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Don't cry over slipped milk

A steep fall in world dairy prices at auction last week sparked a flurry of questions from the market about whether a key part of the New Zealand economy's good-news story is coming unstuck. We would recommend cool heads for now: an easing in dairy prices in response to increased supply is something we have been expecting for a long while, although we are alert to the risk that prices could continue to fall.

Dairy prices fell 8.9% in the first GlobalDairyTrade auction for April, the biggest fall in a single auction in two years. While that followed a combined 9% drop in the two auctions in March, this was clearly the first time that it had registered on the market's radar; up until the auction results, the New Zealand dollar had been powering ahead to new post-float highs on a trade-weighted basis.

The sudden downturn in prices seems to have generated a great deal of concern in markets about its causes, including whether it could signal something more sinister such as a steep drop in Chinese household demand. While nothing can be ruled out, the fact that the price drop seems fairly isolated to dairy products would argue instead for supply being the driver.

At the least, we can say that the scarcity premium is coming out of dairy prices. Domestic milk production is expected to be up 10% this season compared to the previous drought-afflicted season, despite very dry conditions again in some parts of the North Island. Meanwhile, European production is growing strongly, the trend in Australian production has improved in the last few months, and improved margins for American producers (thanks to higher dairy prices and lower feed costs) should

Don't cry over slipped milk continued

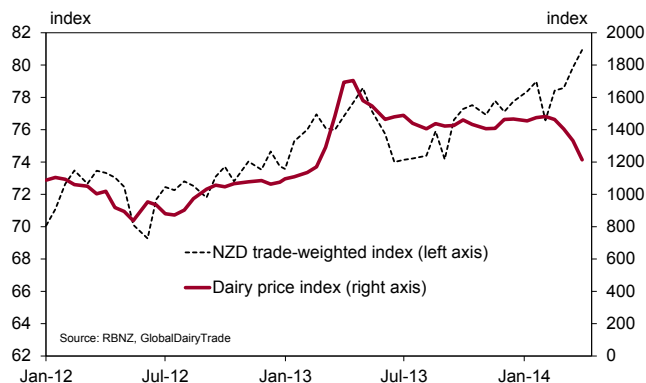
see output increase there too this year. We have long been expecting dairy prices to soften in 2014 as the world ramped up production in response to the high prices on offer. But as the economist Rudi Dornbusch observed, in economics things take longer to happen than you'd expect, and then they happen faster than you'd believe.

While the fall in dairy prices won't have entirely come as a surprise to the Reserve Bank either, it's the combination of lower export prices and a higher exchange rate that presents a challenge to the RBNZ's outlook. The trade-weighted index has fallen about 1% since the dairy auction, but it's still about 2% higher than the RBNZ assumed in its March *Monetary Policy Statement* – none of which can be justified by changes in the state of the New Zealand economy in that time.

If both the currency strength and dairy price softness are sustained, that will tend to reduce inflation pressure and lessen the need for interest rate hikes. The RBNZ's March projections implied around 200 basis points of OCR hikes over the next two years; if it re-ran its forecasts today, this may be closer to 175bps. Still, that's a modest change, and it's unlikely that it would affect the RBNZ's short-term strategy. An April OCR hike, with a signal of more to come, still looks assured.

The other potential spoiler for the RBNZ's interest rate projections is the state of the housing market, and the impact of the restrictions on high loan-to-value ratio (LVR) mortgage lending that came into force last October. It's clear that the housing market has slowed more than intended in recent months, so it's interesting to note some recent comments from the RBNZ that could be aimed at paving the way for a loosening of the LVR restrictions. In a speech last month, Deputy Governor Grant Spencer touched on the conditions for reducing or removing the restrictions. That was followed last week by a *Bulletin* article noting that the restrictions are intended to mitigate the "extremes" in credit and house price cycles – to our knowledge, the first time that the RBNZ has placed such strict conditionality around the restrictions.

NZ dollar and world dairy prices



When the RBNZ introduced the restrictions it envisaged that high-LVR loans, including those that qualified for exemption, would account for 15% of new lending; the actual share in recent months has been closer to 5%. On that basis, there may be a case for 'recalibrating' the limits to bring them more in line with the intended outcomes. We suspect this would happen fairly soon, unless the housing market picks up of its own accord in the near future. Spencer's speech noted that the RBNZ will publish new estimates of the impact of the LVR limits in its next *Financial Stability Report* in May; that might be too soon to expect an announcement on any changes, but the *FSR* would at least help to build the case for it.

Part of the shortfall in high-LVR may have been due to heightened caution by lenders in the face of previously untested rules, and there are signs that this issue is starting to resolve itself. Banks are reported to be easing their lending standards to make up for the shortfall in high-LVR lending, and mortgage approvals have been ticking up again in the last couple of months. Last week Barfoot & Thompson, the largest real estate agency in Auckland, reported a strong rise in house sales in March, albeit after a very soft February.

Fixed vs Floating for mortgages

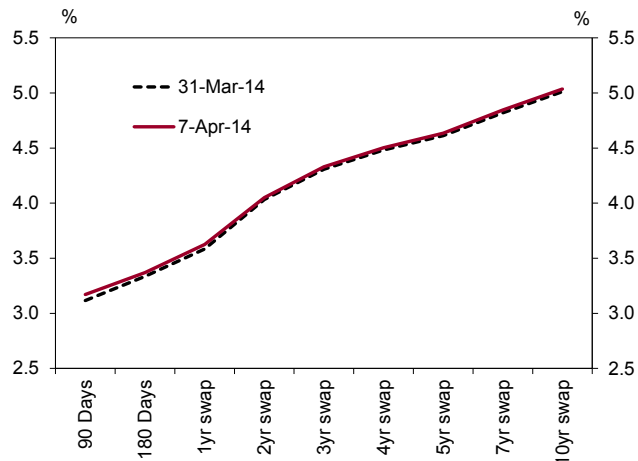
Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates, such as the six month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

For those who are looking to fix, there is little to gain from waiting. Fixed rates are more likely to rise than fall over the next few months.

Among the standard fixed rates, anything from six months to three years appears to offer similar value. Three-year rates are higher, but this is a fair reflection of where we think shorter-term rates are going to go over the next few years.

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.

NZ interest rates

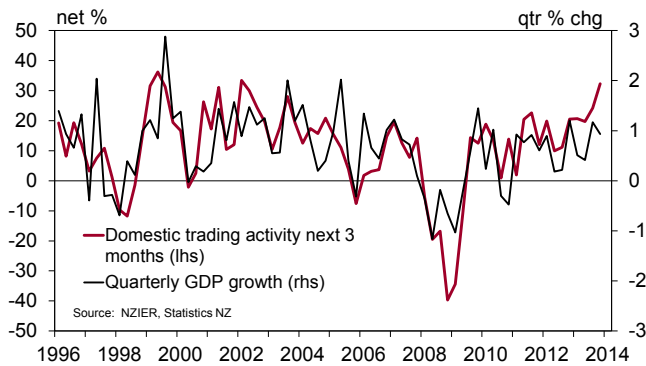


NZ Q1 NZIER business opinion

Apr 8, Last: 52

- Business sentiment reached a 20-year high in the December 2013 quarter, with a net 52% of firms expecting better conditions over the following six months. The monthly ANZ business confidence survey has extended further since then.
- The own-activity measure in this survey is probably the best single indicator of quarterly GDP growth. Our preliminary forecast is for 1.1% growth in the March quarter; sentiment indicators are suggesting something even stronger, but 'hard' activity data didn't have the best start to the quarter.
- With the upturn in activity well-established, evidence of price pressures have taken on more importance. While capacity and difficulty finding workers are growing concerns, evidence of pricing power has largely been absent to date.

QSBO domestic trading activity and GDP

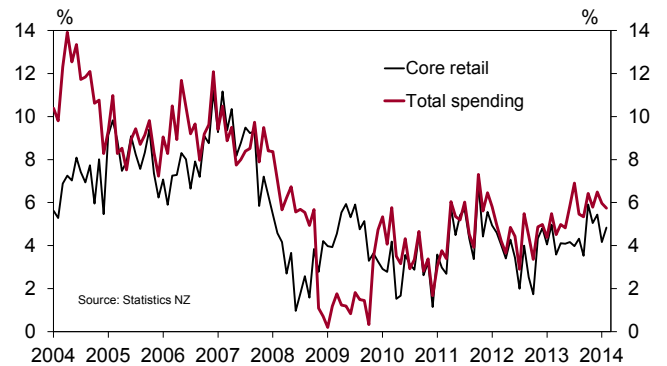


NZ Mar electronic card transactions

Apr 9, last 0.6%, WBC f/c: 0.6%

- Electronic card rebounded in February from a surprisingly weak January. However, taking January and February together still suggests that card spending lost momentum in the new year.
- We suspect this is short-term volatility, exacerbated by a surge in the penetration of cards last year (possibly due to increasing use of contactless payment). With both consumer and retailer confidence remaining close to multi-year highs in March, we expect a return to a firmer underlying trend of growth.
- Advance spending figures from Paymark (New Zealand's biggest card processor) are likely to be released early next week, providing additional information.

Card transactions, annual % change

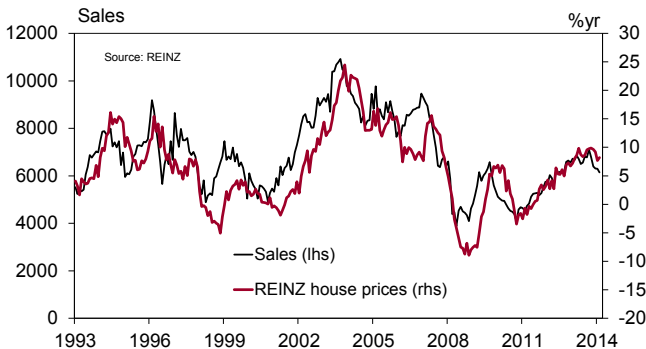


NZ Mar REINZ house prices and sales

Apr 11 (tbc), Sales last: -2.4%, Prices last: 8.2%yr

- Higher mortgage rates and the RBNZ's restrictions on high loan-to-value ratio (LVR) mortgage lending are now clearly working to cool the housing market, with sales down 13% from their peak last October. Rising mortgage approvals and a jump in sales for Auckland's largest real estate agency suggest that sales could be finding a base.
- The issue of what is happening to house prices is a vexed one. A steeper drop in sales of low-end properties may have skewed reported sale prices upward. The REINZ price indices are stratified by suburb, which partially adjusts for composition changes, but not entirely; annual house price growth accelerated from 7.7% to 8.2% in February, with Auckland hitting 17%yr. The most reliable take on house prices is probably Quotable Value's monthly Property Value Index (due Tuesday), which is unaffected by the composition of sales, but comes with an effective lag of two months.

REINZ house prices and sales



Aus Apr Westpac-MI Consumer Sentiment

Apr 9, Last: 99.5

- The Westpac-Melbourne Institute Consumer Sentiment Index has been under pressure in recent months. After hitting a post-election high of 110.3 in Nov, the Index has fallen back to just under the neutral 100 level in Mar. Heightened concerns about the economic outlook and jobs have been a key factor. The latter has clearly been exacerbated by a string of corporate lay-off announcements from Qantas, Toyota, Holden etc, and expectations of Federal Budget cuts in May.
- This month's survey is in the field from Mar 31 to Apr 6. With no surprises from the April 1 RBA meeting and financial market moves neither here nor there, sentiment may be more influenced by the strengthening housing market (albeit with the double-edged sword of fears of a correction). It will be interesting to see how labour market views evolve as 'bad news' fades and actual conditions show signs of improving.

Consumer Sentiment Index

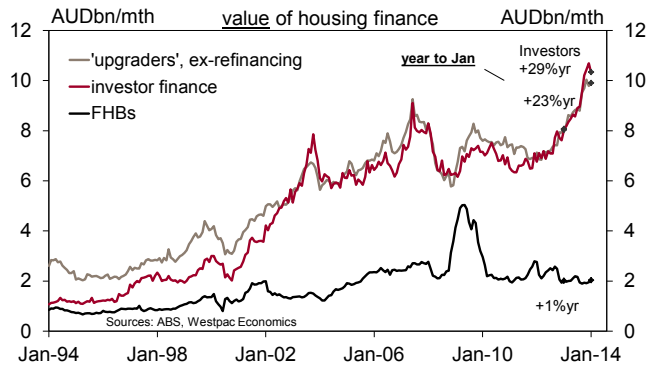


Aus Feb housing finance (no.)

Apr 9, Last: flat%, WBC f/c: 2.0%
Mkt f/c: 1.5%, Range: -0.6% to 2.0%

- The number of owner occupier finance approvals held flat in Jan with the survey detail mostly downbeat (Dec revised down to a 3.3% fall and the value of investor loans down 3.3% in Jan). Construction-related finance approvals were a bright spot with a strong 5.8% gain although these have lagged behind the much stronger pick-up in dwelling approvals in 2013.
- Industry figures suggest Feb was a better month. We expect owner-occupier finance approvals to post a 2% gain. However, the surge in activity looks likely to top out by the middle of the year – the Westpac-MI consumer sentiment survey has shown a definite cooling in assessments of ‘time to buy a dwelling’ that, coupled with increased job concerns and taking into account the lags between sentiment and activity, point to annual growth in finance approvals stalling flat by Jun.

Value of finance approvals by segment

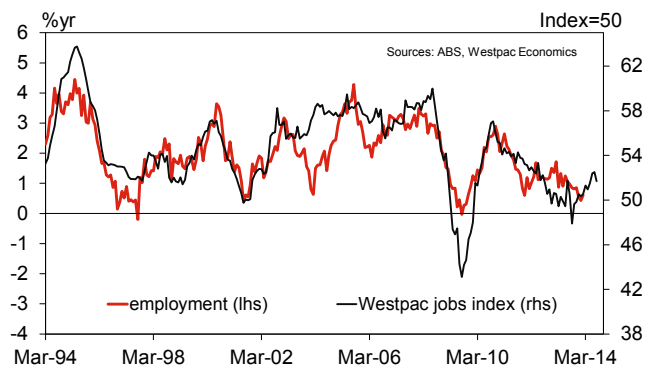


Aus Mar employment

Apr 10, Last: 47.3k, WBC f/c: -20k
Mkt f/c: 5k, Range: -20k to 25k

- Total employment rose 47.3k in Feb; full-time employment rose 80.5k and part-time fell 33.3k. This is obviously a stronger than expected print for employment (market +15k, Westpac +20k).
- With seasonal re-analysis, Jan was revised from -3.7k to +18k (our Jan forecast was +20k). Along with the Feb print this has changed what originally appeared to be a dismal start to 2014 (-10.4k in three months to Jan) to a more positive 41.0k in the three months to Feb (or 13.7k per month).
- The labour market indicators have lifted suggesting that the weak patch during 2013H2 has passed. Nevertheless, given that sample rotation explained 37% of the February increase in employment there is a higher than usual probability of a statistical correction in Mar.

Our jobs index suggests the worst is past, for now

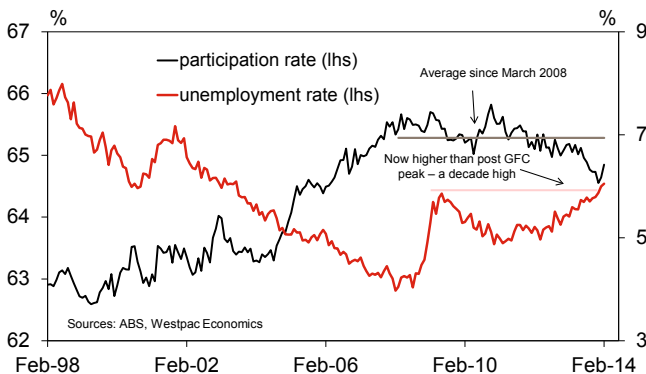


Aus Mar unemployment rate

Apr 10, Last: 6.0%, WBC f/c: 6.1%
Mkt f/c: 6.1%, Range: 5.9% to 6.2%

- Even with the much strong print for total employment in Feb, the unemployment rate still came in on expectations - flat at 6.0% (6.05% unrounded from 5.99%).
- Our bulletin on the release noted that a flat unemployment rate alongside a strong jobs print is often a hint not to take the reported jobs strength at face value. A matching rise in participation suggests that the new group rolled into the sample was more attached to the labour force than the group that rolled out; that is the new group has both higher participation and higher employment than the group that rolled out.
- Our forecast for -20k on total employment incorporates a fall in participation, a move which limits the rise in unemployment to 6.1%.

Unemployment and participation rates



Data calendar

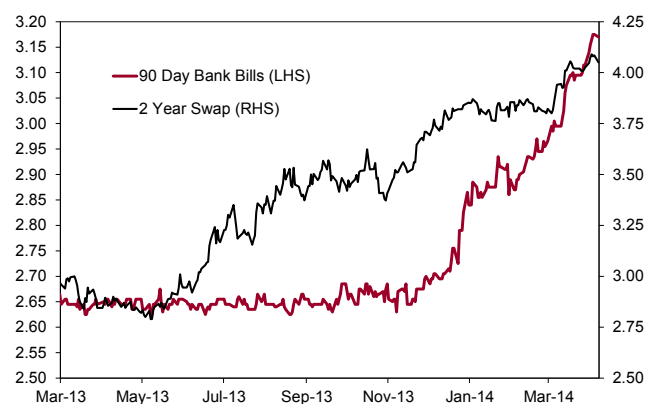
		Last	Market median	Westpac forecast	Risk/Comment
Mon 7					
Aus	End of daylight saving	–	–	–	NSW, Vic, SA, Tas, ACT.
	Mar ANZ job ads	5.1%	–	–	Job ads now down just –4.8%yr from a low of –18.8%yr in Jun 13.
Eur	Apr Sentix investor confidence	13.9	13.6	16.0	Ukraine risks subsided, ECB, China stimulus hopes, equities higher.
Ger	Feb industrial production	0.8%	0.3%	0.6%	Feb-Mar PMI data suggest slight moderation in output growth.
US	Feb consumer credit \$bn	13.7	14.2	–	Auto and student loans the drivers; easier to get than home loans.
Can	Q1 BoC loan officer survey	–10.8	–	–	Little change in credit tightness since late 2011.
	Q1 business outlook survey	29	–	–	Future sales index.
Tue 8					
NZ	Q1 NZIER business opinion	52	–	–	Sentiment remains high; awaiting evidence of price pressures.
Aus	Mar NAB business survey	0	–	–	Conditions index at 0, in line with L/R avg, but down from +5 in Jan.
UK	Feb industrial production	0.1%	0.3%	0.5%	Recent lower mid 50 PMI readings imply moderate growth.
US	Mar NFIB small business optimism	91.4	92.3	92.5	Just partial recovery from Feb plunge.
	Fedspeak	–	–	–	Kocherlakota and Plosser.
Can	Mar housing starts	6.4%	–	–	Feb saw first rise in four months, led by condos.
	Feb building permits	8.5%	–	–	BoC has warned further housing stimulus could be "trouble".
Wed 9					
NZ	Mar electronic card transactions	0.6%	0.5%	0.6%	Consumer confidence reached multi-year highs in March.
Aus	Apr Westpac-MI Consumer Sentiment	99.5	–	–	Dropped back below 'neutral' on economic outlook, jobs concerns.
	Apr Westpac-MI unempl' expectations	5.5%	–	–	Lifted 15.5% in 6mths, 17.7%yr. Household more nervous about jobs.
	Feb housing finance	flat	1.5%	2%	Still rising in Feb but expected to 'top out' by mid-2014.
Ger	Feb exports	2.2%	–0.5%	–0.5%	Chinese new year may have impacted German exports in Feb.
UK	Mar BRC shop price index %yr	–1.4%	–	–	Pointing to further CPI deceleration. Leads CPI turning points by 2-3 mth
	Feb trade balance £bn	–9.8	–9.2	–	Exports down 4% and imports up 3.4% saw deficit re-widen in Jan
US	Feb wholesale inventories	0.7%	0.5%	0.8%	Inventories built up during snow disruption.
	Mar 18-19 FOMC minutes	–	–	–	Discussion re factors other than snow driving slower data of interest.
	Fedspeak	–	–	–	Evans.
Thu 10					
NZ	Mar manufacturing PMI	56.2	–	–	Above 55 for seven of the last eight months.
	Mar food price index	–1.0%	–	0.0%	Annual food price inflation is starting to tick higher again.
Aus	Mar employment, chg '000	47.3	5	–20	Sample roll explained 37% of the Feb rise, chance of correction is high.
	Mar unemployment rate	6.0%	6.1%	6.1%	Falling participation will hold a likely rise in unemployment to 6.1%.
	Apr MI Consumer inflation expect'ns	2.1%yr	–	–	Inflationary expectations are up off their low but still well contained.
Chn	Mar trade balance USDbn	–22.99	–0.95	–	Exports normalising, imports look vulnerable: surplus possible.
	Mar foreign reserves USDbn (end qtr)	3821	–	–	Tentative date: large inflows early in the qtr, outflows late.
	Mar new loans RMBbn	644.5	1000	–	Tentative date: 2013 saw up, down, up pattern in Jan-Feb-Mar.
	Mar total social financing RMBbn	938.7	2050	–	Tentative date: 'shadow' elements down on a year ago ex entrusted.
	Mar M2 money supply %yr	13.3%	13.0%	–	Tentative date: softer inflows late in the quarter should show up here.
UK	Mar house prices net %	45	43	–	RICS surveyors a bit less up-beat on house prices in recent months.
	Bank of England policy decision	0.5%	0.5%	0.5%	Policy firmly on hold with inflation down, given forward guidance.
US	Initial jobless claims w/e Apr 5	326k	–	325k	Claims' renewed downtrend since late Feb may have stalled.
	Mar import prices	0.9%	0.2%	0.3%	Oil prices a little changed on avg' than in Feb; US\$ weaker though.
	Mar federal budget \$bn	–	–	–	Feb data showed narrower deficit than a year prior.
	Fedspeak	–	–	–	Tarullo; Evans with CB officials from ECB, Brazil, India in Washington
Can	Feb new house prices %yr	1.5%	–	–	Housing slowdown has seen new build price inflation moderate.
Fri 11					
NZ	Mar REINZ house sales	–2.4%	–	–	Could be released late this week. Sales down 13% since Oct.
	Mar REINZ house price index %yr	8.2%	–	–	Drop in low-end sales has skewed price measures upward.
Chn	Mar PPI %yr	–2.0%	–2.2%	–	Deflation has reaccelerated in early '14, with PMI price details very soft.
	Mar CPI %yr	2.0%	2.5%	–	Sharp m/m fall in food prices March 2013 not fully replicated in '14.
UK	Feb construction output	1.8%	–	–	PMI survey points to strong underlying picture; flooding in Feb a risk.
US	Mar PPI final demand	–0.1%	0.1%	0.1%	Modest services price inflation to be main driver of the revamped
	Mar PPI fd core	–0.2%	0.2%	0.1%	PPI.
	Apr UoM consumer sentiment prelim	80.0	81.0	82.0	300 responses in prelim; IBD-TIPP up sharply with 900 replies.
	World Bank/IMF	–	–	–	Spring meeting in Washington.

New Zealand forecasts

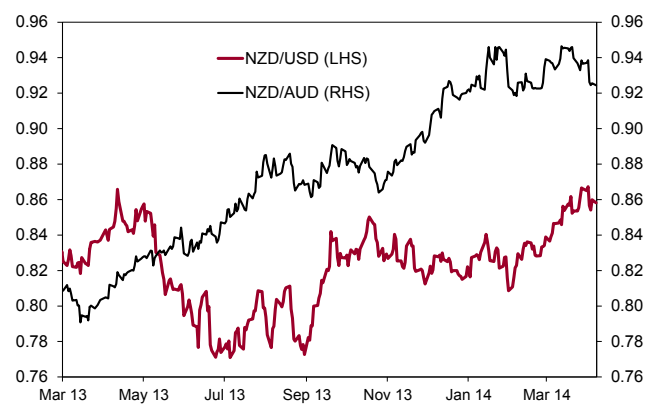
Economic Growth Forecasts	March years				Calendar years			
	2013	2014f	2015f	2016f	2012	2013	2014f	2015f
% change								
GDP (Production) ann avg	2.3	3.1	4.0	3.0	2.6	2.7	4.0	3.2
Employment	0.4	3.3	2.8	1.5	0.4	2.9	2.9	1.8
Unemployment Rate % s.a.	6.2	5.8	5.1	4.8	6.8	6.0	5.1	4.7
CPI	0.9	1.6	1.8	2.4	0.9	1.6	1.8	2.2
Current Account Balance % of GDP	-3.9	-3.1	-4.9	-5.2	-4.1	-3.4	-4.1	-5.3

Financial Forecasts	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
Cash	3.25	3.50	3.75	4.00	4.00	4.25
90 Day bill	3.50	3.75	4.00	4.20	4.30	4.50
2 Year Swap	4.10	4.30	4.50	4.65	4.80	5.00
5 Year Swap	4.70	4.80	4.90	5.05	5.20	5.35
10 Year Bond	4.80	5.00	5.10	5.20	5.30	5.40
NZD/USD	0.86	0.86	0.84	0.83	0.82	0.83
NZD/AUD	0.95	0.96	0.95	0.95	0.94	0.93
NZD/JPY	89.4	88.6	85.7	85.5	85.3	86.6
NZD/EUR	0.63	0.63	0.64	0.64	0.63	0.63
NZD/GBP	0.50	0.51	0.50	0.49	0.47	0.45
TWI	80.5	80.9	80.0	79.6	78.6	78.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 7 Apr 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.75%	2.75%	2.50%
30 Days	3.00%	2.95%	2.87%
60 Days	3.09%	3.01%	2.93%
90 Days	3.17%	3.08%	3.01%
2 Year Swap	4.05%	4.02%	3.95%
5 Year Swap	4.64%	4.62%	4.59%

NZ foreign currency mid-rates as at Monday 7 Apr 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8582	0.8548	0.8443
NZD/EUR	0.6265	0.6196	0.6086
NZD/GBP	0.5177	0.5185	0.5043
NZD/JPY	88.62	87.29	86.89
NZD/AUD	0.9244	0.9406	0.9343
TWI	80.18	79.98	78.97



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	2.7	3.0
CPI inflation % annual	2.8	3.0	2.2	2.7	2.4	2.5
Unemployment %	5.2	5.2	5.3	5.8	6.5	6.3
Current Account % GDP	-3.5	-2.8	-4.1	-2.9	-3.1	-2.0
United States						
Real GDP %yr	2.5	1.8	2.8	1.9	2.2	2.5
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.5	1.5
Unemployment Rate %	9.6	8.9	8.1	7.4	6.8	6.2
Current Account %GDP	-3.0	-2.9	-2.7	-2.3	-2.4	-2.3
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.6	1.5	1.3
Euroland						
Real GDP %yr	1.9	1.6	-0.6	-0.4	0.8	0.8
United Kingdom						
Real GDP %yr	1.6	1.2	0.2	1.7	2.6	2.1
China						
Real GDP %yr	10.4	9.3	7.7	7.7	7.3	7.6
East Asia ex China						
Real GDP %yr	7.8	4.3	3.9	4.0	4.0	5.0
World						
Real GDP %yr	5.2	3.9	3.2	2.9	3.2	3.8
Forecasts finalised 4 April 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	2.67	2.55	2.55	2.55	2.55	2.65
10 Year Bond	4.18	3.90	3.70	4.00	4.20	4.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.80	2.60	2.50	2.80	3.00	3.20
ECB Repo Rate	0.25	0.25	0.25	0.25	0.25	0.25

Exchange Rate Forecasts	Latest	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
AUD/USD	0.9230	0.91	0.90	0.88	0.87	0.87
USD/JPY	103.90	104	103	102	103	104
EUR/USD	1.3720	1.36	1.34	1.30	1.28	1.28
AUD/NZD	1.0800	1.06	1.05	1.05	1.05	1.06

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Disclaimer continued

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