Weekly Commentary

Nugget Point, Balclutha

In this issue

Curtain raiser

The recent run of strong economic data has solidified the case for higher interest rates this year; now it's the tactical considerations around how to kick off that process that are coming to the fore. Last week's higher than expected inflation figures have raised the odds that the Reserve Bank decides to act immediately. But we think that on balance the March *Monetary Policy Statement* would be the preferred option, in terms of explaining the decision to raise interest rates and guiding expectations of future moves.

The data released so far this year have pretty consistently pointed in the direction of a strengthening economy. GDP growth appears to have been strong over the second half of 2013, consumer and business confidence are at back to pre-recession levels (the latter reaching a 20-year high), perceived job opportunities are improving, retail spending is growing strongly, manufacturers are doing well in spite of the high New Zealand dollar and the softening Australian economy, and export commodity prices remain high.

The one sector that hasn't shown the same momentum is the housing market. The latest REINZ house sales figures show that the housing market is clearly cooling, albeit no more than the 'soft landing' that the RBNZ was hoping for from its high-LVR home loan restrictions. Sales fell by around 11% in the three months to December, and there are tentative signs that house prices are now rising at a slower rate, though not falling outright. Banks have brought their shares of high-LVR lending to well within the 10% cap, and if anything have some wiggle room to increase it again (weekly data on mortgage approvals suggest there was a small uptick in December).

All told, the recent data will have strengthened the RBNZ's view that the economy is heading into a sustained upturn, which will generate greater inflation pressures over the coming years. The RBNZ's most recent forecasts in December indicated at least 100 basis points of OCR increases this year, with March as the most likely starting date.

Curtain raiser continued

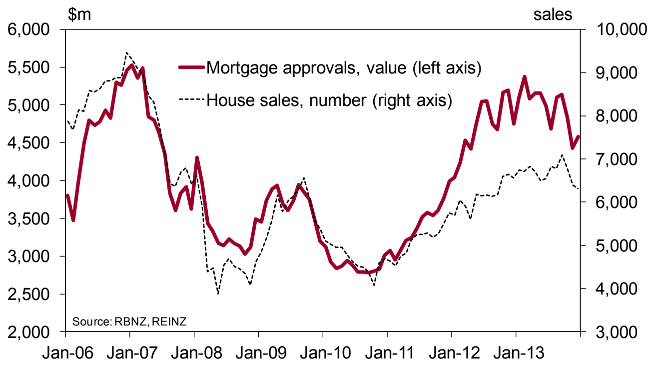
However, last week's inflation figures upped the stakes in terms of the timing of the first OCR move. Annual inflation rose from 1.4% to 1.6% in the December quarter, against the RBNZ's forecast (and our own) that it would hold steady. Some of the surprise was due to larger than usual seasonal increases in airfares, which may be unwound again in the March quarter. However, there were two elements that could prove to be more persistent. The first was that there were larger than expected price increases (or smaller than usual price decreases) across a range of imported and import-competing items, suggesting that the dampening effect of a rising NZ dollar, which has helped to keep inflation very low over the last couple of years, is now waning. The second was that housing-related price pressures are becoming stronger, and are no longer being confined to the quake-hit Canterbury region.

Following the inflation figures, financial market pricing now gives a greater than 50% chance that the RBNZ will deliver its first interest rate hike at this Thursday's OCR review, rather than at the March *Monetary Policy Statement.* The case for raising interest rates in the near future is clear-cut. So we acknowledge that Thursday's review is 'live'.

But from a tactical point of view, we think that the RBNZ will prefer to signal an impending rate hike this week and deliver in March. Compared to the one-page media release that typically accompanies a January OCR review, an *MPS* comes with vastly superior opportunities to communicate and justify a hiking decision. The RBNZ under Governor Graeme Wheeler has made a greater commitment on transparency and communication, and the occasion of the first OCR move in nearly three years will be an important test of that commitment.

Waiting until the March *MPS* would also give the RBNZ a chance to provide clear guidance on the extent and timing of future interest rate hikes once the cycle has been kicked off. Without this, markets could easily extrapolate from a January hike and send term interest rates higher than the RBNZ intended. In turn, this would lead to an unnecessarily large rise in the exchange rate. The central bank would have to work to unwind any such overreaction later.

Housing turnover



The benefit of hiking this week would be that interest rates would get to where they need to be more promptly. But this benefit is only slight. If the central bank's intentions are clearly and credibly signalled, financial markets should lift term interest rates well in anticipation of a hiking cycle, achieving many of the RBNZ's goals early. This is exactly what has happened in the current cycle – term interest rates have already risen substantially.

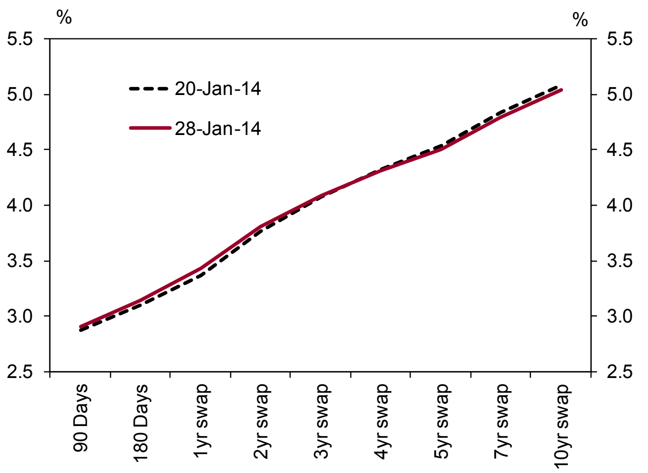
At the margin, political considerations could also be a factor. An early and unsignalled rate hike is bound to raise some hackles, especially given that the opposition parties have already indicated that they intend to make the monetary policy framework an issue in the upcoming election campaign.

We expect that an on-hold decision on Thursday, with a signal that "we expect to begin removing policy stimulus over the coming months", would have a muted market impact. Markets are already well acquainted with the idea that the OCR will need to be normalised as the economy rebounds, and term interest rates already reflect the view that the OCR will be increased several times over the course of this year.

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

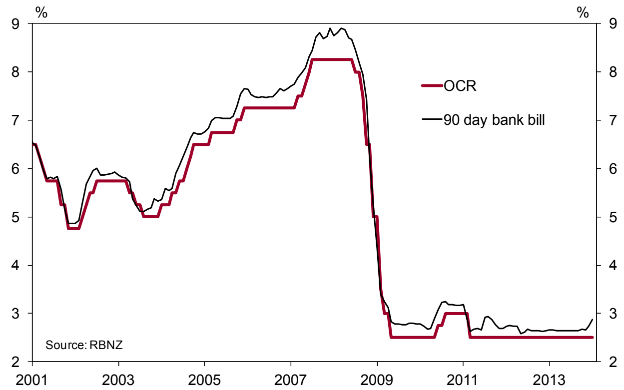


NZ RBNZ OCR review

Jan 30, Last: 2.50%, Westpac f/c: 2.50%, Mkt f.c: 2.50%

- A strong run of activity data, high commodity prices, and higher-than-expected inflation have sealed the case for interest rate hikes this year.
- However, we expect the RBNZ will wait until March before initiating the hiking cycle. The March Monetary Policy Statement offers a far superior opportunity to communicate and justify a hiking decision. March will be backed by full forecasts, a five-chapter booklet, and a media conference. By contrast, the January OCR review will be accompanied only by a one-page press release.
- The text of the January review will clearly foreshadow a March hike.

NZ OCR and 90 day rate

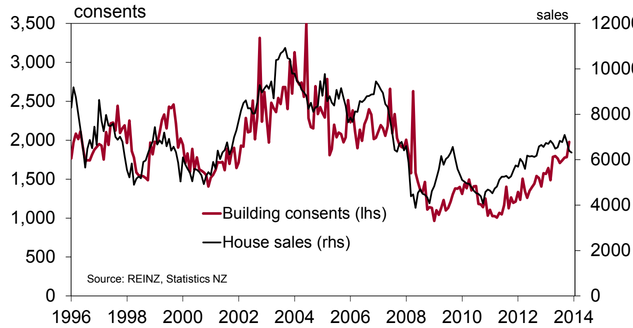


NZ Dec building consents

Jan 30, Last: +11.1%, Westpac f/c: -12.0%

- The 11% jump in residential building consents in November was driven by a massive spike in apartment consents (492, compared to an average of around 140 in the previous 12 months). Our forecast of a 12% drop in total consents is based on apartments returning to average levels in December, but the outcome could go sharply either way.
- We have assumed a modest 1% rise in ex-apartment consents for December, with the post-earthquake rebuild in Canterbury continuing to lead the way.
- In December the RBNZ exempted construction loans from its new high-LVR loan restrictions, due to concerns about an adverse effect on housing supply. Whether or not those concerns were valid, we suspect the impact of the restriction would have affected consents with a lag of several months.

NZ Dec building consents

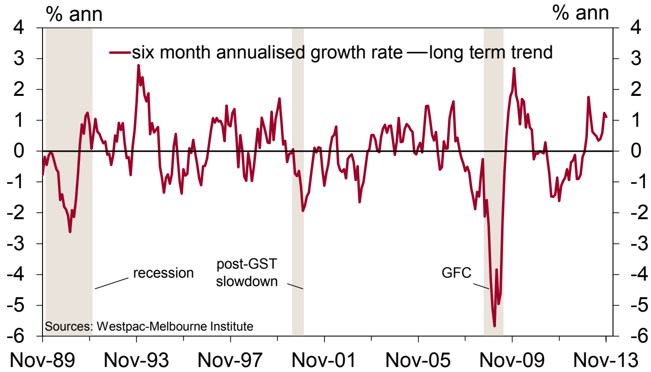


Aus Dec Westpac–MI Leading Index

Jan 29, Last: 1.1%

- The six month annualised deviation from trend growth rate of the Westpac Melbourne Institute Leading Index of Economic Activity edged down to 1.1% in Nov from 1.2% in Oct. Although lower, that still marks a continuation of the comfortably above trend pace recorded throughout 2013.
- Components have been mixed in recent months. The CSI Expectations Index declined 2% in Jan following a 5% fall in Dec. The Unemployment Expectations Index was also less positive with a 0.7% uptick in Jan following a 4.6% rise in Dec (higher readings indicate a poorer outlook). Dwelling approvals were down 1.5% in Nov but are at a relatively high level overall following Sep's 16.8% spike. Other components have been more positive with US industrial production up 0.3% in Dec, AUD commodity up 3.3% and the yield spread widening a further 10bps in Dec.

Westpac-MI Leading Index

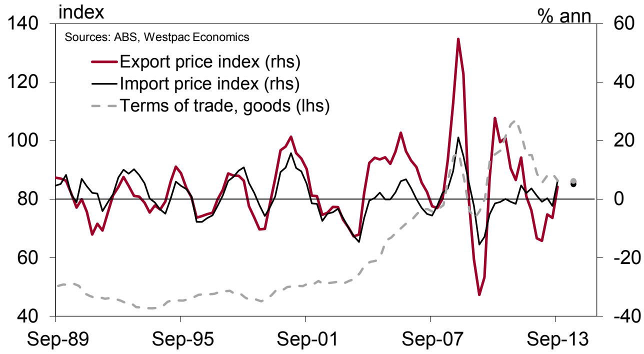


Aus Q4 import price index

Jan 30, Last: 6.1%, WBC f/c: –0.7%
Mkt f/c: 2.0%, Range: –0.7% to 3.6%

- Import goods prices are expected to edge lower in the December quarter, declining by a forecast 0.7%.
- This follows a sizeable jump in prices in the September quarter, with the import price index rising 6.1%qtr, 6.1%yr.
- Fluctuations in the Aussie dollar are typically the key driver of quarter to quarter movements in import prices. The currency consolidated in the December quarter, rising 0.7% on a TWI basis after a 6.6% depreciation in Q3.
- Global oil prices were broadly neutral in Q4, with little change in USD terms.

Import & export prices



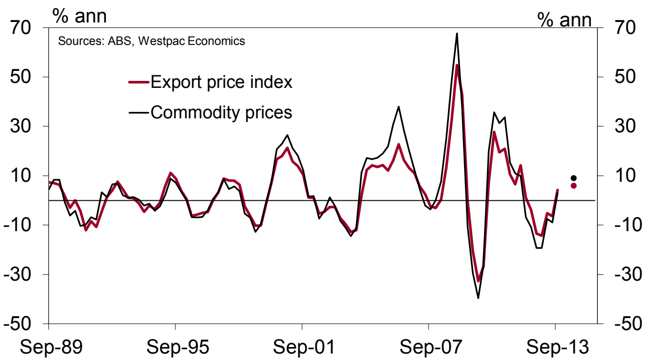
The week ahead

Aus Q4 export price index

Jan 30, Last: 4.2%, WBC f/c: –0.7%
Mkt f/c: –0.2%, Range: –1.0% to 2.0%

- The export goods price index is expected to decline by 0.7% in the December quarter, matching the move in import goods prices.
- In Q3 the export price index rose by 4.2%qtr, 4.2%yr.
- Global commodity prices stabilised in Q4, up 0.8% in USD terms. That followed a sharp sell-off over the previous nine quarters, down 31% in total.
- However, the dominant factor in the quarter was a firming of the Aussie dollar, up 1.4% against the USD. That placed downward pressure on export goods prices.
- The terms of trade for goods will be flat in Q4 on our forecasts, and little changed during 2013. That contrasts with a 20% drop in the five quarters to 2012 Q4.

Commodity prices & export price index

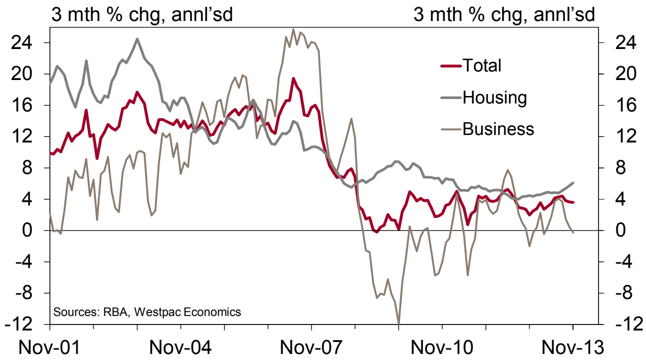


Aus Dec private sector credit

Jan 31, Last: 0.3%, WBC f/c: 0.4%
Mkt f/c: 0.4%, Range: 0.2% to 0.5%

- Credit to the private sector expanded by a relatively subdued 3½% in recent years, increasing by 3.3% in 2010; 3.5% in 2011; 3.6% in 2012 and rising by a likely 3.7% in 2013.
- We expect a 0.4% rise in the final month of 2013, up a fraction from gains of 0.3% in each of the past four months.
- Housing credit is on the improve in response to low interest rates. However, gains have been limited by existing mortgage holders accelerating repayments. In November housing credit rose 0.5%mth, 5.1%yr, with the 3 month annualised pace 6.0%.
- Business credit stalled once more during the second half of 2013, with gains of 0.1% in both August and October offset by falls of 0.1% in September and November. We anticipate a slight rise in December.

Credit momentum

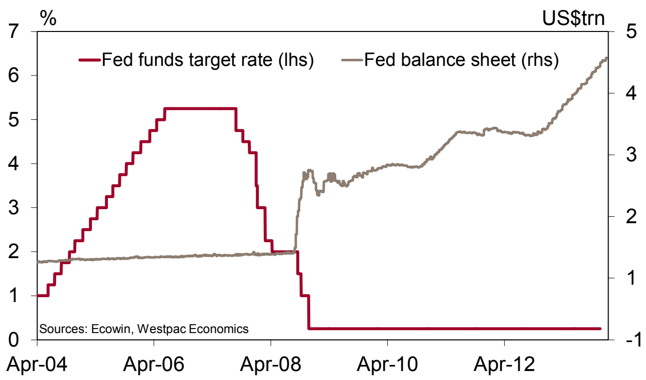


US FOMC meeting; another taper

Jan 29, Last: $75bn, WBC f/c: $65bn

- The past month has added much colour (and a great deal of uncertainty) to the taper debate. Post December's taper, FOMC communications have remained very upbeat, while available data have been somewhat erratic. This disparity is a forerunner of the tension that will be with us throughout 2014. Now that the Fed has begun the tapering process, they will be much more willing to weather poor data before seeing a need to respond by halting the process.
- In other words, with GDP growth shifting up a gear, persistent low inflation and mediocre jobs growth will not provide enough reason for the Fed to sway from what it sees as a slower pace of policy easing, at least in the short-term. However we continue to expect the economy to disappoint enough by midyear for the Fed to delay ongoing tapering, perhaps at the June FOMC meeting.

Fed funds target rate and balance sheet

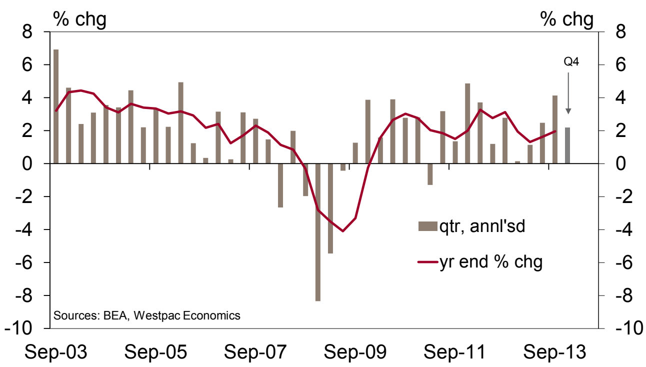


US Q4 GDP growth: slower due destocking

Jan 30, Last: 4.1% ann'lsd, WBC f/c: 2.2%

- US GDP grew 4.1% annualised in Q3 (revised up from 2.8% in the advance report). Inventory accumulation explained 1.7ppts of that; personal consumption growth was on trend at 2.0%, constrained once again by weak growth in services spending; business investment growth was steady at just under 5%; residential slowed to 10%; gov't spending growth remained subdued; and net exports were another small positive.
- Q4 partials point to a probable temporary weather induced upswing in services spending, which should lift consumption growth to 2.7%, its strongest since early 2012 (but Q1 should be weaker). A larger contribution from net exports and only partial reversal of the stocks contribution point to growth in GDP at half Q3's pace. Annual growth (from Q4 12) would lift to 2.5% yr, still slower than 3.1% yr in Q3 12 when the Fed launched QE3 - so growth has slowed despite the latest QE round, though not as much as earlier in 2013.

US GDP growth



Data calendar

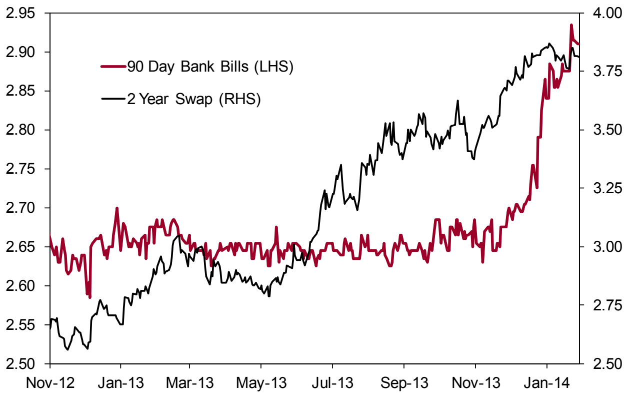
		Last	Market median	Westpac forecast	Risk/Comment
Tue 28					
Aus	Dec NAB business survey	–3	–	–	Nov: conditions index +1pt to –3; confidence –1pt to +5.
Chn	Dec industrial profi ts %ytd	13.2%	–	–	Rebound in nominal GDP in second half has supported profitability.
UK	Q4 GDP advance	0.8%	0.7%	0.7%	Despite retail sales surge, Dec IP data suggest growth not accelerating.
US	Nov house prices %yr	13.6%	13.7%	–	S&P-Case Shiller 20 city index.
	Jan Conf Board consumer confidence	78.1	77.5	77.5	Dec saw first rise since Aug. UoM sentiment weaker in Jan.
	Dec durable goods orders	3.4%	1.7%	2.0%	Headline boosted by aircraft but core capital goods downside risk.
	Jan Richmond Fed factory index	13	12	7	Held close to year's high in Dec after mid-year volatility.
Wed 29					
Aus	Dec Westpac–MI leading index	1.1%	–	–	6mth annl'sd deviation from tend growth of index 1.1% in Nov.
Eur	Dec money supply M3 %yr	1.5%	1.7%	–	Slowed from 3.9% yr peak in Oct 2012. Private loans down 2% yr.
Ger	Jan GfK consumer confidence	7.6	7.6	–	Surveyed early Jan but labelled Feb. At highest since 2007.
US	FOMC decision $bn per mth	75	65	65	We accept case against further taper not strong for now. See text box.
Thu 30					
NZ	RBNZ OCR review	2.50%	2.50%	2.50%	Strong signal of March hike expected.
	Dec building consents	11.1%	–	–12.0%	Trending higher, led by Auckland and Christchurch.
	Dec net migration	2,770	–	2,550	Annual net immigration approaching 20,000, expected to rise further.
Aus	Q4 import price index	6.1%	2.0%	–0.7%	Import prices a touch lower on small gain in AUD, +0.7% on TWI basis.
	Q4 export price index	4.2%	–0.2%	–0.7%	Lower as AUD up +1.4% vs USD, while commodity prices stabilise.
Chn	Jan HSBC manufacturing PMI - final	49.6	–	–	Market surprised by flash. Jan-Feb data.
Eur	Jan business climate indicator	0.27	–	0.20	Business surveys back at pre-recession levels in 2011; we question
	Jan economic confidence	100.0	100.9	100.0	sustainability of upswing.
Ger	Jan unemployment ch'	–15k	–2k	–	H2 2013 jobless rise 19k, steeper than in H1 last year.
	Jan CPI prelim %yr	1.4%	1.5%	–	1.4% is below midpoint of April-July spike from 1.2% yr to 1.9% yr.
UK	Dec net mortgage lending £bn	0.9	1.2	–	BoE/Treasury FLS credited with modest rise in household loan out-
	Dec net consumer credit £bn	0.6	0.9	–	standings, though demand for credit outside mortgages still weak.
	Dec M4 money supply ex IOFCs %yr	4.9%	–	–	Down from 7.9% yr in Aug 12, a function of BoE APP suspension.
US	Q4 GDP advance	4.1%	3.2%	2.2%	Growth to slow from Q3 inventories boosted outcome; see text box.
	Dec pending home sales	0.2%	0.2%	1.0%	No significant rise in sales since May last year.
	Initial jobless claims w/e Jan 25	326k	330k	320k	Potential for distortion by Martin Luther King day holiday.
Can	Nov average weekly earnings	1.4%	–	–	Uptrend from late 2011 turned into downtrend since late 2012.
Fri 31					
NZ	Dec merchandise trade balance $m	183	-	600	Dairy export volumes recovering, but imports to rebound from Sep.
	Dec private sector credit %yr	4.9%	-	-	Mortgage growth steady to date, likely to slow with housing market.
Aus	Dec private sector credit	0.3%	0.4%	0.4%	To round up to 0.4% as housing improves.
	Q4 PPI fi nal stage %qtr	1.3%	–	1.0%	Weaker AUD, construction & services all pushing producer prices higher.
Chn	Lunar New Year	–	–	–	Markets closed around the region.
Eur	Jan CPI flash %yr	0.8%	–	–	Ger CPI due 30/1 helpful clue. Eurozone core was 0.7%yr in Dec.
	Dec unemployment rate %	12.1%	12.1%	12.1%	Steady German jobless rate but French job market weaker.
UK	Jan GfK consumer confidence	–13	–12	–	Sep was highest since 2007 at –10 but down through Q4.
US	Dec core PCE deflator	0.1%	0.1%	0.1%	Core CPI 0.1% in Dec.
	Dec personal income	0.2%	0.2%	0.1%	Hourly earnings soft and hours worked down nin Dec.
	Dec personal spending	0.5%	0.2%	0.1%	Quarterly aggregates will be known from GDP report.
	Q4 employment cost index	0.4%	0.4%	0.4%	Job market not driving wages pressures.
	Jan Chicago PMI	60.8	–	56.0	Back above 60 right through Q4; too strong given GDP slowdown.
	Jan Milwaukee NAPM	54.3	–	–	Milwaukee lesser watched.
	Jan UoM consumer sentiment final	80.4a	81.0	80.0	Weekly confidence data suggests sentiment softened later in Jan.
Can	Nov GDP %yr	2.7%	–	–	Oct growth strongest in over a year.

New Zealand forecasts

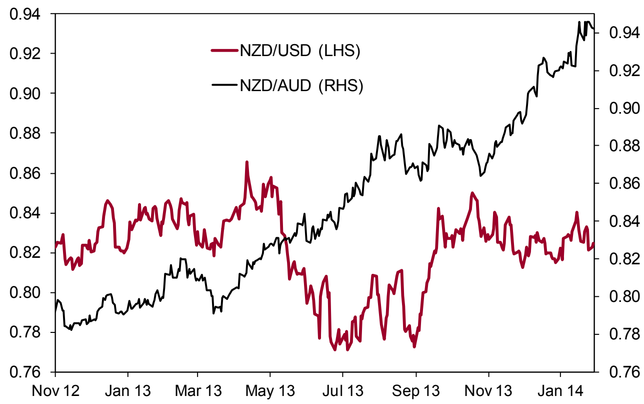
Economic Growth Forecasts	March years				Calendar years			
% change	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
GDP (Production) ann avg	2.4	2.3	3.1	3.8	1.9	2.6	2.8	3.9
Employment	0.9	0.4	3.0	2.6	1.6	0.4	2.4	2.8
Unemployment Rate % s.a.	6.8	6.2	5.7	5.1	6.3	6.7	6.0	5.1
CPI	1.6	0.9	1.3	2.2	1.8	0.9	1.5	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	84.7	82.8	81.0	79.2	79.0	77.7
NZD/EUR	0.62	0.63	0.62	0.63	0.63	0.63
NZD/GBP	0.52	0.51	0.51	0.50	0.48	0.48
TWI	78.6	78.5	77.7	77.2	76.6	76.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 28 Jan 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.74%	2.72%	2.67%
60 Days	2.82%	2.79%	2.77%
90 Days	2.91%	2.86%	2.86%
2 Year Swap	3.81%	3.78%	3.85%
5 Year Swap	4.51%	4.63%	4.72%

NZ foreign currency mid-rates as at Tuesday 28 Jan 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8246	0.8296	0.8164
NZD/EUR	0.6034	0.6066	0.5935
NZD/GBP	0.4975	0.5033	0.4953
NZD/JPY	84.70	86.23	85.88
NZD/AUD	0.9422	0.9220	0.9210
TWI	78.04	78.19	77.20

International forecasts

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	2.7	2.3
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	2.50	2.25	2.00	2.00
90 Day Bill	2.62	2.55	2.55	2.30	2.10	2.10
10 Year Bond	4.09	4.10	3.90	3.70	4.00	4.10
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.78	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	0.8770	0.90	0.88	0.87	0.86	0.85
USD/JPY	103.50	102	101	100	99	100
EUR/USD	1.3680	1.34	1.30	1.30	1.27	1.26
AUD/NZD	1.0580	1.07	1.06	1.06	1.06	1.06

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Disclaimer continued

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