



Spring Lupines, Lake Tekapo

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The house rules

A household-centric week of local data has reinforced our view that the Reserve Bank will be raising interest rates early next year, even with the likely introduction of mortgage lending restrictions in the near future. As we've been saying for some time, this is not merely a housing story: the economy's upswing is becoming widespread and self-sustaining, and in time that will see inflation pressures re-emerge, just as in previous cycles.

The REINZ house sales figures for July were of particular interest to us last week. With sales, mortgage approvals and the annual pace of house price growth all slowing a little over May and June, we were on alert for any sign that the housing market might be cooling of its own accord. That doesn't seem to be the case though: sales rose nearly 4% in seasonally adjusted terms in July, with sales in Auckland rebounding to their highest level in six years. There was a jump in new listings in July, lending some credence to the idea that a lack of supply was constraining turnover in previous months. Meanwhile, annual house price inflation ticked up from 8.4% to 8.6%, and has now been around the 8-9% mark for the last six months.

With no sign of the housing market relenting, and with consumer price inflation still subdued, it now seems inevitable that the RBNZ will resort to one or more of its macroprudential tools in the near future. Last week the RBNZ produced the final version of its framework for restrictions on high loan-to-value ratio (LVR) home loans, following a round of public consultation. In our view, this tool should be considered 'live' from here on.

The details of the framework are largely unchanged from what was signalled a few months ago. The RBNZ can set a 'speed limit' on the share of high-LVR home loans – for instance, loans with an LVR above 80% could be limited to no more than 15% of new lending. Any tightening of the limits will be done on fairly short notice (at least two weeks), to reduce the risk of home buyers rushing in to load up on debt ahead of the new limits. The RBNZ will also be on the lookout for any efforts to actively subvert the

The house rules

continued

rules, and can apply tougher restrictions on individual banks if necessary.

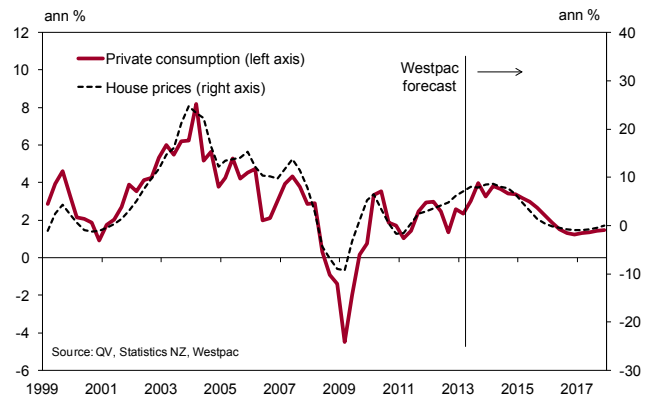
As we've detailed before, our view is that these restrictions are likely to have only a modest impact on house prices. While they would shut some potential buyers out of the market, they would have no effect on willingness to pay for those buyers who are able to muster up a large enough deposit. If anything this could be a boon for low-LVR borrowers, if greater bank competition for this pool of customers drives down mortgage rates.

The fact that many of those shut out of the market will be first-time buyers has not been lost on the Government, which has announced that it will give first-home buyers greater support through the Kiwisaver savings scheme and the Welcome Home loan guarantee scheme. Some have commented that boosting housing demand at a time when the RBNZ is trying to dampen it seems counter-productive. But we need to keep in mind the purpose of LVR restrictions: not to control the housing market, but to avoid the build-up of excessive risk in the banking system. A policy that helps first-time buyers get into the market with a decent chunk of equity in their home wouldn't necessarily conflict with that goal.

While we don't disagree with the case for macroprudential restrictions, our view is that we are well beyond the point where the housing market can be treated as an isolated issue. A strong housing market has implications for consumer spending, both in terms of direct linkages and as an indicator of households' general fortunes and sentiment. That in turn makes housing a direct issue for monetary policy, as stronger demand leads to inflation pressures over time.

In the latest Westpac-McDermott Miller confidence survey, consumers told us that they were more eager to spend than they have been for many years. The retail trade figures for the June quarter show that they meant it. The 1.7% rise in real retail sales was substantially faster than the 0.9% increase in the March quarter. While the total was in line with our forecast, what blew

House price inflation and consumer spending



us away was the 2.3% rise in the core retail sectors (excluding cars and fuel), the biggest quarterly increase since December 2006. To put it in context: the increase in core sales over the quarter was about as large as the spending boost provided by the 2011 Rugby World Cup.

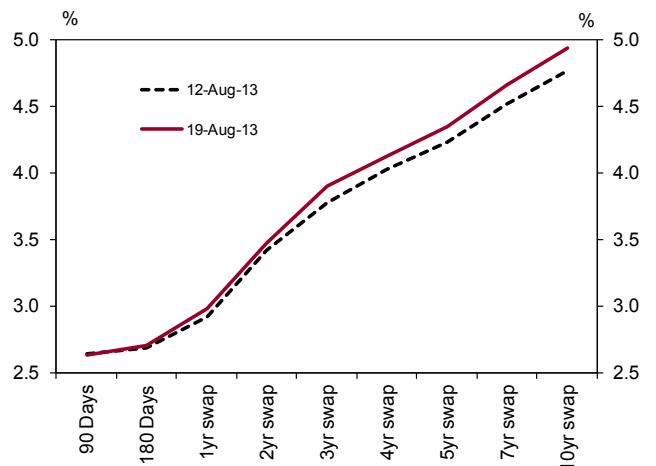
And it wasn't just good news for the retail sector last week. The PMI manufacturing survey rose to 59.5 in July, its highest level in nine years. We've noted before that while the manufacturing sector is often portrayed as being export-dependent, it's actually more keyed into domestic activity and construction in particular. The boost provided by the Christchurch rebuild seems to be far outweighing the impact of a five-year high in the NZD/AUD exchange rate.

With the recent run of strong activity data, wholesale interest rates have shot up to their highest in two years. The market is more than fully pricing an OCR hike by March next year, and we're increasingly being asked whether the RBNZ might even move before year-end. Our view is that the hurdle for such an early move is probably too high. As at June, the RBNZ was forecasting that annual inflation wouldn't get back to the 2% midpoint of its target band until mid-2015. For the RBNZ to bring that profile forward, it would need to be persuaded that stronger activity is translating through to demand-pull pressure on prices. We believe that this step is coming, just as in past cycles, but we're not sure that the RBNZ will be across the line as soon as December. Our forecast remains for a March 2014 start to OCR hikes.

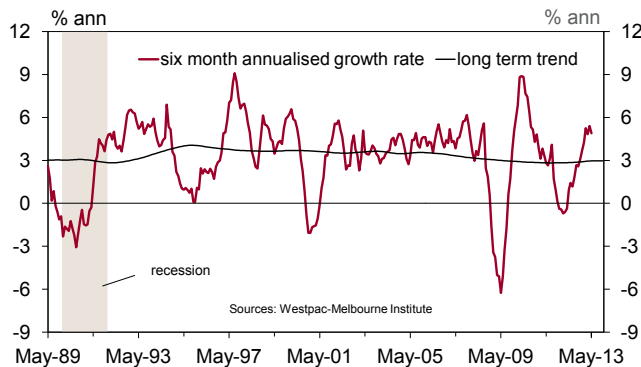
Fixed vs Floating for mortgages

We favour fixing for longer terms. The RBNZ is now widely expected to begin an extended series of OCR hikes from early next year, which will drive floating rates substantially higher over the next few years. So while fixed-term rates for three years or more are higher than the current floating rate, we believe that they still offer good value at the moment. This opportunity may not last for long - with wholesale interest rates rising to their highest in two years, there will be further upward pressure on retail rates.

NZ interest rates



Westpac-MI Leading Index

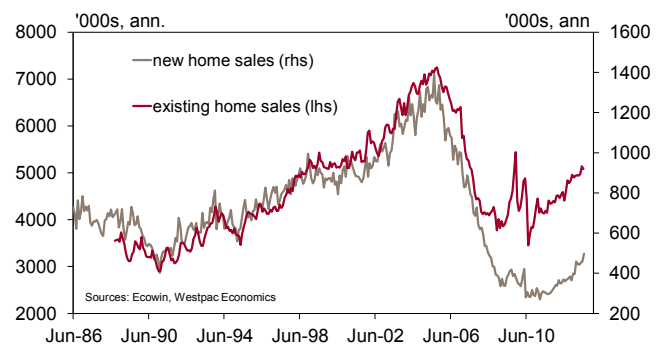


Aus Jun Westpac-MI Leading Index

Aug 21, Last: 4.9% annualised

- The Leading Index registered its sixth-successive month of above-trend growth in May; the 4.9% annualised pace was down on April's 5.4%, but comfortably above the long-run trend of 3.0%.
- The June reading will incorporate updated monthly component data on: equities (ASX -2.8%, vs -4.9% in May); money supply (+0.4%, vs 0.8% in May); dwelling approvals (-6.9%*mth*, vs -4.3%*mth* in May) and US IP (+0.3%*mth*, vs flat in May). Looking ahead, the ASX snapped out of its decline in Jul (+5.4%), but has been flat so far in August. Quarterly components, which will be included once a full set are available in September, have so far been mixed, with overtime up strongly (+17, vs -11 in Q1), but commodity prices lower.

US housing sales



US Jul existing and new home sales

Aug 21, existing home sales, Last: -1.2%

Aug 23, new home sales, Last: 8.3%

- US new home sales jumped 8.3% in June, the fastest monthly rise in five years, to reach a 497k annualised pace, up 38%*yr*. But existing home sales were down 1.2% in June, a surprise given the 10% year-to-date rise in pending home sales. Existing home sales completions are only up 5%*ytd*; that could indicate more sales falling through, or longer settlement times.
- Limited supply of homes for sale and rising mortgage rates in recent months are factors that would constrain both pending and existing sales; the latter (higher rates) would also impact new housing sales, where starts have been patchy at best, but homebuilder confidence keeps soaring.
- Tying all these strands together, we expect to see a 1% rise in existing home sales in July, but a correction lower of 3% or so in the often-volatile (and revised) new home sales series.

Data calendar

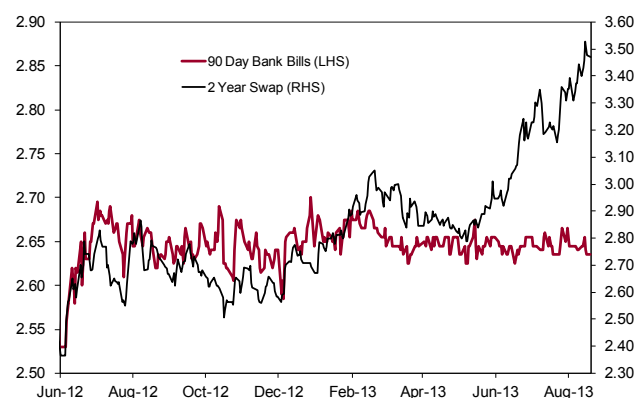
| | | Last | Market median | Westpac forecast | Risk/Comment |
|---------------|---------------------------------------|--------|---------------|------------------|--|
| Mon 19 | | | | | |
| Aus | Jul new motor vehicle sales | 4.00% | – | –4.0% | Tax changes may have a bigger impact in coming months. |
| Thai | Q2 GDP %yr | 5.30% | 3.30% | – | Partial data weak. Usual raw seasonal dip would push annual to <2½%. |
| UK | Aug house prices %yr | 4.80% | – | – | Rightmove index of asking prices. |
| Tue 20 | | | | | |
| Aus | RBA meeting minutes | – | – | – | Expect tone to match SoMP. |
| NZ | RBNZ survey of inflation expectations | 2.10% | – | 2.00% | Continuing to follow headline inflation lower for now. |
| Twn | Jul export orders %yr | –3.5% | –0.7% | – | PMI new export orders fell to 46.5 in July; weak, but July 2012 was 45.6. |
| Ger | Jul producer prices %yr | 0.60% | 0.70% | – | Edging up from post recession lows. |
| US | Jul Chic Fed national activity index | –0.13 | – | – | Based on 80 or so data inputs, not a business survey. |
| Can | Jun wholesale trade | 2.30% | – | – | Steep rise to record high on food and fertilizer sales in May. |
| Wed 21 | | | | | |
| Aus | Jun Westpac–MI leading index | 4.90% | – | – | Decelerated in May, but still well above average. |
| NZ | Net immigration, July (s.a.) | 2330 | – | 2100 | Net immigration now a solid contributor to New Zealand's economic upswing. |
| Myr | Q2 GDP %yr | 4.10% | – | – | Fairly resilient outcome anticipated. IP averaged 3.7% in the quarter. |
| Thai | Bank of Thailand decision | 2.50% | 2.50% | 2.50% | July Minutes: "... policies remain sufficiently accommodative". |
| UK | Jul PSNCR £bn | 3.1 | – | – | Public sector net credit requirement. PSNB ex int'ns £8.5bn in Jun. |
| | Aug CBI industrial trends survey | –12 | –9 | – | Total orders index. |
| US | Jul existing home sales | –1.2% | 0.90% | 1.00% | Constrained by lack of supply and rising mortgage rates mid-year. |
| | FOMC minutes | – | – | – | To Jul 30-31 meeting. |
| Thu 22 | | | | | |
| Chn | Aug HSBC manufacturing PMI - flash | 47.7 | 48.2 | – | Not helped by base effects like other July data, but detail 'less bad'. |
| Eur | Aug PMI factory adv | 50.3 | 50.6 | 50.3 | Gap between French & German PMIs has narrowed substantially of late. |
| | Aug PMI services adv | 49.8 | 50.2 | 49.7 | Composite PMI fact/ser was 50.5 in Jul. |
| US | Initial jobless claims w/e 16/8 | 320k | 330k | 30k | Claims back at pre-recession levels. |
| | Aug Kansas City Fed factory index | 6 | – | –2 | No back-to-back >0 readings since Q3 last year. |
| | Jun house prices | 0.70% | 0.60% | – | FHFA index. |
| | Jul leading index | 0.00% | 0.50% | – | Patchy growth story ahead if leading index is any guide. |
| | Kansas Fed Jackson Hole Summit | – | – | – | No top Fed officials on the leaked agenda. |
| | Fedspeak | – | – | – | Fisher in FI. Also Treasury Secretary Lew in Ca. |
| Can | Jun retail sales | 1.90% | –0.5% | – | May retail sales up sharply across the board. |
| Fri 23 | | | | | |
| Twn | Jul industrial production %yr | –0.43% | –0.3% | – | PMI output weakened in July to 46.9, even lower than July 2012 (47.1). |
| Eur | Aug consumer confidence advance | –17.4 | –16.7 | –16.9 | Pessimism has eased, but little evidence household spending higher. |
| Ger | Q2 GDP final | 0.7% a | 0.70% | – | More detail on the composition of growth. |
| UK | July mortgages no. | 37.3k | – | – | BBA data covering about 70% of the market. |
| | Q2 GDP first revision | 0.6% a | 0.60% | – | More detail on the composition of growth. |
| | Q2 business investment | –1.9% | – | – | Measured on different basis to national accounts capital spending. |
| US | Jul new home sales | 8.30% | –1.4% | –3.5% | Volatile series; starts weak; mortgage rates higher. See text box. |
| Can | Jul CPI % yr | 1.20% | 1.40% | – | BoC core rate 1.3%yr in June. |

New Zealand forecasts

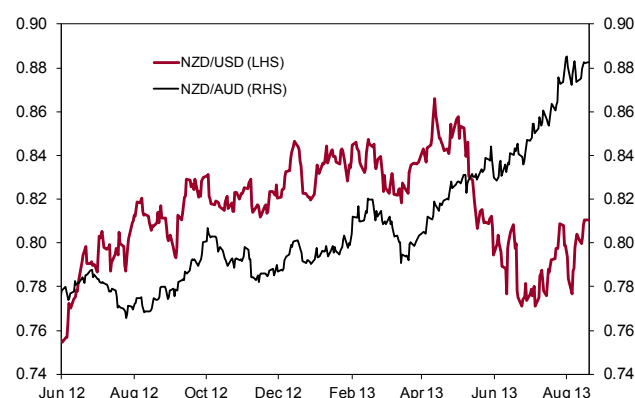
| Economic Growth Forecasts | March years | | | | Calendar years | | | |
|----------------------------------|-------------|-------|-------|-------|----------------|------|-------|-------|
| | 2012 | 2013f | 2014f | 2015f | 2011 | 2012 | 2013f | 2014f |
| % change | | | | | | | | |
| GDP (Production) ann avg | 1.9 | 2.5 | 2.8 | 3.8 | 1.4 | 2.7 | 2.6 | 3.7 |
| Employment | 1.0 | 0.4 | 2.3 | 2.8 | 1.5 | -1.4 | 3.5 | 2.9 |
| Unemployment Rate % s.a. | 6.8 | 6.2 | 5.7 | 4.8 | 6.3 | 6.8 | 5.9 | 4.9 |
| CPI | 1.6 | 0.9 | 1.7 | 2.5 | 1.8 | 0.9 | 1.6 | 2.3 |
| Current Account Balance % of GDP | -4.4 | -4.8 | -5.0 | -5.9 | -4.0 | -5.0 | -4.7 | -5.8 |

| 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 | 3.40 | 3.40 | 3.50 | 3.60 | 3.80 | 4.00 |
| 5 Year Swap | 4.20 | 4.00 | 4.00 | 4.10 | 4.20 | 4.40 |
| 10 Year Bond | 4.30 | 4.10 | 4.10 | 4.20 | 4.30 | 4.40 |
| NZD/USD | 0.80 | 0.82 | 0.83 | 0.81 | 0.78 | 0.76 |
| NZD/AUD | 0.87 | 0.89 | 0.90 | 0.90 | 0.90 | 0.89 |
| NZD/JPY | 79.2 | 80.4 | 80.5 | 77.8 | 74.1 | 71.4 |
| NZD/EUR | 0.60 | 0.62 | 0.62 | 0.62 | 0.62 | 0.62 |
| NZD/GBP | 0.51 | 0.51 | 0.51 | 0.50 | 0.50 | 0.49 |
| TWI | 75.3 | 77.0 | 77.7 | 76.6 | 75.1 | 73.9 |

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 19 Aug 2013

| Interest Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| Cash | 2.50% | 2.50% | 2.50% |
| 30 Days | 2.63% | 2.63% | 2.63% |
| 60 Days | 2.64% | 2.63% | 2.63% |
| 90 Days | 2.64% | 2.64% | 2.63% |
| 2 Year Swap | 3.47% | 3.29% | 3.22% |
| 5 Year Swap | 4.35% | 4.22% | 3.98% |

NZ foreign currency mid-rates as at Monday 19 Aug 2013

| Exchange Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| NZD/USD | 0.8104 | 0.7731 | 0.7915 |
| NZD/EUR | 0.6080 | 0.5821 | 0.6023 |
| NZD/GBP | 0.5191 | 0.5055 | 0.5181 |
| NZD/JPY | 79.10 | 76.49 | 79.41 |
| NZD/AUD | 0.8827 | 0.8659 | 0.8619 |
| TWI | 76.09 | 73.63 | 75.08 |



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 | 2.2 | 2.5 |
| Unemployment % | 5.6 | 5.2 | 5.2 | 5.4 | 6.2 | 6.4 |
| Current Account % GDP | -4.2 | -2.9 | -2.3 | -3.7 | -2.4 | -2.3 |
| United States | | | | | | |
| Real GDP %yr | -3.1 | 2.4 | 1.8 | 2.8 | 1.4 | 1.5 |
| Consumer Prices %yr | -0.3 | 1.6 | 3.1 | 2.1 | 1.4 | 1.6 |
| 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 | -3.0 | -3.1 |
| 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 | -4.3 | 1.9 | 1.5 | -0.5 | -1.0 | -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 | 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 9 August 2013

| Interest Rate Forecasts | Latest | Sep 13 | Dec 13 | Mar 14 | Jun 14 | Sep 14 |
|-------------------------|--------|--------|--------|--------|--------|--------|
| Australia | | | | | | |
| Cash | 2.50 | 2.50 | 2.25 | 2.00 | 2.00 | 2.00 |
| 90 Day Bill | 2.58 | 2.55 | 2.30 | 2.10 | 2.10 | 2.10 |
| 10 Year Bond | 3.97 | 3.60 | 3.40 | 3.30 | 3.20 | 3.10 |
| International | | | | | | |
| Fed Funds | 0.25 | 0.125 | 0.125 | 0.125 | 0.125 | 0.125 |
| US 10 Year Bond | 2.78 | 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 | 0.9147 | 0.92 | 0.92 | 0.92 | 0.90 | 0.87 |
| USD/JPY | 97.58 | 99 | 98 | 97 | 96 | 96 |
| EUR/USD | 1.3342 | 1.33 | 1.33 | 1.33 | 1.30 | 1.25 |
| AUD/NZD | 1.1339 | 1.15 | 1.12 | 1.11 | 1.11 | 1.12 |

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