



Nugget Point, Balclutha

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A firm footing

Before large swathes of the population started their annual migration to beaches and holiday hotspots around New Zealand, there was a flurry of activity on the New Zealand data calendar. In short, news over the closing weeks of 2013 underscored the growing strength of the New Zealand economy. Data in the first full week of 2014 largely reinforces this view, reminding us that the economy is starting 2014 on a firm footing.

To briefly recap: GDP growth jumped 1.4% in the September quarter (fuelled by a post-drought rebound in agricultural activity), export commodity prices remained extremely high, net migration is strongly positive, and both businesses and consumers are more confident than they have been in years. All this points to an economy not only accelerating, but accelerating even more quickly than the RBNZ had envisioned as recently as the December Monetary Policy Statement. This strong domestic data, combined with international developments (which included the start of tapering by the Federal Reserve) led us to conclude that the OCR hiking cycle would be more front-loaded than we'd previously thought. Before heading away on holiday we changed our OCR call. This year, we are now expecting five OCR hikes of 25 basis points each in March, April, June, September and December.

Developments since then have reinforced these key themes. The ANZ commodity price index rose a further 1% in December, leaving it less than 1% below its all-time high. While dairy prices were once again the star performer, up 40% in world price terms over the last year, prices for a broad range of commodities posted sizable improvements over 2013. Early indications are that this strength has continued into the New Year. Dairy prices fell just 0.8% in last week's GlobalDairyTrade auction – signalling that so far demand remains robust even as prices remain near record levels. For our part, we continue to forecast softening dairy prices, particularly from the second quarter of 2014 under the weight of increased global production. But we recognise that to date demand, especially out of China, has probably been stronger than we had expected.

A firm footing continued

Sky high commodity prices, combined with excellent farming conditions in many regions, are providing a big boost to rural incomes. In NZ dollar terms, commodity prices are up 22.6% on a year ago and we suspect dairy production could be up 8.5% this season. This is ensuring that the positive momentum in the New Zealand economy is increasingly being driven not only by the Canterbury construction sector (which continues to steam ahead according to December consents data) but by an increasingly broad range of regions and sectors. This trend is likely to be evident in the December Quarterly Survey of Business Opinion released tomorrow. This survey of business sentiment has posted substantial improvements in recent quarters. And as confidence has grown, firms have become more willing to invest in expanding their capacity. We'll also be on high alert for further signs of emerging pricing pressures in this survey.

One sector swimming against the tide of good news is the housing market. Here, evidence continues to mount that higher mortgage rates, and the Reserve Bank's restrictions on low equity lending, are cooling the market. Last week Barfoot and Thompson, the largest real estate agency operating in the Auckland market, reported an 11.6% (s.a.) fall in sales volumes in December (after an almost 9% fall in November). In contrast, house price inflation continued to edge higher (though this measure is not adjusted for quality, and could be skewed by fewer low end properties selling in the month). We'll get a more comprehensive update on national house sales and prices in December with the release of national REINZ data this week. But given the dominance of the Auckland market, we'd expect it to exhibit a similar trend; fewer sales, but no slowing in house prices just yet. Given the historical

Auckland house sales, seasonally adjusted



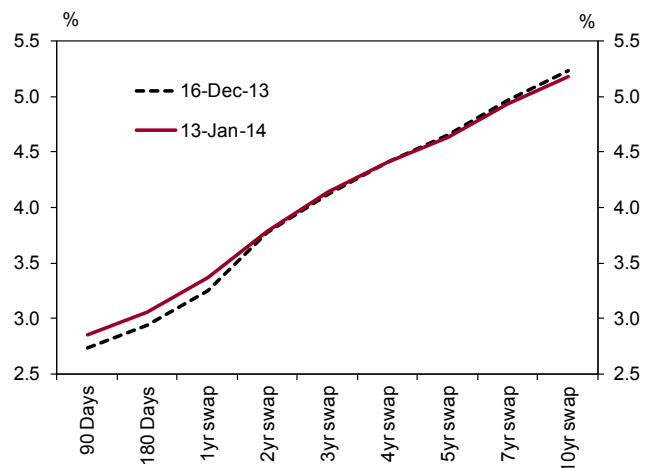
lag between changes in house sales, and house price inflation, that should start to change in early 2014 when we expect to see the first signs of slowing house price inflation. We think it is likely that house prices will undershoot the RBNZ's forecasts in early 2014.

Growing evidence of a slowing housing market may well be one factor discouraging the RBNZ to hike rates as soon as January. But set against the backdrop of strong data which clearly show the New Zealand economy is gaining a head of steam, it won't be enough to offset the need for higher interest rates for long. As inflation pressure builds, interest rates will need to rise substantially over the next couple of years.

Fixed vs Floating for mortgages

We are indifferent between fixing and floating at present. Interest rates are currently higher for longer fixed terms. However, we expect floating rates and short-term fixed rates to rise substantially over the coming three years. In our view, floating and short-term fixed rates offer no better or worse value than longer-term fixed rates.

NZ interest rates

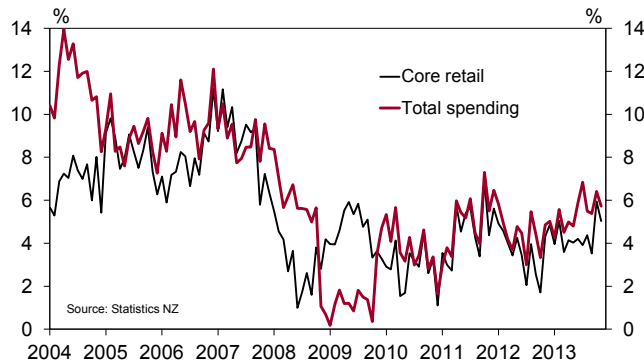


NZ Dec electronic card transactions

Jan 14, last: 0.2%, WBC f/c: 0.7%

- Electronic card spending rose 0.2% in November, consolidating gains made in the previous month. Core spending on cards in the month was running at a 6% annual pace. Spending figures from Paymark, the country's largest card processor, suggest the monthly pace of spending picked up again in December.
- Consumer spending has accelerated over the second half of 2013, supported by an improving labour market, rising house prices and strong growth in rural incomes. Consumer confidence also improved further in the December quarter as people became increasingly optimistic about both the near-term economic outlook and the state of their own finances.

Card transactions, annual % change

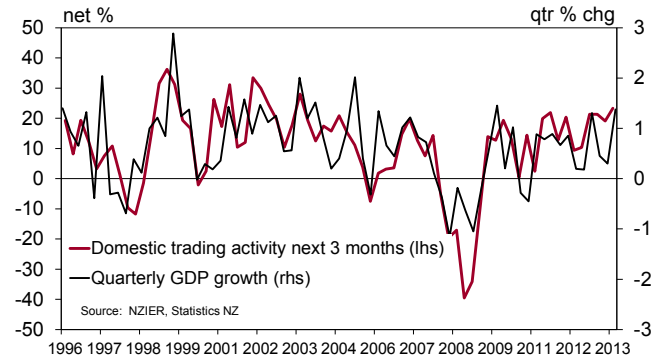


NZ Quarterly Survey of Business Opinion

Jan 14, Last: 32

- This measure of business sentiment improved further in the September quarter as businesses across a range of industries reported improved conditions. Since then, monthly surveys of business confidence have shown that optimism continues to climb.
- There is now little debate that the New Zealand economy gained substantial momentum over the second half of 2013. The focus is increasingly turning to the extent that inflation pressures are being generated by this lift in growth. Although there have been few signs of emerging inflation pressures in this survey to date, pricing intentions, cost expectations and capacity utilisation measures will all be worth careful examination.

QSBO domestic trading activity and GDP

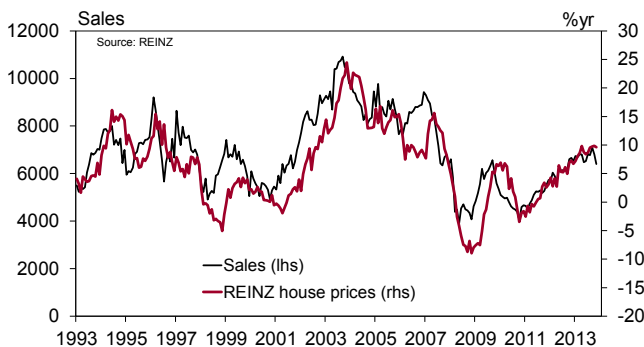


NZ Dec REINZ house prices and sales

Jan 15 (tbc), Sales last: -6%/m/m, Prices last: +9.6%/yr

- Evidence of a slowing NZ housing market continues to accumulate. Nationwide sales volumes fell 10% over September and October. Partial data on the Auckland housing market suggests turnover declined further in December.
- The timing of this slowdown is consistent with our long-held view that higher interest rates and the Reserve Bank's restrictions on high loan-to-value lending would slow turnover in the housing market from around November. Our view remains that, while high-LVR lending restrictions are likely to bite hard initially, the impact of the new rules should moderate over time as investors step into the market to replace sidelined first-home buyers.
- The annual pace of house price inflation remained high in November at 9.6%. Given the relationship between house sales and house prices, we don't expect to see the pace of house price inflation start to cool until 2014.

REINZ house prices and sales



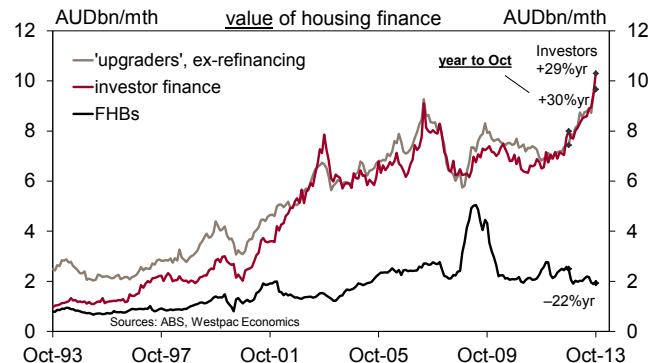
Aus Nov housing finance (no.)

Jan 13, Last: 1.0%, WBC f/c: 1.5%

Mkt f/c: 1.1%, Range: 0.0% to 2.0%

- Finance approvals posted a solid 4.4% bounce in Sep, more than reversing the 4% decline in Aug that looked somewhat out of kilter with the apparent strengthening in the housing market upturn. October then saw a modest 1.0% gain. The main weak spot in the detail continues to be first home buyers which have hit a new low due to a combination of affordability issues and the legacy effect of changes in state government assistance in NSW, Qld and Vic. However, this has been more than offset by strong rises across other, much larger, segments.
- Nov is expected to see gains consolidate, with a 1.5% rise in finance approvals.

Value of finance approvals by segment

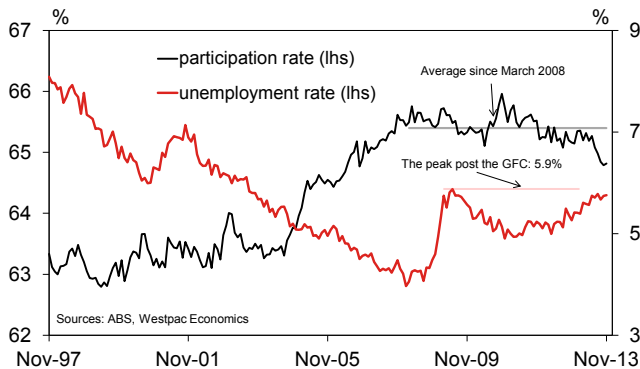


Aus Dec labour force

Jan 16, Last: 21k, WBC f/c: -10k
Mkt f/c: 10k, Range: -10k to 25k

- Nov saw a 21.0k increase in employment, a little stronger than the statistical bounce we had been expecting. Through the year, employment growth remained insipid at 0.8%yr, or 87.8k. Hours worked growth had been the outperforming indicator of the labour force survey in 2013, but it fell back to 0.4%yr in Nov. The participation rate was little changed, but stronger population growth saw the unemployment rate tick up to 5.8%, just below its post-GFC high of 5.9%.
- Following Nov's statistical bounce, we expect 10k in job losses in Dec. With the participation rate little changed in the month, this will result in the unemployment rate rising 0.1ppts to 5.9%. It bears remembering that, while this would match the post-GFC peak, had the participation rate not declined substantially through 2013, the unemployment rate would be much higher.

Unemployment and participation rates

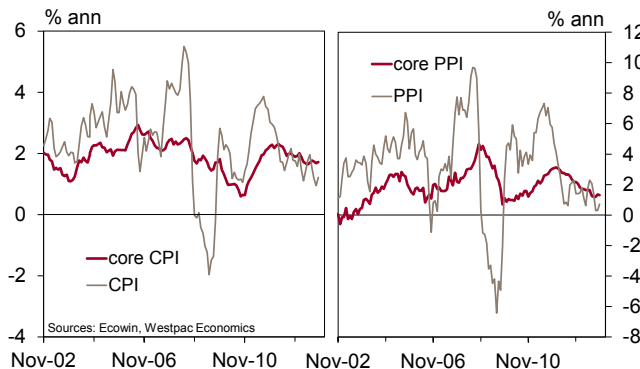


US Dec consumer price index

Jan 16, CPI: Last: 0.0%, WBC f/c: 0.2%

- The CPI was flat in Nov for a 1.2%yr annual pace, just above Oct's post-2009 low of 1.0%yr. Energy prices fell 1.0% in Nov, offsetting a 0.1% food price gain and core inflation of 0.2%, its least-weak monthly rise since January. Nevertheless, key points included the third straight fall in apparel prices and a 0.0% medical care outcome for the second month running. Owners' rent, on the other hand, rose an above-trend 0.3% – it accounts for 29% of the core CPI.
- Gasoline and other energy prices rose in Dec. The Nov PPI showed wholesale food prices levelling off, suggesting little pressure there. If, as we expect, medical care and owners' rent normalise somewhat, the core CPI will print 0.1% again in Dec, with 0.0% a risk given rent's high weighting. The headline CPI should print higher on energy, circa 0.2%.

US price inflation

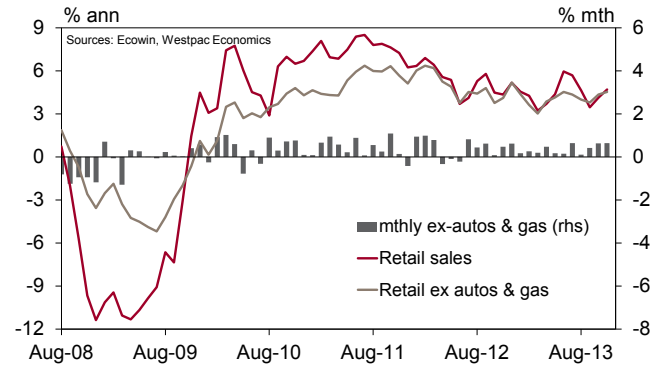


US Dec retail sales to be constrained by autos

Jan 14, Last: 0.7%, WBC f/c: 0.0%

- Retail sales rose 0.7% in Nov. Auto sales rose a further 1.8%, but gasoline sales fell 1.1%, down for the third month in four. Excluding those components, core retail was up 0.6% in Nov, while Oct was revised up to 0.6% from 0.3%. With Sep also revised up, the core 3-month annualised pace was 5.4% compared the 3.6% originally reported for Oct – the latest data are the most robust set of retail figures since the start of 2013.
- Auto unit sales reversed most of their Nov spike in Dec, while gasoline prices rose. A late Thanksgiving might mean heavily revised data, so the core retail picture may not look as solid in Q4. We expect a flat headline, held back by autos.

US retail sales

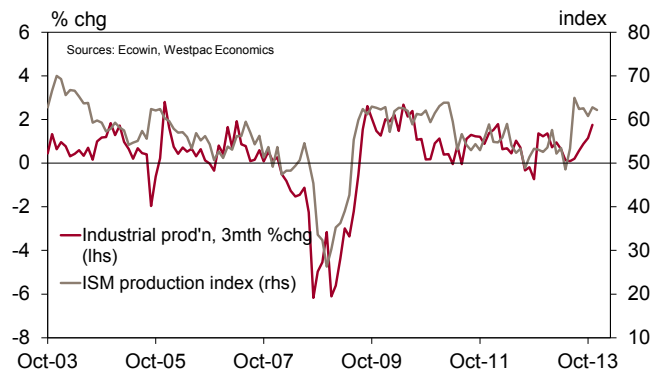


US Dec industrial production

Jan 17: Last: 1.1%, WBC f/c: 0.4%

- Industrial production jumped 1.1% in Nov. Manufacturing finally kicked in with solid back-to-back gains in Oct (revised up to 0.5%) and Nov (0.6%), the strongest pair of months in 2013. Autos, home electronics and business supplies saw solid output gains. A mining rebound of 1.7% and a cold snap-driven utilities gain of 3.9% pushed the IP bottom line growth rate to its fastest in a year.
- Even so, annual growth of 2.9%yr in manufacturing is slower than the 3.7%yr pace recorded a year earlier in Nov 2012, consistent with the slower GDP growth rate since then and a stark contrast to the runaway ISM survey – at 30-month highs.
- Factory hours worked data are not yet available for Dec. Auto sales were down sharply in the month; but core capital goods orders rose sharply in Nov. The Dec ISM factory survey showed orders and production holding above 60, but this strong signal has not been fully reflected in the Fed's IP data of late.

US industrial sector



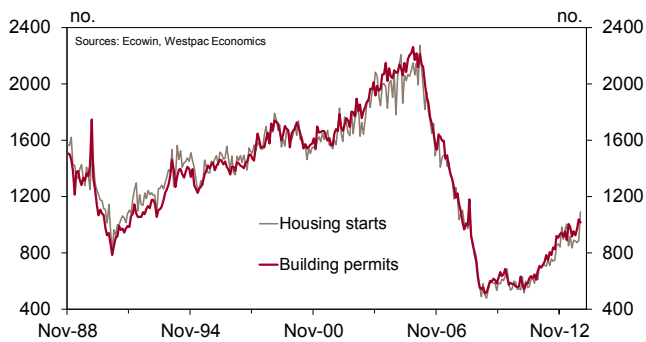
US Dec housing starts/permits

Jan 17, housing starts: Last: 22.7%, WBC f/c: -10.0%

Jan 17, housing permits: Last: -2.1%, WBC f/c: 3.0%

- Housing starts surged 23% in Nov. Unusually, single-family starts rose 21% in Nov to a 727k annualised pace, but single-family permits rose just 2.1% to 634k. Over the three months to Nov, single starts ran at a 636k annualised pace vs 623k for permits – nothing really out of the ordinary, although permits were running ahead of starts in the middle of the year.
- Dec is likely to see a partial reversal of the Nov rise in starts. We anticipate a 10% decline in the month. The uncharacteristic volatility in single-family starts is likely to persist as the Nov spike normalises. A 3.0% gain for permits will also help bring the two series back into line.

US housing starts & permits



Data calendar

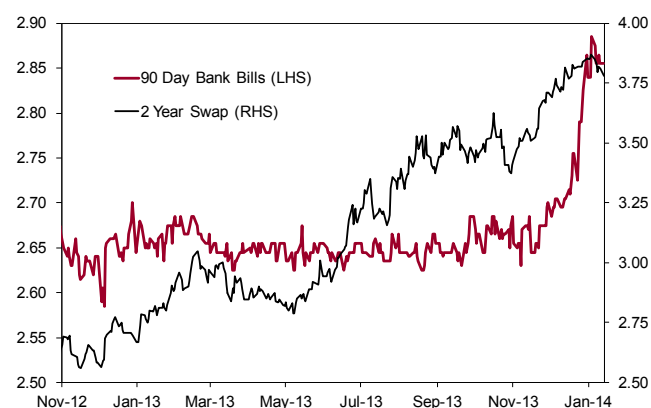
| | | Last | Market median | Westpac forecast | Risk/Comment |
|---------------|---------------------------------------|--------|---------------|------------------|---|
| Mon 13 | | | | | |
| Aus | Nov housing finance | 1.0% | 1.1% | 1.5% | FHB weakness offset by investor and upgrader strength. |
| US | Nov monthly budget statement, \$bn | -135 | 44 | - | Budget issues in Congress slowly being resolved. |
| | Fedspeak | - | - | - | Lockhart |
| Can | Q4 business outlook survey | 31 | - | - | Future sales index. |
| | Q4 BoC loan officer survey | -7.3 | - | - | Credit conditions reasonably benign. |
| Tue 14 | | | | | |
| NZ | Dec electronic card transactions | 0.2% | - | 0.7% | Solid pace of spending growth to continue. |
| | Q4 NZIER Business Opinion | 32 | - | - | Business confidence remained buoyant in the December quarter. |
| Eur | Nov industrial production %yr | -1.1% | 1.5% | 1.4% | German IP (ex construction) rose 1.9% in Nov after a 1.2% Oct fall. |
| UK | Dec PPI %yr | 0.7% | 0.9% | - | Core output measure. |
| | Nov ONS house prices %yr | 5.5% | - | - | Will soaring pace of gain be impacted by recent FfL changes in 2014? |
| | Dec CPI %yr | 2.1% | 2.1% | - | Close to 2% target; core rate even lower at 1.8%yr in Nov. |
| US | Dec NFIB small business optimism | 92.5 | 93.0 | 92.8 | Nov gain likely due to post government shutdown bounce. |
| | Dec retail sales | 0.7% | 0.1% | 0.0% | Auto sales down sharply; late Thanksgiving this year. See text box. |
| | Dec US import prices | -0.6% | 0.3% | 0.7% | Oil prices recovered in Dec (but have fallen away again since). |
| | Nov business inventories | 0.7% | 0.3% | 0.2% | Inventories unlikely to make contribution to Q4 growth as in Q3. |
| | Fedspeak | - | - | - | Plosser, Fisher. |
| Can | Dec house prices %yr | 3.4% | - | - | Teranet measure; prices accelerating not falling as in late 2011, 2012. |
| Wed 15 | | | | | |
| NZ | Dec Food price index | -0.2% | - | - | Annual price inflation ticking up over the second half of 2013. |
| | Dec REINZ house sales | -6% | - | - | Due around this date. LVR restrictions slowing turnover. |
| | Dec REINZ house price index %yr | 9.6% | - | - | Impact on prices not likely until 2014. |
| Eur | Nov exports | 0.2% | - | 0.2% | German exports growth slowed sharply to 0.3% in Oct and Nov. |
| US | Dec producer prices | -0.1% | 0.4% | -0.1% | Energy prices up sharply in Dec; core PPI to remain subdued. |
| | Fed beige book | - | - | - | Prepared ahead of (Bernanke's last) FOMC meeting at end of the month. |
| | Jan NY Fed factory survey | 1.0 | 3.0 | 3.0 | Languished close to 0 during Q4 last year. |
| | Fedspeak | - | - | - | Lockhart, Evans. |
| Can | Dec existing home sales | -0.1% | - | - | Mar to Aug saw solid gains in sales after sombre 2012. |
| Thu 16 | | | | | |
| Aus | Dec ANZ job ads | -0.8% | - | - | Job ads weak relative to history. |
| | Dec labour force | 21k | 10k | -10k | Nov saw statistical bounce; weak trend persists. |
| Eur | Dec CPI %yr final | 0.9% a | 0.8% | 1.1% | Flash report included yet lower core CPI at 0.7%yr. |
| UK | Dec RICS house price balance | 58% | 59% | - | Mortgages no longer qualify for BoE Funding for Lending - impact? |
| US | Dec CPI | 0.0% | 0.3% | 0.2% | Gasoline prices rose in Dec, but PPI suggests food pressures abating. |
| | Dec CPI core | 0.2% | 0.1% | 0.1% | Downside risk from rent but upside from medical care. |
| | Initial jobless claims w/e 11/1 | 330k | 325k | 330k | Seasonal adjustment problematic at present. |
| | Jan NAHB housing market index | 58 | 58 | 55 | Upswing in confidence sustained but not building. |
| | Nov TIC data, \$bn | 35.4 | - | - | Net long-term TIC flows. |
| | Jan Philadelphia Fed factory survey | 6.4 | 8.7 | 6.0 | Well below highs reached just a few months ago. |
| | Fedspeak | - | - | - | Bernanke on central bank challenges; also Williams. |
| Fri 17 | | | | | |
| Eur | Nov construction output | -1.2% | - | -1.5% | Construction -1.7% in Nov in Germany after a -0.7% Oct. |
| UK | Dec retail sales inc auto | 0.3% | 0.5% | 0.5% | Momentum building into year end. |
| US | Dec housing starts | 22.7% | -9.3% | -10.0% | Starts spike for (single-family dwellings) set to unwind. |
| | Dec building permits | -2.1% | -0.7% | 3.0% | Modest lift in permits to offset Nov fall. See text box. |
| | Dec industrial production | 1.1% | 0.3% | 0.4% | Nov's strong gain unsustainable. See text box. |
| | Jan UoM consumer confidence prelim | 82.5 | 83.2 | 83.0 | Stockmarket supportive of confidence throughout late 2013. |
| | Fedspeak | - | - | - | Lacker. |
| Sat 18 | | | | | |
| Chn | Dec 70 city new house prices %net bal | 91.4% | - | - | New prices resilient to curbs, secondary market actually accelerating. |

New Zealand forecasts

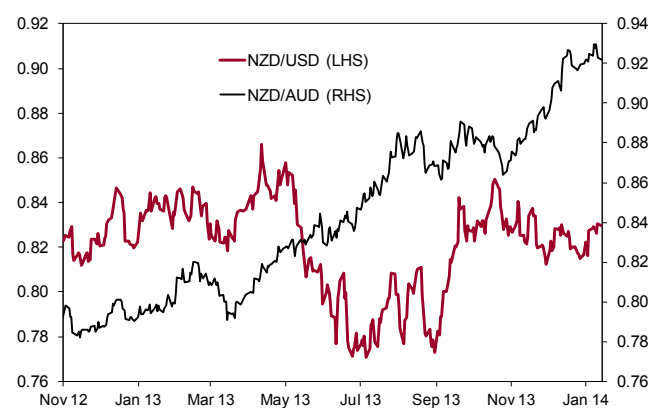
| Economic Growth Forecasts | March years | | | | Calendar years | | | |
|----------------------------------|-------------|-------|-------|-------|----------------|------|-------|-------|
| | 2012 | 2013f | 2014f | 2015f | 2011 | 2012 | 2013f | 2014f |
| % change | | | | | | | | |
| GDP (Production) ann avg | 2.4 | 2.3 | 3.1 | 3.8 | 1.9 | 2.6 | 2.8 | 3.9 |
| Employment | 0.9 | 0.4 | 3.0 | 2.6 | 1.6 | 0.4 | 2.4 | 2.8 |
| Unemployment Rate % s.a. | 6.8 | 6.2 | 5.7 | 5.1 | 6.3 | 6.7 | 6.0 | 5.1 |
| CPI | 1.6 | 0.9 | 1.3 | 2.2 | 1.8 | 0.9 | 1.5 | 1.9 |
| Current Account Balance % of GDP | -3.1 | -3.9 | -3.4 | -4.0 | -2.9 | -4.1 | -3.7 | -3.4 |

| Financial Forecasts | Mar-14 | Jun-14 | Sep-14 | Dec-14 | Mar-15 | Jun-15 |
|---------------------|--------|--------|--------|--------|--------|--------|
| Cash | 2.75 | 3.25 | 3.50 | 3.75 | 4.00 | 4.00 |
| 90 Day bill | 3.10 | 3.50 | 3.75 | 4.00 | 4.20 | 4.30 |
| 2 Year Swap | 3.90 | 4.10 | 4.30 | 4.50 | 4.60 | 4.80 |
| 5 Year Swap | 4.60 | 4.70 | 4.80 | 4.90 | 5.00 | 5.10 |
| 10 Year Bond | 4.75 | 4.80 | 4.85 | 4.90 | 4.95 | 5.00 |
| NZD/USD | 0.83 | 0.82 | 0.81 | 0.80 | 0.79 | 0.78 |
| NZD/AUD | 0.92 | 0.93 | 0.93 | 0.93 | 0.93 | 0.92 |
| NZD/JPY | 79.7 | 77.9 | 76.1 | 74.4 | 74.3 | 73.4 |
| NZD/EUR | 0.64 | 0.65 | 0.65 | 0.65 | 0.64 | 0.64 |
| NZD/GBP | 0.53 | 0.52 | 0.52 | 0.51 | 0.49 | 0.48 |
| TWI | 78.6 | 78.4 | 77.9 | 77.3 | 76.5 | 75.8 |

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 13 Jan 2014

| Interest Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| Cash | 2.50% | 2.50% | 2.50% |
| 30 Days | 2.72% | 2.67% | 2.68% |
| 60 Days | 2.79% | 2.77% | 2.70% |
| 90 Days | 2.86% | 2.86% | 2.74% |
| 2 Year Swap | 3.78% | 3.85% | 3.78% |
| 5 Year Swap | 4.63% | 4.72% | 4.65% |

NZ foreign currency mid-rates as at Monday 13 Jan 2014

| Exchange Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| NZD/USD | 0.8296 | 0.8164 | 0.8265 |
| NZD/EUR | 0.6066 | 0.5935 | 0.6019 |
| NZD/GBP | 0.5033 | 0.4953 | 0.5072 |
| NZD/JPY | 86.23 | 85.88 | 85.31 |
| NZD/AUD | 0.9220 | 0.9210 | 0.9225 |
| TWI | 78.19 | 77.20 | 77.85 |



Economic and Financial Forecasts

| Economic Forecasts (Calendar Years) | 2009 | 2010 | 2011 | 2012 | 2013f | 2014f |
|-------------------------------------|------|------|------|------|-------|-------|
| Australia | | | | | | |
| Real GDP % yr | 1.5 | 2.3 | 2.6 | 3.6 | 2.4 | 2.6 |
| CPI inflation % annual | 2.1 | 2.8 | 3.0 | 2.2 | 2.3 | 2.5 |
| Unemployment % | 5.6 | 5.2 | 5.2 | 5.3 | 5.8 | 6.4 |
| Current Account % GDP | -4.7 | -3.5 | -2.8 | -4.1 | -3.1 | -3.8 |
| United States | | | | | | |
| Real GDP %yr | -2.8 | 2.5 | 1.8 | 2.8 | 1.6 | 1.6 |
| Consumer Prices %yr | -0.3 | 1.6 | 3.1 | 2.1 | 1.5 | 1.7 |
| Unemployment Rate % | 9.3 | 9.6 | 8.9 | 8.1 | 7.5 | 7.1 |
| Current Account %GDP | -2.7 | -3.0 | -2.9 | -2.7 | -2.5 | -2.5 |
| Japan | | | | | | |
| Real GDP %yr | -5.5 | 4.7 | -0.6 | 2.0 | 1.7 | 1.6 |
| Consumer Prices %yr | -1.3 | -0.7 | -0.3 | 0.0 | -0.2 | 0.1 |
| Unemployment Rate % | 5.2 | 5.1 | 4.5 | 4.3 | 4.3 | 4.3 |
| Current Account %GDP | 2.8 | 3.6 | 2.0 | 2.1 | 2.0 | 2.0 |
| Euroland | | | | | | |
| Real GDP %yr | -4.4 | 2.0 | 1.5 | -0.6 | -0.5 | -0.1 |
| Consumer Prices %yr | 0.3 | 1.7 | 2.7 | 2.2 | 1.4 | 1.2 |
| Unemployment Rate % | 9.5 | 10.0 | 10.1 | 11.7 | 12.4 | 13.0 |
| Current Account %GDP | -0.2 | -0.1 | 0.0 | 0.9 | 1.0 | 1.0 |
| United Kingdom | | | | | | |
| Real GDP %yr | -5.2 | 1.7 | 1.1 | 0.2 | 1.1 | 0.9 |
| Consumer Prices %yr | 2.2 | 3.2 | 4.0 | 2.8 | 2.3 | 1.8 |
| Unemployment Rate % | 7.6 | 7.8 | 8.4 | 8.0 | 8.5 | 8.5 |
| Current Account %GDP | -1.3 | -2.5 | -1.9 | -3.8 | -2.5 | -1.5 |

Forecasts finalised 11 December 2013

| Interest Rate Forecasts | Latest | Mar-14 | Jun-14 | Sep-14 | Dec-14 | Mar-15 |
|-------------------------|--------|--------|--------|--------|--------|--------|
| Australia | | | | | | |
| Cash | 2.50 | 2.50 | 2.25 | 2.00 | 2.00 | 2.00 |
| 90 Day Bill | 2.64 | 2.55 | 2.30 | 2.10 | 2.10 | 2.10 |
| 10 Year Bond | 4.26 | 4.10 | 3.60 | 3.80 | 4.00 | 4.10 |
| International | | | | | | |
| Fed Funds | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 |
| US 10 Year Bond | 2.97 | 2.80 | 2.80 | 2.60 | 2.80 | 3.00 |
| ECB Repo Rate | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |

| Exchange Rate Forecasts | Latest | Mar-14 | Jun-14 | Sep-14 | Dec-14 | Mar-15 |
|-------------------------|--------|--------|--------|--------|--------|--------|
| AUD/USD | 0.8901 | 0.90 | 0.88 | 0.87 | 0.86 | 0.85 |
| USD/JPY | 104.91 | 102 | 101 | 100 | 99 | 100 |
| EUR/USD | 1.3611 | 1.34 | 1.30 | 1.30 | 1.27 | 1.26 |
| AUD/NZD | 1.0790 | 1.08 | 1.07 | 1.07 | 1.08 | 1.08 |

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Disclaimer continued

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