



Mt. Taranaki, Mt. Egmont National Park.

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Swings and roundabouts

Last week's soft dairy auction result, and a monster March quarter for the construction industry, add to the pluses and minuses that RBNZ Governor Wheeler will be considering as he approaches Thursday's *Monetary Policy Statement*. On balance we continue to think that expectations for a significant downgrade in the RBNZ's interest rate forecasts will be disappointed.

Last week we noted that our forecast for a NZ\$7.10 milk price next season 'depends on international dairy prices stabilising at around current levels'. Accordingly, the latest Fonterra dairy auction clearly places that forecast under a cloud. Not only did the headline trade-weighted index drop another 4.2%, but prices for whole milk powder – the space where NZ suppliers dominate – were down a full 8.5% on a fortnight ago. Even with the usual caveats, a 2014/15 payout with a 6-handle on it is now looking a bit more likely.

The casual observer could be forgiven for thinking that the auction result simply adds to the case for the RBNZ to tone down its hawkish rhetoric in Thursday's *Monetary Policy Statement*. But as we emphasised last week, things aren't so simple.

In reality, New Zealand's data flow over the past month or so has been extremely mixed. Even within New Zealand's export commodity complex, dairy has only been part of the story: lamb and beef prices have actually strengthened, such that the overall commodity price index for May was only down 3.1% on a year earlier (versus 15% for dairy).

Last week also saw the release of some shockingly strong construction data for the March quarter, which at the very least puts paid to fears that the Canterbury rebuild may have come off the boil, and on its own suggests our forecast of 1.1% GDP growth may have been too cautious. (The flipside, of course, is that we are likely to get less of a further ramp-up later in the year. We will do a full review of our quarterly GDP forecasts over the coming week once the manufacturing and wholesale trade surveys are available.)

Swings and roundabouts continued

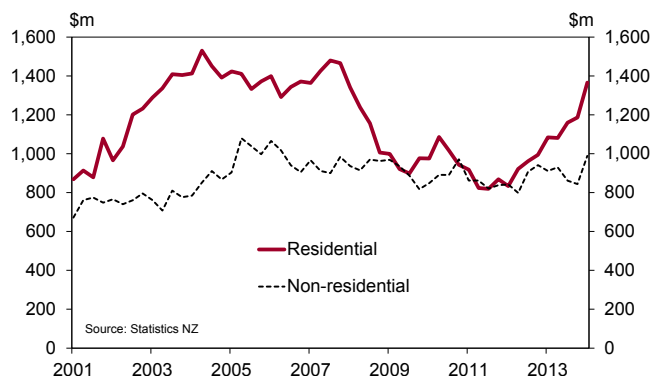
Building activity in New Zealand went through a surprising flat patch over much of 2013, falling behind what the pipeline of consented work would have suggested. We anticipated a period of solid catch-up growth in the March quarter. What we got was a building spree worthy of the characters in the Lego Movie, with consented building activity rising 16%, the biggest quarterly increase since records began (1990 by volume and 1981 by value).

As such, the level of activity is now only about 5% below its mid-2000s peaks, and on track to exceed those levels at some point in the current cycle. Unsurprisingly, Canterbury and the wider Auckland region continued to be the star performers, with the former seeing a 25% lift in the quarter (31% for residential and 16% for non-residential). The regional breakdown is only available by value, and there's no doubt that a fraction of Canterbury's 'outperformance' of the past few years is simply due to the steep rise in building costs in the region. But the numbers are large enough to confirm that the post-quake rebuild is now generating a significant amount of activity, while the value of residential building in Auckland now exceeds last decade's highs (though again, probably not in inflation-adjusted terms).

Last week's dairy auction and building data are unlikely to have made it within the cut-off point for the RBNZ's formal forecast update for the June MPS. But they add to the sense that the Reserve Bank will be weighing up a very mixed bag of surprises, with some information – the recent drop in the exchange rate and retail mortgage rates, a surprisingly generous May Budget, and very strong migration – strengthening the case for OCR hikes as well as weakening it.

On balance we continue to expect at most a modest downgrade to the RBNZ's signalled path of future interest rates. We regard the recent drop in mortgage rates – the average 2-year rate has fallen 34 basis points in two months – as particularly significant. Along with the uplift in migration,

Real building work put in place



it raises the possibility that the housing market could see a second wind, a prospect that the RBNZ would regard as very unwelcome. So even if the balance of developments justifies a slightly less anxious tone about inflation than in the March MPS, and a slightly lower 90-day rate forecast, we expect the Reserve Bank will also want to prod errant financial markets into lifting two or three year swap rates.

That will be a delicate balance. One way to strike it may be by signalling that, from here, the OCR hiking programme will proceed at a pace of 25 basis points a quarter. That would allow the RBNZ to skip the July OCR Review while still leaving no doubt about its intention to hike twice more before the year is out. (We expect those hikes to come in September and December.)

If we are correct, Thursday's *Monetary Policy Statement* could produce quite a reaction on financial markets, with both wholesale interest rates and the exchange rate rising.

Fixed vs Floating for mortgages

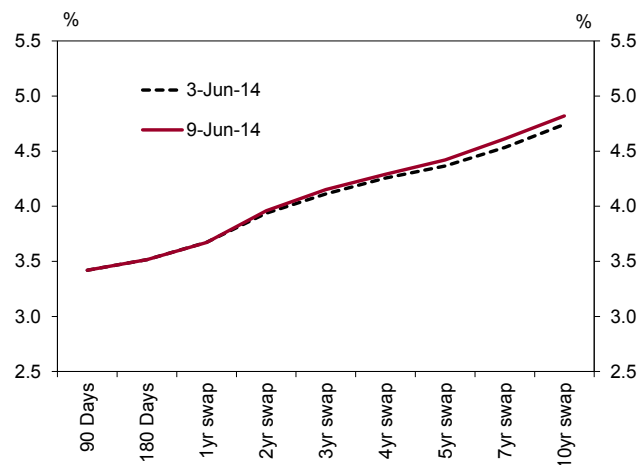
We believe that the current 2-3 year fixed-rate specials offer good value.

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

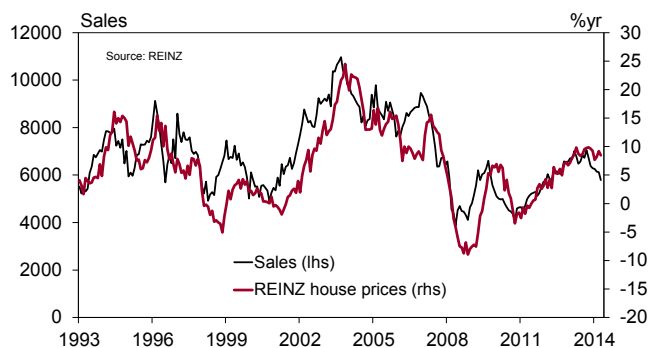


NZ May REINZ house prices and sales

Jun 9-13 (tbd), Sales last: -5.5%, Prices last: 8.5%yr

- House sales fell 5.5% in April, leaving them down 18% since the Reserve Bank's limits on high-LVR mortgage lending came into force last October. The degree of weakness in April may have been overstated by the timing of public holidays this year – something that appears to have affected much of the activity data for April. If so, we should see some rebound in May, within the context of a still-weak trend.
- There are signs that house prices have accelerated again recently, after having slowed to a crawl by the start of this year – much in line with other countries' experiences with LVR limits. That said, we think the 8.5% year-on-year increase in April overstates the case, as the LVR limits have led to a change in the composition of sales compared to a year ago (with fewer low-end properties). We expect annual house price growth to slow to 5.5% by the end of this year.

REINZ house prices and sales

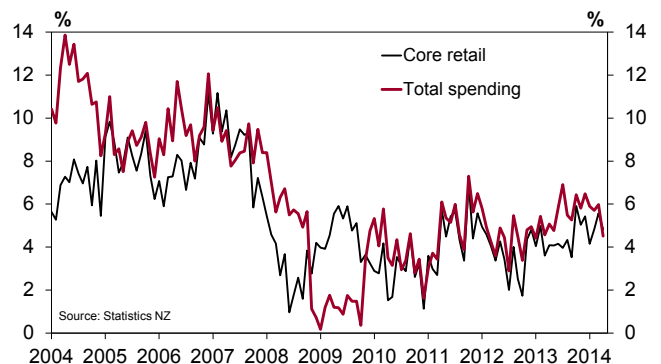


NZ May electronic card transactions

June 11, last -0.4%, WBC f/c: 1.0%

- Electronic card spending fell a second straight month in April, largely due to a decline in the non-retail categories. The annual rate of increase was the slowest since last September.
- A range of New Zealand activity indicators have been on the soft side in April, possibly reflecting an unusually large Easter holiday effect – for the first time since 2003, Easter Monday fell in the same week as Anzac Day. Our forecasts assume a corresponding bounceback in May – within what does appear to be a slowing trend in retail activity, as a slowing housing market and rising interest rates start to bite.
- Advance spending figures from Paymark (New Zealand's biggest card processor) are likely to be published closer to the release, providing additional information.

Card transactions, annual % change

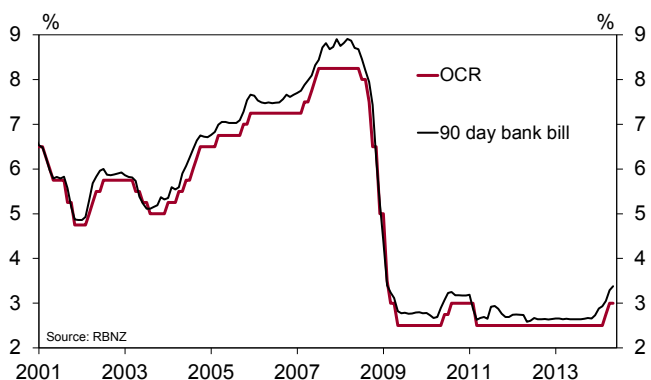


RBNZ Monetary Policy Statement

Jun 12, Last: 3.00%, Westpac f/c: 3.25%, Market f/c: 3.25%

- We expect the RBNZ to lift the OCR by 25bp next week, and to reaffirm its intention to gradually raise rates over the next couple of years.
- Lower dairy prices, a higher exchange rate and lower than expected inflation would suggest a softer tone from the RBNZ compared to its March forecasts. But there have also been some positives in the form of a surge in net migration and a more stimulatory Budget. We expect that on balance the RBNZ will have only marginally lowered its interest rate projections.
- In contrast, markets have substantially downgraded their expectations for OCR hikes – to the point where some mortgage rates are now lower than they were in March. A relatively unmoved RBNZ statement, as we're expecting, would push swap rates and the NZD higher on the day.

NZ OCR and 90 day rate

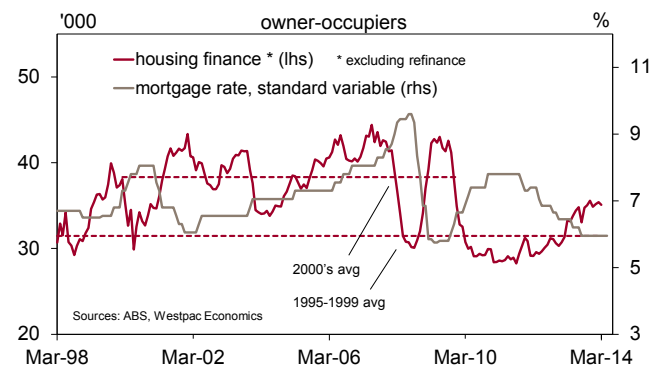


Aus Apr housing finance (no.)

Jun 10, Last: -0.9%, WBC f/c: flat
Mkt f/c: 0.2%, Range: -3.9% to 1.0%

- The number of owner occupier housing finance approvals declined 0.9% in Mar following a 2.3% rise in Feb and a flat Jan. Overall, the broad picture is of approvals flattening out: after trending higher at a 24% annualised pace in Q2 of last year, trend approvals have gradually slowed to be basically flat in Q1 2014. Note that the headline number is for owner-occupier finance approvals only – investor approvals are excluded except in totals for the value of approvals.
- Industry figures suggest approvals continued to stabilise in Apr. We expect owner-occupier finance approvals to be flat for the month. A more significant weakening now looks likely through the middle of the year though following sharp declines in consumer assessments of 'time to buy a dwelling'. Investor activity is harder to predict.

Owner-occupier finance & the rate cycle

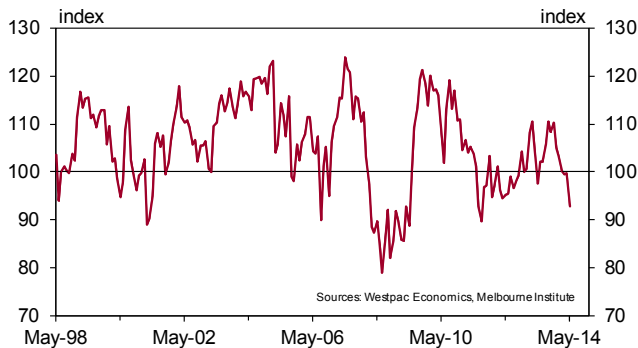


Aus Jun Westpac-MI Consumer Sentiment

Jun 11 Last: 92.9

- The Westpac-Melbourne Institute Consumer Sentiment Index fell heavily in May from around neutral to an outright 'pessimistic' reading of 92.9.
- The May reading was a clear negative reaction to the Budget. As such, the June survey (conducted from June 2 to June 7) will be an important gauge of how much of the decline was an initial over-reaction. The evidence from Budget history is mixed with some clear instances of over-reaction but others showing more prolonged reactions and other periods an apparent indifference. Other influences this month may include: the RBA's decision to again leave rates on hold and its stance unchanged; the strong Q1 GDP, but more mixed partial data and more signs of a housing slowdown.

Consumer Sentiment Index

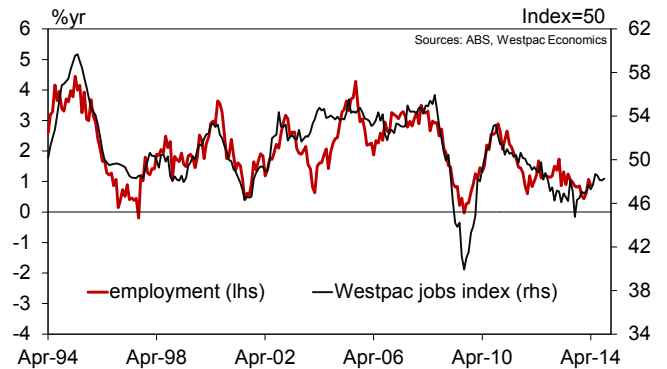


Aus May employment

Jun 12, Last: 14.2k, WBC f/c: 17k
Mkt f/c: 10k, Range: 5k to 25k

- Total employment rose 14.2k in Apr, a modest print but the details were slightly more upbeat with all of the gain coming via full-time jobs. Part-time employment was flat in the month.
- While Apr may have been a sound report card on the labour market, it does not suggest an accelerating market. Total employment grew 101k in year to Apr (0.9%yr) a moderation from the 122k (1.1%yr) in the year to Mar.
- Total employment has grown an average of 28.5k per month in the three months to Apr. The leading indicators are still pointing to employment growth of around 1%yr which only needs around 10k to 15k per month for the next three months to hold above that pace.

Business surveys suggest momentum will continue

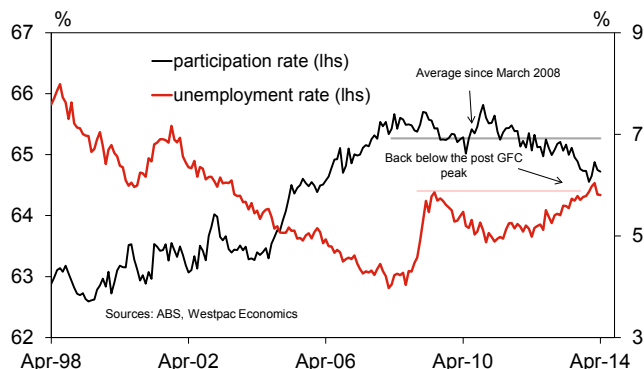


Aus May unemployment rate

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

- Normally, a 14k rise in total employment would not be enough to hold the unemployment rate flat (5.82% in Apr vs. 5.81% in Mar). But the participation rate fell back to 64.7% and thus the labour force grew by just 13.8k.
- An ageing population is driving down the participation rate. But we had suspected that the dip in late 2013 was much more cyclical than structural and thus expected the participation rate to bounce. That it hasn't is something to seriously consider. Were it not of the confusion of the Easter/ANZAC/school holiday effect, the recent data may be suggesting that participation has found a structurally lower trend.
- A small lift in participation, to 64.8% rounded, is enough to leave the unemployment rate flat at 5.8%.

Unemployment and participation rates

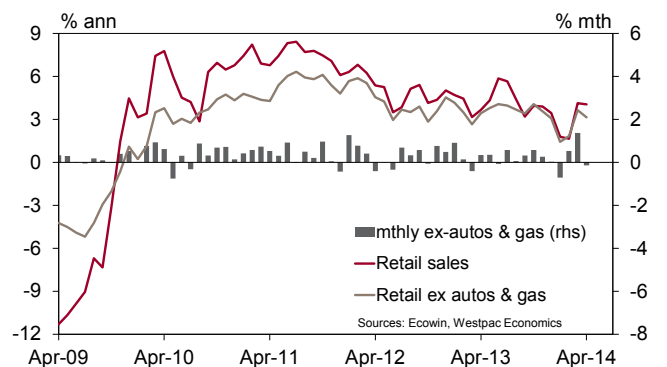


US May retail sales

Jun 12, Last: 0.1%, WBC f/c: 0.2%

- Retail sales recovered from the snow disrupted turn of year slump by posting decent gains in Feb-Mar, and the April report showed sales holding up despite 0.1% slippage in core retailing after a 2% rise over the previous two months.
- We suspect that April's report was boosted by pre-Easter and spring break spending that most years takes place in March (Good Friday was April 18 this year), but this late Easter impact was hard to discern given post-snow bounce-back.
- May retailing will likely be weakened by the post Easter spending slowdown more than in most years, and April's report risks a downward revision when the last week of the month is included, as in May 2011, after that year's late Easter (Good Friday 22/4/11) initially boosted April spending. May 2014 headline will be supported by auto sales, however.

US retail sales



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 9					
NZ	May REINZ house sales	-5.5%	-	-	Due this week. Easter timing may have depressed April sales.
	May REINZ house price index %yr	8.50%	-	-	Prices have surged again in the last three months.
	Q1 wholesale trade	2.70%	-	-	A sectoral input for GDP.
Aus	Queen's Birthday	-	-	-	Public holiday except in WA.
	RBA Governor Stevens speaking	-	-	-	'Financial Regulation: Some Observations', San Francisco, 2.00am AEST.
Eur	Jun Sentix investor confidence	12.8	13.0	14.5	ECB meeting on first day of survey period.
US	Fedspeak	-	-	-	Bullard and Rosegren.
Can	May housing starts	24.4%	-	-	Single family starts up 6.5%, multiples up 35% in April.
Tue 10					
NZ	Q1 manufacturing sales	5.70%	-	-	Another input into Q1 GDP.
Aus	May NAB business survey	0.0	-	-	In April: conditions index -0.4ppts to 0.0 & confidence +1.5ppts to +6.
	Apr housing finance	-0.9%	0.2%	flat	Surge in 2013 has clearly topped out in 2014.
	May ANZ job ads %mth	2.2%	-	-	Job ads are now up 1.5%yr highlighting a labour market turnaround.
Chn	May PPI %yr	-2.0%	-1.5%	-	Deflationary impulse in business surveys lessened in May.
	May CPI %yr	1.8%	2.4%	-	Food bouncing back, shelter rolling over, capping non-food prices.
	May new loans RMBbn	775	750	-	Tentative date: potential upside here with stance beginning to shift.
	May aggregate financing RMBbn	1554	1350	-	Tentative date: Bonds up in April, shadow ex trusts 'less weak'.
	May money supply M2 %yr	13.2%	13.1%	-	Tentative date: Corp. depos. likely firmer on better operating conditions.
UK	May BRC retail survey %yr	4.2%	-	-	Same store sales. Post Easter effect to downside?
	Apr industrial production	-0.1%	0.3%	-	Mar manufacturing up 0.5% but oil/gas/mining down sharply.
US	May NFIB small business optimism	95.2	-	95.5	Other surveys stronger in May.
	May wholesale inventories	1.1%	0.6%	0.3%	Inventory accumulation slowing.
Wed 11					
NZ	May electronic card transactions	-0.40%	-	1.0%	Expect post-Easter/Anzac Day bounceback within a slowing trend.
Aus	Jun Westpac-MI Consumer Sentiment	92.9	-	-	Sharp post-Budget fall last month.
	Jun Westpac-MI unemploy. expect.	158.3	-	-	The index is down 3.7% in 3mths taking the annual pace down to 6.2%.
UK	May unemployment ch	-25k	-28.5k	-25k	Unemployment falling rapidly as economy grows at above trend pace.
US	May federal budget \$bn	-	-	-	In better shape than recent years but still a long term concern.
Thu 12					
NZ	RBNZ Monetary Policy Statement	3.00%	3.25%	3.25%	A slightly lower OCR track, but not by as much as the market thinks.
Aus	May employment, ch	14.2k	10k	17k	The leading indicators suggests the momentum can continue, for now.
	May unemployment rate	5.8%	5.9%	5.8%	A small rise in participation is not enough to lift unemployment.
	Jun MI inflation expectations %yr	4.4%	-	-	New symmetric trim produces a higher rate but it is more cyclical.
Eur	Apr industrial production	-0.3%	0.5%	-1.5%	German IP due 6/6.
UK	May house prices, net balance	54%	51%	-	RICS survey.
US	Initial jobless claims w/e 7/6	312k	-	309k	Highly volatile recently.
	May retail sales	0.1%	0.4%	0.2%	Auto sales solid, but post-Easter slump and risk of downward ...
	May retail sales ex gas/autos	-0.1%	-	-0.4%	... revision to hit core retailing. See text box.
	Apr business inventories	0.4%	0.4%	0.3%	Guide to stockbuilding early in Q2.
	May import prices	-0.4%	0.2%	0.1%	Some gain on average in oil prices.
Can	Q1 capacity utilisation	82.0%	-	-	Highest since prior to 2008 recession.
	Apr new house prices	0.2%	-	-	Running 1.6% yr annual pace.
	May house prices %yr	4.9%	-	-	Teranet National Bank index
	BoC financial system review	-	-	-	Twice yearly check up.
Fri 13					
NZ	May manufacturing PMI	55.2	-	-	Christchurch rebuild more than offsetting weak export markets.
	May food price index	0.60%	-	0.20%	Annual food price inflation is starting to tick higher again.
Chn	May fixed investment %ytd	17.3%	17.1%	-	Utilities to pick up, but other major sub-cycles softening.
	May retail sales %yr	11.9%	12.2%	-	Consensus implies a volume slowdown, with CPI f/c to rise 0.6ppt.
	May industrial production %yr	8.7%	8.8%	-	Upside risk with surveys bouncing and stock rundown coming to an end.
Eur	Apr trade balance €bn sa	15.2	-	-	Exports and imports both down around 0.5% in Mar.
UK	Apr construction output	-1.0%	-	-	Down two months running in Feb-Mar, that should reverse in Q2.
US	May PPI final demand	0.6%	0.1%	0.0%	Services prices main driver, recent unusually strong gains to unwind
	Jun consumer sentiment	81.9	83.0	80.0	Prelim read from Uni of Michigan. Weekly data suggest downside risk.
Can	Apr manufacturing sales	0.4%	0.8%	-	Mar level highest since 2008

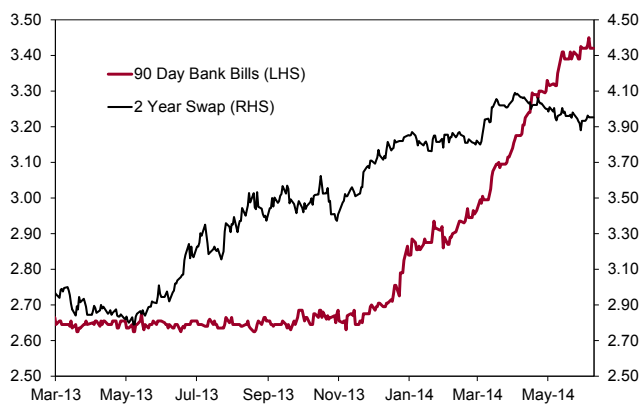


New Zealand forecasts

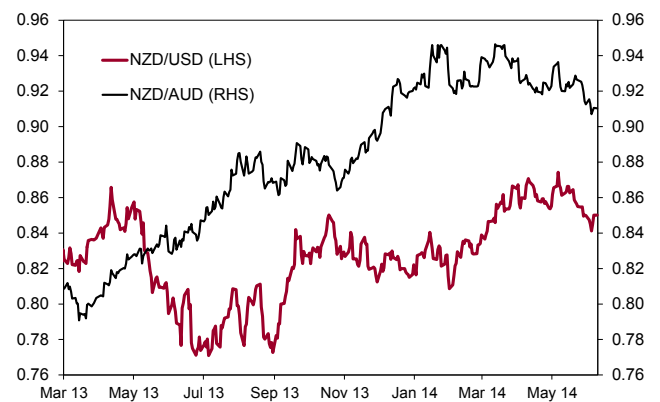
Economic Growth Forecasts	March years				Calendar years			
	2013	2014e	2015f	2016f	2012	2013	2014f	2015f
% change								
GDP (Production) ann avg	2.3	3.1	3.9	3.1	2.6	2.7	3.9	3.3
Employment	0.4	3.8	2.5	2.0	0.4	2.9	2.9	2.4
Unemployment Rate % s.a.	6.2	6.0	5.3	4.9	6.8	6.0	5.5	4.9
CPI	0.9	1.5	1.9	2.6	0.9	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 Monday 9 June 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.00%	3.00%	3.00%
30 Days	3.03%	3.27%	3.19%
60 Days	3.11%	3.34%	3.27%
90 Days	3.42%	3.41%	3.36%
2 Year Swap	3.95%	3.96%	3.96%
5 Year Swap	4.41%	4.40%	4.41%

NZ foreign currency mid-rates as at Monday 9 June 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8501	0.8542	0.8626
NZD/EUR	0.6231	0.6270	0.6272
NZD/GBP	0.5058	0.5074	0.5122
NZD/JPY	87.13	87.10	87.90
NZD/AUD	0.9103	0.9249	0.9214
TWI	79.25	79.79	80.12



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	3.2	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	-3.2	-2.5	-2.0
United States						
Real GDP %yr	2.5	1.8	2.8	1.9	1.7	2.6
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	-2.3	-2.3
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.5	1.3	1.3
Euroland						
Real GDP %yr	2.0	1.6	-0.6	-0.4	0.8	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 6 June 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	2.69	2.60	2.55	2.55	2.55	2.65
10 Year Bond	3.77	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	2.58	2.60	2.70	2.80	3.00	3.20
ECB Repo Rate	0.15	0.15	0.15	0.15	0.15	0.15

Exchange Rate Forecasts	Latest	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
AUD/USD	0.9333	0.92	0.91	0.90	0.90	0.92
USD/JPY	102.33	102	101	100	101	102
EUR/USD	1.3660	1.36	1.35	1.32	1.32	1.33
AUD/NZD	1.0986	1.07	1.06	1.06	1.07	1.10

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Disclaimer continued

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