



Spring Lupines, Lake Tekapo

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Keep calm and carry on

There are still many unknowns around the Fonterra whey product contamination scare, but on the evidence of last Tuesday's dairy auction it has not evolved into a serious negative for the wider economy. Meanwhile, the New Zealand labour market continues to gradually improve, but wage pressures have yet to emerge.

World dairy prices fell just 2.4% in last week's GlobalDairyTrade auction, a modest decline in light of the contamination issue. Prices were still the sixth highest on record and over 70% higher than a year ago.

Indeed, the fall was not significantly different to what we were expecting before the contamination issue broke. We had penciled in a decline of around 20% over the remainder of 2013 as New Zealand dairy production recovered from the recent drought. In particular, we were expecting some payback from a 5.3% rise in the previous auction.

So at this juncture, the contamination issue doesn't seem to have had a major impact on Fonterra's pricing power. Only time will tell what the longer-term consequences will be for trust in the Fonterra and New Zealand brands.

There has been a lot of discussion whether New Zealand should diversify its exports to reduce risks like the botulism scare. Of course, more diversity would be nice. But the question is how New Zealand would diversify, and at what cost. We have focused on exporting milk for a reason – it is lucrative. There is some optimal balance between specialisation and diversification, but how does one tell if New Zealand has struck the right balance? Can bureaucrats really dictate a better mix than the free market? If so, exactly what market failure led to a situation where thousands of businesses each followed their best interests, yet the nation as a whole reached a sub-optimal outcome?

Some are pointing to Fonterra's structure, but we are not convinced. We doubt that the industry's structure has led to more dairy conversions than are socially optimal, or to laxer food safety standards. Probably quite the opposite.

Keep calm and carry on continued

A more plausible argument focuses on New Zealand's tax structure. We tax land-intensive economic activities like farming very lightly. Consequently, the cost of schools and hospitals falls more heavily on those involved in other economic activities, such as manufacturing and services.

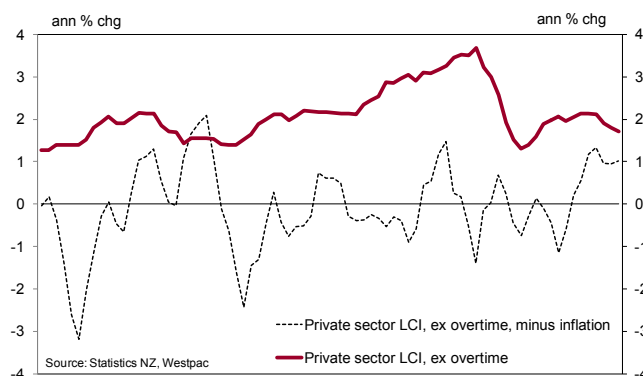
Beyond tax reform, we think the best way for New Zealand to address "concentration risk" is to remain nimble. If dairy or China falter, we should be ready to change, and follow whatever new opportunity the changing world presents.

It is impossible to anticipate these opportunities before they arise. But a serious dairy shock would have one sure consequence which would help the economy adapt: a significantly lower NZ dollar. Of course this would spread the pain of lower dairy revenues, by reducing the purchasing power of New Zealand dollars for everyone. But it would also immediately make non-dairy exporters more competitive and speed up a reorientation away from the dairy industry.

The other main development last week was the swathe of June quarter labour data. The job market has been a laggard in this economic recovery, but the week's data confirmed that it is now riding the coat-tails of the broader upswing. Granted, the unemployment rate ticked up to 6.4%. But that was expected 'pay-back' from a very strong March quarter, and still leaves unemployment comfortably below last year's levels. Meanwhile, the employer-based Quarterly Employment Survey (which has been less volatile than the Household Labour Force Survey of late) posted another quarter of solid growth in jobs and earnings.

But while the job market may be improving, it's equally clear that there is still a fair amount of slack to be absorbed. Unemployment at 6.4% is still well above pre-2009 levels, and the Labour Cost Index report showed few if any signs of wage pressure. To be sure, wage growth in the Canterbury construction sector continue to sprint ahead at 3.4% a year. But construction sector wage inflation elsewhere in the country is holding steady in the low 2's, and in most other industries wage inflation slowed.

NZ private sector labour costs



Importantly, that doesn't equate to an income squeeze as such. It's worth remembering that consumer price inflation is at 14-year lows, which means we should expect to see less in the way of cost of living adjustments. In fact, once we adjust for inflation, real labour costs rose about 1% over the past year, quite a decent clip by historical standards.

So in real terms, income growth is now actually quite supportive of retail spending, which appears to have had a very strong month in the June quarter – we expect this week's retail trade data to show a 1.8% jump in sales volumes in the quarter alone. (Of course, the other main source of support for spending has been the housing market. On the basis of this morning's July Real Estate Institute data, prices continue to rise at a roughly 8.5% annual pace on the back of a very tight market.)

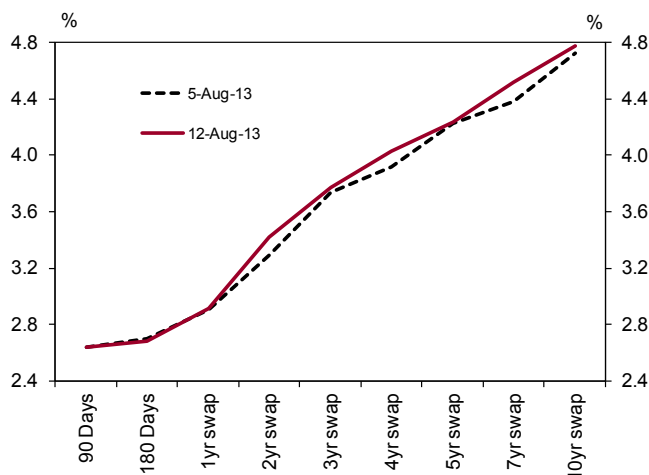
By the same token, the recent trend for wage growth to slow may not last for that much longer. We believe the June quarter was the low point for consumer price inflation – a stronger domestic economy coupled with an exchange rate that is no longer appreciating should see inflation start to rise.

But last week's data do support the RBNZ's intention to keep rates on hold this year. If anything, June's *Monetary Policy Statement* suggests the wage and unemployment numbers were probably a smidgen softer than the RBNZ was expecting – but the surprise would have been too small for us to change our monetary policy outlook. We continue to expect a first OCR hike in March 2014, and a steady series of increases thereafter.

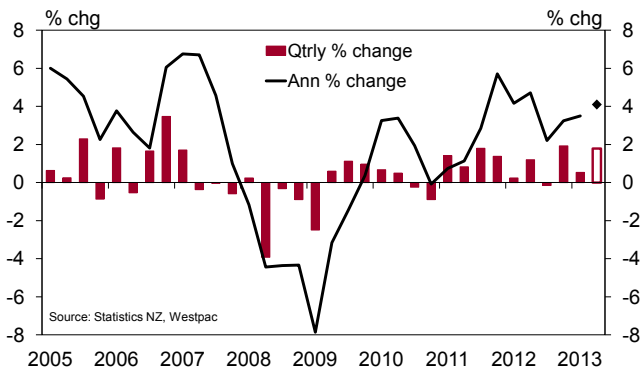
Fixed vs Floating for mortgages

We favour fixing over floating. Fixed-term rates out to two years are currently below floating rates, while three-year and longer fixed rates are only slightly higher. Staying on floating would only be the lower-cost option if the RBNZ actually cut the OCR, which we regard as unlikely. In fact, we expect the floating mortgage rate to rise significantly over the 2014 to 2016 period.

NZ interest rates



Real retail sales



NZ Q2 real retail sales

Aug 14, Last: 0.5%, WBC f/c: 1.8%

- Solid growth in card spending and subdued prices over the June quarter imply another strong increase in real retail sales. We estimate that ex-auto sales rose 1.1% in nominal terms, with the record-high NZ dollar at the time pushing retail prices down slightly, giving a 1.2% real increase.
- Cards data point to strong growth in spending on household and electronic goods, a rebound in clothing after a weatheraffected 2.4% drop last quarter, and gains in accommodation and hospitality as overseas visitor numbers have picked up strongly this year.
- We expect a 6% increase in vehicle sales, with registrations rising strongly over the quarter. However, these are only a loose indicator, and a similarly large jump in registrations in the March quarter failed to show up in the retail survey. We see this as a two-way risk to our forecast.

Consumer sentiment

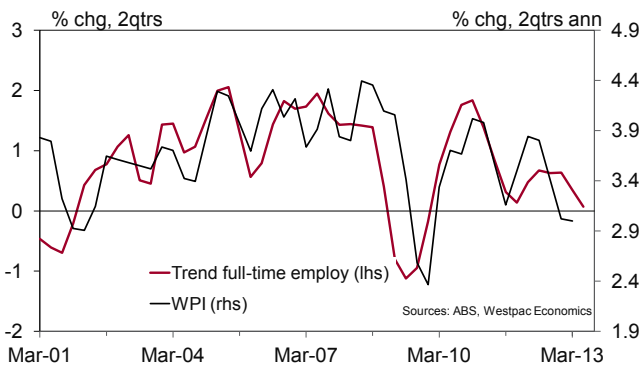


Aus Aug Westpac-MI consumer sentiment

Aug 14, Last: 102.1

- Consumer Sentiment was basically unchanged in July, holding in 'slightly optimistic' territory but still down a hefty 7.6% from its March peak. The survey detail points to powerful cross-currents with family finances still under pressure but a somewhat improved outlook for the economy.
- August is shaping up as another 'tug of war' between rate cuts and fiscal deterioration. The survey is in the field from August 5 to 11 and will capture reactions to both the RBA's 25bp rate cut and another significant downgrade to the Government's economic and fiscal forecasts. Local economic data has also been soft (retail sales flat, jobs down 10k) although the sharemarket posted a solid gain (ASX +3.5% vs previous survey). The AUD continued to slide though, shedding another 1.9¢ to go below 90¢US. Related to this, petrol prices topped \$1.51/litre nationally, up 10¢ in 2 months.

Soft labour market, wage pressures ease

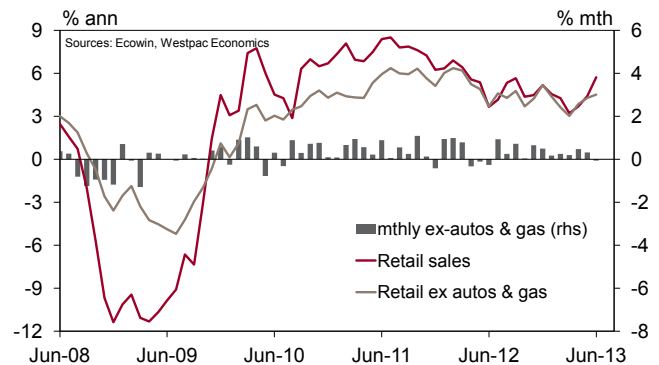


Aus Q2 wage price index

Aug 14, Last: 0.7%, WBC f/c: 0.7%
Mkt f/c: 0.7%, Range: 0.6% to 0.8%

- Total hourly wage rates ex bonuses (WPI) rose 0.7% in Q1, just a touch under Westpac's and the market's forecast for a 0.8%qtr rise.
- Wage inflation in the private sector has eased as the labour market softens. The private sector WPI rose 0.6%qtr/3.1%yr in 2013Q1. Private sector wage inflation had a recent peak of 3.9%yr in 2012Q2. More significantly, if you include bonuses, private sector wage inflation has fallen to 2.6%yr, on par with the post GFC low.
- The labour market has continued to soften, business surveys suggest it is easier to find labour, and growth in full-time employment has stalled. We see wage inflation moderating further in Q2, to a 0.7%qtr rise and the annual rate easing to 3.0%yr from 3.2%yr in Q2.

US retail sales

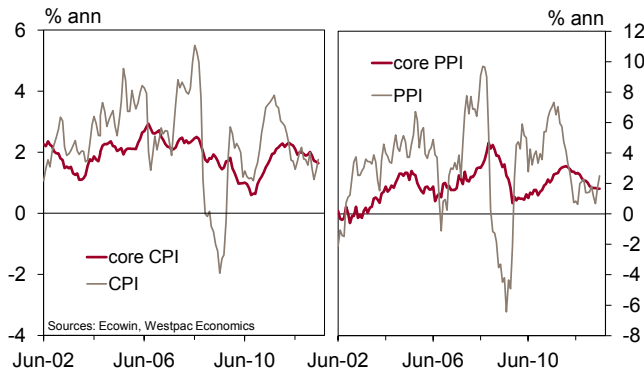


US Jul retail sales

Aug 13, Last: 0.4%, WBC f/c: 0.2%

- Retail sales rose 0.4% in June supported by auto and gasoline sales but core retailing slipped 0.1%, the first monthly decline in a year.
- In July hourly earnings and hours worked both declined, a rare occurrence in a recovery, and that will have constrained household income. With savings already run down in June, when personal spending growth exceeded that of income, consumers may be more cautious in the third quarter.
- Auto sales slipped a little in July but gasoline prices rose. Core retailing likely remained subdued. We expect a 0.2% rise in retail sales, both headline and core.

US price inflation

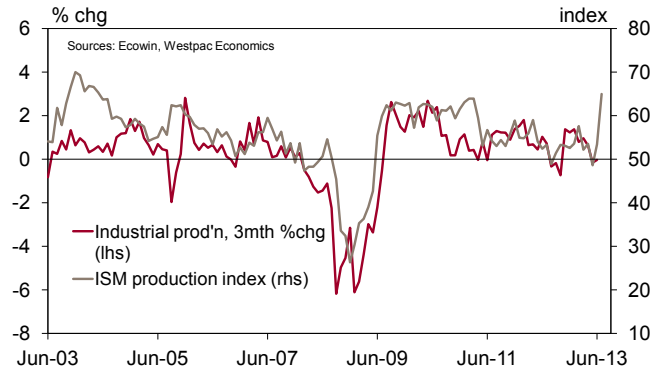


US Jul PPI and CPI

Aug 14, PPI Last: 0.8%, WBC f/c: 0.2%
Aug 15, CPI Last: 0.5%, WBC f/c: 0.2%

- Producer prices rose 0.8% in June on higher gasoline prices, while the core PPI rose 0.2% with auto prices posting a 0.8% rise after falls in April and May. The July PPI is likely to be constrained by falling energy prices but there is risk of a jump in the core (as in July 2011 and 2012) possibly due to a seasonal issue. A 0.4% core rise would leave the headline rate up 0.2%.
- Consumer prices rose 0.5% in Jun, boosted by a 6.3% jump in gasoline prices, the fastest clothing price rise in nearly two years, higher medical care and auto costs and food prices. Ex food and energy, the core rate rose 0.2%, for the second month running. In July, June's above trend components should correct lower, partly offsetting mild food and energy gains for a 0.2% headline and 0.1% core gain.

US industrial sector

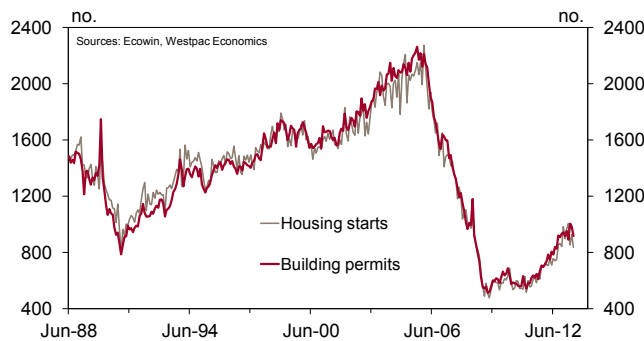


US Jul industrial production

Aug 15, Last: 0.3%, WBC f/c: 0.6%

- US industrial production rose 0.3% in June, the fastest rise since February. The manufacturing component also rose 0.3%, boosted in part by a 1.3% jump in auto production and 1.5% rise in machinery output. For the third month running, utilities were a drag on the IP bottom line, though only slightly in June.
- In July, hours worked in factories fell 0.1%, which suggests another subdued month for activity, but the ISM manufacturing survey's production component soared to its highest in nine years. June orders data for machinery and autos were solid too.
- We expect a 0.6% IP gain in July, with factory output up 0.3% (supported by shorter auto plant shutdowns this summer) and utilities bouncing. Risks around the forecast are to the upside.

US housing starts & permits

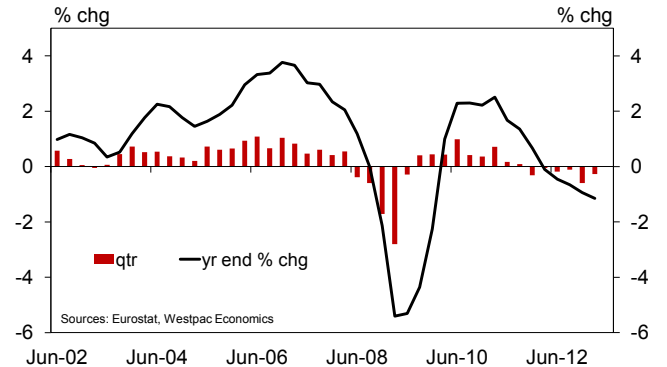


US Jul housing starts & permits

Aug 16, Starts Last: -9.9%, WBC f/c: 6.0%
Aug 16, Permits Last: 6.8%, WBC f/c: 3.5%

- Housing starts fell 9.9% in June led by a 26% fall in multiples, although single family starts fell 0.8%, their third decline in four months. Housing permits also saw a multiples driven fall of 6.8%, although the single family component was up 0.5%, on top of rises in April and May.
- With existing home sales constrained by short supply, homebuilder confidence solid and new home sales at a five year high in June, single family starts should recover in Q3, especially given that the annualised pace of permits in June of 624k was running above that of starts on 591k. Multiples are likely to bounce as well, so the July headlines for starts and permits should be solid, as well as the singles detail.

Euro zone GDP growth



Eur Q2 GDP

Aug 14, Last: -0.3%, WBC f/c: 0.0%

- GDP has contracted for six consecutive quarters, most recently by 0.3% in Q1 this year, when subdued, weather-constrained German growth of just 0.1% failed to offset contraction elsewhere (including in France, Italy and Spain).
- Partial data point to a construction-led rebound in German GDP of 0.5% in Q2. Preliminary figures for the quarter show ongoing but milder recession in Italy (-0.2%) and Spain (-0.1%). Mixed French partial and much less weak survey figures suggest that economy may have stabilised.
- With the smaller peripheral economies mostly still in recession, the Euroland aggregate report is likely to show a marginal contraction, though the risk is it rounds up to 0.0%.

Data calendar

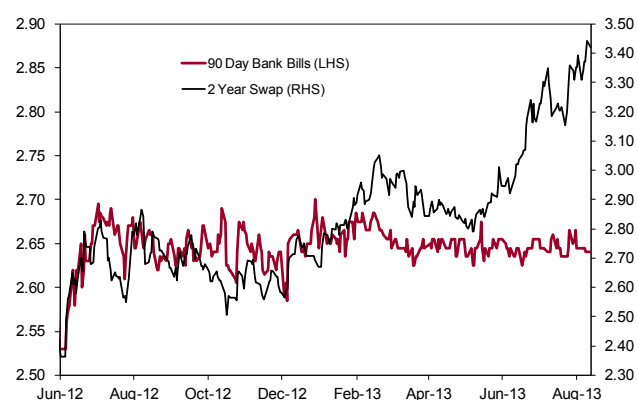
		Last	Market median	Westpac forecast	Risk/Comment
Mon 12					
NZ	Jul food price index	2.10%	-	0.60%	Jun figures hinted at an upturn after two years of effectively flat prices.
US	Jul federal budget \$bn	-69	-	-90	Impact of fiscal compromise/sequester to show up here.
Tue 13					
Aus	Jul NAB business survey	-8	-	-	Conditions index down 4pts to -8, lowest since 2009. Confidence +1 to 0.
	Pre-Election Economic & Fiscal Update	-	-	-	Superseded by Government's Economic Statement
Eur	Jun industrial production	-0.30%	1.10%	1.00%	German IP rose 2.4% in June.
Ger	Aug ZEW analysts' expectations	36.3	38	40	Sentix euro survey jumped in early Aug.
UK	Jul house prices net balance	21%	27%	-	RICS surveyors series.
	Jul PPI %yr	1.00%	-	-	Core output measure.
	Jun ONS house prices %yr	2.90%	-	-	Still behind 3.3%yr in Dec, fastest pace of gain since late 2010.
	Jul CPI %yr	2.90%	2.90%	-	Shop price inflation at lowest since recession; special factors at play.
US	Jul NFIB small business optimism	93.5	-	94.5	ISM surveys of big business improved in July.
	Jul import prices	-0.2%	0.80%	1.00%	Oil prices rose sharply in July.
	Jul advance retail sales	0.40%	0.30%	0.20%	Auto sales down, gasoline prices higher. See text box.
	Jul retail sales ex auto, gas	-0.10%	0.40%	0.20%	Core retailing to be constrained by weak incomes growth.
	Jun business inventories	0.10%	0.30%	0.20%	Inventories expanded in Jan but kept tight since then.
	Fedspeak	-	-	-	Lockhart.
Wed 14					
NZ	Q2 real retail sales	0.50%	1.5%	1.80%	Further steady growth as the domestic economy gains momentum.
Aus	Aug Westpac-MI Consumer Sentiment	102.1	-	-	Another tug of war between rate cuts and fiscal deterioration?
	Q2 wage price index	0.70%	0.70%	0.70%	Soft labour market, wage inflation to drop to 3.0%yr from 3.2%yr.
Eur	Q2 GDP	-0.30%	0.20%	0.00%	Marginal contraction to round up to 0.
Ger	Q2 GDP	0.10%	0.50%	0.50%	One-offs to boost Q2 but H2 2013 to slow.
UK	Aug BoE minutes	-	-	-	Not so exciting given inflation report already released.
	Jul unemployment ch'	-8.6k	-13k	-8k	Benefit claimants. Survey and some hard data on UK encouraging.
US	Jul PPI	0.80%	0.30%	0.20%	See text box.
	Jul PPI core	0.20%	0.20%	0.40%	Core PPI has tended to spike in July recently.
	Fedspeak	-	-	-	Bullard
Can	Jul house prices %yr	1.80%	-	-	Teranet/National Bank index.
Thu 15					
NZ	Jul manufacturing PMI	54.7	-	-	Consistently strong so far this year, partly boosted by quake rebuild.
Aus	Aug Westpac-MI unemp' expectations	-3.6% ^{mth}	-	-	Up 3.2%yr and 20% higher than historical average; job worries remain.
	Aug MI inflation expectations	2.4% ^{yr}	-	-	Trending higher but still well contained within the RBA's target band.
UK	Jul retail sales inc fuel	0.20%	0.60%	0.80%	Weather and Royal Baby factors at play.
US	Initial jobless claims w/e 9/8	333k	-	330k	Claims now at lowest level since prior to the recession.
	Jul CPI	0.50%	0.20%	0.20%	June's above trend components should correct lower,
	Jul core CPI	0.20%	0.20%	0.10%	partly offsetting mild food and energy gains
	Jul industrial production	0.30%	0.30%	0.60%	Factory output +0.3% & utilities bouncing. Upside risks. See textbox.
	Aug NY Fed factory survey	9.5	10	1	Tends to slump mid year; Richmond Fed weaker in July.
	Aug Philadelphia Fed factory survey	19.9	15.5	10	Mid-year slumps in 2010-11-12; Richmond Fed weaker in July.
	Aug NAHB housing market index	57	57	56	Upswing at risk from rising mortgage rates.
	Jun TIC data, \$bn	-27.2	-	-	Net long term TIC flows.
	Fedspeak	-	-	-	Bullard
Can	Jul existing home sales	3.30%	-	-	Recently established series with just over a year's data.
Fri 16					
Aus	RBA Assist. Gov DeBelle speaking	-	-	-	On impact of reforms on the RBA's provision of liquidity, 11.30am AEST.
Eur	Jun current account surplus €bn sa	19.6	-	-	€24bn record surplus in April; was in deficit in 2011! Trade data due too.
	Jul CPI %yr final	1.6% ^a	-	1.60%	Flash report now includes core which was lower at 1.1%yr in Jul.
US	Q2 non-farm productivity	0.50%	0.50%	0.00%	Productivity growth weak as GDP growth soft despite hours worked
	Jul housing starts	-9.90%	8.30%	6.00%	Starts pace for (single-family dwellings) now running behind permits
	Jul building permits	-6.8%	2.90%	3.50%	Ongoing multiples volatility. See text box.
	Aug UoM consumer sentiment prelim	85.10%	85.5	83	300 responses in prelim; IBD-TIPP weaker in Aug with 900 replies.
Can	Jun manufacturing sales	0.70%	0.30%	-	May was up on chemicals, fist rise since Feb.
Sun 18					
Chn	Jul new house prices %net bal	84.30%	-	-	Peaked in March at 95.7%. Price appreciation clearly slowing.

New Zealand forecasts

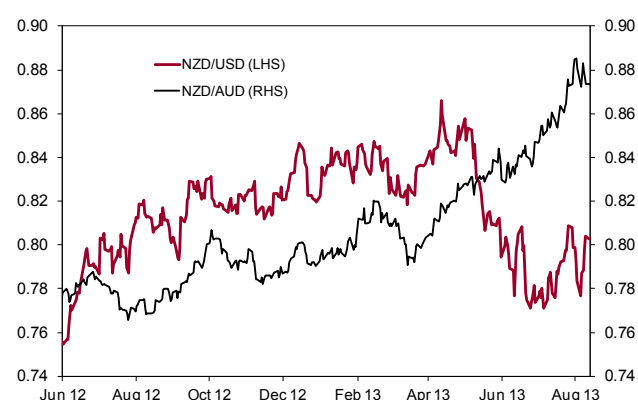
Economic Growth Forecasts	March years				Calendar years			
	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
% change								
GDP (Production) ann avg	1.9	2.5	2.7	3.8	1.4	2.7	2.5	3.7
Employment	1.0	0.4	2.3	2.8	1.5	-1.4	3.5	2.9
Unemployment Rate % s.a.	6.8	6.2	5.7	4.8	6.3	6.8	5.9	4.9
CPI	1.6	0.9	1.7	2.5	1.8	0.9	1.6	2.3
Current Account Balance % of GDP	-4.4	-4.8	-5.0	-5.9	-4.0	-5.0	-4.7	-5.8

Financial Forecasts	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Cash	2.50	2.50	2.75	3.00	3.25	3.50
90 Day bill	2.70	2.75	3.00	3.25	3.50	3.75
2 Year Swap	3.30	3.30	3.50	3.60	3.80	4.00
5 Year Swap	4.00	3.90	4.00	4.10	4.20	4.40
10 Year Bond	4.10	3.90	3.90	4.00	4.10	4.20
NZD/USD	0.80	0.82	0.83	0.81	0.78	0.76
NZD/AUD	0.87	0.89	0.90	0.90	0.90	0.89
NZD/JPY	79.2	80.4	80.5	77.8	74.1	71.4
NZD/EUR	0.60	0.62	0.62	0.62	0.62	0.62
NZD/GBP	0.51	0.51	0.51	0.50	0.50	0.49
TWI	75.3	77.0	77.7	76.6	75.1	73.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 12 Aug 2013

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.63%	2.64%	2.65%
60 Days	2.63%	2.65%	2.65%
90 Days	2.64%	2.67%	2.67%
2 Year Swap	3.42%	3.36%	3.18%
5 Year Swap	4.23%	4.16%	3.97%

NZ foreign currency mid-rates as at Monday 12 Aug 2013

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8029	0.8080	0.7785
NZD/EUR	0.6027	0.6081	0.5951
NZD/GBP	0.5185	0.5253	0.5150
NZD/JPY	77.24	79.24	77.36
NZD/AUD	0.8736	0.8726	0.8586
TWI	75.30	75.96	74.05

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2009	2010	2011	2012	2013f	2014f
Australia						
Real GDP % yr	1.4	2.5	2.4	3.6	2.5	2.3
CPI inflation % annual	2.1	2.8	3.0	2.2	2.2	2.5
Unemployment %	5.6	5.2	5.2	5.4	6.2	6.4
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.4	-2.3
United States						
Real GDP %yr	-3.1	2.4	1.8	2.8	1.4	1.5
Consumer Prices %yr	-0.3	1.6	3.1	2.1	1.4	1.6
Unemployment Rate %	9.3	9.6	8.9	8.1	7.7	7.6
Current Account %GDP	-2.7	-3.0	-3.0	-2.8	-3.0	-3.1
Japan						
Real GDP %yr	-5.7	4.9	-0.5	1.9	1.7	2.2
Consumer Prices %yr	-1.3	-0.7	-0.3	0.0	-0.2	0.1
Unemployment Rate %	5.2	5.1	4.5	4.3	4.3	4.3
Current Account %GDP	2.8	3.6	2.0	2.1	2.0	2.0
Euroland						
Real GDP %yr	-4.3	1.9	1.5	-0.5	-1.0	-0.6
Consumer Prices %yr	0.3	1.7	2.7	2.2	1.4	1.2
Unemployment Rate %	9.5	10.0	10.1	11.7	12.4	13.0
Current Account %GDP	-0.2	-0.1	0.0	0.9	1.0	1.0
United Kingdom						
Real GDP %yr	-4.0	1.8	0.9	0.2	1.1	0.9
Consumer Prices %yr	2.2	3.2	4.0	2.8	2.3	1.8
Unemployment Rate %	7.6	7.8	8.4	8.0	8.5	8.5
Current Account %GDP	-1.3	-2.5	-1.9	-3.8	-2.5	-1.5

Forecasts finalised 9 August 2013

Interest Rate Forecasts	Latest	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14
Australia						
Cash	2.50	2.50	2.25	2.00	2.00	2.00
90 Day Bill	2.60	2.55	2.30	2.10	2.10	2.10
10 Year Bond	3.67	3.60	3.40	3.30	3.20	3.10
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.59	2.40	2.20	2.10	2.00	2.00
ECB Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50

Exchange Rate Forecasts	Latest	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14
AUD/USD	0.9100	0.92	0.92	0.92	0.90	0.87
USD/JPY	96.64	99	98	97	96	96
EUR/USD	1.3382	1.33	1.33	1.33	1.30	1.25
AUD/NZD	1.1374	1.15	1.12	1.11	1.11	1.12

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