



Nugget Point, Balclutha

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A question of timing

The Reserve Bank is going into this week's interest rate decision armed with plenty of reason to reiterate the message that interest rates will rise next year. However, those who expect it to flag rate rises as soon as their next January meeting are likely to be disappointed – the exchange rate is too high, and the recently introduced restrictions on low-deposit mortgage lending are too fresh, to warrant sending that signal now.

Last week's economic data offered further confirmation that the New Zealand economy has gone from strength to strength in recent months.

Export prices have continued to defy gravity. After slipping slightly in the last month or two, dairy prices bounced 3.9% in the latest Fonterra auction. That's prompted us to nudge up our forecast of the 2013/14 farm gate milk price to \$8.40 kgMs – still on the assumption that rebounding New Zealand milk production and more modest improvements in dairy production elsewhere will see global prices ease off in 2014. (We are likely to get an update on Fonterra's own milk price forecast, currently \$8.30, this week.)

The dairy sector isn't an isolated case – beef and log prices have also maintained extremely high levels. Combined with subdued inflation in much of the rest of the world, this has lifted New Zealand's terms of trade to their highest level since 1974. Bluntly stated, New Zealand's position on international markets is the strongest it has been in four decades. Combined with a post-drought lift in farm production, this is helping ensure that the current upswing in economic activity is broadening far beyond the bright lights of Auckland or the construction hotbed in Canterbury.

That said, rebuilding activity in Canterbury has continued to surge: building work data for the September quarter showed both residential and non-residential work in the region easily at their highest levels on record. In Auckland, too, residential construction rose nearly 20% in the quarter. The one fly in the ointment was a surprising drop in non-

A question of timing continued

residential building work outside Canterbury. We suspect this will prove temporary given the continued gradual uptrend in building consents, but it does remove some of the upside risk around our September quarter GDP forecast. So for now we continue to expect a 1.4% increase in the quarter. We will finalise that number after we receive manufacturing data later on Monday morning.

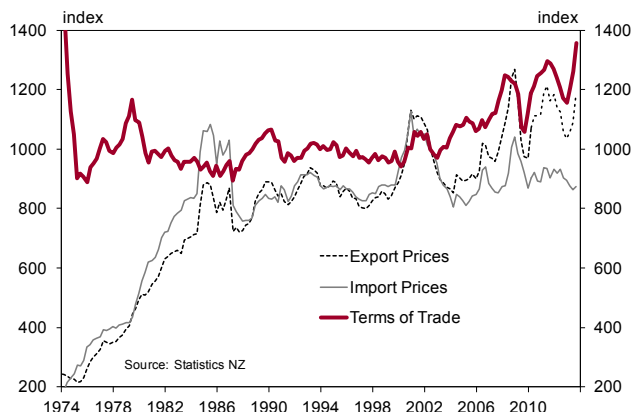
It's against this bullish backdrop that the RBNZ will be presenting its December *Monetary Policy Statement* on Thursday. Unsurprisingly, therefore, we expect the *Statement* will reaffirm the RBNZ's basic message that it expects to raise interest rates next year as stronger growth starts to translate into inflation pressures. That is no longer controversial, at least in financial markets – market pricing (as reflected in longer-term interest rates) is now broadly in tune with the Reserve Bank's longer-term hiking plans.

The debate now is not if interest rates will rise, but when. Financial market pricing has settled on March, and is giving credence to the significant possibility of a January OCR hike. We fear these expectations will be dashed on Thursday, and continue to expect that rate hikes will begin in April, along the lines the Reserve Bank signalled back in September.

The two big hurdles to earlier OCR increases, as we noted last week, are the high exchange rate and the uncertain impact of the RBNZ's mortgage lending restrictions on the housing market. Some of the recent strength in the exchange rate is simply a reflection of the sky-high terms of trade, and greater optimism about the New Zealand economy. But some of it is due to the US Federal Reserve's decision not to 'taper' its asset purchasing programme. Reserve Bank Governor Wheeler gave newspaper interviews in late October and early November in which he expressed his surprise at the Fed's no-taper decision and said he had been hoping that Fed tapering would allow the RBNZ "to tighten monetary policy from a position of a lower exchange rate." By implication, the renewed strength of the exchange rate raises the bar for hiking the OCR.

The main issue with the restrictions on high loan-to-value ratio (LVR) mortgage lending is that it will take some months for their full impact on the housing market to become clear, and until then it's unlikely that the Reserve Bank will want to commit itself to raising rates in the imminent future.

New Zealand export and import prices



In the latest news on that front, data from a major Auckland real estate agency showed both house sales and listings in the Auckland region falling sharply in November in seasonally adjusted terms. (Nationwide figures from the Real Estate Institute out this week will give a fuller picture.) This suggests we were right to expect that the lending restrictions would have a 'sticker shock' effect on the market come November, and it also looks broadly consistent with the Reserve Bank's own modelling, which suggested we'd see a 5% fall in nationwide sales over the first year.

What will take longer to emerge is the impact on house price inflation – the Reserve Bank's acid test for whether the restrictions are serving their purpose of reducing financial stability risks. With sellers more reluctant to release their properties into a more uncertain market, it's likely to be some months before we see prices actually slow. And time will tell whether the drop in November sales was a short-lived confidence effect. Our view is that the impact of the restrictions will moderate over time. Houses will continue to sell, but at a slower rate, as those buyers who are able to get a high-LVR loan or muster up a large enough deposit take advantage of the opportunities the lending restrictions have opened up. With all banks now running specials for low-LVR loans, 1-year and 3-year mortgage rates on those terms have already fallen back substantially since October.

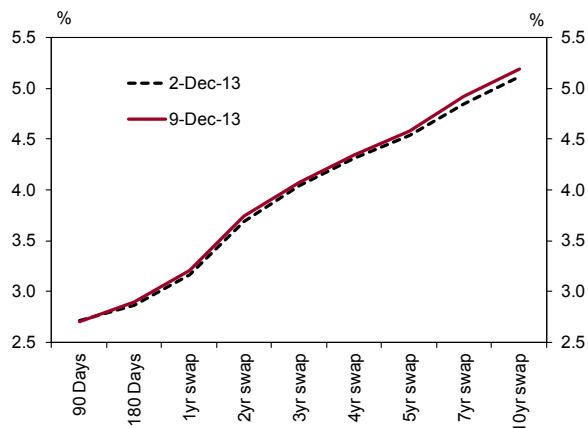
Fixed vs Floating for mortgages

From March 2012 until August 2013, we recommended fixed rates for mortgage customers. At the time, fixed rates were lower than or similar to floating rates. That offered a great opportunity to borrowers, given that we expected floating rates would rise substantially in coming years.

But fixed mortgage rates rose in mid-2013. On 2nd September 2013 we switched to an "indifferent" stance - fixed rates seemed a fair reflection of the expected increase in floating rates, and we could identify no term that was better value than another. We maintained that neutral stance until last week.

This week, we are switching to recommending fixed rates of one to three years for customers with lower than 80% loan to value ratios (LVRs). One-year rates are below floating for low-LVR borrowers. Three year rates are higher than floating, but are still very good value. Three year rates are too low to be a fair reflection of where we think short-term rates are heading. This opportunity to fix may not last long - wholesale interest rates are on the rise again, which could translate to higher fixed mortgage rates in the coming weeks.

NZ interest rates

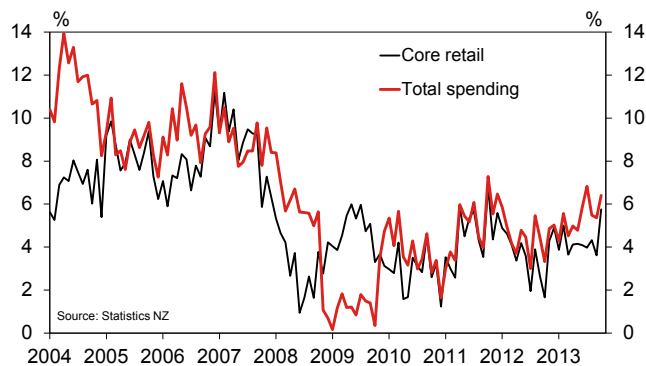


NZ Nov electronic card transactions

Dec 10, Last: 1.1%, WBC f/c: +0.6%, Mkt f/c: 0.3%

- Electronic card spending surged 1.1% in October. This more than made up for a weak September, leaving the value of card spending 6.4% higher than a year earlier.
- There are good reasons to think that momentum in retail activity has picked up again after a slower September quarter. Consumer spending is now being supported on multiple fronts by an improving labour market, higher farm incomes, and rising house prices. Consumer confidence in November was the highest since early 2010. There are signs that the Reserve Bank's home loan restrictions hit housing turnover in November, but it's too soon to expect any flow-on effects to wider spending.
- With no special factors at play (petrol prices were little changed in the month), we believe card spending is currently running at a roughly 6% annual pace.

Card transactions, annual % change

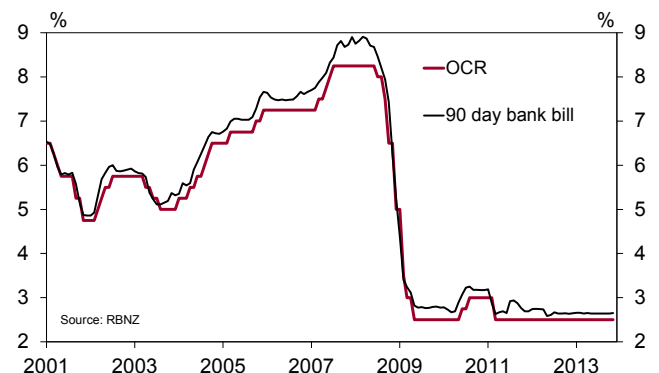


RBNZ Monetary Policy Statement, Dec 2013

Dec 12, Last: 2.5%, Westpac f/c: 2.5%, Market f/c: 2.5%

- The RBNZ's message has been that interest rates will rise next year, with the extent and timing of hikes dependent on the exchange rate and inflation pressures emanating from the construction and housing sectors. The first hike was forecast to occur around April 2014.
- The economy has been slightly stronger than expected, but the exchange rate is higher. These surprises roughly offset one another, so we expect the RBNZ will retain its previous plan.
- Markets are pricing either a January or March hike, but that would require the RBNZ to strongly signal imminent hikes at the Dec MPS. We expect no such signal will be forthcoming.

NZ OCR and 90 day rate

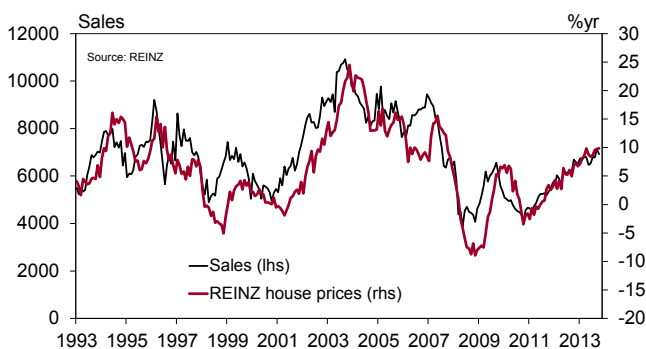


NZ Nov REINZ house prices and sales

Dec 13 (tbc), Sales last: -2.9%, Prices last: 9.9%yr

- We've long been saying that higher mortgage rates and the new restrictions on high loan-to-value ratio home loans would start to cool the housing market from around November, with the impact on house prices emerging early next year.
- The November reports from several real estate agencies have been right in line with our view: sales appear to have slowed sharply, but prices are still rising at a rapid clip, particularly in Auckland. The nationwide REINZ figures (release date not confirmed, but usually around the 10th working day of the month) will provide a fuller picture.
- Recently published figures from the RBNZ showed that high-LVR lending slowed sharply in October, but was offset to a substantial degree by a rise in low-LVR lending. This is consistent with our view that the LVR restrictions would shut out some buyers, but create opportunities for others, softening the impact on the housing market over time.

REINZ house prices and sales



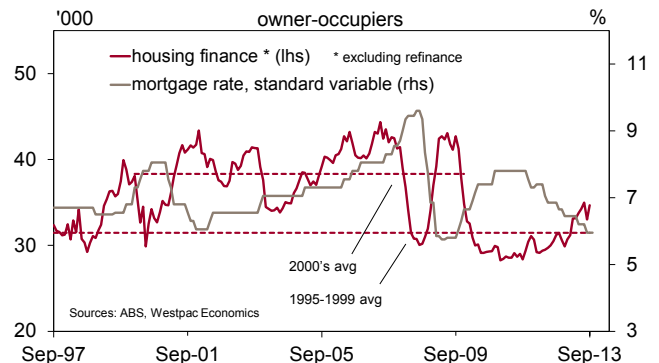
Aus Oct housing finance (no.)

Dec 10, Last: 4.4%, WBC f/c: 1.5%

Mkt f/c: 1.0%, Range: 0.5% to 5.0%

- Finance approvals posted a solid 4.4% bounce in Sep, more than reversing the 4% decline in Aug that looked somewhat out of kilter with the apparent strengthening in the housing market upturn. The main weak spot in the detail continues to be first home buyers, which hit a new low due to a combination of affordability issues and the legacy effect of changes in state government assistance in NSW, Qld and Vic. However, this has been more than offset by strong rises across other, much larger, segments.
- Oct is expected to see gains consolidate, with a 1.5% rise in finance approvals.

Owner-occupier finance & the rate cycle

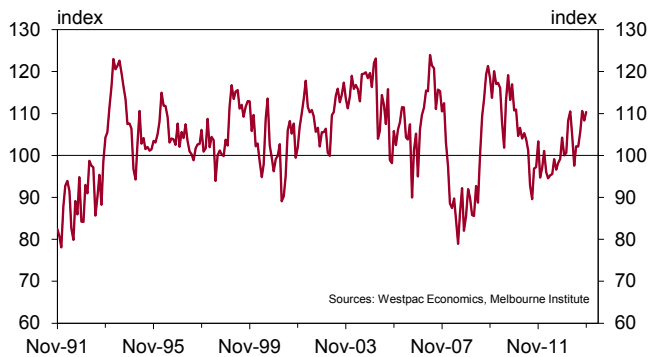


Aus Dec Westpac-MI Consumer Sentiment

Dec 11, Last: 110.3

- Consumer Sentiment rose 1.9% in Nov, essentially holding onto the solidly optimistic levels seen since Sep's post-election rally. The detail suggests the positive mood may be consolidating, with a notable improvement in views around family finances that likely reflects the recent pick-up in house prices. Job loss fears, embodied in consumers continued high reads on unemployment expectations, remain a stand-out weak spot.
- The Dec survey is in the field from Dec 2 to 7. Factors that may influence sentiment include: the RBA's decision to again leave rates on hold; more signs of strength in housing markets, but weaker than expected growth figures for Q3; and further gains in financial markets (ASX up 4% since the Oct survey, and up over 20%yr). We may start to see more of the post-election boost dissipate, with recent polls showing a notable fall in the new government's ratings.

Consumer Sentiment

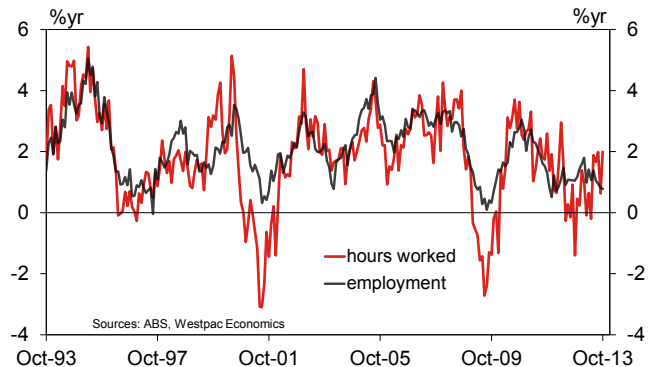


Aus Nov labour force survey, employment

Dec 12, Last: 11.1k, WBC f/c: 15k
Mkt f/c: 10k, Range: 0k to 35k

- Total employment rose 1.1k in Oct, softer than the market median (10k), but not quite as weak as Westpac's forecast (-10k). In 2013, we have seen an insipid rate of employment growth as total employment has lifted just 0.8%yr or 89.2k in the year to Oct, broadly in line with the leading indicators
- More importantly, total employment in the last six months has fallen 16.1k. You have to go back to June 2009, in the aftermath of the GFC, to find a comparably weak employment print (-16.5k in six months).
- Hours worked rose 0.4% in Oct, lifting the annual rate to 2.0%yr. Compare this to the 0.8%yr pace in total employment. Firms have been lifting hours instead of employing more staff. The leading indicators suggest they may be starting to reconsider this strategy, hence our modest 15k forecast.

Unemployment and participation rates

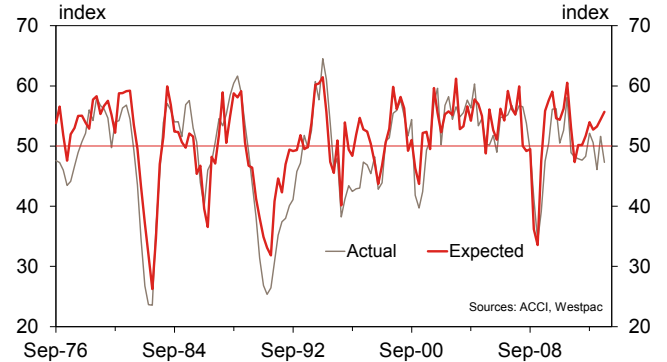


Aus Q4 Westpac-ACCI Survey of Industrial Trends

Dec 12, Last: 47.3

- The December quarter 2013 ACCI-Westpac Survey of Industrial Trends - the 209th report of this long running survey - will provide a timely update on current economic conditions and prospects. It was in the field from 4 Nov to 2 Dec.
- In the September quarter, the Westpac-ACCI Actual Composite fell from 51.6 to 47.3. However, the Expected Composite rose to 55.7, from 54.4. This report highlighted the substantial impediments to growth, most notably a lack of momentum in the domestic economy and uncertainty ahead of the Federal election.
- Key for the December quarter release will be manufacturers' labour market and investment intentions. Growth in the Australian economy is decidedly sub-trend; with the mining investment boom cresting, there is a real need for momentum in other sectors of the economy.

Westpac-ACCI composite indexes. Actual & expected, sa

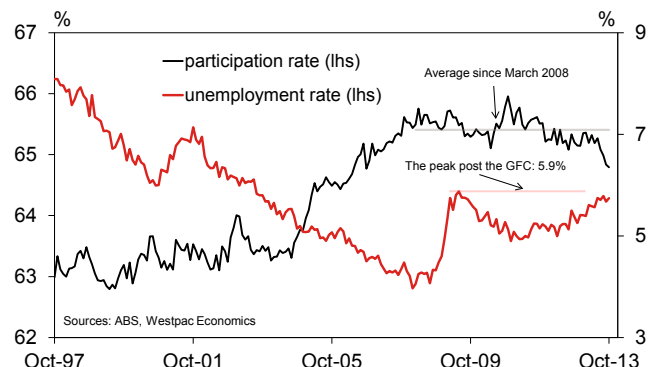


Aus Nov labour force survey

Dec 12, Last: 5.7%, WBC f/c: 5.8%
Mkt f/c: 5.8%, Range: 5.6% to 5.9%

- The unemployment rate rose to 5.7% from 5.6%; the decline in the participation rate (64.79% from 64.84%) limited the rise in the labour force to just 10.1k. Compare this to the employment to population ratio which, at 61.5%, is now well below the post-GFC lows of 2009.
- Oct was the lowest rate of participation since Oct 2006. Back then, male participation was 72.2% while female participation was 57.6%. Compare this to now: male participation has fallen to 71.2% and female participation has lifted to 58.5%.
- Westpac estimates that had, the participation rate held around its average since early 2008 (65.41%), then the unemployment rate would have printed at 6.6% in October.
- Our forecast for a small rise in the participation rate to around 64.9% will lift the unemployment rate to 5.8% with 15k jobs.

Hours worked vs. employment

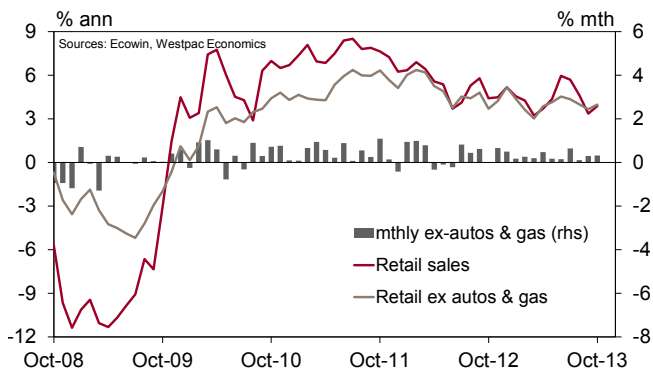


US Nov retail sales to be lifted by autos

Dec 12, Last: 0.4%, WBC f/c: 0.6%

- Retail sales rose 0.4% in Oct, supported by auto sales up 1.3%, with a modest drag from lower gasoline prices. Core retail sales ex autos/gas rose 0.3% for the second month running, with five other storetypes posting 1+% gains, and only building materials registering a sharp fall (down 3 months now).
- Cheap auto loans and volatile gasoline prices drive occasional gains, but weaker confidence and incomes growth have prevented core retail regaining the momentum of a year ago. Core retail's 3mth ann'lsd pace was 4.5% in Aug-Oct 2012, rose to 5.3% in Nov-Jan, then slowed to 3.6% this Aug-Oct.
- Auto unit sales surged last month; gasoline prices steadied. A late Thanksgiving might mean the advance report cut-off misses any strength at the start of the holiday shopping season; if so, watch for revisions in Dec. We expect a 0.6% headline on autos, but slower 0.2% core retail gain.

US retail sales



Data calendar

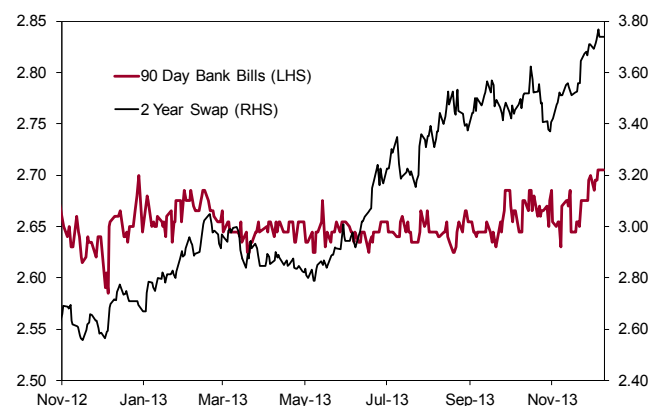
		Last	Market median	Westpac forecast	Risk/Comment
Mon 9					
NZ	Q3 manufacturing sales	-3.4%	-	-	Meat and dairy processing to rebound sharply post-drought.
Aus	ANZ job ads %mth	-0.1%	-	-	Annual pace -11.6%yr is much weaker than jobs, but it has improved.
Chn	Nov consumer prices %yr	3.2%	3.1%	-	Vegetables spiked again, housing flat at 2.6%, non-food flat at 1.6%.
	Nov producer prices %yr	-1.5%	-1.5%	-	Raw materials and consumer durables both saw deeper deflation in Oct.
Eur	Dec Sentix investor confidence	9.3	10.2	-	Equities had longest string of weekly gains since 1998 in Germany.
Ger	Q3 labour costs %yr	1.8%	-	-	Plunged to slowest annual growth pace since 2010 in Q2.
	Oct exports	1.6%	-	-	Back to back gains in Aug-Sep despite appreciating euro.
	Oct industrial production	-0.9%	-	0.8%	German factory PMI expanding.
UK	BoE Gov Carney	-	-	-	Speaking at Eco Club of NY
US	Fedspeak	-	-	-	Lacker, Bullard and Fisher.
Can	Nov housing starts	1.2%	-	-	Urban single family housing coming off the boil.
Tue 10					
NZ	NZ Nov electronic card transactions	1.1%	0.3%	0.6%	Early signs that spending has picked up again after a slower Sep quarter.
Aus	Oct housing finance	4.4%	1.0%	1.5%	Housing upswing has clearly strengthened in recent months.
	Nov NAB business conditions	-4	-	-	Confidence fell from 11.6 to 5.5 in Oct. Conditions remained weak.
Chn	Nov industrial production %yr	10.3%	10.1%	-	Manufacturing now past the sweet spot of the inventory cycle.
	Nov fixed investment %ytd	20.1%	20.1%	-	Decisive peak in year-ended total construction growth, led by railways.
	Nov retail sales %yr	13.3%	13.3%	-	Auto sales picking up, job security improving with firmer activity backdrop.
	Nov new bank loans RMBbn	506	577	-	Tentative date: lending flow traditionally tails off going into year end.
	Nov M2 money supply %yr	14.3%	14.2%	-	Tentative date: Trade surplus, onshore profits assisting deposit growth.
	Nov total new credit RMBbn	856	920	-	Tentative date: non-bank financing has been weak in 3 of last 5 months.
UK	Nov RICS house price balance	57%	59%	-	Mortgages no longer qualify for BoE Funding for Lending - impact?
	Oct exports	-0.8%	-	-	With imports up in Sep, the trade deficit widened to £9.8bn.
	Oct industrial production	0.9%	0.3%	0.8%	UK factory PMI at highest since early 2011.
US	Nov NFIB small business optimism	91.6	-	92.8	Some rebound from Oct survey, presumably hit by govt shutdown.
	Oct wholesale inventories	0.4%	0.3%	-	Inventories behind much of growth spurt in Q3.
Wed 11					
Aus	Westpac-MI Consumer Sentiment	110.3	-	-	Will post-election boost start to fade?
	Westpac-MI unemploy. expectations	144.7	-	-	Has remained at elevated levels consistent with rising unemployment.
US	Nov monthly budget statement, \$bn	-142	-	-	Budget issues in Congress still unresolved.
Thu 12					
NZ	RBNZ Monetary Policy Statement	2.50%	2.50%	2.50%	RBNZ to reiterate previous message, first hike in April.
	Nov food price index	-1.0%	-	0.0%	Annual price inflation starting to tick up after two flat years.
Aus	MI inflation expectations (median)	1.8%	-	-	Inflationary expectations remain well anchored below 2%yr.
	ACCI Survey of Industrial Trends	47.3	-	-	Employment and investment intentions key.
	Nov employment, ch	1.1k	10k	15k	Firms have been lifting hours worked rather than employment.
	Nov unemployment rate	5.7%	5.8%	5.8%	Soft jobs, small lift in participation will boost unemployment by 0.1ppt.
Eur	Oct industrial production	-0.5%	0.3%	0.3%	PMI expanding; German and French IP data due earlier in week.
US	Initial jobless claims w/e 6/12	298k	300k	315k	Should be cleaner read with Nov's holiday distortions out of way.
	Nov producer prices	-0.2%	0.0%	-0.1%	Energy prices still falling; core PPI to slow from 0.2% in Oct.
	Nov retail sales	0.4%	0.5%	0.6%	Auto sales surged, but late Thanksgiving this year. See text box.
	Oct business inventories	0.6%	0.4%	0.2%	Inventories unlikely to make same contribution to Q4 growth as Q3.
Can	Oct new house prices	0.0%	-	-	Running slower 1.6%yr pace.
	Nov house prices %yr	3.1%	-	-	Teranet measure; prices accelerating not falling as in late 2011, 2012
	Q3 capacity utilisation %	80.6%	-	-	Upswing in CapU since 2009 has stalled since mid last year.
Fri 13					
NZ	Nov REINZ house sales	-2.9%	-	-	Due around this date. LVR limits appear to have squeezed Nov sales.
	Nov REINZ house price index %yr	9.9%	-	-	Impact on prices may not be apparent for another few months.
	Nov manufacturing PMI	55.7	-	-	Well above the 50 mark throughout 2013.
UK	Oct construction output, %yr	-0.9%	-	1.5%	Construction PMI at all time high, suggests bounce from Sep fall.

New Zealand forecasts

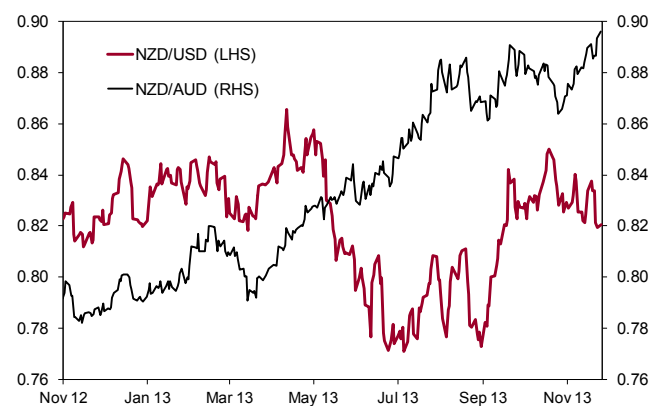
Economic Growth Forecasts	March years				Calendar years			
	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
% change								
GDP (Production) ann avg	1.9	2.7	3.0	3.8	1.4	2.7	2.8	3.8
Employment	1.0	0.4	2.6	2.7	1.5	-1.4	3.8	2.8
Unemployment Rate % s.a.	6.8	6.2	5.6	5.1	6.3	6.8	5.7	5.0
CPI	1.6	0.9	1.3	2.2	1.8	0.9	1.5	1.9
Current Account Balance % of GDP	-3.8	-4.5	-3.8	-4.9	-3.6	-4.7	-3.9	-4.4

Financial Forecasts	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Cash	2.50	2.50	3.00	3.25	3.50	3.75
90 Day bill	2.65	2.90	3.25	3.50	3.75	4.00
2 Year Swap	3.50	3.70	3.90	4.10	4.40	4.60
5 Year Swap	4.50	4.60	4.70	4.80	4.90	5.00
10 Year Bond	4.60	4.70	4.75	4.80	4.85	4.90
NZD/USD	0.85	0.84	0.82	0.79	0.77	0.76
NZD/AUD	0.89	0.90	0.91	0.91	0.90	0.90
NZD/JPY	82.5	80.6	77.9	74.3	71.1	70.4
NZD/EUR	0.63	0.63	0.64	0.64	0.64	0.63
NZD/GBP	0.52	0.52	0.51	0.51	0.50	0.48
TWI	78.5	78.3	77.8	76.3	74.7	74.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 9 Dec 2013

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.67%	2.67%	2.66%
60 Days	2.69%	2.67%	2.67%
90 Days	2.71%	2.68%	2.68%
2 Year Swap	3.74%	3.64%	3.54%
5 Year Swap	4.58%	4.54%	4.44%

NZ foreign currency mid-rates as at Monday 9 Dec 2013

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8287	0.8178	0.8256
NZD/EUR	0.6047	0.6037	0.6182
NZD/GBP	0.5075	0.5039	0.5159
NZD/JPY	85.38	82.84	81.91
NZD/AUD	0.9076	0.8912	0.8797
TWI	77.80	76.73	77.19



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	3.7	2.5	2.3
CPI inflation % annual	2.1	2.8	3.0	2.2	2.4	2.6
Unemployment %	5.6	5.2	5.2	5.3	5.8	6.4
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.6	-3.0
United States						
Real GDP %yr	-3.1	2.4	1.8	2.8	1.6	1.6
Consumer Prices %yr	-0.3	1.6	3.1	2.1	1.5	1.7
Unemployment Rate %	9.3	9.6	8.9	8.1	7.5	7.3
Current Account %GDP	-2.7	-3.0	-2.9	-2.7	-2.5	-2.6
Japan						
Real GDP %yr	-5.7	4.9	-0.5	1.9	1.8	1.7
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	-4.4	1.9	1.6	-0.6	-0.5	-0.1
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 8 November 2013

Interest Rate Forecasts	Latest	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14
Australia						
Cash	2.50	2.50	2.25	2.00	2.00	2.00
90 Day Bill	2.60	2.60	2.35	2.10	2.10	2.10
10 Year Bond	4.44	3.90	3.60	3.40	3.80	4.00
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.87	2.50	2.40	2.40	2.80	3.00
ECB Repo Rate	0.25	0.25	0.25	0.25	0.25	0.25

Exchange Rate Forecasts	Latest	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14
AUD/USD	0.9133	0.95	0.94	0.92	0.92	0.90
USD/JPY	103.00	97	96	95	94	93
EUR/USD	1.3706	1.38	1.34	1.31	1.31	1.28
AUD/NZD	1.1022	1.12	1.12	1.11	1.11	1.11

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