



Mt. Taranaki, Mt. Egmont National Park.

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End of the golden weather

The New Zealand economy appeared to have hit a sweet spot in the early part of this year, but a number of previously supportive factors have started to turn in recent months. We're becoming more convinced that the pace of growth has already passed its peak, although the June quarter should mark the low point for GDP growth this year. And with the economy running short of spare capacity, future growth is increasingly likely to be accompanied by higher inflation.

Last week, the June *Quarterly Survey of Business Opinion* showed a substantial drop in business sentiment compared to March. To put that in context though, the previous reading was the highest in two decades, and even the softer June results were among some of the highest on record. That suggests the economy was still growing at a solid pace over the June quarter, but less than the 1% or so recorded in each of the previous three quarters.

Consequently, we've revised down our estimate of June quarter GDP growth from 0.9% to 0.7%. Some of the slowdown during the quarter may prove to be a temporary Easter effect. So we expect growth to be a little stronger over the last two quarters of this year, though still shy of the earlier 1% pace.

We've also revised our forecast of Fonterra's milk price for the current season to \$6.40/kg, a substantial downgrade from our earlier forecast of \$7.10/kg. World dairy prices have fallen more than we expected, down 29% at auction since February. What's more, the exchange rate has failed to act as a buffer in this time – instead of falling, it has continued to trend higher, coming very close to a new record high against the US dollar this week. There's a high degree of uncertainty around the milk price given that

End of the golden weather continued

we're still near the start of the season; our forecast assumes that world dairy prices stabilise over the next few months. We'll discuss the outlook for dairy in more detail our *Fortnightly Agri Update* on Wednesday.

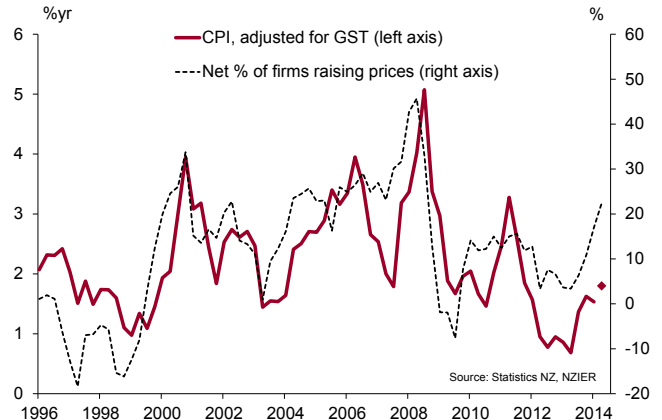
There are several reasons to think that the current economic upturn, while far from over, has passed its peak rate of growth. The strong growth in recent quarters was supported by an extended period of low interest rates, rising house prices, record revenues for dairy farmers, and a surge in construction activity. Many of those factors are now turning, and it's unlikely we'll see such a confluence of favourable forces again in the near future.

What's more, with the economy now operating above of its non-inflationary potential, the easy gains have already been made. Of course, the economy's 'potential' isn't directly observable, and trying to pin down an estimate is fraught with difficulties. Forecasts of potential growth are inextricably tied to forecasts of actual growth; data revisions can significantly change the track record of how quickly the economy grew in the past, which in turn affects our understanding of what's achievable in the future; and sometimes judgement is necessary to deal with specific circumstances.

All three of these factors played a part in the Reserve Bank's decision to revise up its estimate of potential GDP growth over the medium term from 2.5% to 2.8%, as detailed in a speech by Assistant Governor John McDermott last week. (This doesn't tell us anything new about upcoming monetary policy decisions, as the change was incorporated back in the March *Monetary Policy Statement*.) This brings the RBNZ's assessment of potential growth more or less back to where it was in 2008, having been revised down substantially in the wake of the Global Financial Crisis.

In terms of the outlook for inflation, though, the RBNZ's concern is not so much the economy's potential rate of activity, but where it sits relative to that potential. And on any plausible measure of potential, we can say with some confidence that that the rapid growth in recent quarters has now taken us above that mark. Indeed, the RBNZ has been remarkably consistent over the last several years in predicting that the crossover to above-potential activity would come by early 2014.

CPI vs share of firms raising prices in last 3 months



As the economy burns through its spare capacity, maintaining the pace of growth requires firms to bid up for increasingly scarce resources – in other words, higher inflation soon follows. The *Quarterly Survey of Business Opinion* confirmed that capacity constraints are becoming tighter, and indeed on some measures the survey suggests that the re-emergence of inflation could be upon us already. Over the last year there's been a steady increase in the number of firms reporting that they not only intend to raise their prices, but have successfully done so in the past three months.

We'll get the official take on this on Wednesday, with the release of the June quarter CPI. We're expecting annual inflation to pick up from 1.5% to 1.8%. That would be broadly consistent with the message from the *QSBO*, although we don't get the sense that price increases have become more widespread; most of the increase in the annual rate appears to have come from food and fuel prices. It's our forecast for inflation to moderate to 1.7% by year-end that look more under threat, in light of what businesses are saying about their pricing intentions for the near future.

Fixed vs Floating for mortgages

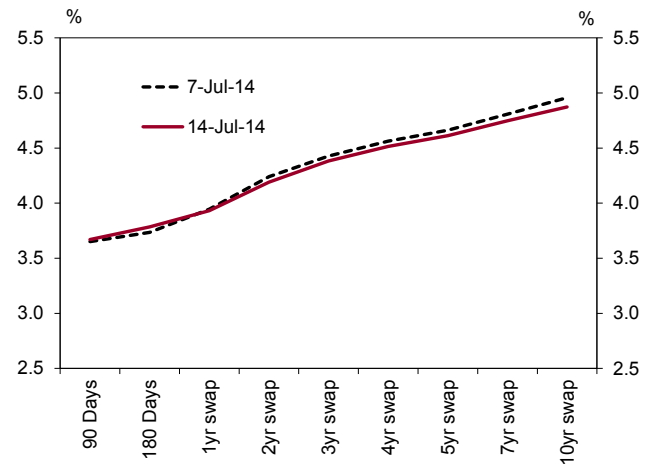
Fixing for two to three years seems likely to prove the cheapest option.

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.

Fixed rates are now on the rise, but in our view 2-3 year rates are still good value, given where we think shorter-term rates are likely 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

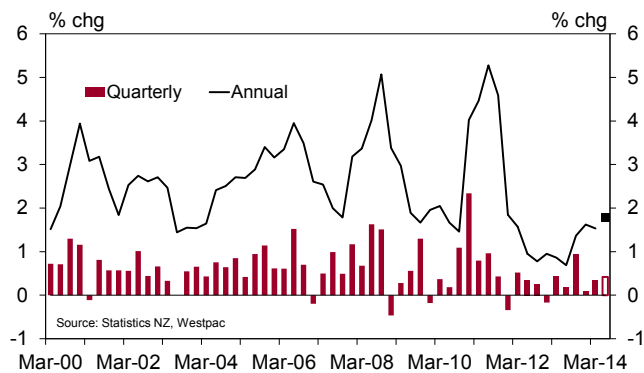


NZ Q2 CPI

Jul 16, Last: 0.3%, Westpac f/c: 0.4%, Mkt f/c: 0.4%

- We expect a 0.4% rise in the Consumer Price Index for the June quarter. This would lift annual inflation to 1.8%, which would be the highest result since December 2011.
- The main contributors will be a slightly above-average seasonal increase in food prices, and annual increases in electricity prices. Fuel prices were broadly flat over the quarter, but will contribute to the rise in annual inflation given that they were falling in the same quarter last year.
- We expect to see a continued tension between high non-tradables inflation (particularly connected to housing) and weak tradables inflation due to the high NZ dollar. Notably, the latter's impact appears to have been waning, and a growing number of firms are reporting that they have raised their prices in the past three months.

NZ CPI inflation

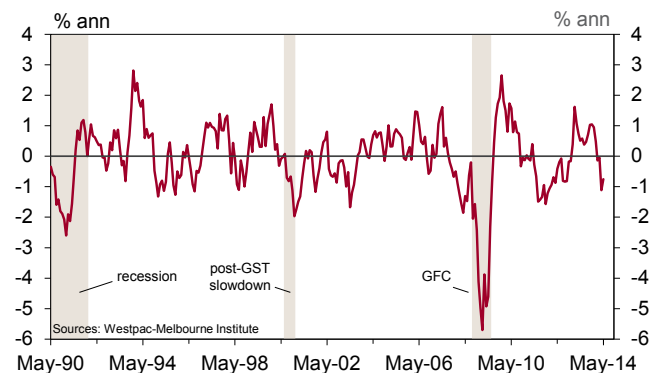


Aus Jun Westpac-MI Leading Index

Jul 16, Last: -0.75%

- The Leading Index improved in May after recording a sharp fall in Apr. Despite this, the Index's benchmark growth rate – 6mth annualised growth, expressed as a deviation from trend – remained in negative territory at -0.75%. The reading points to a slowing pace of economic growth over the next 3-9mths.
- Components were mixed in Jun: hours worked rose 0.9% in Jun, with May's bounce revised up to +2.1%; the CSI Expectations Index rose 3.8%, still only up marginally from its post-Budget slump but better than Jun's 1.6% gain; consumers' unemployment expectations also improved; and dwelling approvals surged 9.9%, more than recovering from a 5.8% drop last month; however, commodity prices continued to slide (-2.8%), the yield gap narrowing a further 8bps, and the ASX declined 1.7%.

Westpac-MI Leading Index

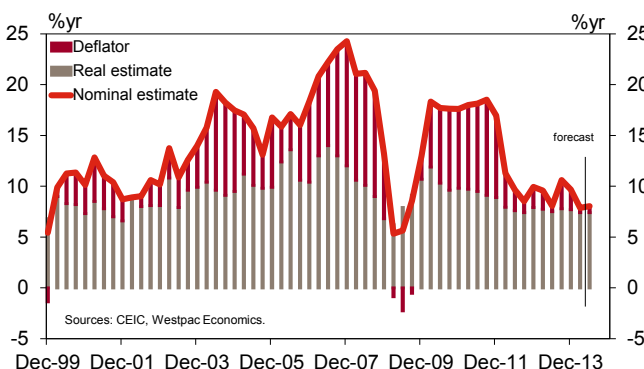


China Q2 real GDP

Jul 16, Last: 7.4%, WBC f/c: 7.4%
Mkt f/c 7.4%, Range: 7.0% to 7.6%.

- The NBS estimated that China grew at a real rate of 7.4%yr in Q1, with a seasonally adjusted change of 1.4%, the equal lowest pulse on record. Our forecasts for Q2 are a stable y/y rate and a pick-up to 1.8% in the quarterly estimate. Tactically, we think that an outcome in the 7¼% to 7½% range would accomplish the two key tasks of 1) producing a credible growth estimate and 2) maintaining the perception that the trajectory of growth is broadly consistent with the annual target of 7½%. Recent comments by the Premier reinforce that chain of logic.
- We anticipate that the substantial decline in nominal activity growth seen in Q1 stabilised in Q2, consistent with our aggregate demand proxies and inflation developments.
- Net exports will be a lesser drag than in Q1, when they subtracted 1.4ppts from growth.

Chinese GDP: real & nominal estimates

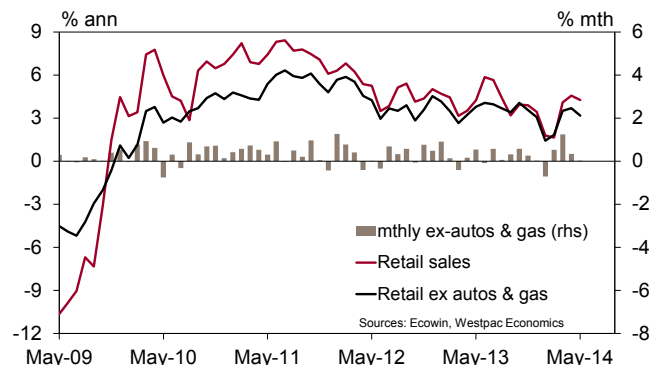


US retail sales pick up from soft May.

Jul 15, Last: 0.3%, WBC 0.7%

- Retail's 0.3% May gain was supported by auto sales up 1.4% (up 9% since Jan) and gasoline sales rising 0.4%; but the other 70% of sales, core retailing, was flat after surging 2% on catch-up spending in Feb-Apr following weather-impacted weakness in Dec-Jan. Notable in the detail: eight of 14 storetypes recorded lower sales; this would have been partly due to the late Easter/Spring break boosting April sales, with payback in May.
- In June, moderate earnings growth and a rise in hours worked will have supported household income and probably discretionary spending (retail jobs rose 40k in June, vs 11k in May). Auto unit sales rose 1.3%, but gasoline demand has been drifting sideways. These factors and the Easter effect dropping out point to a 0.6% rise in core retailing; the headline gain will likely be a little higher due to autos.

US retail sales



US Yellen's semi-annual monetary policy report

Jul 15

- In the May 7 testimony, the Fed Chair predicted the economy would grow faster in 2014 (2.9%yr) than in 2013 (2.6%yr). At the June 18 FOMC presser, the Fed Chair presented downgraded 2014 forecasts, centred around 2.2%yr, that already looked too optimistic even before the subsequent downward revisions to Q1 GDP growth. Our forecast is for 1.0%yr growth this year.
- The Fed has implicitly "set aside" the unsustainability of recent solid jobs growth in an economy which potentially contracted in H1 2014 by projecting GDP growth will accelerate towards 3%yr over the next year, a forecast they have more or less stuck with each year since the 2009 recession. Only last year did growth match the projection, thanks to temporary excessive contributions from inventories and net exports (at the expense of 2014 growth). How Yellen navigates this issue will be a particular focus for us.

Forecasts for US GDP growth at start of year

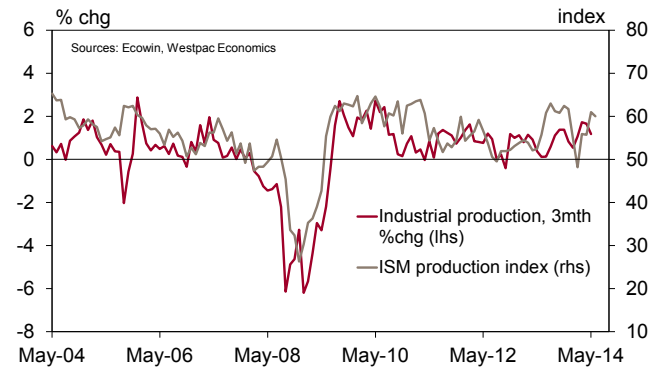
	2010	2011	2012	2013	2014	2014 latest
FOMC	3.5	3.2	2.7	2.6	2.9	2.2
Westpac	2.4	1.8	1.5	1.9	2.2	1.0
Actual	2.8	2.0	2.0	2.6	?	?

US Jun industrial production

Jul 16: Last: 0.6%, WBC f/c: 0.5%

- Industrial production rose 0.6% in May. The detail showed factory output also rising 0.6%, boosted by autos and business equipment; a further 1.3% rise in mining (only two monthly declines since the start of last year); but a fourth straight decline in utilities of 0.8%, with the unwind from the mid-winter surge in gas and electricity demand followed by a recently slightly milder than usual spring.
- Factory hours worked were flat in June. Auto sales were up 1% in the month, and back in May, orders for autos rose 2%. However, core capital goods orders have lost momentum after rising sharply in late Q1. The June ISM factory survey showed orders and production at or close to the year's highs to date. These mixed signals point to a modest gain in factory output of 0.3%. The IP bottom line is forecast at 0.5%, assuming mining output rises again and we see a moderate recovery in utilities.

US industrial sector



US housing starts/permits in June

Jul 17, Housing starts: Last: -6.5%, WBC f/c: 8.0%

Jul 17, Housing permits: Last: -5.1%, WBC f/c: 10.0%

- Housing starts fell 6.5% in May and permits were down 6.4%, led by 7.6%/19.5% multiples falls. But single family starts fell 5.9% to 625k annualised – higher than in January and February, but still down 7.4% on the 710k pace reached in November last year, and only 4.6% higher than a year earlier in May 2013.
- Single family permits rose 3.7% in May, but their annualised pace of 619k does not suggest much near-term upward momentum for starts. In contrast, homebuilder sentiment recovered some of its early 2014 loss in June, while new and pending/existing home sales jumped sharply in May.
- The starts/permits headlines will once again be driven by volatile multiples, with bounces expected. Single family starts will also rise; we expect by 4%, though a steeper rise in singles permits would be needed for this to be sustainable.

US housing starts & permits



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 14					
NZ	Jun Performance of Services Index	54.2	–	–	Fell sharply in May, but does tend to be very volatile.
Eur	May industrial production	0.8%	–1.2%	–1.0%	German IP down nearly 2% in May, so too French IP, –1.7%.
Can	May house prices %yr	4.6%	–	–	Teranet-National \Bank index.
Tue 15					
Aus	Jun new vehicle sales	0.3%	–	2.5%	Industry figures show solid rise in consumer sales.
	RBA minutes	–	–	–	Look for further detail on g'th drivers; risks to outlook.
Ger	July ZEW analysts' expectations	29.8	30.0	32.0	Sentix euro survey recovered some of May-Jun loss.
UK	Jun BRC retail survey % yr	0.5%	–	2.0%	Extent of monthly swings might moderate heading into H2 2014.
	Jun PPI %yr	1.0%	–	–	Core output measure.
	May ONS house prices %yr	9.9%	–	–	Approaching 2010's recent peak for house price inflation.
	Jun CPI %yr	1.5%	1.7%	1.4%	Shop price inflation at post-recession low, means scope for lower CPI.
US	Jul NY Fed factory survey	19.3	17.0	10.0	Since 2010, excessive strength in NY/Philly Fed has proven sort-lived.
	Jun advance retail sales	0.3%	0.6%	0.7%	Auto sales up, gasoline prices flat. See text box.
	Jun retail sales ex auto, gas	0.0%	0.6%	0.6%	Core retailing to recover from post Easter pause; June incomes up.
	May business inventories	0.6%	0.6%	0.6%	Factory stocks up 0.8%, wholesale inventories up 0.5%.
	Fedspeak	–	–	–	Yellen delivers semi annual report on policy to Senate.
Can	Jun existing home sales	5.9%	–	–	Mar to May solid gains, after sombre 2012 for sales.
Wed 16					
NZ	GlobalDairyTrade auction	–4.9%	–	–	Prices have fallen 29% from their February peak.
	Q2 consumer prices	0.3%	0.4%	0.4%	Annual inflation rising to 1.8% on food, fuel prices.
Aus	Jun Westpac–MI Leading Index	–0.75%	–	–	Improved in May, but remained negative; components mixed in June.
Chn	Jun fixed investment %ytd	17.2%	17.2%	–	Weak sub-cycles in real estate & manuf, but fiscal support on the rise.
	Jun retail sales %yr	12.5%	12.5%	–	Sentiment fell heavily in May, job concerns at the forefront.
	Jun industrial production %yr	8.8%	9.0%	–	PMIs have improved, inventory stress mostly passed, exports firmer.
	Q2 GDP %yr	7.4%	7.4%	7.4%	Implies a lift in the pulse from ~5½% in Q1 to ~7¼% in Q2.
UK	Jun unemployment ch'	–27k	–27k	–28k	Benefit claimants.
US	Jul NAHB housing market index	49	50	48	Tentative upswing re-emerging after early 2014 slump.
	May TIC data, \$bn	–24.2	–	–	Net long term TIC flows.
	Jun PPI final demand	–0.2%	0.2%	0.1%	Services the main swing factor in recent outcomes of expanded PPI.
	Jun industrial production	0.6%	0.3%	0.5%	Factory hours worked flat. Utilities/mining to gain. See text box.
	Fed beige book	–	–	–	Prepared ahead of the next FOMC meeting at the end of the month.
	Fedspeak	–	–	–	Fisher on monetary policy.
Can	Bank of Canada rate decision	1.0%	1.0%	1.0%	Policy on hold with no clear bias.
	May manufacturing sales	–0.1%	0.5%	–	Oil led April's plunge.
Thu 17					
Eur	Jun CPI %yr final	0.5% a	0.5%	0.5%	Flash report includes core which was up a tick to 0.8%yr in Jun.
	May construction output	0.8%	–	–1.0%	Construction fell 5% in Germany, after 6% Mar-April fall.
US	Initial jobless claims w/e 12/7	304k	310k	311k	Clear downtrend in claims earlier this year may have stalled.
	Jun housing starts	–6.5%	1.9%	8.0%	Starts pace for single family dwellings now running behind permits.
	Jun building permits	–5.1%	4.2%	10.0%	See text box.
	Jul Philadelphia Fed factory survey	17.8	16.0	–12.0	Mid-year slumps in 2010-11-12 began in Q2 or July!
	Fedspeak	–	–	–	Fisher on monetary policy.
Fri 18					
Chn	Jun new dwelling prices %net bal	–22.9%	–	–	18 cities rising m/m and 34 falling. Prior cycle low was –75.7%.
	Jun secondary dwelling prices %net bal	–25.9%	–	–	20 cities rising m/m and 38 falling. Prior cycle low was –70.0%.
	Jul MNI business indicator	55.0	–	–	Has done well picking the direction of the flash PMI of late.
Eur	May current account €bn	21.5	–	–	€25.4bn record surplus in Jan; was in deficit in 2011!
Ger	Jun producer prices %yr	0.2%	–	–	Just off May's 0.1%yr cycle low.
US	Jun leading indicators	0.5%	0.5%	0.6%	Building permits the only negative out of ten components in May.
	Jul Uni of Mich consumer sent prelim	82.5	83.5	93.0	Weekly data show confidence into July.
Can	Jun CPI %yr	2.3%	2.4%	–	BoC core rate rose 0.5 ppts to 1.5%yr in May.
	May wholesale sales	1.2%	–	–	New record level of wholesale sales in April.

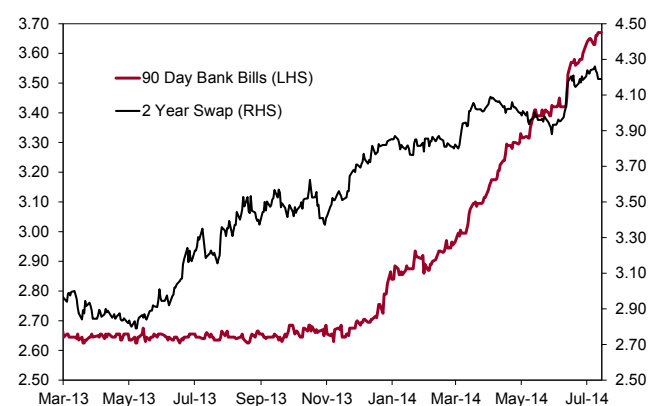


New Zealand forecasts

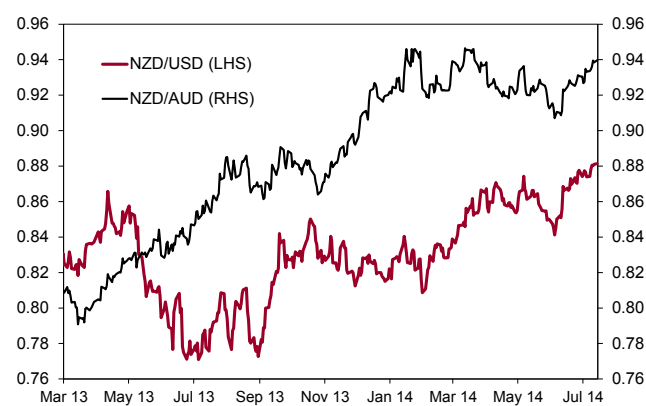
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2012	2013	2014f	2015f
% change								
GDP (Production) ann avg	2.3	3.3	3.5	3.1	2.5	2.9	3.7	3.2
Employment	0.4	3.8	2.4	2.0	0.4	2.9	2.7	2.3
Unemployment Rate % s.a.	6.2	6.0	5.5	5.1	6.8	6.0	5.6	5.1
CPI	0.9	1.5	1.9	2.6	0.9	1.6	1.7	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	3.75	4.25	4.25	4.50	4.50
90 Day bill	3.70	4.00	4.30	4.45	4.60	4.75
2 Year Swap	4.40	4.60	4.80	4.90	5.00	5.10
5 Year Swap	4.80	5.00	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	0.86	0.85	0.84	0.84	0.84	0.84
NZD/AUD	0.95	0.94	0.93	0.91	0.90	0.89
NZD/JPY	86.9	85.0	84.8	85.7	86.5	87.4
NZD/EUR	0.65	0.65	0.65	0.64	0.64	0.64
NZD/GBP	0.52	0.51	0.49	0.47	0.47	0.47
TWI	81.2	80.6	79.7	79.1	79.0	78.7

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 14 July 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.25%	3.25%	3.25%
30 Days	3.56%	3.43%	3.43%
60 Days	3.62%	3.53%	3.49%
90 Days	3.67%	3.62%	3.54%
2 Year Swap	4.19%	4.21%	4.18%
5 Year Swap	4.61%	4.61%	4.58%

NZ foreign currency mid-rates as at Monday 14 July 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8814	0.8780	0.8667
NZD/EUR	0.6478	0.6437	0.6400
NZD/GBP	0.5150	0.5155	0.5106
NZD/JPY	89.35	89.04	88.46
NZD/AUD	0.9397	0.9320	0.9227
TWI	81.91	81.48	80.73



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	3.2	3.0
CPI inflation % annual	2.8	3.0	2.2	2.7	2.5	2.6
Unemployment %	5.2	5.2	5.3	5.8	6.2	5.9
Current Account % GDP	-3.5	-2.8	-4.1	-3.2	-3.0	-2.5
United States						
Real GDP %yr	2.5	1.8	2.8	1.9	1.3	2.5
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.8	1.8
Unemployment Rate %	9.6	8.9	8.1	7.4	6.3	5.8
Current Account %GDP	-3.0	-2.9	-2.8	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.6	1.6	1.3
Euroland						
Real GDP %yr	2.0	1.6	-0.6	-0.4	0.8	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	7.2	7.6
East Asia ex China						
Real GDP %yr	7.8	4.4	4.0	4.0	4.2	5.0
World						
Real GDP %yr	5.2	3.9	3.2	3.0	3.0	3.7
Forecasts finalised 4 July 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	2.55	2.55	2.55	2.65	3.00
10 Year Bond	3.42	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	2.53	2.70	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	0.9390	0.91	0.90	0.90	0.92	0.93
USD/JPY	101.28	101	100	101	102	103
EUR/USD	1.3603	1.32	1.30	1.30	1.31	1.31
AUD/NZD	1.0657	1.06	1.06	1.07	1.10	1.11

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

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Disclaimer continued

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