Weekly Commentary

18 March 2013

The horns of a dilemma

The RBNZ reiterated its 'on hold' outlook for the OCR last week, but threw markets a curve ball with its discussion of the risks on both sides of that outlook – sending both interest rates and the NZ dollar sharply lower. Our own forecast remains for the OCR hiking cycle to begin in December this year, though that could change depending on how long the North Island drought lingers.

The Reserve Bank made a subtle but important change to the bottom line of Thursday's *Monetary Policy Statement*, stating that there are both upside and downside risks to its projection for the Official Cash Rate to stay on hold at 2.50% over the next year.

On the upside, the economy is gaining momentum – helped by reconstruction in Canterbury – and the housing market is heating up, which together could add to domestic inflation pressures. But on the downside, the exchange rate could stay strong for longer, undermining export returns and creating a serious downward drag on prices of tradable goods.

The discussion of upside risks was along much the same lines foreshadowed in the RBNZ's last OCR review back in February. It was the renewed emphasis of downside risks – including the possibility that the OCR could be reduced if the high exchange rate proved more stubborn than forecast – that caught markets by surprise. The two-year swap rate fell 10 basis points in response, and the exchange rate fell nearly a cent.

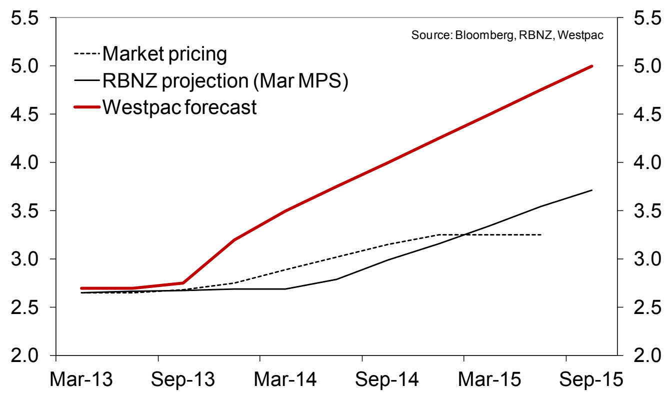
Diverging trends for the tradable and non-tradable sectors are hardly a new dilemma for the RBNZ. Nor is this the first time in recent history that the RBNZ has opened the door to interest rate cuts. The risk of a stronger-for-longer exchange rate is very real. But we continue to be more worried about the upside risks.

Indeed, what the RBNZ describes as upside risks strikes us as quite likely to occur. The RBNZ is currently assuming that "this time is different" – that rising house prices will not lead to the usual increase in consumer spending, and that the construction boom will not generate the usual degree of inflation pressure. We are highly sceptical on both counts. Our view is that the present cycle will more closely follow historical trends – rising house prices will increasingly generate a "borrow and spend" dynamic and booming construction will provoke inflation pressures.

This week's consumer confidence figures will present fresh evidence on the extent of "consumer caution". For now, last week's economic data showed further signs that the housing market is tightening and that retail spending is trending up. According to the Real Estate Institute house sales slowed a touch in February, but the number of days it takes to sell the average house fell further (to the lowest since mid-2007), and prices rose another 0.5%, to be 8.1% higher on a year ago. Meanwhile electronic cards spending posted its fifth consecutive increase in February and is now roughly 5% higher than a year ago – a reasonably solid pace, not too dissimilar to what we saw in mid-2011 before the Rugby World Cup.

There was very little discussion at the RBNZ's press conference of whether the RBNZ might use 'macro-prudential' regulatory tools to break through its dilemma. Rightly so: the RBNZ's firm and consistent message has been that these tools are primarily there to safeguard the health of the banking system, rather than to assist monetary policy. However the RBNZ's Deputy Governor did comment on these tools before Parliament later the same day. While the RBNZ is uncomfortable with the rate at which house prices are rising, it estimates that raising bank

90-day rate – market pricing and forecasts



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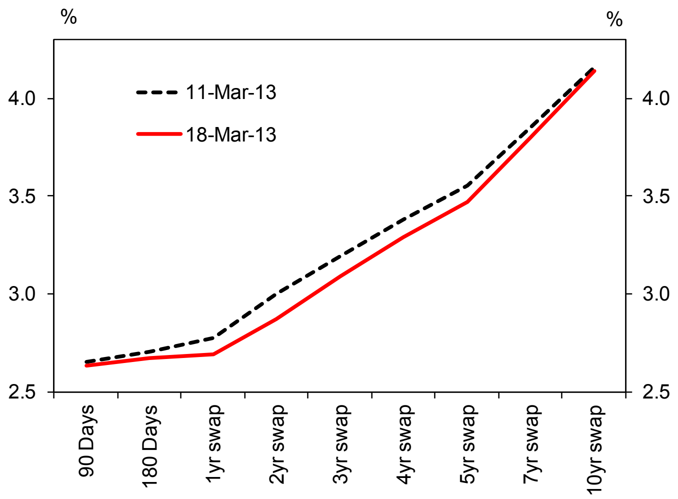
capital or liquidity requirements would have less impact on mortgage rates than a single OCR hike. In other words, the OCR remains the RBNZ's most effective tool to influence the economic cycle and keep inflation close to 2%.

So while it may have moved markets, the RBNZ's review hasn't prompted us to change our own interest rate forecast. What could yet change our view is current dry weather conditions. The entire North Island has now officially been declared a drought zone. While rain on Sunday provided some relief we will need to see more for the drought to break. If dry conditions persist, the impact on national income this year would be significant (even allowing for some partial offsets such as higher prices for dairy farmers). In that situation we would probably revise our interest rate call with an eye to later hikes.

The main data event this week is December quarter GDP. (We will also see the release of New Zealand's latest balance of payments figures, but with the current account deficit still fairly subdued we don't expect that to get much market attention.) Of course, drought won't affect those numbers, which refer to a period before the dry weather began. Indeed, a swathe of indicators is pointing to a strong and broad-based rebound in the economy in the December quarter. After sifting through the sectoral data we have revised up our pick to an above-consensus 1.2%, with additional upside risk. If we're right that should see a modest lift in interest rates and the NZ dollar on the day, though markets are currently more focused on drought concerns than on the positive growth story.

Fixed vs floating for mortgages: Given last week's Monetary Policy Statement, there is a chance fixed rates could fall in the near future. However, even at current 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 still regard as unlikely.

NZ interest rates



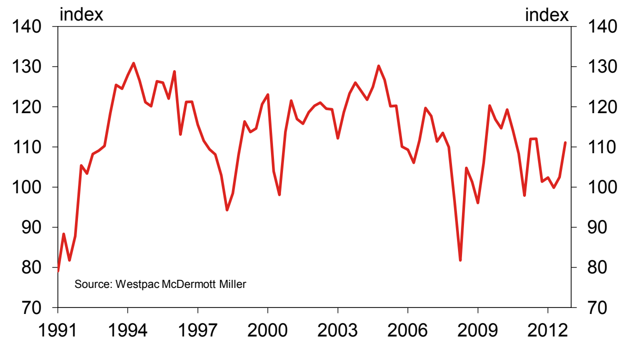
Key Data Previews

NZ Q1 Westpac-MM Consumer Confidence

Mar 18, Last: 111.1

- Consumer confidence rose to its highest level in more than a year in the December quarter. The improvement was pervasive, with households more positive about their financial situation, more optimistic for the future, and more willing to spend on big-ticket items.
- This lift in confidence coincided with a strong pick up in retail activity in the December quarter.
- The latest survey was conducted during 1-11 March.

NZ Westpac McDermott Miller Consumer Confidence Index

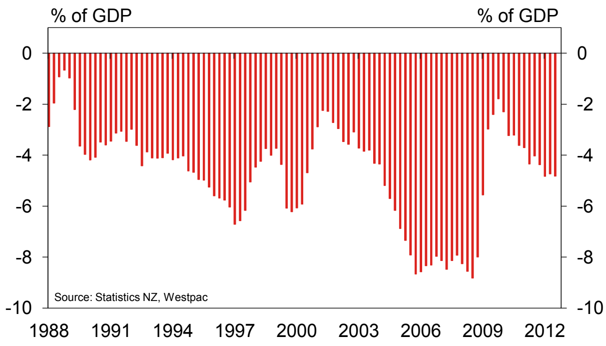


NZ Q4 current account balance

Mar 20, Last: -4.7%, WBC f/c: -4.8%, Mkt f/c: -4.9%

- We expect the current account deficit to widen from 4.7% to 4.8% of GDP for the year to December, owing mainly to a lower annual goods and services balance.
- Looking just at the December quarter, the seasonally adjusted goods balance is expected to improve – import values fell (particularly import volumes) by more than export values. We expect the investment income deficit to widen in Q4 as profits paid by foreign-owned NZ firms bounce back after a temporary low in Q3.
- Over the next couple of years, a widening current account deficit is likely to be one symptom of growing economic imbalances. In turn, these imbalances are likely to be due to accelerating domestic demand growth (Canterbury rebuild and housing) crowding out the export sector.

NZ annual current account deficit

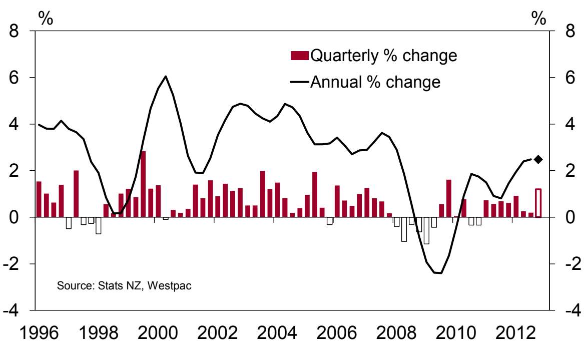


NZ Q4 GDP

Mar 21, Last: 0.2%, WBC f/c: 1.2%, Mkt: 0.9%

- After a weak patch for the economy in the September quarter (and a surprise downward revision to Q2 GDP), a broad range of indicators pointed to a strong rebound over the December quarter. We estimate a 1.2% rise in GDP, which would be the strongest quarter in three years.
- We expect the strongest contributions to come from agricultural output and services. Milk production was stronger in Q4 and slaughter numbers also picked up. Wholesale and retail trade each rose by 2%, and hours worked in the Quarterly Employment Survey were very strong for business and personal services.
- Our forecast is at the top of the range of market forecasts, and we see upside to risk to our call. An outturn in line with our forecast should see a positive market reaction, but drought concerns may end up overtaking this dated release.

NZ production based GDP

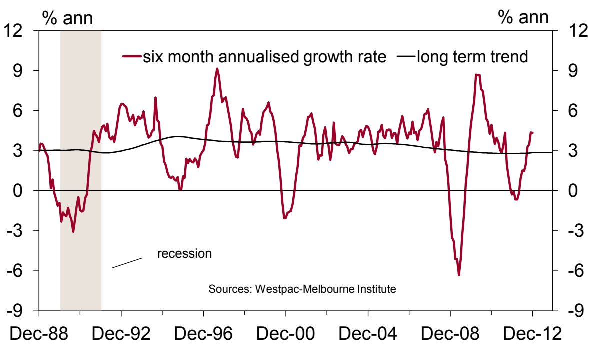


Aus Jan Westpac–MI Leading Index

March 20, Last: 4.3% annualised

- The Westpac–Melbourne Institute Leading Index showed a surprisingly buoyant growth signal in late 2012. The annualised growth rate of the index, which indicates the likely pace of economic activity three to nine months into the future, was 4.3% in December, above the long-run trend of 2.8%; Dec was the third above-trend reading in a row.
- The Jan release will include updated monthly data on: equities (ASX +5.1% vs +3.2% in Dec); money supply (+0.7% vs +0.6% in Dec); US industrial production (–0.1% vs +0.4% in Dec); and dwelling approvals (–2.4% vs –1.7% in Dec, revised up from –4.4%). It will also incorporate 2012 Q4 data on: overtime worked (+13% vs –5% in Q3); manufacturing materials prices (+1.1%qtr vs –0.7%qtr in Q3); the unit labour cost measure of productivity (–0.9%qtr vs +0.1%qtr in Q3); and corporate profits (–1.8%qtr vs –1.1%qtr in Q3).

Westpac-MI Leading Index

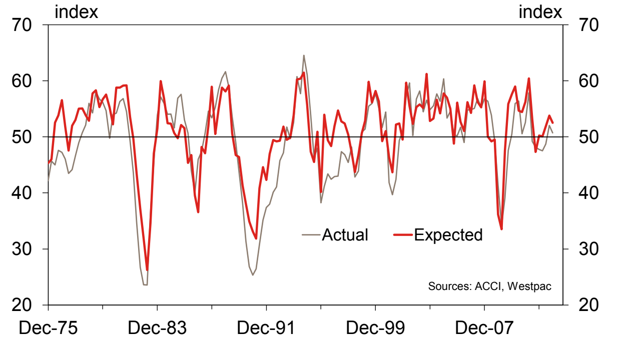


Aus ACCI–Westpac Survey of Industrial Trends

Mar 21, Last: 50.7

- The March quarter 2013 ACCI–Westpac Survey of Industrial Trends - the 206th report of this long running survey - will provide a timely update on current economic conditions and prospects.
- In the December quarter, the Westpac–ACCI Actual composite declined to 50.7, from 51.9. The Expected Composite was a touch stronger at 52.5, from 53.3. Overall, the Survey suggested that, although manufacturers had benefited from the rate cut cycle, they remained under significant pressure.
- Key in the March quarter release will be manufacturers' labour market and investment intentions; as we near the peak of the mining investment boom, conditions in the non-mining sectors of the economy will become all the more critical.

Westpac-ACCI composite indexes, actual and expected, sa



US housing starts/permits/sales in Feb

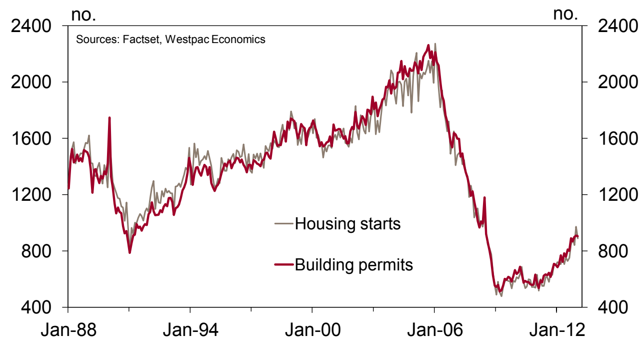
Mar 19, Housing starts: Last: –8.5%, WBC f/c: –2.0%

Mar 19, Housing permits: Last: –0.6%, WBC f/c: 2.0%

Mar 21, Existing home sales: Last 0.4%, WBC f/c: 2.0%

- Housing starts fell 8.5% in Jan, but single-family starts rose 0.8% to a 613k annualised pace (a new post-recession high); volatile multiples (–24.1%) explained all the fall. The permits fall reflected a 1.9% rise in singles (have not fallen since March last year), and a 4.8% multiples fall. The singles permits annualised pace (584k) has remained below that of starts since mid 2012, suggesting some starts downside risk ahead.
- Existing home sales rose 0.4% in Jan, partially reversing the 1.2% Dec fall. This was reportedly partly due to very low supply (4 months at the current sales pace); Jan's 4.99mn annualised sales pace is still the second-highest since Nov 2009. Pending home sales rose 4.5% in Jan, so closings in Feb as measured by existing sales should rise further.

Us housing starts and permits

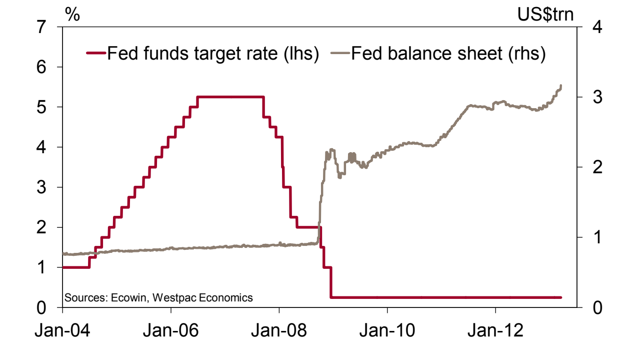


US FOMC decision

Mar 20

- On Dec 12, the Fed announced QE4 with economic parameters replacing the date-based low-rate guidance. The conclusion of Operation Twist then saw the $45bn in monthly Treasury purchases continue on an unsterilised basis. This is on top of the $40bn of MBS that comprises QE3.
- The Jan 30 statement reiterated that policy stance, but the minutes to that meeting revealed a wide range of views, with some arguing that asset purchases might need to end earlier or be adjusted based on the incoming data flow. Somewhat upbeat data, especially on jobs, has given this "dissenting" view some support. Throughout the recovery, activity growth has remained sporadic; we continue to believe that the Fed will need to see persistent strength before it looks to reduce the support it has given to the economy.
- There will be a Bernanke presser and new committee forecasts.

Fed funds target rate and balance sheet



Key Data and Events

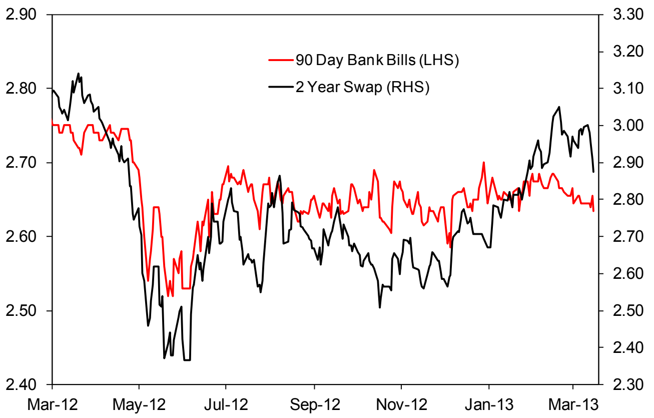
		Last	Market median	Westpac forecast	Risk/Comment
Mon 18					
NZ	Q1 Consumer Confidence	111.1	–	–	Rose to highest level in over a year in December.
	Feb Performance of Services Index	52.6	–	–	One of many indicators that improved in late 2012.
Chn	Feb property prices % rising m-o-m	71.4%	–	–	57 up out of 70 in Jan, last straw for policymakers on lax enforcement.
Eur	Jan exports	–1.8%	–	–	Down three months in last four.
UK	Feb house prices %yr	1.1%	–	–	Rightmove index of asking prices.
US	Mar NAHB housing market index	46	48	49	Supply of established homes back at 2005 lows, benefiting new build.
Tue 19					
Aus	RBA meeting minutes	–	–	–	Perceived strength of non-mining sectors key for rate outlook.
Eur	Jan construction output	–1.7%	–	2.0%	Construction jumped 3% in Germany.
Ger	Mar ZEW analyts' expectations	48.2	46.0	47.0	Feb reading highest since Q2 2010.
UK	Feb PPI %yr	1.4%	–	–	Core output measure.
	Jan house prices %yr	3.3%	–	–	Fastest pace of gain since late 2010 on official ONS measure.
	Feb CPI %yr	2.7%	2.8%	–	BoE holds out little hope of fall back to 2% target within 2 years.
US	Feb housing starts	–8.5%	2.8%	–2.0%	Starts pace for single family dwellings has been running ahead of
	Feb building permits	–0.6%	2.3%	2.0%	permits. See text box.
Can	Jan wholesale sales	–0.9%	0.3%	–	Oct-Nov gains took sales to highest level since June, unwound in Dec.
	Jan manufacturing sales	–3.1%	0.5%	–	Steep Dec loss led by transport, chems.
Wed 20					
NZ	Q4 Current Account Balance	–4.7%	–4.9%	–4.8%	Watch for a widening deficit over the year.
Aus	Jan Westpac–MI leading index	4.3%	–	–	
Eur	Mar consumer confidence advance	–23.6	–23.0	–24.5	Up three months running from post recession low.
	Jan current a/c balance sa €bn	13.9	–	–	In surplus since late 2011, Nov's was the largest.
Ger	Feb producer prices %yr	1.7%	1.5%	–	Bottomed at 0.9%yr in July last year.
UK	Mar BoE minutes	–	–	–	Three of the nine including Gov King wanted more QE in Feb.
	Feb unemployment ch'	–12.5k	–5k	–	Benefit claimant count. Jobs up and jobless down despite flat economy.
	2013 Budget	–	–	–	More austerity from Chancellor Osborne.
US	FOMC decision	0-0.25%	0-0.25%	0-0.25%	Including Bernanke presser and updated FOMC member forecasts
Can	Feb house prices %yr	2.7%	–	–	Teranet/National Bank index.
Thu 21					
NZ	Q4 GDP	0.2%	0.9%	1.2%	Broad-based strength clawing back Q2/Q3 weakness.
Aus	Q4 Westpac–ACCI Industrial survey	50.7	–	–	Timely update on current conditions faced by manufacturing sector.
Chn	Mar HSBC manufacturing PMI - flash	50.4	50.9	–	Likely to bounce post LNY, although Jan-Feb IP was not amazing.
Eur	Mar PMI factory adv	47.9	48.1	–	Jan-Feb saw gap between French and Germany PMIs widen substantially.
	Mar PMI services adv	47.9	48.1	–	Composite PMI fact/ser was 47.9 in Feb
UK	Feb retail sales inc fuel	–0.6%	0.4%	0.2%	BRC solid in Feb, CBI retail survey less so.
	Mar CBI industrial trends	–14	–15	–	Total orders index.
	Feb PSNCR £bn	–35.6	–	–	Public sector net credit requirement. PSNB ex intv'ns –£11.4bn
US	Initial jobless claims w/e 16/3	332k	343k	345k	New year seasonality swings that hit Jan/Feb data now likely over.
	Jan house prices	0.6%	0.7%	–	FHFA index.
	Feb existing home sales	0.4%	1.6%	2.0%	Pending sales rose sharply in Jan. See text box.
	Feb leading indicators	0.2%	0.3%	–	Likely to remain weak.
	Mar Philadelphia Fed factory survey	–12.5	–3.3	–3.0	Regional factory bosses worried about sequester, weaker yen?
Can	Jan retail sales	–2.1%	0.6%	–	Dec sales slumped after five gains on the trot.
Fri 22					
NZ	Feb Net immigration, (s.a.)	350	–	350	Trans-Tasman departures on a choppy downtrend.
Ger	Mar Ifo business climate index	107.4	107.5	104.8	Up in Nov, Dec, Jan, Feb; Q4 GDP slump viewed as one-off.

New Zealand Economic and Financial Forecasts

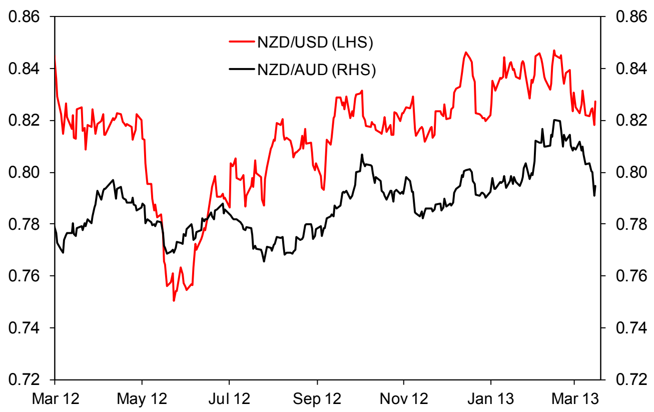
Economic Growth Forecasts	March years				Calendar years			
% change	2012	2013f	2014f	2015f	2011	2012e	2013f	2014f
GDP (Production) ann avg	1.9	2.4	3.2	3.2	1.5	2.5	3.0	3.2
Employment	1.0	0.1	2.8	2.5	1.5	-1.4	4.1	2.6
Unemployment Rate % s.a.	6.7	6.8	5.8	4.8	6.4	6.9	6.0	5.0
CPI	1.6	1.1	1.9	2.3	1.8	0.9	2.0	2.3
Current Account Balance % of GDP	-4.4	-4.6	-4.8	-6.2	-4.0	-4.8	-4.5	-5.9

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	0.86	0.86	0.86	0.85	0.83	0.82
NZD/AUD	0.83	0.84	0.85	0.86	0.86	0.85
NZD/JPY	79.1	78.3	76.5	74.8	71.4	68.9
NZD/EUR	0.64	0.65	0.67	0.67	0.67	0.68
NZD/GBP	0.55	0.55	0.55	0.56	0.54	0.53
TWI	77.8	78.2	78.7	78.6	77.3	76.5

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 18 March 2013

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.65%	2.66%	2.66%
60 Days	2.65%	2.66%	2.67%
90 Days	2.64%	2.65%	2.69%
2 Year Swap	2.88%	2.96%	3.03%
5 Year Swap	3.47%	3.46%	3.56%

NZ foreign currency mid-rates as at Monday 18 March 2013

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.8273	0.8233	0.8441
NZD/EUR	0.6327	0.6327	0.6323
NZD/GBP	0.5474	0.5472	0.5444
NZD/JPY	78.830	77.085	79.098
NZD/AUD	0.7948	0.8074	0.8197
TWI	75.840	75.600	76.890

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2009	2010	2011	2012e	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	2.5	2.8
Unemployment %	5.6	5.2	5.2	5.3	6.1	6.1
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-3.0	-3.8
United States						
Real GDP %yr	-3.1	2.4	1.8	2.2	1.6	1.5
Consumer Prices %yr	-0.3	1.6	3.1	2.1	2.1	2.0
Unemployment Rate %	9.3	9.6	8.9	8.1	7.8	7.8
Current Account %GDP	-2.7	-3.0	-3.1	-3.0	-2.9	-2.9
Japan						
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
Euroland						
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	1.4
Unemployment Rate %	9.5	10.0	10.1	11.7	12.0	12.5
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	0.7	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	-2.0	-1.5

Forecasts finalised 8 March 2013

Interest Rate Forecasts	Latest	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14
Australia						
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	3.62	3.50	3.50	3.30	3.20	3.00
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.02	2.10	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	1.0366	1.04	1.03	1.01	0.99	0.97
USD/JPY	96.08	92	91	89	88	86
EUR/USD	1.3015	1.34	1.32	1.29	1.26	1.23
AUD/NZD	1.2632	1.21	1.20	1.17	1.16	1.17

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