



Sunrise over Mt. Ruapehu crater.

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Not so fast

Developments over the past week or two have served to increase the odds of OCR cuts later this year – odds that we already felt were approaching fifty-fifty. However, we remain firmly of the view that the RBNZ will leave the OCR on hold this week. It is possible that the *Monetary Policy Statement* will give an explicit signal of future cuts. But more likely, the RBNZ will stick to the conditional easing bias it articulated in April.

There are three reasons we consider a cut at this week's *MPS* unlikely:

- In April the RBNZ set out two clear conditions for OCR cuts– wage and price setting behaviour would have to settle below the inflation target, and domestic demand would have to cool. Those conditions have not been met. Indicators of current domestic demand have remained very firm (especially the housing market), and inflation expectations have not fallen as much as expected.
- Changing the OCR now would be out of keeping with normal RBNZ behaviour. Every series of OCR changes since 2005 (except the emergency cut following the 2011 earthquake) has been preceded by a blunt signal consisting of a sloping 90-day interest rate forecast and a comment in a press release along the lines of “...we are likely to..” or “...we expect to..” reduce/increase the OCR. No such signal has been given on this occasion.
- By our reckoning, the inflation outlook has not changed dramatically since April, when the RBNZ first articulated its conditional easing bias. Downside data developments have been largely offset by the falling exchange rate.

We see two plausible scenarios for the commentary accompanying this week's OCR decision. The first possibility is that the RBNZ will use this *Monetary Policy Statement* to signal an impending OCR reduction. We view this as the less likely scenario, but it is still worth articulating so that everybody is prepared. In this scenario the 90-day interest rate forecast would fall to 3.2% or lower by December 2015, and would probably be flat thereafter. The key sentence of the press release would read something like:

“Providing wage and price setting behaviour remains subdued, we expect to reduce the OCR later in the year.”

The surrounding text would contain plenty of caveats and commentary about the timing of cuts depending on the data, so that the RBNZ still has an out if needed. But the use of the word “expect” would still be a very powerful signal to markets.

Not so fast continued

The second possible scenario is the one we view as most likely – that the RBNZ retains some form of conditionality to its easing bias. In this case the 90-day interest rate forecast would be flat at 3.6% (which is close to the current level), or at most would feature a slight downward slope over the course of two years. Either forecast would imply a risk of OCR cuts but no conviction. The risk of cuts (as opposed to an expectation) could be further conveyed via alternative scenarios within the *Monetary Policy Statement*. For example, back in March the RBNZ published an alternative scenario in which inflation expectations drop away and the 90-day rate falls.

The press release accompanying such an *MPS* would probably contain generally dovish commentary, including observations that the economy has more spare capacity than previously thought, export sector incomes are falling, and recent policy changes might help cool the overheated housing market. However, the statement would also note recent strong data relating to the housing market and domestic demand. The core policy guidance sentence would not be substantively different from April – the RBNZ would still say something along the lines of:

"If... [insert conditions here] ...it may become appropriate to lower the OCR."

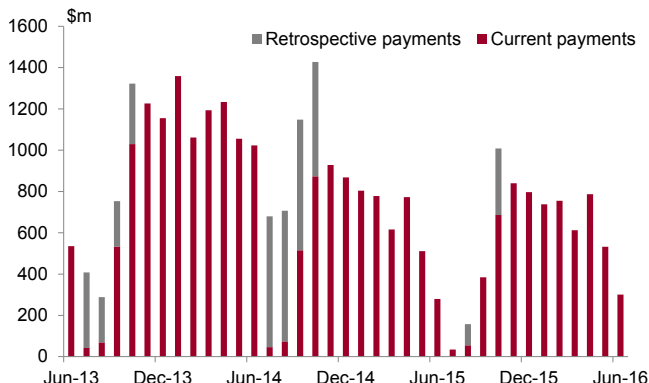
Should our preferred scenario come to pass, markets would be disappointed. However, the potential for two-year swap rates or the exchange rate to rise vigorously is limited, because markets will probably continue to price in future OCR cuts.

In an effort to avoid a lurch higher in the exchange rate, the RBNZ is going to have to repeat the "unjustified and unsustainable" characterisation that has become such a security blanket for markets. Our guess at the RBNZ's exchange rate paragraph would be something like:

"The exchange rate has fallen recently, but it remains unjustified and unsustainable given recent weakness in export commodity prices. A further fall in the exchange rate would be welcome."

While we remain adamant that a cut this week is unlikely, the arguments in favour of OCR cuts later in the year are gaining ground. Last week's 4.3% fall in the global dairy auction price was both surprising and important. Dairy auction prices are now down almost 30% from February's short-lived price spike, and we have downgraded our forecast of Fonterra's farmgate milk price for 2015/16, to \$5.40 per kilogram of milk solids.

Fonterra revenues distributed to farmers and shareholders



Fonterra's own recently-released forecast is \$5.25. Neither Fonterra's forecast nor ours is likely to be the last word, but Fonterra's number carries important implications for advance payments to farmers in spring. Farm cashflow has actually been quite reasonable until recently, but is about to drop off a cliff. Payments to Fonterra suppliers and shareholders over July, August and September 2014 totalled \$2.53bn. Over the same months of 2015 payments will total just \$0.58bn.

On our travels around New Zealand we have detected growing angst about this impending cashflow crunch, even if the business environment more generally remains positive. That angst appeared to show through in last week's ANZ Business Outlook survey, which registered a marked drop in business confidence and a fair-sized drop in businesses' own business activity expectations, although the survey does remain consistent with strong economic growth.

These recent developments have bolstered the case for OCR cuts at some point later this year. However, there has also been an offset in the plunging exchange rate – the trade weighted index is down 7.4% since 21 April, and it could fall further if the US Federal Reserve remains on track to hike interest rates in September. Whether the OCR actually falls this year or not remains a close call – we will reassess our OCR forecast after this week's *Monetary Policy Statement*.

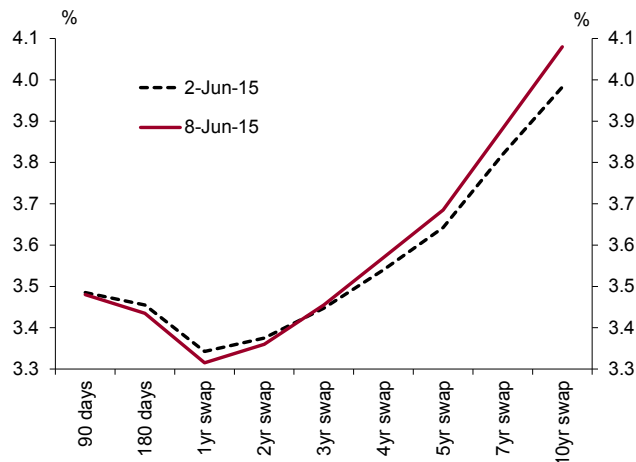
Fixed vs Floating for mortgages

With short-term interest rates more likely to fall than to rise over the year ahead, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability. For borrowers with a deposit of 20% or more, the best value probably continues to lie in the two-year ahead and three-year ahead terms. Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the next four or five years, though the gap has continued to narrow.

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

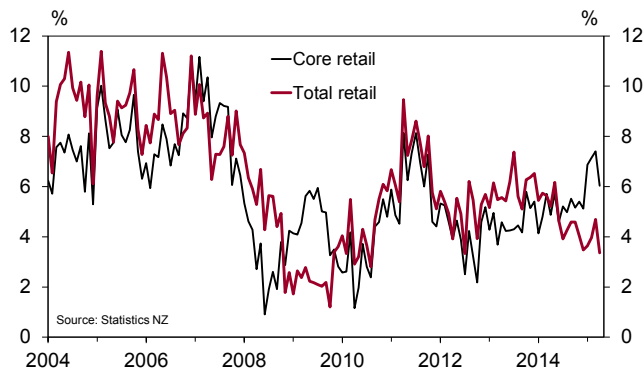


NZ May retail electronic card spending

June 10, last -0.7%, Westpac f/c: 0.6%

- Electronic retail spending fell back sharply in April, after growing very strongly over February and March.
- We suspect this was a temporary pull-back, in part reflecting the end to a very strong tourist season (visitor numbers surged in February, though we suspect this was mainly due to the Chinese Lunar New Year confusing Western seasonal adjustment algorithms, rather than the Cricket World Cup).
- That said, there are a number of factors suggesting a more moderate pace of growth from here – surveyed consumer confidence has eased back over the past six months, and petrol prices have been rising again.

Card transactions, annual % change

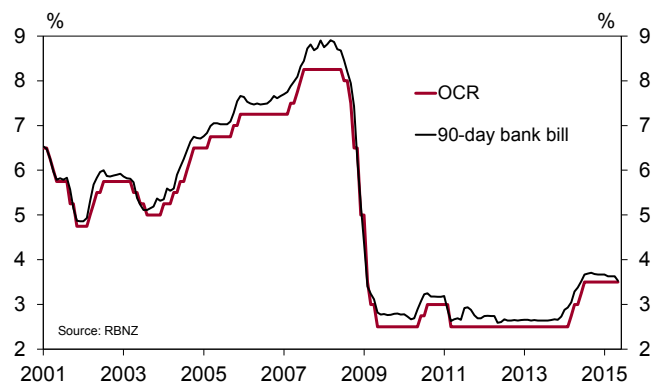


RBNZ Monetary Policy Statement

Jun 11, Last: 3.50%, Westpac f/c: 3.50%, Market f/c: 3.50%

- Market expectations of OCR cuts have ramped up significantly in recent weeks, with a recent poll showing 6 out of 16 economists picking a cut in Thursday's Monetary Policy Statement.
- We remain of the view that the RBNZ will leave the OCR on hold next week, sticking to the conditional easing bias that it articulated in the April review. However, we acknowledge the risk that the RBNZ could give a more explicit signal of future rate cuts.
- Recently developments have served to increase the odds of OCR cuts later this year. But as the New Zealand data weakens, the exchange rate has fallen. So whether OCR cuts will prove necessary remains a close call.

NZ OCR and 90-day rate

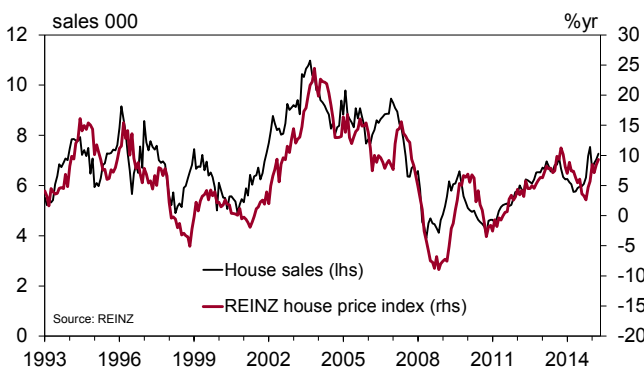


NZ May REINZ house prices and sales

Jun 12 (tbc), Sales last: 3.2%, Prices last: 9.3%yr

- The housing market has continued to strengthen in recent months, fuelled by population growth, falling mortgage rates and a shortage of available listings. Price growth in Auckland has significantly outstripped the rest of the country; we think that the recent push to reduce regulation around the use of land in central Auckland has played an important part in this.
- Two major housing policy measures were unveiled in mid-May: a tightening of loan-to-value limits for property investors in Auckland (and a loosening for all buyers in the rest of the country) and a firming up of the tax rules for investors who buy and sell within two years. We will be closely watching the impact of these measures, but we wouldn't expect it to be visible in the May data.

REINZ house prices and sales



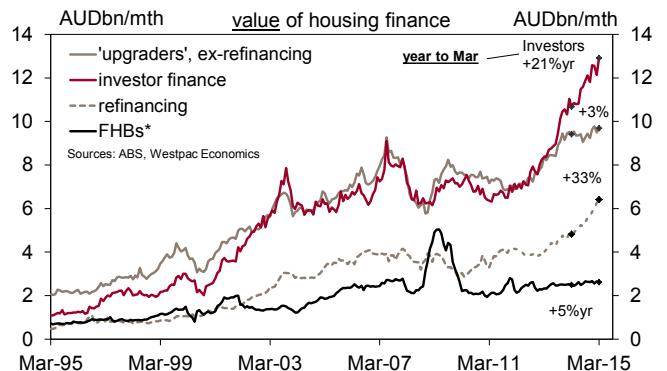
Aus Apr housing finance (no.)

Jun 9, Last: 1.6%, WBC f/c: -1.5%

Mkt f/c: -2.0%, Range: -4.0% to 1.0%

- The 1.6% rise in owner occupier finance approvals in March was almost entirely due to a surge in refinancing (+4% mth, 21% yr) with loans ex refi up just 0.3% mth, and down 3% yr. Construction-related approvals were soft but the value of loans to investors jumped 6.4% (clearly no impact of 'macro-prudential pressure' on this segment so far).
- Industry data suggests owner-occupier approvals were down a touch in April, a somewhat surprising result given the February rate cut and strong auction activity. This likely reflects regional disparities with auctions only a meaningful indicator for Sydney and Melbourne. We expect approvals to show a 1.5% dip. There will again be keen interest in the investor numbers which may start to show the impact of regulatory efforts to contain credit growth in this segment.

Value of finance approvals by segment

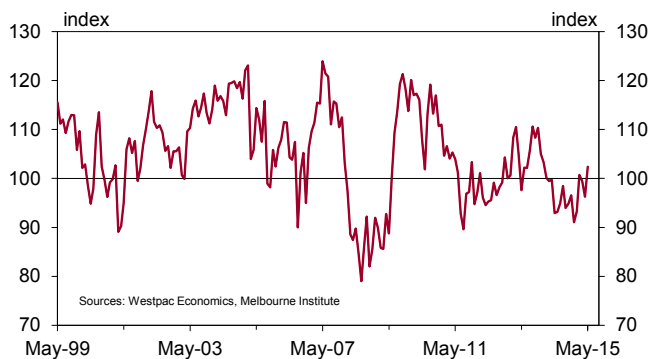


Aus Jun Westpac-MI Consumer Sentiment

Jun 10 Last: 102.4

- May saw the Westpac-Melbourne Institute Consumer Sentiment Index post a welcome bounce into positive territory – rarely seen in recent years – as the boost from a better than feared Federal Budget combined with a 25bp rate cut from the RBA.
- The June update will include reactions to the RBA's June decision to leave rates on hold, with an apparent 'soft easing bias'; a better than expected Q1 GDP result, albeit with the detail and other data releases such as the Q1 Capex expectations still showing weak conditions across many key parts of the economy; and a further decline in the sharemarket (ASX now down 6½% since the Apr survey). More generally, policy-related sentiment bounces like that seen in May do tend to retrace a little in subsequent months.

Consumer Sentiment Index



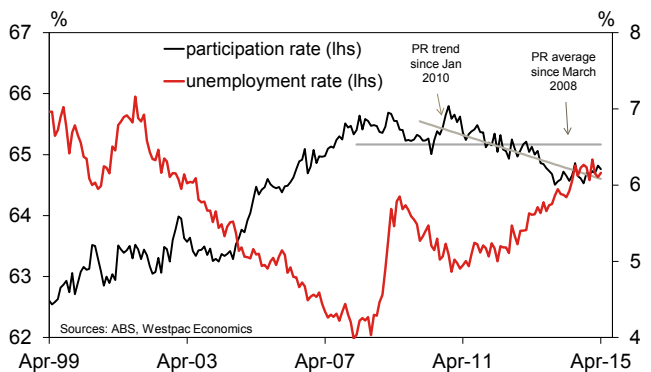
Aus May unemployment rate

Jun 11, Last: 6.2%, WBC f/c: 6.2%

Mkt f/c: 6.2%, Range: 6.1% to 6.3%

- The 2.9k fall in total employment in April, given a broadly flat participation rate (64.8%), was enough to generate a 0.1ppt rise in the unemployment rate to 6.2%. At two decimal places it rose from 6.10% to 6.16%, so it was a soft 6.2%.
- The unemployment rate, with revisions, is now reported as peaking at 6.3% in December 2014. So far in 2015, the Labour Force Survey has been reporting better labour market outcomes than in late 2014.
- If we hold the participation rate at around 64.8%, the current pace of working age population growth will drive a 23k rise in the labour force. As such, our forecast for the unemployment rate rounds down to 6.2% which, if all else is held as is, suggests there is an upside risk to this forecast.

Unemployment and participation rates



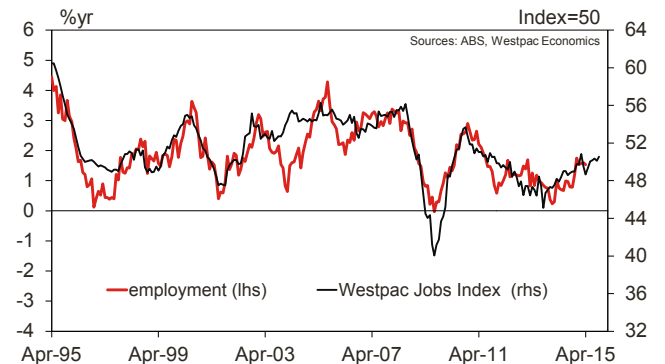
Aus May employment change

Jun 11, Last: -2.9k, WBC f/c: +12k

Mkt f/c: 13.5k, Range: -5k to +20k

- Total employment fell just 2.9k in April, roughly mid-way between Westpac's forecast (-10k) and the market's expectation (5k). Estimates ranged from -20k to +20k.
- The detail painted a mixed picture. Full-time employment fell 21.9k in April while part-time employment rose 19.0k. Full-time employment grew 100.6k/1.3%yr compared to 77.0k/2.2%yr for part-time employment. The trend for more robust growth in part-time employment has returned.
- A very robust signal came via hours worked which rose 1.1% in April, building on the 0.4% bump in March but it is curious that the hours worked gains are concentrated in Victoria.
- The Westpac Jobs Index has been on an improving trend since November and the data to date for May continues to point to employment growth of around 1¾%yr.

Jobs Index volatile around a 1¾%yr jobs pace

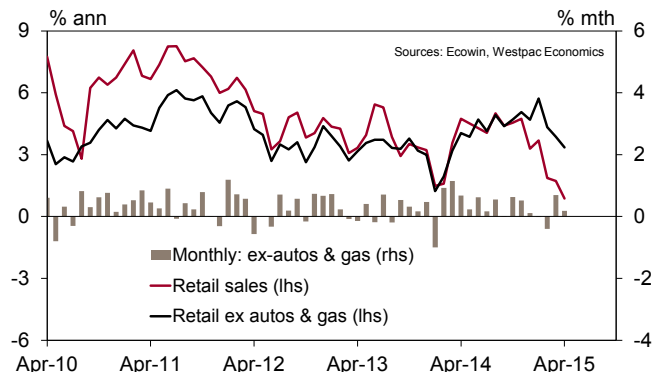


US May retail sales

Jun 11, Last: 0.0%, WBC f/c: 0.7%

- Retail sales were flat in April, with modest declines in auto and gasoline sales offsetting a 0.2% gain in core retailing. Gains and losses across most storetypes were not steep, and nothing really stood out in the detail.
- Lower import prices would have weighed on these nominal sales figures but by mid April the US dollar was weakening again limiting further near-term drag on sales values. To the extent April lost pre-Easter/spring break spending to March (Good Friday was April 3), May might show some correction.
- The May retail headline will also be boosted by stronger auto sales and the recent recovery in gasoline prices. But with the dividend from lower gasoline prices not really spent and now being eroded, and incomes growth subdued, consumer behaviour might mean core retailing disappoints again.

US retail sales



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
sometime this week					
Chn	May new loans RMBbn	805	–	–	Interbank market volumes are high but is it transmitting?
	May total credit RMBbn	1050	1150	–	Considerable interest in new flows of bond and equity financing.
	May M2 money supply %yr	10.1%	10.5%	–	Slowdown highlights the need for a more assertive central bank.
Mon 8					
Aus	Queen's Birthday	–	–	–	Public holiday (excluding WA).
Chn	May trade balance USDbn	34.1	44.9	–	Exports may bounce, but import bill weighed down by price collapse.
Eur	Jun Sentix investor confidence	19.6	19.0	20.0	May PMI survey revised higher;.
US	May labour market conditions index	–1.9	–	–	Fed's LMCI at weakest for 3yrs (later in 2012 Fed embarked on QE3).
Can	May housing starts	–4.1%	–	–	Single family starts up 11.4%, multiples down 14.2% in April.
	Apr building permits	11.6%	–	–	Residential rose 11.6% but non-res surged 22.1% in March.
Tue 9					
NZ	Q1 manufacturing sales	0.9%	–	–	The last major sectoral indicator ahead of Q1 GDP.
Aus	Apr housing finance	1.6%	–2.0%	–1.5%	Industry figs point to a dip despite Feb rate cut. All eyes on investor loans.
	May ANZ job ads %mth	2.3%	–	–	Up 7.3%yr, a moderation from the 14%yr pace in Jan but still a +ve outlook.
	May NAB business survey	4	–	–	Conditions index at +4 which is > LR avg. But confidence +3 < LR avg.
Chn	May CPI %yr	1.5%	1.3%	–	Major interest in rents, private housing, for additional signs of healing.
	May PPI %yr	–4.6%	–4.5%	–	Deflation most pronounced upstream where excess capacity reigns.
Ger	Q1 labour costs %yr	2.0%	–	–	Down from 3.8%yr two years earlier.
UK	May BRC retail survey %yr	–2.4%	–	–	Same store sales. Post Easter downside effect to correct higher.
	Apr trade balance £bn	–10.1	–9.9	–	Exports rose 1.3% while imports fell 1.0% in March.
US	May NFIB small business optimism	96.9	97.0	96.0	Hiring intentions component +11% in April.
	Apr wholesale inventories	0.1%	0.2%	0.3%	Inventory accumulation slowing largely a function of energy prices.
	Apr job openings and labour turnover	4994	–	–	Further guide to labour market dynamics.
Wed 10					
NZ	May retail electronic card spending	–0.7%	0.9%	0.6%	April's decline likely to have been an aberration.
Aus	Jun Westpac–MI Consumer Sentiment	102.4	–	–	Budget relief and rate cut bumped sentiment into positive in May.
	Jun Westpac–MI unemploy. exp. %mth	–5.8%	–	–	Down 7%yr, hrs worked have run ahead so further improvement possible.
	RBA Governor Stevens speaking	–	–	–	Topic TBA, Brisbane, 12:50 pm AEST.
UK	Apr industrial production	0.5%	flat	–	Mar manufacturing up 0.4%, oil/mining up sharply but utilities down.
US	May federal budget \$bn	–100.5	–	–	In better shape than recent years but still a long term concern.
Thu 11					
NZ	RBNZ policy decision, MPS	3.50%	3.50%	3.50%	OCR cuts this year remain a close call.
Aus	Jun MI inflation expectations %yr	3.6%	–	–	The trimmed mean measure picked up as petrol prices lifted.
	May employment, ch	–2.9k	13.5k	12k	Leading indicators suggest that current modest growth pace continues.
	May unemployment rate %	6.2%	6.2%	6.2%	April was a soft 6.2% and we expect May to round down so upside risks.
Chn	May retail sales %yr	10.0%	10.1%	–	Westpac-MNI points to a tentative bottoming in spending plans.
	May industrial production %yr	5.8%	6.0%	–	Heavy subset still very weak, external demand still subdued.
	May fixed asset investment %ytd	12.0%	11.9%	–	Weakness in the usual suspects, infrastructure the partial offset.
UK	May house prices, net balance	33%	33%	–	RICS survey.
US	Initial jobless claims w/e 6/6	276k	–	278k	Still sub 300k but off century (so far) lows
	May retail sales	0.0%	1.1%	0.7%	Auto sales surged 7%, gasoline prices up sharply ...
	May retail sales ex gas/autos	0.2%	0.5%	0.2%	... meaning less scope for core retailing to accelerate.
	Apr business inventories	0.1%	0.2%	0.1%	Guide to stockbuilding early in Q2.
	May import prices	–0.3%	0.9%	1.0%	Significant gain on average in oil prices.
	Q1 household net worth \$bn	1517	–	–	Q4 renewed gain after Q3 saw net worth stall.
Can	Q1 capacity utilisation	83.6%	83.6%	–	Highest since 2006, well prior to 2008 recession.
	Apr new house prices	flat	–	–	Running at 1.2% yr annual pace.
Fri 12					
NZ	May manufacturing PMI	51.8	–	–	Recent readings have been softer on average, though choppy.
	May food price index	–0.3%	–	0.5%	Annual food price inflation has picked up marginally this year.
	May REINZ house sales	3.2%	–	–	Due around this date. Loan approvals continued to rise in May.
	May REINZ house price index %yr	9.3%	–	–	Too soon to expect an impact from new LVR and tax rules.
Eur	Apr industrial production	–0.3%	0.4%	–	German IP due 8/6.
UK	Apr construction output	3.9%	–0.4%	–	Fastest gain in over a year unsustainable given sector PMI downtrend.
US	May PPI final demand	–0.4%	0.4%	0.5%	Services prices subdued recently; energy price swings a key driver.
	Jun consumer sentiment	90.7	91.0	90.0	Prelim read from Uni of Michigan. Weekly data suggest downside risk.
Can	May house prices %yr	4.4%	–	–	Teranet National Bank index.

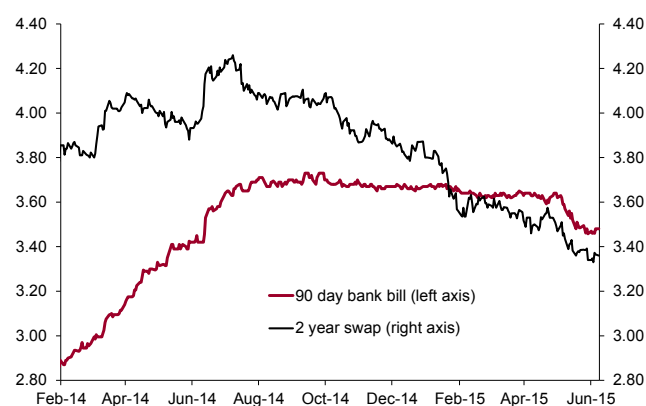


New Zealand forecasts

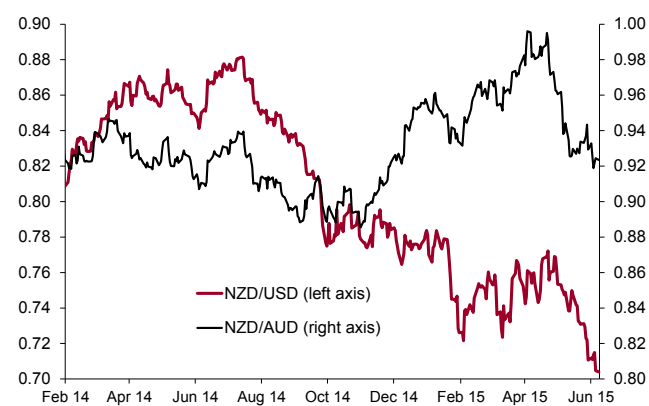
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2013	2014f	2015f	2016f
% change								
GDP (Production) ann avg	2.2	2.5	3.3	2.9	2.3	3.3	3.0	3.0
Employment	0.2	3.8	3.2	2.8	2.9	3.6	2.7	2.9
Unemployment Rate % s.a.	6.3	6.0	5.8	5.1	6.1	5.8	5.2	4.5
CPI	0.9	1.5	0.1	1.3	1.6	0.8	0.4	2.1
Current Account Balance % of GDP	-3.7	-2.6	-4.0	-4.9	-3.3	-3.3	-4.8	-4.6

Financial Forecasts	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Cash	3.50	3.50	3.50	3.50	3.50	3.50
90 Day bill	3.50	3.55	3.60	3.70	3.70	3.70
2 Year Swap	3.40	3.40	3.50	3.60	3.70	3.80
5 Year Swap	3.60	3.60	3.70	3.80	3.90	4.00
10 Year Bond	3.60	3.60	3.70	3.80	3.90	3.90
NZD/USD	0.72	0.69	0.68	0.68	0.68	0.69
NZD/AUD	0.92	0.94	0.94	0.94	0.94	0.94
NZD/JPY	87.8	85.4	85.7	85.7	86.4	87.7
NZD/EUR	0.66	0.66	0.65	0.65	0.65	0.66
NZD/GBP	0.48	0.47	0.47	0.47	0.46	0.46
TWI	76.4	75.3	74.9	74.8	74.8	75.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 8 June 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.50%	3.56%	3.59%
60 Days	3.50%	3.52%	3.59%
90 Days	3.48%	3.49%	3.57%
2 Year Swap	3.36%	3.38%	3.44%
5 Year Swap	3.69%	3.64%	3.65%

NZ foreign currency mid-rates as at Monday 8 June 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7040	0.7314	0.7477
NZD/EUR	0.6345	0.6648	0.6678
NZD/GBP	0.4615	0.4726	0.4840
NZD/JPY	88.41	88.88	89.47
NZD/AUD	0.9235	0.9345	0.9429
TWI	74.11	76.02	77.31



Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014	2015f	2016f
Australia						
Real GDP % yr	2.7	3.6	2.1	2.7	2.4	3.0
CPI inflation % annual	3.0	2.2	2.7	1.7	2.3	2.6
Unemployment %	5.2	5.3	5.8	6.2	6.5	6.5
Current Account % GDP	-2.8	-4.4	-3.3	-2.8	-3.2	-2.8
United States						
Real GDP %yr	1.6	2.3	2.2	2.4	2.2	3.2
Consumer Prices %yr	3.1	2.1	1.5	1.6	0.1	2.0
Unemployment Rate %	8.9	8.1	7.4	6.2	5.3	5.0
Current Account %GDP	-2.9	-2.9	-2.4	-2.4	-2.5	-2.5
Japan						
Real GDP %yr	-0.5	1.8	1.6	-0.1	1.0	1.7
Euroland						
Real GDP %yr	1.6	-0.8	-0.4	0.8	1.2	1.1
United Kingdom						
Real GDP %yr	1.6	0.7	1.7	2.6	2.5	2.7
China						
Real GDP %yr	9.3	7.8	7.8	7.4	7.0	7.0
East Asia ex China						
Real GDP %yr	4.4	4.5	4.3	4.1	4.4	5.0
World						
Real GDP %yr	4.2	3.4	3.3	3.4	3.2	4.0
Forecasts finalised 8 May 2015						

Interest Rate Forecasts	Latest	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.15	2.20	2.20	2.20	2.20	2.20
10 Year Bond	3.05	2.90	2.90	3.00	3.10	3.30
International						
Fed Funds	0.125	0.125	0.375	0.625	0.875	1.125
US 10 Year Bond	2.32	2.20	2.30	2.50	2.70	3.00
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
AUD/USD	0.7703	0.78	0.73	0.72	0.72	0.72
USD/JPY	124.45	122	124	126	126	127
EUR/USD	1.1219	1.09	1.05	1.04	1.04	1.04
AUD/NZD	1.0785	1.07	1.02	1.01	1.01	1.01

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Disclaimer continued

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