



Mt. Taranaki, Egmont National Park.

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Cat among the pigeons

The big news of last week was an 8.9% fall in the GlobalDairyTrade auction price, after a 5% drop a fortnight previously. This is quite a different beast to the period of falling dairy prices we experienced back in March and April.

That earlier episode was the unsurprising consequence of improving milk production levels in New Zealand and elsewhere – froth coming out of the market, if you will. The latest round of falling milk prices was unanticipated, and is probably more to do with waning demand. The fallout is not limited to dairy alone – log export prices have also fallen sharply in recent months, although meat export prices are still rising.

The culprit here is a marked slowdown in consumer demand in China, exacerbated by a classic inventory cycle. Chinese wholesalers now have more than sufficient stocks on hand to meet relatively-soft demand, and the consequences are rolling up the supply chains for dairy products and logs.

The Chinese economy clearly decelerated in late-2013 and early-2014, following the earlier implementation of restrictive fiscal and monetary policies. China's economic authorities are now loosening the reins, and the results are starting to show. June quarter Chinese GDP figures, released last week, showed signs of modest recovery in heavy industry and net exports. However, we suspect the consumer sector will be a laggard, and could remain weak for some time. The monthly Westpac-MNI China Consumer Sentiment survey fell sharply in June, and the Chinese housing market is still very soft. So while we are fairly confident that China's rate of economic growth will accelerate over the course of 2014, a recovery in demand for New Zealand export products may take a bit longer.

With this in mind, we have once again revised down our forecast for this season's milk price payout to Fonterra farmers, to \$6.00 per kilogram of milk solids. This is a far cry from the \$8.40 payout of last season, and the effects will reverberate around rural New Zealand for some time.

The exchange rate took its time to react to the deteriorating export outlook, but eventually a significant drop in the New Zealand dollar did take place. The Kiwi has so

Cat among the pigeons continued

far fallen from 88.2 US cents to 86.8, and we suspect it could fall further from here – we are now forecasting the exchange rate to average 83 US cents over the remainder of this year.

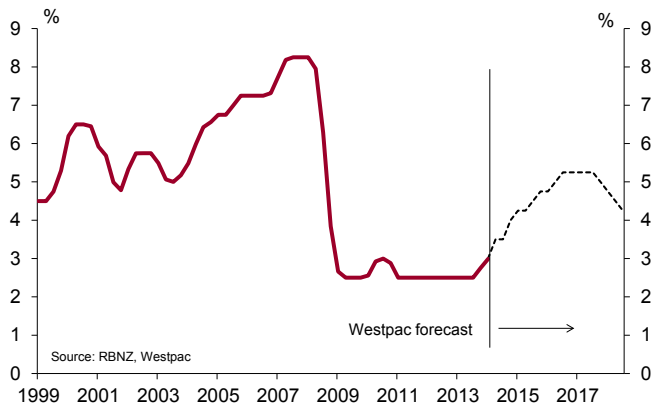
Once next week's OCR Review is out of the way the Reserve Bank may well consider intervening in foreign-exchange markets by selling New Zealand dollars. A frequently-heard objection to this idea is that the RBNZ would not sell NZ dollars during an OCR hiking cycle. This is incorrect. The Reserve Bank is perfectly entitled under its Policy Targets Agreement to seek a different mix of monetary conditions involving a lower exchange rate and higher interest rates. The RBNZ would have no more difficulty hitting its target of two percent average inflation target under this mix of monetary conditions than under any other.

Those who remain sceptical of the RBNZ intervening might like to consider the following quote from Graham Wheeler back in May: *"If the currency remains high in the face of worsening fundamentals, such as a continued weakening in export prices, it would become more opportune for the Reserve Bank to intervene in the currency market to sell New Zealand dollars."*

The current combination of deteriorating export conditions and a high exchange rate has raised legitimate questions about the number of OCR hikes that the RBNZ will need to deliver. These questions were given additional emphasis by this week's June inflation data. Annual inflation turned out to be 1.6%, which was only slightly weaker than the RBNZ's forecast of 1.7% or our forecast of 1.8%. However, the detail of report painted a more benign underlying inflation picture than we expected. In particular, there was no "smoking gun" of accelerating housing-related inflation.

Despite the weak data, we believe the RBNZ will persist with a 25 basis point OCR hike at this week's OCR Review. Our thinking is coloured by an alternative scenario within the June *Monetary Policy Statement*, which explained what the RBNZ would do if export prices deteriorated unexpectedly. The scenario indicated that the RBNZ would still hike the OCR rapidly in the near-term, although the pace of hikes later on would be slower than otherwise. The current RBNZ administration has built an admirable record of clear and accurate communication regarding future OCR changes, and

Westpac OCR forecast



a July hike has been well signalled. Failing to deliver the hike would risk squandering the RBNZ's hard-won credibility.

Of course, the one-page press release accompanying the OCR decision will acknowledge the recent bout of weaker data. The RBNZ will probably signal a pause in its OCR hiking cycle, while repeating the overarching message that the OCR is likely to head higher over a period of years. The "bottom line" of the OCR Review might read something like:

"For now, a short period of stability in the OCR seems appropriate. Over time, further OCR increases are likely to be needed to keep future average inflation near the 2 percent target mid-point."

We now expect that the RBNZ's pause will last until January 2015 (previously December).

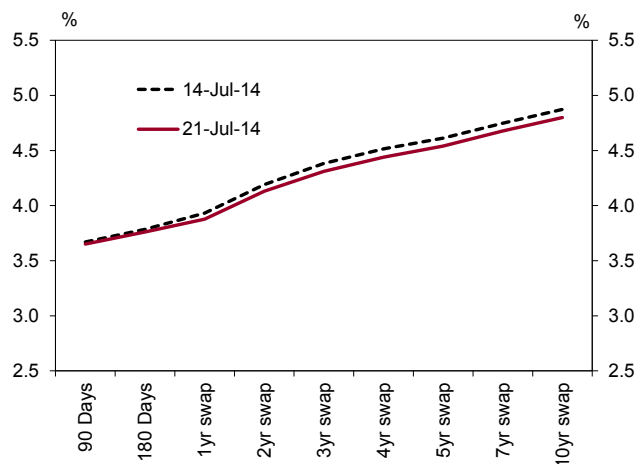
At the end of this year we expect inflation will still be just 1.6%, and we doubt that the current housing market rebound will prove vigorous. But through all of this detail, it is worth remembering that the biggest story of the New Zealand economy remains unchanged – the construction boom is putting pressure on the economy's productive resources, and the OCR must rise to offset these pressures. We continue to forecast a peak OCR of 5.25% in 2016.

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 various fixed rates on offer, 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.

NZ interest rates

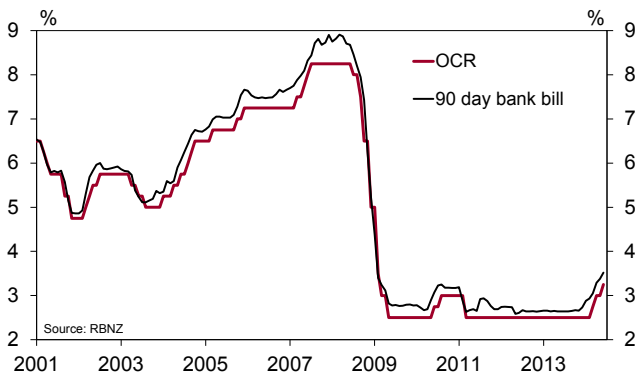


RBNZ Jul OCR Review

Jul 24, Last: 3.25%, Westpac f/c: 3.5%, Mkt f/c: 3.5%

- At the June MPS, the RBNZ clearly signalled that it intends to hike the OCR in July.
- Falling commodity export prices, the high exchange rate, reasonably benign inflation data and signs the NZ economy has lost a little of its (considerable) momentum have raised legitimate questions. However, the weak data is not enough for the RBNZ to imperil its hard-won reputation for clear and accurate communication. We expect a 25bps hike.
- The RBNZ may signal a pause in the hiking cycle, while emphasising that over the coming years the OCR is set to rise. We expect the pause will span the remainder of 2014.

NZ OCR and 90 day rate

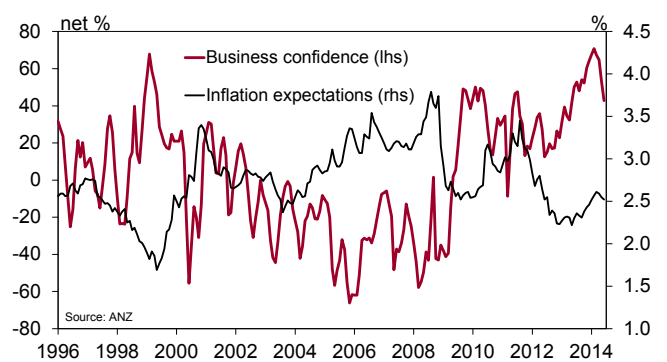


NZ Jun business confidence

Jun 25, Last: 42.8

- Business confidence fell for a fourth straight month in June, having reached a 20-year high in February this year.
- While confidence remains at a relatively high level, the survey adds to the list of other indicators in recent months suggesting the economy has passed its peak rate of growth.
- The indicators of price pressures in the survey were also slightly softer in June, with small declines in inflation expectations, capacity utilisation, and pricing intentions. The July survey would have predated the release of the soft June quarter CPI report and the latest drop in global dairy prices, whereas fuel prices have continued to rise – so we may see a modest tick up in these measures in July.

NZ business confidence and inflation expectations

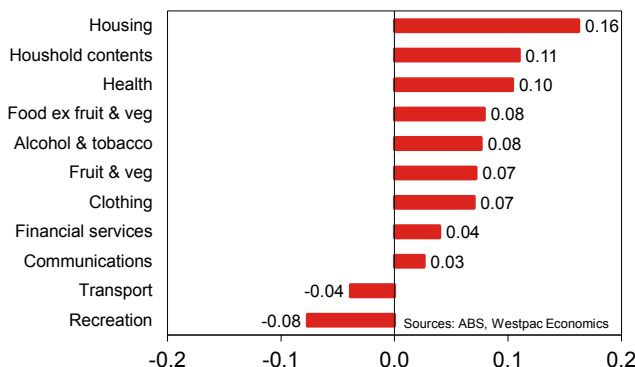


Aus Q2 CPI

Jul 23, Last: 0.6%, WBC 0.6% (avg RBA core: 0.7%)
Mkt f/c CPI: 0.5%, Range: 0.4% to 0.7%
Mkt f/c avg RBA core: 0.7%, Range: 0.4% to 0.7%

- The Q2 CPI rose 0.6%, softer than the market expectation of a 0.8% rise. The trimmed mean rose 0.5%qtr while the weighted median rose 0.6%qtr. The annual pace of the average of the core inflation measures is now 2.7%yr. There are a number of surprises in any CPI release but in Q2 these were broadly-based and in a consistent direction – mostly on the low side.
- Our Q2 headline CPI forecast is 0.6%qtr/3.2%yr. Core inflation, as measured by the average of the trimmed mean and weighted median, is forecast to rise by 0.7%qtr/2.8%yr.
- June is seasonally a softer quarter and this seasonality is helping to hold down the pace of inflation despite a robust contribution from food, housing and health costs. The seasonally adjusted CPI is forecast to rise 0.8%qtr.

Contributions to 2014Q2 CPI forecast

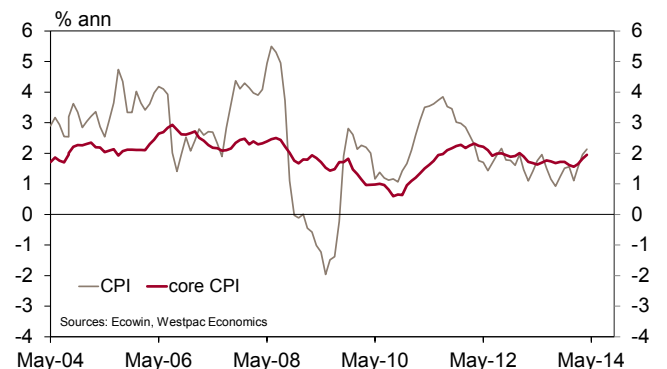


US Jun CPI

Jul 22, CPI: Last: 0.4%, WBC f/c: 0.2%

- May CPI rose 0.4%, mostly due to core rate jumping 0.3%, its (equal) fastest in over 6 years. The only standout component was a 5.8% jump in airfares in a month that would usually see post Easter/spring break discounts kicking in. Autos, clothing, rents, medical care and tobacco all posted gains of 0.2%-0.3% but none of these five usual suspects were weak or negative, and that was the main reason for the higher core outcome: the year long run of sub 0.2% core outcomes (before rounding) was due to one or more of these printing soft every month. Food prices rose 0.5% and energy was up 0.9%.
- Flat gasoline prices will show a June seas. adj. rise offsetting food prices which should start to ease back from snow-constrained supply. Most likely to post soft outcomes are autos, airfares and/or medical care, such that June delivers a 0.2% gain for both headline and core CPI.

US consumer price inflation

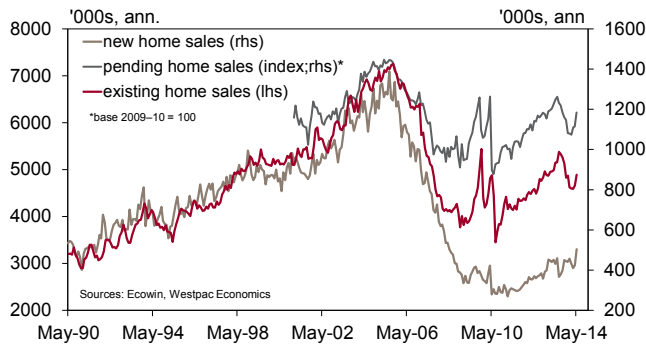


US Jun existing and new home sales

Jul 22, existing home sales, Last: 4.9%, WBC f/c: 2.0%
 Jul 24, new home sales, Last: 18.6%, WBC f/c: -7.0%

- In April-May, existing home sales recovered just over a third of the 15% decline between last July and March. That represents a bigger bounce than March-April data on pending home sales recorded, but pending sales jumped 6.1% in May. May's existing sales pace of 4.89mn annualised is about where sales were in Dec, so the recovery would include a post-winter disruption bounce and similar-sized gains are unlikely in coming months, though sales will rise.
- May's 19% jump in new sales took the annualised pace to 504k, but it recovered just 5.9ppts of the 81% decline in sales between 2005 and 2011. The Jan-May annualised sales pace of 446k compares to 447k in the first half of 2013, so on that basis the new build market has really just been treading water. With starts down sharply, June is likely to record a sales decline from a downwardly revised May worth -7% all up.

US housing sales

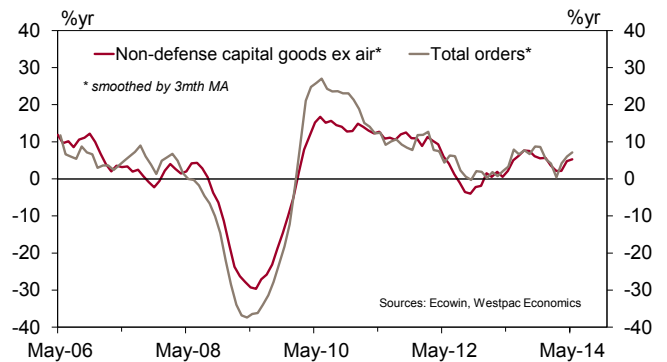


US Jun durable goods orders

Jul 25, Last: -0.9%, WBC f/c: -0.5%

- In May, a 31% fall in defence orders and a 4% fall in civilian aircraft were partially offset by a 2.1% rise in autos and a 0.7% gain in core capital goods orders ex aircraft & defence. That failed to reverse the 1.1% fall in April but with core orders up 4.7% back in March the early Q2 outcomes at least held on to most of that late Q1 rise. Shipments of same fell and rose 0.4% in April and May after a late Q1 spurt of 2.2% in March.
- ISM factory orders rose to 58.9 in June, the highest yet this year but well below 64+ readings in late 2013. Boeing took 109 orders in Jun from 98 in May. Auto sales rose 1.3% but production was down 0.3%; business equipment output rose just 0.1% and machinery fell 0.5% last month. With ISM the sole exception, these signals point to little change in orders, with a bias towards weakness. We expect a 0.5% headline durables fall and similar core capital orders slippage. Risks are to the upside thanks to the ISM.

US durable goods orders



Data calendar

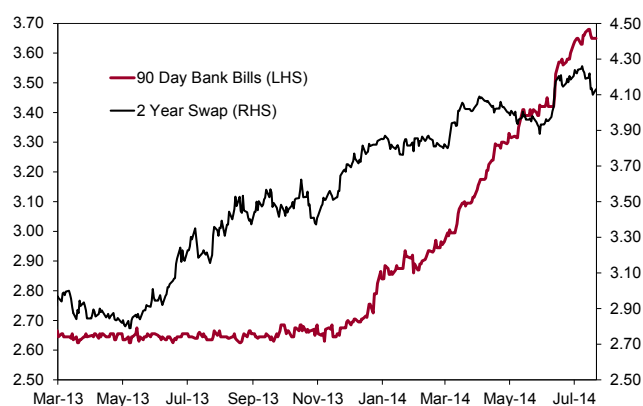
		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
NZ	Jun net immigration (s.a.)	3,980	–	4,000	Immigration likely to stay strong until Aus jobs picture improves.
Ger	Jun producer prices %yr	–0.8%	–	–	The PPI has been deflating for over a year now.
UK	Jul house prices %yr	7.7%	–	–	Rightmove index of asking prices peaked at 8.9% yr in May.
US	Jun Chicago Fed national activity index	0.21	–	–	Derived from 80 or so data series, not surveyed directly.
Tue 22					
Aus	RBA Assist. Governor Debelle speaking	–	–	–	2nd Latin America Australia Investors Forum, Sydney, 9.25 am AEST.
	RBA Governor Stevens speaking	–	–	–	Anika Foundation Luncheon, Sydney, 1.00 pm AEST.
UK	Jun PSNCR £bn	8.5	–	–	Public sector net credit requirement.
	Jul CBI industrial trends survey	11	–	–	Total orders index. Qtrly business optimism survey included this month.
US	Jun CPI	0.4%	0.3%	0.2%	Food prices should ease after surge due to harsh winter impacting spring
	Jun CPI core	0.3%	0.2%	0.2%	harvest. Gasoline prices modestly higher. Core rate back to trend.
	Jul Richmond Fed factory index	3	5	6	Richmond Fed considerably less upbeat than NY/Phily this yr.
	May house prices	0.0%	0.3%	–	FHFA series.
	Jun existing home sales	4.9%	1.6%	2.0%	Pending home sales figures suggest a rise of 2% in sales in pipeline.
Wed 23					
Aus	Q2 CPI	0.6%	0.5%	0.6%	Seasonality is offsetting robust food, housing and health costs.
	Q2 average RBA core CPI	0.5%	0.7%	0.7%	Core measures are seasonally adjusted, housing key to lift in forecast.
	RBA Deputy Governor Lowe speaking	–	–	–	RMB Internationalisation Round Table, Sydney, 11.20 am AEST.
Eur	Jul consumer confidence adv	–7.5	–	–7.0	German confidence resumed upswing in June-July.
UK	Jul BoE minutes	–	–	–	Policy decision was "more balanced" for some members in June.
	Jun mortgages no.	41.8k	–	–	BBA data; May saw the fewest new mortgages in nine months.
	Jul CBI retail survey	4	17	–	Jun reported sales down again to weakest for year so far.
Can	May retail sales	1.1%	0.5%	–	Apr retail rise supported by autos, but ex auto up solid 0.7%.
Thu 24					
NZ	RBNZ policy decision	3.25%	3.50%	3.50%	One last hike before pausing for the remainder of 2014.
Chn	Jul HSBC manufacturing PMI - flash	50.7	51.0	–	MNI up sharply. Order-stocks ratio points to a modest further gain.
Eur	Jul PMI factory adv	51.8	51.8	51.5	Economic growth has clearly moderated in Q2, but the Eurozone
	Jul PMI services adv	52.8	52.7	52.5	aggregate surveys will find a >50 base, even if France can't.
UK	Jun retail sales incl fuel	–0.5%	0.1%	0.2%	May fell from April's late Easter boost; June BRC/CBI surveys weak.
US	Initial jobless claims w/e 19/7	302k	–	310k	Summer auto plant shutdown distortion remains a lurking risk.
	Jul PMI	57.3	57.5	–	Has told different story to ISM factory series recently.
	Jun new home sales	18.6%	–4.8%	–7.0%	Sales to settle at 450k+ annualised pace in H2. Watch May revisions.
	Jul Kansas City Fed factory index	6	–	4	Shows better fit with recent US growth developments than NY/Phily.
Fri 25					
NZ	Jun business confidence	42.8	–	–	Confidence off its recent peaks, but still at a relatively high level.
Eur	Jun money supply M3 %yr	1.0%	1.1%	–	Loans to the private sector fell 2%yr in May.
Ger	Aug GfK consumer confidence	8.9	8.9	–	Labelled Aug but surveyed in Jul. Close to eight year highs.
	Jul IFO business climate index	109.7	109.5	109.9	June saw first reading below 110 for the year to date.
UK	Jul house prices %yr	6.0%	–	–	Hometrack series.
	Q2 GDP	0.8%	0.9%	0.7%	Growth unlikely to match Q1 given recent/upcoming June partials.
US	Jul durable goods orders	–0.9%	0.5%	–0.5%	Modest defence, autos, aircraft swings this month. See text box.

New Zealand forecasts

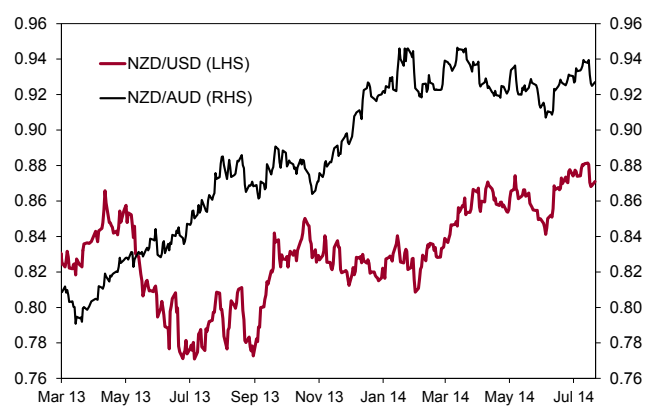
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2012	2013	2014f	2015f
% change								
GDP (Production) ann avg	2.3	3.3	3.5	3.1	2.5	2.9	3.7	3.2
Employment	0.4	3.8	2.4	2.0	0.4	2.9	2.7	2.3
Unemployment Rate % s.a.	6.2	6.0	5.5	5.1	6.8	6.0	5.6	5.1
CPI	0.9	1.5	1.8	2.6	0.9	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 21 July 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.25%	3.25%	3.25%
30 Days	3.58%	3.51%	3.42%
60 Days	3.62%	3.59%	3.49%
90 Days	3.65%	3.65%	3.57%
2 Year Swap	4.13%	4.24%	4.15%
5 Year Swap	4.54%	4.66%	4.53%

NZ foreign currency mid-rates as at Monday 21 July 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8710	0.8749	0.8702
NZD/EUR	0.6439	0.6435	0.6403
NZD/GBP	0.5097	0.5097	0.5114
NZD/JPY	88.29	89.30	88.85
NZD/AUD	0.9270	0.9341	0.9284
TWI	81.03	81.42	80.98



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	2.64	2.55	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	2.46	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	0.9361	0.91	0.90	0.90	0.92	0.93
USD/JPY	101.35	101	100	101	102	103
EUR/USD	1.3526	1.33	1.31	1.31	1.32	1.33
AUD/NZD	1.0785	1.10	1.08	1.07	1.10	1.11

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