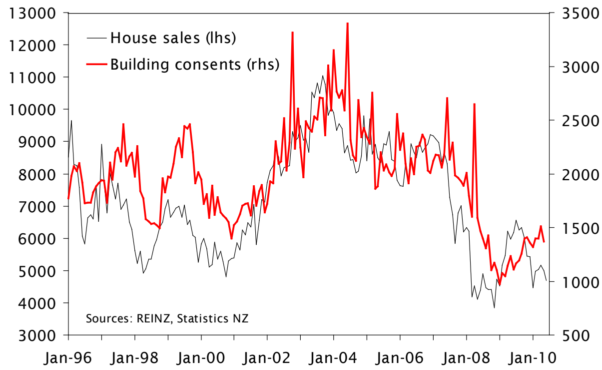


NZ Jun building consents s.a.

Jul 30, Last: –9.6%, WBC f/c: 11%

- Dwelling consents fell by more than expected in May. Although some of the weakness was likely related to the unwind of a trading day effect in April, a collapse in apartment consents (to just 27 in the month) also contributed.
- We expect the volatility to continue in July. Our forecast for a pick up of around 11% factors in around 40 apartment consents. We expect ex-apartment consents to almost fully unwind the decline in May. With anecdotes suggesting that builders are looking to get work done ahead of the GST increase on 1 October, we see risks to the upside.
- Recent business surveys suggest that sentiment in the non-residential space has turned, although we expect it will be another 3-6 months before we really begin to see the benefits.

***NZ housing activity** (monthly, seasonally adjusted)*

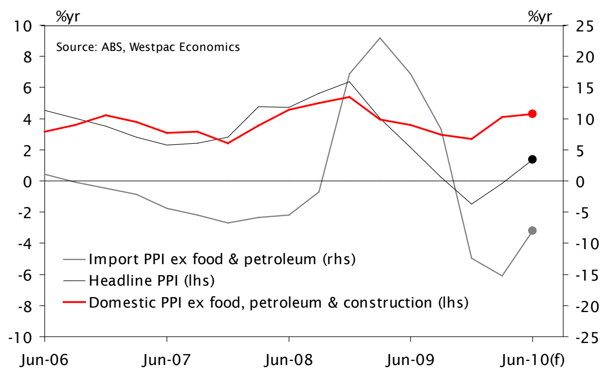


Aus Q2 PPI

Jul 26, Last: 1.0%, WBC f/c: 0.7%, Mkt f/c: 0.8%, Range: 0.2% to 1.8%

- Q1 saw a reemergence of upstream pressures, with a 1.0%qtr rise (highest since 2008Q4) lifting the annual rate to –0.1%yr. Non-core items added 0.14ppts to the qtrly rate (food –0.3% offset by petroleum +8.2%). Core import prices rose 1.4% with the AUD TWI steady, utilities saw a seasonal solid 3.2% jump, building construction prices stepped up to a 0.6% pace, and the domestic core ex-construction & utilities accelerated with a 1.1% rise. The overall core PPI jumped 1.0%qtr.
- Q2 core PPI is f/c to see a solid 0.8%qtr result. Higher mfer prices in our WBC–ACCI Survey support a firm 0.9% rise in the domestic core ex-construction & utilities. Utilities will be more stable (0.1%) and construction is f/c again at 0.6%, but core import prices are f/c to jump 1.8% with a lower TWI. Food prices (–0.6%) and petroleum (+5.1%) take the total PPI f/c to 0.7%qtr, lifting the annual rate to 1.4% (highest since 2009Q2).

PPI: firm domestic core, M core up ($A), oil up

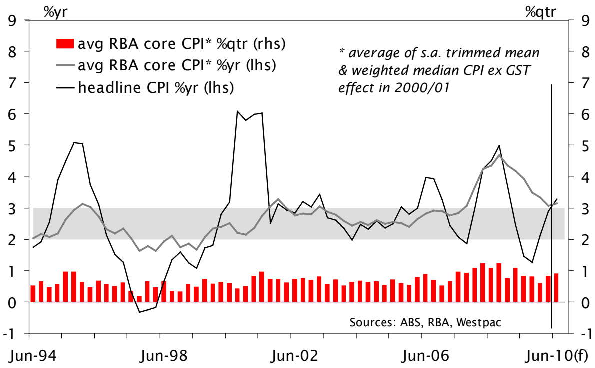


Aus Q2 CPI

Jul 28, Last: 0.9%, WBC f/c: 0.9%, Mkt f/c: 1.0%, Range: 0.8% to 1.2%

- Our Q2 headline CPI f/c is +0.9%qtr, lifting annual inflation to 3.3% (highest since 2008Q4) from 2.9%. With early mid-year department store sales, historically weak Q2 pricing is expected across sale items. However, this drag is offset by strong positive contributions from tobacco (excise hike), hospital & medical services (health insurance premiums), petrol, deposit & loan facilities, house purchase costs, overseas holidays (airfares & weaker A$) and rents.
- Despite the early June dept store sales, Q2 sees less price falls than Q1 (with Jan sales), leaving less price falls in the Q2 trimmed mean. Also, with the strongest increases f/c in high weight items (D&L facil., hospital & med. serv., o/s hols, tobacco), more strong increases remain in the Q2 trimmed mean than Q1. This gives a higher avg underlying CPI f/c of 0.9%qtr (vs 0.8% prev) leaving the annual rate steady at 3.1%.

Inflation: core still high, headline rising

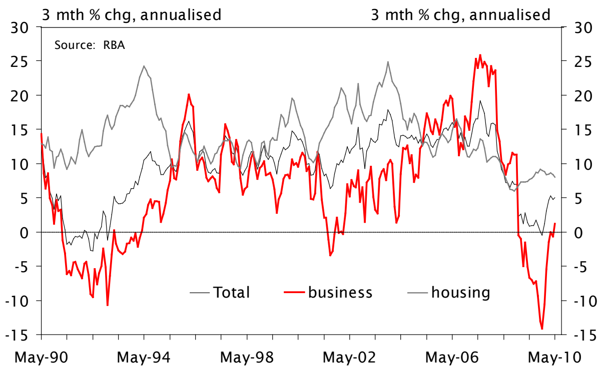


Aus Jun private credit

Jul 30, Last: 0.5%, WBC f/c: 0.4%, Mkt f/c: 0.4%, Range: 0.3% to 0.6%

- The private credit has turned the corner as business segment stabilises. However, interest rate rises are a headwind. Monthly growth was 0.4% over the last half year, up from 0.1% the six months prior. We're forecasting a 0.4% rise in June.
- Business credit has levelled out over the last six months, reflecting improved economic and financial conditions, after an 8.3% fall over the year to November.
- Housing credit was running at 8.0% annualised over the last three months, down from 9.1% in October. The removal of stimulus (rates and government incentives) has had an impact on owner-occupiers (growth rates of 7.5% and 10.7% respectively). An upswing in the investor segment has provided a partial offset (9.2% annualised in May, up from 5.6% in Oct).

Credit turns the corner

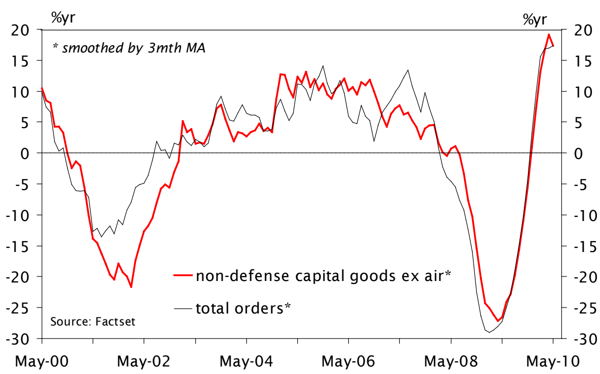


US June durable goods orders to rise, due to aircraft

Jul 28, Last: –0.6%, WBC f/c: 1.0%, Mkt f/c: 1.0%

- Durable goods orders fell 0.6% in May, the first fall for six months. The decline was mostly due to a 30% fall in aircraft orders. Non-defence capital goods excluding aircraft posted a healthy 3.9% increase, suggesting that business investment is holding up despite April's 2.8% fall in this measure of core capital goods orders.
- The aircraft component will again dominate in June: Boeing saw just 5 orders in May vs 49 in June. Boeing data don't always track Commerce Dept figures but that points to a decent rebound well in excess of 100%. Elsewhere, signals are less favourable: the ISM factory survey new orders index fell from 65.7 to 58.5, its lowest since October last year; and factory output fell 0.4% in June. So total durable orders should post a gain, but ex transport (and core capital goods) will probably reveal a weaker orders picture.

US durable goods orders

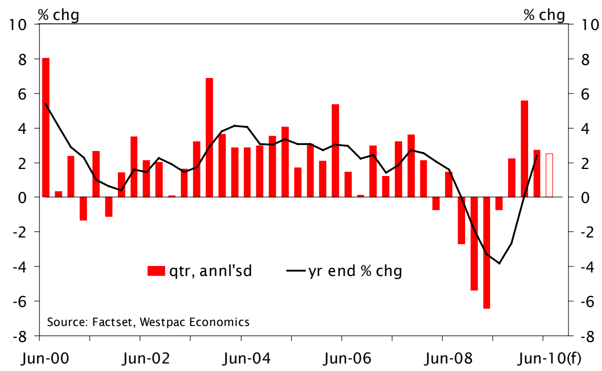


US Q2 GDP growth to slow further

Jul 30, % annualised: Last: 2.7%, WBC f/c: 2.5%, Mkt f/c: 2.5%

- The US economy has posted three quarters of growth since the recession of 2008-09, and Q2 should comfortably make it four.
- However with Federal fiscal support for the economy being wound back during the last quarter (end of the tax rebate for home buyers), many State governments strapped for cash, and inventory rebuilding making less of a contribution to growth, Q2 may struggle to match Q1's 2.7% growth pace.
- Also, partial data point to slower consumer spending and no contribution to growth from the export sector.
- We expect growth of 2.5% in Q2, and see evidence that growth will slow even further in H2 2010, to around a 1.5% annualised pace.

US GDP growth



Key Data and Events

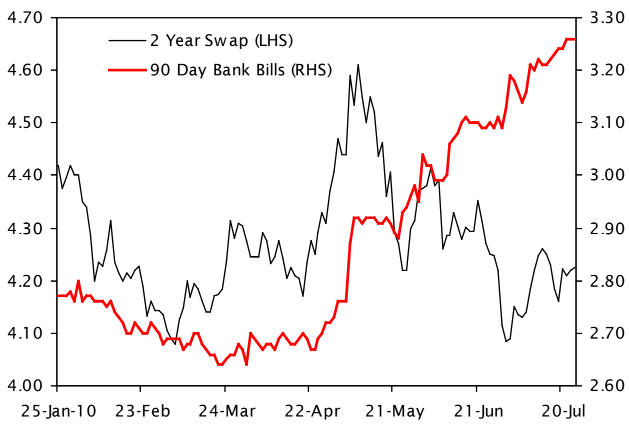
		Last	Market Median	Westpac Forecast	Comments
Mon 26 Jul					
Aus	Q2 PPI %qtr	1.0%	0.8%	0.7%	Gives 1.4%yr vs -0.1%; firm domestic core & M core (A$ fell), oil up.
Jpn	Jun Trade Balance ¥bn sa	416	539	–	¥ has hurt competitiveness; but import price falls may boost June.
US	Jun Chicago Fed Activity Index	0.21	–	–	Based on 80 previously released data points; June likely to be weaker.
	Jun New Home sales	-32.7%	3.7%	0.0%	New lower level for sales after the tax rebate expiry.
	Jul Dallas Fed Manuf. Activity Index	-4.0	-2.5%	0.0	Weakened sharply in May-June so may not fall further in July.
UK	Jul House Prices %yr	2.1%	–	–	Hometrack index.
Tue 27 Jul					
US	May House Prices %yr	3.8%	3.9%	–	S&P/CS composite-20 index.
	Jul Richmond Fed Factory Index	23	11	10	Other regionals suggest steeper fall ahead.
	Jul Consumer Confidence	52.9	51.0	54.5	Conference Board index. Only modest bounce after steep June fall.
Jpn	Jun Corp Services Price Index %yr	-0.8%	-0.9%	–	Corporate appetite for rise in 'negotiable' costs is basically zero.
Eur	Jun M3 sa 3 mth ave.	-0.2%	-0.1%	–	Has not posted positive annual growth since Oct last year.
Ger	Aug GfK Consumer Confidence Survey	3.5	3.5	–	Surveyed early July but misleadingly labelled Aug.
Wed 28 Jul					
NZ	Jul NBNZ Business Confidence	40.2%	–	–	Confidence high but starting to ease from peak levels.
Aus	Q2 Headline CPI %qtr	0.9%	1.0%	0.9%	Jun sales offset by tobacco, medical serv, fuel, D&L, house purch, o/s hols.
	Q2 Avg RBA Underlying CPI %qtr	0.8%	0.8%	0.9%	sales items drop out; rises in high-wgt items; 'administered' pressures.
US	Jun Durable Goods Orders	-0.6%	1.0%	1.0%	Boeing data very solid but not reliable recently. Business surveys soft.
	Fed Beige Book	–	–	–	Further evidence of softening outlook, as noted in Jun FOMC minutes
Jpn	Jul Small Business Confidence	47.4	–	–	SME elements in Tankan consistent with the high 40s for this index.
Ger	Jun CPI %yr	0.9%	1.1%	–	German inflation significant driver of sub 2% Euroland CPI story.
Can	May House Prices %yr	12.9%	–	–	Teranet/National Bank index.
Thu 29 Jul					
NZ	RBNZ OCR Review	2.75%	3.00%	3.00%	Recent data subdued, but RBNZ will continue to normalise rates.
	Jun Merchandise Trade NZDm	814	368	100	Drought expected to hurt export receipts.
US	Initial Jobless Claims w/e 24/7	464k	460k	–	July claims distorted by seasonality around auto shutdowns.
Jpn	Jun Retail sales %yr	2.8%	3.2%	–	Boosted by subsidised discretionary items – will not last.
Eur	Jul Business Climate Indicator	0.37	0.39	–	As of June these surveys had only captured modest evidence of concern
	Jul Economic Confidence	98.7	99.1	–	about the Euroland economy.
Ger	Jul Unemployment Change, no.	-21k	-20k	–	Has been falling for a year now, mainly due to govt short-week scheme.
UK	Jul House Prices %yr	8.7%	7.0%	–	Nationwide index.
	Jun Net Consumer Credit £bn	0.3	0.2	–	Credit to the household sector is growing again, albeit very modestly
	Jun Net Lending Sec. on Dwellings £bn	1.2	1.0	–	due to constrained supply and weak demand.
Can	Jun Industrial Product Prices	0.3%	0.2%	–	Has fallen just once since Nov last year.
Fri 30 Jul					
NZ	Jun Building Consents s.a.	-9.6%	–	11.0%	Housing shortage dictates underlying upward trend will remain.
Aus	Jun Private Sector Credit	0.5%	0.4%	0.4%	Turned the corner as business stabilises. But, rate rises a headwind.
US	Q2 GDP % ann'lsd	2.7%	2.5%	2.5%	Modestly slower than Q1, but further slowdown to come in H2 2010.
	Q2 Employment Cost Index	0.6%	0.5%	0.5%	Still modest cost growth but off the lows of last year.
	Jul Chicago Purchasing Manager	59.1	56.0	55.0	Our view that the US economy is slowing in H2 2010 is reflected in
	Jul NAPM-Milwaukee	59.0	57.0	55.0	our lower forecasts for all the major business surveys.
Jpn	Jun Industrial Production	0.1%	0.2%	–	Noise emanating from inventory cycle becoming less audible.
	Jul Nomura PMI	53.9	–	–	Global trend for softening PMIs likely to be reflected here also.
	Jun Unemployment Rate	5.2%	5.2%	–	Labour force exit and participation increasingly influential factors.
	Jun National CPI %yr	-0.9%	-0.7%	–	Output gap narrowed in late '09, early '10, but still a chasm.
	Jun Household Spending %yr	-0.7%	-0.8%	–	Real outlays underwhelming given strong policy support for durables.
	Jun Housing Starts %yr	-4.6%	1.8%	–	737k saar in May is still 46% below cycle peak rate.
	Jun Construction Orders %yr	9.2%	–	–	Foreign orders drove the May improvement. Very volatile.
Eur	Jun Unemployment Rate	10.0%	10.0%	10.0%	German jobless rate steady at 7.7% in June.
	Jul CPI Flash %yr	1.4%	1.7%	–	Weaker euro and energy prices key drivers. Core pressures soft.
Ger	Jun Retail sales	0.4%	-0.2%	–	Tentative date, due 27/7-3/8.
UK	Jul GfK Consumer Confidence Survey	-19	-20	-20	June conf weaker, surveyed before June 22 budget, Jul to fall too.
Can	May GDP	0.0%	0.2%	–	Apr saw slowest monthly outcome since Aug last year.

New Zealand Economic and Financial Forecasts

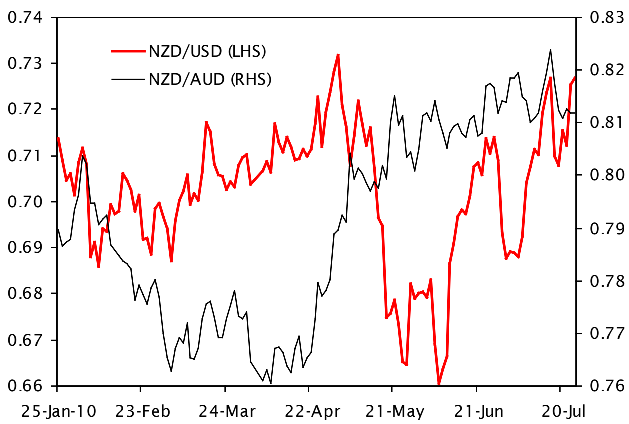
Economic Growth Forecasts	March years				Calendar years			
% change	2009	2010	2011f	2012f	2009	2010f	2011f	2012f
GDP (Production) ann avg	-1.5	-0.4	3.5	3.3	-1.6	2.9	4.4	3.4
Employment	0.7	-0.1	2.2	1.7	-2.4	2.2	2.0	1.6
Unemployment Rate % s.a.	5.1	6.0	5.4	4.7	7.1	5.7	5.2	4.9
CPI	3.0	2.0	4.7	2.7	2.0	4.7	2.4	3.3
Current Account Balance % of GDP	-7.9	-2.4	-3.3	-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	3.75	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	0.84	0.84
NZD/JPY	65.5	70.3	74.5	76.5	77.7	78.8	79.9
NZD/EUR	0.57	0.58	0.59	0.60	0.61	0.60	0.59
NZD/GBP	0.49	0.49	0.49	0.50	0.50	0.49	0.46
TWI	68.7	70.4	71.9	72.5	72.9	72.4	71.5

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 26 July 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.75%	2.75%	2.75%
30 Days	3.02%	2.94%	2.92%
60 Days	3.11%	3.04%	3.02%
90 Days	3.27%	3.22%	3.09%
2 Year Swap	4.24%	4.25%	4.25%
5 Year Swap	4.83%	4.90%	4.98%

NZ foreign currency midrates as at Monday 26 July 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7267	0.7103	0.7141
NZD/EUR	0.5633	0.5639	0.5772
NZD/GBP	0.4713	0.4724	0.4739
NZD/JPY	63.580	62.920	63.750
NZD/AUD	0.8109	0.8119	0.8168
TWI	68.110	67.550	68.330

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 26)	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	5.20	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	2.99	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 26)	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
AUD/USD	0.8962	0.88	0.90	0.92	0.90	0.88
USD/JPY	87.49	91	95	98	102	105
EUR/USD	1.2900	1.26	1.28	1.29	1.25	1.21
AUD/NZD		1.22	1.22	1.21	1.20	1.19