



Castle Hill, Canterbury.

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Yin and yang

Rarely do all parts of the NZ economy move perfectly in synch. A much more common occurrence is that some sectors perform strongly while others confront much more challenging times. Such is the case now.

Our view is that recent positive and negative developments largely offset each other from the Reserve Bank's point of view. By contrast, financial markets appear to have concentrated only on the negative developments. So when the RBNZ issues its *Monetary Policy Statement* later this week, markets might be surprised by the Reserve Bank's more balanced take on the economy. Nevertheless, the OCR will remain on hold and we suspect that the RBNZ will rule out an October hike to boot.

The tide has well and truly turned for New Zealand's largest export sector, dairy. Last week saw yet another disappointing GlobalDairyTrade auction. Prices fell 6% on a trade weighted basis, with Whole Milk Powder prices more than reversing the small increase of the previous auction. Skim Milk Powder prices have come under particular pressure in recent auctions, likely reflecting a combination of strong northern hemisphere milk production and of Russia's yearlong ban on exports from a number of countries. And with the all-important Chinese consumer remaining downbeat in the latest Westpac-MNI Chinese consumer sentiment survey, the clouds hanging over the dairy sector show few signs of departing any time soon. Our \$5.80 KgMs payout forecast once again looks too optimistic. We'll look to revise it down following the next GlobalDairyTrade auction.

Eventually falling dairy prices will be the catalyst for pushing NZs terms of trade down from its current four decade high. But surprisingly, last week's data showed that the terms of trade did eke out another small increase in the June quarter, as import prices fell by more than export prices. Beneath this headline, there were hints of what is to come. Dairy and forestry prices both fell in the quarter. And as we noted above, dairy prices have continued to tumble in recent months which will be reflected in forthcoming terms of trade data.

But while the external sector has certainly weakened, core components of NZs domestic economy remain robust. Last week's building activity data showed a 1%

Yin and yang continued

increase in building work in the June quarter. While this might not appear particularly impressive at first glance, it follows a 15% jump in the March quarter and leaves the nationwide level of building activity 17% higher than a year ago.

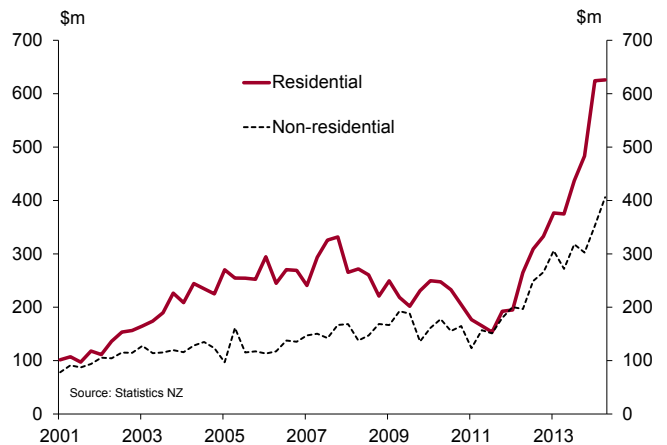
Unsurprisingly Canterbury remains a central hub of building activity. And with the fourth anniversary of the first Canterbury earthquake having just passed, it is useful to take stock of how the rebuild is progressing. Consented residential construction activity in the region has increased 67% over the last year, and is up 314% over the last 3 years. And as the rebuild continues to progress, the nature of the work required is gradually changing. In particular, there has been a marked acceleration of non-residential building work in the region. In fact, the level of both non-residential and residential building activity is already more than double the peak of the last building boom. Of course this doesn't mean the massive rebuild task is anywhere near completion. On our tally the rebuild is only a quarter of the way through, meaning that even four years after the initial quake, the vast majority of repair and rebuilding work is yet to be done.

As well as providing an update on activity in the construction sector, the quarterly building work put in place survey was an important input into GDP calculations. Both this data and the wholesale trade survey (which showed a 1.8% increase in sales) were broadly in line with expectations. Consequently our pick for June quarter GDP remains at 0.7%, which is a slight slowdown from the 1% quarterly pace of growth in March. Still, we expect annual GDP growth will remain a respectable 3.9%.

Turning to the Reserve Bank's upcoming *Monetary Policy Statement*, the mixed nature of recent developments will be the theme. GDP growth, inflation, export prices and house prices have all turned out weaker than the Reserve Bank forecast in its last missive, the June Monetary Policy Statement. But in contrast, net immigration has snowballed unexpectedly, fixed mortgage rates are falling, and the exchange rate has dropped. It is not entirely clear which of these developments dominates so far as the medium-term inflation outlook is concerned.

The RBNZ's press release is likely to repeat the July comment that it "is prudent that there now be a period of assessment...".

Value of building work in Canterbury



effectively ruling out an October hike and casting doubt on the likelihood of a move in December. The statement will probably also reiterate the Bank's broad intention to continue to increase the OCR over the next few years. The RBNZ may downgrade its forecast of 90-day interest rates compared to past forecasts, but only slightly.

We suspect that the RBNZ's take on the outlook for interest rates will be quite different to current financial market pricing, which suggests only one OCR hike between now and next June. But despite this underlying difference of opinion, now is not the time for the RBNZ to push the point. A general election is scheduled for just nine days after the MPS, and the outcome could render economic forecasts obsolete. We suspect that the RBNZ will take a softly-softly approach, and therefore any market reaction to the MPS will be muted. A relatively small increase in swap rates is the most likely response on the day.

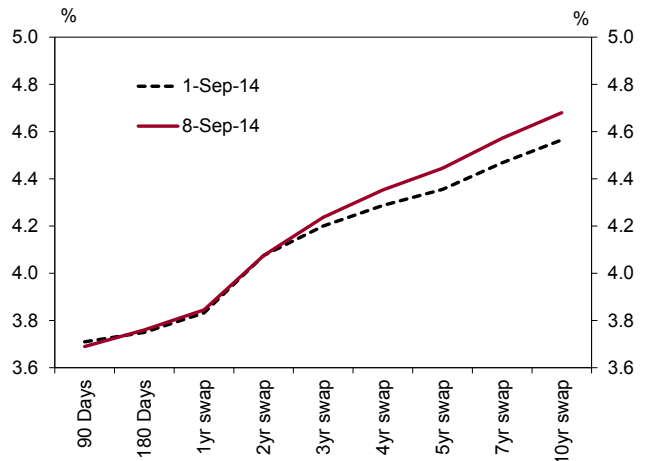
Whatever the tone of the RBNZ's statement, it will remain our view that markets are under-pricing the true risk of OCR hikes. This provides an opportunity for borrowers to fix their interest rates.

Fixed vs Floating for mortgages

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.

Among the standard fixed rates, the best deals for borrowers with a deposit of 20% or more are clustered around the two-year term, and these offer substantial value relative to where we expect shorter-term rates to go over the next two years. There is little point in fixing for just one year, given that these rates are higher than the two-year rate in most cases. Opting for three- or four-year terms would require higher payments up front, but could help to insulate the borrower if the Reserve Bank follows through with an extensive OCR hiking cycle.

NZ interest rates

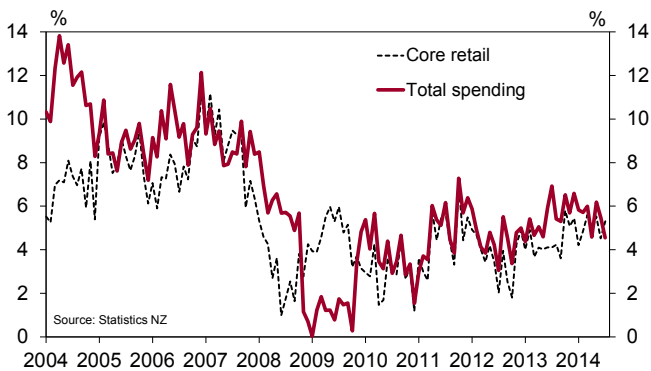


NZ Aug electronic card transactions

Sep 9, last -0.1%, Westpac f/c: 0.3%, Market f/c: 0.6%

- The uptrend in card spending appears to have slowed this year, in accordance with the cooling in the housing market. Total spending fell slightly in July, though the less volatile 'core retail' component rose by 0.5%.
- We see a below-trend outturn as more likely in August. A surprising moderation in food prices in July and a short-lived drop in petrol prices in August are likely to have restrained the nominal value of spending over the month.

Card transactions, annual % change

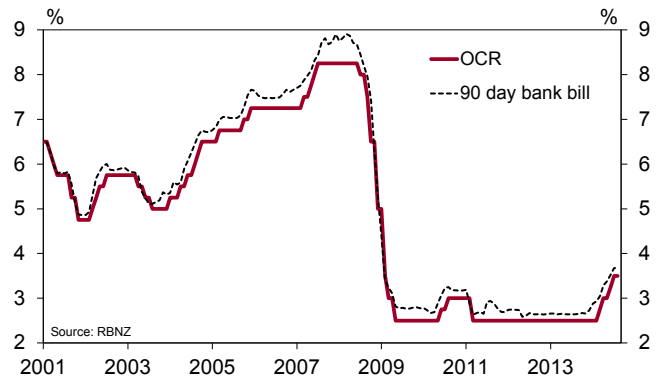


RBNZ Monetary Policy Statement

Sep 11, Last: 3.5%, Westpac f/c: 3.5%, Market f/c: 3.5%

- In July, the RBNZ said that after four consecutive OCR hikes a "period of assessment" was appropriate. That message will no doubt be repeated in the September MPS, indicating that hikes are unlikely to resume before year-end.
- Recent economic developments have been softer on balance, and will prompt a slight downgrade to the RBNZ's interest rate projections - but not nearly as far as what markets are now pricing in. The intention to return the OCR to neutral levels over the next few years remains intact.
- However, we think the RBNZ will opt for a low profile in its communications. Given the uncertain environment and the looming election, now is not the time to put a stake in the ground. We expect market interest rates to rise only a little on the day.

NZ OCR and 90 day rate

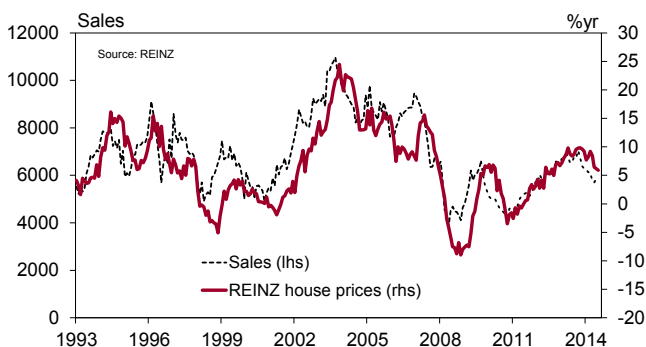


NZ Aug REINZ house prices and sales

Sep 12 (tbc), Sales last: 0.5%, Prices last: 5.9%yr

- House sales ticked up slightly in June and July, breaking a nine-month run of declines since last October, when the RBNZ's cap on low-equity mortgage lending came into effect.
- Partial data has suggested a quite subdued August for the housing market. Nervousness ahead of this month's general election has been cited as a factor, and seems plausible this time given that the opposition are campaigning on a tougher tax treatment for investment properties.
- Both we and the RBNZ are expecting the housing market to regain some momentum over the rest of this year, with net immigration hitting new highs, and some fixed-term mortgage rates actually lower since the first OCR hike.

REINZ house prices and sales

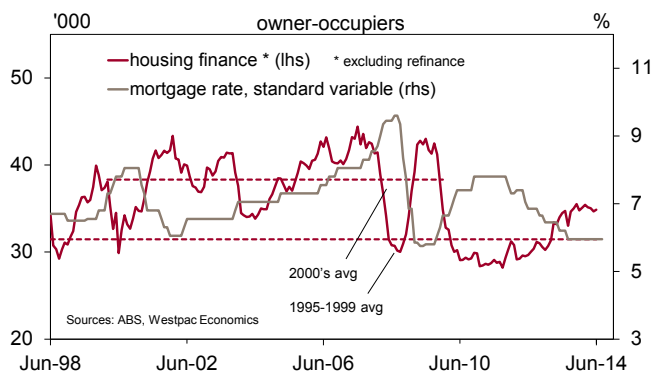


Aus Jul housing finance (no.)

Sep 9, Last: 0.2%, WBC f/c: 1.0%
Mkt f/c: 1.0%, Range: -0.5% to 1.5%

- The number of housing finance approvals dipped 0.2% in June, taking annual growth to just 2.4%, down from a peak of 14.9%yr in November. That said, the detail would have been viewed as reasonably favourable by the RBA, with signs of a cooling off in the value of new lending to investors (not included in the total number of approvals which covers owner-occupier loans only), but continued strength in construction-related approvals.
- Industry data suggests the number of owner-occupier finance approvals posted a modest gain in July. We expect a 1% gain which would hold annual growth at just over 2%. Cooling consumer sentiment towards house purchase and renewed job loss fears continue to point to modest declines in the second half of 2014.

Owner-occupier finance & the rate cycle

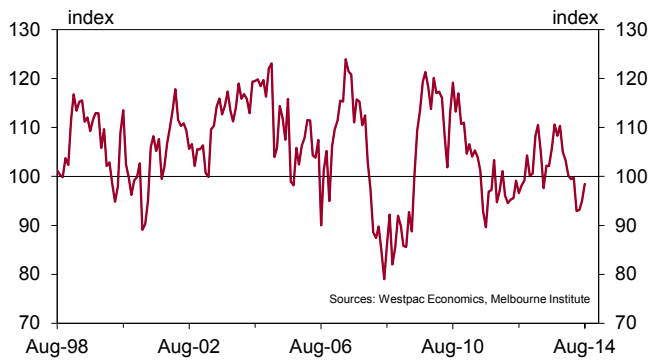


Aus Sep Westpac-MI Consumer Sentiment

Sep 10 Last: 98.5

- The Westpac-Melbourne Institute Consumer Sentiment Index increased 3.8% in August, from 94.9 in July to 98.5, leaving it a touch below the neutral 100 level. The Index has now recovered nearly all of the 6.8% post-Budget drop in May. Moreover, the August monthly gain was sustained despite a surprise jump in the unemployment rate to 6.4% reported during the survey week.
- The September survey was in the field in the week to September 5. Factors that may influence sentiment this month include: the RBA's decision to again leave rates on hold maintaining its 'extended period of stability' guidance; mixed economic data with modest, though positive, GDP growth in Q2, and retail sales posting a similarly positive, though modest, gain. Financial markets may be a positive, with the ASX up 3.6% since the Aug survey. Housing markets have also caught a second wind, with solid price gains reported for August.

Consumer Sentiment Index

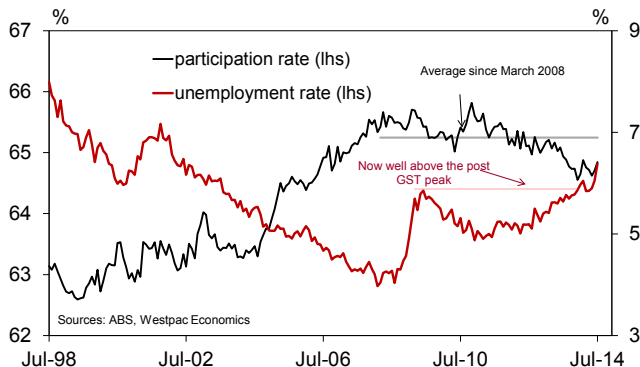


Aus Aug Labour Force Survey - unemployment

Sep 11, Last: 6.4%, WBC f/c: 6.3%
Mkt f/c: 6.3%, Range: 6.0% to 6.4%

- The real surprise in July was the surge in the unemployment rate to 6.4% (6.38%) from 6.0% (6.05%), exceeding Westpac's market high call of 6.1%. The market was expecting a flat print at 6.0% (range 5.8% to 6.1%).
- Why was the rise in unemployment so large? Employment growth below the 14k expected is worth 0.1ppt; the lift in the participation rate (from 64.7% to 64.8%) is worth about 0.2ppts; then rounding gets us to 6.4%. There were changes to the definitions of 'actively looking for work' which may have lifted participation. If this is true, then the lift is structural and we should not be looking for a correction in August.
- Holding participation flat at 64.8% and allowing for a trend rise in working age population will result in a fall in the unemployment rate to 6.3%.

Unemployment and participation rates

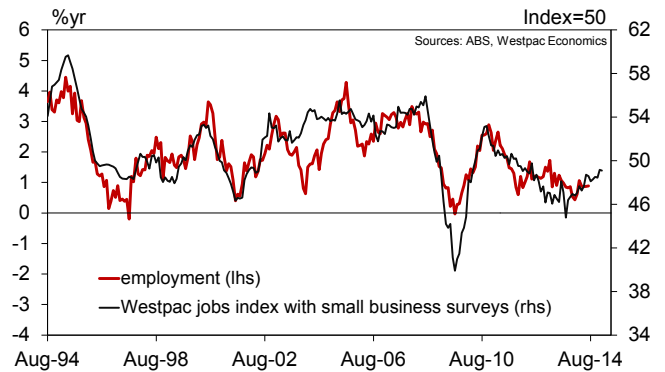


Aus Aug Labour Force Survey - total employment

Sep 11, Last: -0.3k, WBC f/c: 15k
Mkt f/c: 15k, Range: -5k to 35k

- Total employment was flat in July (-0.3k), well below market expectations for a 13.9k rise, but very close to Westpac's +5k forecast. There were only minor revisions to the June data.
- Full-time employment rose 14.5k, offset by a 14.8k fall in part-time employment. Full-time employment is now up 61.0k in the year (0.8%yr) compared to a 40.6k rise in part-time employment (1.2%yr). Only a month earlier, part-time employment was up 57k in the year (1.6%yr) compared to a 43.5k rise in full-time employment (0.5%yr).
- The employment indicators from the various business surveys continued to improve, pointing to a modest lift in the pace of employment growth. Our +15k forecast lifts the annual rate of employment growth to 1.1%yr.

Westpac's jobs index continues to improve

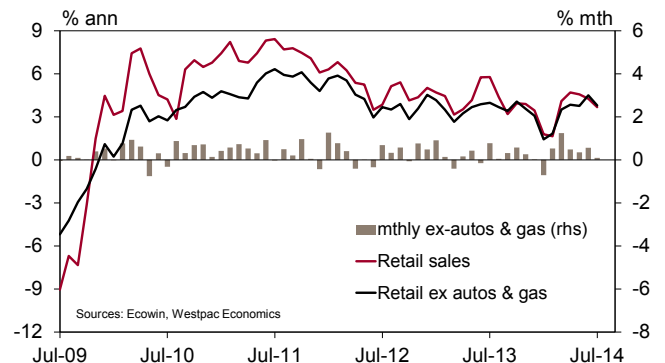


US Aug retail sales

Sep 12, Last: 0.0%, WBC f/c: 0.7%

- Retail sales were flat in July, reflecting a broad-based pause across most storetypes after a relatively buoyant second quarter. Auto sales fell 0.2% and four other storetypes recorded losses, though only one was greater than -0.1%. Of the 8 gainers (including gasoline up 0.1%), only one rose by more than 0.4%. Core retail ex autos/gas rose just 0.1%.
- This broad-based retail weakness at the start of Q3 could just be a pause that gets revised away; the last five reports have all seen the previous month's core retail figure revised higher; also consumer sentiment improved during August. Or, it may be that sluggish earnings and slower jobs growth, less catch-up spend from winter disruption, and the recent savings uptrend mean core retail momentum slows from 0.5% per mth in Q2.
- Auto sales jumped 6% in Aug, but sharply lower gasoline prices will have weighed on sales. We expect core retail rose 0.3%, and total sales by 0.7%.

US retail sales



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 8					
NZ	Q2 manufacturing sales	0.5%	–	–	The last major indicator for Q2 GDP later this month.
Aus	Aug ANZ job ads %mth	0.3%	–	–	The annual pace is now solidly positive at 4.2%yr.
Chn	Aug trade balance USDbn	47.3	40.6	–	'Perfect storm' surplus in July to partially unwind. Exports should slow.
Eur	Sep Sentix investor confidence	2.7	2.0	4.5	Equity rally through Aug and ECB QE prospects to offset geopolitics.
Ger	Q2 labour costs	1.1%	–	–	Has reversed much of the 2010-13 increase to 4+% over the past year.
	Jul exports	0.9%	0.6%	–	Exports growth at risk given falling foreign orders.
US	Jul consumer credit \$bn	\$17.3	\$17.2	–	Student and auto loans still the big drivers.
Can	July building permits	13.5%	–	–	Non-residential approvals behind June jump in permits.
Tue 9					
Aus	Aug NAB business survey	8	–	–	Conditions up 6pts to +8 in July, a 4yr high. A slight pull-back in Aug?
	Jul housing finance	0.2%	1.0%	1.0%	Housing market has caught a second wind in recent months.
UK	Aug BRC retail survey %yr	–0.3%	–	–	Sales values for same store sales lower than last year in June-July.
	Jul trade balance £bn	–9.4	–9.0	–	Exports down 1.6% but imports about flat in June.
	Jul industrial production	0.3%	0.3%	0.2%	PMI lower in Jul; European orders falling due geopolitics, stronger £.
US	Aug NFIB small business optimism	95.7	95.9	97.0	Mixed regional surveys, national ISM surveys very strong.
	Jul JOLTS	4671k	–	–	Job openings.
Can	Aug housing starts	0.7%	–	–	Housing construction back in upswing.
Wed 10					
Aus	Sep Westpac–MI Consumer Sentiment	98.5	–	–	Solid lift in Aug taking Index back near pre-Budget levels.
	Sep Westpac–MI unemploy. expect.	–3.0%	–	–	Have been falling for five months straight and looking for a sixth.
US	Jul wholesale inventories	0.3%	0.5%	–	Inventories accounted for third of Q2 GDP growth.
Can	Q2 capacity utilisation %	82.5%	–	–	Upswing in CapU since 2009 stalled last year but underway again.
Thu 11					
NZ	RBNZ Monetary Policy Statement	3.5%	3.5%	3.5%	Modest downgrade to projected interest rate hikes.
Aus	Aug labour force survey total employ.	–0.3k	15k	15k	Leading indicator pointing to modest gains in employment lifting pace to above 1%yr. This will be enough to result in a modest fall in unemployment.
	Aug labour force survey unemploy	6.4%	6.3%	6.3%	
	Sep MI consumer inflation expectations	3.1%	–	–	Inflationary expectations peaked in May at 4.4%yr.
Chn	Aug PPI %yr	–0.9%	–1.1%	–	Over-stocking force has lessened, but raw materials weakening anew.
	Aug CPI %yr	2.3%	2.2%	–	Shelter component losing altitude, weighing down non-food prices.
UK	Aug RICS house price balance	49%	47%	–	Prices softening on some indices; London market included.
US	Initial jobless claims w/e 769	302k	–	297k	Trending at post recession low.
	Aug monthly budget statement, \$bn	–135	–	–	Almost a year since budget statement led to government shutdown!
Can	Jul new house prices	0.2%	–	–	Running steady at 1.5%yr pace in recent months.
Fri 12					
NZ	Aug manufacturing PMI	53.0	–	–	Still positive but markedly softer in the last three months.
	Aug food price index	–0.7%	–	0.7%	Surprisingly soft across the board in July.
	Aug REINZ house sales	0.5%	–	–	Due by this date. Sales have stabilised in the last two months.
	Aug REINZ house price index %yr	5.9%	–	–	Prices still drifting higher but at a slower pace than last year.
Eur	Jul industrial production	–0.3%	0.4%	–1.0%	PMI flat in Jul but trending lower; Jun orders plunged across Europe.
UK	Jul construction output, %yr	1.2%	–	–	Construction sector still solid, up 5.3%yr in June.
US	Aug import prices	–0.2%	–0.9%	–1.5%	Oil prices down \$5 in Aug, USD appreciated nearly 2% in Aug vs Jul.
	Aug retail sales	0.0%	0.4%	0.7%	Gasoline prices down; autos sales up sharply.
	Aug retail sales ex autos and gas	0.1%	–	0.3%	Sentiment upswing through month may not translate to retail upswing.
	Jul business inventories	0.4%	0.5%	–	Inventories accounted for third of Q2 GDP growth.
	Sep Uni of Mich. consumer confidence	82.5	83.0	85.0	Equity market surge boost to final Aug UoM, should also lift prelim Sep.
Can	Aug house prices	1.1%	–	–	Teranet measure; prices up 4.9%yr in Jul.
Sat 13					
Chn	Aug fixed assets ex rural ytd %yr	17.0%	16.9%	–	One cyclical (housing) and one structural weak spot (heavy industry).
	Aug retail sales %yr	12.2%	12.1%	–	Consumer sentiment remains fragile, finances and jobs weighing.
	Aug industrial production %yr	9.0%	8.8%	–	August PMIs have given back earlier gains, exports only wild card.
Tentative					
Chn	Aug new bank loans RMBbn	385	700	–	"Other short term" loans were the discontinuity in July. Should bounce.
	Aug total credit RMBbn	273	1155	–	Weakness of July looks like an aberration, needs to lift to prove that.
	Aug M2 supply %yr	13.5%	13.4%	–	Non-trade capital inflows have been patchy of late, moderating M2.

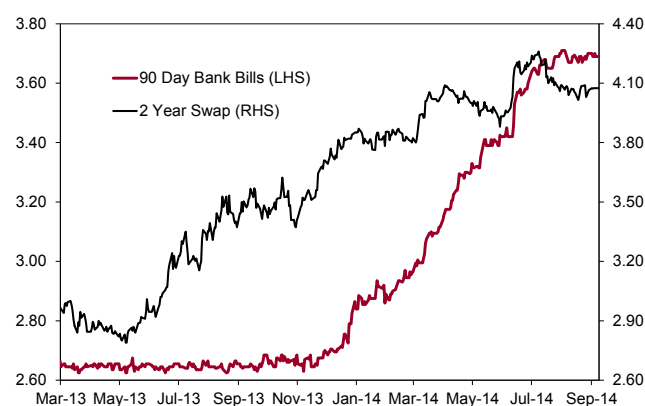


New Zealand forecasts

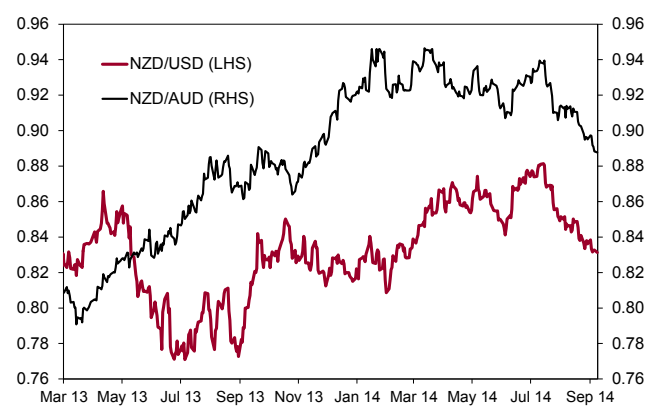
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2012	2013	2014f	2015f
% change								
GDP (Production) ann avg	2.3	3.3	3.4	3.2	2.5	2.9	3.6	3.2
Employment	0.4	3.8	2.8	2.6	0.4	2.9	3.0	2.9
Unemployment Rate % s.a.	6.2	5.9	5.3	4.7	6.8	6.0	5.4	4.7
CPI	0.9	1.5	1.8	2.1	0.9	1.6	1.6	2.0
Current Account Balance % of GDP	-3.9	-2.8	-4.5	-4.6	-4.1	-3.4	-3.5	-4.9

Financial Forecasts	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Cash	3.50	3.50	4.00	4.25	4.50	4.50
90 Day bill	3.70	3.90	4.20	4.45	4.65	4.70
2 Year Swap	4.20	4.40	4.60	4.80	4.90	5.00
5 Year Swap	4.60	4.80	5.00	5.10	5.20	5.30
10 Year Bond	4.40	4.60	4.80	4.90	5.00	5.05
NZD/USD	0.83	0.83	0.84	0.84	0.84	0.84
NZD/AUD	0.89	0.92	0.93	0.91	0.90	0.89
NZD/JPY	87.2	85.5	87.4	88.2	89.0	89.9
NZD/EUR	0.64	0.65	0.66	0.66	0.66	0.65
NZD/GBP	0.51	0.53	0.52	0.50	0.49	0.47
TWI	78.9	79.8	80.8	80.1	79.9	79.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 8 September 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.66%	3.64%	3.65%
60 Days	3.67%	3.67%	3.67%
90 Days	3.69%	3.67%	3.67%
2 Year Swap	4.08%	4.09%	4.06%
5 Year Swap	4.45%	4.42%	4.42%

NZ foreign currency mid-rates as at Monday 8 September 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8313	0.8398	0.8463
NZD/EUR	0.6415	0.6364	0.6313
NZD/GBP	0.5136	0.5075	0.5045
NZD/JPY	87.30	87.56	86.50
NZD/AUD	0.8877	0.9021	0.9123
TWI	78.95	79.30	79.35

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2010	2011	2012	2013	2014f	2015f
Australia						
Real GDP % yr	2.3	2.6	3.6	2.3	3.2	3.2
CPI inflation % annual	2.8	3.0	2.2	2.7	2.3	2.8
Unemployment %	5.2	5.2	5.3	5.8	6.4	6.1
Current Account % GDP	-3.5	-2.8	-4.4	-3.3	-3.0	-2.0
United States						
Real GDP %yr	2.5	1.8	2.3	2.2	2.0	2.5
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.9	1.9
Unemployment Rate %	9.6	8.9	8.1	7.4	6.3	5.7
Current Account %GDP	-3.0	-2.9	-2.9	-2.4	-2.5	-2.4
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.6	1.6	1.4
Euroland						
Real GDP %yr	1.9	1.6	-0.6	-0.4	0.7	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	7.4	7.5
East Asia ex China						
Real GDP %yr	7.8	4.4	4.0	4.0	3.9	5.0
World						
Real GDP %yr	5.2	3.9	3.2	3.0	3.1	3.7
Forecasts finalised 5 September 2014						

Interest Rate Forecasts	Latest	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
Australia						
Cash	2.50	2.50	2.50	2.50	2.75	2.75
90 Day Bill	2.65	2.55	2.55	2.65	3.00	3.00
10 Year Bond	3.49	3.60	3.80	4.20	4.50	4.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.250	0.250
US 10 Year Bond	2.46	2.70	2.70	2.80	3.20	3.20
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.15

Exchange Rate Forecasts	Latest	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
AUD/USD	0.9337	0.90	0.90	0.92	0.93	0.93
USD/JPY	105.29	103	104	105	106	103
EUR/USD	1.2929	1.27	1.27	1.28	1.28	1.33
AUD/NZD	1.1249	1.08	1.07	1.10	1.11	1.11

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Disclaimer continued

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