

# Weekly Commentary

8 April 2013

## A drought like no other

**Last week we noted that the total impact of the recent drought on the economy could be less negative than originally feared. Since then global dairy prices have continued to surge. We will keep monitoring developments, but for now our economic outlook is largely back to where it was a few months ago: a domestic-led expansion is underway, and we expect it to prompt interest rate rises from late this year.**

Global dairy prices rose a stunning 14% in last week's Fonterra online auction. Over the past four auctions alone, they have risen by nearly 50%. In response to the latest lift we have further revised up our forecast total dairy payout (for a 100% share-backed farmer) to \$6.60/kg for the 2012/13 season – 30 cents higher than Fonterra's own upgraded forecasts last week. We would regard even this as conservative – if global prices stay at current levels rather than correcting downwards, the season payout could go as high as \$6.90/kg.

Of course, drought has led to a major redistribution of earnings in the dairy industry, towards those with access to water away from those without. But for the dairy industry as a whole, the financial impact of higher prices is now larger than the financial cost of drought. And while increases in dairy prices will be small comfort to sheep and beef farmers, meat prices have also held up rather better than we might have expected against the backdrop of record slaughter levels.

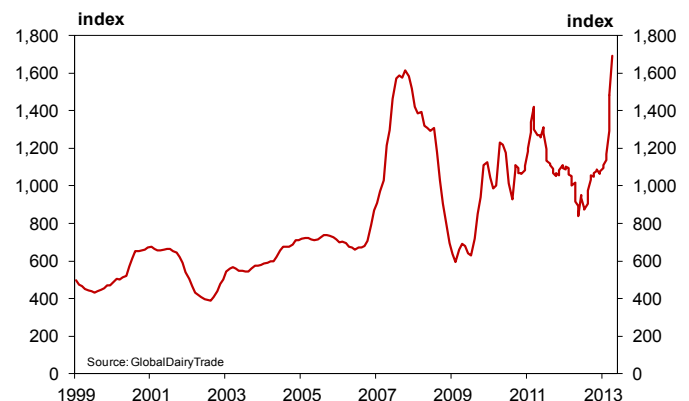
The scale of recent global dairy price rises has surprised (even shocked) us, but it's a reflection of how New Zealand's dairy industry has evolved in recent years. New Zealand's production of whole milk powder has nearly doubled over the last 5 years, by about 600,000 tons – roughly equivalent to Europe's total annual output of whole milk powder. Much of this has gone to meet rising Chinese demand, which is still growing at a rapid pace. As a result New Zealand is now a much bigger player in a tight market, and local production shortfalls are having a bigger impact on price. (Rapidly rising Chinese demand may also have helped cushion meat prices.) Another thing that's changed in recent years is that growth in dairy production has increasingly taken place in the South Island, where irrigation is more prevalent, making farms more resilient to drought.

So in important ways this episode is different from recent droughts. We will of course continue to watch the weather in coming weeks. Because this particular drought has had such unequal impacts on different parts of New Zealand's farm sector, there's also still some uncertainty around the flow-on effects on confidence and spending – those whose incomes get a boost may not raise their spending by as much as those whose incomes have taken a hit curtail theirs.

But for now, our outlook for the New Zealand economy has largely reverted back to where it was before the drought hit. On the positive side, a massive spending injection from the Canterbury rebuild is being felt in the domestic economy, while low interest rates are increasingly stimulating the housing market (the Auckland market tightened further in March, according to a major regional real estate agency). Based on a continued uptick in a broader range of monthly indicators we remain comfortable with our expectation that the economy grew 0.8% in the March quarter. We will review that judgment after this week's Quarterly Survey of Business Opinion – the single best indicator of economic activity in the quarter other than GDP.

At the same time, the high NZ dollar and a fiscal austerity drive amounting to roughly 3% of GDP over the next couple of years remain major economic dampeners, meaning that the pace of

### World dairy prices





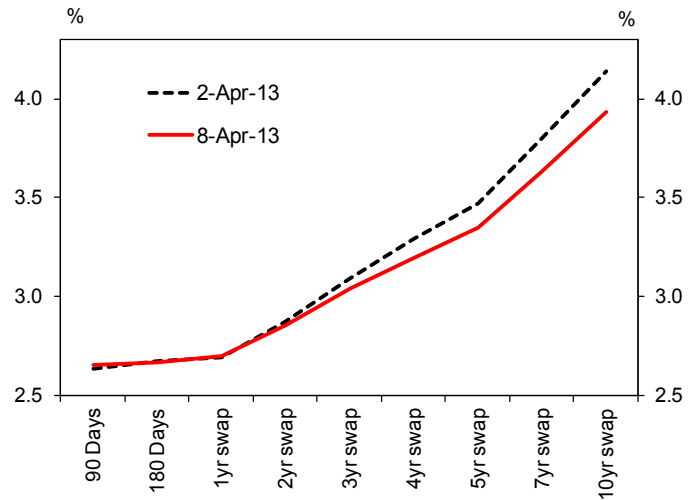
expansion will stay fairly modest by historical standards. The Government's financial statements are coming in a little rosier than forecast, but the Government's target for surplus by 2014/15 continues to leave little fiscal wiggle-room.

Recent economic developments have been unambiguously stronger than the RBNZ was assuming in its March Monetary Policy Statement. At the time, the RBNZ was allowing for a net negative hit to GDP from drought. Since then the RBNZ's assumptions around the drought impact are likely to have shifted in the same direction as ours, and the December quarter GDP report also came in much stronger than the RBNZ had forecast. What's more, there has been little offset to the recent dairy price moves from a higher NZ dollar – which is probably not that surprising, if these really are temporary price spikes caused by drought. So at the very least, it has become much harder to argue the case for lower interest rates (flagged by the RBNZ as a possibility if the exchange rate moved further out of step with the economic fundamentals).

For our part, the impact of the high exchange rate on inflation remains key to our interest rate outlook, and later this month we will be parsing the March quarter CPI report very closely. But low interest rates are clearly stimulating the housing market, mortgage debt is once again outpacing household incomes, domestic demand is picking up in line with our expectations, and we remain sceptical that the RBNZ's proposed counter-cyclical macro-prudential tools will have much of an impact on borrowing costs. We continue to expect the first OCR hike to come in the December quarter this year.

**Fixed vs floating for mortgages:** At current mortgage rates we regard fixing as being better value than floating over the next few years. Fixed-term rates out to two years are currently well below floating rates, while three-year and longer fixed rates are only slightly higher. So staying on floating would only be the better option if the RBNZ actually cut the OCR – which we regard as unlikely.

NZ interest rates



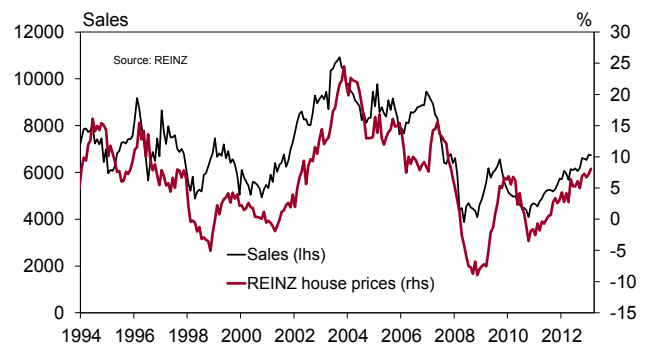
Key Data Previews

NZ Mar REINZ house prices and sales

Apr 8-12, Sales last: -0.3%, Prices last: 0.5%

- The New Zealand housing market continued ticking over at a rapid clip in February. The level of sales remained above-average, time to sell shortened further, and prices kept rising.
- March figures may be released this week, though they could be later due to the Easter holidays. Data from a major Auckland agency showed a small rise in sales, while mortgage approvals fell a little from February's cycle highs.
- Our call that house prices would rise 9% in 2013 no longer looks like much of a stretch, and notably the RBNZ has adopted a similar view. Housing shortages in Auckland and Christchurch are clearly a factor in the sharp rise in prices in these cities, but prices are now rising in all of the main centres. Low interest rates are the bottom line, and are expected to remain low for most of this year.

REINZ house prices and sales



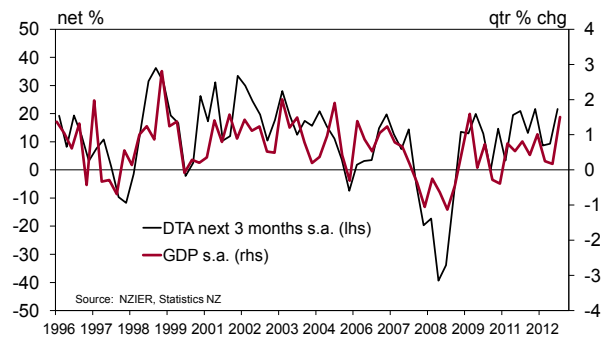


## NZ Q1 NZIER business opinion

Apr 9, Last: 20

- Business sentiment bounced sharply in the December quarter, providing one of the earliest and ultimately the clearest signal of a strong GDP reading (although the 1.5% outturn was well beyond what any of the top-down growth indicators suggested).
- Confidence and activity indicators have generally been at least as positive over the March quarter, suggesting another solid result for the NZIER survey. Notably, the agricultural sector is not directly covered by this survey, so recent concerns about drought are unlikely to weigh on overall sentiment.
- Inflation pressures have been muted to date, outside of the construction sector where the Christchurch rebuild is placing a growing strain on resources. We will be watching closely for any signs of broader price pressures emerging – the last but by no means the least hurdle to OCR hikes this year.

## QSBO domestic trading activity and GDP

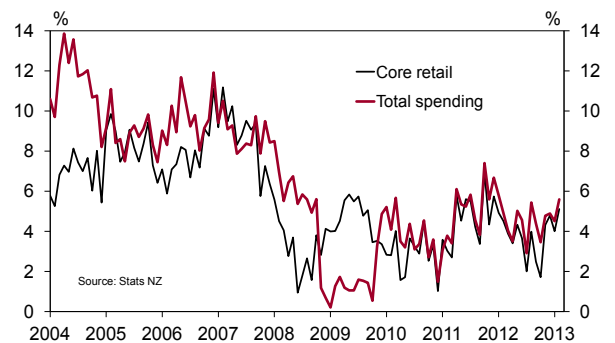


## NZ Mar electronic card transactions

Apr 10, Last: 0.8%, WBC f/c: 0.0%

- Consumer spending has entered a steady upturn, with annualised growth of around 7% in the last five months. Downward pressure on some retail prices, due to the strong NZ dollar, suggests that volume growth has been at least as strong as this.
- We expect a flat outturn overall in March. Lower fuel prices (at least in seasonally adjusted terms) will be a drag on total spending. Unusually warm weather could play havoc with clothing sales, though this is a small share of the total. These factors aside, the continued momentum in a range of activity indicators suggests that core retail spending should continue to hold up.
- A flat March outturn would still see a small uptick in year-on-year growth to 5.8%.

## Card transactions, annual % change

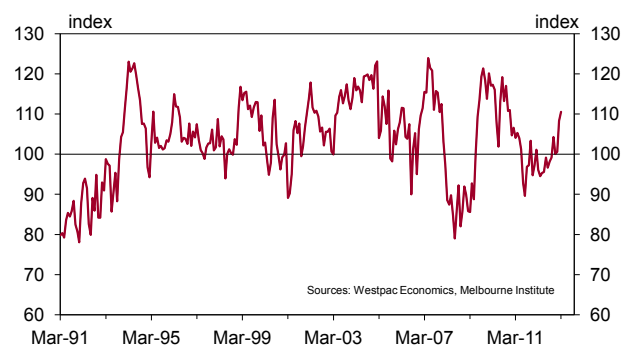


## Aus Apr Westpac-MI Consumer Sentiment

Apr 10, Last: 110.5

- Consumer sentiment rose 2% in Mar, building on a strong 7.7% gain in Feb and moving into solidly optimistic territory.
- The Apr survey is in the field from Apr 1 to 7. There would have been a mix of influences on sentiment in the month. The RBA again left rates on hold at its Apr meeting and although it kept a clear easing bias there has been some media speculation that the next move in rates may be up. Local economic data has been fairly positive, strong gains in retail sales in particular, with house prices also recording further gains (+1.3% in Mar). However, financial markets have been mixed after strength in previous months with the ASX down 2.5% between Mar and Apr and surveys, and the AUD 2c higher vs the USD. The Gov't's flagging of plans to change the tax treatment of super and the latest EU sovereign rescue for Cyprus may also be influences.

## Consumer Sentiment





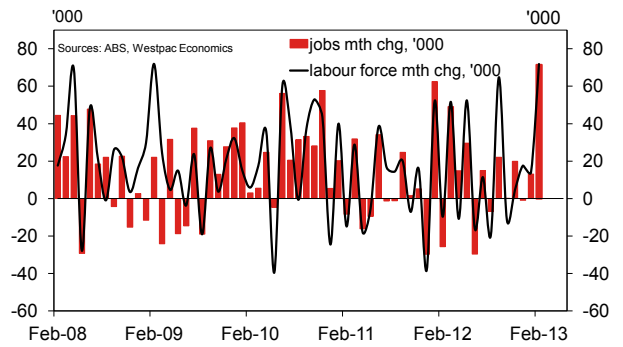
## Aus Mar employment

Apr 11, Last: 71.5k, WBC f/c: -10k

Mkt f/c: -7.5k, Range: -55k to +15k

- Total employment rose 71.5k in Feb, the largest monthly gain since the 82.9k print in July 2001. To put this in some perspective this represents 42% of the 197.4k total gain in employment in the past year (a total rise of 1.7%yr).
- We are cautious when a jump in employment coincides with a significant pop in participation. It appears that the rotated portion of the sample, i.e. households that were added to the survey in the Feb month, may have accounted for a large proportion of the increase in employment.
- Our analysis of previous similar events suggest an outsized rise is not automatically reversed in the following month. However, given that most of the gains were part-time and most of the volatility was in Vic, we are looking for a 10k pull back taking the annual growth rate down to 1.2%yr, which is about right compared to the leading indicators.

## Labour force vs. total employment



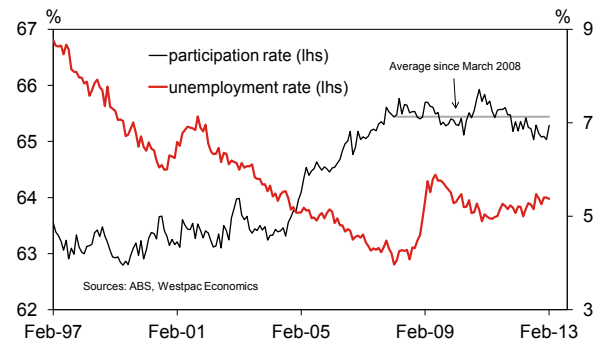
## Aus Mar unemployment rate

Apr 11, Last: 5.4%, WBC f/c: 5.4%

Mkt f/c: 5.4%, Range: 5.4% to 5.5%

- The unemployment rate was flat in Feb at 5.4% as the participation rate rose 0.3ppt to 65.3%. With a robust lift in the population estimate, it always has a larger than trend jump in Jan, Feb & Mar. The rise in participation was associated with a large 71.9k jump in the labour force, the strongest rise since Nov 2002.
- Normally such a large rise in participation and the labour force together tends to be followed by a reversal in the following month.
- We are looking for the participation rate to drop back to 65.1% (it was 65.0% in Jan) which should be enough to generate a small drop in the labour force. Given our forecast for a small 10k fall in employment, we then expect that the unemployment rate will be flat at 5.4%.

## Unemployment and participation rates

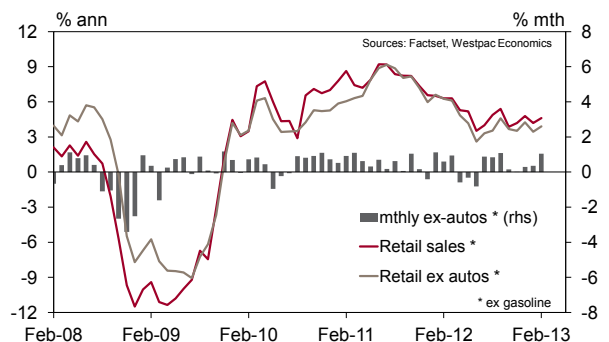


## US Mar retail sales

Apr 12, Last: 1.1%, WBC 0.1%

- Retail sales rose 1.1% in Feb, almost half of which was due to gasoline sales up 5% on higher prices, but core sales ex autos & gas rose 0.4% and back revisions were positive. In the detail, auto sales rose 1.1% but other storetypes saw mixed detail.
- Recent job market gains and the greater availability of vehicle loans are currently supporting household spending. However, the ongoing structural impediments to growth (specifically the substantial leverage of the household sector and the need for fiscal restraint) continue to restrict growth to sporadic bursts.
- Auto sales were down slightly in Mar and gasoline prices eased. We expect headline retailing to rise 0.1% as gasoline and auto sales decline slightly and core retail loses some momentum.

## US retail sales





**Key Data and Events**

		Market	Westpac		
		Last	median	forecast	Risk/Comment
<b>Mon 8</b>					
<b>NZ</b>	Mar REINZ house sales	-0.3%	-	-	TBC but probably this week. Low interest rates are the key...
	Mar REINZ house price index	0.5%	-	-	...with prices expected to accelerate further this year.
<b>Aus</b>	Mar ANZ job ads %mth	3.0%	-	-	Jan was flat, and the Feb rise was the first in 10 months.
<b>Eur</b>	Apr Sentix investor confidence	-10.6	-13.1	-16.0	Cyprus, Draghi comments should rattle recent investor complacency
<b>UK</b>	Feb house prices %yr	1.3%	-	-	Halifax index due 4-8 Mar.
	Feb house prices %yr	-0.3%	-	-	Hometrack index.
	Feb PMI construction	48.7	-	49.0	Sector in doldrums since middle of 2012.
<b>US</b>	Fedspeak	-	-	-	Pianalto.
<b>Can</b>	Q1 BoC loan officer survey	-3.4	-	-	Little change in credit tightness since late 2011
	Q1 business outlook survey	16	-	-	Future sales index
<b>Tue 9</b>					
<b>NZ</b>	Q1 NZIER business opinion	20	-	-	Q4 momentum has continued into this year.
<b>Aus</b>	Mar NAB business survey	3.0	-	-	Conditions, -1ppt to -3. Confidence -2ppts to +1. Both below historic avg.
<b>Chn</b>	Mar consumer prices %yr	3.2%	2.5%	-	Food jumped in February, predictably, non-food edging higher.
	Mar producer prices %yr	-1.6%	-1.8%	-	Base effects will be 'inflationary' through most of next two quarters.
<b>UK</b>	Mar BRC sales %yr	2.7%	-	-	Same store sales. Impact of freezing weather to be expected.
	Mar house prices net %	-6%	-4%	-	RICS surveyors neutral on house prices in Dec, more bearish since.
	Feb industrial production	-1.2%	0.1%	-0.1%	Recent sub 50 PMI readings imply falling output.
	Feb trade balance £bn	-8.2	-8.8	-	Exports down 3.5% and imports down 4.2% saw deficit narrow in Jan
<b>US</b>	Mar NFIB small business optimism	90.8	-	90.5	As in 2011 and 2012, early year gains won't last.
	Feb wholesale inventories	1.2%	0.5%	0.2%	Inventories being kept tight.
	Fedspeak	-	-	-	Bernanke, Lacker, Lockhart
<b>Can</b>	Mar housing starts	13.7%	-1.7%	-	Five straight declines in Sep-Jan followed by Feb bounce
	Feb building permits	1.7%	5.0%	-	Residential up 18%, non-res down 19% yr in Jan
<b>Wed 10</b>					
<b>NZ</b>	Mar electronic card transactions	0.8%	0.3%	0.0%	Lower fuel prices in Mar but core spending should be OK.
<b>Aus</b>	Mar Westpac-MI Cons. Sentiment	110.5	-	-	Has rallied into solidly optimistic territory in early 2013.
	RBA Assist Gov Kent speaking	-	-	-	Bloomberg Economic Summit, Sydney.
<b>Chn</b>	Mar trade balance USDbn	15.25	15.30	-	Bounceback on both sides of the accounts.
	Mar new loans RMBbn	620	890	-	Tentative date. Expect a bounce in March to complete a decent Q1.
	Mar M2 money supply %yr	15.2%	14.5%	-	Tentative date. Enterprise deposits are growing again.
	Mar total social financing RMBbn	1070	1775	-	Tentative date. A last hurrah before the prudential cavalry arrives?
<b>US</b>	Mar federal budget \$bn	-	-	-	Impact of fiscal compromise to show up here.
	Mar 18-20 FOMC minutes	-	-	-	A range of views re QE profile going forward.
	Fedspeak	-	-	-	Fisher, Kocherlakota, Lockhart
	IMF's Lagarde	-	-	-	Speaking at Economic Club of NY.
<b>Thu 11</b>					
<b>NZ</b>	Mar manufacturing PMI	56.3	-	-	Has defied NZD strength and global manufacturing trends.
<b>Aus</b>	Mar employment	71.4k	-7.5k	-10k	Sample roll boosted Feb but a part-time correction is behind the Mar -ve.
	Mar unemployment rate	5.4%	5.4%	5.4%	Some, but not all, of the 0.25ppt jump in participation to reverse in Mar.
	Apr Westpac-MI unemployment expect.	-3.7%	-	-	Expectations fell 10% in the last 6 months, the labour market has firmed.
	Apr MI inflation expectations	2.3%yr	-	-	Inflationary expectations are well anchored in the lower half of the band.
<b>Jpn</b>	Feb machinery orders %mth	-13.1%	6.9%	-	Foreign orders will probably crater, domestic more resilient.
<b>US</b>	Initial jobless claims w/e Apr 6	385k	360k	365k	Recent upswing likely due to Easter holiday distortion.
	Mar import prices	1.1%	-0.5%	-0.7%	Oil prices a little lower on avg than in Feb; US\$ higher.
	Fedspeak	-	-	-	Plosser, Bullard.
<b>Can</b>	Feb new house prices %yr	2.2%	-	-	Little impact of housing slowdown on new build prices yet.
<b>Fri 12</b>					
<b>NZ</b>	Mar food price index	-0.3%	-	-0.2%	Seasonal dip in produce prices; annual inflation bottoming out.
<b>Eur</b>	Feb industrial production	-0.4%	0.2%	0.2%	German data on 8/4 expected to show just modest gain at best.
<b>US</b>	Mar advance retail sales	1.1%	flat	0.1%	Auto sales down, gasoline prices lower. See text box.
	Mar retail sales ex auto, gas	0.4%	0.3%	0.2%	Core retailing to lose recent momentum.
	Mar PPI	0.7%	-0.1%	0.5%	Energy prices to unwind some of Feb's rise, food prices to drift up.
	Mar PPI core	0.2%	0.2%	0.2%	Core trend now around 0.2%, few special factors at play in Feb.
	Feb business inventories	1.0%	0.4%	0.2%	Inventories being kept tight.
	Apr UoM consumer sentiment prelim	78.6	78.3	78.0	300 responses in prelim; IBD-TIPP rebounded with 900 replies.
	Fedspeak	-	-	-	Bernanke, Rosengren

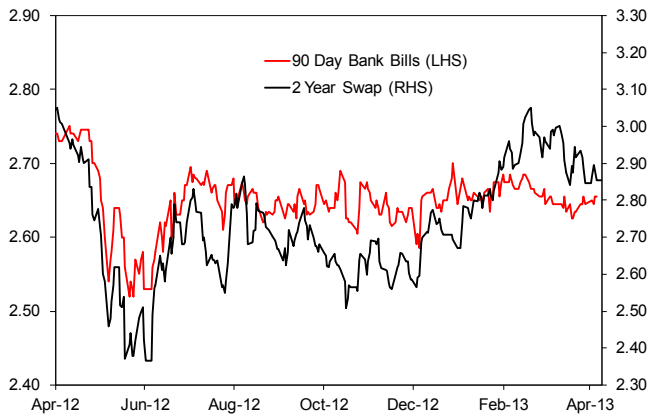


## New Zealand Economic and Financial Forecasts

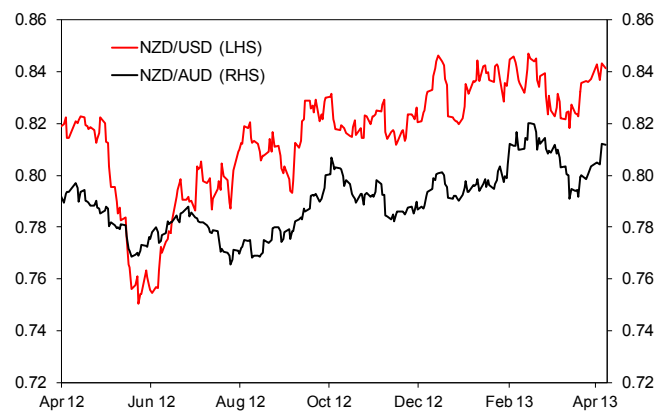
Economic Growth Forecasts	March years				Calendar years			
	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
% change								
GDP (Production) ann avg	1.9	2.5	3.0	3.4	1.4	2.5	3.0	3.2
Employment	1.0	0.0	2.6	2.5	1.5	-1.4	3.7	2.6
Unemployment Rate % s.a.	6.7	7.0	6.1	5.1	6.4	6.9	6.3	5.3
CPI	1.6	1.1	1.9	2.3	1.8	0.9	2.0	2.3
Current Account Balance % of GDP	-4.4	-4.9	-5.0	-6.0	-4.0	-5.0	-4.8	-5.8

Financial Forecasts	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
Cash	2.50	2.50	2.75	3.25	3.50	3.75
90 Day bill	2.70	2.75	3.20	3.50	3.75	4.00
2 Year Swap	3.00	3.10	3.30	3.60	3.90	4.20
5 Year Swap	3.50	3.60	3.80	4.00	4.30	4.50
10 Year Bond	3.80	3.90	4.10	4.30	4.40	4.50
NZD/USD	0.85	0.85	0.85	0.84	0.83	0.82
NZD/AUD	0.82	0.83	0.84	0.85	0.86	0.85
NZD/JPY	81.6	80.8	79.1	77.3	74.7	72.2
NZD/EUR	0.65	0.66	0.68	0.69	0.70	0.70
NZD/GBP	0.56	0.56	0.56	0.56	0.56	0.54
TWI	78.1	78.5	79.1	79.0	78.7	77.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



**NZ interest rates as at market open on Monday 8 April 2013**

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.64%	2.64%	2.66%
60 Days	2.64%	2.64%	2.66%
90 Days	2.66%	2.64%	2.66%
2 Year Swap	2.85%	2.92%	3.00%
5 Year Swap	3.35%	3.49%	3.55%

**NZ foreign currency mid-rates as at Monday 8 April 2013**

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.8413	0.8340	0.8197
NZD/EUR	0.6488	0.6435	0.6311
NZD/GBP	0.5497	0.5472	0.5495
NZD/JPY	82.695	78.777	78.637
NZD/AUD	0.8119	0.7990	0.8028
TWI	77.680	76.45	75.600



## Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2009	2010	2011	2012e	2013f	2014f
<b>Australia</b>						
Real GDP % yr	1.4	2.5	2.4	3.6	2.5	2.3
CPI inflation % annual	2.1	2.8	3.0	2.2	2.5	2.8
Unemployment %	5.6	5.2	5.2	5.3	5.9	5.8
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.8	-3.6
<b>United States</b>						
Real GDP %yr	-3.1	2.4	1.8	2.2	1.7	1.6
Consumer Prices %yr	-0.3	1.6	3.1	2.1	2.0	2.0
Unemployment Rate %	9.3	9.6	8.9	8.1	7.7	7.7
Current Account %GDP	-2.7	-3.0	-3.1	-3.1	-2.9	-2.9
<b>Japan</b>						
Real GDP %yr	-5.7	4.9	-0.4	1.9	1.3	1.9
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
<b>Euroland</b>						
Real GDP %yr	-4.4	1.9	1.5	-0.5	-0.5	-0.5
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
<b>United Kingdom</b>						
Real GDP %yr	-4.0	1.8	0.9	0.3	0.7	0.2
Consumer Prices %yr	2.2	3.2	4.0	2.7	2.3	1.8
Unemployment Rate %	7.6	7.8	8.4	8.0	8.5	8.5
Current Account %GDP	-1.3	-2.4	-1.9	-3.8	-2.5	-1.5

Forecasts finalised 8 April 2013

Interest Rate Forecasts	Latest	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14
<b>Australia</b>						
Cash	3.00	2.75	2.75	2.75	2.75	2.75
90 Day Bill	3.07	3.00	3.10	3.10	3.00	3.00
10 Year Bond	3.40	3.50	3.50	3.30	3.20	3.00
<b>International</b>						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	1.76	2.00	2.20	2.10	2.00	1.80
ECB Repo Rate	0.75	0.75	0.75	0.50	0.50	0.50

Exchange Rate Forecasts	Latest	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14
AUD/USD	1.0416	1.04	1.03	1.01	0.99	0.97
USD/JPY	96.485	96	95	93	92	90
EUR/USD	1.2926	1.30	1.28	1.25	1.22	1.19
AUD/NZD	1.2393	1.22	1.21	1.19	1.18	1.17

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