Weekly Commentary

27 May 2013

Self-reinforcing cycles

The fall in the New Zealand dollar over the last few weeks highlights the sensitivity of global markets, but at this stage it doesn't warrant a reassessment of our inflation or interest rate forecasts. Local news last week was low-key, but there was one release that we feel speaks volumes about the self-sustaining nature of the economic upturn.

Since early May, the NZ dollar has fallen from just shy of 86c against the US dollar to around 81c today. That mostly reflects a resurgence in the USD against all currencies, although the NZD has been hit harder than most (among the majors only the Australian dollar has fallen further). The main catalyst has been a sense that the US Federal Reserve will soon start to scale back its quantitative easing (QE) programme, which was left open-ended when it began late last year.

We've said in the past that when it comes to exchange rates, perceptions about money-printing seem to matter more than the reality. The fact is that the US money supply, measured in broad terms, has seen only modest growth – slower than before the financial crisis, and slower than in New Zealand today. Nevertheless, the perception that the US is flooding the system with dollars has been an important factor behind the weakness of the USD in recent years. We're now seeing that reasoning being applied in reverse, with the prospect of a marginal change in US monetary policy causing an outsized response in exchange rates.

We don't expect the US dollar's rise to be sustained. We acknowledge that ultimately the USD will rise as the US returns to more conventional monetary policy, and that the currency market will try to pre-empt this. We're just not convinced that this is the start of that process. The US recovery is still fragile even with ultra-loose monetary policy, and the Fed has said that it doesn't intend to scale back QE in a linear fashion – which suggests that the market could be prone to jumping the gun for a while longer.

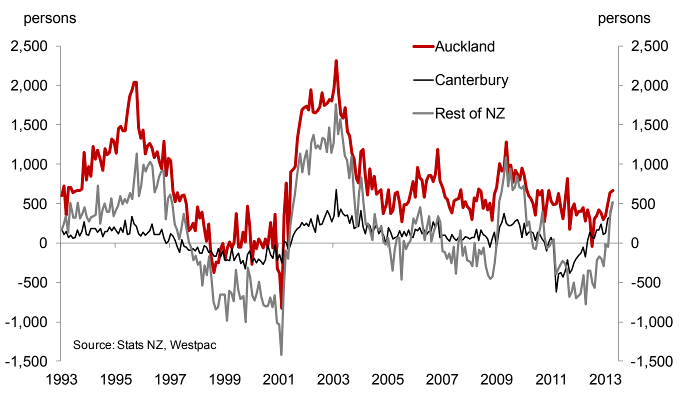
From a New Zealand perspective, the fall in the currency to date doesn't present a challenge to the economic outlook. The NZD trade-weighted index is still slightly above what the RBNZ assumed in its March *Monetary Policy Statement*, which in itself was regarded as uncomfortably high. And in terms of our forecasts, higher inflation (and hence higher interest rates) would require the fall in the NZD to be sustained – and we're not convinced that's the case at this stage.

Turning to local events, the most notable release last week was the migration figures for April, which showed a net inflow of nearly 1,600 people – the strongest month since January 2010. The annual net inflow has reached nearly 5,000 people, compared to a net outflow of over 4,000 people in the previous year. The annual pace is still below the historical average (about 12,000 people), but on current trends will surpass that level by the end of the year.

Much of the turnaround in recent months has been due to fewer New Zealanders heading overseas, particularly to Australia, although arrivals of foreign migrants also appear to have picked up. While the turnaround in the last few months has been surprisingly quick, we had been expecting it to head in this direction for some time. Australian employment growth has been cooling, whereas New Zealand is moving into an upswing, aided by the Canterbury rebuild.

New Zealand's migration figures often attract attention in relation to the housing market – that is, population growth creates more demand for housing. Our modelling indicates that there is a direct effect on house prices, albeit a modest one; interest rates have the greatest influence. With that in mind, it's worth noting what the migration figures suggest in terms of house price growth by region. As the chart shows, the pickup in net migration hasn't been in the Auckland region, which didn't suffer much of a downturn in the first place. Instead, the growth has been in Canterbury – following an initial population loss

Monthly net migration by region (s.a.)



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

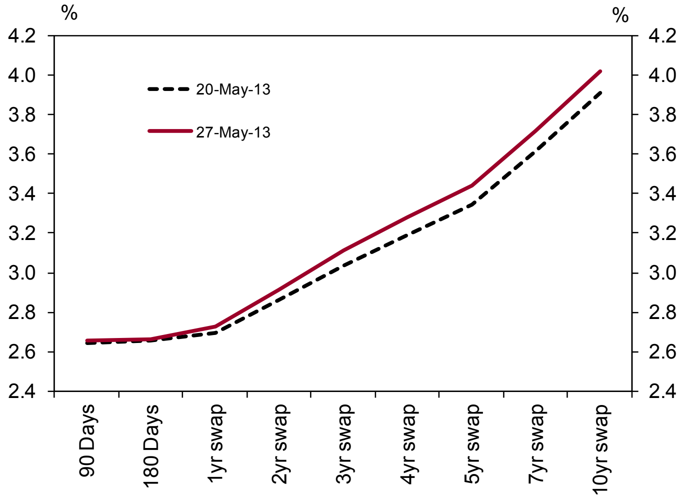
Published by Westpac, PO Box 934, Auckland, ph: (09) 348 9117. For further information contact Dominick Stephens, Michael Gordon, Nathan Penny or Felix Delbrück. For email address changes contact WNZResearch@westpac.co.nz

after the earthquakes – and more recently in the remainder of New Zealand. That's consistent with the fact that the major change has been fewer departures (which occur all around the country) rather than more arrivals (which tend to concentrate in Auckland). This trend is another reason to expect rising house prices to become more of a nationwide phenomenon over the course of this year.

Our view is that migration and housing are mostly linked by a common cause – the upswing in the economy. While the Canterbury rebuild may have been an early catalyst, the upturn is clearly becoming broader in scope. The number of indicators that are pointing up – whether it's migration, house prices, construction, retail spending, vehicle sales, consumer confidence, or manufacturing output – are suggestive of a recovery that is now becoming self-sustaining, after a few halting starts in recent years.

Fixed vs floating for mortgages: 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. That said, there is little upward pressure on banks' funding costs, and fixed-rate 'specials' remain a feature of the mortgage market. Consequently, while we favour fixing over floating for the next couple of years, there's scope to time your entry to take advantage of further fixed-rate deals.

NZ interest rates



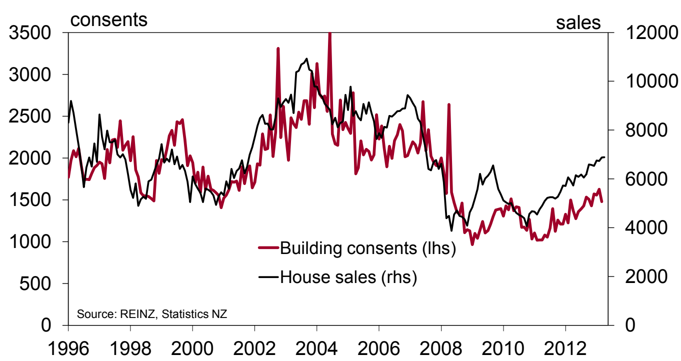
Key Data Previews

NZ Apr building consents

May 30, Last: -9.1%, WBC f/c: 13.0%

- March consents were dragged down by two factors: a drop in the volatile apartment consents to rock-bottom levels (from 142 to 16), and the early Easter holidays which meant one less working day than usual.
- Both of these factors will have reversed in April - in fact consents are likely to be above-trend, due to having one more working day than usual. We've assumed a 6% rise in non-apartment consents, but it could be higher.
- Growth in consents should continue to be led by Auckland and Canterbury, the regions where housing shortages are most apparent. Even with the Easter effect, consents in Canterbury reached a new record high in March, with the focus increasingly shifting away from the outer regions and towards Christchurch City itself.

NZ housing activity

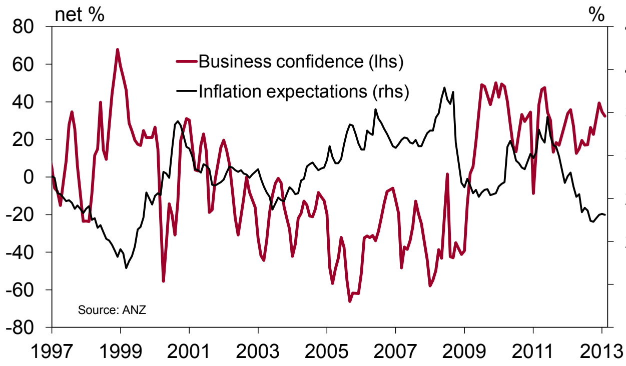


NZ May ANZ business confidence

May 31, Last: 32.3

- Business confidence has fallen in the last two months, largely within the agriculture and manufacturing sectors, which were affected by the drought over much of the country in February and March. Growing conditions have been more favourable since then, with both rain and warm weather.
- If the April survey proves to be the low point, then the knock-on effects of the drought will have been surprisingly limited. We suspect that the survey will overstate the strength of GDP growth through the middle of this year, given the known impact on agricultural volumes.
- Lower fuel prices and another subdued inflation print in late April suggest that inflation expectations could fall back towards their 13-year lows. We expect annual inflation to fall to just 0.7% in the current quarter.

NZ business confidence and inflation expectations

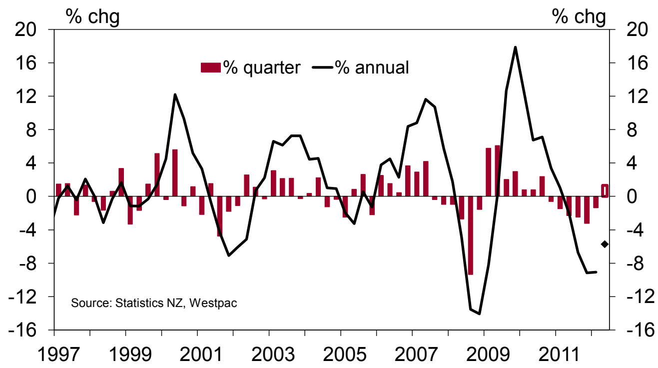


NZ Q1 terms of trade

May 31, Last: -1.4%, WBC f/c: 1.5%

- We expect a 1.5% rise in the terms of trade in Q1, though after falling through 2012, it will remain 5.5% lower than at March 2012.
- The Q1 data will mainly reflect weak world inflation, compounded by a strong NZ dollar. We expect a 1.5% fall in import prices. Export prices are forecast to be flat, as falls in other export prices offset the very early stages of the dairy price spike.
- We estimate that export volumes rose 2.5% in Q1, in large part due to the record meat slaughter during the worst of the drought.
- World dairy prices surged higher from March 2013, though this will not be captured in the terms of trade until the June quarter. Combined with weak world inflation, we expect the dairy price surge to push the terms of trade to a record high by the end of 2013.

NZ Terms of Trade

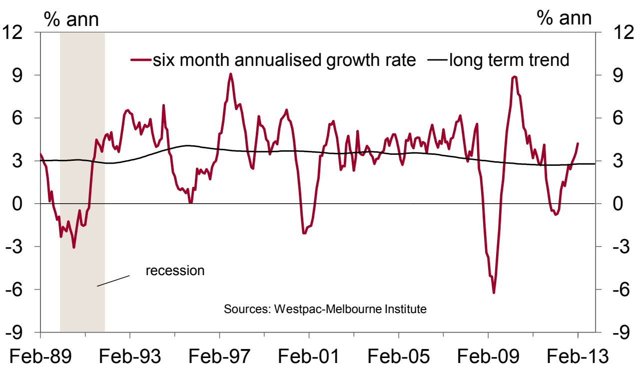


Aus Mar Westpac–MI Leading Index

May 29, Last: 4.2% annualised

- The **Westpac–Melbourne Institute Leading Index** continued to show a lift in momentum in Feb. The annualised growth rate of the index, which indicates the likely pace of economic activity three to nine months into the future, was 4.2%, comfortably above the long run trend of 2.8%. That said there remain question marks over how well this momentum will be sustained over the course of 2013.
- The March release will see mostly weaker updates of monthly data including: equities (ASX –2.7% vs +4.5% in Feb); money supply (+0.5% vs +0.2% in Feb); US industrial production (+0.3% vs +0.9% in Feb); and dwelling approvals (–5.5% vs +3.0% in Feb). Looking ahead, April will see the inclusion of quarterly updates for Q1 with sharply weaker data on overtime worked (–11% vs +13% in Q4) and manufacturing materials prices (flat vs +1.1%qtr in Q4).

Westpac-MI Leading Index

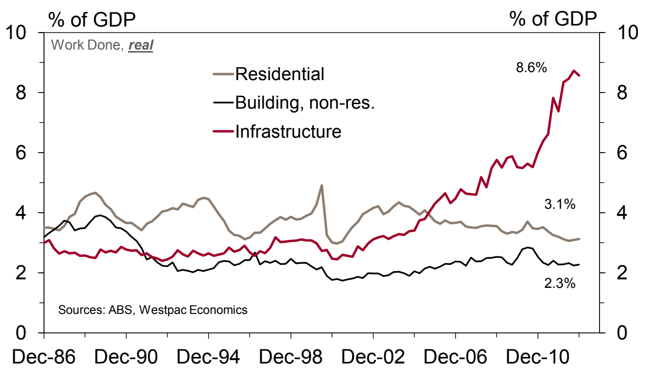


Aus Q1 construction work done

May 29, Last: –0.1%, WBC f/c: 1.0%
Mkt f/c: 1.0%, Range: –2.0% to 3.2%

- Construction work continued to trend higher in 2012, although there was a loss of momentum. Work is forecast to rise by 1.0% in Q1, following a broadly flat Q4. Annual growth, pending revisions, will moderate to 4% from 12%.
- Private infrastructure activity has lost considerable momentum as mining investment approaches a peak. We anticipate a 2% rise, reversing a 2.5% fall in Q4.
- Private building strengthened in 2012, up 5.7%, following a 1.5% rise in 2011. We anticipate a further modest gain in Q1, with new dwelling construction trending higher.
- Public construction, down 5% over 2012 on lower building work, is likely to be flat to down in Q1.

Construction

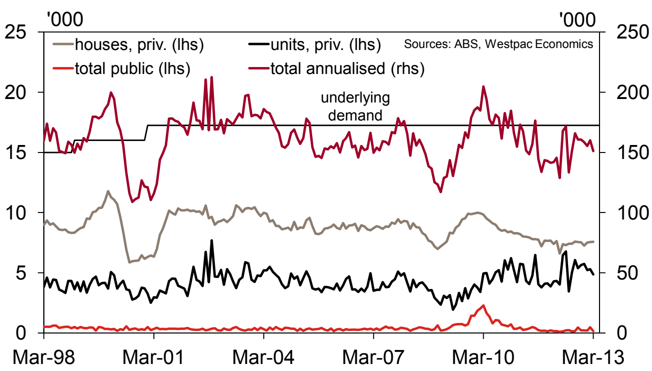


Aus Apr dwelling approvals

May 30, Last: –5.5%, WBC f/c: 4.0%
Mkt f/c: 4.0%, Range: 2.0% to 7.0%

- Dwelling approvals posted a sharp 5.5% fall in March, extending what has been a disconcertingly weak start to 2013. Although the decline was concentrated in 'units' rather than detached houses, the March fall was more than just noise due to lumpy 'high rise' projects with several months now of weakness in the 'low to mid-rise' segment that had driven most of the earlier gains.
- While that suggests the recovery has lost some momentum in 2013 the picture from finance approvals is more promising. Finance for construction and for the purchase of newly built dwellings (which covers 'off the plan' sales) jumped 10% in March and is trending higher at a 25% annualised pace. This burst may take a few months to flow through fully to dwelling approvals though. Overall we expect a solid bounce though with approvals rising 4% in April.

Dwelling approvals

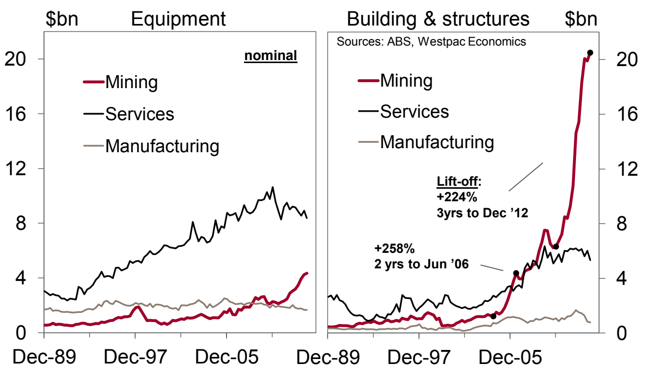


Aus Q1 private capex

May 30, Last: –1.2%, WBC f/c: flat
Mkt f/c: 0.5%, Range: –2.1% to 3.0%

- Private business is in cost control mode. CAPEX spending has hit a flat spot in our view. We expect spending to be unchanged in Q1, following a 1.2% dip in Q4. Annual growth will moderate to 2% from 10%.
- Building & structures spending is expected to edge 1.5% higher, offsetting falls of 0.9% in Q3 and 0.6% in Q4.
- Equipment spend fell 2.3% in Q4 and the risk is a further fall in Q1. We anticipate a decline in the period of around 2.8%. Capital imports were sharply lower and the mood of business remained downbeat.

CAPEX: by industry by asset

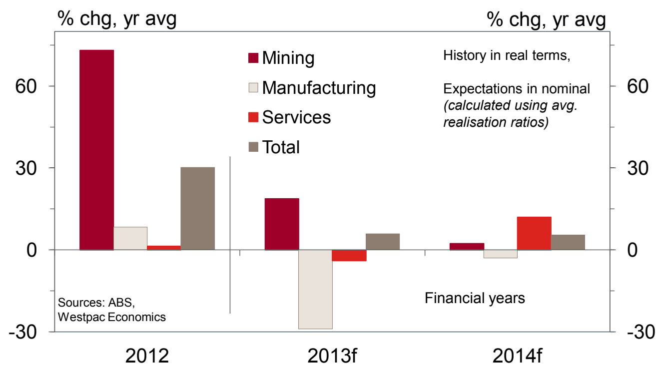


Aus 2012/13 & 2013/14 capex plans

May 30

- Estimate 5 of capex for 2012/13 was $168bn. We calculate that this implies an actual outcome of $164bn, a 6% rise on 2011/12. By its nature, this calculation is sensitive to “realisation ratios”. Est. 6 will need to hold steady at $168bn to also imply a rise of 6%.
- Est. 1 of 2013/14 was $152.49bn, implying an actual outcome of $173bn, +5.5%, on our calculations.
- Estimate 2 needs to be around $157bn to also imply a rise of 5.5% (assuming the 2012/13 figure is as anticipated).
- The risks are skewed to the downside. Mining is increasingly focused on cost cutting and the initial estimate of services capex for 2013/14 appeared to be overly optimistic. A figure for Est 2 closer to around $151bn may be more likely, implying growth of 1% (subject to Est 6 for 2012/13).

CAPEX: plans by industry

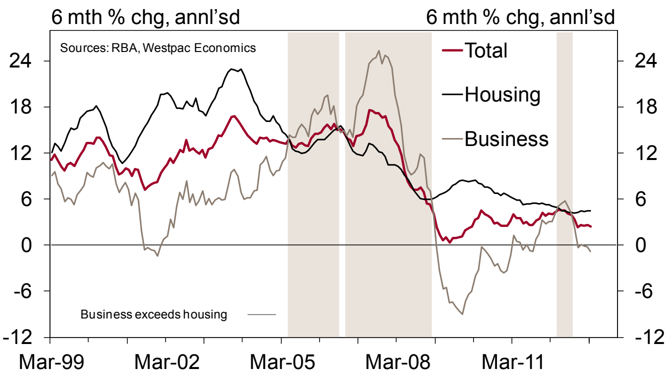


Aus Apr private sector credit

May 31, Last: 0.2%, WBC f/c: 0.2%
Mkt f/c: 0.3%, Range: 0.2% to 0.4%

- Credit to the private sector is expanding at a slow pace, increasing by 0.2% in each of the initial three months of 2013. Annual growth slowed to 3.2% in March.
- Monthly credit growth is likely to hold at 0.2% in April. This will, absent revisions and rounding issue, see annual growth dip to 2.9%, the first sub 3% result since August 2011.
- Business credit has stalled since mid 2012, following a 4.4% increase in the year to June 2012. The risk is another flat outcome in April.
- Housing credit growth strengthened a touch in Q1, to 1.2%, from 1.1% in Q4, as new lending responds to low interest rates. We expect housing credit to rise 0.4% in April.

Credit momentum

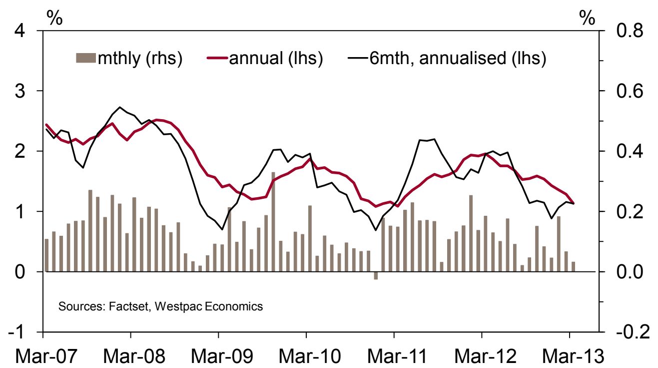


US Apr core PCE deflator, personal income/spending

May 31, Core PCE deflator: Last: –0.1%, WBC f/c: –0.2%
May 31, Personal income: Last: 0.2%, WBC f/c: 0.1%
May 31, Personal spending: Last 0.2%, WBC f/c: 0.0%

- Personal income jumped in Q4 2012 as remuneration was pulled forward to avoid the tax increases that came into effect from 1 January 2013. With these distortions now out of the way, income growth is likely to return to a soft trend pace.In April we expect a 0.1% rise following March’s 0.2%.
- Q1 was a mixed quarter for consumption, despite the healthy headline result for Q1 GDP. Durables and non-durables consumption growth both weakened through the quarter; in contrast, services activity rose owing to unusually cold weather. A services reversal is likely in April, while goods consumption is likely to be soft. A flat result seems likely.
- Inflation pressures are non existent in the US at present. A further decline in prices is likely in April, circa –0.2%.

US core PCE deflator



Key Data and Events

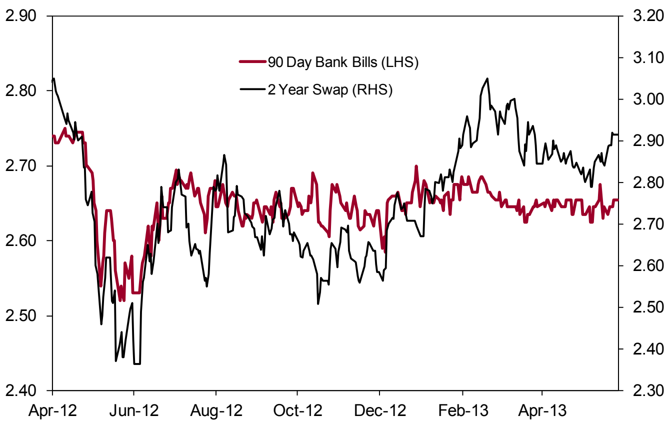
		Last	Market median	Westpac forecast	Risk/Comment
Mon 27					
Chn	Apr industrial profits %ytd	12.1%	–	–	On a modest upswing but held back by soft nominal activity rebound.
UK	May Hometrack house prices	0.3%	–	–	Tentative date: 27/5 to 4/6
Tue 28					
UK	May Nationwide house prices	–0.1%	0.3%	–	Tentative date: 28/5 to 1/6
US	Mar house prices	1.2%	0.9%	0.8%	S&P Case-Shiller 20-city index.
	May Richmond Fed manuf. index	–6	–	–	Regional indexes have mostly been soft in May to date...
	May Dallas Fed manuf. index	–15.6	–	–	... will slowdown persist as was the case in previous years.
	May consumer confidence	68.1	70.0	–	Confidence remains sub par despite stock market strength.
Wed 29					
Aus	Mar Westpac–MI leading index	4.2%	–	–	As at Feb, momentum was comfortably above trend. Will it sustain?
	Q1 construction work done	–0.1%	1.0%	1.0%	Trending higher. New dwelling construction up. Mining losing momentum.
Ger	May unemployment chg	4k	5k	–	Germany remains the outlier for the region; Q2 looks better than Q1.
Thu 30					
NZ	Apr building consents	-9.1%	-	13.0%	Bouncing back from an early Easter distortion.
Aus	Apr dwelling approvals	–5.5%	4.0%	4.0%	Recovery has lost momentum in 2013 but finance app's up strongly in Apr.
	Q1 private capex	–1.2%	0.5%	flat	Business in cost control mode. Equipment spend likely fell for a 2nd qtr.
	2013/14 private capex plans, AUDbn	152	–	–	Est1 was relatively positive - possibly overly so. See textbox.
Eur	May economic confidence	88.6	89.0	–	Enduring weakness apparent throughout the region ...
	May business climate indicator	–0.93	–	–	... unsurprisingly, firms remains very concerned over outlook.
US	Q1 GDP second estimate	2.5%	2.5%	2.5%	Revisions likely offsetting for second estimate.
	Apr pending home sales	1.5%	2.0%	1.7%	Lead on existing home sales; momentum has waned in 2013.
	Initial jobless claims	340k	341k	340k	Week ending 25 May.
Fri 31					
NZ	May ANZ business confidence	32.3	-	-	Confidence high, but drought will weigh on real activity mid-year.
	Apr private sector credit %yr	3.8%	-	-	Housing credit growing steadily, business flat except property/business services
	Q1 Terms of Trade	-1.3%	-	+1.5%	Dairy prices surging through 2013.
Aus	Apr private sector credit	0.2%	0.3%	0.2%	Housing growth inching higher, but still soft. Business flat.
Eur	May CPI flash estimate	1.2%	1.4%	1.1%	Inflationary pressures absent; disinflation more likely.
	Apr unemployment rate	12.1%	12.2%	12.2%	PMI's point to further deterioration in activity in Q2.
UK	May GfK consumer confidence	–27	–26	–	Confidence in outlook remains weak.
	Apr net consumer credit £bn	0.5	–	–	Consumers' appetite for credit remains soft ...
	Apr mortgage lending £bn	0.4	–	–	... will improved house price trend bolster demand?
	Apr M4 money supply	0.3%	–	–	M4 ex IOFCs up 4.6% annualised in Mar (from 7.9% yr in Aug).
US	Apr personal income	0.2%	0.2%	0.1%	Soft income growth to persist in 2013...
	Apr personal spending	0.2%	0.1%	0.0%	... limiting support for household spending.
	Apr PCE deflator	–0.1%	–0.2%	–0.2%	Inflation pressure non existent; puts focus on activity for FOMC.

New Zealand Economic and Financial Forecasts

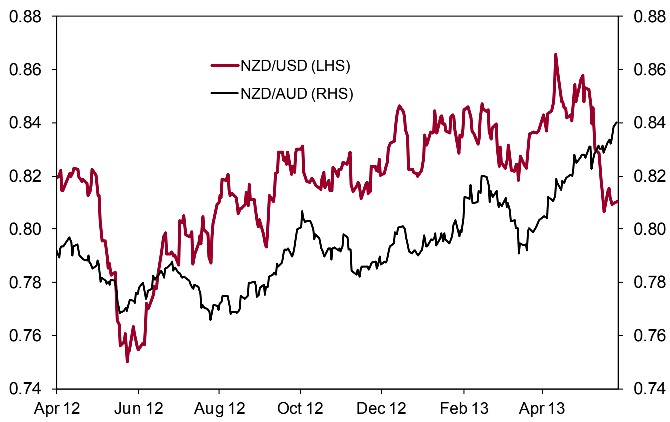
Economic Growth Forecasts		March years				Calendar years		
% change	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
GDP (Production) ann avg	1.9	2.5	2.9	3.7	1.4	2.5	2.8	3.6
Employment	1.0	0.4	2.4	2.8	1.5	-1.4	3.2	3.2
Unemployment Rate % s.a.	6.7	6.2	5.7	4.8	6.3	6.8	6.1	5.0
CPI	1.6	0.9	1.4	2.5	1.8	0.9	1.3	2.3
Current Account Balance % of GDP	-4.4	-4.9	-4.6	-5.6	-4.0	-5.0	-4.5	-5.3

Financial Forecasts	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
Cash	2.50	2.50	2.50	2.75	3.00	3.25
90 Day bill	2.65	2.70	2.75	3.00	3.25	3.50
2 Year Swap	2.90	3.00	3.10	3.30	3.50	3.70
5 Year Swap	3.40	3.45	3.50	3.60	3.70	3.85
10 Year Bond	3.30	3.40	3.45	3.50	3.55	3.60
NZD/USD	0.82	0.84	0.85	0.85	0.84	0.83
NZD/AUD	0.84	0.84	0.86	0.88	0.88	0.86
NZD/JPY	82.0	83.2	83.3	82.5	80.6	78.9
NZD/EUR	0.63	0.64	0.66	0.68	0.68	0.67
NZD/GBP	0.54	0.54	0.54	0.55	0.54	0.52
TWI	76.8	77.9	79.2	80.2	79.4	78.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 27 May 2013

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.64%	2.64%	2.64%
60 Days	2.65%	2.64%	2.64%
90 Days	2.66%	2.64%	2.66%
2 Year Swap	2.92%	2.87%	2.85%
5 Year Swap	3.44%	3.37%	3.30%

NZ foreign currency mid-rates as at Monday 27 May 2013

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.8103	0.8288	0.8482
NZD/EUR	0.6265	0.6393	0.6500
NZD/GBP	0.5354	0.5397	0.5473
NZD/JPY	81.94	84.46	83.09
NZD/AUD	0.8403	0.8284	0.8251
TWI	76.43	77.52	78.23

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	2.0	2.8
Unemployment %	5.6	5.2	5.2	5.4	6.2	6.0
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.6	-3.3
United States						
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	1.9	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	-3.0	-3.1	-3.2
Japan						
Real GDP %yr	-5.7	4.9	-0.4	2.0	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	2.0	1.4	-0.6	-0.8	-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	0.7	0.2
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 10 May 2013

Interest Rate Forecasts	Latest	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14
Australia						
Cash	2.75	2.50	2.50	2.25	2.00	2.00
90 Day Bill	2.80	2.55	2.55	2.30	2.10	2.10
10 Year Bond	3.32	3.20	3.40	3.25	3.10	2.85
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.00	2.00	2.20	2.10	2.00	1.80
ECB Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50

Exchange Rate Forecasts	Latest	Jun 13	Sep 13	Dec 13	Mar 14	Jun 14
AUD/USD	0.9670	0.98	1.00	0.99	0.97	0.96
USD/JPY	101.65	100	99	98	97	96
EUR/USD	1.2920	1.30	1.31	1.29	1.25	1.24
AUD/NZD	1.1960	1.20	1.19	1.16	1.14	1.14

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