

Weekly Commentary

21 January 2013

Below target, on track

Last week's CPI release showed headline inflation coming in below the RBNZ's target range for the second quarter in a row. Markets responded by sending the NZ dollar and swap rates lower. However, it's the medium-term inflation outlook that matters for the RBNZ's interest rate decisions – and on that score we don't see the CPI report as a game changer, particularly as the evidence continues to mount that the economy is over its September quarter speed bump. We remain comfortable with our view that the RBNZ will stay on hold for now and start raising the OCR in September this year.

Key to our view is the composition of the CPI result. The surprises were once again mainly on the tradable goods side, with a greater than expected prevalence of discounting for clothing and appliances. This raises important questions about the impact of online competition, and how the process by which low overseas prices and a high exchange rate 'pass through' to local prices may be changing.

However, the underlying forces pushing import prices down, and thus making room for discounting – last year's 7% rise in the exchange rate, and low global inflation – are fading. Global commodity prices and global demand are reviving. And while that should also see the NZ dollar stay high, we don't see the same scope for further appreciation that there was last year.

By contrast, non-traded inflation is evolving broadly as expected by us and the RBNZ. In particular, housing-related costs continue to tick up. For now these costs remain fairly contained. However, it's in this space that inflation pressures are likely to build as the Canterbury rebuild continues to accelerate through 2013, eventually requiring interest rate hikes. (Just a reminder here that we expect residential construction to increase 30% this year, and the RBNZ expects a lift of 29% in the year to March 2014.) There was nothing in the CPI report to change that story.

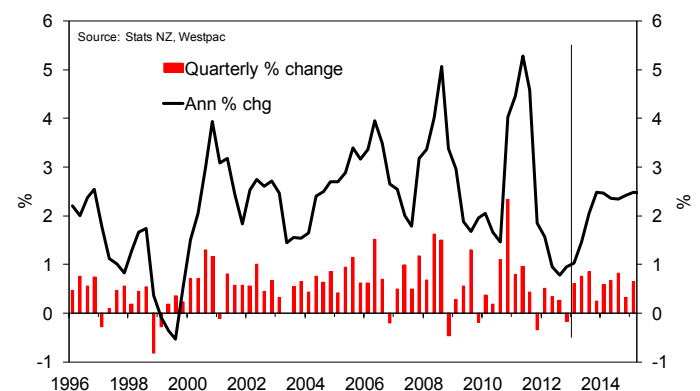
When thinking about how the RBNZ is likely to read the CPI data, we're also mindful of the growing body of evidence that the economy picked up pace in the last few months of 2012. Consider the week's other developments: electronic spending saw a decent increase for a second month, we had a solid (not stellar) housing market update from the Real Estate

Institute, and business confidence rebounded in the NZIER's December *Quarterly Survey of Business Opinion*. Meanwhile dairy prices continued their good start to 2013 in Wednesday's GlobalDairyTrade auction, adding another 1.1% to their 2% rise a fortnight ago.

We paid particular attention to the *Quarterly Survey of Business Opinion (QSBO)*, which is one of the most comprehensive snapshots of New Zealand economic activity ahead of December quarter GDP. In many ways, the picture it painted was remarkably positive. We weren't surprised to see headline business sentiment rebound (probably as much a reflection of the diminishing 'fear factor' around international financial markets as of the domestic situation). But there was also a big lift in both past and expected domestic trading activity – key indicators for the near-term economic outlook. Reported trading activity over the past three months was the highest since June 2007, and activity expected over the next six months rose back to where it was in March last year, when the economy expanded 0.9%.

If anything, that suggests that recent economic growth may have been a touch stronger than we had pencilled in: we've lifted our December quarter GDP forecast to 0.8%. (We'll refine that estimate further as more information about the various sectors of the economy comes in).

Consumer Price Index





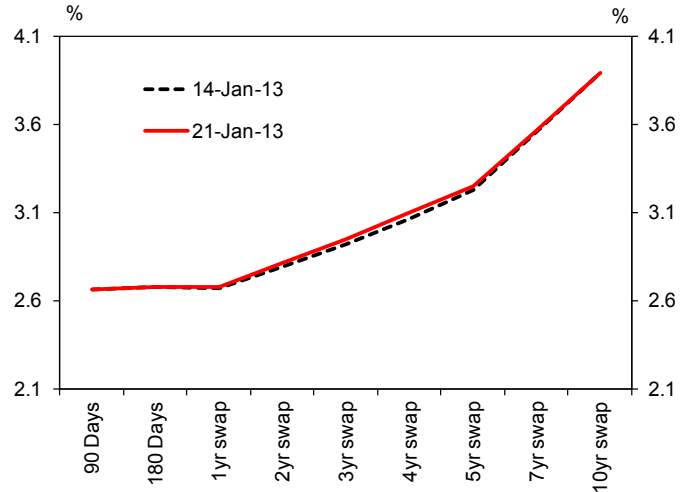
Confidence around the Christchurch rebuild is clearly a factor behind the lift in business sentiment: the biggest improvement came from manufacturers and builders, and the NZIER reported a particularly large bounce in reported activity in the Canterbury region (after an oddly weak Q3). However, activity improved across the other broad industrial sectors and geographic regions as well, suggesting that the September quarter was a temporary but broad-based 'hole' in growth.

The report wasn't uniformly rosy – it showed that growth remains lopsided, and that the persistently high exchange rate remains a constraining factor. While overall activity rose strongly, there was little change in expected profits, employment intentions or investment in buildings. The one area where planned investment picked up sharply was in plant and machinery equipment, which has a large imported component. That suggests another way in which the high exchange rate is affecting the economy: expanding businesses are choosing capital in favour of labour, and imported capital over domestic.

The QSBO also echoed the message from the CPI data that there is little in the way of rising inflation or capacity pressures right now, though construction-related costs are picking up. In fact fewer firms expected costs to increase than in the September survey, while only a net 9% of firms intended to raise their prices in the next quarter - both measures were the lowest since mid-2009. It's because of this that we expect the RBNZ to keep interest rates on hold until late this year.

Fixed vs floating: Fixing is likely to prove 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. Staying on floating would only be the better option if the RBNZ actually cut the OCR - while that's a risk, our central view remains that the OCR will stay on hold for now, and increase steadily from the second half of this year. Fixed-rate specials are starting to disappear as mortgage market competition seems to be settling back into more normal levels, reinforcing the sense that there is limited value in waiting to fix.

NZ interest rates



Key Data Previews

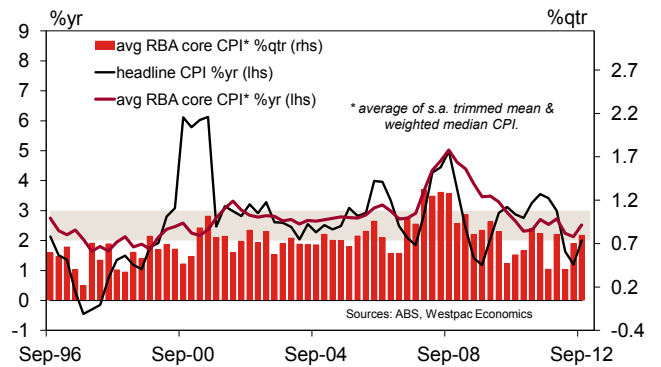
Aus Q4 CPI

Jan 23, Last: 1.4%, WBC f/c: 0.2%

Mkt f/c: 0.4%, Range: 0.2% to 0.7%

- The introduction of the carbon price added to the strong rise in food and medical services prices lifting the CPI by 1.4%qtr in Q3. This was well above market expectations for 1.0%qtr and lifted the annual rate to 2.0%yr from 1.2%yr
- Westpac is forecasting that the usual Q4 seasonal moderation in headline inflation will be deepened by a large drop in fresh fruit & vegetable prices. Our Q4 forecast is for a 0.2%qtr rise and with the flat print for 2011Q4 dropping out, the annual rate will lift from 2.0%yr to 2.3%yr.
- We estimate a modest tick up in core inflation with a 0.8%qtr (0.82% unrounded) rise in the average of the RBA measures. With a 0.76%qtr rolling out from 2011Q, the annual pace lifts a touch to 2.59%yr from 2.52%yr in Q3.

Headline inflation at the bottom of the band



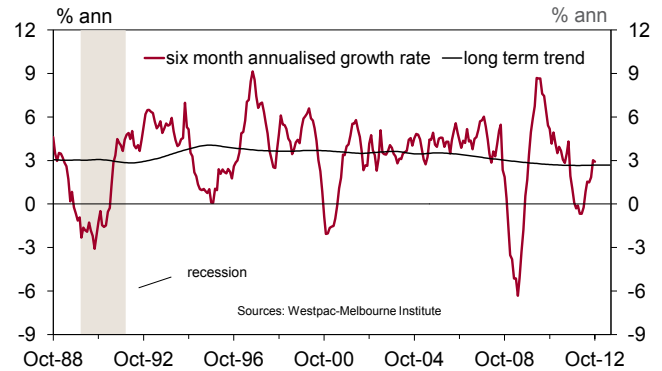


Aus Nov Westpac-MI Leading Index

Jan 23, Last: 2.9% annualised

- The annualised growth rate of the **Westpac-Melbourne Institute Leading Index**, which indicates the likely pace of economic activity 3 to 9 months into the future, was 2.9% in October 2012, a touch above its long term trend of 2.7%.
- The Index was running below its long term trend throughout the period September 2011 to August 2012.
- November will see updates of monthly data on: US industrial production (+1.0% vs -0.3%); dwelling approvals (+2.9% vs -5.0%); equity markets (ASX -0.4% vs +2.9% in October) and money supply (+0.2% vs +0.3% in October).

Westpac -MI Leading Index

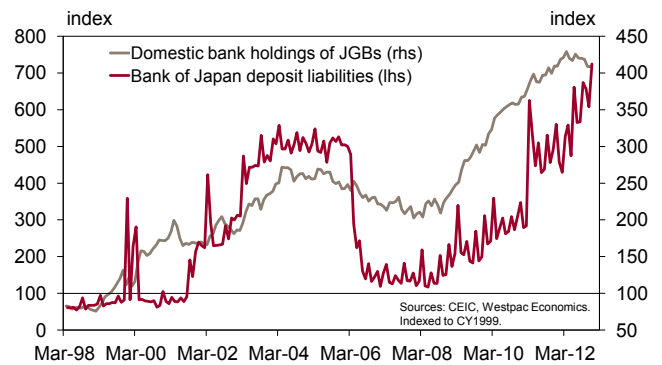


Bank of Japan meeting

Jan 22: last ¥10 trillion increase in asset purchases

- The new government's policy manifesto is heavy on both increased public works spending and "encouraging" the BoJ to adopt more aggressive monetary policy. This is the first BoJ meeting since the election. The yen has depreciated sharply since the last one, mainly on political rhetoric.
- Concrete requests from the government include a more ambitious inflation target of 2%; a broader mandate to target employment as well; and greater 'cooperation' on debt management issues. A recent media report on a potential joint statement by the Govt and the BoJ highlights that the Bank will be left to choose the tools by which it fights deflation. A further ¥10 trillion increase in the asset purchase program is the least that can be expected at this meeting.
- Note that Governor Shirakawa's term expires in April. Perhaps it is the next Governor who will really 'go to the whip'?

The BoJ's balance sheet & bank JGB holdings



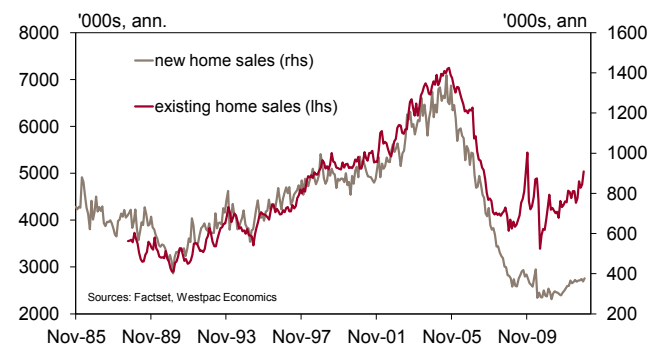
US existing and new home sales

Jan 22, existing home sales: Last: 5.9%, WBC f/c 1.0%

Jan 25, new home sales: Last: 4.4%, WBC f/c 2.0%

- Existing homes sales rose by 5.9% in November to be 14.5% higher than a year ago. The annualised sales pace stands at 5 million, up 49% from its mid 2010 low. Pending home sales rose by 9.8% over the year to November; this suggests we will see a moderation in existing home sale growth as we head into 2013. For December 2012, we expect a 1.0% gain.
- The bulk of the 15% annual gain for new home sales occurred in February. Since then, new home sales have been broadly stable, rising just 3% – thanks in no small part to the 4.4% gain seen in November. Home builders remain more confident than they were in the first half of 2012, but conditions remain soft. We expect a modest 2% gain in Dec.

US housing sales





Key Data and Events

Market Westpac
Last median forecast Risk/Comment

		Last	median	forecast	Risk/Comment
Mon 21					
Ger	Dec producer prices %yr	1.4%	1.8%		– Fell 0.1% in Nov; inflation pressures are benign.
UK	Jan house prices	-3.3%	–		– Rightmove measure; prices are up 1.4%yr
US	Martin Luther King, Jr. Day	–	–		– Public holiday
Can	Nov wholesale sales	0.9%	0.3%		– Oct saw broad-based rebound which offset Sep fall.
Tue 22					
Jpn	Bank of Japan decision	0.1%	0.1%	0.1%	Abe's full court press should spark some creativity, see box.
Eur	Jan ZEW sentiment survey	7.6	–		– Expectations are on the improve, but conditions are stagnant.
UK	Dec PSNCR £bn	-6.8	–		– Public sector net credit requirement.
US	Dec existing home sales	5.9%	1.2%	1.0%	Slower growth for pending sales points to moderation for existing.
	Dec Chicago Fed activity index	0.10	–		– Improved in Nov, but level points to weak economic momentum
	Jan Richmond Fed manufacturing index	5	–		– Dec saw a further modest improvement, but detail was mixed.
Can	Nov retail sales	0.7%	-0.2%		– Excluding autos, sales rose 0.5% in Oct.
Wed 23					
Aus	Q4 CPI	1.4%	0.4%	0.2%	Large falls in fresh food adding to the usual Q4 seasonal softness.
	Q4 avg RBA core inflation	0.7%	0.65%	0.8%	Core inflation is lifted to 2.6%yr, 2.3%yr if the carbon price is excluded.
	Nov Westpac-MI leading index	2.9%	–		– Growth pace above historic avg. of 2.7%. Nov data mixed, see textbox.
Eur	Jan consumer confidence	-26.5	-25.8		– Has stabilised at a depressed level in recent months.
UK	Bank of England minutes	–	–		– Minutes for January meeting.
	Dec unemp claimant count rate	4.8%	4.8%		– Jobless claims fell 3k in Nov.
	Nov ILO unemployment rate	7.8%	7.9%		– Employment rose 40k over three months to Oct.
Can	Dec Teranet house price index	-0.4%	–		– House prices have risen 3.4% over past year.
	Bank of Canada meeting	1.00%	1.00%	1.00%	Activity slowed through 2012, but Bank of Canada not concerned.
Thu 24					
Eur	Jan PMI manufacturing	46.1	46.8		– Advance release; manufacturing activity continues to decline.
UK	Jan CBI reported sales	19	15		– Surge to 33 in Nov is likely to continue to unwind in Jan.
US	Initial jobless claims	336k	360k	350k	Surprised with 37k fall last week; stabilisation likely.
	Dec leading indicators	-0.2%	0.3%		– Momentum remained soft in US ahead of year end.
	Jan Kansas City Fed manufacturing index	-2	–		– Three consecutive declines; activity expectation improved in Dec.
Fri 25					
Jpn	Dec national CPI %yr	-0.2%	-0.2%		– Ex fresh food and energy is at -0.5%yr. Tokyo lead indicator softer.
Ger	Jan IFO business climate index	102.4	103.0		– Dec saw second consecutive gain on expectations; conditions index fell.
UK	Q4 GDP	0.9%	-0.2%	-0.4%	Partials point to renewed decline in activity in Q4.
US	Dec new home sales	4.4%	1.3%	2.0%	But for Feb, 2012 has seen little in the way of an improvement.
Can	Dec CPI %yr	0.8%	–		– Bank of Canada core was flat in Nov, up benign 1.2%yr.

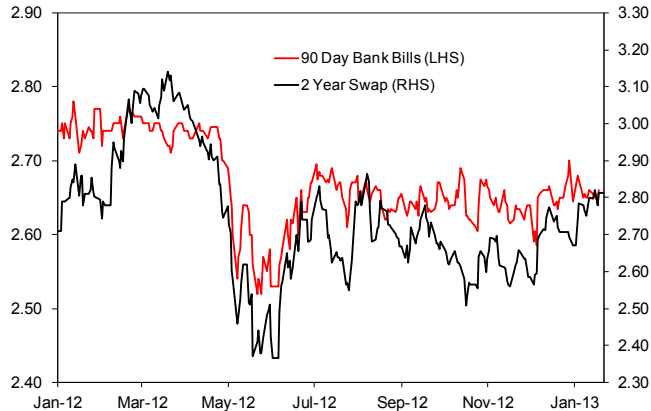


New Zealand Economic and Financial Forecasts

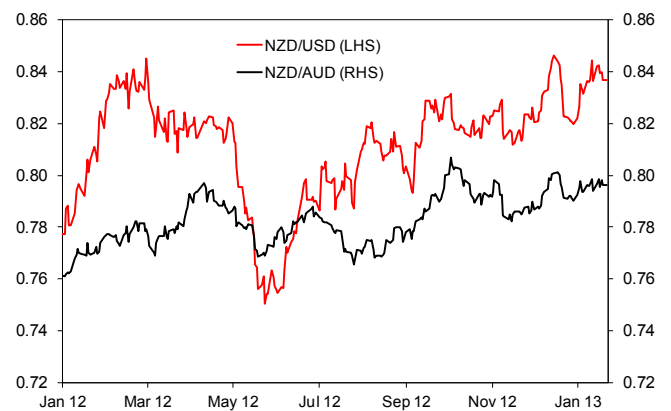
Economic Growth Forecasts	March years				Calendar years			
	2011	2012	2013f	2014f	2011	2012e	2013f	2014f
% change								
GDP (Production) ann avg	1.5	1.9	2.2	3.6	1.5	2.3	3.2	3.2
Employment	1.8	1.0	0.4	2.7	1.5	0.5	2.3	2.2
Unemployment Rate % s.a.	6.5	6.7	6.9	5.8	6.4	7.0	6.1	5.3
CPI	4.5	1.6	1.0	2.5	1.8	0.9	2.5	2.4
Current Account Balance % of GDP	-3.6	-4.4	-5.1	-5.7	-4.0	-5.1	-5.4	-6.4

Financial Forecasts	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Cash	2.50	2.50	2.75	3.00	3.50	4.00
90 Day bill	2.70	2.75	3.00	3.40	3.90	4.25
2 Year Swap	2.80	2.90	3.10	3.40	3.70	4.00
5 Year Swap	3.30	3.50	3.70	3.90	4.10	4.35
10 Year Bond	3.60	3.70	3.80	4.00	4.20	4.40
NZD/USD	0.85	0.86	0.85	0.84	0.83	0.82
NZD/AUD	0.80	0.80	0.81	0.82	0.82	0.83
NZD/JPY	68.9	69.7	68.0	66.4	64.7	64.8
NZD/EUR	0.66	0.66	0.66	0.66	0.67	0.67
NZD/GBP	0.53	0.52	0.52	0.52	0.52	0.50
TWI	75.7	76.0	75.7	75.2	75.1	74.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 21 January 2013

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.67%	2.65%	2.66%
60 Days	2.67%	2.66%	2.67%
90 Days	2.66%	2.65%	2.66%
2 Year Swap	2.81%	2.78%	2.78%
5 Year Swap	3.25%	3.23%	3.21%

NZ foreign currency mid-rates as at Monday 21 January 2013

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.8370	0.8317	0.8458
NZD/EUR	0.6288	0.6413	0.6417
NZD/GBP	0.5279	0.5208	0.5230
NZD/JPY	75.391	73.507	71.383
NZD/AUD	0.7962	0.7963	0.8019
TWI	75.340	75.370	75.300



Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2008	2009	2010	2011	2012f	2013f
Australia						
Real GDP % yr	2.5	1.4	2.5	2.4	3.5	2.7
CPI inflation % annual	3.7	2.1	2.8	3.0	2.4	2.1
Unemployment %	4.3	5.6	5.2	5.2	5.3	5.5
Current Account % GDP	-4.5	-4.2	-2.9	-2.3	-3.8	-3.4
United States						
Real GDP %yr	-0.3	-3.1	2.4	1.8	2.2	1.7
Consumer Prices %yr	3.8	-0.3	1.6	3.1	2.0	2.0
Unemployment Rate %	5.8	9.3	9.6	9.0	8.1	8.0
Current Account %GDP	-4.7	-2.7	-3.0	-3.1	-3.3	-3.5
Japan						
Real GDP %yr	-1.0	-5.5	4.8	-0.7	1.9	1.0
Consumer Prices %yr	1.4	-1.3	-0.7	-0.3	-0.1	-0.4
Unemployment Rate %	4.0	5.0	5.1	4.5	4.3	4.3
Current Account %GDP	3.3	2.8	3.6	2.0	2.1	2.0
Euroland						
Real GDP %yr	0.3	-4.4	1.9	1.5	-0.5	-0.4
Consumer Prices %yr	3.3	0.3	1.7	2.7	2.2	1.4
Unemployment Rate %	7.5	9.5	10.0	10.1	11.5	12.0
Current Account %GDP	-0.8	-0.2	-0.1	-0.0	0.9	1.0
United Kingdom						
Real GDP %yr	-1.0	-4.0	1.8	0.9	-0.1	0.8
Consumer Prices %yr	3.6	2.2	3.2	4.0	2.5	1.8
Unemployment Rate %	5.6	7.6	7.8	8.4	8.0	8.5
Current Account %GDP	-1.6	-1.3	-2.4	-1.9	-3.8	-2.0

Forecasts finalised 12 December 2012

Interest Rate Forecasts	Latest	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14
Australia						
Cash	3.00	2.75	2.75	2.75	2.75	2.75
90 Day Bill	2.99	2.85	3.00	3.10	3.10	3.00
10 Year Bond	3.39	3.10	3.20	3.20	3.50	3.60
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	1.88	1.70	1.90	2.00	2.30	2.40
ECB Repo Rate	0.15	0.50	0.50	0.50	0.50	0.50

Exchange Rate Forecasts	Latest	Mar 13	Jun 13	Sep 13	Dec 13	Mar 14
AUD/USD	1.0510	1.06	1.07	1.05	1.03	1.01
USD/JPY	89.80	81	81	80	79	78
EUR/USD	1.3370	1.29	1.31	1.29	1.27	1.24
AUD/NZD	1.2590	1.25	1.24	1.24	1.23	1.22

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