Weekly Commentary

29 January 2013

Walking a fine line

On a trade weighted basis the New Zealand dollar has risen another 2% in January, taking it very close to the all-time highs reached in 2007. The soaring New Zealand dollar is hurting exporters and firms that compete with imports. But for consumers it is a boon, helping to keep inflation down. The current constellation of global economic and financial conditions is certainly aligned towards further appreciation of the NZD. Monetary easing among the major central banks has created a "search for yield" environment, boosting demand for New Zealand government bonds and other financial assets. We are now forecasting the NZD to average 87 cents against the US dollar in the third quarter of this year.

The performance of the New Zealand dollar, combined with the low level of inflation, has also prompted us to revise our interest rate forecasts. We now expect the OCR to remain at 2.5% until December 2013 (previously September 2013). And we have slightly moderated the forecast pace of hikes over 2014. To be sure, we still expect a more extensive OCR tightening cycle than markets are currently pricing. Our long-held view has been that the buoyant housing market and the Canterbury rebuild will provoke inflationary pressures, requiring tighter monetary conditions. However, it now seems that the high exchange rate is set to provide some of the necessary tightening, leaving less work for interest rates.

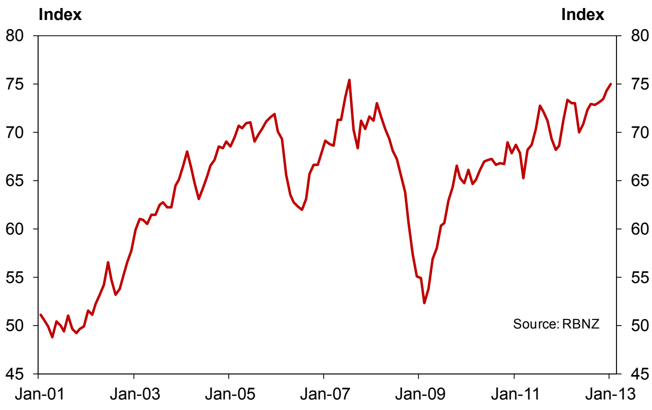
The RBNZ may well come to similar conclusions when it reviews the OCR this week. The main message of the December 2012 OCR review was that the post-earthquake reconstruction boom and the buoyant housing market would boost domestic demand and "cause inflation to rise gradually towards the 2 percent target". Next week's review the Reserve Bank may soften the commentary on inflation – perhaps something like "Inflation is now expected to rise towards 2 percent more gradually than previously assumed."

The high exchange rate will be one factor constraining the RBNZ's assessment of inflation. The other will be the recent inflation figures, which showed inflation was just 0.9% for 2012, compared to the Reserve Bank's forecast of 1.2%. That was the sixth consecutive inflation print to come in below the Reserve Bank's expectations, and once again the surprise was low prices for internationally tradable goods and services. The consistent direction of these surprises hints at some change in the economy's structure that could keep tradables inflation subdued for some time yet.

The key positive spin within the OCR review will be the assessment of domestic economic activity. Recent data has certainly suggested economic growth at the end of 2012 was stronger than the RBNZ anticipated. And for the week ahead we expect building consents data will provide further evidence that the construction sector is ramping up rapidly, both in quake-affected Canterbury and elsewhere – we have pencilled in a 6% increase in residential building consents for the month of December, although when apartments are excluded the forecast is a more modest 2%.

The RBNZ will be walking a fine line in this review – it will be keen to avoid any hint that the next change in the OCR could be down, for fear of stoking the overheating housing market. The RBNZ's new Policy Targets Agreement (PTA) requires it to monitor house prices and have regard to financial stability when setting monetary policy. Given these requirements, it would be difficult for the RBNZ to reduce the OCR when house prices are rising rapidly in an already-overvalued market – even with

NZD trade-weighted index



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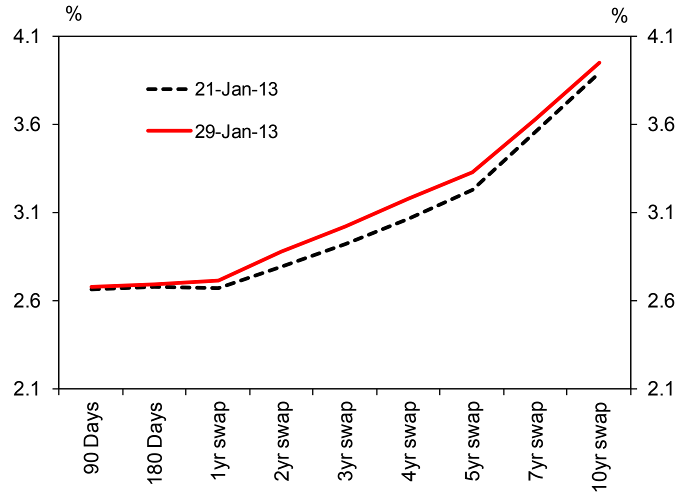
inflation below target. So we would expect the RBNZ to retain the barest of hiking biases by repeating the "bottom line" phrase from last December: "On balance it remains appropriate to leave the OCR on hold". We will be very interested to see whether the RBNZ goes a step further by actually mentioning the new PTA and the housing market as independent justifications for keeping the OCR at 2.5%.

On the same day as the OCR is released, we will get an oblique assessment of the housing market via the Reserve Bank's own December credit growth figures. Household credit grew 0.6% in November, compared to the 0.2-0.4% increases of earlier months. The balance of household credit tends to evolve only slowly, so this was a significant development - in fact, it was easily the largest monthly increase since February 2008. Another month of strong credit growth would really call into question whether terms like 'deleveraging' and 'rebalancing' are now appropriate descriptions of the New Zealand economy. New Zealand is really starting to feel more like an economy that is 'releveraging'" and becoming more 'imbalanced'.

Rounding out this week's data, the December Merchandise Trade Balance is revealed on Wednesday. We expect the seasonally adjusted trade balance will improve, although on an annual basis the deficit will widen. Improving world dairy prices will shine through as the main driver of the improved monthly balance, while drops in vehicle imports and in petroleum imports should keep the import bill contained.

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 late 2013. Fixed-rate specials are becoming less prominent than they were late last year 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



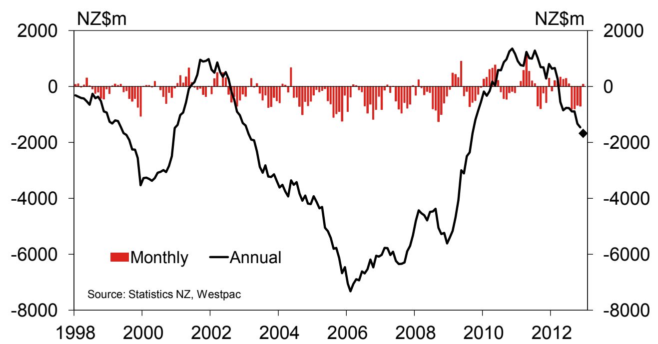
Key Data Previews

NZ Dec merchandise trade

Jan 29, Last: –$700m, WBC f/c: +$80m, Mkt f/c: –$105m

- We expect improving world dairy prices to continue to shine through in the December trade data. Dairy prices rose in line with rising world grain prices (owing to Northern hemisphere drought) and recovering Chinese demand for dairy products over the second half of 2012.
- Drops in vehicle imports and in petroleum imports, after a strong November, should see import values take a breather in December. Overall, we expect the trade balance to improve on a seasonally adjusted basis.
- On an annual basis we expect the trade deficit to widen in December, reflecting earlier weakness in export values. Further out, the annual trade deficit should narrow as dairy export values rise over 2013.

NZ merchandise trade balance

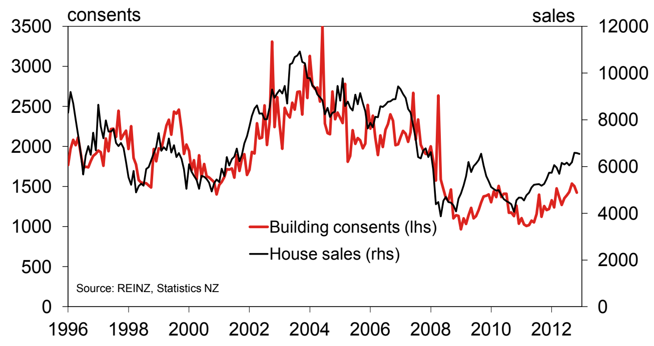


NZ Dec building consents

Jan 30, Last: –5.4%, WBC f/c: 6.0%

- Residential building consents have continued to trend higher, led in the first instance by post-quake rebuilding in the Canterbury region, but also in line with a broad-based pick-up in housing demand over the last year. We have assumed a 2% rise in ex-apartment consents in December.
- Total consents for November were weighed down by the volatile apartments component, which went from above-average to minimal. We've assumed a partial rebound to below-average levels, which leaves sizeable room for error on either side of our +6% forecast.
- Non-residential building consents are also trending higher now, especially in Canterbury. However, the lag to building activity tends to be long and variable, and the 12% surge in building work in Q3 is likely to have reflected a backlog of consented work.

NZ housing activity

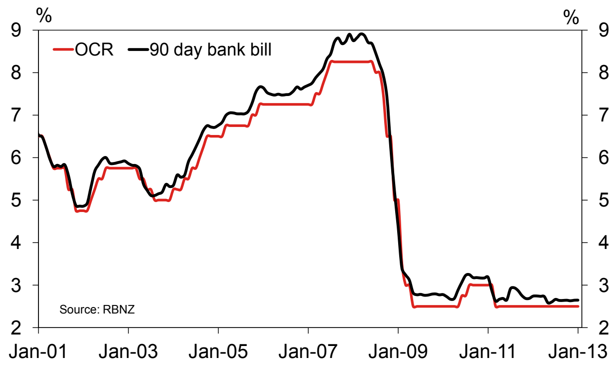


RBNZ OCR Review

Jan 31, Last: 2.5%, WBC f/c: 2.5%, Mkt f/c: 2.5%

- Low inflation and the high exchange rate will compel the RBNZ to soften its commentary on future inflation, making the OCR slightly more dovish than markets are anticipating.
- But we doubt the RBNZ will alter its "on hold" stance for the OCR, for fear of stoking the overheating housing market.
- The RBNZ might invoke its new mandate to monitor asset prices to explain the stance of monetary policy.

NZ OCR and 90 day rate

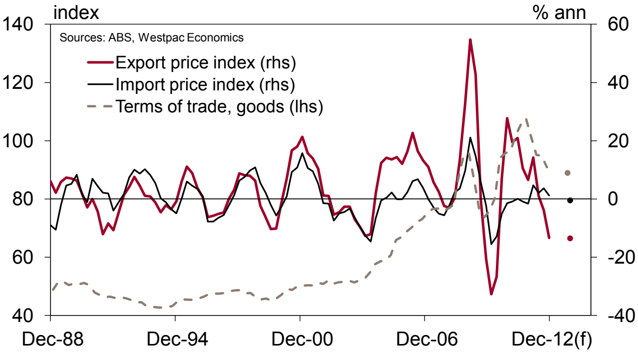


Aus Q4 import price index

Jan 31, Last: –2.4%, WBC f/c: 0.7%
Mkt f/c: 0.4%, Range: –2.0% to 1.2%

- Import prices most likely edged higher in the December quarter, to be little changed over the year.
- The import price index, covering goods but excluding services, is forecast to rise by 0.7% in Q4 to be 0.5% lower than a year earlier.
- The Australian dollar was unchanged at 104¢ vs the US dollar in Q4 but weakened 1.0% on a TWI basis. This, and a modest increase in global oil prices (+2%) will act to increase import prices.

Import and export prices



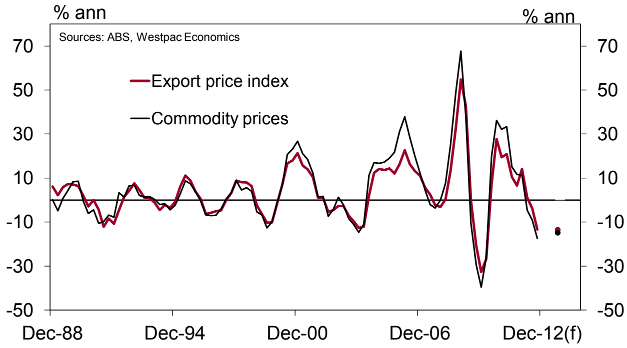
Aus Q4 export price index

Jan 31, Last: –6.4%, WBC f/c: –1.5%

Mkt f/c: –1.5%, Range: –2.5% to 1.0%

- Export prices weakened from the second half of 2011 and throughout much of 2012 as global demand slowed.
- Accordingly, the export price index declined, falling by a estimated 1.5% in the December quarter, after a slump of 6.4% in Q3. On our forecast, the index will be down 13.5% over the year and almost 15% below the peak of September 2011.
- Global commodity prices of Australian exports fell by around 2.0% in Q4, in both AUD and USD terms, although monthly readings have shown some improvement since Oct-Nov.
- Note, the export price index covers goods only.

Commodity prices and export index



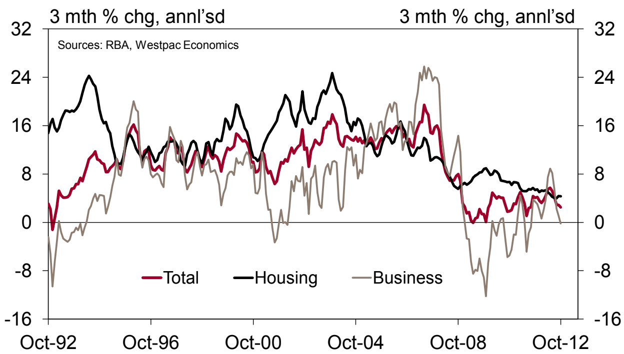
Aus Dec private credit

Jan 31, Last: 0.0%, WBC f/c: 0.2%

Mkt f/c: 0.2%, Range: 0.0% to 0.4%

- Credit growth, after some improvement during the first half of 2012, lost momentum as the year drew to a close.
- Business credit was somewhat stop-start in 2012. A 3.2% rise was recorded over the six months to July 2012, an acceleration from a 1.0% rise over the previous six months. However, confidence amongst firm has evaporated. Business credit initially consolidated and then slumped 0.6% in November. We're anticipating a flat result for December.
- Housing credit growth remains soft. A 0.40% gain was recorded in November, up fractionally from an average monthly rise of 0.35% during Q2 and Q3. Lower interest rates will boost demand for housing finance, although gains to date have been relatively modest.

Credit momentum



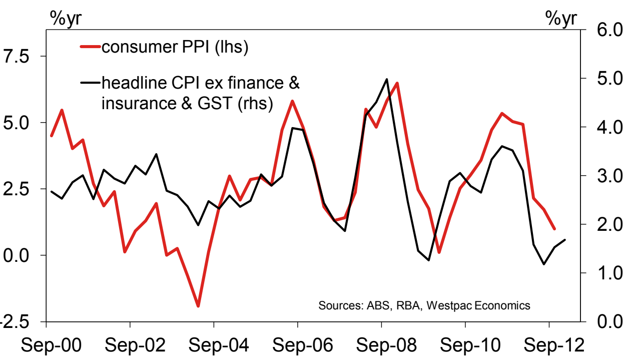
Aus Q4 producer price index (final stage) %qtr

Feb 1, Last: 0.6%, WBC f/c: 0.3%

Mkt f/c: 0.4%, Range: –0.3% to 0.7%

- The Sept quarter PPI printed below market expectations (0.6%qtr vs market 1.0%qtr). Given that this was the quarter when the carbon price was introduced, which should hit more predictably at the wholesale level, the very muted rise in the PPI suggests there are no significant 'upstream' price pressures in the supply chain.
- Now that the PPI is being released after the CPI, it is less useful for inflation forecasting purposes. The PPI is effectively now a second-order data release worth noting for risks to the medium-term inflation outlook but of little value for the near-term monetary policy debate. About the only positive from the changed release timing is that we can use various components in the CPI (dwelling construction, utilities, food and petroleum products) to help forecast the PPI.

Consumer PPI headline CPI

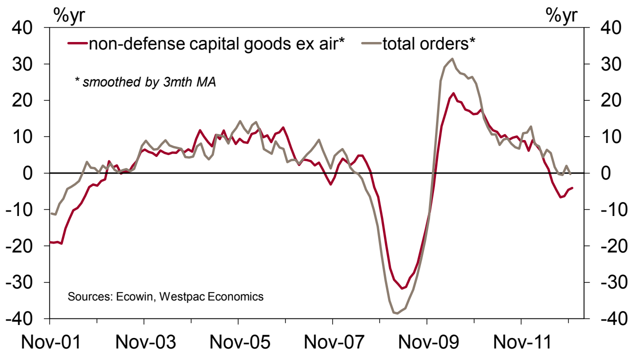


US December durable goods orders

Jan 28, Last: 0.8%, WBC f/c: 1.5%
Mkt f/c: 1.9%

- Durable goods orders rose by 0.8% in November, 0.8%yr. Core durable good orders (non-defense; excluding aircraft) were stronger, rising by 2.6% in the month to be up 1.1%yr.
- Core orders are a good leading indicator for near-term equipment investment growth. The recent improvement in orders points to an end to the deceleration in business investment growth seen through 2012.
- That being said, this series frequently prints weak quarter-end outcomes and, given the year-end uncertainty surrounding the fiscal cliff, a partial unwind of recent gains seems likely. We expect a –1.5% December result. A rise in Boeing orders in the month points to continued strength in transport orders in the month. Total orders will therefore likely see another rise in December, circa 1.5%.

US durable goods orders

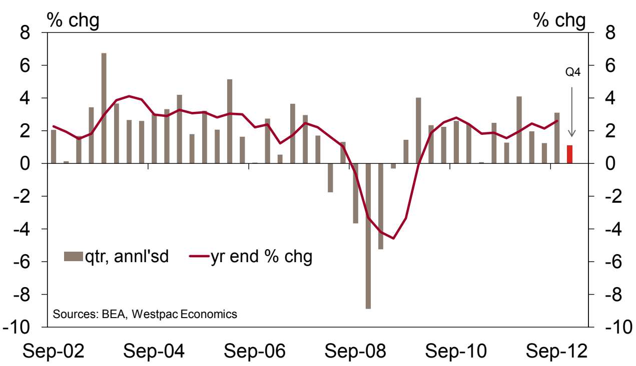


US Q4 GDP

Jan 30, Last: 3.1%, WBC f/c: 1.1%
Mkt f/c: 1.2%

- US GDP growth accelerated sharply in the September quarter, from 1.3% to 3.1% (annualised). Lacklustre services consumption growth offset further strength in durables. Business investment weakened in the quarter, but residential investment growth was robust. Net exports and inventories were supportive, as was government spending (thanks to a spike in defense spending).
- We expect a return to soft growth in Q4. Robust durable consumption growth will again be offset by persistent weakness in services consumption. Business investment likely declined again ahead of the fiscal cliff decision. After its Q3 spike, government spending will decline again in Q4. A smaller increase in inventories will be yet another drag. All told, that leads us to expect growth of 1.1% annualised.

US GDP growth

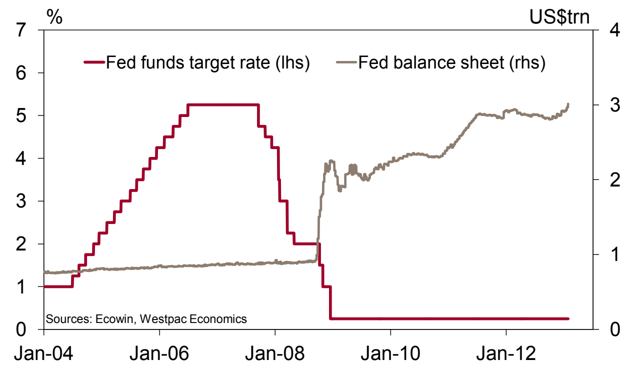


US FOMC decision

Jan 29–30, Last: 0.25%, WBC f/c: 0.25%
Mkt f/c: 0.25%

- The December meeting saw the introduction of additional Treasury purchases from January 2013 to offset the completion of the Fed's maturity extension program.
- Through 2013, the Fed will purchase $45bn in longer-term Treasury securities as well as $40bn in mortgage-backed securities per month. The buy-rate will depend on macroeconomic conditions as well as the perceived costs and benefits of these alternative measures.
- As we move through the year, the new explicit target for the unemployment rate (6.5%) will be a key benchmark for policy. Stronger employment growth that brings the unemployment rate nearer the benchmark will see alternative measures curtailed; but, an absence of said stronger employment growth will see QE persist indefinitely.

Fed funds target rate and balance sheet

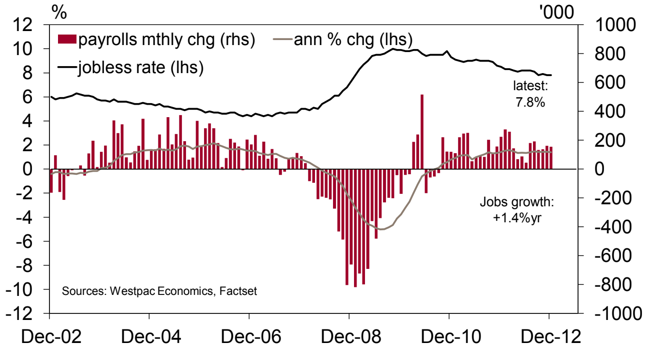


US January non-farm payrolls

Feb 1, Last: 155k, WBC f/c: 150k
Mkt f/c: 155k

- Private non-farm payrolls rose by 155k in December, broadly in line with the overall average of 2012. In the month, health care added 45k jobs, food services & beverages rose 38k, construction gained 30k, and manufacturing added 25k. While the addition of 153k per month is welcome, it is hardly strong.
- The household survey painted a much more sombre picture for December, reporting just 28k new jobs versus a 192k net addition to the labour force. The participation rate was unchanged, but the employment-to-population ratio edged lower to 58.6% to be just shy of its multi-decade low of 58.2%.
- For Jan, we expect to see another subdued non-farm payrolls print of 150k. The unemployment rate and participation rate will be unchanged at 7.8% and 63.6%. However, look out for initial annual revisions to payrolls.

US Payrolls



Key Data and Events

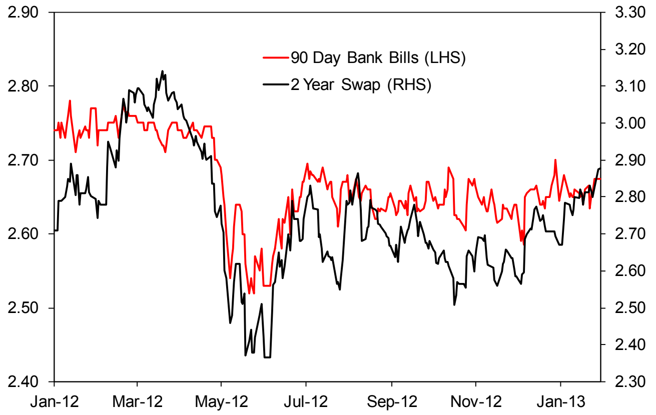
		Last	Market median	Westpac forecast	Risk/Comment
Tue 29					
NZ	Dec trade balance $m	–700	–105	80	Look for commodity export values to narrow trade deficit over 2013
Aus	Dec NAB business survey	–5	–	–	Conditions index at –5 is well below avg (+1) & down from +2 in Q1.
Ger	Feb GfK consumer confidence	5.6	5.7	–	Softer growth likely to weigh on confidence through H1 2013.
US	Nov S&P/C-S home price index	0.66%	0.70%	–	House prices are up 4.3%yr, led by areas most affected by GFC.
	Jan consumer confidence	65.1	64.0	–	Confidence weakens again; level weak.
Wed 30					
NZ	Dec building consents	–5.4%	6.0%	6.0%	Trending higher as the Christchurch rebuild picks up.
Eur	Jan economic confidence	87.0	88.0	–	Will 2013 bring stronger confidence?
	Jan business climate indicator	–1.12	–	–	Equities have fared well, but have actual conditions improved?
UK	Dec net consumer credit, £bn	0.1	0.3	–	Lending secured by buildings fell £0.2bn in Nov; Dec f'cast +£0.5m.
US	Jan ADP employment	215k	163k	–	Erratic leading indicator of payrolls.
	Q4 GDP, advance SAAR	3.1%	1.2%	1.1%	Soft growth set to return in Q4; likely to persist through 2013.
	FOMC policy decision	0.25%	0.25%	0.25%	Mixed data, improved market confidence; change in tone unlikely.
Thu 31					
NZ	RBNZ OCR review	2.50%	2.50%	2.50%	Softer commentary on inflation making this a slightly dovish review.
	Dec private sector credit %yr	3.3%	–	–	Housing lending accelerated in Nov.
Aus	Q4 import price index	–2.4%	0.4%	0.7%	Import prices up on weaker AUD (on a TWI basis) & higher oil prices.
	Q4 export price index	–6.4%	–1.5%	–1.5%	Export prices down as global commodity prices decline 2%.
	Dec private sector credit	0.0%	0.2%	0.2%	Business credit anticipated to stabilise following 0.6% slump In Nov.
Jpn	Jan Markit/JMMA manuf. PMI	45.0	–	–	Last above 50 in May. Moving in opposite direction to Asian trend.
	Dec industrial production %mth	–1.4%	4.1%	–	Stars are aligned for a strong bounce from depressed levels.
Eur	Jan CPI, %yr	2.2%	2.3%	–	Stronger EUR disinflationary impulse in early 2013.
Ger	Jan unemployment rate	6.9%	6.9%	–	Unemployment rose by 3k in Dec.
UK	Jan GfK consumer confidence	–29	–29	–	Weak macro conditions => confidence remaining absent.
	Jan Nationwide house prices	–0.1%	–	–	Down 1% over year.
US	Dec personal income	0.6%	0.8%	0.7%	PCE spending g'th weaker than retail on soft services; rose 0.4% in Nov.
	Dec PCE deflator	–0.2%	flat	flat	Core flat in Dec, 1.5%yr; inflation unlikely to concern in 2013.
	Jan Chicago ISM	48.9	51.0	49.5	Dec revised from 51.6 to 48.9; soft Jan likely.
	Initial jobless claims	330k	355k	340k	Has surprised to the downside of late; partial post-holiday reversal likely.
Can	Nov GDP	0.1%	0.2%	–	Up 1.1% over the year. Soft momentum likely to persist.
Fri 01					
Aus	Jan AiG PMI	44.3	–	–	Manufacturing index well in contractionary zone, avg'd 44.1 from April.
	Jan RP Data-Rismark house prices	–0.3%	–	1.3%	Daily index up solidly but less reliable due to low sales over holiday period.
	Q4 PPI final stage %qtr	0.6%	0.3%	0.3%	Construction, food & utilities in the Q4 CPI pointing to a soft PPI print.
Chn	Jan NBS manufacturing PMI	50.6	51.0	–	Output to lead the gain in headline, new orders may level off.
	Jan HSBC manufacturing PMI - final	51.5	52.0	–	Market expecting a slight mark-up on flash estimate of 51.9.
Eur	Dec unemployment rate	11.8%	11.9%	11.9%	Unemployment continues to rise throughout periphery – and in France.
	Jan PMI manufacturing, final	47.5	47.5	–	Advance release showed modest improvement, but still well below 50.
Ger	Jan CPI, %yr	2.0%	2.0%	–	Preliminary estimate, EU harmonised measure.
	Jan PMI manufacturing	48.8	48.8	–	Advance release pointed to solid improvement in manuf & services.
UK	Jan PMI manufacturing	51.4	–	–	PMI points to manufacturing growing, albeit at modest pace.
US	Jan payrolls	155k	155k	150k	Subdued employment growth, stable unemployment rate and part rate.
	Jan U. of Michigan consumer conf.(f)	71.3	71.3	–	Preliminary reading was 71.3, down on 72.9 in Dec. All weak.
	Dec construction spending	–0.3%	0.5%	0.2%	Recent improvement in residential sector promising, but level weak.
	Jan ISM manufacturing	50.7	50.5	50.5	Regional weakness points to downside risks.
	Jan vehicle sales, total mn	15.3	15.2	–	Durables consumption is outpacing non durables and services.

New Zealand Economic and Financial Forecasts

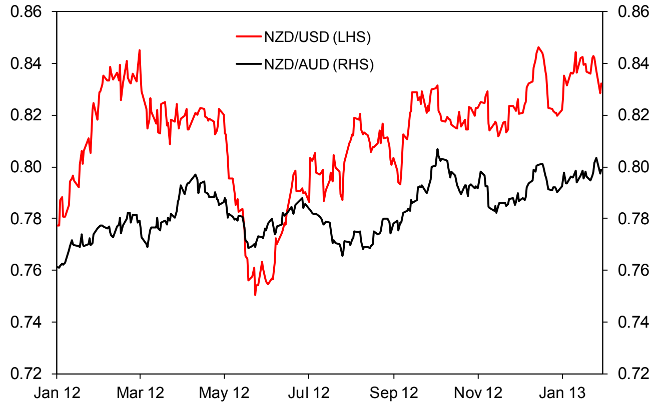
Economic Growth Forecasts		March years				Calendar years		
% change	2011	2012	2013f	2014f	2011	2012e	2013f	2014f
GDP (Production) ann avg	1.5	1.9	2.2	3.2	1.5	2.4	3.0	3.2
Employment	1.8	1.0	0.4	2.7	1.5	0.5	2.3	2.2
Unemployment Rate % s.a.	6.5	6.7	6.9	5.8	6.4	7.0	6.1	5.3
CPI	4.5	1.6	1.0	2.0	1.8	0.9	1.9	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	2.50	2.75	3.25	3.50
90 Day bill	2.70	2.70	2.75	3.20	3.50	3.75
2 Year Swap	2.80	2.90	3.00	3.20	3.60	3.90
5 Year Swap	3.30	3.40	3.50	3.70	4.00	4.30
10 Year Bond	3.60	3.70	3.80	4.00	4.20	4.40
NZD/USD	0.85	0.86	0.87	0.87	0.85	0.83
NZD/AUD	0.80	0.80	0.83	0.84	0.84	0.84
NZD/JPY	72.3	71.4	70.5	69.3	66.3	65.6
NZD/EUR	0.64	0.64	0.66	0.67	0.67	0.67
NZD/GBP	0.52	0.51	0.52	0.52	0.52	0.49
TWI	75.7	75.7	77.0	77.1	76.3	75.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 29 January 2013

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.66%	2.65%	2.66%
60 Days	2.67%	2.65%	2.67%
90 Days	2.68%	2.66%	2.66%
2 Year Swap	2.88%	2.79%	2.78%
5 Year Swap	3.33%	3.22%	3.21%

NZ foreign currency mid-rates as at Tuesday 29 January 2013

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.8323	0.8380	0.8458
NZD/EUR	0.6186	0.6275	0.6417
NZD/GBP	0.5303	0.5196	0.5230
NZD/JPY	75.477	74.829	71.383
NZD/AUD	0.7991	0.7949	0.8019
TWI	75.010	75.150	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 finalised12 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	2.98	2.95	3.00	3.10	3.10	3.00
10 Year Bond	3.32	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	1.85	1.70	1.90	2.00	2.30	2.40
ECB Repo Rate	0.75	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	1.0451	1.06	1.07	1.05	1.03	1.01
USD/JPY	90.465	81	81	80	79	78
EUR/USD	1.3368	1.29	1.31	1.29	1.27	1.24
AUD/NZD	1.2499	1.25	1.24	1.21	1.19	1.19