



Sunrise over Mt. Ruapehu crater.

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The clouds darken

With global dairy prices still under pressure, mounting signs that the Canterbury rebuild is no longer an engine of growth, and business confidence dropping like a stone, the gloss has well and truly come off New Zealand's near-term growth outlook.

Dairy prices dropped another 5.9% at last week's GlobalDairyTrade auction, taking the overall price index to a six-year low. This is a serious blow for the dairy industry, but it's worth noting that much of the pain is sector-specific. Prices for New Zealand's other main commodity exports in recent weeks have ranged from strong (beef and wool) to steady (lamb) to soft but improving (wood). So it's not the case that soft commodity prices in general are under pressure. We suspect other factors specific to dairy are at play, such as the recent removal of European milk production quotas, signs of ongoing oversupply in the US, and the extension of Russia's import ban.

Meanwhile, it's increasingly clear that reconstruction activity in Canterbury is close to if not at a peak. The pipeline of residential building consents in Canterbury has already slowed, and while there is still plenty of work to do on the commercial side, these more complex projects are likely to be relatively more drawn-out.

Importantly, both these developments have percolated through to New Zealand consumer and business sentiment. While the latest drop in headline business confidence was particularly stark, businesses' expectations for their own activity have fallen sharply for a second month in a row, with the decline concentrated among construction firms as well as farmers. This own-activity measure tends to be a leading indicator for GDP growth, and signals a slower economy through mid-2015. We have heard similar messages in our own conversations with businesses, and our own consumer confidence surveys are shown households feeling more pessimistic about both the economy and their own job and earning prospects.

The clouds darken continued

We now expect four OCR cuts this year

In light of these developments – and the possibility that the current volatility on global markets will further depress confidence in the months ahead – we now expect three more OCR cuts this year, in July, September and October, taking the OCR back down to 2.5%.

Of course, there have also been developments arguing against more OCR cuts – chief among them the plunging exchange rate, which will push up inflation, and the housing market. Emerging data suggest that lower mortgage rates have done more to boost housing demand than the threat of tax changes and new LVR rules has dampened it. The Auckland market in particular continues to steam ahead, with the latest data from QVNZ showing prices rising 17% over the past year and 5.5% over the last three months alone.

But these arguments are likely to count for relatively little to the Reserve Bank, which is under pressure to lift inflation towards 2%, is wary of further downside surprises to inflation, and has been dismissive of the inflation risks posed by rising house prices.

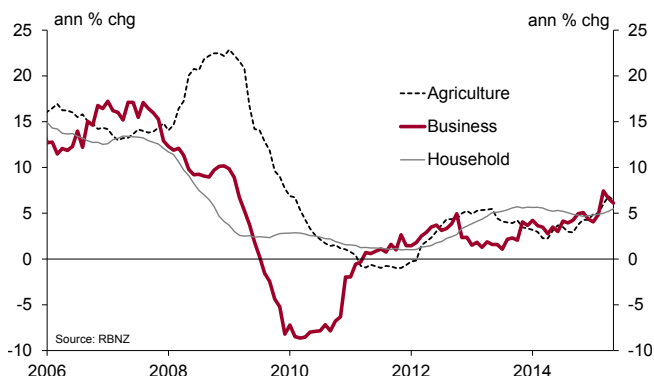
Back to imbalances

While we are comfortable forecasting further OCR cuts, there is also no question that the combination of a dairy downturn and a booming Auckland property market will see New Zealand's financial imbalances widen.

New Zealand's balance sheet has been on the mend over the past few years. Incomes grew thanks to rising dairy prices and insurance-funded reconstruction activity in Christchurch, and farmers, businesses and households were mostly cautious about taking on debt. As a result New Zealand's net foreign debt burden shrank from more than 80% of GDP in 2008 to 64% in March this year (66% after stripping out the artificial boost to New Zealand's assets from quake-related reinsurance claims).

That is a comforting thought as the Greek drama continues to unfold. New Zealand is more resilient to a global financial

Domestic credit growth



shock now than it was back in 2008. Unfortunately, that resilience is once again starting to erode, as the latest credit figures from the RBNZ clearly show. Debt is now growing at a faster rate than nominal GDP, for both sensible reasons (dairy farmers are accessing credit lines to get through bad times), and more worrying ones (mortgage debt is rising on the back of Auckland's property market). It's worth noting that much of the deleveraging of recent years has been on the corporate side – the ratio of household debt to household income is already back where it was in 2008. It is likely to rise further if house prices continue their upward trajectory.

If there is one saving grace, it's our floating exchange rate. We've noted many times that this provides New Zealand with an important mechanism to adjust to changing international conditions. Now is one of those times – in our assessment, the weaker NZ dollar has gone a long way in balancing out the recent falls in world dairy prices, and is likely to fall further from here. That will provide a much needed cushion for dairy farmers' cash flows. For many other agricultural exporters, a weaker currency will prove to be a welcome windfall. Consumers will feel the pain in terms of more expensive imported goods, but that is also part of the adjustment to leaner times.

Fixed vs Floating for mortgages

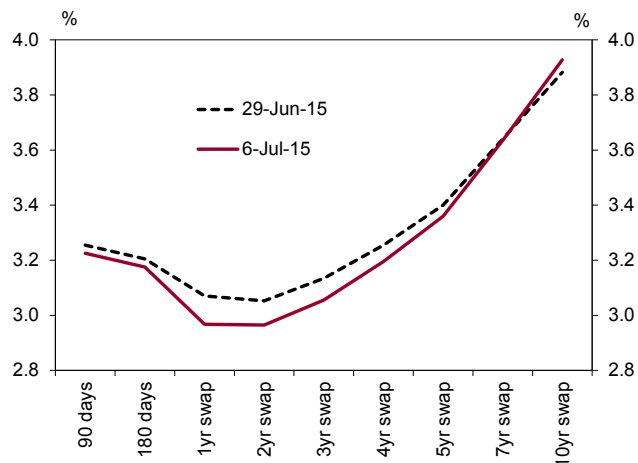
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability, but even those looking to fix may want to wait a while longer.

For borrowers with a deposit of deposit of 20% or more, the best value probably continues to lie in the two-year ahead and three-year ahead terms. Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the next four or five years.

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

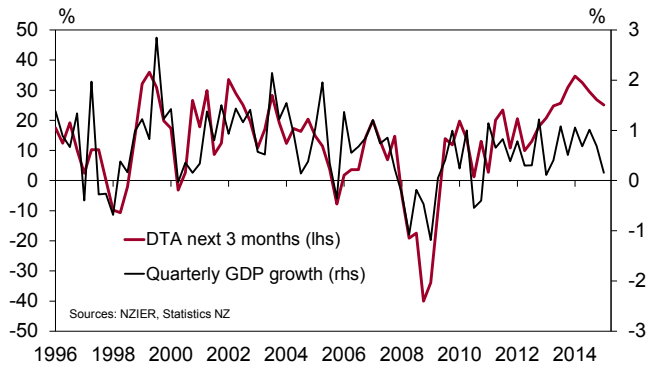


NZ Q2 Quarterly Survey of Business Opinion

Jul 7, General business confidence - last 23%

- In the first quarter of the year, businesses reported that trading conditions had remained healthy, but that they had softened. As we moved into the middle of the year, signs that the economy is losing momentum have continued to mount. Most recently, export prices for dairy have fallen sharply, and confidence across the economy has pulled back. On top of this, there is increased concern around the global environment. We expect that these developments will be reflected in falls in the Survey of Business Opinion's confidence and activity gauges.
- The survey's pricing gauges will be closely watched. Inflation pressures in the economy remain low, a key concern for the RBNZ. However, in light of recent falls in the NZD and the lift in petrol prices, we will be watching to see if there has been any recovery in businesses' pricing intentions.

QSBO domestic trading activity and GDP

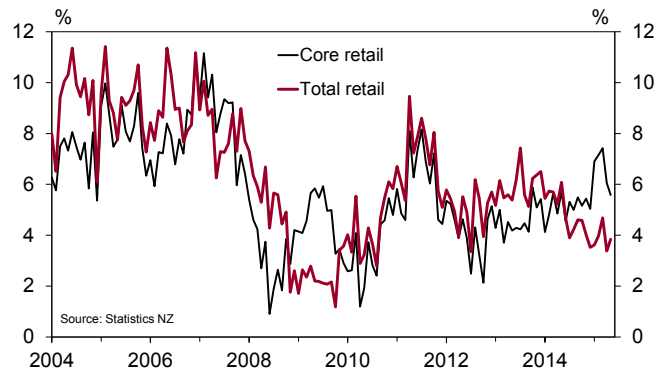


NZ June retail electronic card spending

Jul 9, last 1.2%, Westpac f/c: 0.6%

- After a very strong start to the year, retail card spending has had a softer run in the June quarter to date, with ex-fuel 'core' spending falling in April and only partly recovering in May.
- One likely reason is the recent rise in petrol prices. Consumers liberally spent the windfall from cheaper fuel in the March quarter, which has since been eroded.
- The most reliable indicator for monthly card spending, from card processor Paymark, is on hold for the time being. We are tentatively pencilling in another modest rise in ex-fuel spending, with a further rise in petrol prices adding to fuel spending in dollar terms.

Card transactions, annual % change

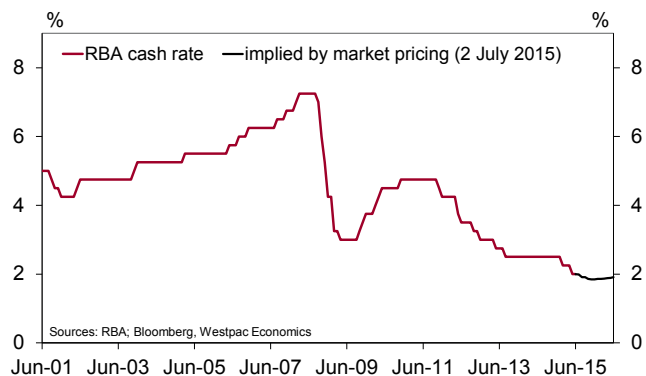


Aus RBA policy decision

Jul 7, Last: 2.00%, WBC f/c: 2.00%
Mkt f/c: 2.00%, Range: 2.00% to 2.00%

- The RBA is expected to leave rates unchanged at its July meeting but adopt a more explicit easing bias. The Bank chose to leave rates on hold in June after a 25bp cut in Feb and a follow-up 25bp cut in May. The decision statement carried a 'soft easing bias' with the emphasis on "information to be received over the period ahead", i.e. the Q1 national accounts. Comments since then indicate the data disappointed, with the Governor voicing a clear easing bias in a June 10 speech ("We remain open to the possibility of further policy easing").
- The RBA's 2016 view is the critical factor for policy. With the Bank releasing updated forecasts in Aug, a July move is unlikely. Even Aug will be too early for a clear view on the consumer trends shaping non-mining investment prospects, with the Q2 national accounts not due until Sep. Our central view is for rates to stay on hold throughout 2015 and 2016.

RBA cash rate

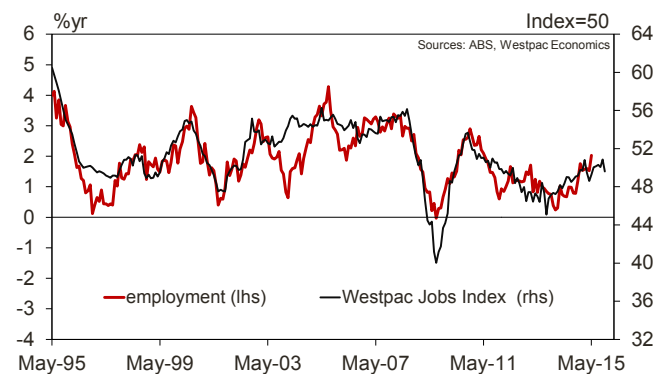


Australian Labour Force - total employment '000

Jul 9, Last: 42k, WBC f/c: -15k
Mkt f/c: flat, Range: -17k to 20k

- Total employment surged 42k in May with full-time employment rising just 14.7k versus a 27.3k surge in part-time employment. Month to month volatility partly explains this outcome, but it is also part of a longer run trend, with annual growth in full-time employment of just 95.2k/1.2%yr against part-time employment's 138.8k/4.0%yr.
- Stepping back from the monthly volatility, the three-month average change in total employment was 25.3k in May, little different from 24.2k in April and 27.6k in March. So far, the momentum seen in Q1 looks to be continuing into Q2. Total employment grew 234k, or 2.0%, in the year to May.
- Westpac's Jobs Index continues to point to employment growth of around 1¾%yr. Our forecast for -15k takes the annual pace of employment growth down to 1.7%yr.

Jobs Index volatile around a 1¾%yr jobs pace

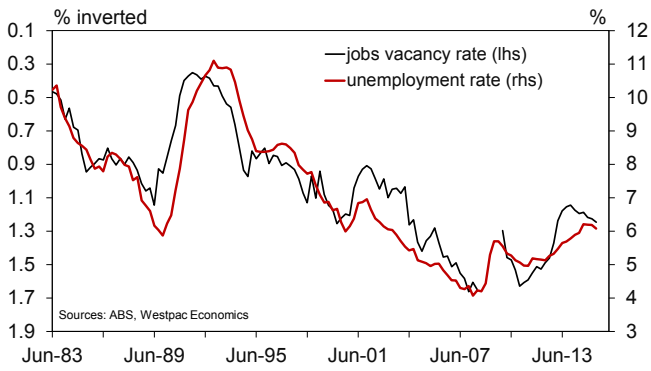


Australian Labour Force - unemployment rate %

Jul 9, Last: 6.0%, WBC f/c: 6.1%
 Mkt f/c: 6.1%, Range: 6.0% to 6.2%

- In May the unemployment rate fell to 6.0% (5.96% unrounded) from 6.1% (6.14%). With a flat participation rate (64.7%), the rise in the labour force was just 20k, hence the 0.1ppt fall in the unemployment rate.
- The unemployment rate peaked at 6.3% in January 2015 and since then has drifted down to 6.0%. It is also worth noting that the participation rate bottomed at 64.5% in October 2014 and has been drifting higher since.
- Holding growth in the working-age population steady – which at 1.7%yr looks a little strong given the recent moderation in long-term arrivals (note, the ABS has noted the re-benchmarking will not be done until August) – and the participation rate steady at 64.7%, the unemployment rate is forecast to rise to 6.1%.

Job vacancies vs unemployment

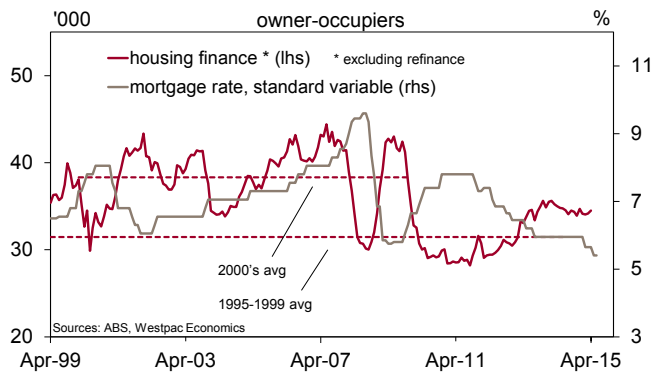


Aus May housing finance (no.)

Jul 10, Last: 1.0%, WBC f/c: -3.0%
 Mkt f/c: -3.0%, Range: -6.5% to 1.5%

- Finance approvals were a slight positive in Apr, with the 1% rise in owner occupier approvals a touch better than expected and the detail mostly positive (refinancing and the value of investor loans recording notably strong gains).
- Industry data points to a pull-back in May – potentially quite a sharp one. While auction activity and price gains remain strong in the key Sydney and Melbourne markets, investors have become the dominant driver (the finance approvals headline figure is for owner occupiers only); also conditions have cooled notably in other markets. Overall, we expect owner-occupier finance approvals to fall 3%. There will again be keen interest in the investor numbers which, in coming months, should start to show some impact from regulatory efforts to tighten lending criteria and limit credit growth.

Owner-occupier finance & the rate cycle



Data calendar

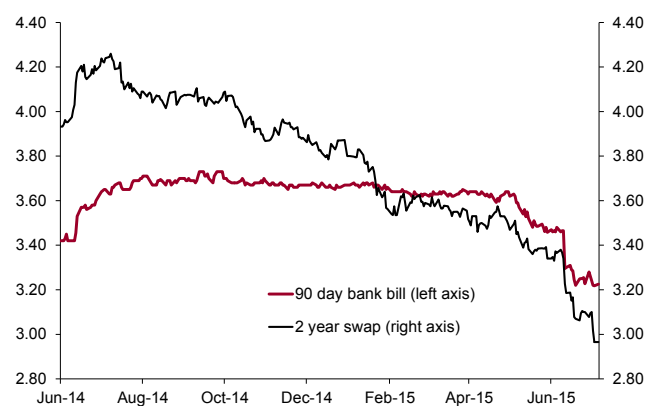
| | | Last | Market median | Westpac forecast | Risk/Comment |
|---------------|---|-------|---------------|------------------|--|
| Mon 6 | | | | | |
| Aus | Jun TD-MI inflation gauge %mth | 0.3% | – | – | Petrol prices rose 4%mth, keeping pressure on the headline Gauge. |
| | Jun ANZ job ads %mth | 0.0% | – | – | Job ads are up 14%yr to May, but base effect suggests pace to slow. |
| Eur | Jul Sentix investor confidence | 17.1 | 15.5 | – | Greek malaise likely to depress confidence. |
| US | Jun Markit composite PMI, final | 54.6 | – | 54.6 | Down from 56.0 in May owing to broadbased slowdown. |
| | Jun ISM non-manufacturing | 55.7 | 56.4 | 56.2 | Despite recent slowdown, services activity remains robust. |
| | Jun labour market conditions index | 1.3 | 2.0 | – | Aggregate indicator of labour market momentum. |
| Can | Jun Ivey PMI | 62.3 | 56.0 | – | Points to continued strong momentum in manufacturing sector. |
| Ger | May factory orders | 1.4% | –0.1% | – | Up just 0.4% for the year, but Apr/May showed material improvement. |
| UK | Jun Halifax house prices | –0.1% | 0.3% | – | Momentum has ebbed in 2015. Tentative date. |
| Tue 7 | | | | | |
| NZ | Q2 Quarterly Survey of Business Opinion | 23% | – | – | Economic conditions have softened. |
| Aus | RBA policy decision | 2.00% | 2.00% | 2.00% | To adopt a clearer easing bias? |
| Ger | May industrial production | 0.9% | 0.1% | 0.3% | Building momentum in factory orders points to further gain. |
| UK | May industrial production | 0.4% | –0.4% | – | Mining output jump drove May headline beat; manufacturing declined. |
| | Jun BRC shop price index, %yr | –1.9% | – | – | No inflation pressures to speak of. |
| US | May trade balance, \$bn | –40.9 | –42.8 | –43.0 | Normalisation after port strike likely completed; USD concern for X'pts. |
| | May JOLTs job openings, 000's | 5376 | 5300 | – | April saw highest level of job openings since series began in Dec 2000. |
| | Jul IBD/TIPP economic optimism | 48.1 | 48.8 | – | Optimism still found wanting in US despite labour market strength. |
| Wed 8 | | | | | |
| UK | Jun RICS house price balance | 34% | 37% | – | Measure of surveyors reporting price increases; softer momentum. |
| | Bank of England policy meeting | 0.50% | 0.50% | 0.50% | Firmly on hold for foreseeable future. |
| US | June FOMC meeting minutes | – | – | – | More details on views of FOMC members; labour market views key. |
| | Fedspeak | – | – | – | Williams on outlook in LA. |
| Thu 9 | | | | | |
| NZ | June retail electronic card spending | 1.2% | 0.5% | 0.6% | Ex-fuel spending has slowed after a very strong Q1. |
| Aus | Jun labour force survey - employment | 42k | flat | –15k | May jump lifted the annual pace to 2%yr; –15k takes it back to 1¼%yr. |
| | Jun labour force survey - unemployment | 6.0% | 6.1% | 6.1% | With flat participation, –15k is enough to lift unemployment 0.1ppt. |
| Chn | Jun CPI %yr | 1.2% | 1.4% | – | Shelter has been firming, food volatile, energy/utills. deflationary. |
| | Jun PPI %yr | –4.6% | –4.6% | – | Too early for activity stabilization to influence upstream pricing. |
| Ger | May trade balance, €bn | 21.8 | 20.5 | 21.0 | May saw upside surprise as exports rose and imports fell. |
| US | Initial jobless claims, w/e 4 Jul | 281k | 277k | 280k | Pace of firing historically low. |
| | Fedspeak | – | – | – | Brainard in Washington; George in Oklahoma; Kocherlakota in Frankfurt. |
| Fri 10 | | | | | |
| Aus | May housing finance | 1.0% | –3.0% | –3.0% | Industry figures suggest pull-back. All eyes on new investor loans. |
| UK | May construction output | –0.8% | 0.7% | – | Bounce likely in May, with confidence over residential activity strong. |
| US | May wholesale inventories | 0.4% | 0.3% | 0.3% | Consumer end-demand questionable; limited need to build stocks. |
| | Fedspeak | – | – | – | Chair Yellen on economic outlook; Rosengren also. |

New Zealand forecasts

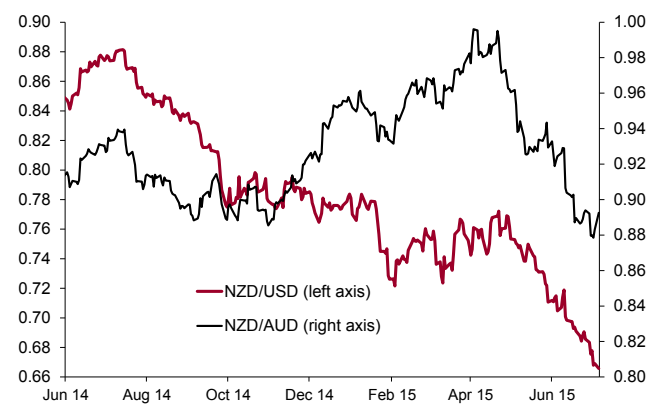
| Economic Growth Forecasts | March years | | | | Calendar years | | | |
|----------------------------------|-------------|------|-------|-------|----------------|------|-------|-------|
| | 2014 | 2015 | 2016f | 2017f | 2013 | 2014 | 2015f | 2016f |
| % change | | | | | | | | |
| GDP (Production) ann avg | 2.5 | 3.2 | 2.4 | 3.3 | 2.2 | 3.3 | 2.4 | 3.1 |
| Employment | 3.8 | 3.2 | 3.0 | 2.3 | 2.9 | 3.6 | 2.8 | 3.0 |
| Unemployment Rate % s.a. | 6.0 | 5.8 | 4.9 | 4.4 | 6.1 | 5.8 | 5.2 | 4.3 |
| CPI | 1.5 | 0.1 | 1.8 | 1.9 | 1.6 | 0.8 | 0.9 | 2.2 |
| Current Account Balance % of GDP | -2.6 | -3.6 | -4.6 | -4.3 | -3.3 | -3.3 | -4.2 | -4.4 |

| Financial Forecasts | Sep-15 | Dec-15 | Mar-16 | Jun-16 | Sep-16 | Dec-16 |
|---------------------|--------|--------|--------|--------|--------|--------|
| Cash | 2.75 | 2.50 | 2.50 | 2.50 | 2.50 | 2.50 |
| 90 Day bill | 2.70 | 2.60 | 2.60 | 2.60 | 2.60 | 2.60 |
| 2 Year Swap | 2.80 | 2.70 | 2.70 | 2.70 | 2.70 | 2.70 |
| 5 Year Swap | 3.20 | 3.10 | 3.10 | 3.20 | 3.30 | 3.40 |
| 10 Year Bond | 3.50 | 3.50 | 3.60 | 3.70 | 3.80 | 3.90 |
| NZD/USD | 0.63 | 0.62 | 0.62 | 0.63 | 0.64 | 0.65 |
| NZD/AUD | 0.86 | 0.86 | 0.86 | 0.88 | 0.88 | 0.88 |
| NZD/JPY | 78.1 | 78.1 | 78.1 | 80.0 | 81.9 | 83.9 |
| NZD/EUR | 0.60 | 0.60 | 0.60 | 0.61 | 0.62 | 0.62 |
| NZD/GBP | 0.43 | 0.43 | 0.43 | 0.43 | 0.43 | 0.42 |
| TWI | 68.9 | 68.3 | 68.2 | 69.3 | 70.2 | 70.8 |

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 6 July 2015

| Interest Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| Cash | 3.25% | 3.25% | 3.50% |
| 30 Days | 3.31% | 3.34% | 3.50% |
| 60 Days | 3.27% | 3.29% | 3.50% |
| 90 Days | 3.23% | 3.24% | 3.48% |
| 2 Year Swap | 2.97% | 3.07% | 3.36% |
| 5 Year Swap | 3.36% | 3.40% | 3.69% |

NZ foreign currency mid-rates as at Monday 6 July 2015

| Exchange Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| NZD/USD | 0.6657 | 0.6904 | 0.7040 |
| NZD/EUR | 0.6047 | 0.6068 | 0.6345 |
| NZD/GBP | 0.4279 | 0.4352 | 0.4615 |
| NZD/JPY | 81.21 | 84.95 | 88.41 |
| NZD/AUD | 0.8925 | 0.8890 | 0.9235 |
| TWI | 70.27 | 71.72 | 74.11 |



Economic and Financial Forecasts

| Economic Forecasts (Calendar Years) | 2011 | 2012 | 2013 | 2014 | 2015f | 2016f |
|-------------------------------------|------|------|------|------|-------|-------|
| Australia | | | | | | |
| Real GDP % yr | 2.7 | 3.6 | 2.1 | 2.7 | 2.4 | 3.0 |
| CPI inflation % annual | 3.0 | 2.2 | 2.7 | 1.7 | 2.5 | 2.5 |
| Unemployment % | 5.2 | 5.3 | 5.8 | 6.2 | 6.5 | 6.3 |
| Current Account % GDP | -2.8 | -4.4 | -3.3 | -2.8 | -3.4 | -3.4 |
| United States | | | | | | |
| Real GDP %yr | 1.6 | 2.3 | 2.2 | 2.4 | 2.0 | 3.2 |
| Consumer Prices %yr | 3.1 | 2.1 | 1.5 | 1.6 | 0.1 | 2.0 |
| Unemployment Rate % | 8.9 | 8.1 | 7.4 | 6.2 | 5.3 | 5.0 |
| Current Account %GDP | -2.9 | -2.9 | -2.4 | -2.4 | -2.5 | -2.5 |
| Japan | | | | | | |
| Real GDP %yr | -0.5 | 1.8 | 1.6 | -0.1 | 1.3 | 1.8 |
| Euroland | | | | | | |
| Real GDP %yr | 1.6 | -0.8 | -0.4 | 0.8 | 1.4 | 1.2 |
| United Kingdom | | | | | | |
| Real GDP %yr | 1.6 | 0.7 | 1.7 | 2.6 | 2.5 | 2.7 |
| China | | | | | | |
| Real GDP %yr | 9.3 | 7.8 | 7.8 | 7.4 | 7.0 | 7.0 |
| East Asia ex China | | | | | | |
| Real GDP %yr | 4.4 | 4.5 | 4.3 | 4.1 | 4.4 | 5.0 |
| World | | | | | | |
| Real GDP %yr | 4.2 | 3.4 | 3.4 | 3.4 | 3.2 | 4.0 |
| Forecasts finalised 10 June 2015 | | | | | | |

| Interest Rate Forecasts | Latest | Sep-15 | Dec-15 | Mar-16 | Jun-16 | Sep-16 |
|-------------------------|--------|--------|--------|--------|--------|--------|
| Australia | | | | | | |
| Cash | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| 90 Day Bill | 2.15 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 |
| 10 Year Bond | 3.07 | 3.00 | 3.10 | 3.25 | 3.40 | 3.60 |
| International | | | | | | |
| Fed Funds | 0.125 | 0.375 | 0.625 | 0.875 | 1.125 | 1.375 |
| US 10 Year Bond | 2.38 | 2.60 | 2.80 | 3.00 | 3.20 | 3.40 |
| ECB Repo Rate | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 |

| Exchange Rate Forecasts | Latest | Sep-15 | Dec-15 | Mar-16 | Jun-16 | Sep-16 |
|-------------------------|--------|--------|--------|--------|--------|--------|
| AUD/USD | 0.7585 | 0.73 | 0.72 | 0.72 | 0.72 | 0.73 |
| USD/JPY | 123.17 | 126 | 128 | 128 | 129 | 130 |
| EUR/USD | 1.1093 | 1.08 | 1.07 | 1.07 | 1.07 | 1.07 |
| AUD/NZD | 1.1291 | 1.16 | 1.16 | 1.16 | 1.14 | 1.14 |

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