



Castle Hill, Canterbury.

In this issue

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

Past the sweet spot

Last week's labour market data raised fresh doubts about the economy's capacity to accommodate all the growth that is going on without generating inflation pressure, supporting the case for raising the OCR further over the next few years. But with dairy prices continuing to fall the Reserve Bank is unlikely to be nudged off its current 'period of assessment' for a while yet.

Dairy prices continued to tumble in Fonterra's latest auction, with whole milk powder prices falling to their lowest level since late 2012.

As we've noted in recent weeks, the most recent bout of weakness can no longer be pinned on recovering global supplies, and instead seems to be due to weaker Chinese demand – more cautious consumers, and a resulting build-up of milk-powder stocks in Chinese warehouses.

The latest fall in auction prices creates a clear risk that the farm gate milk price for the current season will come out below our current forecast, which sits at \$6. We will await another auction result before formally cementing in a new forecast – there is still a lot of water to go under the bridge before the end of the season, and we still expect a solid rebound in dairy prices by the end of the year as Chinese wholesalers work off their stocks and demand starts to recover. But clearly, the further dairy prices keep falling, the harder it will be for prices to stage a rebound of the size required to meet our \$6 forecast – at least in the absence of drought, rocketing grain prices or some other disruption to dairy supplies. And those don't look likely - US grain prices are falling, and earlier warnings of a severe El Niño event have been downgraded.

There is no doubt that the current downturn in dairy prices will mean pain for New Zealand's rural economy. For the Reserve Bank, this has to be balanced against developments in the more domestically-focussed parts of the economy. On that score, the latest labour data offered mixed messages. On the one hand, they added to the evidence that the domestic economy has come off the boil over the past few months.

Past the sweet spot continued

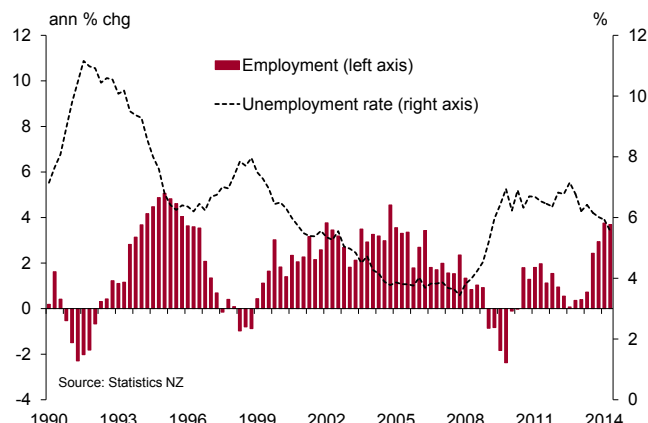
But they also suggested that the economy's spare capacity may be eroding more rapidly than previously thought.

What was remarkable over the past year was the seeming scope for the economy to grow, and the labour market to expand, without generating a significant amount of inflation pressure. Growing demand for workers was met by rapid population growth and a rise in the rate of labour force participation to record highs. The latest figures suggest that sweet spot may be coming to an end. Jobs growth was surprisingly modest in the June quarter, at just 0.4%. But the participation rate also edged lower, so the rise in jobs, modest as it was, came entirely out of the ranks of the unemployed.

We would caution against reading too much into the low jobs print. We suspect that some of the recent ups and downs in jobs growth and participation are survey noise – volatility in these measures often goes hand in hand. Looking back over the past year, both still suggest a healthy lift in labour demand – employment is up 3.7% on a year ago, while the participation rate is 0.8 percentage points higher.

The more unequivocal message from the labour data is that the labour market's capacity to accommodate jobs growth is diminishing. The drop in the unemployment rate to 5.6% was surprisingly large, and there was also a surprising uptick in private sector wage inflation, to 1.8%, its highest in over a year. It's also worth noting that these signs of a tightening labour market are now spreading across sectors and regions. Canterbury unsurprisingly remains the star performer, but the construction boom hasn't been confined to the region. While construction jobs in Canterbury are up 27% on a year ago, they have risen by a very respectable 14% elsewhere, and wage inflation has also started to pick up again for construction workers outside Canterbury. Conversely, recent jobs growth in Canterbury hasn't just been a construction story - there have also been significant gains in manufacturing, retail and public administration.

Household labour force survey



So on balance, we think the labour data support the case for further OCR hikes in coming years. But they have to be kept in perspective. Wage inflation may be ticking higher, but outside the Canterbury construction sector it is still at historically low levels, even by post-2008 standards. In part, that is a legacy of sub-2% inflation over the last few years, which has clearly had an impact on pay negotiations. We expect that to change as slack in the labour market continues to be eroded, but that will take time – wage inflation tends to evolve with a significant lag to the economic cycle. So the numbers are a warning for the RBNZ, not an alarm bell. We expect the Reserve Bank to remain on pause through this year.

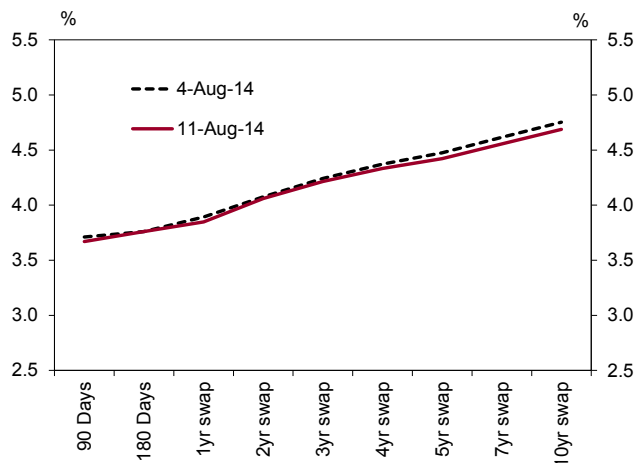
Fixed vs Floating for mortgages

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.

Among the standard fixed rates, we have no clear favourite. Shorter-term fixed rates, such as the six month or one year rate, are currently low but are expected to rise over the coming two years. Opting for the three or four year rate would require higher payments up front, but would help insulate the borrower if the Reserve Bank does follow through with an extensive OCR hiking cycle. At this stage, it is not clear which option will result in lower average mortgage payments over the life of the loan.

Banks sometimes offer "specials" on particular fixed terms. These are usually good value.

NZ interest rates

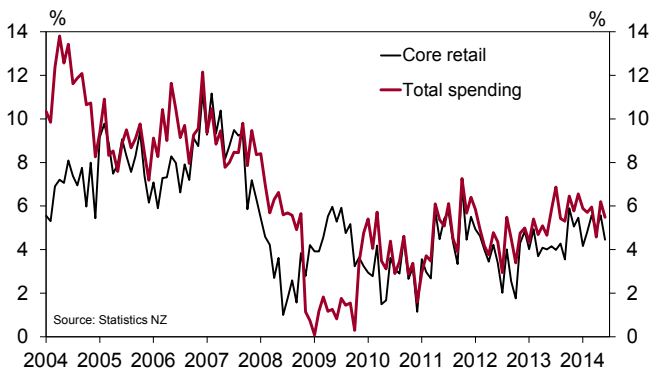


NZ Jul electronic card transactions

Aug 11, last 0.5%, WBC f/c: 0.7%

- Electronic card spending was surprisingly soft in June, with the retail components coming in flat and the 'core' retail items (ex fuel and vehicle-related spending) falling 0.4%.
- We suspect this was a continuation of recent monthly volatility, following on from May's post-Easter surge. A rebound in monthly consumer confidence and signs of a modest revival in the housing market argue for continued growth in retail spending, albeit not at the pace seen late last year.

Card transactions, annual % change

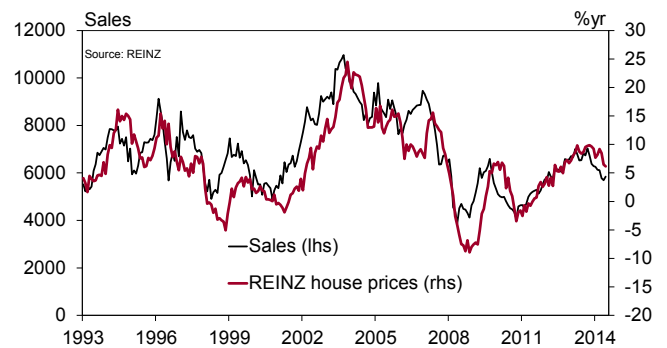


NZ Jul REINZ house prices and sales

Aug 14 (tbc), Sales last: 2.7%, Prices last: 6.2%yr

- The June REINZ figures showed an uptick in house sales for the first time since last September, just before the RBNZ's cap on low-equity home loans came into effect. However, there's not a great deal of evidence so far that this recovery continued into July.
- The REINZ's stratified house price index has been quite volatile from month to month, and may be distorted by changes in the composition of houses sold. The more refined QV index indicates that prices have continued to rise steadily in recent months, just not as fast as last year.
- Both we and the RBNZ are expecting the housing market to regain some momentum over the second half of this year, with net immigration hitting record highs, banks utilising more of the low-equity home loan cap, and some fixed-term mortgage rates actually lower since the first OCR hike.

REINZ house prices and sales

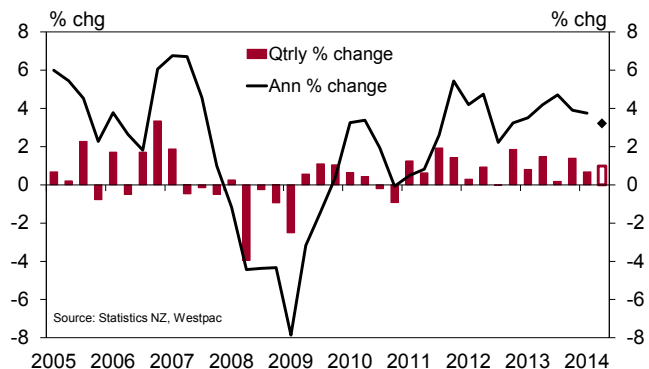


NZ Q2 real retail sales

Aug 14, Last: 0.7%, WBC f/c: 1.0%, Mkt f/c: 1.0%

- Electronic cards spending data suggest that the value of retail spending accelerated a little in the June quarter, though not back to the rates of growth IP seen late last year – consistent with evidence of a modest revival in the housing market.
- Retail price inflation appears to have remained very subdued. Our forecast of a 1% increase in retail volumes consists of a 0.9% rise in nominal spending and a 0.1% drop in prices.
- Vehicle sales remain a wild card. In recent quarters surging car registrations have not translated into an equivalent rise in sales, perhaps due to a shift towards sales of newly imported cars. We have assumed that vehicle sales continued to undershoot in the June quarter.

Real retail sales

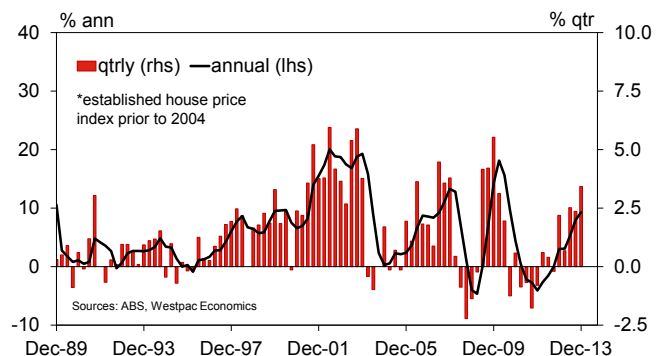


Aus Q2 residential property price index

Aug 12, Last: 1.7%, WBC f/c: 1.8%
Mkt f/c: 1.0%, Range: flat to 2.3%

- Australia's housing markets surged in 2013 with the ABS residential property price index showing quarterly gains of 0.7%, 2.5%, 2.5% and 3.8%. Prices continued to rise in 2014 but at a more modest pace than with Q1 showing a 1.7%qtr gain, lifting annual growth to 10.7%yr. Note that this measure now includes 'attached' dwellings (i.e. townhouses, terraces, units etc). In the past it was confined to just detached houses.
- Available private data on 'all dwelling' measures show gains of 1.9%qtr, 9.2%yr (APM), 2.0%qtr, 9.0%yr (Residex), and 1.1%qtr, 10.8%yr (RP Data-Rismark). The ABS measure tends to track the APM series more closely due to their similar construction. As such we expect it to show a solid 1.8% gain, holding annual price growth at just over 10%.

Residential property price index, ABS measure



Aus Aug Westpac-MI Consumer Sentiment

Aug 13 Last: 94.9

- The Westpac-Melbourne Institute Consumer Sentiment Index increased 1.9% in July but at 94.9 was still well below its pre-Budget level in Apr (99.7) and a world away from the optimistic 110.3 reading in Nov last year. Budget concerns and job loss fears continue to weigh heavily on sentiment.
- The August survey is in the field in the week to August 10. Factors that may influence sentiment this month include: the RBA's decision to again leave rates on hold maintaining its 'extended period of stability' guidance; a better than expected update on retail sales but a shock jump in the unemployment rate to 6.4% in July, a 12yr high. Financial markets have been mixed, with the ASX erratic, surging 4.4% in July but selling off 2.2% in the August month to date. Opinion polls suggest Budget-related negativity may be starting to dissipate.

Consumer Sentiment Index

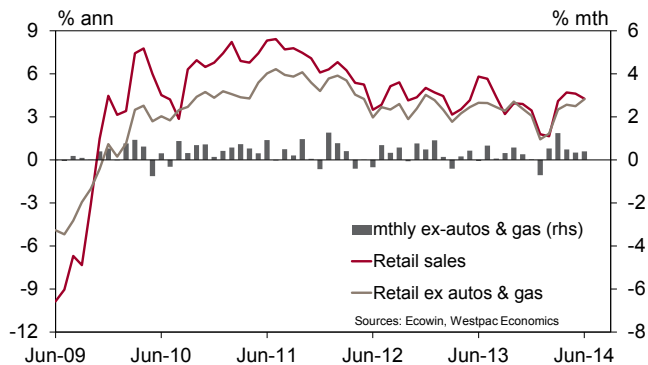


US Jul retail sales

Aug 13, Last: 0.4%, WBC f/c: flat

- Retail sales rose 0.2% in June, and core retail sales (ex autos and gas) rose 0.4%, on top of substantial back revisions which added about 0.5ppts to the April and May retail gains. Of the 14 main storetypes, only 4 recorded declines in June, 3 of them minimal (autos, furniture and eating/drinking), and there was a 1% fall in building materials after a cumulative 4.3% rise in March-May.
- In July, hourly earnings were flat and hours worked rose a modest 0.2%, somewhat constraining household income, though a savings buffer has been built up this year (5.3% saving rate in June, up from 4.1% in Dec).
- Auto sales fell 3% in July. Gasoline prices also fell despite the driving season. Core retailing is unlikely to sustain recent momentum. We expect a flat headline with core retail up 0.2%.

US retail sales

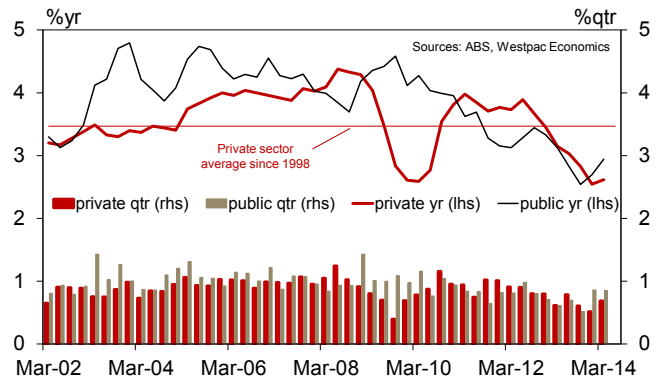


Q2 wage price index %qtr

Aug 13, Last: 0.7%, WBC f/c: 0.8%
Mkt f/c: 0.7%, Range: 0.6% to 0.8%

- The Q1 wage price report was in line with market expectations, but a bit above our own. Total wages grew by 0.7% in Q1. Wage growth in the public sector continued to outperform, rising 0.8% in Q1 after Q4 2013's 0.9% gain (at three decimal points, the Q4 and Q1 gains were almost identical, 0.855% and 0.847% respectively). Private sector wage growth accelerated to 0.7% in Q1, following a particularly weak reading of 0.5% in Q4.
- Despite the improvement in the quarterly pace, annual growth remains historically weak. Total wages have risen 2.6% over the year to March, well below the historic average for the series of 3.5%, which dates back to mid-1998.
- The labour market is lacklustre and pressures from the mining boom have eased significantly. Still, momentum appears to have bottomed. Our forecast holds the annual rate at 2.7%yr.

Private vs. public sector wages

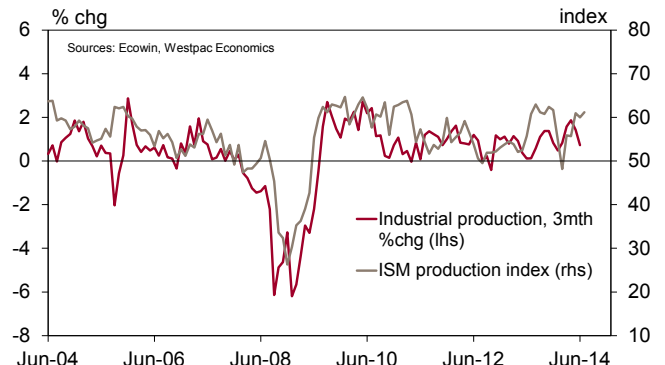


US Jul industrial production

Aug 15, Last: 0.2%, WBC f/c: 0.4%

- US industrial production rose just 0.2% in June, with manufacturing up 0.1%, its weakest rise since factory output fell 1% in weather-disrupted January. Mining was on trend with a 0.8% rise but utilities were down for the fifth month running, by -0.3%. Within manufacturing, autos fell 0.3%, machinery was down 0.5%, business equipment/supplies were both about stalled but construction supplies rose 0.5%.
- In July, factory hours worked fell 0.2%, suggesting another subdued month, but the ISM survey's production component held above 60 for the 3rd month. In Q2 core capital goods orders growth outpaced shipments, also suggesting upside risk. Orders for autos fell 2% in June and sales fell in July but plant summer shutdowns were shorter than normal. Given these contrary clues, we expect a 0.4% IP gain in July, with factory output up 0.3% and utilities bouncing.

US industrial sector

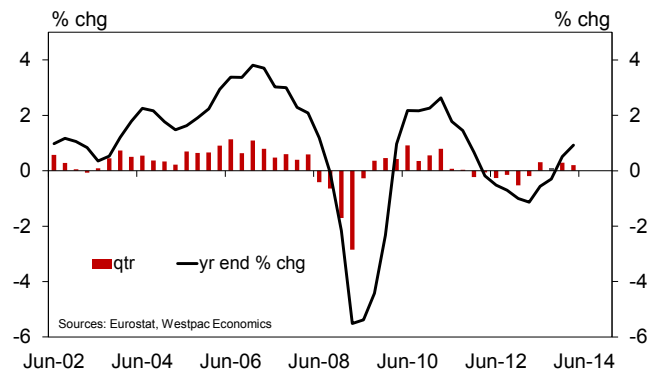


Eur Q2 GDP

Aug 14, Last: 0.2%, WBC f/c: 0.0%

- Partial data suggest the German economy may have contracted slightly in Q2, but still round up to the flat estimate by the Bundesbank. Growth there will resume in Q3 once the weather 'pull-forward' has passed. That cannot be said for France, locked in an uncompetitive zero growth trend, with another flat quarterly outcome in prospect for Q2.
- Two advance reports revealed very different fortunes elsewhere around the Mediterranean. Spanish GDP accelerated to a 0.6% growth pace in Q2, the fastest yet of the now year long recovery and indeed since 2007. But Italian GDP contracted 0.2% in Q2, so Italy re-enters recession.
- With Spain, Italy and Belgium (+0.1%) known, and our flat forecasts for the larger economies, the aggregate will struggle to print 0.1% growth and mostly likely stalled in Q2.

Euro zone GDP



Data calendar

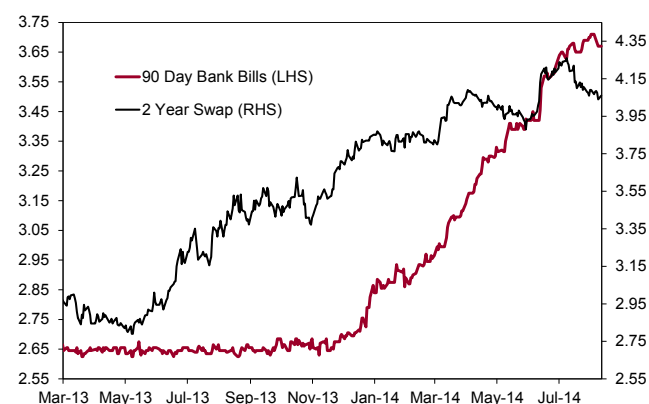
		Last	Market median	Westpac forecast	Risk/Comment
Mon 11					
NZ	Jul electronic card transactions	0.5%	–	0.7%	Consumer confidence reviving and housing market stabilising.
Can	Jul housing starts	0.6%	–	–	June saw modest gains in singles/multiples, on top of Apr-May gains.
Tue 12					
Aus	Jul NAB business survey	+2	–	–	In June, conditions index +3pts to +2 & confidence +1pt to +8.
	Q2 residential property price index	1.7%	1.0%	1.8%	Annual price growth holding at just over 10% nationally.
Ger	Aug ZEW analysts' expectations	27.1	13.5	0	Sentix survey fell in early Aug; Italian recession, sanctions since then.
UK	BRC retail sales %yr	–0.8%	–	–	Same store measure. May and June weaker after late Easter Apr boost.
US	Jul NFIB small business optimism	95.0	95.0	96.0	ISM surveys of big business surged in July.
	Jun JOLTS job openings	4365	–	–	Yellen has made this indicator popular.
	Jul federal budget \$bn	–69	–98	–90	Impact of fiscal compromise/sequester to show up here.
Wed 13					
Aus	Aug Westpac–MI Consumer Sentiment	94.9	–	–	Yet to recover convincingly from sharp post-Budget decline.
	Aug Westpac–MI Unemployment Expsns.	156.1	–	–	Consumers have been bracing for sharp rise in jobless rate for 12mths.
	Q2 wage cost index	0.7%	0.7%	0.8%	Annual growth rate bottoming out at around 2.7%.
Chn	Jul fixed investment %ytd	17.3%	17.4%	–	Plenty of interest in progress of June's tentative housing stabilisation.
	Jul retail sales %yr	12.4%	12.5%	–	Westpac-MNI Sentiment picked up modestly in July.
	Jul industrial production %yr	9.2%	9.1%	–	Manufacturing has cut stocks, exports firmer, construction demand flat.
Eur	Jun industrial production	–1.1%	0.4%	0.5%	German IP rose 0.3% in June, French IP out 8/8.
	Q2 GDP	0.2%	0.0%	0.0%	Marginal rise to round down to flat.
	Jul CPI %yr final	0.4% a	0.4%	0.4%	Flash core was steady at 0.8%yr in Jul.
Ger	Q2 GDP	0.8%	–0.1%	0.0%	Weather pull forward into Q1 and geopolitical factors weighing on Q2
UK	Aug BoE inflation report	–	–	–	Latest data suggests BoE 's H2 slowdown still possible.
	Jul unemployment ch'	–36k	–30k	–25k	Benefit claimants. Some survey and hard data on UK softer.
US	Jul advance retail sales	0.2%	0.3%	0.0%	Auto sales down, gasoline prices down.
	Jul retail sales ex auto, gas	0.4%	0.3%	0.2%	Core retailing to lose some momentum.
	Jun business inventories	0.5%	0.4%	0.3%	Inventories were big contributor to Q2 GDP.
	Fedspeak	–	–	–	Dudley and Rosengren.
Can	Jul house prices %yr	4.4%	–	–	Teranet/National Bank index.
Thu 14					
NZ	Q2 real retail sales	0.7%	1.0%	1.0%	Card transactions picked up in June quarter, but not to late 2013 pace.
	Jul manufacturing PMI	53.3	–	–	Still positive but markedly slower in the last two months.
	Jul REINZ house sales	2.7%	–	–	Due by this date. June increase was the first in nine months.
	Jul REINZ house price index %yr	6.2%	–	–	House price growth has slowed, but REINZ measure can be choppy.
Aus	Aug MI consumer inflation expectations	3.8%	–	–	Any impact from carbon tax repeal?
UK	Jul house prices net balance	53%	50%	–	RICS surveyors series. Still close to 58% high point in March.
US	Initial jobless claims w/e 9/8	289k	–	295k	Claims not far off 40 year lows.
	Jul import prices	0.1%	–0.4%	–0.6%	Oil prices fell sharply in July.
Can	Jun new house prices %yr	1.5%	–	–	Downtrend in growth rate since 2010 stabilised since start of year.
Fri 15					
UK	Q2 GDP first revision	0.8% a	0.8%	0.7%	Sticking with our forecast from a month ago.
US	Jul PPI final demand	0.4%	0.1%	0.2%	Now includes services.
	Aug NY Fed factory survey	25.6	20.0	15.0	Runs above 20 have tended not to last in past half decade.
	Jun TIC data, \$bn	19.4	–	–	Net long term TIC flows.
	Jul industrial production	0.2%	0.3%	0.4%	Factory output +0.3% & utilities bouncing.
	Aug UoM consumer sentiment prelim	81.8	82.5	80.0	IBD-TIPP weaker in Aug and stocks down since then.
Can	Jun manufacturing sales	1.6%	0.4%	–	May boosted by autos.
	Jul existing home sales	0.8%	–	–	Have not posted a fall since Jan.

New Zealand forecasts

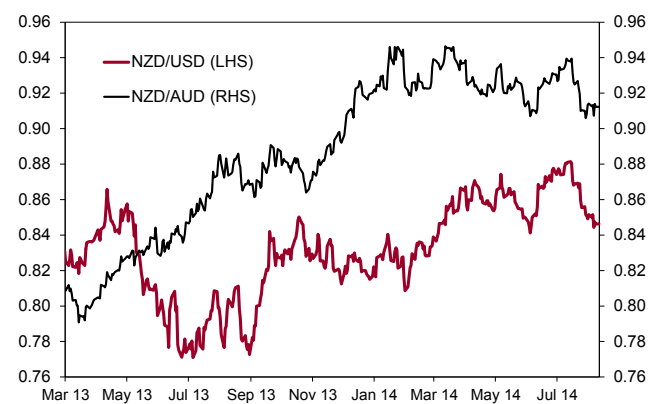
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2012	2013	2014f	2015f
% change								
GDP (Production) ann avg	2.3	3.3	3.5	3.1	2.5	2.9	3.7	3.2
Employment	0.4	3.8	2.8	2.6	0.4	2.9	3.0	2.9
Unemployment Rate % s.a.	6.2	5.9	5.3	4.7	6.8	6.0	5.4	4.7
CPI	0.9	1.5	1.8	2.6	0.9	1.6	1.5	2.6
Current Account Balance % of GDP	-3.9	-2.8	-3.8	-4.2	-4.1	-3.4	-2.9	-4.4

Financial Forecasts	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Cash	3.50	3.50	4.00	4.25	4.50	4.50
90 Day bill	3.70	3.85	4.30	4.45	4.60	4.75
2 Year Swap	4.20	4.40	4.70	4.90	5.00	5.10
5 Year Swap	4.60	4.80	5.10	5.20	5.30	5.40
10 Year Bond	4.60	4.80	4.90	5.00	5.05	5.10
NZD/USD	0.83	0.83	0.84	0.84	0.84	0.84
NZD/AUD	0.91	0.92	0.93	0.91	0.90	0.89
NZD/JPY	83.8	83.0	84.8	85.7	86.5	87.4
NZD/EUR	0.62	0.63	0.64	0.64	0.63	0.64
NZD/GBP	0.50	0.49	0.49	0.47	0.47	0.47
TWI	78.1	78.5	79.4	78.8	78.6	78.7

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 11 August 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.25%
30 Days	3.65%	3.63%	3.56%
60 Days	3.67%	3.65%	3.62%
90 Days	3.67%	3.69%	3.67%
2 Year Swap	4.06%	4.09%	4.19%
5 Year Swap	4.42%	4.47%	4.61%

NZ foreign currency mid-rates as at Monday 11 August 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8463	0.8554	0.8814
NZD/EUR	0.6313	0.6368	0.6478
NZD/GBP	0.5045	0.5038	0.5150
NZD/JPY	86.50	87.07	89.35
NZD/AUD	0.9123	0.9104	0.9397
TWI	79.35	79.82	81.91

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2010	2011	2012	2013	2014f	2015f
Australia						
Real GDP % yr	2.3	2.6	3.6	2.4	3.2	3.0
CPI inflation % annual	2.8	3.0	2.2	2.7	2.3	2.8
Unemployment %	5.2	5.2	5.3	5.8	6.4	6.1
Current Account % GDP	-3.5	-2.8	-4.2	-3.2	-3.1	-2.5
United States						
Real GDP %yr	2.5	1.8	2.8	2.2	1.9	2.5
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.9	1.9
Unemployment Rate %	9.6	8.9	8.1	7.4	6.3	5.8
Current Account %GDP	-3.0	-2.9	-2.9	-2.4	-2.5	-2.5
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.6	1.6	1.4
Euroland						
Real GDP %yr	2.0	1.6	-0.6	-0.4	0.7	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	7.4	7.5
East Asia ex China						
Real GDP %yr	7.8	4.4	4.0	4.0	3.9	4.9
World						
Real GDP %yr	5.2	3.9	3.2	3.0	3.1	3.7
Forecasts finalised 8 August 2014						

Interest Rate Forecasts	Latest	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
Australia						
Cash	2.50	2.50	2.50	2.50	2.50	2.75
90 Day Bill	2.63	2.60	2.55	2.55	2.65	3.00
10 Year Bond	3.36	3.60	3.70	3.80	4.20	4.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.250
US 10 Year Bond	2.42	2.60	2.70	2.70	2.80	3.20
ECB Repo Rate	0.15	0.15	0.15	0.15	0.15	0.15

Exchange Rate Forecasts	Latest	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
AUD/USD	0.9265	0.91	0.90	0.90	0.92	0.93
USD/JPY	102.06	101	100	101	102	103
EUR/USD	1.3354	1.33	1.31	1.31	1.32	1.33
AUD/NZD	1.0958	1.10	1.08	1.07	1.10	1.11

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Disclaimer continued

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