Weekly Commentary

Mt. Taranaki, Mt. Egmont National Park.

In this issue

Off the boil, but still hot

While the New Zealand economy started the year at a rolling boil, it now appears to have slowed to a steady simmer. Even so, we think that markets are overestimating what recent developments means for interest rates. On balance, conditions are not all that different to what the Reserve Bank expected three months ago – and this month's *Monetary Policy Statement* could give markets a pointed reminder of that fact. That means the recent opportunities for borrowers to lock in lower fixed-term rates could be short-lived.

For many, the key event last week will have been Fonterra's initial milk price forecast for the next dairying season, given speculation in the preceding days that the figure could be down sharply from the previous season's record high. The outcome was probably a touch more positive than the market had been expecting: the milk price for next season was set at $7.00 per kilo of milksolids, compared to $8.40 for the season just finished (which was itself revised down from $8.65).

While this clearly represents a substantial drop in dairy farmers' incomes compared to last season, it was more or less in line with our longstanding forecast. We had expected a fall in international dairy prices this year, as global supply (a rebound from drought in New Zealand, and a lift in production elsewhere in response to high prices) fell in line with demand.

Nor is it likely to have come as a negative surprise to the RBNZ, which never expected the extreme highs in New Zealand's terms of trade to be sustained. Governor Wheeler noted in a recent speech 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"* (our emphasis). In contrast, our forecast of the milk payout for next season (and, it seems, Fonterra's) depends on international dairy prices stabilising at around current levels.

Off the boil, but still hot continued

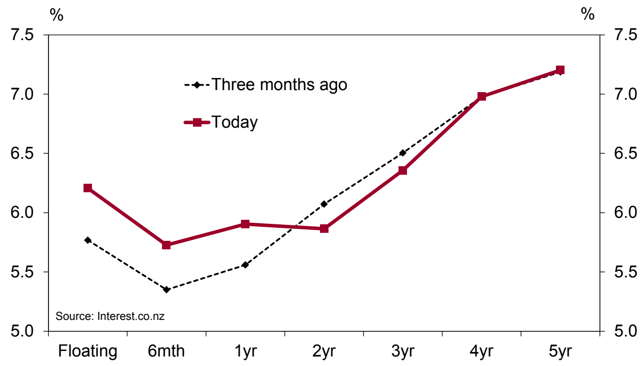
Something that came as more of a surprise to us last week was a sizeable drop in business confidence for the May survey, following a small decline over the previous two months. At a net 53% positive, the level of confidence is still consistent with a strong pace of economic growth; the survey is coming off the 20-year high reached in February, and has only fallen to around the level reached in October last year. But it does add to an emerging picture that the New Zealand economy's momentum has passed its peak and cooled a little in recent months.

Admittedly, that picture has been blurred slightly by the possibility of an unusually large Easter effect in April. Easter Monday fell in the same week as Anzac Day this year, creating a three-day workweek that many people are likely to have turned into a week-long break. As we anticipated, the activity data for April has been fairly consistently on the soft side; the latest manifestation of this was a 5% drop in building consents (excluding apartment units, a lumpy component that had an unusually large month). Of course, to confirm our suspicions of an Easter timing effect, we'll need to see a solid rebound across the suite of May activity data.

Still, our impression is that the economy has indeed come off the boil, relative to the frantic pace that was set over the second half of last year. But although financial markets seem to be focused on the negative factors that have emerged since the RBNZ's March *Monetary Policy Statement,* there have been a host of positive factors too. As we noted last week, net migration is running well ahead of forecasts, and the 2014 Budget's spending projections were more stimulatory than the RBNZ may have expected. The exchange rate, while still higher than the RBNZ assumed, has eased back a little in the last few weeks. And critically, some key interest rates have actually been falling.

The fall in long-term interest rates in recent weeks has been partly due to the local market following the global trend downward. But there also appears to have been some genuine downgrading of expectations for the OCR. Interest rate markets are more or less factoring in another 25bp hike at the June *MPS*, but are only factoring in one further hike after that for this year, whereas we expect another two (as the RBNZ projected in March). As wholesale interest rates have fallen, retail rates have started to respond, with the result that mortgage rates for the popular two- and three-year fixed terms are actually lower now than they were before the first OCR hike – at a time when the RBNZ would have been expecting them to rise.

Average advertised mortgage rates



The concern for the RBNZ will be that a sustained fall in mortgage rates could create a second wind in the housing market. We suspect the RBNZ now feels that a firmly worded *Monetary Policy Statement* is in order this month. That could come as a shock to markets that are downplaying the odds of future OCR hikes.

If the RBNZ is successful in nudging OCR expectations higher again, borrowers need to consider that the favourable fixed-term rates currently on offer – many of which are promoted as 'specials' – could indeed prove to be temporary.

Fixed vs Floating for mortgages

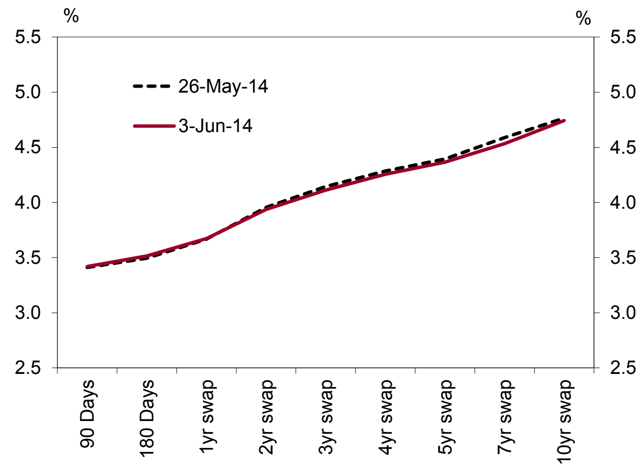
We believe that the current 2-3 year fixed-rate specials offer good value.

The standard fixed rates from around six months to three years appear to offer similar value, and are a fair reflection of where we think shorter-term rates are going to go over the next few years. However, there are a number of specials currently on offer, particularly for 2-3 year fixed terms, that are substantially below our expectation for short-term rates over those horizons. Fixed rates are more likely to rise than fall over the next few months, so for those who are looking to fix there is little to gain from waiting.

Fixing for four or five years may result in higher interest payments over the life of the loan than opting for shorter-term fixed rates. However, these longer-term fixed rates may still be preferred by those who are willing to pay for certainty.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates, such as the six month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



NZ Q1 terms of trade

Jun 3, Last: 2.3%, WBC f/c: 2.8%

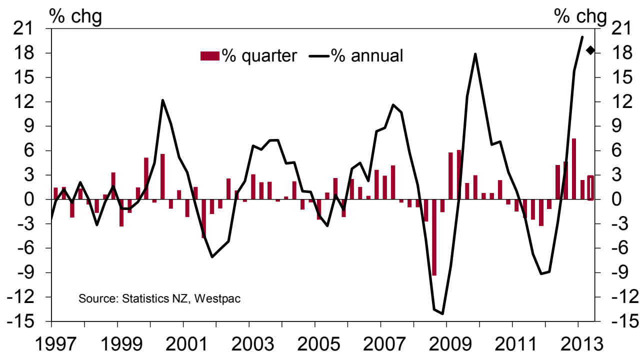
- A combination of further improvement in export prices and softer import prices should lead to a fifth consecutive increase in the terms of trade in the March quarter. New Zealand's terms of trade remain at very elevated levels, and on our forecast are set to rise to a fresh four decade high.
- With a 20% plus fall in dairy prices in recent months now dragging New Zealand's export prices lower, the March quarter is likely to be the peak in the terms of trade for now. However, over a longer horizon, strong demand from emerging markets, especially China, for some of key New Zealand's commodity exports should see New Zealand's terms of trade remain elevated.

NZ Q1 building work put in place

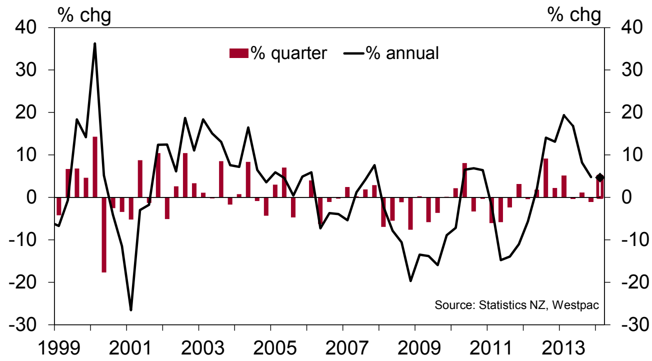
Jun 4, Last: -1.0%, WBC f/c: 5.0%

- Nationwide building activity has been close to flat over the last three quarters, though that reflects diverging trends across regions and building types.
- Residential work has surged ahead, particularly in Canterbury as the post-quake rebuild has ramped up, and to some degree in the under-supplied Auckland market. We expect a further 6% increase in this category.
- In contrast, non-residential construction has slowed, falling to extremely low levels outside of Canterbury. The level of building work has now fallen below what the pipeline of consented work would suggest, and we have assumed a 3% catch-up in the March quarter.

NZ Terms of Trade



NZ real building work put in place



Aus Apr retail trade

Jun 3, Last: 0.1%, WBC f/c: 0.3%
Mkt f/c: 0.3%, Range: –0.5% to 0.7%

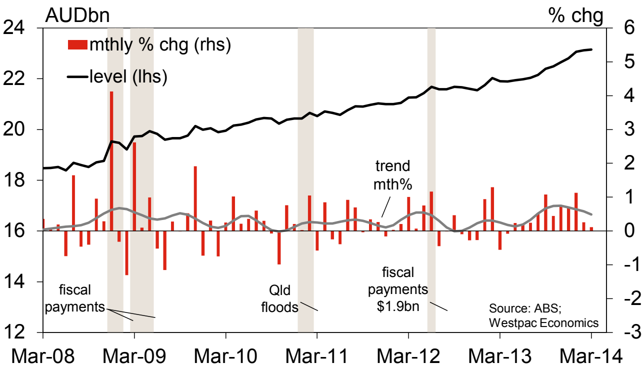
- Monthly sales has shown a clear slowing in momentum in 2014, with gains of 1.1% in Jan, 0.3% in Feb and 0.1% in Mar. This is consistent with a pull-back in consumer sentiment from solidly optimistic territory late last year to around neutral in Mar-Apr. Notably, the Mar detail showed sales down 0.5%mth across 'non-food' segments, despite a continued acceleration in the housing-related sub-categories.
- Apr should see a continuation of this slowing, with a subdued 0.3% gain. There is a wildcard around the potential impact of public holidays: the timing of Easter and ANZAC Day encouraged many to take leave over the 3 days in between. The Apr labour force survey recorded a sharp 2.5% drop in total hours worked, consistent with this phenomenon. How this impacts retail is unclear, with spending able to shift between days, and holiday-related spending an offsetting positive.

Aus Q1 current account balance, AUDbn

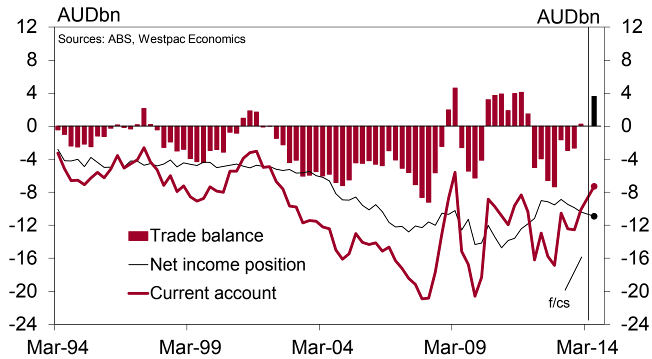
Jun 3 Last: –10.1, WBC f/c: –7.3
Mkt f/c: –7.0, Range: –10.1 to –5.8

- Australia's current account deficit is forecast to narrow to $7.3bn in Q1, from a revised deficit of $11.0bn in Q4. (Note, the ABS advise of a material revision to the trade position.
- As a share of the economy, the current account balance improves to –1.8% of GDP in Q1, from –2.8% in Q4.
- The trade balance swung to a surplus of $3.6bn in Q1, from a deficit of $0.6bn in Q4. Export earnings increased by 6%, while the import bill grew by 0.9%.
- As a partial offset, we anticipate a $0.5bn widening in the net income deficit, to $10.9bn.

Monthly retail sales



Current account: Q1 f/c –$7.3bn



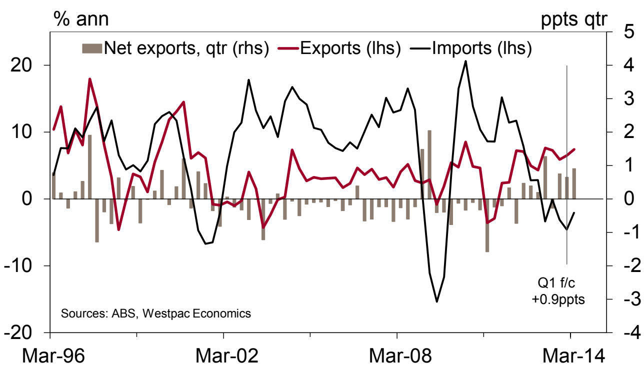
The week ahead

Aus Q1 net exports, cont'n

Jun 3 Last: 0.6ppts, WBC f/c: 0.8ppts
Mkt f/c: 0.8ppts, Range: 0.3ppts to 1.2ppts

- Net exports are forecast to add 0.9ppts to Q1 GDP growth. That follows on from a 0.6ppt contribution in Q4. Over the year to Q1, net exports will add 2.1ppts.
- The mining investment boom has been a huge success. Export volumes are expanding strongly as additional capacity comes on stream.
- Export volumes are forecast to increase by 3.0%qtr, 7.4%yr, in Q1. The opening months of 2014 saw an increase in shipments of iron ore, coal, gas and rural goods.
- Import volumes are forecast to print at -1.2%qtr, -2%yr, in Q1. We estimate that consumption and intermediate goods were up in the quarter, but that this was offset by a further fall in capital goods and a decline in services.

Export & import volumes

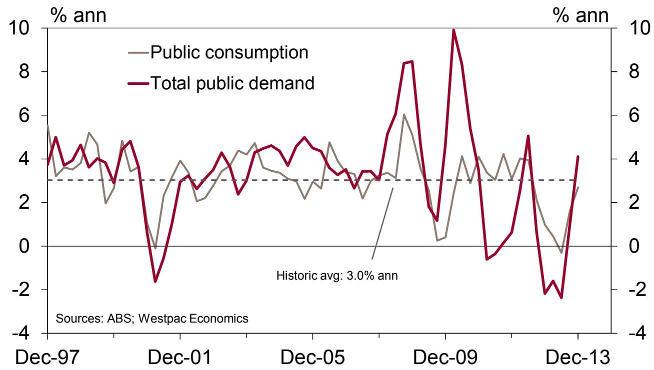


Aus Q1 public demand

Jun 3 Last: 1.1%, WBC f/c: –0.8%

- Weakness in public demand, after a brief reprieve in 2013, is set to re-emerge. There is a renewed focus on budget repair at the Federal level after the deficit widened in 2013/14.
- Public demand is forecast to decline by 0.8% in the March quarter. That contrasts with a bounce in Q4, up 1.1%qtr, 4.1%yr.
- We expect soft consumption, which accounts for 80% of total public demand.
- Public investment rose 4.6%qtr, 10.3%yr, in Q4. A pull-back is anticipated following this strong result, as suggested by the weakness in public works – as reported in the Construction Work Survey.

Public demand: volatile around a weak trend

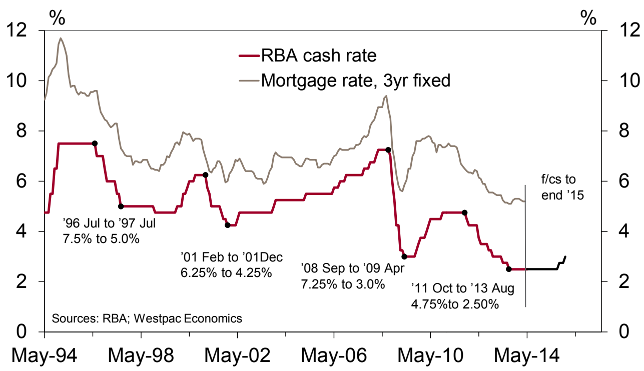


Aus RBA policy decision

Jun 3 Last: 2.50%, WBC f/c: 2.50%
Mkt f/c: 2.50%, Range: 2.50% to 2.50%

- The RBA is widely expected to leave interest rates unchanged following the May Board meeting. Rates have been on hold since last August, when they were lowered by 0.25% to 2.50%, down from a peak of 4.75% at the start of November 2011.
- The housing sector has responded to low interest rates. Private dwelling approvals totalled a record-high 197k annualised over the past six months, up 26% on a year ago. The labour market has stirred, with employment up 0.9% in six months and unemployment ticking lower.
- However, headwinds persist. Consumer sentiment retreated to 92.9 in May, down from a high of 110.3 in November. The RBA expects sub-trend conditions in the year to June 2015, with GDP growth forecast to be 2.75%yr.

Mortgage rates – at historic low

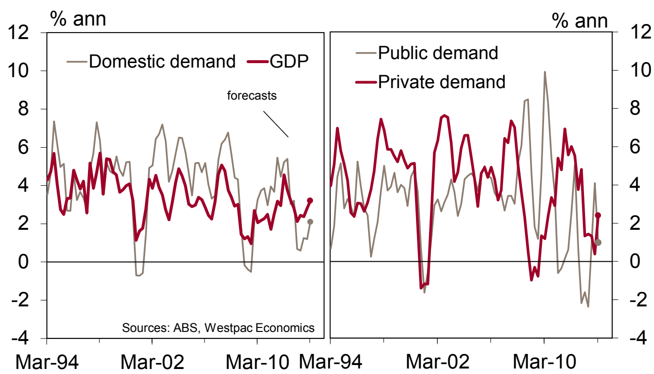


Aus Q1 GDP

Jun 4 Last: 0.8%, WBC f/c: 0.9%
Mkt f/c: 0.9%, Range: 0.5% to 1.4%

- GDP is forecast to grow by 0.9% in Q1, following 0.8% in Q4. Annual growth lifts from 2.8% to a "trend" 3.2%. Available information on the expenditure components point to upside risks to our 0.9%, but business surveys suggest otherwise.
- A surge in resource exports, as the mining boom transitions to the output stage, and a burst of consumer spending, ignited by interest rate cuts in mid-2013, are the key supports. In addition, a strong upswing in housing construction has commenced.
- However, conditions elsewhere were mixed. We expect a pull-back in public demand; only a modest rebound in business investment, constrained by falling mining investment; and inventories are expected to subtract from growth, as a bumper winter crop is exported.

Australian economic conditions



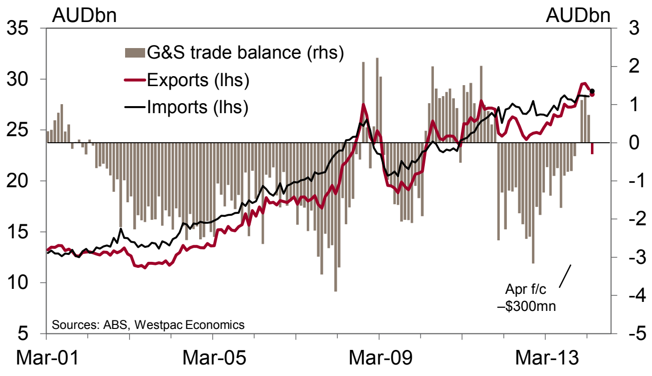
The week ahead

Aus Apr trade balance, AUDmn

Jun 5 Last: 731, WBC f/c: –300
Mkt f/c: 510, Range: –300 to 1,000

- Australia's trade balance has been in surplus for four consecutive months, following a run of 23 deficits. However, the risk is that the accounts slide back into deficit in April on a rebound in imports and lower commodity prices.
- The trade balance is forecast to be a deficit of $300mn, a $1bn turnaround from a $731mn surplus in March.
- We anticipate a 1.8% rise in imports. Volumes appear to have rebounded from a run of soft outcomes. Note, the AUD strengthened in April, +2.7% vs USD and +2.5% on a TWI basis.
- Exports are forecast to declined by 1.8%, weighed down by the higher AUD and lower commodity prices. A lift in iron ore shipments provides a partial offset.

Australia's trade position

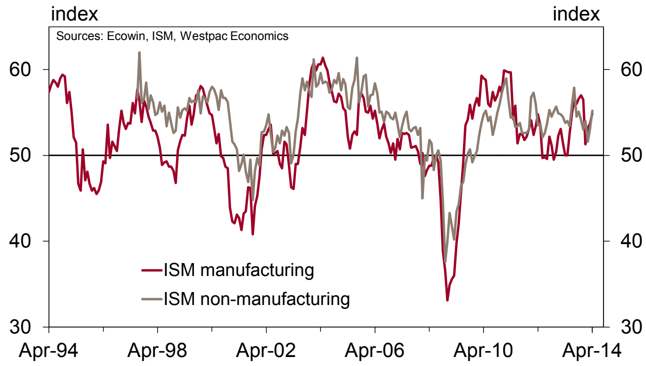


US May ISM non-manufacturing

Jun 4, ISM non-manufacturing Last: 55.2, WBC f/c: 55.4

- The ISM non-manufacturing survey rose from its lowest in four years in Feb to its highest since Aug last year in April. Business activity spiked to 60.9; orders were sharply higher; but jobs slowed again after March's partial recovery from Feb's slump. Expect a (modest) further improvement in month.

US ISMs

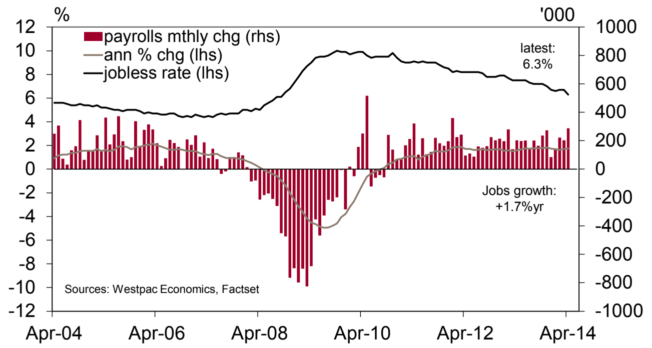


US May non-farm payrolls

Jun 6, Payrolls: Last: 288k, WBC f/c: 110k

- Payrolls grew by a cracking 288k in April. A late Easter/spring break may have boosted the report at the expense of May. Easter was late in 2011 (Good Friday April 22); April payrolls rose 244k vs expectations of185k, with upward revisions worth 46k. Notable in the detail was solid retail and leisure employment. In May 2011, payrolls was forecast at 165k but came in at 54k, with retail/leisure jobs down 15k accounting for two thirds of the shortfall relative to the previous month.
- April 2014 (GF April 18) saw 63k new jobs in these two sectors and a 75k jump in business services, including 24k temps that would be vulnerable in May if 2011's pattern repeats. Our May forecast is: 288-63-75-40=110k (the 40k being an estimate of the combined job losses in those 3 sectors). Revisions should be to the downside.

US payrolls

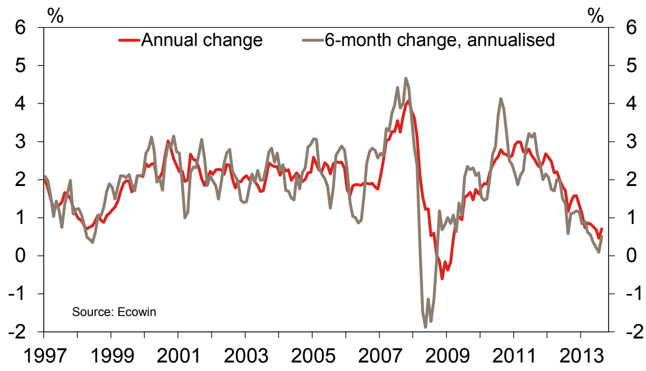


ECB policy decisions

Jun 5, ECB Last: 0.25%, WBC f/c: 0.00%

- The ECB took no policy action on May 8, but Draghi openly acknowledged that the Council was disturbed by the inflation outlook and "is comfortable with acting next time, but [first] we want to see the June staff projections". He said a decision to ease in June had not been taken, but he was giving "a preview of the discussion we will be having". That is a very strong signal that the ECB is on the cusp of further easing.
- The ECB would favour using its balance sheet as well as an interest rate cut for a range of reasons including: the likelihood QE would tend to weaken the euro more because of its potentially unlimited size; and purchasing asset backed securities would also address the issue of contracting lending in the Eurozone. But the June policy easing will likely include a rate cut (and negative deposit rates), with the ECB is not technically ready to fully employ the power of its balance sheet. However, Draghi will formally set the process in motion.

Euro area inflation impulse



Data calendar

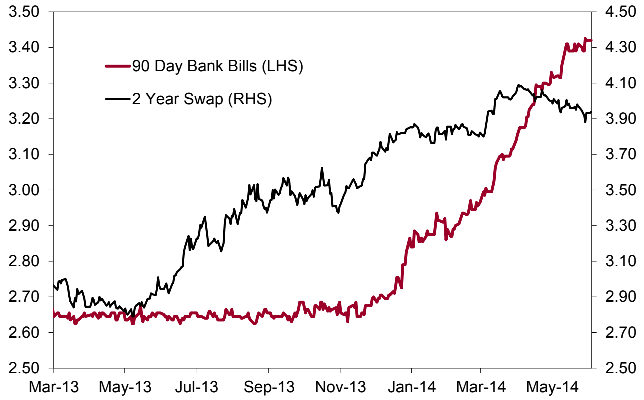
		Last	Market median	Westpac forecast	Risk/Comment
Tue 3					
NZ	Q1 terms of trade	2.3%	–	2.8%	Export prices peaking, strong NZD depressing import prices.
Aus	Apr retail sales	0.1%	0.3%	0.3%	Momentum slowing. ABS adjusts for Easter timing but could still impact.
	Q1 current account balance, AUDbn	–10.1	–7.0	–7.3	Sizeable narrowing on an improved trade performance, led by exports.
	Q1 net exports, cont'n	0.6	0.8	0.9	Export volumes up a f/c 3.0% and imports down 1.2%.
	Q1 public demand	1.1%	–	–0.8%	Soft consumption (public servant numbers) & a reversal of investment.
	RBA policy decision	2.50%	2.50%	2.50%	No move, with rates on hold since last August.
Chn	May NBS non-manufacturing PMI	54.8	–	–	Looks somewhat rich in level terms, but survey universe is turning.
	May HSBC manufacturing PMI - final	49.7	49.7	–	Flash beat headline expectations and also featured promising detail.
Eur	May CPI %yr, adv	0.7%	0.7%	0.6%	Inflation momentum key to the policy outlook.
UK	May Nationwide house prices	1.2%	0.6%	–	Tentative date.
US	May factory orders	0.9%	0.5%	0.5%	Momentum currently lacking in investment partials.
Wed 4					
NZ	GlobalDairyTrade auction	-1.80%	–	–	Signs of stabilisation in recent auctions.
	Q1 building work put in place	-1.00%	–	5.00%	Dwelling consents have surged, especially in Canterbury.
	May commodity prices	-4.00%	–	–	Another fall likely, reflecting weaker dairy prices.
Aus	Q1 GDP	0.8%	0.9%	0.9%	Exports surge, burst consumer spending key positives.
	RBA Head of Fin. Stability Ellis speaking	–	–	–	Topic TBA, Adelaide, 6.00pm AEST.
Eur	Markit services PMI, final	53.5	53.5	53.5	Growth still apparent, but momentum questionable.
	GDP, second estimate	0.2%	0.2%	0.2%	Surprised to the downside in initial estimate.
US	May ADP private payrolls	220k	218k	120k	Not terribly useful as a partial for nonfarm payrolls.
	May ISM non-manufacturing	55.2	55.5	55.4	Modest further improvement likely in month.
	June Fed Beige book	–	–	–	Qualitative guide on conditions across the Fed regions.
Can	Bank of Canada policy meeting	1.00%	1.00%	1.00%	On hold.
Thu 5					
Aus	Apr trade balance, AUDmn	731	510	–300	To slide back into deficit, commodity prices down, import vols up.
Chn	May HSBC services PMI	51.4	–	–	Chinese surveys have taken a turn for the better in May thus far.
	May HSBC composite PMI	49.7	–	–	'New biz from China' fell heavily in April. That should rebound in May.
Eur	ECB policy meeting	0.25%	0.10%	0.00%	Negative deposit rate and initial steps towards full alternative easing.
UK	BOE policy meeting	0.5%	0.5%	0.5%	Comfortably on hold for foreseeable future.
US	Initial jobless claims	300k	315k	310k	Currently near lower bound of recent (volatile) range.
Fri 6					
US	May nonfarm payrolls	288k	218k	110k	Apr boosted by holiday effect; May to be much softer as a consequence.
	May unemployment rate	6.3%	6.4%	6.4%	Participation a key concern for labour market.
	Apr consumer credit, $bn	17.5	16.5	–	Continues to be driven by student loans.
Sun 8					
Chn	May trade balance USDbn	18.5	–	–	Export & imports both subdued, expect a similar bounce in growth rates.

New Zealand forecasts

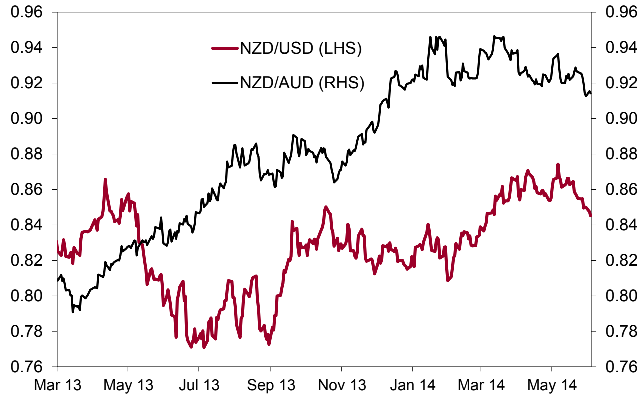
Economic Growth Forecasts	March years				Calendar years			
% change	**2013**	**2014e**	**2015f**	**2016f**	**2012**	**2013**	**2014f**	**2015f**
GDP (Production) ann avg	2.3	3.1	3.9	3.1	2.6	2.7	3.9	3.3
Employment	0.4	3.8	2.5	2.0	0.4	2.9	2.9	2.4
Unemployment Rate % s.a.	6.2	6.0	5.3	4.9	6.8	6.0	5.5	4.9
CPI	0.9	1.5	1.9	2.6	0.9	1.6	1.7	2.6
Current Account Balance % of GDP	-3.9	-2.9	-4.1	-4.5	-4.1	-3.4	-3.2	-4.7

Financial Forecasts	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
Cash	3.25	3.50	3.75	3.75	4.00	4.25
90 Day bill	3.40	3.70	3.90	4.00	4.20	4.45
2 Year Swap	4.10	4.30	4.50	4.70	4.90	5.00
5 Year Swap	4.60	4.80	5.00	5.10	5.20	5.25
10 Year Bond	4.50	4.70	4.90	5.00	5.05	5.10
NZD/USD	0.86	0.86	0.85	0.84	0.84	0.84
NZD/AUD	0.93	0.94	0.94	0.93	0.91	0.90
NZD/JPY	86.9	85.5	85.0	84.8	85.7	86.5
NZD/EUR	0.62	0.63	0.63	0.63	0.62	0.62
NZD/GBP	0.50	0.50	0.50	0.48	0.46	0.45
TWI	79.9	79.9	79.9	78.9	78.3	78.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 3 June 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.00%	3.00%	3.00%
30 Days	3.31%	3.26%	3.18%
60 Days	3.39%	3.33%	3.25%
90 Days	3.42%	3.39%	3.32%
2 Year Swap	3.94%	3.98%	4.00%
5 Year Swap	4.37%	4.41%	4.52%

NZ foreign currency mid-rates as at Tuesday 3 June 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8452	0.8636	0.8679
NZD/EUR	0.6216	0.6307	0.6251
NZD/GBP	0.5047	0.5136	0.5141
NZD/JPY	86.54	87.70	88.68
NZD/AUD	0.9142	0.9214	0.9339
TWI	79.04	80.25	80.60

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2010	2011	2012	2013	2014f	2015f
Australia						
Real GDP % yr	2.2	2.6	3.6	2.4	3.0	3.0
CPI inflation % annual	2.8	3.0	2.2	2.7	2.5	2.6
Unemployment %	5.2	5.2	5.3	5.8	6.2	5.9
Current Account % GDP	-3.5	-2.8	-4.1	-2.9	-2.5	-1.2
United States						
Real GDP %yr	2.5	1.8	2.8	1.9	1.8	2.5
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.6	1.6
Unemployment Rate %	9.6	8.9	8.1	7.4	6.5	5.9
Current Account %GDP	-3.0	-2.9	-2.7	-2.3	-2.7	-2.6
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.5	1.3	1.3
Euroland						
Real GDP %yr	2.0	1.6	-0.7	-0.4	0.9	1.0
United Kingdom						
Real GDP %yr	1.7	1.1	0.3	1.8	2.6	2.1
China						
Real GDP %yr	10.4	9.3	7.7	7.7	7.2	7.6
East Asia ex China						
Real GDP %yr	7.8	4.4	4.0	4.0	4.2	5.0
World						
Real GDP %yr	5.2	3.9	3.2	3.0	3.1	3.7
Forecasts finalised 9 May 2014						

Interest Rate Forecasts	Latest	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Australia						
Cash	2.50	2.50	2.50	2.50	2.50	2.50
90 Day Bill	2.72	2.60	2.55	2.55	2.55	2.65
10 Year Bond	3.67	3.90	4.00	4.10	4.30	4.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.47	2.60	2.70	2.80	3.00	3.20
ECB Repo Rate	0.25	0.25	0.25	0.25	0.25	0.25

Exchange Rate Forecasts	Latest	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
AUD/USD	0.9330	0.92	0.91	0.90	0.90	0.92
USD/JPY	101.60	101	100	100	101	102
EUR/USD	1.3600	1.38	1.36	1.34	1.34	1.35
AUD/NZD	1.0960	1.06	1.06	1.06	1.07	1.10

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

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