



Mt. Taranaki, Mt. Egmont National Park.

In this issue

Fixed vs floating	2
The week ahead	3
Data calendar	6
New Zealand forecasts	7
International forecasts	8

Tougher choices

Last week the Reserve Bank increased the OCR for a third consecutive time to 3.25%, and delivered much the same guidance on future interest rates as it did in its March *Monetary Policy Statement (MPS)*. Despite some prominent negative factors in the last few months – in particular the ongoing drop in world dairy prices – we had warned beforehand that the balance of risks hadn't shifted as much as markets seemed to think. Sure enough, there was a strong market reaction to the RBNZ statement, with wholesale interest rates and the New Zealand dollar jumping higher.

If there was any softening in the RBNZ's tone, it was only to the extent that it is now further down the monetary tightening path that it laid out in March. The RBNZ's projections, both then and now, suggested about 200 basis points of tightening over two years; with 75 basis points already under its belt, each subsequent OCR review becomes a little less pressing and more data-dependent.

That said, our impression is that the RBNZ is eyeing a fourth consecutive hike at the July OCR review, and the onus is on the data to persuade it otherwise. Hence, we've brought forward our forecast of the next hike from September to July – though we always recognised this as a close call, and it still is. What could potentially swing the RBNZ over coming weeks are the major data releases (GDP this week and inflation on 16 July) and the evolution of commodity export prices, the exchange rate and fixed-term mortgage rates.

Beyond the July review, the RBNZ's projections suggest that it intends to lift the OCR to 4.25% by March next year. While we are a little more downbeat on some aspects than the RBNZ – particularly house prices – we don't have sufficient reason to think that the RBNZ won't carry through with its intentions. We have revised our OCR forecasts to include hikes in October, January and March.

Tougher choices continued

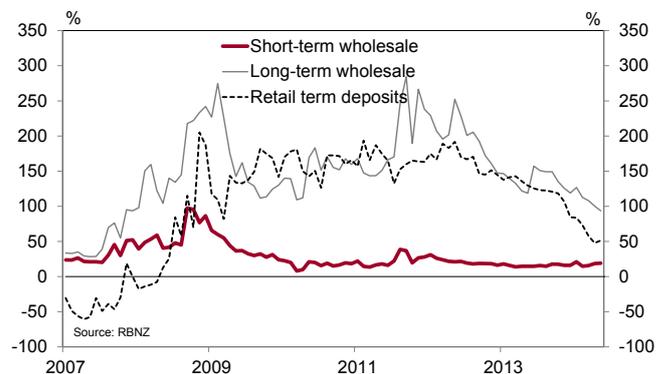
The RBNZ recognises that the economy is in a strong and broad-based upswing, growing at an annualised pace of around 4%. Building activity both in Christchurch and elsewhere is a key driver of growth, strong net inward migration is seen to be boosting consumer spending and house prices, and business and consumer confidence remain very high. The RBNZ judges that GDP is already running 1% above its non-inflationary potential, and that the gap will widen further this year.

Even so, the RBNZ still expects inflation to remain low over the next three years, and has actually lowered its near-term inflation forecasts since March, due to a weaker starting point (March quarter inflation is softer than expected) and a higher exchange rate. Inflation is expected to settle at the 2% midpoint of the RBNZ's target range over the medium term – on the condition, of course, that interest rates are back at 'normal' levels by that time.

One of the more significant changes to the RBNZ's views since March – and the one that the market seemed to be fixated upon beforehand – was a downgrade to its export price forecasts, reflecting the steep fall in world dairy prices in the last few months. While the fall has been greater than the RBNZ expected in March, it's also worth noting that prices have peaked at a higher level than the RBNZ thought. Furthermore, meat prices have been steadily rising. The net result was only a modest downgrade to the RBNZ's assumption about the long-term level of export prices.

Against this substantial negative factor, there were a number of positive surprises. Fiscal policy is less of a restraining factor now, due to the spending increases signalled in the May Budget. Net migration is tracking stronger than previously expected; recent RBNZ research has asserted a strong link between net migration and house price inflation, with the result that the RBNZ has actually upgraded its expectation for a resurgence in house prices over the second half of this year.

Bank funding margins (spread to OCR)



And perhaps most significantly, term interest rates are behaving in a very different way to what the RBNZ would have anticipated. It's not merely a local issue: a fall in global long-term interest rates has dragged rates down here as well. And on top of this, the risk premiums charged by international lenders have continued to narrow; while they're not yet back to pre-GFC levels, they are now a long way below their peaks. In New Zealand, these forces have manifested as a fall in some popular fixed-term mortgage rates, which risks re-stimulating the housing market.

The RBNZ clearly has some concern about this trend – its media release noted that the speed and extent of future OCR hikes will depend on financial as well as economic data. There's no sense that the RBNZ believes that it can combat this trend, given its global origins. But – like a more stimulatory fiscal policy – it forms part of the backdrop against which the central bank makes its interest rate decisions. Lower funding spreads, if sustained, would mean that the OCR has to do more of the tightening work.

Fixed vs Floating for mortgages

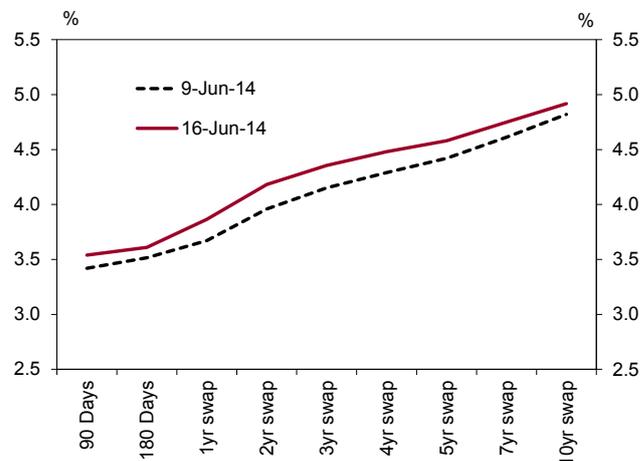
We believe that the current 2-3 year fixed-rate specials offer good value.

The standard fixed rates from around six months to three years appear to offer similar value, and are a fair reflection of where we think shorter-term rates are going to go over the next few years. However, there are a number of specials currently on offer, particularly for 2-3 year fixed terms, that are substantially below our expectation for short-term rates over those horizons. Fixed rates are more likely to rise than fall over the next few months, so for those who are looking to fix there is little to gain from waiting.

Fixing for four or five years may result in higher interest payments over the life of the loan than opting for shorter-term fixed rates. However, these longer-term fixed rates may still be preferred by those who are willing to pay for certainty.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates, such as the six month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates

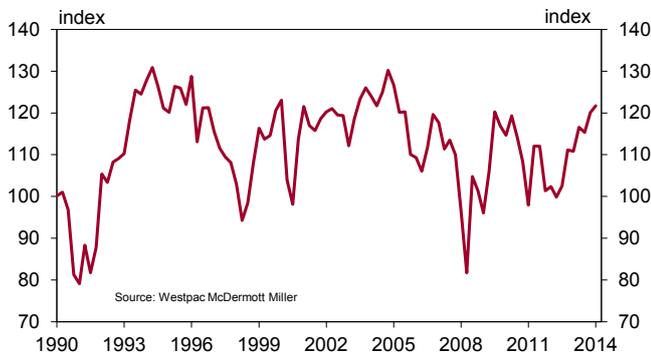


NZ Q2 Westpac-MM Consumer Confidence

Jun 16, Last: 121.7

- Consumer confidence edged up further in March, to its highest level since 2005.
- The lift in New Zealand consumer confidence has largely been driven by economic optimism, which in March approached levels last seen during the mid-1990s and mid-2000s boom periods.
- This optimism hasn't translated to spending appetites to the same extent. Consumers' sentiment about their own finances, and their attitudes towards discretionary spending, have also improved significantly, but were still well below previous cycle highs in March.
- The June survey was in the field over 1-10 June.

Westpac-McDermott Miller consumer confidence

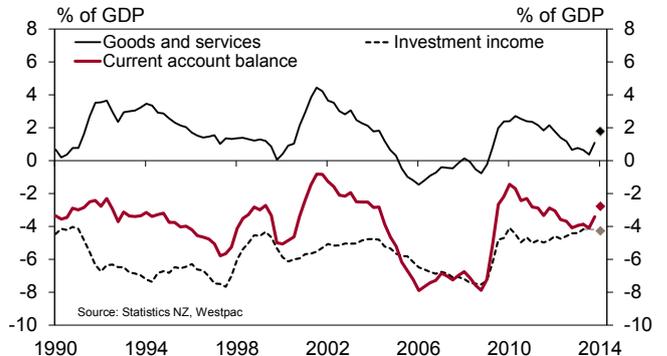


NZ Q1 current account % of GDP

Jun 18, Last: -3.4%, Westpac f/c: -2.8%, Mkt f/c: -2.8%

- We expect the current account deficit to narrow to 2.8% of GDP for the year to March, from 3.4% in December and 4.1% in September.
- Given that the balance is reported on an annual basis, the recent improvement reflects how things have changed compared to a year ago: in early 2013, export prices were edging down and a short but severe drought constrained milk production. By early 2014, both prices and volumes for dairy exports had bounced to record levels.
- The sharp improvement in the good trade balance will be augmented by a rise in services exports, reflecting a jump in spending by overseas visitors. The investment income deficit should widen a little, given the rising profitability of overseas-owned firms in New Zealand as the economy picks up.

Annual current account balance

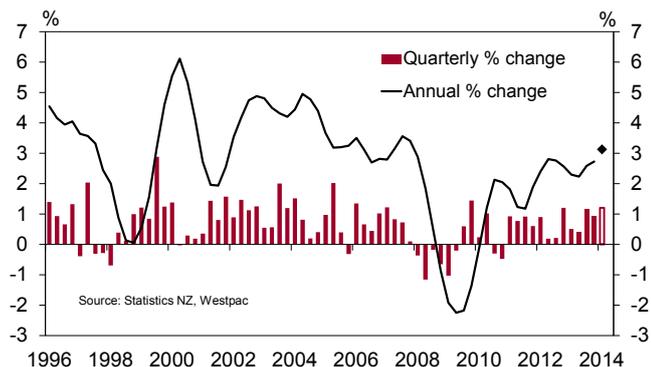


NZ Q1 GDP

Jun 19, Last: 0.9%, Westpac f/c: 1.2%, Mkt f/c: 1.2%

- We estimate that GDP grew by 1.2% in the March quarter, following gains of 1.2% and 0.9% over the two previous quarters. Barring any downward revisions to recent history, this would see the New Zealand economy's annual average growth rate top 3% for the first time since 2007, before the Global Financial Crisis hit.
- A 16% nationwide surge in construction activity - making up for some lacklustre outturns in the two previous quarters - accounted for around half of the rise in GDP over the quarter.
- Our forecast is in line with the market median and is similar to the RBNZ's forecast of 1.1%, which would have been prepared before the whopper construction figures were available.

Production based GDP

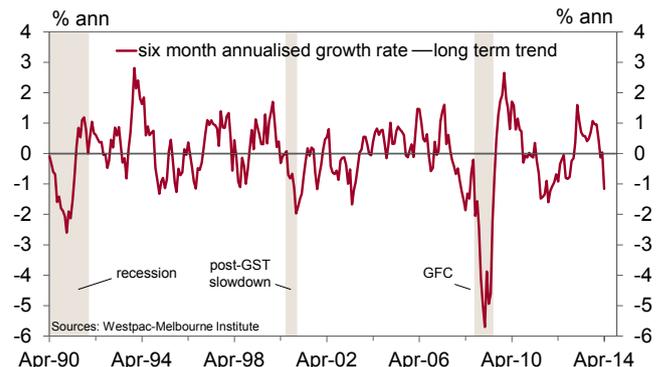


Aus May Westpac-MI Leading Index

Jun 18, Last: -1.16%

- The Leading Index recorded a sharp fall in Apr, the 6mth annualised growth rate of sinking to -1.16%, indicating growth momentum well below trend. This was the weakest reading since 2011 and a rapid turnaround on Oct's +1.07%.
- At least some of that sharp fall was due to factors that will reverse this month. In particular, hours worked declined 2.2% in Apr but bounced back 1.7% in May - reflecting the timing of public holidays in 2014 - and the CSI Expectations Index recorded a slight 1.6% recovery from its 9.8% post-Budget slump. The Unemployment Expectations Index, which was more resilient post-Budget, also registered a slight improvement. Against this though, financial components were mostly weaker with a further fall in commodity prices (-1%), a sharp 26bp narrowing in the yield gap but the ASX flat.

Westpac-MI Leading Index

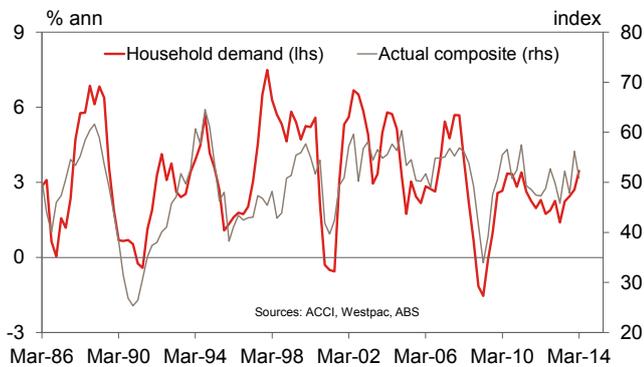


Aus Q2 Westpac-ACCI Survey of Industrial Trends

Jun 19, Last: 50.9

- The June quarter 2014 ACCI–Westpac Survey of Industrial Trends - the 211th report of this long running survey - will provide a timely update on the manufacturing sector and insights into economy wide trends. The June survey was in the field from May 13 to June 9.
- In the March quarter, the Westpac–ACCI Actual Composite moderated to 50.9 from 56.2. While a pull-back, the Composite remained above levels of a year earlier, evidence that manufacturing is benefitting from improved household demand.
- New orders consolidated in Q1, with a net 1% reporting a decline. That followed a burst in Q4, when a net 32% reported a rise in orders, the strongest reading since 1994.
- In the June survey, a key focus will be around the momentum of the current upswing. Record low interest rates are providing a tailwind but headwinds persist.

Westpac-ACCI composite index & household demand

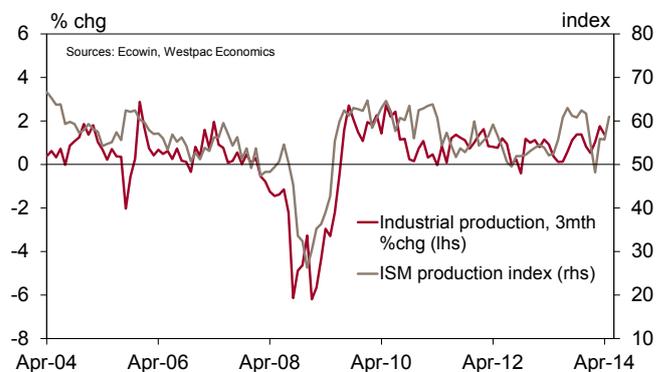


US May industrial production

Jun 16, Last: -0.6%, WBC f/c: 0.8%

- Industrial production saw broad-based weakness in April. Utility output fell 5.3% as the weather warmed, and factory production was down 0.4%, after surging 2.1% in Feb-March following January's snow disrupted 0.9% fall. Factory output was still up 0.9% compared to end 2013, so running about a 2.7% annualised pace since the start of the year.
- In May, the ISM production component soared to its highest for the year so far, at 61.0. Hours worked in factories rose 0.5%, led by durables. Auto sales were up sharply in May, despite weak orders in April for autos and indeed other equipment.
- In May, a partial rebound in utility output, and a solid factory production gain, with some offset possible from a small pull-back in mining after sharp March-April gains, should see IP rise by around 0.8%.

US industrial sector

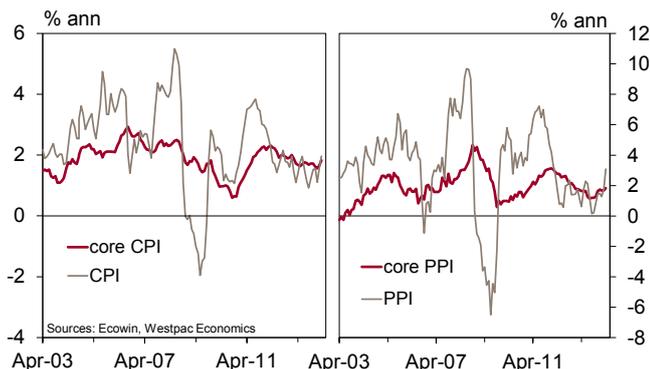


US May consumer price index

Jun 17, CPI core: Last: 0.2%, WBC f/c: 0.0%

- The CPI posted back to back 0.2% core rises in March and April which might be regarded as a tentative sign that inflation has found a base and will eventually edge back up towards the Fed's 2% target. The core rate's near two year downtrend from 2.3% yr in April 2012 to 1.6% yr in Feb 2014 looks to have reversed with April's 1.8% yr the highest in just over a year.
- But this year's late Easter meant that travel discounts that cut in after Good Friday/spring break occurred too late to impact the April data. Airfares for example rose 2.6% after seasonal adjustment but will fall sharply in May, which, along with some moderation in other prices (some also Easter related) could see a flat core outcome after rounding. That would pull the core annual pace back down to 1.7% yr. Food prices seem to have some upward momentum but higher gasoline prices should be offset by falling home energy costs for a 0.1% headline CPI gain.

US price inflation



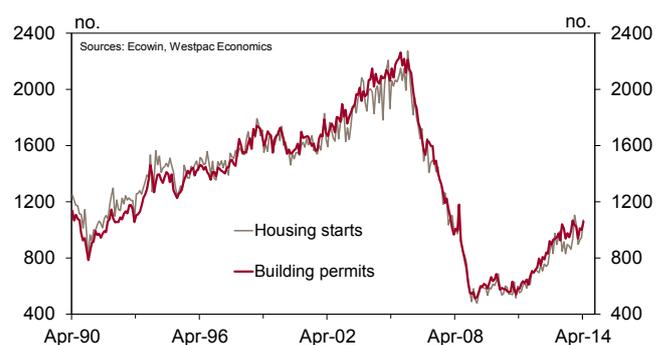
US housing starts/permits in May

Jun 17, Housing starts: Last: 13.2%, WBC f/c: 0.0%

Jun 17, Housing permits: Last: 5.9%, WBC f/c: 2.0%

- Starts/permits were again supported by multiples up 40%/20%, indeed with multiple permits running almost 20% ahead of starts in Jan-Apr, there is some prospect of sustainability here.
- A cumulative single starts rise of 11% in Feb-Apr recovered some of the 18% plunge in Dec-Jan. But the April singles pace of 649k remains 8.6% lower than the 2013 peak of 710k in Nov, and even the weather impacted Dec pace of 675k was higher than in March/April. This is consistent with the lack of any rebound in homebuilder confidence after its Feb plunge, and new house sales struggling this year below 2013's prevailing sales rate.
- With single family permits annualising to 598k so far in 2014 vs starts' 616k, there is some prospect that singles starts could drift lower again in coming months. So multiples up, singles down.

US housing starts & permits

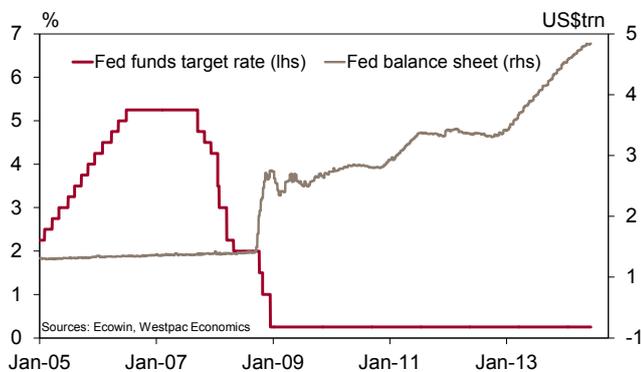


US FOMC meeting, statement, press conference

Jun 18

- A run of good labour market news but contracting GDP growth at the start of the year will keep Fed tapering of asset purchases in place despite some likely further downgrades to participants' growth forecasts for this year, after the central tendency was revised down from 3.0% to 2.9% in March. In testimony last month Janet Yellen said "economic activity will expand at a somewhat faster pace this year than it did last year" (2.6% yr in Q4 13) which requires GDP growth of at least 4% annualised in the current and next two quarters to get 2.7% yr by Q4 14. Q2 might manage that kind of bounce from the disruption in Q1, but that's very optimistic for H2 2014. One caveat: GDP annual revisions can be substantial and will be published in late July, and there is no indication which way those numbers will swing. Recent inflation outcomes have been higher but we suspect late Easter issues, as noted above: Yellen's comments would be interesting on this point, a day after the May CPI release.

Fed funds target rate and balance sheet



Data calendar

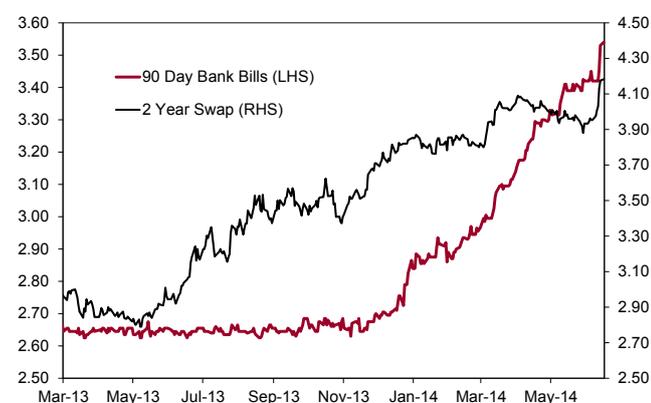
		Last	Market median	Westpac forecast	Risk/Comment
Mon 16					
NZ	Q2 Westpac-MM consumer confidence	121.7	–	–	Consumer confidence rose to a nine-year high in March.
	May Performance of Services Index	58.9	–	–	After a 7yr high in April, risks are to the downside.
Aus	RBA Assist. Governor Economic	–	–	–	Chris Kent speaking on labour market developments, Sydney, 1:20pm
Eur	May CPI %yr final	0.5%	–	0.5%	Still potential for CPI to edge to new lows later in 2014.
UK	Jun house prices %yr	8.9%	–	–	Rightmove index of asking prices.
US	Jun NY Fed index	19.0	15.0	–	Volatile of late, jumped from 1 to 19 in May.
	Apr TIC data \$bn	4.0	–	–	Net long term TIC flows.
	Jun NAHB housing market index	45	47	49	Struggling to recover to 56+ highs of 2013 and earlier this year.
	May industrial production	–0.6%	0.5%	0.8%	ISM and hours worked point to sharpish gain. See text box.
Can	May existing home sales	2.7%	–	–	Up three months running after 4 month winter slump (data are s.a.).
Tue 17					
Aus	May new vehicle sales	flat	–	1%	Easter timing dampened Apr sales, underlying trends subdued.
	RBA minutes	–	–	–	Is the Board more nervous than the decision statement let on?
Eur	Q1 labour costs	1.4%	–	–	Cycle low was 1.1% yr in Q3 last year, may yet be revisited.
Ger	Jun ZEW economic sentiment	33.1	33.8	36.0	Analyst expectations down every month this year but due to turn.
UK	May CPI %yr	1.8%	1.7%	1.7%	Late Easter boosted travel component in April, will reverse in May.
	May PPI %yr	1.0%	1.1%	–	Core output prices.
	Apr house prices %yr	8.0%	–	–	ONS series.
US	May housing starts	13.2%	–3.7%	0.0%	Multiples strength driving headlines but single family housing off
	May housing permits	5.9%	1.0%	2.0%	last year's highs. See text box.
	May CPI	0.3%	0.2%	0.1%	Higher gasoline prices, other energy lower, food prices up.
	May CPI core	0.2%	0.2%	0.0%	Easter effect on airfares etc to lower core CPI. See text box.
Wed 18					
NZ	GlobalDairyTrade auction	–4.20%	–	–	Recent declines suggest downside risk to dairy payout this season.
	Q1 current account % of GDP	–3.4%	–2.8%	–2.8%	Much improved conditions for exports compared to a year ago.
Aus	May Westpac-MI Leading Index	–1.16%	–	–	Momentum has dropped sharply in 2014.
Chn	May new property prices %net	52.9%	–	–	Consumer house price expectations rose in May on policy easing ...
	May secondary property prices %net	12.9%	–	–	... but secondary market will remain under the pump for the moment.
	Jun MNI business indicator	53.7	–	–	Reasonable predictor of direction of change in the two PMIs.
Eur	Apr construction output	–0.6%	–	–	Mild winter saw fewer stoppages but Q2 payback began in April
UK	Jun BoE MPC minutes	–	–	–	Arguments in favour of earlier rate rise building, not compelling yet.
US	Q1 current account \$bn	–81.1	–96.6	–	Wider trade deficit key driver.
	Jun FOMC meeting	0-0.25%	0-0.25%	0-0.25%	See text box. Yellen press conference.
Can	Apr wholesale sales	–0.4%	–	–	Mar fall driven by autos.
Thu 19					
NZ	Q1 GDP	0.9%	1.2%	1.2%	Surging construction accounts for about half of this growth.
Aus	Q2 ACCI-Westpac Survey of Ind. Trends	50.9	–	–	A timely update. Actual Composite down 5.4pts in Q1 but still above 50.
	RBA Q2 bulletin	–	–	–	Includes research articles.
UK	May retail sales	1.3%	–0.6%	–0.7%	Late Easter boost to April to largely reverse in May (as in CBI, BRC).
	Jun CBI industrial trends survey	0	2	–	Total orders index
US	Initial jobless claims w/e 14/6	317k	315k	315k	Claims downtrend stalled?
	Jun Philadelphia Fed factory index	15.4	14.0	–	In May, index held onto most of April's jump from 9 to 16.6.
	May leading index	0.4%	0.6%	–	Has not posted a fall for a full year now.
Fri 20					
Eur	Jun consumer confidence adv	–7.1	–	–	Confidence just shy of highs since euro notes and coins introduced
	Apr current account sa €bn	18.8	–	–	Large surplus a factor preventing euro depreciation
Ger	May PPI %yr	–0.9%	–	–	Just above cycle low of –1.1% yr in Jan.
UK	May PSNCR £bn	–10.6	–	–	Public sector net credit requirement.
Can	May CPI %yr	2.0%	2.0%	–	Right on target midpoint though core 1.4% yr in April.
	Apr retail sales	–0.1%	0.4%	–	March sales slipped on autos from Feb's record sales level.

New Zealand forecasts

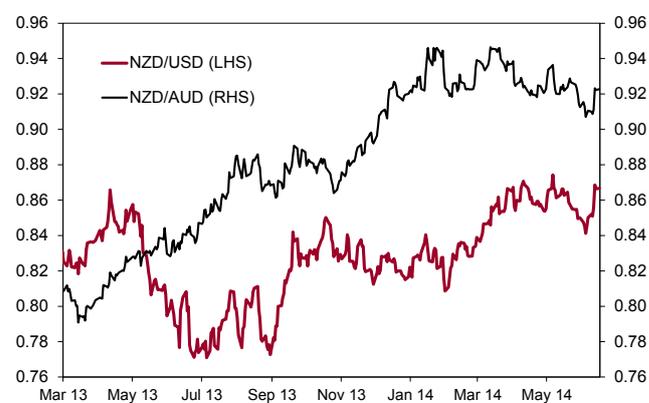
Economic Growth Forecasts	March years				Calendar years			
	2013	2014e	2015f	2016f	2012	2013	2014f	2015f
% change								
GDP (Production) ann avg	2.3	3.1	3.9	3.1	2.6	2.7	4.0	3.2
Employment	0.4	3.8	2.5	2.0	0.4	2.9	2.9	2.4
Unemployment Rate % s.a.	6.2	6.0	5.3	4.9	6.8	6.0	5.5	4.9
CPI	0.9	1.5	1.9	2.6	0.9	1.6	1.7	2.6
Current Account Balance % of GDP	-3.9	-2.8	-3.8	-4.2	-4.1	-3.4	-2.9	-4.4

Financial Forecasts	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
Cash	3.25	3.50	3.75	4.25	4.25	4.50
90 Day bill	3.40	3.70	4.00	4.30	4.45	4.60
2 Year Swap	4.20	4.40	4.60	4.80	4.90	5.00
5 Year Swap	4.60	4.80	5.00	5.10	5.20	5.30
10 Year Bond	4.50	4.60	4.80	4.90	5.00	5.05
NZD/USD	0.86	0.86	0.85	0.84	0.84	0.84
NZD/AUD	0.93	0.94	0.94	0.93	0.91	0.90
NZD/JPY	86.9	85.5	85.0	84.8	85.7	86.5
NZD/EUR	0.62	0.63	0.63	0.63	0.62	0.62
NZD/GBP	0.50	0.50	0.50	0.48	0.46	0.45
TWI	79.9	79.9	79.9	78.9	78.3	78.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 16 June 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.25%	3.00%	3.00%
30 Days	3.43%	3.31%	3.26%
60 Days	3.49%	3.39%	3.33%
90 Days	3.54%	3.42%	3.39%
2 Year Swap	4.18%	3.94%	3.98%
5 Year Swap	4.58%	4.37%	4.41%

NZ foreign currency mid-rates as at Monday 16 June 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8667	0.8452	0.8636
NZD/EUR	0.6400	0.6216	0.6307
NZD/GBP	0.5106	0.5047	0.5136
NZD/JPY	88.46	86.54	87.70
NZD/AUD	0.9227	0.9142	0.9214
TWI	80.73	79.04	80.25

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2010	2011	2012	2013	2014f	2015f
Australia						
Real GDP % yr	2.2	2.6	3.6	2.4	3.2	3.0
CPI inflation % annual	2.8	3.0	2.2	2.7	2.5	2.6
Unemployment %	5.2	5.2	5.3	5.8	6.2	5.9
Current Account % GDP	-3.5	-2.8	-4.1	-3.2	-2.5	-2.0
United States						
Real GDP %yr	2.5	1.8	2.8	1.9	1.7	2.6
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.6	1.6
Unemployment Rate %	9.6	8.9	8.1	7.4	6.5	5.9
Current Account %GDP	-3.0	-2.9	-2.7	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.5	1.3	1.3
Euroland						
Real GDP %yr	2.0	1.6	-0.6	-0.4	0.8	1.0
United Kingdom						
Real GDP %yr	1.7	1.1	0.3	1.8	2.6	2.1
China						
Real GDP %yr	10.4	9.3	7.7	7.7	7.2	7.6
East Asia ex China						
Real GDP %yr	7.8	4.4	4.0	4.0	4.2	5.0
World						
Real GDP %yr	5.2	3.9	3.2	3.0	3.1	3.7
Forecasts finalised 6 June 2014						

Interest Rate Forecasts	Latest	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Australia						
Cash	2.50	2.50	2.50	2.50	2.50	2.50
90 Day Bill	2.69	2.60	2.55	2.55	2.55	2.65
10 Year Bond	3.78	3.90	4.00	4.10	4.30	4.50
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.60	2.60	2.70	2.80	3.00	3.20
ECB Repo Rate	0.15	0.15	0.15	0.15	0.15	0.15

Exchange Rate Forecasts	Latest	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
AUD/USD	0.9410	0.92	0.91	0.90	0.90	0.92
USD/JPY	101.80	102	101	100	101	102
EUR/USD	1.3560	1.36	1.35	1.32	1.32	1.33
AUD/NZD	1.0860	1.07	1.06	1.06	1.07	1.10

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Disclaimer continued

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