Weekly Commentary

15 July 2013

All those in favour, say "Aye"

The economy has passed its vote of economic confidence. The Canterbury-construction sector ticket rallied enough votes, but then again other factions such as the Auckland-housing market needed little convincing. Even the rumblings from backbenchers (the manufacturing and tourism sectors) are fading. The drought had the potential to hold up the vote, but it seems rain, high world dairy prices and the positive vibe from the rest of the economy have headed off that challenge.

The June Quarterly Survey of Business Opinion (QSBO) provided more support for the view that the New Zealand economy has entered a self-sustaining upswing. The ramp-up in the Canterbury rebuild has clearly been a driving force in the last few quarters, but there is good reason to believe that the effects of dropping $40 billion into our second largest city are spilling over into other regions and industries.

Outside the direct hit to agricultural production, the economy appears to have largely shrugged off the impact of the drought. Some of the hit to agricultural production will still be evident, particularly in June quarter GDP data, but beyond that growth looks on track to accelerate to an annual pace of 3% or more.

The economy's laggard has been employment and to a lesser extent investment – but now the general vote of economic confidence extends to hiring and investment intentions. The QSBO showed that actual and expected employment were both at their highest levels since the 2008 recession. Also, investment intentions for both buildings and capital equipment remain near the top of their historical ranges.

The survey also showed that the manufacturing sector is riding the construction wave. This may come as a surprise to some. A net 35% of firms were positive about the next six months, compared to a net -1% the same time last year. We've noted before that the manufacturing sector is actually quite closely linked to construction; it's likely that the Canterbury rebuild is more than offsetting the soft export environment.

The June Performance of Manufacturing Index re-enforced this message. The June number remained firmly in expansionary mode. Moreover, a healthy new orders reading and low stock levels point to ongoing, if not accelerating, manufacturing activity.

The QSBO suggests that inflation pressures are gradually re-emerging, but that it's early days yet. A net 22% of firms intend to raise their prices in the next three months, the highest in five quarters.

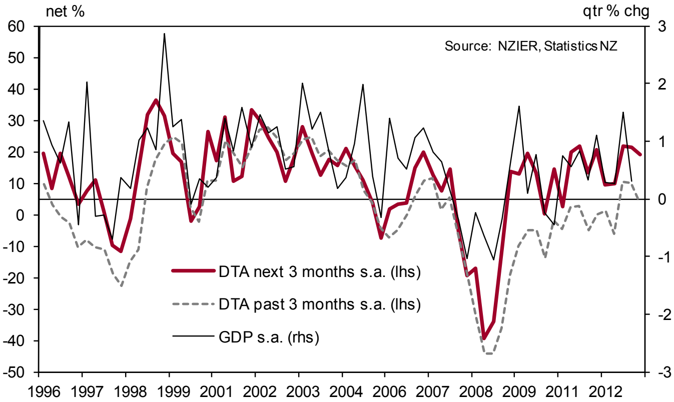
That said, we expect the June quarter to mark the low point in inflation. Incorporating last week's food price index data, we have pegged annual inflation at 0.7%. However, from there we expect annual inflation to more than double by year end.

On the capacity front, there was mixed evidence around the tightening of constraints. The ease of finding workers was similar to the March quarter, and the overall capacity utilisation rate fell slightly. With TradeMe job ads up 11% in the June quarter over year ago levels, we expect capacity constraints, particularly for labour, to resume tightening over the year ahead. As yet this is not translating materially to wage pressures on a nationwide basis, but as inflation turns and job vacancies remain high increasing wage growth may not be that far away.

The general positive vibe has extended to continued strength in retail spending over the last few months. Electronic card spending rose 1.2% in June, following a 0.7% rise in May. The main contributor was a rise in fuel spending following petrol price increases. However, the pace of spending in the other categories also beat our expectations.

Higher spending suggests solid growth in the retail volumes. Total card spending was up 5.9% on a year ago, the fastest pace since December 2011. With flat retail prices (aside from fuel), the remaining growth must have come from an increase in the volume of retail spending.

Domestic trading activity



This publication has been prepared by the Auckland, Sydney and London Economic Departments

Published by Westpac, PO Box 934, Auckland, ph: (09) 348 9117. For further information contact Dominick Stephens, Michael Gordon, Nathan Penny or Felix Delbrück. For email address changes contact WNZResearch@westpac.co.nz

Meanwhile, the housing market remains as tight as a drum. National house prices rose 0.3% in June to stand 8.4% higher than a year ago. Auckland prices are rising at more than double the national rate, approaching 20%, while Canterbury prices are also rising faster than the rest of the country.

While these trends are not new, what did surprise was a slowdown in sales. In normal circumstances, falling turnover would suggest slacker price action to come. However, a lack of houses for sale appears to be crimping turnover. An Auckland agency's recent report showed that it had just 2.8 months' worth of sales listed on the market - the lowest figure on record.

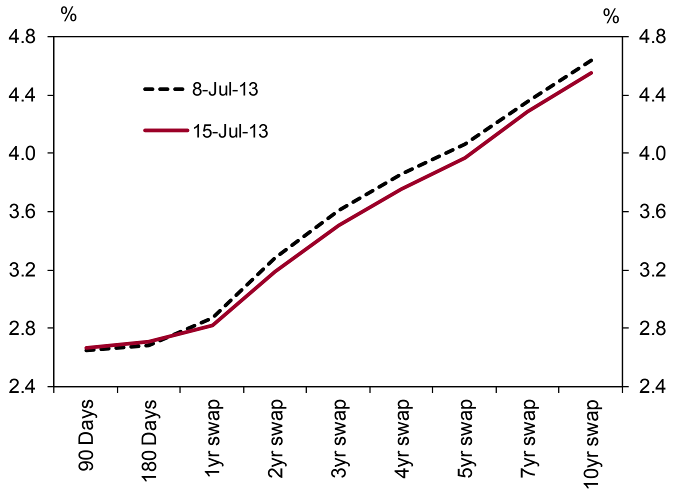
Also, a recovery in tourism is flying under the radar. Since, the Global Financial Crisis tourism has effectively been in recession. Hindering the recovery were the Christchurch earthquakes and more recently a strong currency on top of weak demand from traditional markets.

Christchurch, however, is on the mend. Tourists are starting to return as earthquake safety concerns fade and more accommodation comes back online. June international guest nights were the second highest on record after the Rugby World Cup surge. Further impetus to the tourism recovery is coming from a rapidly expanding Chinese tourist market. In the year to May 2013, arrivals from China were 28% ahead of the same period a year ago.

Overall, the economy is moving from recovery to growth near its potential by year end. Moreover, the economy has now started to eat into its spare capacity and will continue to do so. This progression is in line with our expectations. The next phase is growing wage and price pressures.

Fixed vs floating for mortgages: We favour fixing over floating. Fixed-term rates out to two years are currently below floating rates, while three-year and longer fixed rates are only slightly higher. Staying on floating would only be the lower-cost option if the RBNZ actually cut the OCR, which we regard as unlikely. In fact, we expect the floating mortgage rate to rise significantly over the 2014 to 2016 period. There may be value in fixing sooner rather than later. Wholesale interest rates have risen sharply in recent weeks, and fixed mortgage rates are already rising in response. We think fixed mortgage rates may rise further in the near term.

NZ interest rates



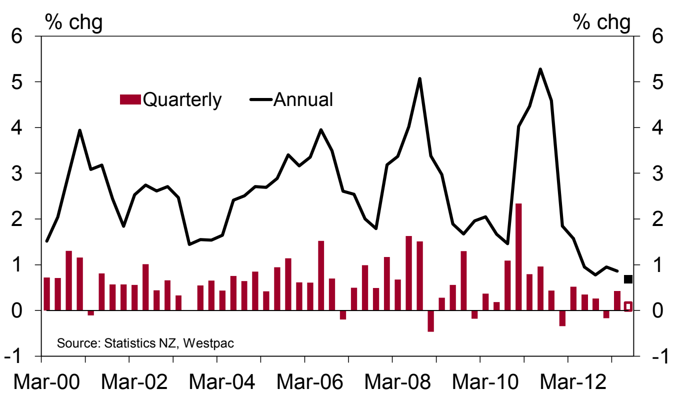
Key Data Previews

NZ Q2 CPI

Jul 16, Last: 0.4%, WBC f/c: 0.2%

- We estimate that consumer prices rose 0.2% in the June quarter, taking annual inflation down to 0.7%, a new low point for this cycle.
- The strong New Zealand dollar probably had its greatest downdraft on the prices of internationally traded goods in the year to June – we estimate that tradables inflation fell to -1.3%yr, the steepest rate of decline since 2004.
- However, we expect that the June quarter will mark the peak of the NZD's disinflationary impact. And, if the currency extends its recent decline, it could become a significant inflationary force in coming years.

NZ CPI inflation



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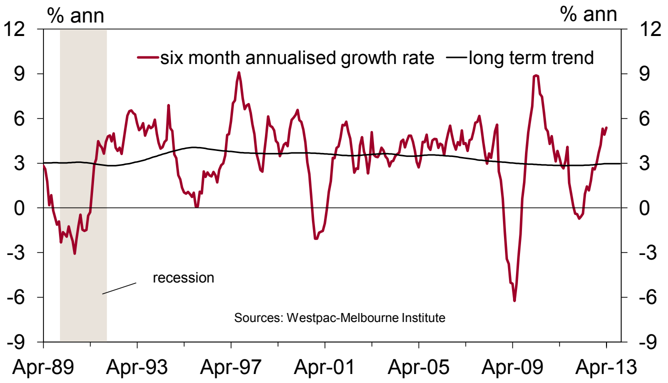
Aus May Westpac–MI Leading Index

Jul 17, Last: 5.4% annualised

- After a slight moderation in Mar, the Leading Index picked up again in Apr, with the annualised growth rate of the index rising to 5.4%, comfortably above its long-run trend of 3%. That points to solid momentum, although we remain concerned about how well this will be sustained over 2013.
- The updated monthly data to be included in the May Index was mostly weaker: equities began a sharp decline (ASX –4.9%, vs +3.8% in Apr); money supply growth moderated a touch (+0.8%, vs +1.0% in Apr); and dwelling approvals dipped (–1.1%mth, vs +9.5%mth in Apr). US IP was flat, vs a –0.4% dip in Apr. Looking ahead, the ASX extended its decline in Jun (–2.8%), but firmed slightly in early Jul. Quarterly components, which will be included once a full set are available in Sep, have so far been a mixed bag, with overtime up strongly (+17, vs –11 in Q1), but commodity prices sharply lower.

Westpac-MI Leading Index



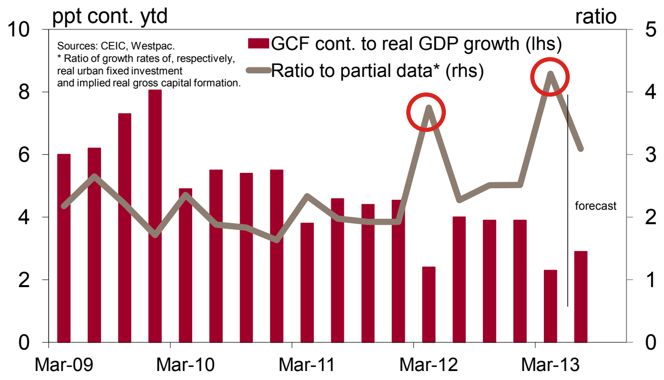
China Q2 GDP

Jul 15, Last: 7.7%yr, WBC f/c: 7.5%yr

Mkt f/c: 7.5%yr

- March quarter GDP was surprisingly weak, and the data flow since implies that activity merely held its ground in Q2. The starting point for contributions by category (in ytd terms) are: consumption, 4.3ppt; investment 2.3ppt; and net exports 1.1ppt. The surprise was the investment outcome. Gross investment (48.1% of GDP) usually has a stable relationship with deflated monthly FAI, but in Q1, the ratio between the two growth rates blew out from ~2 to ~4. Our forecast of a bounce to a 2.9ppt cont. implies a ratio of ~3. We are awake to the possibility of upward revisions to Q1, although it is impossible to build such an expectations into the formal forecast.
- We expect the increase in the investment cont. will be offset by respective 0.3ppt falls in the consumption and net exports conts, leaving the ytd rate unchanged at 7.7%. Under these assumptions, the through-the-year pace should decline from 7.7% to 7.5%, assuming no revisions.

China: real investment & its GDP contribution

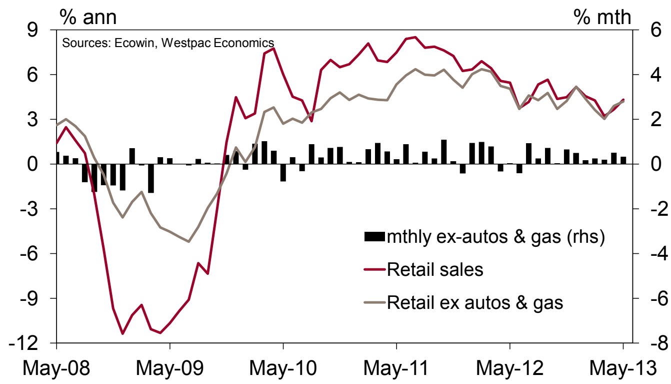


US Jun retail sales supported by income growth

Jul 15, Last: 0.6%, WBC 0.7%

- Retail sales rose 0.6% in May, the fastest rise in three months; this was mainly because a steeper rise in auto sales (1.8%) was no longer offset by plunging gasoline sales, down only 0.2% in May compared to 3% falls in March and April (when prices were in a steep downswing). Core retail sales (ex autos and gas) growth slowed from 0.5% to 0.3%; but in Q2 so far, the May over March gain of 0.85% was worth more than the total core retail for Q1 of just 0.61%.
- In June, faster earnings growth and a rise in hours worked will have boosted household income and probably discretionary spending (retail jobs rose sharply in June). Auto sales rose 4%, but gasoline prices were drifting lower. These factors point to a 0.6% rise in core retailing. The headline gain will be close to that figure, depending on which impacts most: more autos sold; discounting by dealers; or cheaper gasoline?

US retail sales

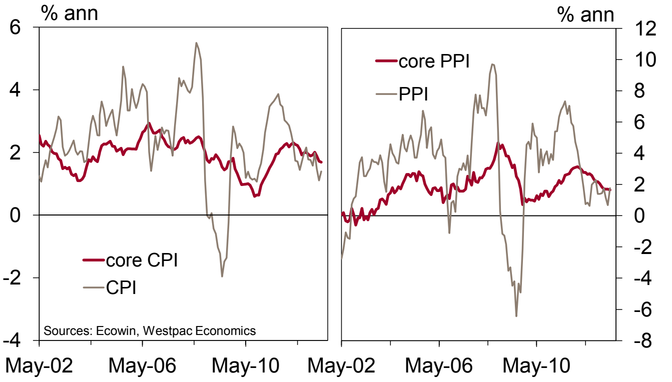


US Jun consumer price index

Jul 16, CPI: Last: 0.1%, WBC f/c: flat

- The CPI rose 0.1% in May after falls in March and April. Clothing prices rose just 0.2% after three declines in Feb-Apr; medical and food prices posted rare falls (both by 0.1%), while fuel bounced marginally, with gasoline flat in the month. The only real pressures were a slightly-above-trend 0.2% rent gain (almost 25% of the CPI by weight), and an outsized 2.2% rise in often-volatile airfares. The core CPI rose 0.2% after 0.1% gains in the prior two months, holding the annual rate at 1.7% – its lowest in almost two years.
- Gasoline prices edged lower in June, but medical care, food and, to a lesser extent, clothing prices all pose upside risks. There is little else we can cite as driving upward price pressures. Indeed, if rents revert to trend, that would leave the subdued inflation picture intact. We forecast a flat headline CPI with downside risk, and a subdued 0.1% core rate.

US price inflation

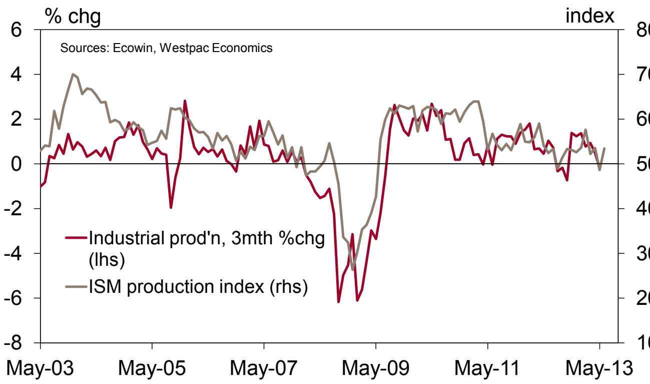


US Jun industrial production

Jul 16: Last: 0.0%, WBC f/c: 0.7%

- Industrial production was flat in May as a meek 0.1% rise in factory output was offset by a 1.8% decline in electric/gas utilities. The factory gain was the first in three months following falls of 0.3%/0.4% in Mar/Apr, so the underlying manufacturing story remains sluggish this year.
- Factory hours worked rose 0.1% in June. Auto sales were up 4% in the month but, back in May, orders for autos fell 1.2%. However, core capital goods orders have been rising steadily in recent months. The June ISM factory survey showed orders and production recovering most of May's plunge. These factors point to a modest gain in factory output.
- The IP bottom line will be driven by the Fed's estimate of utility output. The return of cold weather in June may have boosted heating usage. Hence, we expect a 0.7% IP outcome in June, assuming mining output rises again. Factory output is forecast to be up 0.3%.

US industrial sector



US housing starts/permits in June

Jul 17, Housing starts: Last: 6.8%, WBC f/c: 4.5%

Jul 17, Housing permits: Last: –2.0%, WBC f/c: 2.5%

- Housing starts rose 7% in May, while permits fell 3%; ongoing volatility in multiples (starts 22%; permits –10%) was the driving factor. Singles starts were up just 0.3% after falling nearly 9% in the previous two months, but singles permits rose 1.3% to a new cycle high – an annualised pace of 622k compared to starts on 599k, suggesting singles starts downside from here should be limited (as did the June jump in homebuilder sentiment).
- But housing remains susceptible to shocks (such as a material rise in borrowing costs). Initial evidence suggests that the recent rise in the 30-year mortgage rate has had a substantial impact on refinancing activity and purchase approvals. Volatile multiples will drive the headlines as usual, but we see singles starts and permits growth struggling in H2 2013.

US housing starts & permits

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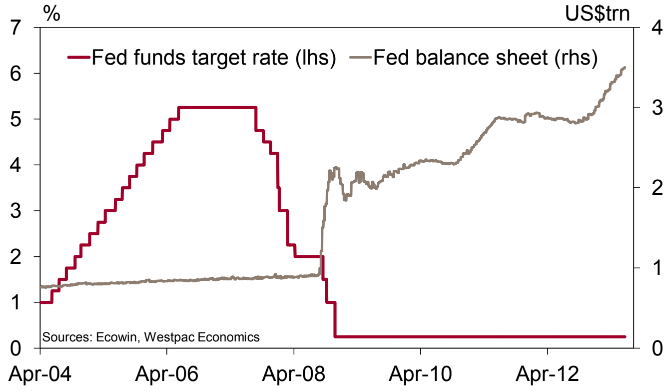
Bernanke's semi annual report

Jul 17–18

- At the June 19 presser, the Fed chair proposed a timetable for tapering the $85bn per month asset purchase program, should the FOMC's forecasts for the economy and jobs be matched by incoming data. The subsequent minutes recorded that "about half" of the committee indicated that the program should be wound down later this year, but that "many others" believed purchases should continue into next year, with many wanting to see stronger activity before tapering commenced.
- Payrolls jobs growth has picked up modestly in the first half of this year compared to H1 2012, but the jobless rate has stalled at just above 7.6%; other measures of jobs and the broader economy remain ambiguous or weaker than last year. Of particular note, Q2 GDP is shaping up to be weaker than Q1. Bernanke's practise has been to signal imminent policy shifts in prior keynote addresses. This is one such opportunity.

Fed funds target rate and balance sheet



Key Data and Events

		Last	Market median	Westpac forecast	Risk/Comment
Mon 15					
NZ	Jun services PSI	56.2	–	–	Has strengthened over this year, reflecting a broadening upswing.
Chn	Q2 GDP %yr	7.7%	7.5%	7.5%	Contribution from investment the major swing factor. See box.
	Jun industrial production %yr	9.2%	9.1%	–	Weak PMI surveys, modest base, mixed sectoral inventory sub-cycles.
	Jun fixed investment %ytd	20.4%	20.2%	–	Manufacturing slowing, transport and real estate levelling out soon.
	Jun retail sales %yr	12.9%	12.9%	–	Grinding along, modest nominal kick from CPI acceleration in June.
UK	Jul house prices %yr	2.7%	–	–	Rightmove index of asking prices. BoE's FLS may be lifting prices.
US	Jul NY Fed factory survey	7.8	5.0	1.0	Tends to slump mid year; June detail weaker than headline.
	Jun advance retail sales	0.6%	0.7%	0.7%	Auto sales up, gasoline prices lower. See text box.
	Jun retail sales ex auto, gas	0.3%	0.3%	0.6%	Core retailing regained momentum earlier in Q2; June incomes up.
	May business inventories	0.3%	0.2%	0.1%	Inventories generally kept tight, but retail stocks may have fallen.
	Fedspeak	–	–	–	Tarullo on banking regulation.
Can	Jun existing home sales	3.6%	–	–	Mar to May solid gains after sombre 2012 for sales.
Tue 16					
Aus	RBA meeting minutes	–	–	–	Further insight into Board's view of outlook.
Eur	Jun CPI %yr final	1.6% a	–	1.6%	Flash report now includes core which was steady at 1.2%yr in Jun.
	May exports	–0.8%	–	–0.6%	German orders, industry and exports data weak in May.
Ger	July ZEW analysts' expectations	38.5	39.0	40.0	Sentix euro survey slipped, but showed higher German confidence.
UK	Jun PPI %yr	0.8%	–	–	Core output measure.
	May ONS house prices %yr	2.6%	–	–	Still behind 3.3%yr in Dec, fastest pace of gain since late 2010.
	Jun CPI %yr	2.7%	2.9%	–	Shop price inflation at lowest since recession; special factors at play.
US	Jul NAHB housing market index	52	51	48	Upswing at risk from rising mortgage rates.
	May TIC data, $bn	12.7	–	–	Net long term TIC flows.
	Jun CPI	0.1%	0.2%	0.0%	Gasoline prices still falling in Jun, but PPI food price pressures a risk.
	Jun CPI core	0.2%	0.2%	0.1%	Jan's 0.3% core the outlier, trend running between 0.1%-0.2%b pm.
	Jun industrial production	0.0%	0.3%	0.7%	Factory hours worked rose 0.1%. Utilities/mining solid. See text box.
	Fedspeak	–	–	–	George on economy and agriculture.
Can	May manufacturing sales	–2.4%	1.0%	–	Oil led April's plunge.
Wed 17					
Aus	May Westpac–MI Leading Index	5.4%	–	–	Updated monthly data to be included in May mostly weaker. See box.
Eur	May construction output	2.0%	–	–0.5%	Construction fell 2% in Germany after 8% April bounce.
UK	Jul BoE minutes	–	–	–	Carney's first meeting introduced forward guidance.
	Jun unemployment ch'	–8.6k	–10k	–8k	Benefit claimants. Survey and some hard data on UK encouraging.
US	Jun housing starts	6.8%	3.9%	4.5%	Starts pace for (single-family dwellings) now running behind permits
	Jun building permits	–2.0%	1.5%	2.5%	See text box.
	Fed beige book	–	–	–	Prepared ahead of the next FOMC meeting at the end of the month.
	Fedspeak	–	–	–	Bernanke delivers semi-annual report on policy to House. Also Raskin.
	Bank of Canada rate decision	1.0%	1.0%	1.0%	Policy on hold "for a period of time", but next move eventually up.
Thu 18					
Chn	Jun new housing prices %net bal	88.6%	–	–	Secondary market 87.1%. The market is now 'warm' rather than 'hot'.
Eur	May current account €bn	19.5	–	–	€26bn record surplus in March; was in deficit in 2011!
UK	Jun retail sales inc fuel	2.1%	0.5%	0.6%	May jump manly due to swings in food sales
US	Initial jobless claims w/e 13/7	360k	–	350k	Clear downtrend in claims earlier this year may have stalled.
	Apr leading indicators	0.1%	0.3%	0.2%	Latest 3 month pulse 0.2% Mar-May down from 0.4% in Dec-Feb.
	Jul Philadelphia Fed factory survey	12.5	5.0	–2	Mid-year slumps in 2010-11-12 began in Q2 or July!
	Fedspeak	–	–	–	Bernanke delivers semi annual report on policy to Senate.
Can	May wholesale sales	0.2%	–	–	Up four months running so far this year.
Fri 19					
NZ	Jun net migration	1740	–	1600	Net immigration looks on track to exceed 15,000 this year.
Ger	Jun producer prices %yr	0.2%	–	–	Just off May's 0.1% yr cycle low.
UK	Jun PSNB ex Interventions £bn	8.8	8.0	–	Public sector net borrowing excluding support for banks
Can	Jun CPI %yr	1.1%	1.3%	–	BoC core rate was steady at 1.1%yr in May.

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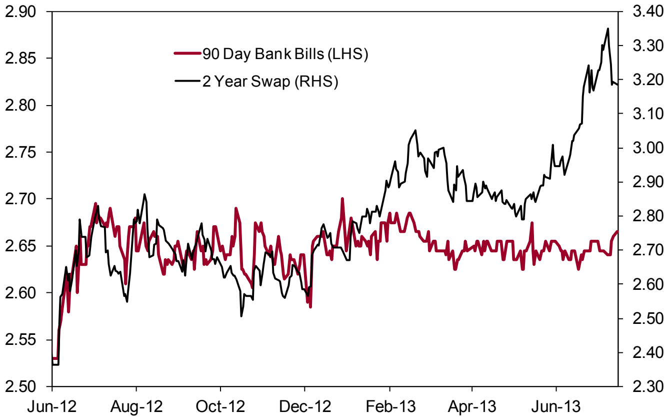
New Zealand Economic and Financial Forecasts

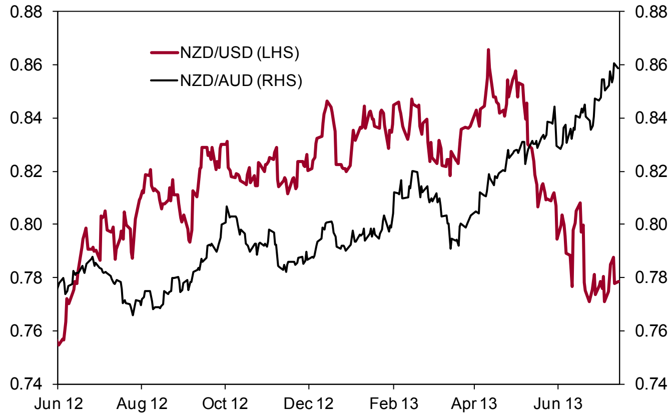
Economic Growth Forecasts	March years				Calendar years			
% change	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
GDP (Production) ann avg	1.9	2.5	2.6	3.7	1.4	2.7	2.4	3.6
Employment	1.0	0.4	2.4	2.8	1.5	-1.4	3.3	3.2
Unemployment Rate % s.a.	6.7	6.2	5.8	5.0	6.3	6.8	6.2	5.1
CPI	1.6	0.9	1.5	2.3	1.8	0.9	1.5	2.0
Current Account Balance % of GDP	-4.4	-4.8	-4.3	-5.4	-4.0	-5.0	-4.2	-5.1

Financial Forecasts	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Cash	2.50	2.50	2.75	3.00	3.25	3.50
90 Day bill	2.70	2.75	3.00	3.25	3.50	3.75
2 Year Swap	3.20	3.20	3.40	3.60	3.80	4.00
5 Year Swap	3.90	3.80	3.90	4.00	4.20	4.40
10 Year Bond	4.10	3.90	3.90	4.00	4.10	4.20
NZD/USD	0.80	0.83	0.83	0.81	0.80	0.80
NZD/AUD	0.85	0.86	0.87	0.87	0.87	0.86
NZD/JPY	80.0	82.2	81.3	78.6	76.8	76.0
NZD/EUR	0.61	0.62	0.64	0.64	0.64	0.63
NZD/GBP	0.52	0.52	0.53	0.51	0.51	0.49
TWI	75.3	77.1	77.9	76.7	76.2	75.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 15 July 2013

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.65%	2.66%	2.64%
60 Days	2.65%	2.66%	2.65%
90 Days	2.67%	2.66%	2.65%
2 Year Swap	3.18%	3.17%	3.03%
5 Year Swap	3.97%	3.91%	3.63%

NZ foreign currency mid-rates as at Monday 15 July 2013

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7785	0.7716	0.8052
NZD/EUR	0.5951	0.5927	0.6033
NZD/GBP	0.5150	0.5074	0.5120
NZD/JPY	77.36	76.558	75.83
NZD/AUD	0.8586	0.8463	0.8419
TWI	74.05	73.34	74.49

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Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2009	2010	2011	2012	2013f	2014f
Australia						
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	2.3	2.6
Unemployment %	5.6	5.2	5.2	5.4	6.1	6.0
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.4	-2.6
United States						
Real GDP %yr	-3.1	2.4	1.8	2.2	1.6	1.6
Consumer Prices %yr	-0.3	1.6	3.1	2.1	1.6	1.8
Unemployment Rate %	9.3	9.6	8.9	8.1	7.7	7.6
Current Account %GDP	-2.7	-3.0	-3.0	-2.8	-2.8	-2.9
Japan						
Real GDP %yr	-5.7	4.9	-0.5	1.9	1.7	2.2
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	1.9	1.5	-0.5	-0.9	-0.6
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	-4.0	1.8	0.9	0.2	0.5	0.4
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 5 July 2013

Interest Rate Forecasts	Latest	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14
Australia						
Cash	2.75	2.50	2.25	2.00	2.00	2.00
90 Day Bill	2.78	2.55	2.30	2.10	2.10	2.10
10 Year Bond	3.77	3.60	3.40	3.30	3.20	3.10
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.57	2.40	2.20	2.10	2.00	2.00
ECB Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50

Exchange Rate Forecasts	Latest	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14
AUD/USD	0.9081	0.94	0.97	0.95	0.93	0.92
USD/JPY	99.38	100	99	98	97	96
EUR/USD	1.3075	1.32	1.33	1.30	1.27	1.25
AUD/NZD	1.1648	1.18	1.17	1.14	1.15	1.15

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Westpac Economics Team Contact Details

Dominick Stephens, Chief Economist Ph: (64-9) 336 5671 dominick_stephens@westpac.co.nz

Michael Gordon, Senior Economist Ph: (64-9) 336 5670 michael_gordon@westpac.co.nz

Felix Delbrück, Senior Economist Ph: (64-9) 336 5668 felix_delbruck@westpac.co.nz

Nathan Penny, Economist Ph: (64-9) 336 5669 nathan_penny@westpac.co.nz

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