Westpac

Institutional Bank

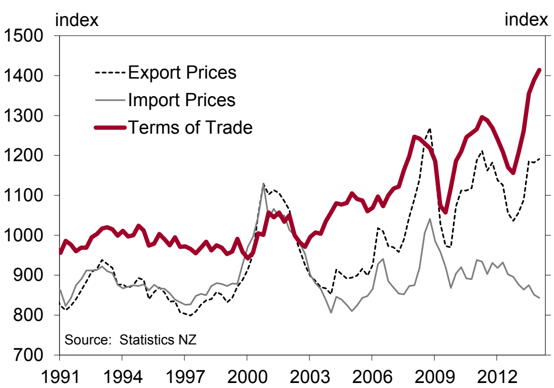
High tide mark

Q1 NZ Terms of Trade

- The terms of trade rose further in the March quarter, to reach its highest level in more than 40 years.
- To date, the sky-high terms of trade have been a key pillar supporting stronger growth in the domestic economy, but its influence is set to wane.
- The March quarter is likely to mark the peak in the terms of trade. The more than 20% fall in dairy prices in recent months is set to drag export prices, and the terms of trade, lower over the rest of the year.
- Yet over a longer horizon, we remain firmly optimistic that sustained strength in the terms of trade, driven by growing engagement with China and other emerging economies, will be a feature of NZ's economic landscape.

	2013Q2	2013Q3	2013Q4	2014Q1
Terms of Trade	4.6%	7.5%	2.5%	1.8%
Export Prices	3.1%	8.8%	-0.3%	0.8%
Import Prices	-1.5%	1.3%	-2.7%	-0.9%
Export Volumes (s.a.)	-6.1%	-0.9%	10.0%	1.6%
Import Volumes (s.a.)	4.5%	4.9%	0.0%	2.3%

Export and Import Prices



New Zealand's terms of trade posted a fifth consecutive increase in the March quarter, climbing 1.8%. This was in line with forecasts and came as no surprise to markets which tend to focus on more timely indicators of external conditions such as fortnightly GlobalDairyTrade auctions. Nonetheless, over the last year the terms of trade has risen an impressive 12.8% to reach its highest level since 1973, and has proven to be a key pillar of support for the stronger NZ economy.

But this impressive run is drawing to a close. We expect the March quarter to mark the peak terms of trade and this bright star of the economy to fade a little over the course of this year as the terms of trade retreats from its current heights. But importantly, we remain optimistic that over a longer horizon the terms of trade will remain elevated by historical standards. At the heart of this view is New Zealand's increasing integration with China (and other emerging markets). In these countries urbanisation, increasing incomes and changing diets mean households are driving increased demand for New Zealand's key export commodities. Add to the mix New Zealand's Free Trade Agreement with China, and this is a trend which is set to be sustained for some time yet.

However, even if the outlook for demand is relatively robust, changes in supply can lead to volatility in commodity markets. For example dairy prices, for so long the star performer of the NZ export sector, have fallen more than 20% in recent months. We have long been warning that the high prices on offer would encourage an increase in supply, both locally an internationally, and that this would weigh on dairy prices this year. And this certainly appears to be to be what has happened. Around the world producers have been lifting production and New Zealand farmers are no exception. While season to season comparisons will be inflated by the impact of last year's drought, there's no doubting that production in the just completed 2013/14 season will be a record breaker.

Looking ahead to the 2014/15 season, lower dairy prices are likely to be reflected in a lower payout. We're forecasting a fall in the milk price Fonterra pays farmers from $8.40 KgMs to $7.10 KgMs. For many farmers this will still signal a very healthy income, but is undoubtedly a step down from current levels.

The Reserve Bank is also unlikely to be surprised by softer dairy prices. In a recent speech Governor Wheeler noted that “the strong supply response from the US, Europe and New Zealand, as a result of the high global dairy prices, is expected to exert downward pressure on international dairy prices over the next two to three years”. We’re probably a little more optimistic than this, and our $7.10 milk price forecast for next season is predicated on dairy prices stabilising around current levels, and even improving a little later in the year.

What will be causing consternation at the RBNZ is the fact that the exchange rate has remained so strong even as export conditions have deteriorated. This could make the central bank less inclined to hike the OCR or even have it considering exchange rate intervention.

Another feature of today’s data which at the margin points to less inflation pressure, is the ongoing growth in imports of capital equipment. With the domestic economy clearly on a stronger footing and confidence in the outlook high, firms have been increasingly willing and able to take advantage of the strong NZD to import capital equipment. Excluding transport equipment, the volume of imports of capital equipment leapt 17% in the March quarter, continuing to the strong upward trend we’ve seen over the last year or so – and far outstripping growth in imports of consumption goods. This investment should help firms become more productive, thus allowing the economy to grow for longer without generating inflation pressure.

Anne Boniface
Senior Economist

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

For email address changes contact:
WNZResearch@westpac.co.nz

Disclaimer

Things you should know: Each time someone visits our site, data is captured so that we can accurately evaluate the quality of our content and make improvements for you. We may at times use technology to capture data about you to help us to better understand you and your needs, including potentially for the purposes of assessing your individual reading habits and interests to allow us to provide suggestions regarding other reading material which may be suitable for you.

If you are located in Australia, this material and access to this website is provided to you solely for your own use and in your own capacity as a wholesale client of Westpac Institutional Bank being a division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ('Westpac'). If you are located outside of Australia, this material and access to this website is provided to you as outlined below.

This material and this website contain general commentary only and does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material and this website may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material and this website does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. The forecasts given in this material and this website are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Transactions involving carbon give rise to substantial risk (including regulatory risk) and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. Statements setting out a concise description of the characteristics of carbon units, Australian carbon credit units and eligible international emissions units (respectively) are available at www.cleanenergyregulator.gov.au as mentioned in section 202 of the Clean Energy Act 2011, section 162 of the Carbon Credits (Carbon Farming Initiative) Act 2011 and section 61 of the Australian National Registry of Emissions Units Act 2011. You should consider each such statement in deciding whether to acquire, or to continue to hold, any carbon unit, Australian carbon credit unit or eligible international emissions unit.

Additional information if you are located outside of Australia

New Zealand: The current disclosure statement for the New Zealand division of Westpac Banking Corporation ABN 33 007 457 141 or Westpac New Zealand Limited can be obtained at the internet address www.westpac.co.nz. Westpac Institutional Bank products and services are provided by either Westpac Banking Corporation ABN 33 007 457 141 incorporated in Australia (New Zealand division) or Westpac New Zealand Limited. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activity.

Disclaimer continued overleaf.

Disclaimer continued

Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

U.K.: Westpac Banking Corporation is registered in England as a branch (branch number BR000106), and is authorised and regulated by the Australian Prudential Regulatory Authority in Australia. WBC is authorised in the United Kingdom by the Prudential Regulation Authority. WBC is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority in the United Kingdom. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. This material and this website and any information contained therein is directed at a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services Act 2000 (Financial Promotion) Order 2005 or (b) high net worth entities, and other persons to whom it may otherwise be lawfully communicated, falling within Article 49(1) of the Order (all such persons together being referred to as “relevant persons”). The investments to which this material and this website relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this material and this website or any of its contents. In the same way, the information contained in this material and this website is intended for “eligible counterparties” and “professional clients” as defined by the rules of the Financial Services Authority and is not intended for “retail clients”. With this in mind, Westpac expressly prohibits you from passing on the information in this material and this website to any third party. In particular this material and this website, website content and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission (“CFTC”) as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC (‘WCM’), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 (‘the Exchange Act’) and member of the Financial Industry Regulatory Authority (‘FINRA’). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

For the purposes of Regulation AC only: Each analyst whose name appears in this report certifies that (1) the views expressed in this report accurately reflect the personal views of the analyst about any and all of the subject companies and their securities and (2) no part of the compensation of the analyst was, is, or will be, directly or indirectly related to the specific views or recommendations in this report.