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In this issue

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

Staying on course

Following recent sharp falls in oil prices and the related softening in the inflation outlook, there has been speculation about the potential for interest rate reductions by the RBNZ. RBNZ Governor Wheeler used his annual speech to the Canterbury Employers' Chamber of Commerce to clarify his thinking on this. He effectively poured cold water on the likelihood of near-term rate cuts, noting that the "most prudent option" at the current time is "a period of OCR stability". This is very much in line with our own view. On our forecasts, the most likely scenario is that we won't see any change in the OCR until June 2016 at the earliest. So what's underlying this outlook?

First of all is the current composition of inflation. It's true that inflation will be very weak in the near term. But this is in large part a result of sharp falls in international commodity prices which the RBNZ looks through when setting policy. This is because OCR reductions to offset the effects of oil price declines that have already occurred may have only a limited impact on near-term inflation. However, they could have unintended and more significant consequences down the track, particularly in terms of conditions in the housing market. In addition, as we've seen over the past week, oil prices can swing rapidly. After falling more than 50% last year, prices bounced over the past week, pushing prices at the pump back up by around 10 c/ltr.

More fundamentally, the current softness in inflation is not a reflection of underlying softness in the domestic sectors of the economy. Indeed, the outlook for domestic growth is still firm. This is likely to result in a gradual increase in longer-term inflation, which is the key focus for the central bank when setting rates.

Staying on course continued

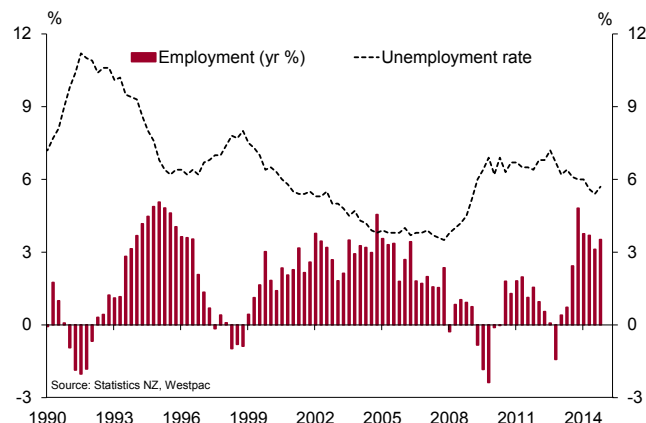
Underpinning this strength in the domestic economy is a strong outlook for housing and construction, particularly in Auckland and Canterbury. Recent building consents data signal that building activity is increasing. However, there is still a way to go before supply catches up with demand. What's more, there have been continued gains in house prices. Barfoot and Thompson data showed that median house prices in Auckland grew by around 2% (seasonally adjusted) in January to be up 20% over the year. Data from QV showed that prices are also rising in other cities and provincial areas, though to a lesser degree.

But it's not just the housing market that is looking firm. The wider economy has also been growing at a robust pace. Recent labour market data showed that employment rose by 3.5% over 2014. While much of this was due to strength in the construction sector, jobs growth was spread across the economy, including strong increases in professional services and in government related sectors. The unemployment rate did pick-up in late 2014, rising to 5.7% in the December quarter. However, rather than reflecting any fundamental weakness in underlying economic conditions, this actually reflects that New Zealand's strong economic outlook has encouraged more people to enter the labour force, with the participation rate rising to a record high of 69.7%.

While the Governor hosed down speculation about rate cuts, he also emphasised that rate hikes were a long way off. Governor Wheeler noted that before any rate hikes occurred, the RBNZ would have to be "confident that capacity utilisation and labour market pressures were generating, or about to generate, a substantial increase in inflation." And last week's labour market data did not indicate that this is likely in the near term. Indeed, despite solid growth in employment, wage inflation has remained stubbornly low, with the private sector ordinary time Labour Cost Index increasing by only 1.8% over the past year.

While our central expectation is for an extended pause, rates cuts are still an outside possibility. The economy is being

Employment and unemployment



buffeted by a range of forces that could significantly affect domestic activity. Of particular concern are the dry conditions affecting agricultural production in parts of the country. Fonterra has already significantly lowered its forecasts for milk volumes over the first half of 2015, and sheep and beef farmers have brought slaughter forward as low prices make the use of supplementary feed uneconomical. Although recent rains may help some farmers, production is still likely to be down on last year.

Tightness in supply resulting from dry conditions is helping to push up prices for dairy exports (prices rose by an average of 9.4% in the latest GlobalDairyTrade auction). As a result, we have revised up our forecasts for Fonterra's farmgate milk price to \$5.00/kg in 2014/15 and \$6.40/kg in 2015/16 - both up 20 c/kg on our earlier estimates. Nevertheless, overall earnings and spending in the agricultural sector will be a drag on growth over 2015. Should conditions in the agricultural sector worsen, or adversely affect confidence in the economy more generally, this could bring cuts back onto the RBNZ's radar.

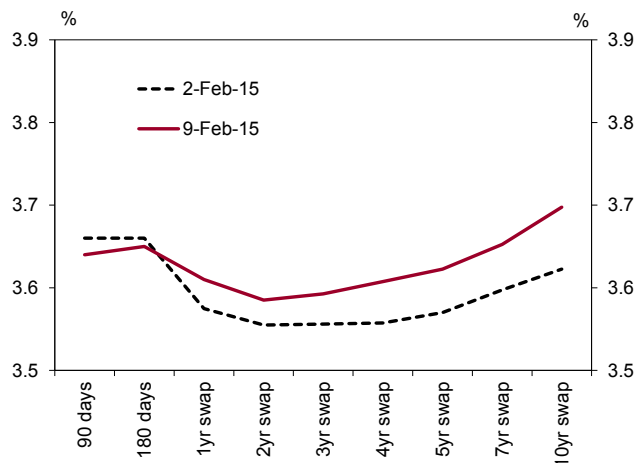
Fixed vs Floating for mortgages

Among the current standard fixed rates, the best value for borrowers with a deposit of 20% or more probably lies in the two-year and three-year terms. However, there is a possibility that fixed mortgage rates will fall even further over the weeks ahead. Waiting a while before fixing might offer even better value.

Four- and five-year rates seem high relative to where we think shorter-term rates are going to go over the coming four or five years, though they do offer stability.

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

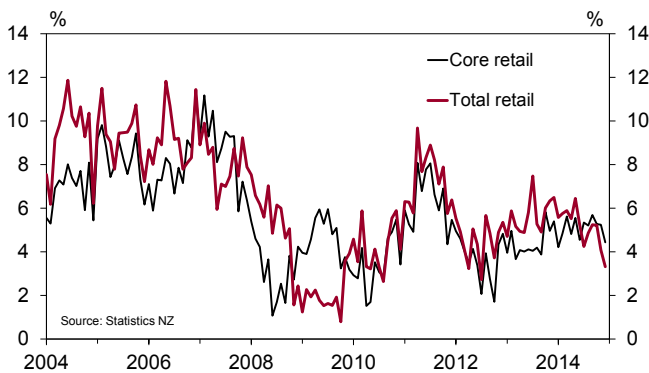


NZ Jan retail electronic card spending

Feb 11, Last -0.1%, Westpac f/c: 0.4%

- Advance data from Paymark (New Zealand's largest cards processor) suggest that electronic retail spending rose 0.4% in January. That would be a very strong outturn in the context of plunging petrol prices. We estimate that seasonally-adjusted petrol prices fell 10% in the month, which on its own would have slashed in the order of 1.5% off the value of spending.
- A strong underlying spending pulse is consistent with other indicators of consumer demand at the start of the year, including rising consumer confidence and an ongoing resurgence in Auckland's housing market.

Card transactions, annual % change

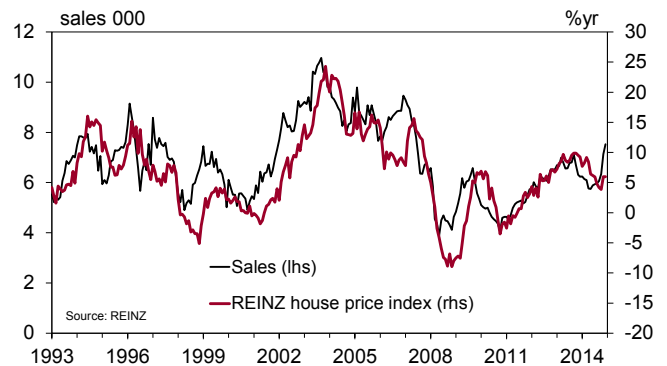


NZ Jan REINZ house prices and sales

Feb 13 (tbc), Sales Last: +5.5%, Prices Last: 6.0%yr

- The housing market has had a strong resurgence in recent months. The waning influence of high-LVR lending restrictions, lower fixed-term mortgage rates and migration-led population growth appear to have generated a great deal of pent-up demand, which was unleashed once pre-election uncertainties were cleared in September.
- Early indications are that the market may have taken a breather in January, which is the low point of the year for sales in any case. However, strong mortgage approvals suggest that house sales are set to resume their climb in February.
- Annual house price inflation has also begun to accelerate, although the gains have been overwhelmingly centred in Auckland. In contrast, there are signs of the Christchurch market starting to settle down, as repairs and rebuilds increase the effective housing stock.

REINZ house prices and sales



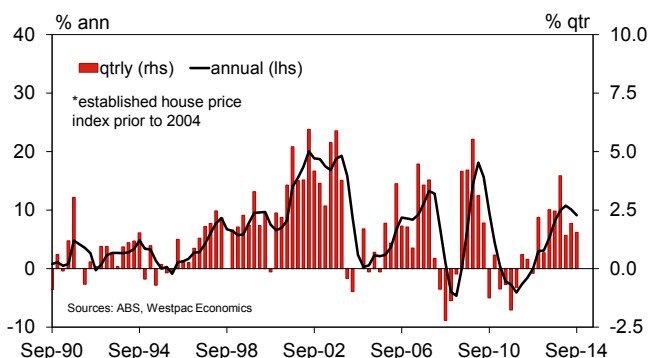
Aus Q4 residential property price index

Feb 10, Last: 1.5%, WBC f/c: 2.0%

Mkt f/c: 1.9%, Range: 1.0% to 2.5%

- The ABS residential property price index posted another meaty 1.5% rise in Q3 following a 1.9% rise in Q2 and a 1.4% rise in Q1. Annual price growth cooled a touch from 10.1% in Q3 to 9.1% in Q3.
- In Q4, available private data on 'all dwelling' measures show gains of 2.3%qtr, 7.1%yr (APM), 1.8%qtr, 7.9%yr (Residex), and 1.7%qtr, 8.1%yr (CoreLogic RP Data). The ABS measure tends to track the APM series more closely due to their similar construction. Accordingly we expect it to show a strong 2.0% with annual price growth easing back to just over 7%.

Residential property price index, ABS measure

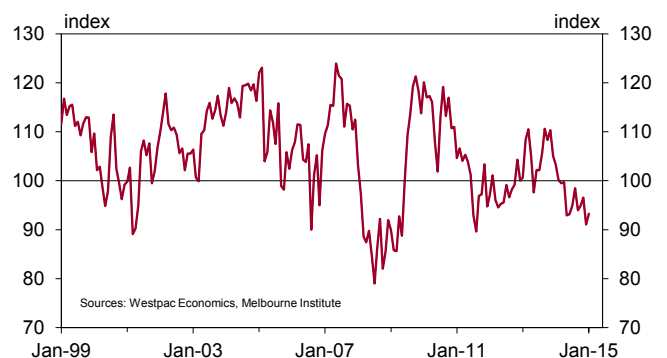


Aus Feb Westpac-MI Consumer Sentiment

Feb 11, Last: 93.2

- In January, the Westpac-Melbourne Institute Consumer Sentiment Index rose 2.4%, recovering some of December's sharp 5.7% fall but leaving the Index still firmly in pessimistic territory below 100.
- The Feb survey is in the field from Feb 2 to 8 and will capture reactions to the RBA's surprise 25bp rate cut. While ordinarily this would be a positive for sentiment, the impact is less clear cut when easing is in response to a downgraded economic outlook. Other potential positives include lower petrol prices (pump prices down -6½¢ a litre since the Jan survey) and a strong surge in the ASX (up 9.7% since the previous survey). Against this, the continued slide in the AUD may tend to weight on sentiment (down 4¢ against the USD since the previous survey), as will the return of political 'tensions' after the summer break (including a change of state government in Qld).

Consumer Sentiment Index

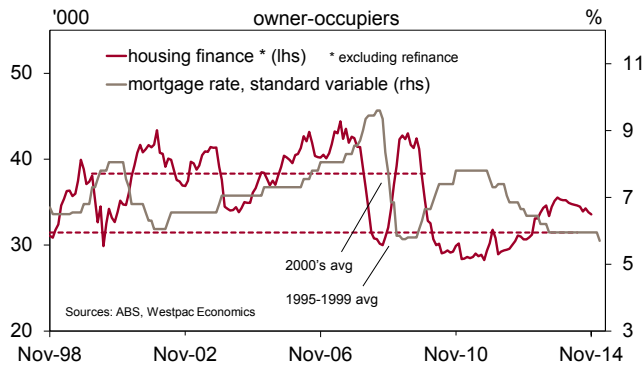


Aus Dec housing finance (no.)

Feb 11, Last: -0.7%, WBC f/c: 2.0%
Mkt f/c: 2.0%, Range: -0.1% to 4.0%

- Housing finance softened in Nov, both for owner-occupiers (-0.7%) and investors (value of new finance -2.2%). Stepping back from the monthly move, finance for the purchase of existing dwellings is trending a lower, down 8.8%yr while finance for construction is trending higher (+7.6%yr) as is the value of finance to investors (+13.0%yr).
- We expect this modest downtrend in owner-occupier activity to carry into early 2015 before Feb's interest rate cut generates some renewed momentum. Industry data suggests Dec approvals were up a touch – as such we expect approvals to show a decent 2% gain in the month.
- Note that the ABS has recently revised up estimates of first home buyer (FHB) approvals from this survey. Incorrect reporting was found to have been understating this segment by 20%. Even with the mark up, FHB activity remains weak.

Owner-occupier finance & the rate cycle

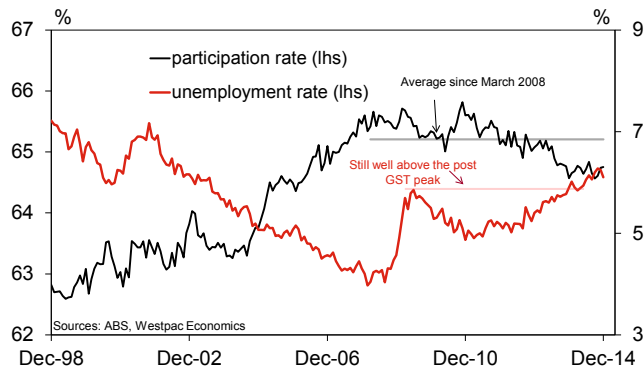


Aus Jan unemployment rate

Feb 12, Last: 6.1%, WBC f/c: 6.2%
Mkt f/c: 6.2%, Range: 6.1% to 6.3%

- In Dec, the participation rate was basically flat at two decimal places (64.75% from 64.74% in Nov) with a relatively modest 21.2k rise in the labour force. This limited the improvement in the unemployment rate to a fall of just 0.1ppt to 6.1% (Nov was revised from 6.3% to 6.2%) leaving the unemployment rate only marginally higher than where it ended 2013 (5.9%). Youth unemployment also eased back to 13.1% from 14.5%.
- If we hold the participation rate flat at 64.8%, this will generate a 18.6k rise in the labour force. Given our forecast for a modest 10k rise in total employment, this will generate a 0.1ppt rise in the unemployment rate to 6.2%.

Unemployment and participation rates

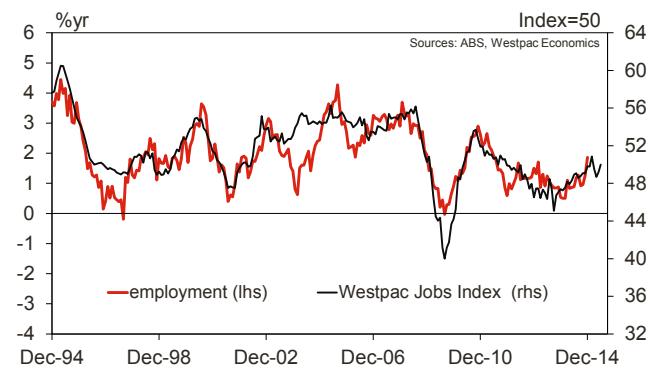


Aus Jan employment, '000

Feb 12, Last: 37.4k, WBC f/c: 10k
Mkt f/c: -5k, Range: -20k to 20k

- Total employment rose 37.4k in Dec compared to Westpac's forecast for a 10k fall. The market had been expecting a 5k rise with a wide range of estimates from -20k to 25k.
- As 2014 ended there was an uptick in employment with the annual pace of employment growth lifting to 1.9%yr. Total employment grew 213.9k through 2014.
- The details highlight broad based strength in the labour market in the month. Full-time employment lifted 41.6k following a 2.6k rise in Nov while part-time employment moderated -4.1k following a 42.3k surge in Nov.
- The Jobs Index suggests that labour demand peaked at the end of 2014 and eased a bit heading into 2015. Our 10k forecast for employment has the annual pace slowing to 1.8%yr.

Jobs Index peaked as 2014 ended

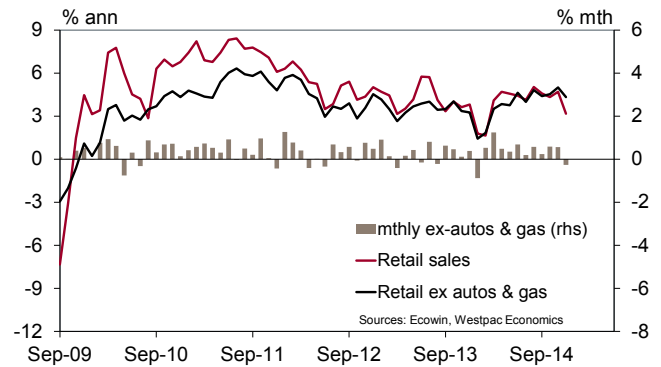


US Jan retail sales

Feb 12, Last: -0.9%, WBC f/c: -0.3%

- Retail sales reportedly fell 0.9% in December, and November was revised down from 0.7% to 0.4%. That left the annual growth impulse at 3.2%yr, well below the 5.0%yr August peak.
- The decline in the price of oil has been a key contributor to the weakness in total sales, with gasoline station sales down 6.5% in December and 14.2% over the year. That said, weakness is apparent elsewhere, with eight of the remaining 12 store types also seeing declines in December.
- The fall in the price of oil has produced a material improvement in confidence and household income expectations, which should support spending. Yet reports of soft conditions over the holidays point to the spending response being restricted by weak actual wage growth and existing debt liabilities. With the oil price declining further in January, we expect another decline in total sales, circa -0.3%.

US retail sales: is momentum topping out?

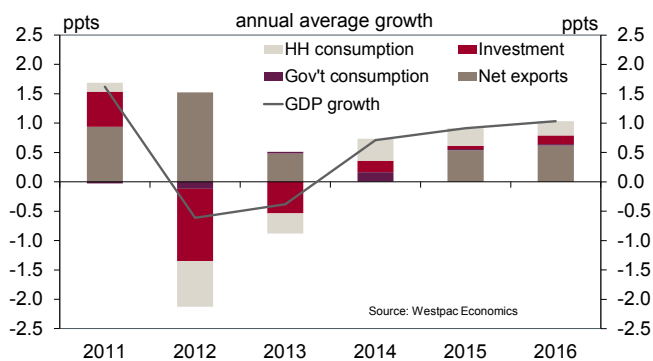


Euro Area Q4 GDP

Feb 13, Last: 0.2%, WBC f/c: 0.2%

- Q3's 0.2% headline outcome was a positive surprise, albeit only just at 2 decimal places (0.16%).
- By country, the surprise came from France, where activity jumped 0.3% in Q3 following a 0.1% fall in Q2. Also, Spain posted another quarter of solid growth, 0.5%. Elsewhere amongst the majors, momentum was decidedly absent.
- Q4 is likely to see an improved performance on the part of Germany (growth circa 0.3%); and Spain has already reported a robust 0.7% gain. Unfortunately the impetus provided by these nations will be mitigated by flat outcomes in Italy and France.
- Overall, the above constellation of results will most likely produce another 0.2% aggregate outcome, and leave annual growth for the region unchanged at a meagre 0.6%yr.

Contribution to Euro area annual growth



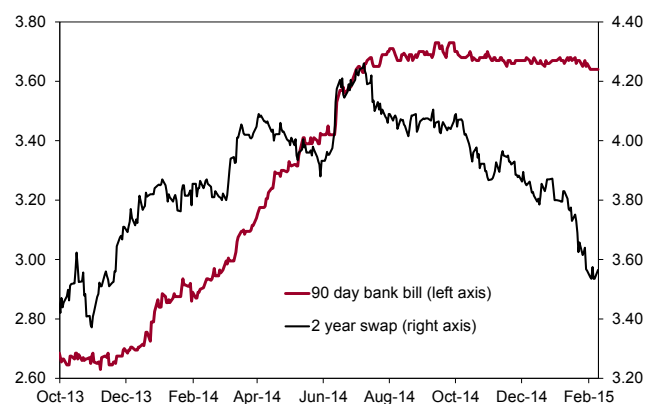
		Last	Market median	Westpac forecast	Risk/Comment
Mon 9					
Aus	RBA Governor Stevens speaking	–	–	–	Remarks, RMB Clearing Bank launch ceremony, Sydney 11:15am.
Eur	Feb Sentix investor confidence	0.9	–	–	ECB decision strong support for markets; but duration open question.
UK	Jan Halifax house prices	0.9%	0.0%	0.2%	Tentative date; prices up 7.8%/yr, momentum waning?
US	Jan Labour market composite index	6.1	–	–	The Fed's composite labour indicator.
Tue 10					
Aus	Q4 ABS residential property prices	1.5%	1.9%	2.0%	Strong gain in Q4 but annual growth moderating to ~7%.
	Jan NAB business survey	4	–	–	In Dec: conditions around LR avg at +4, but confidence below LR avg.
Chn	Jan CPI %yr	1.5%	1.0%	–	Administrative energy price adjustments are now more frequent.
	Jan PPI %yr	–3.3%	–3.8%	–	Tiers of deflation: raw, then basic materials, capital goods, csr durables.
UK	Jan BRC like-for-like sales	–0.4%	–	–	Will softer tone of Q4 continue into the new year?
	Dec industrial production	–0.1%	0.2%	–	Construction surprised to downside in Nov; oil & gas also weighed.
US	Jan NFIB small business optimism	100.4	101.0	102.0	Notable improvement as oil price has fallen.
	Dec wholesale inventories	0.8%	0.1%	0.2%	Inventories were big support for growth in Q4.
	Feb IBD/TIPP economic optimism	51.5	51.5	52.0	Confidence has received strong support from oil and labour market.
	Dec JOLTS job openings	4972	–	–	A longer survey period and broader report than payrolls, but is dated.
Wed 11					
NZ	Jan Retail card spending	–0.1%	–	0.4%	Strong underlying spending growth, tempered by plunging petrol prices.
Aus	Feb Westpac-MI Consumer Sentiment	93.2	–	–	What impact will RBA rate cut have? Drag from PM leadership turmoil?
	Dec housing finance	–0.7%	2.0%	2.0%	Dec to show slight kick up with-in a clear gradual downtrend.
US	Jan monthly budget statement, \$bn	2.0	–2.6	–	Return to marginal deficit after marginal surplus in December.
Thu 12					
Aus	Jan employment, '000	37.4	–5	10.0	Employment picked up as 2014 ended but the Jobs Index has peaked.
	Jan unemployment rate	6.1%	6.2%	6.2%	If participation is falt, 10k employment will see a rise in unemployment.
	Feb MI Consumer Inflation Expectations	3.2%	–	–	Down from 4.1% in Nov, falling petrol should have dragged them further.
Eur	Dec industrial production	0.2%	0.3%	–	Down 0.4%/yr; weaker Euro should support hence, world perhaps less so.
UK	Bank of England inflation report	–	–	–	Focus is on current disinflationary concerns, not inflation further out.
	Jan RICS house price balance	11%	–	–	Fell to its lowest level in 19 months in Dec; suggests price g'th waning.
US	Jan retail sales	–0.9%	–0.4%	–0.4%	Petrol price weakness to continue in Jan; but core likely soft.
	Initial jobless claims	278k	–	–	Trend rise in jobless claims likely as oil price fall sees job losses.
	Dec business inventories	0.2%	0.2%	0.2%	Inventories were big support for growth in Q4.
Can	Jan house prices	–0.2%	–	–	Teranet/ National Bank measure.
Fri 13					
NZ	Jan Food Price Index	0.3%	–	–	Poor growing conditions could boost some prices.
	Jan REINZ house sales	5.5%	–	–	Due this week. Sales have rebounded strongly in recent months.
	Jan REINZ house price index %yr	6.0%	–	–	House price acceleration has been dominated by Auckland.
Aus	RBA Governor Stevens speaking	–	–	–	Parliamentary Testimony, 9:30am.
Eur	Q4 GDP	0.2%	0.2%	0.2%	Another soft quarter as ECB policy impeded by state of union.
	Dec trade balance, €bn	20	–	15	Weaker Euro to continue to provide boost to region's exporters.
US	Feb consumer confidence, prelim	98.1	98.1	98.5	Uni of Mich measure; lower oil price equates to stronger to confidence.
Can	Dec manufacturing sales	–1.4%	–1.0%	–	Jan decline led by motor vehicles; third decline in four months.

New Zealand forecasts

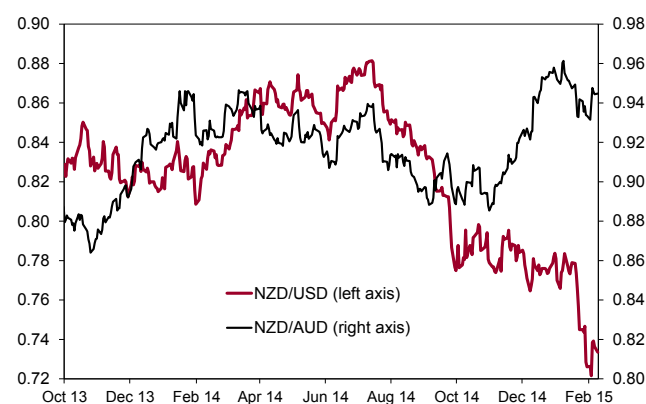
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2013	2014f	2015f	2016f
% change								
GDP (Production) ann avg	2.2	2.5	3.3	2.9	2.2	3.3	2.9	3.6
Employment	0.4	3.8	2.9	3.0	2.9	3.5	2.6	2.5
Unemployment Rate % s.a.	6.2	6.0	5.5	4.7	6.0	5.7	4.8	4.3
CPI	0.9	1.5	0.2	1.5	1.6	0.8	0.7	2.3
Current Account Balance % of GDP	-3.7	-2.6	-3.9	-5.0	-3.3	-3.1	-5.0	-4.6

Financial Forecasts	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
Cash	3.50	3.50	3.50	3.50	3.50	3.75
90 Day bill	3.70	3.70	3.70	3.70	3.75	4.00
2 Year Swap	3.50	3.60	3.70	3.80	4.00	4.20
5 Year Swap	3.60	3.70	3.80	3.90	4.10	4.40
10 Year Bond	3.30	3.40	3.50	3.70	3.90	4.20
NZD/USD	0.71	0.73	0.74	0.75	0.77	0.79
NZD/AUD	0.95	0.95	0.95	0.95	0.95	0.94
NZD/JPY	83.9	87.6	90.3	93.0	95.5	98.8
NZD/EUR	0.62	0.64	0.64	0.65	0.66	0.66
NZD/GBP	0.47	0.48	0.47	0.47	0.48	0.47
TWI	74.9	76.3	77.1	77.9	79.2	80.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 9 February 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.64%	3.66%	3.63%
60 Days	3.64%	3.66%	3.65%
90 Days	3.64%	3.65%	3.66%
2 Year Swap	3.57%	3.63%	3.80%
5 Year Swap	3.58%	3.66%	3.91%

NZ foreign currency mid-rates as at Monday 9 February 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7335	0.7416	0.7846
NZD/EUR	0.6486	0.6581	0.6623
NZD/GBP	0.4818	0.4918	0.5167
NZD/JPY	87.43	87.85	92.80
NZD/AUD	0.9447	0.9365	0.9561
TWI	76.20	76.61	79.75

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014e	2015f	2016f
Australia						
Real GDP % yr	2.7	3.6	2.1	2.7	2.7	3.5
CPI inflation % annual	3.0	2.2	2.7	1.7	2.1	3.0
Unemployment %	5.2	5.3	5.8	6.2	6.4	6.0
Current Account % GDP	-2.8	-4.4	-3.3	-2.9	-2.3	-1.0
United States						
Real GDP %yr	1.6	2.3	2.2	2.4	2.7	3.2
Consumer Prices %yr	3.1	2.1	1.5	1.6	1.0	2.1
Unemployment Rate %	8.9	8.1	7.4	6.2	5.5	5.0
Current Account %GDP	-2.9	-2.9	-2.4	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	-0.3	1.8	1.6	0.4	1.0	1.7
Euroland						
Real GDP %yr	1.6	-0.6	-0.4	0.7	0.9	1.0
United Kingdom						
Real GDP %yr	1.1	0.3	1.7	2.6	2.5	2.7
China						
Real GDP %yr	9.3	7.7	7.7	7.4	7.3	7.5
East Asia ex China						
Real GDP %yr	4.5	4.5	4.3	4.1	4.8	5.8
World						
Real GDP %yr	4.1	3.4	3.3	3.2	3.5	4.4
Forecasts finalised 6 February 2015						

Interest Rate Forecasts	Latest	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Australia						
Cash	2.25	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.40	2.20	2.20	2.20	2.22	2.25
10 Year Bond	2.40	2.40	2.50	2.70	2.90	3.20
International						
Fed Funds	0.125	0.125	0.125	0.250	0.500	0.750
US 10 Year Bond	1.81	1.90	2.00	2.20	2.50	2.80
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
AUD/USD	0.7799	0.75	0.77	0.78	0.79	0.81
USD/JPY	117.50	118	120	122	124	124
EUR/USD	1.1475	1.14	1.15	1.15	1.16	1.17
AUD/NZD	1.0540	1.05	1.05	1.05	1.05	1.05

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Disclaimer continued

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