



Sunrise over Mt. Ruapehu crater.

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An udder surprise

The Reserve Bank has honed in on the woes of the dairy sector, judging that they pose such a risk that an immediate OCR cut was warranted. The only question now is the timing of further cuts – we see one more cut in September as the most likely scenario, but all will depend on the next few dairy auctions.

The Reserve Bank surprised much of the market, including us, by reducing the OCR by 25 basis points to 3.25% at last week's *Monetary Policy Statement*.

While the case for interest rate cuts this year was growing, we didn't expect the Reserve Bank to move so soon, given the conditions it had laid out in its April review. Based on those previous signals, the Reserve Bank was readying itself to cut the OCR if domestic demand weakened, and wage and price-setting outcomes settled below the inflation target. On both fronts, we felt the evidence to date was still too inconclusive for the Reserve Bank to move without preparing markets appropriately.

But in the event, the Reserve Bank judged that the current weakness in global dairy prices presented a sufficient risk to domestic demand over the coming months that cuts were needed now to bring inflation back to 2% within an acceptable time-frame.

What next?

The Reserve Bank's updated interest rate projections imply one more 25bp cut to the OCR this year (and probably an ongoing easing bias). However, the Reserve Bank was vague about whether the next cut might come in the July or September OCR reviews, simply noting that it will "depend on the emerging data".

For the time being, we favour one more move in September – largely based on our expectations for the June quarter CPI, which will come out a week before the July OCR Review. The Reserve Bank's forecast is for a 0.4% rise in prices in the quarter, which looks on the low side to us. We expect a print of 0.8%, reflecting the lower NZ

An udder surprise continued

dollar and recent rebound in petrol prices. An upside surprise on inflation could cause the Reserve Bank sufficient pause for thought to wait until September.

Then again, last week's move was all about dairy, and the three GlobalDairyTrade auctions between now and the July OCR Review will be crucial for the Reserve Bank's next move. If world dairy prices continue to soften in the next few auctions, we'll have no qualms about bringing forward our rate cut call to July, and would probably look to forecast more than two cuts, taking the OCR below 3%.

The other key piece of "data" to watch in coming weeks will be the exchange rate – the New Zealand dollar is under considerable downward pressure at present. If it falls further, the case for a July OCR cut will diminish – we are forecasting 65 cents by the end of the year. If the NZD stabilises at current levels, the case for a July cut would be bolstered.

Lastly, there is domestic activity itself. By the time the July OCR review comes around we will have had another quarterly business survey, and another round of monthly retail, housing and migration data. This week's March quarter GDP report will probably be less influential, having largely been overtaken by more recent events. Like the RBNZ, we are expecting a print of 0.6%, with mixed details – weakness in primary production (in part reflecting the spell of dry weather at the start of the year), but solid growth in a range of service industries, notably retail.

A risky decision

Interestingly, the Reserve Bank's inflation forecasts are now higher than they were three months ago, when the OCR was still firmly on hold. But the makeup of the inflation forecast is significantly different. The Reserve Bank has slashed its forecasts for non-tradables inflation (reflecting its heightened concerns around domestic demand), but upgraded its forecast for tradables inflation (on the assumption that the exchange rate will continue to fall).

The inference is that the Reserve Bank has been happy to accept slightly higher headline inflation as insurance against the risks posed by the dairy downturn.

90-day interest rate forecast



That judgement seems entirely reasonable in the current low-inflation environment – even on the Reserve Bank's new forecasts, inflation doesn't rise far above 2%. We are less convinced by the Reserve Bank's judgements around housing. Wholesale interest rates fell sharply in response to this week's surprise OCR cut, and fixed-term mortgage rates are likely to follow. The risk is that this will further whip up an already frenzied Auckland housing market. Last week's Real Estate Institute data showed the Auckland house price index rising 25.6% over the year to May, a pace of increase not seen in more than two decades. If that continues, domestic demand (and domestic inflation) will surely get a lift.

The Reserve Bank is well aware of these risks, but has decided that they are worth running, or can in any event be addressed through other measures. But we don't feel it has made a compelling case to that effect. In particular, on its own estimates the proposed restrictions on loan-to-value ratios for investor lending in Auckland are expected to reduce house price inflation by 2% to 4% - less than the gain the market made in the month of May alone, according to the Real Estate Institute data. There is every chance that last week's OCR cut will eventually lead to yet another turn of the macro-prudential screws.

Fixed vs Floating for mortgages

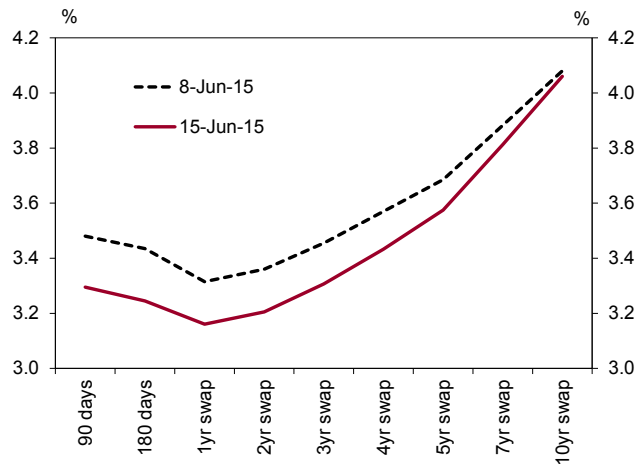
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability, but given last week's drop in wholesale rates, even those looking to fix may want to wait a while longer.

For borrowers with a 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, though the gap has narrowed.

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

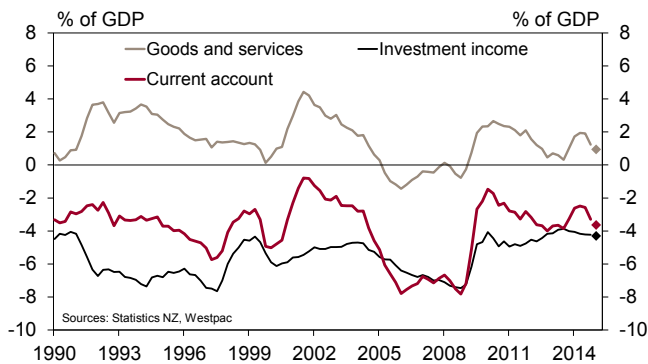


NZ Q1 current account % of GDP

Jun 17, Last: -3.3%, Westpac f/c: -3.6%, Mkt f/c: -3.8%

- We expect the current account deficit to widen further to 3.6% of GDP for the year to March, as the rough halving of dairy export prices since early 2014 continues to flow through with a lag.
- That said, the March quarter itself is likely to show a substantial improvement in seasonally adjusted terms. The fall in dairy export prices was more than offset by the plunge in the price of imported fuel, and tourist spending recorded another quarter of very strong growth.
- We expect to see a modest widening in the investment income deficit. The outflow of profits from overseas-owned firms operating in New Zealand is likely to have risen, while lower interest rates in the rest of the world lowered the returns on New Zealanders' overseas investments.

Annual current account balance

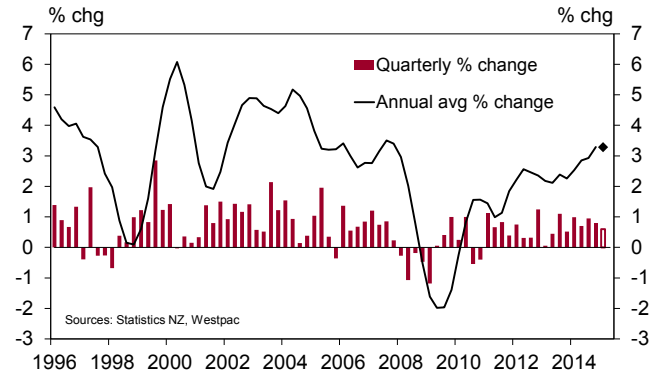


NZ Q1 GDP

Jun 18, Last: 0.8%, Westpac f/c: 0.6%, Mkt f/c: 0.6%

- We estimate that GDP grew by 0.6% in the March quarter, a slightly slower pace than in the past year but still enough to maintain an annual growth pace of more than 3%.
- The primary sector was the main drag on growth. Dry weather early this year reduced milk production by 4% (which has more or less recovered in the June quarter), and the plunge in oil prices is likely to have dampened oil exploration.
- Elsewhere, growth in the services sectors remained as robust as ever, particularly in retail as consumers took advantage of the windfall from lower fuel prices. Construction activity continued to rise, although the days of rampant growth appear to be in the past, with the Christchurch rebuild now well advanced.

Production based GDP

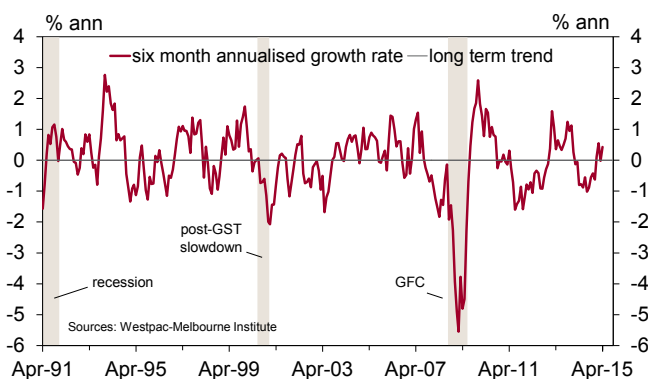


Aus May Westpac-MI Leading Index

Jun 17, Last: +0.43%

- The 6mth annualised growth rate of the Index lifted from -0.02% in March to +0.43% in April, a positive sign after persistently weak, below trend readings throughout 2014 although the growth pulse is still not strong.
- Unfortunately the May update is likely to be weaker. Consumer-related components fell sharply in June, reversing all of their post-Budget gains. Amongst the other components, dwelling approvals, commodity prices, US industrial production, hours worked were about flat as was the ASX in May (posting material declines in early June). The yield spread turned more positive as short rates dipped and bond rates rose but this is unlikely to offset other weaknesses in the month.

Westpac-MI Leading Index

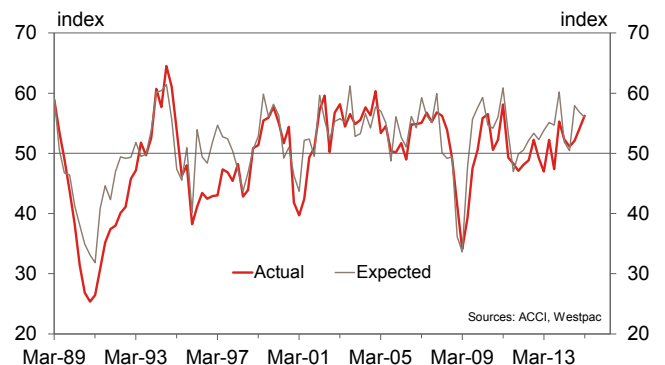


Aus Q2 ACCI-Westpac survey

Jun 18, Last: 56.2

- The ACCI-Westpac survey of the manufacturing sector provides a timely update on conditions, with insights into economy-wide trends. The Westpac-ACCI Actual Composite tracks movements in household demand, highlighting the key linkages between the consumer, home building and manufacturing.
- In Q1, the Actual Composite strengthened to 56.2, up 2.0pts from Q4. Strength was centred on a lift in new orders and in output, as well as overtime, but not employment.
- Manufacturing is benefiting from the strong upswing in home building activity and some improvement in service sector investment. The macro settings have become more accommodative. The RBA has lowered rates, the currency has moved lower and the Federal Budget included a small business package. However, the cycle remains constrained. Consumer spending is sub-trend and mining investment is falling.

Westpac-ACCI composite indexes

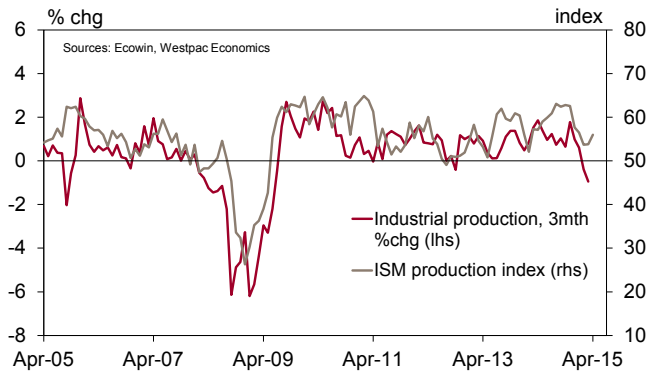


US May industrial production

Jun 15, Last: -0.3%, WBC f/c: 0.2%

- Industrial production has not posted a rise since November last year, when a 6% surge in auto production was not fully offset by falling mining output (down 0.5% in Nov 14), and utility output was up a solid 3.6%. Since then, manufacturing itself has shown little or no growth outside of autos, mining (oil especially) has been a near continuous drag, and in recent months the utilities have resumed their output declines after the winter cold snap.
- In May, ISM production slipped, but not to its lowest for the year so far. Hours worked in factories rose 0.2%, led by durables. Auto sales were up sharply in May, despite flat orders in April for autos. Machinery orders rose 3.1% in April.
- In May, a partial rebound in utility output, a modest factory production gain, albeit with further offset from pull-back in mining should see IP post its first modest gain in 6 months.

US industrial sector

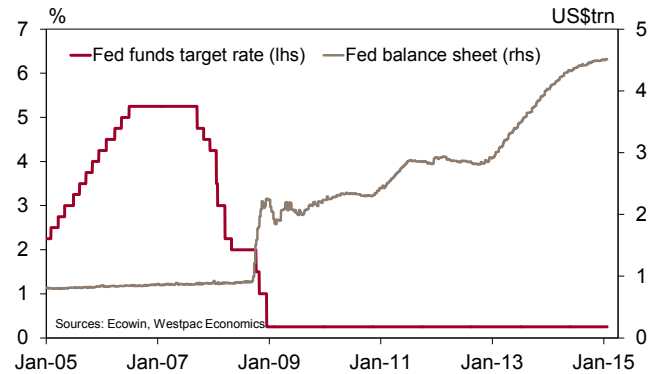


US FOMC meeting

Jun 17

- Recent commentary from Fed chair Yellen suggests that she still sees Fed funds target lift-off starting this year as it becomes clear that the labour market has continued to improve, most of the factors weighing on Q1 GDP growth have proven to be transitory and the headwinds holding back the household sector have shown clear signs of abating.
- Recent data have supported her position, most notably the May payrolls report, showing renewed strength in hiring and decent gains in both hours worked and hourly earnings.
- The release of Q2 GDP data in late July has the potential to further support Yellen's position, if it shows that recent hires have been more productive than currently estimated, thus making jobs gains more sustainable.
- FOMC statement to keep options open, remain data dependent.

Fed funds target rate and balance sheet



Data calendar

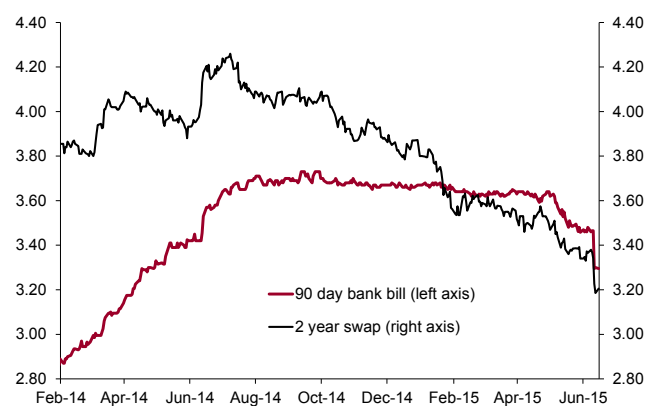
| | | Last | Market median | Westpac forecast | Risk/Comment |
|---------------|--|---------|---------------|------------------|---|
| Mon 15 | | | | | |
| NZ | May Performance of Services Index | 56.5 | – | – | Has remained strong while manufacturing survey has softened. |
| Aus | RBA Assistant Governor Economic | – | – | – | Chris Kent, speech, Australian National University, Canberra, 5:30pm. |
| Eur | Apr exports | 1.7% | – | – | Imports rose 3.9% so trade deficit narrowed to €19.7bn. |
| UK | Jun house prices %yr | 2.5% | – | – | Rightmove index of asking prices, was running 10.4% yr in June 2014. |
| US | Jun NY Fed index | 3.1 | 5.0 | – | Weak start to year typical; can H2 14 surge to 20+ be replicated? |
| | Apr TIC data \$bn | 17.6 | – | – | Net long term TIC flows. |
| | Jun NAHB housing market index | 54 | 56 | 57 | Struggling to recover to 58-59 highs of 2013-14 but sales higher. |
| | May industrial production | –0.3% | 0.2% | 0.2% | ISM and hours worked point to modest gain. |
| Can | May existing home sales | 2.3% | – | – | Up three months running after 5 month fall-winter slump. |
| | Apr manufacturing sales | 2.9% | – | – | March data very strong, led by autos. |
| Tue 16 | | | | | |
| Aus | May new vehicle sales | –1.5% | – | –1.5% | FCAI sales soft in May, –1.3%yr nationally and –15.8%yr in WA! |
| | RBA Minutes June Board meeting | – | – | – | RBA in a wait & see mode, to assess response to Feb & May rate cuts. |
| | RBA Assistant Governor Financial Mkts | – | – | – | Speech, Launch of Financial Integration in the Asia Pacific, Sydney, 8am. |
| Ger | Jun ZEW analysts' expectations | 41.9 | 38.5 | 35.0 | Analyst expectations down in April-May after 5 month surge. |
| UK | May CPI %yr | –0.1% | 0.1% | 0.0% | Inflation unlikely to turn substantially positive in next little while. |
| | May PPI %yr | 0.1% | 0.1% | – | Core output prices. |
| | Apr house prices %yr | 9.6% | – | – | ONS series. |
| US | May housing starts | 20.2% | –3.1% | –5.5% | Multiples strength only part of story; single family starts up 17% and permits up 15% in April. |
| | May housing permits | 9.8% | –3.5% | –2.0% | |
| Wed 17 | | | | | |
| NZ | GlobalDairyTrade auction | –4.3% | – | – | Upcoming auctions will be crucial to the timing/extent of OCR cuts. |
| | Q1 current account % of GDP | –3.3% | –3.8% | –3.6% | Soft dairy prices, partly offset by cheaper oil and tourist spending. |
| Aus | May Westpac-MI Leading Index | 0.43% | – | – | Most components weaker over the last month. |
| Eur | May CPI final %yr | 0.3% | 0.3% | – | Deflation over but risks persist. |
| | Apr construction output | 0.8% | – | – | Mild winter less of a positive factor this year than in 2014. |
| UK | May unemployment ch' | –7k | –13.8k | – | Benefit claimant count, including universal credit. |
| | Jun BoE MPC minutes | – | – | – | Arguments in favour of rate hike finely balanced for just 2 on MPC. |
| US | Jun FOMC meeting | 0-0.25% | 0-0.25% | 0-0.25% | See text box. Yellen press conference to keep alive Sep lift off prospect. |
| Can | Apr wholesale sales | 0.8% | – | – | Mar gain led by building materials. |
| Thu 18 | | | | | |
| NZ | Q1 GDP | 0.8% | 0.6% | 0.6% | Temporary softness in agri and mining, robust growth elsewhere. |
| Aus | Q2 Westpac-ACCI survey of indust. trends | 56.2 | – | – | Actual Composite +2.0pts to 56.2 in Q1. |
| | RBA Bulletin | – | – | – | Includes recent research articles. |
| Chn | May property prices | – | – | – | Market has turned in tier 1, and a number of smaller coastal cities. |
| Eur | Q1 labour costs | 1.1% | – | – | Cycle low was 0.7% yr in Q1 last year. |
| UK | May retail sales | 1.2% | 0.2% | –0.7% | Retail sales jumped in April with apparel especially strong. |
| US | Initial jobless claims w/e 13/6 | 279k | – | 275k | Claims downtrend stalled? |
| | May CPI | 0.1% | 0.5% | 0.4% | Higher gasoline prices to lift headline CPI. |
| | May CPI core | 0.3% | 0.2% | 0.1% | Easter effect on airfares etc to reverse in May. |
| | Q1 current account \$bn | –113.5 | –116.4 | – | Ports closure, dollar appreciation, oil prices all factors at play. |
| | Jun Philadelphia Fed factory index | 6.7 | 8.0 | – | Only Fed factory index not to turn negative in recent months. |
| | May leading index | 0.7% | 0.4% | – | Started Q2 with second strongest reading in a year. |
| Fri 19 | | | | | |
| NZ | Jun ANZ consumer confidence | 123.9 | – | – | Softer this year, in contrast to the sharp rise in core retail sales. |
| Chn | Jun MNI business indicator | 49.7 | – | – | Leading indicator of PMI. |
| Eur | Apr current account sa €bn | 18.6 | – | – | Large surplus a factor acting against further euro depreciation |
| Ger | May PPI %yr | –1.5% | –1.1% | – | Just above cycle low of –2.2% yr in Jan. |
| UK | May PSNCR £bn | –4.0 | – | – | Public sector net credit requirement. |
| Can | May CPI %yr | 0.8% | – | – | CPI headline fall not matched by core rate lately. |
| | Apr retail sales | 0.7% | – | – | Autos supportive of March retailing. |

New Zealand forecasts

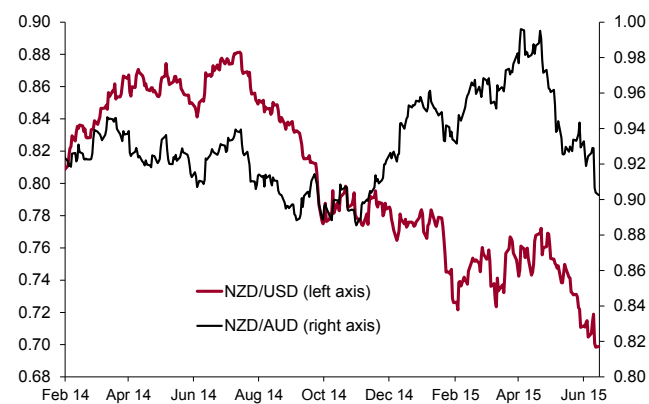
| Economic Growth Forecasts | March years | | | | Calendar years | | | |
|----------------------------------|-------------|------|-------|-------|----------------|-------|-------|-------|
| | 2013 | 2014 | 2015f | 2016f | 2013 | 2014f | 2015f | 2016f |
| % change | | | | | | | | |
| GDP (Production) ann avg | 2.2 | 2.5 | 3.3 | 2.6 | 2.3 | 3.3 | 2.8 | 3.1 |
| Employment | 0.2 | 3.8 | 3.2 | 2.9 | 2.9 | 3.6 | 2.6 | 3.0 |
| Unemployment Rate % s.a. | 6.3 | 6.0 | 5.8 | 5.0 | 6.1 | 5.8 | 5.3 | 4.5 |
| CPI | 0.9 | 1.5 | 0.1 | 1.8 | 1.6 | 0.8 | 0.9 | 2.2 |
| Current Account Balance % of GDP | -3.7 | -2.6 | -3.2 | -3.8 | -3.3 | -3.3 | -3.3 | -3.6 |

| Financial Forecasts | Jun-15 | Sep-15 | Dec-15 | Mar-16 | Jun-16 | Sep-16 |
|---------------------|--------|--------|--------|--------|--------|--------|
| Cash | 3.25 | 3.00 | 3.00 | 3.00 | 3.00 | 3.00 |
| 90 Day bill | 3.20 | 3.10 | 3.10 | 3.10 | 3.10 | 3.10 |
| 2 Year Swap | 3.20 | 3.10 | 3.10 | 3.20 | 3.30 | 3.30 |
| 5 Year Swap | 3.60 | 3.50 | 3.50 | 3.60 | 3.70 | 3.70 |
| 10 Year Bond | 3.60 | 3.60 | 3.70 | 3.80 | 3.90 | 3.90 |
| NZD/USD | 0.71 | 0.66 | 0.65 | 0.65 | 0.65 | 0.65 |
| NZD/AUD | 0.91 | 0.90 | 0.90 | 0.90 | 0.90 | 0.89 |
| NZD/JPY | 86.6 | 81.8 | 81.9 | 81.9 | 82.6 | 83.2 |
| NZD/EUR | 0.65 | 0.63 | 0.63 | 0.63 | 0.63 | 0.63 |
| NZD/GBP | 0.48 | 0.45 | 0.45 | 0.45 | 0.44 | 0.43 |
| TWI | 75.4 | 72.1 | 71.6 | 71.5 | 71.5 | 71.3 |

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 15 June 2015

| Interest Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| Cash | 3.25% | 3.50% | 3.50% |
| 30 Days | 3.35% | 3.54% | 3.58% |
| 60 Days | 3.33% | 3.51% | 3.55% |
| 90 Days | 3.30% | 3.48% | 3.52% |
| 2 Year Swap | 3.21% | 3.35% | 3.37% |
| 5 Year Swap | 3.58% | 3.60% | 3.64% |

NZ foreign currency mid-rates as at Monday 15 June 2015

| Exchange Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| NZD/USD | 0.6990 | 0.7088 | 0.7443 |
| NZD/EUR | 0.6231 | 0.6487 | 0.6507 |
| NZD/GBP | 0.4495 | 0.4662 | 0.4730 |
| NZD/JPY | 86.15 | 88.47 | 88.79 |
| NZD/AUD | 0.9026 | 0.9316 | 0.9254 |
| TWI | 72.98 | 74.57 | 76.50 |



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 | 2.3 | 2.6 |
| Unemployment % | 5.2 | 5.3 | 5.8 | 6.2 | 6.5 | 6.5 |
| Current Account % GDP | -2.8 | -4.4 | -3.3 | -2.8 | -3.2 | -2.8 |
| United States | | | | | | |
| Real GDP %yr | 1.6 | 2.3 | 2.2 | 2.4 | 2.2 | 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 | 1.0 | 1.7 |
| Euroland | | | | | | |
| Real GDP %yr | 1.6 | -0.8 | -0.4 | 0.8 | 1.2 | 1.1 |
| 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 | 3.3 | 3.4 | 3.2 | 4.0 |
| Forecasts finalised 8 May 2015 | | | | | | |

| Interest Rate Forecasts | Latest | Jun-15 | Sep-15 | Dec-15 | Mar-16 | Jun-16 |
|-------------------------|--------|--------|--------|--------|--------|--------|
| Australia | | | | | | |
| Cash | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| 90 Day Bill | 2.16 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 |
| 10 Year Bond | 3.02 | 2.90 | 2.90 | 3.00 | 3.10 | 3.30 |
| International | | | | | | |
| Fed Funds | 0.125 | 0.125 | 0.375 | 0.625 | 0.875 | 1.125 |
| US 10 Year Bond | 2.36 | 2.20 | 2.30 | 2.50 | 2.70 | 3.00 |
| ECB Repo Rate | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 |

| Exchange Rate Forecasts | Latest | Jun-15 | Sep-15 | Dec-15 | Mar-16 | Jun-16 |
|-------------------------|--------|--------|--------|--------|--------|--------|
| AUD/USD | 0.7740 | 0.78 | 0.73 | 0.72 | 0.72 | 0.72 |
| USD/JPY | 123.45 | 122 | 124 | 126 | 126 | 127 |
| EUR/USD | 1.1240 | 1.09 | 1.05 | 1.04 | 1.04 | 1.04 |
| AUD/NZD | 1.1050 | 1.10 | 1.11 | 1.11 | 1.11 | 1.11 |

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Disclaimer continued

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