



Castle Hill, Canterbury.

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Overcooked

The events of the last week reinforced the message that conditions for the New Zealand economy have softened since the start of the year. Yet the news hasn't been all one-way, and indeed our assessment is that the 'pulse' of the economy has actually improved on balance in the last couple of months. We believe that financial markets are – once again – overestimating how much the ground has shifted for the Reserve Bank, and are under-pricing the odds of future interest rate hikes.

The twice-monthly GlobalDairyTrade auction was the focus of attention last week, given the cumulative 40% fall in dairy prices since February (and the 17% drop in the previous two auctions alone). The latest auction showed some tentative signs of stabilisation in prices, with the trade-weighted index just 0.6% lower. Prices for whole milk powder, the main product in New Zealand's exports, rose by 3.4%, the first increase since mid-June.

Of course, the latest result doesn't make up for the surprisingly large price falls in previous auctions. We have revised our forecast of Fonterra's milk price for the current season from \$6.00 to \$5.80 per kilo of milk solids. Even achieving this outcome relies on both a rebound in dairy prices by year's end and a lower New Zealand dollar. That may seem like an unusual combination, given that the two tend to move in tandem over the longer term. But commodity prices aren't the only influence on the NZ dollar, and there has been a notable turn in sentiment towards a stronger US dollar in recent times.

Some of the knock-on effects from the fall in dairy prices this year are beginning to show through. The Treasury's Pre-Election Economic and Fiscal Update (PREFU) revealed a modest downgrade to the projections for growth and tax revenue compared to the May Budget. The outlook for a return to operating surplus from the June 2015 year remained intact, but the implication is that there is less in the kitty for any future spending (or tax cut) plans.

Overcooked continued

It should be noted that the changes to the Treasury's forecasts were relatively small. The earlier than usual election date this year meant that the PREFU came only three months after the Budget, which itself had already incorporated a sizeable fall in the terms of trade.

The softening in the economic outlook also manifested in the Reserve Bank's quarterly survey of expectations. Along with a softer set of growth forecasts, expectations of the inflation rate two years from now fell from 2.36% to 2.23%. There's probably a backwards-looking element to this, given that recent inflation outturns have remained subdued. Nevertheless, the RBNZ will welcome any evidence that expectations remain in check, which at the margin reduces the need to intervene with higher interest rates.

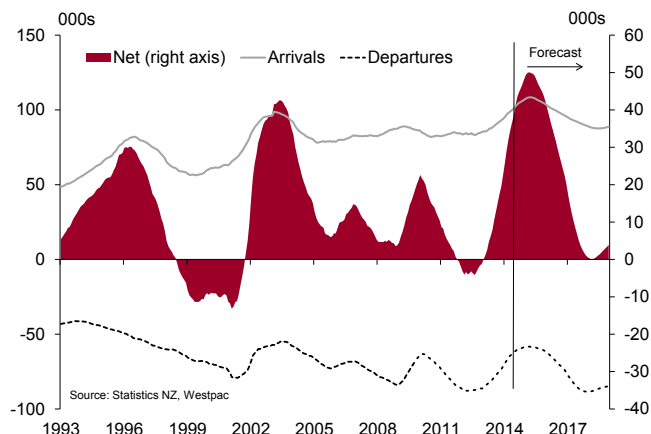
There were, however, some pockets of strength as well in last week's data. The Business NZ Performance of Services Index rose to 58.4 in July, just shy of the seven-year high recorded in April. This survey is jumpy from month to month, but it does suggest that the softening in the previous couple of months was temporary.

More significantly, net immigration was once again even stronger than expected in July, reaching an annual pace of over 41,000 people. The main driver continues to be the movements of both New Zealanders and Australians across the Tasman as the Australian job market has cooled. We expect the annual net inflow to peak at around 50,000 people by early next year.

An inflow of this scale will inevitably have an impact on housing demand, and is one of the reasons we expect a modest revival in house prices and sales over the second half of this year. Interestingly, we've encountered a distinctly negative tone to recent anecdotes from the industry, even as the data has steadily improved. These anecdotes may simply be a belated recognition that the market has cooled compared to last year.

The other major reason we expect a pickup in housing demand is that fixed-term mortgage rates have been falling again, in some cases to below where they were before the first OCR hike in March. In large part that's the product of another bout

Net migration to New Zealand



of market scepticism about the extent of future OCR hikes, with only one 25 basis point increase in the OCR factored in over the coming year (we expect three hikes in that time). The willingness to sell the NZ dollar after releases that largely repeated what we already know about dairy prices (such as the PREFU and the producer price index), while ignoring significant positive news such as the migration figures, tells us something about where market sentiment currently lies.

We think that the market is once again getting the balance of risks wrong. On the one hand, dairy prices have fallen further since the last OCR review, and inflation has remained lower than forecast. But net immigration is very strong and will have major implications for the RBNZ's forecasts, the housing market is showing renewed signs of life, and the NZ dollar has had a meaningful drop in recent weeks. We suspect that in the September *Monetary Policy Statement*, the market could be caught out by how little the RBNZ's stance has shifted.

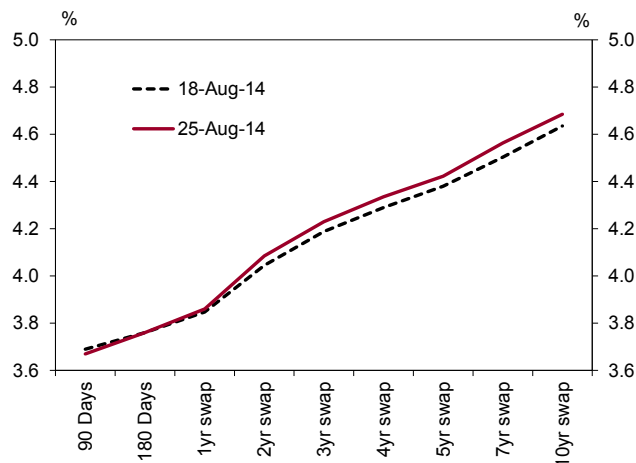
In the meantime, this mispricing will be to the benefit of borrowers, who have yet another opportunity to lock in a favourable interest rate for the next couple of years.

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, the best deals for borrowers with a deposit of 20% or more are clustered around the two-year term, and at 5.99% these offer substantial value relative to where we expect shorter-term rates to go over the next two years. There is little point in fixing for just one year, given that these rates are higher than the two-year rate in most cases. Opting for three- or four-year terms would require higher payments up front, but could help to insulate the borrower if the Reserve Bank follows through with an extensive OCR hiking cycle.

NZ interest rates

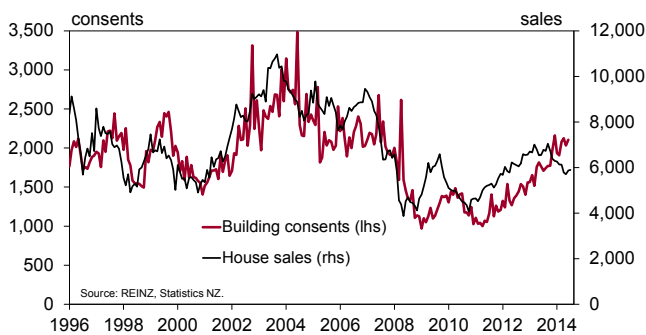


NZ Jul building consents

Aug 29, Last: +3.5%, Westpac f/c: -1.0%

- The strong upward trend in building consents has remained intact this year, though with the usual choppiness in the headline figures from month to month largely due to the apartment units category. Our forecast for July assumes underlying growth of 1% but a modest pullback in apartments, which were slightly above average in June.
- The Canterbury post-quake rebuild is still picking up momentum, and construction in Auckland has room to expand much further, given population pressures and still rapidly-rising house prices. Interestingly, consents have started to pick up in the rest of the country as well this year, despite limited evidence for a shortage of houses.

NZ housing activity

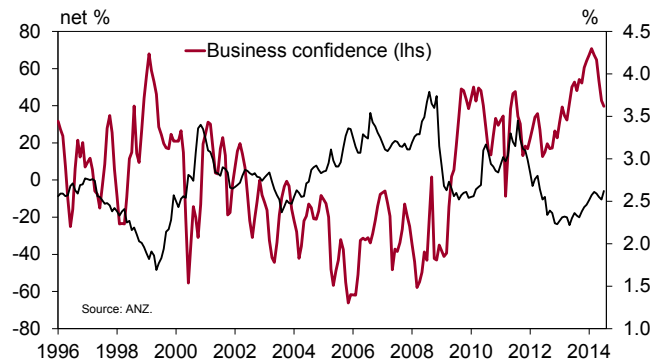


NZ Aug business confidence

Aug 29, Last: 39.7

- Having reached a two-decade high in February, business confidence has slid in recent months. However it remains at high levels by historical standards, particularly on the 'own activity' measure which corresponds most closely to GDP growth.
- Since the July survey, the economic news has included: a further fall in dairy prices (the survey probably won't capture the mid-August auction where prices showed signs of stabilising), a \$1/kg downgrade to Fonterra's milk price forecast, a larger than expected drop in the unemployment rate, a softer than expected inflation outturn, and a fourth OCR hike but with a clearly signalled pause.

NZ business confidence & inflation expectations



Aus Q2 construction work

Aug 27 Last: 0.3%, WBC f/c: -1.0%
Mkt f/c: -0.5%, Range: -4.7% to 2.4%

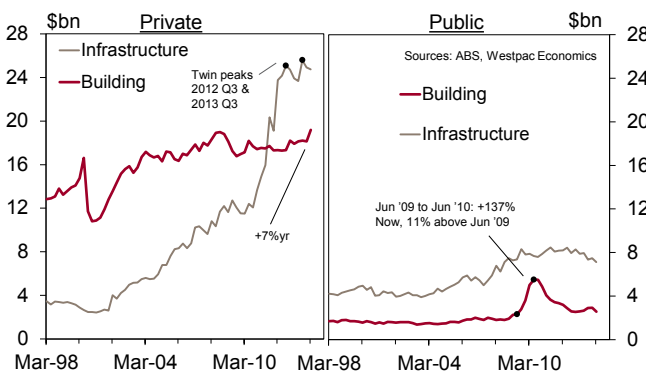
- Construction work remains uneven, reflective of the cross-currents impacting the economy at present.
- Total work is forecast to decline by 1.0% in the June quarter. This would have annual growth slow to 1.2%.
- Weakness in Q2 is centred around a downward trend in private infrastructure, driven by the mining sector, and a decline in public works.
- Housing construction, spurred on by record low interest rates, is rising strongly. New dwelling construction is expected to rise by 2.0%, following a sharp jump in Q1. Private non-residential building is also trending higher, albeit more modestly.

Aus Q2 capex

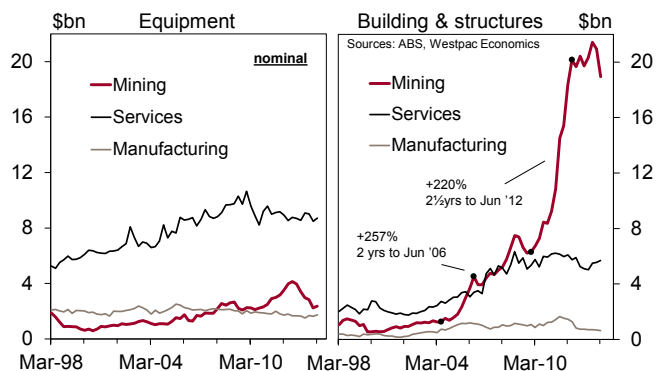
Aug 28 Last: -4.2%, WBC f/c: -0.8%
Mkt f/c: -0.9%, Range: -4.2% to 3.1%

- Capex spending in Q2 is likely to be mixed.
- We expect overall capex to decline by 0.8%, with a fall in building & structures (-2.0%) offsetting a further partial rebound in equipment (+1.5%).
- Building & structures spending fell by 7.4% in Q1 to be 2.5% lower than a year earlier. Note that the national accounts reported a smaller fall for Q1, a decline of 3.3%. The downward trend likely continued in Q2, as mining construction loses altitude.
- Equipment spending plunged 16% in 2013, as reported by the capex survey. A stabilisation was apparent early in 2014, with spending edging 2.8% higher in Q1. We expect a further modest rebound in Q2.

Construction work: divergent trends



CAPEX: by industry by asset

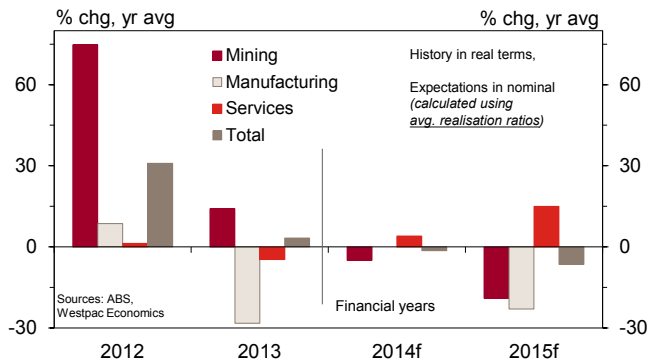


Aus capex plans for 2014/15, AUDbn

Aug 28 Last: 137

- The survey points to a decline in business capex in 2014/15, centred on a sharp decline in mining, with only a partial offset from a rise in investment by the services sector.
- We expect this broad picture to be restated in this update, which includes Est 3 of capex plans for the 2014/15 year. The survey was conducted over July, early August.
- Est 2 was \$137bn, which is 12% lower than Est 2 for 2013/14. This represents an upgrade from Est 1 of \$125bn, which is 17% below Est 1 for 2013/14.
- By industry, the figures for Est 2 on Est 2 of a year ago are: mining, -21% (an upgrade from -25% for Est 1); services sectors, +9.5% (upgraded from +0.4%); and manufacturing, -18%.

CAPEX plans by industry

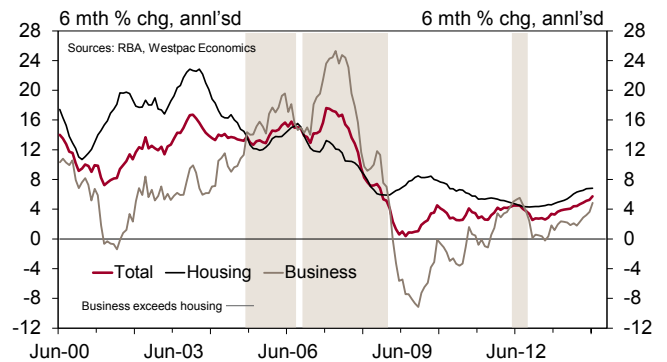


Aus Jul private sector credit

Aug 29, Last: 0.7%, WBC f/c: 0.4%
Mkt f/c: 0.5%, Range: flat to 0.6%

- Credit growth is tracking a little higher in 2014 than in 2013 as the business segment advances. Annual growth is now 5.1%, up from 3.0% a year ago.
- We expect credit to increase by 0.4% in July. Such an outcome would be in line with the average from January to May. In June, a 0.7% rise was recorded, boosted by a 1.0% spike in business credit, associated with a one-off transaction.
- Business credit is trending higher at a modest pace, rising 1.8% in the six months to May. This trend likely continued in July.
- Housing credit strengthened during 2013 on low and falling interest rates. This has given way to a consolidation in 2014 with interest rates on hold. Housing credit rose 0.6% in the month of June, to be 6.4% higher over the year.

Credit momentum

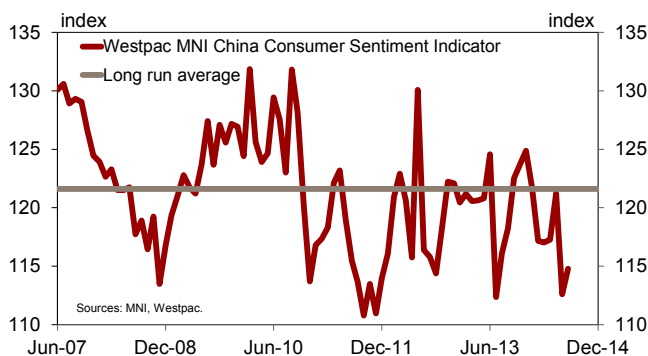


China Aug Westpac MNI Consumer Sentiment

July 30 Last: 114.8

- The headline index rose to 114.8 in July from 112.6 in June a 1.9% change over the month and 2.1% over the year. The July outcome was 5.6% below the long run average.
- We noted at the time of the July release that households were less impressed with the state of the economy than the two PMIs. Given the much softer than expected round of official July data that followed, it seems that the instinctive scepticism of the consumer was closer to the mark.
- We will be looking for the following in August. 1. Whether forward looking responses are picking up to a greater degree than current conditions, implying a pick-up in consumption in Q4. 2. What consumers are now saying about the labour market, coming off bad June-July readings. 3. The evolving attitude of consumers towards the ongoing housing correction, in the context of easier policy. 4. What all the above has done to savings attitudes (avenues and motivations) over the month.

Westpac MNI China Consumer Sentiment

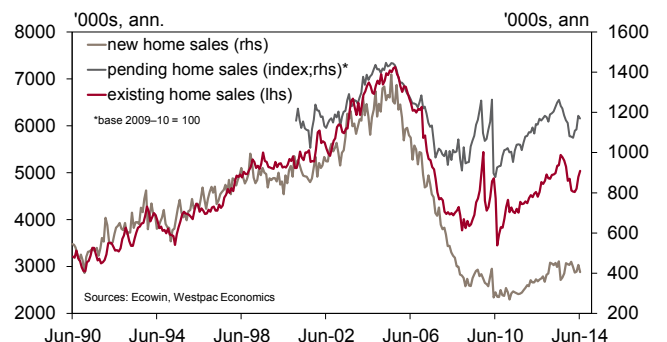


US Jul new and pending home sales

Aug 25, new home sales, Last: -8.1%, WBC f/c: 8.0%
Aug 28, pending home sales, Last: -1.1%, WBC f/c: 2.0%

- New home sales fell 8.1% in June, for a 406k annualised pace, weaker than most of last year except for the summer sales slump in Q3. In the last 50 years, the US has produced houses at less than a 400k annualised pace just four times: 2008-13, early 1980s, early 1970s, and mid 1960s. In those three earlier episodes, sales recovered by at least 200k over the next year. This time around, they have simply stalled. Our forecast 8% rise in July (matching the 8% rise in single family house starts) won't make much difference and might be revised away next month!
- Pending home sales fell 15% peak to trough (May 2013 to Feb) and had recovered 9ppts of that fall by May 2014 before they fell 1.1% in June. By July, existing home sales (closings) had recovered 10+ ppts of their 15% fall so pending home sales should post a catch-up 2% rise in July (they usually lead!).

US housing sales

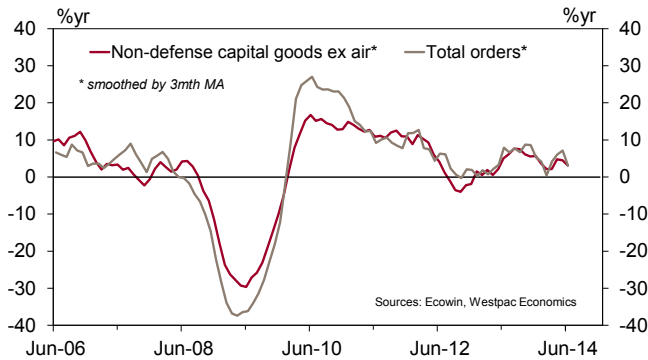


US Jul durable goods orders to rise sharply

Aug 26, Last: 1.7%, WBC f/c: 5.0%

- Durable orders rose 1.7% in revised June data. Core capital goods orders excluding aircraft & defence saw a 3.3% jump in June. In Q2, the core orders annualised gain was 8.8%, double Q1's 4.1% pace but still behind Q4's 12.1% annualised. Shipments of same rose 5.6% in Q2.
- ISM factory orders jumped 4.5pts in July to their highest for the year so far. Boeing took 324 orders in July but only 109 in June. Last year July was down sharply on June so the seasonality is not clear. Auto sales fell slightly but production surged 10% in July as automakers shortened their summer shutdowns. Business equipment output rose 1.3% too. These signals point to a headline jump in durable orders led by transport, with a further 1% rise in core capital goods orders. Defence spending is likely to be on the rise again soon as well.

US durable goods orders



US core PCE deflator and personal income/spending

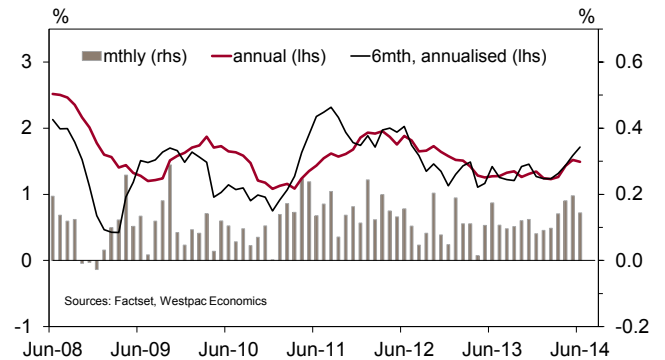
Aug 29, Core PCE deflator: Last: 0.1%, WBC f/c: 0.1%

Aug 29, Personal income: Last: 0.4%, WBC f/c: 0.2%

Aug 29, Personal spending: Last 0.4%, WBC f/c: 0.0%

- Personal income and spending both rose 0.4% in June, and the core PCE deflator slowed to 0.1% after 0.2% gains in April-May.
- Hourly earnings were flat in July but hours worked rose 0.2%. Retail sales were flat in July, with auto sales weaker. The savings rate rose from 4.1% at end 2013 to 5.3% in June. The core CPI was steady at 0.1% in July.
- Income and spending growth look to have started Q3 in subdued fashion, with slower income growth of 0.2% and a continuation of the savings uptrend expected to have prevented any increase in personal spending in the month. The core PCE deflator should settle back into a 0.1% trend.

US core PCE deflator



Data calendar

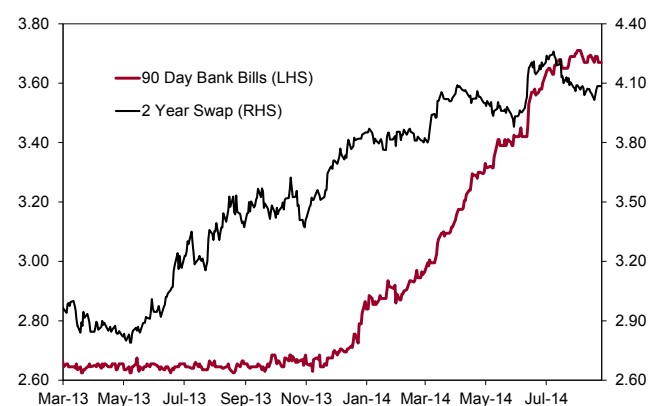
		Last	Market median	Westpac forecast	Risk/Comment
Mon 25					
Ger	Aug Ifo business climate index	108.0	107.0	107.6	German economy to resume growth in Q3, despite geopolitics.
UK	August bank holiday	–	–	–	FTSE closed.
US	Jul Chicago Fed national activity index	0.12	0.20	–	Based on 80 or so data inputs, not a business survey.
	Aug PMI services	60.8	59.1	–	Reasonable guide to ISM services, if not to the broader economy.
	Jul new home sales	–8.1%	4.7%	8.0%	Volatile series; single family house starts recovered in July. See text box.
	Aug Dallas Fed factory index	12.7	13.0	8.0	Mixed district Fed surveys so far in Aug.
Tue 26					
NZ	Jul merchandise trade balance \$m	247	–475	–650	Falling dairy prices to weigh on exports, plus a \$200m plane import.
UK	Aug house prices %yr	10.6%	10.2%	–	Tentative date for Nationwide index due 26-29/8.
	Jul mortgages approved, no.	43.3k	–	–	BBA data covering 70% of market.
US	Jun house prices	0.4%	0.3%	–	FHFA index.
	Jun house prices %yr	9.3%	8.2%	–	S&P Case Shiller 20 city index.
	Jul durable goods orders	1.7%	7.5%	5.0%	Boeing, autos likely higher, underlying story supportive; see text box.
	Aug Conf Board consumer confidence	90.9	89.0	88.5	IBD-TIPP, UoM both weaker in Aug.
	Aug Richmond Fed factory index	7	8	6	In July Richmond presaged Aug weakness in NY but Philly yet to fall.
Wed 27					
NZ	Jul food price index	1.4%	–	0.7%	Seasonal increases through winter.
Aus	Q2 construction work done	0.3%	–0.5%	–1.0%	Cross currents: housing a strong upswing, infrastructure losing altitude.
Chn	Aug Westpac–MNI consumer sentiment	114.8	–	–	Subdued prints in Jun-July was the best lead on weak July official data.
Ger	Jul retail sales	1.0%	–	–	Tentative date. Volatile and oft revised series.
	Sep GfK consumer confidence	9.0	9.0	–	Has not posted decline since early 2013, despite this year's issues.
Thu 28					
Aus	Q2 private capex	–4.2%	–0.9%	–0.8%	Building & structures decline to offset partial rebound in equip, +1.5%.
	2014/15 capex plans, AUDbn	137	–	–	–12% Est 2 vs Est 2 for 2013/14, mining is –21%, services +9.5%.
Chn	Jul industrial profits %ytd	11.4%	–	–	Profitability improved in Q2 on both better sales and wider margins.
Eur	Jul money supply M3 %yr	1.5%	1.5%	–	About to expand as June easing measures impact.
	Aug business climate indicator	0.17	–	0.00	Escalation of Russia-Ukraine tensions and flat GDP data unhelpful.
	Aug economic confidence	102.2	101.6	108.5	for both these indicators. Advance consumer confidence weaker.
Ger	Aug unemployment ch	–12k	–5k	–10k	German joblessness resumed declines in Jul after May-June rise.
	Aug CPI prelim %yr	0.8%	0.8%	0.8%	Base effects may prevent further decline for now.
UK	Aug CBI retail survey	21	–	–	Reported sales see-saw pattern of late becoming muted on upswing.
US	Initial jobless claims w/e Aug 23	298k	–	300k	Claims close to multi-decade lows.
	Jul pending home sales	–1.1%	0.5%	2.0%	Housing data noisy of late but some better data expected short-term.
	Q2 GDP 1st revision	4.0% a	3.9%	4.0%	Net exports and inventories revisions likely to be offsetting.
	Aug Kansas City Fed factory index	9	–	7	Just one negative reading in past year, in Dec 2013.
Can	Q2 current account C\$bn	–12.4	–	–	Trade edging back into surplus but debt needs to be serviced.
	Jun average weekly earnings	2.6%	–	–	Downtrend in pace of growth since mid 2012.
Fri 29					
NZ	Jul building consents	3.5%	1.0%	–1.0%	Strong uptrend in Auckland and Canterbury remains intact.
	Aug ANZ business confidence	39.7	–	–	Falling dairy prices could weigh further on confidence.
	Jul private sector credit %yr	4.5%	–	–	Lending growth has picked up a little since May.
Aus	Jul private credit	0.7%	0.5%	0.4%	June result boosted by a one-off business loan.
Eur	Aug CPI flash %yr	0.4%	0.3%	0.3%	Jul CPI was 0.38% before rounding, 0.3% yr or lower likely by end Q3
	Jul unemployment rate %	11.5%	11.5%	12.6%	Steady German jobless rate, likely higher in France, Italy, lower in Spain.
UK	Aug GfK consumer confidence	–2	0	–12	Jul saw steepest fall since late 2012. Rate rise talk may be in focus.
	Aug house prices %yr	5.8%	–	–	Hometrack index.
US	Jul core PCE deflator	0.2%	0.1%	0.1%	Core CPI was 0.1% in Jul.
	Jul personal income	0.4%	0.3%	0.2%	Hourly earnings flat but hours worked rose 0.2% in July. See text box.
	Jul personal spending	0.4%	0.2%	0.0%	Retail sales flat in Jul; recent savings increase may have continued.
	Aug Chicago PMI	52.6	56.5	54.0	Aug regional surveys have mostly had a weaker tone so far.
	Aug UoM consumer sentiment final	79.2 a	80.1	81.0	Equities sharply higher since preliminary survey.
Can	Q2 GDP % annualised	1.2%	2.6%	2.8%	Rebound from weather constrained Q1.
	Jun GDP %yr	2.3%	–	3.1%	Base effects (flooding and strike disruption in June 2013) supportive.

New Zealand forecasts

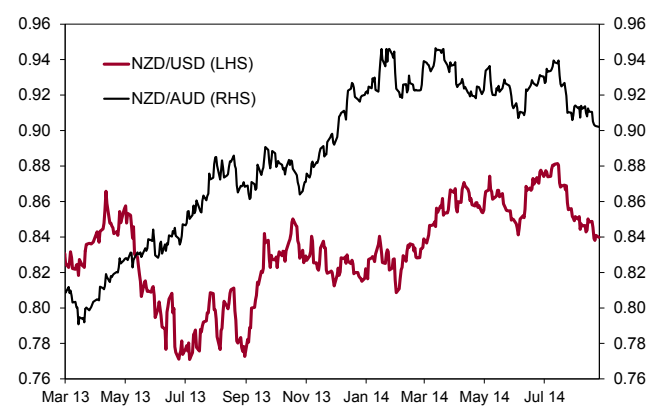
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2012	2013	2014f	2015f
% change								
GDP (Production) ann avg	2.3	3.3	3.5	3.1	2.5	2.9	3.7	3.2
Employment	0.4	3.8	2.8	2.6	0.4	2.9	3.0	2.9
Unemployment Rate % s.a.	6.2	5.9	5.3	4.7	6.8	6.0	5.4	4.7
CPI	0.9	1.5	1.8	2.6	0.9	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 25 August 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.64%	3.65%	3.63%
60 Days	3.67%	3.67%	3.65%
90 Days	3.67%	3.67%	3.69%
2 Year Swap	4.09%	4.06%	4.09%
5 Year Swap	4.42%	4.42%	4.47%

NZ foreign currency mid-rates as at Monday 25 August 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8398	0.8463	0.8554
NZD/EUR	0.6364	0.6313	0.6368
NZD/GBP	0.5075	0.5045	0.5038
NZD/JPY	87.56	86.50	87.07
NZD/AUD	0.9021	0.9123	0.9104
TWI	79.30	79.35	79.82



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	2.64	2.60	2.55	2.55	2.65	3.00
10 Year Bond	3.47	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	2.41	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	0.9326	0.91	0.90	0.90	0.92	0.93
USD/JPY	103.71	101	100	101	102	103
EUR/USD	1.3288	1.33	1.31	1.31	1.32	1.33
AUD/NZD	1.1072	1.10	1.08	1.07	1.10	1.11

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