



Sawcut Gorge, Isolated Hill Scenic Reserve, South Marlborough

In this issue

Fixed vs floating	2
The week ahead	3
Data calendar	6
New Zealand forecasts	7
International forecasts	8

The cat is out of the bag

Last week we finally witnessed the 16-year low in inflation we had been awaiting for some time. Annual inflation fell to just 0.1% in the March 2015 quarter – slightly softer than we or the market expected, though it was a touch higher than the Reserve Bank’s forecast of zero inflation.

As expected, the steep fall in fuel prices accounted for most of the decline in the annual inflation rate. But even aside from fuel, the picture remained one of subdued inflation across a wide range of sectors. Tradable goods and services prices, excluding fuel, were down 0.9% on a year ago due to the still-high New Zealand dollar and low global inflation. Import-heavy categories such as clothing (-1.2%), household contents (-1.3%), recreational goods (-1.1%) and vehicles (-1.5%) have been falling in price for some time, and continued to do so in the latest data.

Meanwhile, annual non-tradables inflation slowed to 2.3%, compared to 3.0% a year ago.

The one exception to this soft inflation picture is housing-related prices. Prices for new homes excluding land were up 5% on a year ago (although that’s down from 5.4% last quarter). There was also a notable acceleration in Auckland rents from 2.2% to a 2.6% rate of annual increase. However, annual rental growth in Canterbury slowed from 4.9% to 4.2%, reflecting the gradual restoration of the region’s housing stock.

But housing-related inflation is becoming an increasingly isolated exception to the general theme of low inflation. The Reserve Bank’s sectoral factor model, which strips out volatile items in an attempt to estimate the underlying trend in inflation, is now showing a downtrend in underlying inflation and sits at just 1.3%. Wage growth and pricing intentions are subdued despite the strong economy. And surveys of inflation expectations have fallen hard.

Assistant Governor John McDermott aired the RBNZ’s concerns about falling inflation expectations in an important speech last week. Dr McDermott pointed out that although surveys of inflation expectations are in line with the inflation target, the RBNZ’s model-based and market-based estimates of inflation expectations are now below the target.

The cat is out of the bag continued

Furthermore, Dr McDermott expressed doubt about how effective strong economic growth would be in dragging inflation back up to target.

Dr McDermott concluded by articulating a clear shift in the outlook for monetary policy. While the central outlook is still for the OCR to remain “on hold”, the speech was less balanced about the risks. Back in March the RBNZ indicated that future interest rate adjustments could be “either up or down”, and the interest rate projection was dead-pan flat. By contrast, last week’s speech indicated that the RBNZ was “not considering any tightening in monetary policy”, and went on to say that “Evidence of weakening demand and domestic inflationary pressures would prompt us to consider lowering the OCR.”

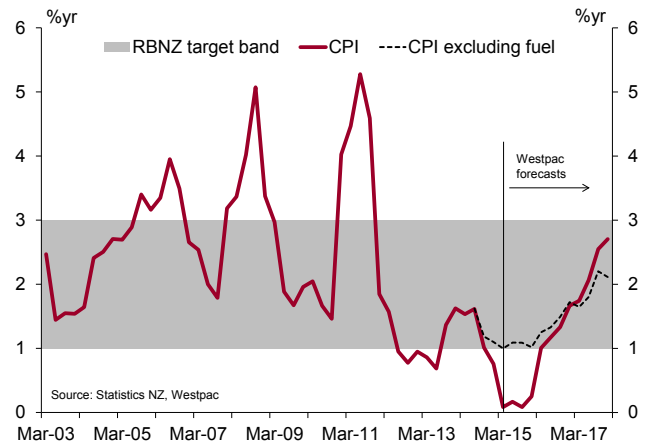
This effectively “let the cat out of the bag” ahead of this week’s OCR Review. It is unlikely that the Review will contradict the Assistant Governor’s speech after only one week. So it is now obvious that this week’s OCR Review will be more dovish than the press release that accompanied the March MPS.

At the very least, the RBNZ will expunge any mention of the OCR going “up” in the Review. We suspect that the RBNZ will find some way of saying that the balance of risks is skewed towards OCR cuts – market reaction on the day will hinge on whether the RBNZ makes that bias explicit, or leaves it implicit.

The other key feature of the OCR Review will be strident language concerning the high exchange rate, especially given the context of falling export commodity prices. However it remains to be seen whether foreign exchange markets will actually react. Markets have become rather inoculated to the Reserve Bank’s rhetoric on the exchange rate, given the paucity of actual exchange rate intervention.

We tend to agree with the RBNZ’s assessment that the risks have shifted. We have ourselves become more ready to countenance OCR cuts this year. On our forecasts, inflation will remain at or below half a percent until next year. That is an awfully long period over which low inflation could influence expectations. So despite our resolutely bullish views on the

CPI inflation forecasts



housing market and economic growth, we ascribe roughly a 40% chance to OCR cuts occurring this year.

If the Reserve Bank were to cut the OCR, it would most likely occur late in the year, for two reasons. First, compelling evidence of falling inflation expectations won’t really be available until at least the middle of this year. Second, macroprudential tightening is one possible resolution to the monetary policy conundrum. The RBNZ has indicated that it will restrict mortgage lending to landlords, which could remove one impediment to OCR cuts by slowing the housing market. However, implementing such restrictions is infeasible until later in the year. The RBNZ may be loath to cut the OCR until it is comfortable that the housing market can be contained another way.

Generally, OCR cuts do not come as singletons. The 40% odds we are ascribing are to *at least two* OCR cuts. Therefore, we have no disagreement with current financial market pricing, which implies around 25 basis points worth of OCR cuts over the coming year. That could be interpreted as 50/50 odds on two or more cuts ahead.

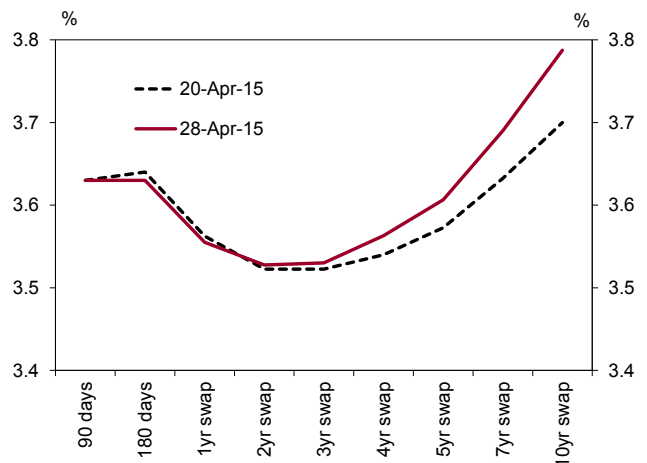
Fixed vs Floating for mortgages

Among the current standard fixed rates, the best value for borrowers with a deposit of 20% or more probably lies in the two-year and three-year terms. However, there is a possibility that fixed mortgage rates will fall even further over the weeks ahead. Waiting a while before fixing might offer even better value.

Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the coming four or five years, though the gap has narrowed in recent weeks, and these longer-term rates do offer the benefit of stability.

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

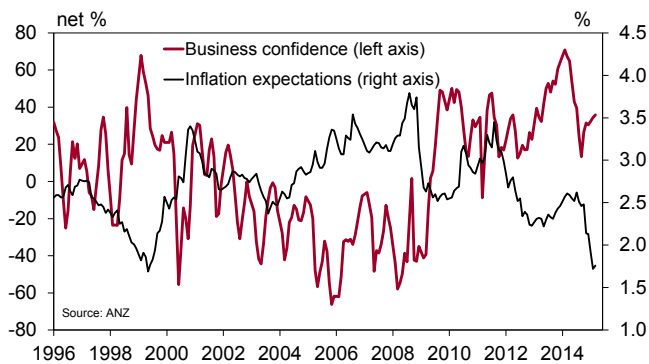


NZ Apr business confidence

Apr 29, Last: 35.8

- Businesses' activity expectations picked up in most sectors in March, and there was notable strength in construction and investment intentions.
- It is not unusual for business confidence to pull back in April. But smoothing through such seasonal variations, we expect that confidence will have remained at robust levels, consistent with continued strength in domestic demand.
- Businesses' inflation expectations and pricing intentions were resilient in the early part of the year. However, with headline inflation now having fallen to its lowest level in well over a decade, there is a risk of a downshift in businesses' price-setting behaviour over the coming months (note that the April survey will have pre-dated last week's CPI release).

NZ business confidence and inflation expectations

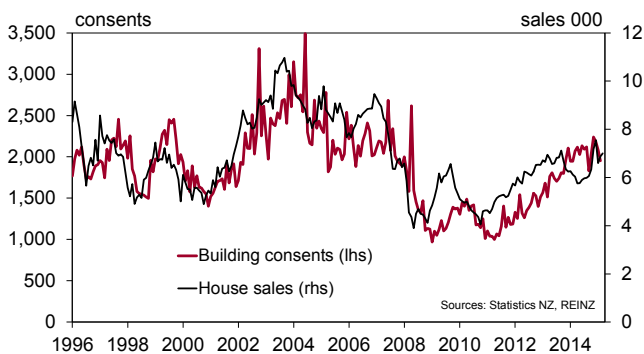


NZ Mar building consents

Apr 30, Last: -6.3%, Westpac f/c: 2.0%

- Residential building consents have fallen a combined 13% in the last three months. Some of this is due to volatility in the apartment units category, but there has been a noticeable softening in the underlying trend as well.
- The two hotspots, Auckland and Canterbury, have both been affected. In the case of Canterbury, the fall in consents actually fits with our assumption about the timing of the peak in quake-related rebuild activity. The slowing pace of growth in Auckland is of more concern, given that building activity is still running below the levels needed to meet population growth.
- There are clear signs of capacity constraints in the building industry, and arguably the quake rebuild in Canterbury has been 'crowding out' activity in Auckland. But constrained capacity can't explain an outright fall in consents at the national level.

NZ housing activity

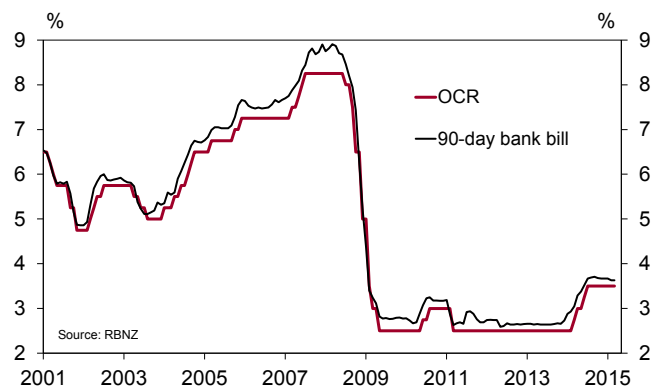


RBNZ OCR review

Apr 30, Last: 3.50%, Westpac f/c: 3.50%, Mkt f/c: 3.50%

- In a speech this week, the RBNZ signalled a shift to a slightly more dovish monetary policy stance. The central outlook is still 'on hold', but the RBNZ would consider cutting if inflation pressures fell any further below the RBNZ's medium-term target.
- Next week's OCR review is unlikely to differ substantially in its wording. There is still scope for a small drop in interest rates and the NZD on the day, depending on the RBNZ's exact words.
- We agree with the RBNZ's assessment. We ascribe a 40% chance to OCR cuts this year - more likely to occur late in the year, once further macroprudential measures and compelling evidence of lower inflation expectations are both in place.

NZ OCR and 90-day rate

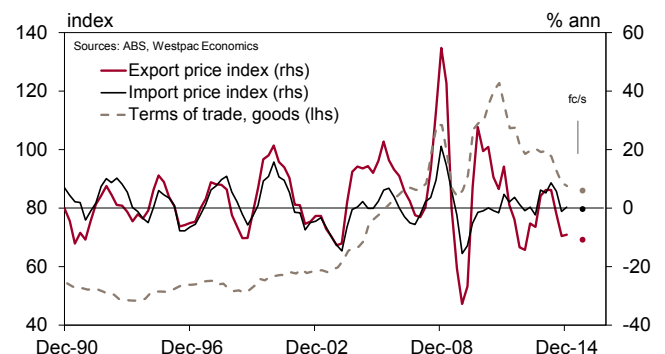


Aus Q1 import price index

Apr 30, Last: 0.9%, WBC f/c: 2.6%
Mkt f/c: 1.0%, Range: -3.5% to 4.0%

- Import goods prices, on average, are expected to rise in the March quarter, increasing by 2.6%. That would see prices little changed over the past year.
- The key forces at play in early 2015 were much the same as in the final months of 2014, namely a sharp drop in the currency and plunging global energy prices.
- In the March quarter, the Australian dollar fell 8% against the US dollar and declined by more than 5% on a TWI basis. Imports are more expensive as a result.
- Against this, global energy prices fell further in the March quarter, plunging by more than 20%. This is significant, with fuel accounting for 15% of total goods imports.

Import & export prices



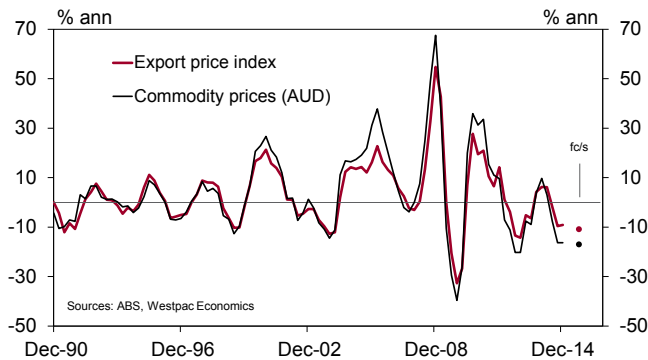
Aus Q1 export price index

Apr 30, Last: 0.0%, WBC f/c: 0.8%
Mkt f/c: 0.0%, Range: -3.0% to 2.0%

- Export prices have come under pressure from weaker global commodity prices, particularly for iron ore. However, offsetting this of late is the sizeable down-step in the currency.
- The export price index is forecast to edge 0.8% higher in the March quarter, but to be 10% lower than a year ago.
- In Q1, global commodity prices fell by around 8%, in USD terms, to be 27% lower than a year ago.
- The terms of trade for goods, on these estimates, declined by almost 2% in the quarter and fell by 12% over the year.

(Note, the Balance of Payments estimates of import and export goods prices can differ from the trade price indexes.)

Commodity prices & export price index

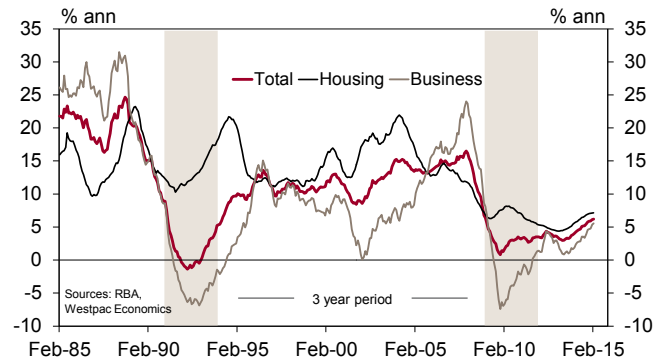


Aus Mar private sector credit

Apr 30, Last: 0.5%, WBC f/c: 0.4%
Mkt f/c: 0.5%, Range: 0.4% to 0.7%

- Private sector credit gained momentum in 2014 and into 2015 as consumers and businesses responded to lower rates.
- In February, credit grew by 0.5% in the month, lifting annual growth to 6.2%, up from 4.3% a year earlier. For March we anticipate a more modest monthly gain of 0.4%.
- Business credit volatility month-to-month is a key risk. For the past four months, gains for business have varied from a low of 0.3% to a high of 0.8%, with a 0.6% rise reported for February. We anticipate a near-term consolidation in business credit given the softening in commercial finance in the second half of 2014.
- Housing credit grew by 0.54% mth, 7.2% yr in February. A similar result is likely in March.

Credit mix: annual growth

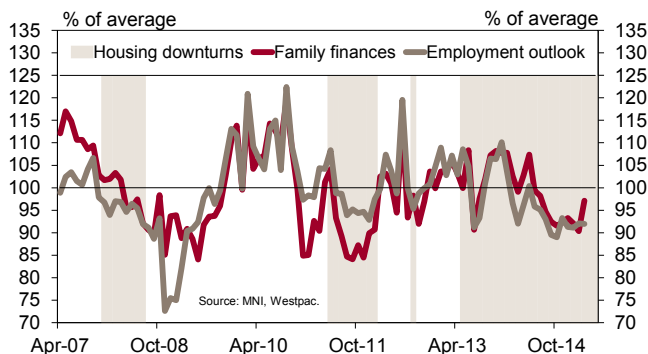


Chn April Westpac MNI China Consumer Sentiment

Wed Apr 29, Last: 114.7

- The headline index increased by 2.7pts in March, printing 114.7 versus 112.0 in February. Consumers are still relatively anxious, but they still responded positively to the February rate cut (as they did to the November move).
- While the previous survey captured the positive effect of the rate cut, the dominant news this time around has been the very weak growth story in Q1. Recall that while the November cut had a clearly discernible positive impact on the December survey, confidence fell back in Jan-Feb, and did not lift again until a further cut was delivered. Further, note that the 100bp RRR cut occurred too late to influence the April survey.
- So, we will be looking to see if the cumulative easing since late last year is able to hold confidence up a month removed from the latest cut; or if consumers still require a shiny new policy every month to keep their chins up.

Westpac MNI China CSI & housing downturns

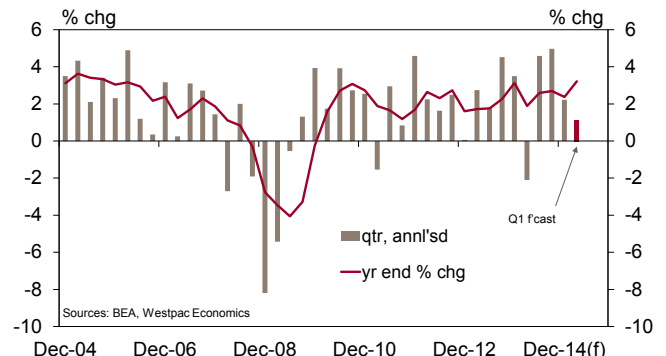


US Q1 GDP growth

April 29, GDP % annualised Last: 2.2%, WBC f/c: 1.1%

- Q4 GDP growth was first reported up 2.6% but has since been revised to 2.2%, lower than the 2.7% average pace recorded over the previous four quarters. Although household consumption surged due to stronger services and non-durables spending, business equipment investment growth stalled, public spending fell and net exports were a significant drag.
- Monthly data suggests personal consumption, housing and business investment growth slowed significantly; a further drag from net exports and no contribution from public spending or inventories should see Q1 growth at 1.1%, half Q4's pace.
- Temporary and ongoing factors are at play: winter disruption; ports disruption; a rising US dollar competitiveness impact; lower price impact on oil sector investment and output; and global growth disappointment. Sufficient headwinds persist to constrain any growth rebound to <3% in Q2 and Q3 '15.

US GDP growth: Q1 a particularly soft quarter

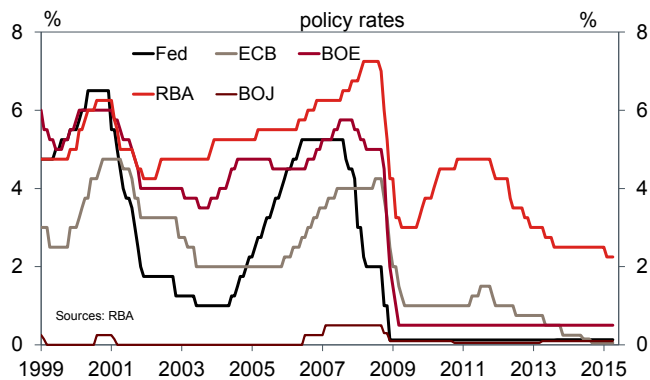


US FOMC policy decision

Apr 29, Last: 0-0.25%, WBC f/c 0-0.25%

- The March 18 FOMC statement forward guidance was “that an increase in the federal funds target rate remains unlikely at the April FOMC meeting”. Subsequent weaker jobs; retail; orders; production; and business survey data has prompted several Fed officials to indicate a preference to “lean to a little later versus a little earlier”. It is now likely that the split apparent in the March meeting minutes over the likely rates lift off date (June or later?) has been resolved: ruling out a June increase may be the updated forward guidance.
- Through 2014 and into 2015, we have maintained that the weaker growth and soft inflation impulse would see the FOMC delay commencing policy normalisation until September. Given we expect further jobs gains and activity growth to accelerate to 3% in late 2015, we retain this call. However, should jobs flag and/or the inflationary impulse fade, the start to normalisation could be further delayed.

Developed world policy interest rates



Data calendar

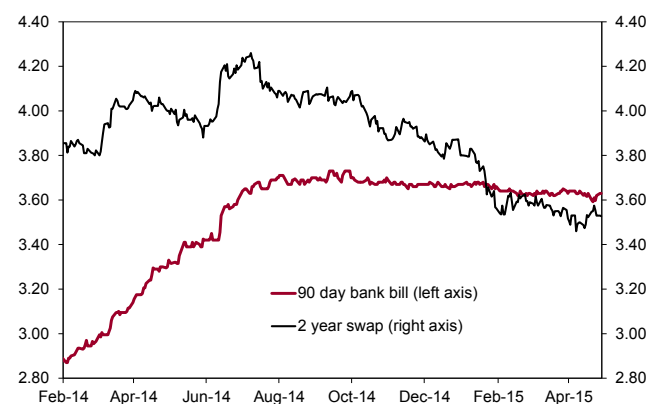
		Last	Market median	Westpac forecast	Risk/Comment
Tue 28					
Aus	RBA Governor Stevens	–	–	–	Australian Financial Review Banking & Wealth Summit, Sydney.
UK	Mar mortgages no.	37.3k	–	–	BBA data covering about 70% of the market.
	Q1 GDP advance	0.6%	–	0.6%	Forecast rounds up to 0.6%, so risk of 0.5% greater than 0.7%.
	Apr house prices %yr	5.1%	4.2%	–	Tentative date for Nationwide index, due 28/4-3/5.
US	Feb house prices %yr	4.6%	4.7%	–	S&P Case Shiller 20-city index.
	Apr Conf Brd consumer confidence	101.3	102.5	102.0	Weekly data suggest confidence steadied; gasoline prices edging lower.
	Apr Richmond Fed factory index	–8	–2	–3	Richmond Fed dived to two-year low in March (3rd weakest since 2009).
Wed 29					
NZ	Mar merchandise trade balance \$m	50	330	360	Dairy exports soft, meat exports strong.
	Apr ANZ business confidence	35.8	–	–	Pricing indicators will be watched closely.
Chn	Apr Westpac–MNI Consumer Sentiment	114.7	–	–	Very weak Q1 GDP a drag and February rate cut boost receding.
Eur	Apr business climate indicator	0.23	0.27	0.12	PMI surveys weaker in April.
	Apr economic confidence	103.9	104.2	104.1	Consumer confidence weaker in advance report, as were PMI surveys.
	Mar money supply M3 %yr	4.0%	4.2%	–	ECB QE impact to show on top of TLTROs
Ger	Apr CPI prelim %yr	0.3%	0.4%	–	Earlier Easter than last year to weigh on CPI temporarily.
UK	Apr CBI retail survey	18	–	–	Reported sales index.
US	Q1 GDP advance % annualised	2.2%	1.0%	1.1%	Growth slowdown in Q1 likely due to more than just temporary factors.
	Mar pending home sales	3.1%	1.0%	2.5%	Recent data show faster new and existing home sales.
	FOMC policy decision	0-0.25%	0-0.25%	0-0.25%	Softer nuanced data tone to see clear language shift away from June hike.
Can	Mar industrial product prices	1.8%	–	–	Energy driven rise in Feb after five straight declines.
Thu 30					
NZ	RBNZ OCR review	3.50%	3.50%	3.50%	On hold this week but growing risk of cuts later this year.
	Mar building consents	–6.3%	–	2.0%	Quake rebuild is peaking; slow growth in Auckland a concern.
	Mar private sector credit %yr	4.8%	–	–	Housing lending has accelerated in recent months.
Aus	Q1 import price index	0.9%	1.0%	2.6%	Import costs up as currency falls, lower fuel costs a notable exception.
	Q1 export price index	0.0%	0.0%	0.8%	Slide in commodity prices (iron ore) offset by lower AUD, –8%qtr vs USD.
	Mar private sector credit	0.5%	0.5%	0.4%	Gain in momentum on lower rates, but commercial finance has softened.
Eur	Apr CPI flash %yr	–0.1%	–	–0.2%	Eurozone's deflation minimal, but key policy driver. Mar core 0.6%yr.
	Mar unemployment rate %	11.3%	11.2%	11.2%	Lower German jobless rate and slightly lower joblessness elsewhere.
Ger	Apr unemployment ch	–14k	–15k	–	German joblessness fell –109k last 6 months vs –5k in Apr-Sep '14.
UK	Apr GfK consumer confidence	4	4	–	Around 20pts higher than 5 years ago, just before the 2010 elections.
US	Q1 employment cost index	0.6%	0.6%	0.5%	Firmer jobs market has seen costs pick up in some sectors.
	Mar core PCE deflator	0.1%	0.1%	0.2%	Core CPI was solid 0.2% in Mar.
	Mar personal income	0.4%	0.2%	0.2%	Quarterly totals will be known from GDP release on 29/4. Earnings rose
	Mar personal spending	0.1%	0.5%	0.6%	but hours fell in Mar, retail sales sluggish but non-retail spending key.
	Initial jobless claims w/e Apr 25	295k	–	–	Claims below 300k for seven weeks running.
	Apr Chicago PMI	46.3	50.0	50.0	Evidence that more than temporary factors slowing economy.
	Apr Milwaukee NAPM	53.3	–	–	Little watched.
Can	Feb GDP %yr	2.4%	–	–	Rising oil output prevented a steeper slowdown in January.
Fri 1					
Aus	Apr AiG PMI	46.3	–	–	Manufacturing sector index up 0.9pts in Mar, but still sub-50.
	April CoreLogic RP Data house prices	1.4%	–	1.0%	Price growth has slowed significantly in Perth/Brisbane/Adelaide.
Chn	Apr NBS manufacturing PMI	49.2	49.4	–	Flash was poor, with deflation signals back to red.
Eur	May day holiday across most Europe	–	–	–	Most continental markets closed.
UK	Mar net mortgage lending £bn	1.7	–	–	Mortgage momentum slowed from £2bn + per mth in mid '14
	Mar net consumer credit £bn	0.7	0.8	–	Demand for consumer credit also giving up modest gains last year.
	Mar M4 money supply %yr	–3.2%	–	–	M4 ex IOFCs up 5.0% 3m ann'lsd in Feb (from 2.3% yr low in May 14).
	Apr PMI factory	54.4	54.7	54.5	Factory sector still underperforming relative to a year ago.
US	Apr ISM factory	51.5	52.0	51.3	Mostly weaker regional survey detail so far for April.
	Apr Markit PMI factory final	54.2 a	–	–	Latest outcome more in line with weaker national ISM survey.
	Mar construction spending	–0.1%	0.5%	0.4%	Housing spending momentum may be picking up again.
	Apr auto sales mn annualised	17.1	16.9	–	Guide to extent of consumer spending momentum in early Q2.
Can	Apr RBC PMI	48.9	–	–	Usually more stable than IVEY, RBC index showed steeper Q1 plunge.

New Zealand forecasts

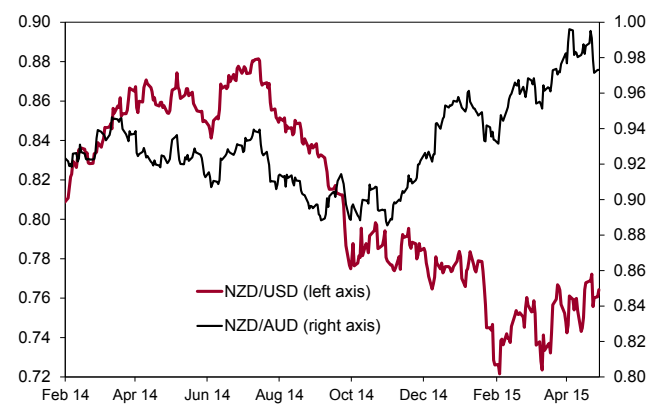
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2013	2014f	2015f	2016f
% change								
GDP (Production) ann avg	2.2	2.5	3.3	3.0	2.3	3.3	3.0	3.4
Employment	0.2	3.8	3.0	3.0	2.9	3.6	2.7	2.3
Unemployment Rate % s.a.	6.3	6.1	5.9	5.1	6.1	5.7	5.2	4.9
CPI	0.9	1.5	0.2	0.9	1.6	0.8	0.3	1.7
Current Account Balance % of GDP	-3.7	-2.6	-4.1	-4.7	-3.3	-3.3	-4.8	-4.4

Financial Forecasts	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Cash	3.50	3.50	3.50	3.50	3.50	3.75
90 Day bill	3.70	3.70	3.70	3.75	3.75	4.00
2 Year Swap	3.40	3.50	3.60	3.70	3.90	4.00
5 Year Swap	3.50	3.60	3.70	3.80	4.00	4.20
10 Year Bond	3.20	3.30	3.40	3.50	3.70	4.00
NZD/USD	0.74	0.72	0.71	0.71	0.71	0.72
NZD/AUD	0.99	0.99	0.99	0.99	0.99	1.00
NZD/JPY	88.8	87.8	88.2	88.0	88.8	90.7
NZD/EUR	0.70	0.70	0.70	0.70	0.70	0.71
NZD/GBP	0.51	0.50	0.50	0.49	0.48	0.48
TWI	79.8	78.9	78.6	78.4	78.4	79.5

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 28 April 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.61%	3.63%	3.63%
60 Days	3.61%	3.63%	3.64%
90 Days	3.63%	3.64%	3.65%
2 Year Swap	3.53%	3.51%	3.56%
5 Year Swap	3.61%	3.58%	3.65%

NZ foreign currency mid-rates as at Tuesday 28 April 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7643	0.7521	0.7562
NZD/EUR	0.7020	0.7102	0.6942
NZD/GBP	0.5018	0.5142	0.5079
NZD/JPY	90.97	90.52	90.16
NZD/AUD	0.9731	0.9808	0.9760
TWI	79.22	79.16	79.10



International forecasts

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	2.2	3.0
CPI inflation % annual	3.0	2.2	2.7	1.7	2.3	2.4
Unemployment %	5.2	5.3	5.8	6.2	6.7	6.4
Current Account % GDP	-2.8	-4.4	-3.3	-2.8	-3.3	-2.9
United States						
Real GDP %yr	1.6	2.3	2.2	2.4	2.6	3.2
Consumer Prices %yr	3.1	2.1	1.5	1.6	1.0	2.1
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	-2.4	-2.4
Japan						
Real GDP %yr	-0.4	1.7	1.6	-0.1	1.0	1.7
Euroland						
Real GDP %yr	1.6	-0.6	-0.4	0.8	1.1	1.1
United Kingdom						
Real GDP %yr	1.1	0.3	1.7	2.6	2.5	2.7
China						
Real GDP %yr	9.3	7.7	7.7	7.4	7.1	7.3
East Asia ex China						
Real GDP %yr	4.5	4.5	4.3	4.1	4.8	5.1
World						
Real GDP %yr	4.1	3.4	3.3	3.2	3.5	4.1
Forecasts finalised 10 April 2015						

Interest Rate Forecasts	Latest	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
Australia						
Cash	2.25	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.26	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.55	2.45	2.60	2.60	2.80	3.00
International						
Fed Funds	0.125	0.125	0.375	0.625	0.875	1.125
US 10 Year Bond	1.96	2.10	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	0.7776	0.75	0.73	0.72	0.72	0.72
USD/JPY	119.54	120	122	124	124	125
EUR/USD	1.0800	1.06	1.03	1.02	1.02	1.02
AUD/NZD	1.0277	1.01	1.01	1.02	1.01	1.01

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