



Sunrise over Mt. Ruapehu crater.

In this issue

Fixed vs floating	2
The week ahead	3
Data calendar	4
New Zealand forecasts	5
International forecasts	6

Cuts to come

A surprisingly weak GDP outturn has strengthened the Reserve Bank's case for lowering interest rates this year. We now expect further OCR cuts in both the July and September reviews, with a risk of more beyond that. The turn in the economy's fortunes has continued to hit the New Zealand dollar in dramatic but, we feel, appropriate fashion.

March quarter GDP grew by just 0.2%, well below the already subdued 0.6% growth that we, the RBNZ and the rest of the market were expecting. Admittedly there were some specific depressing factors that will be reversed, or at least won't be repeated, next time. Milk production fell over the quarter due to drought, but has recovered strongly since, while oil production was hit by a temporary shutdown on a major oil field. (Oil exploration, however, is likely to remain subdued as a result of the plunge in world prices.)

But at the same time, many of the bright spots in the quarter were linked to a surge in tourist spending, which manifested in areas such as retail spending, hospitality, international flights and recreation. It's unclear how much of this can be attributed to the Cricket World Cup, and how much to the growing significance of travel during the Lunar New Year. But both of these are March quarter phenomena; we would expect to see a drop in visitor spending in the next quarter.

We were also surprised by the weakness in business investment, with plant and machinery investment falling by 10% to its lowest level in nearly two years. Admittedly the quarterly figures are quite volatile, but at the very least there's a sense that the trend in business investment has stalled, which doesn't speak to a great deal of confidence about the economy's prospects over the medium term.

Among the reasons that the RBNZ cited for lowering the OCR this month was a reassessment of where the economy sits relative to its non-inflationary potential. The RBNZ judged that the economy had only just reached its potential, and would run slightly above this level over the next few years – helping to generate some home-

Cuts to come continued

grown inflation, but not quickly enough to meet the target of 2% average inflation over the medium term. The weak March quarter GDP outturn will cast further doubt on whether the economy is running fast enough to generate those inflation pressures.

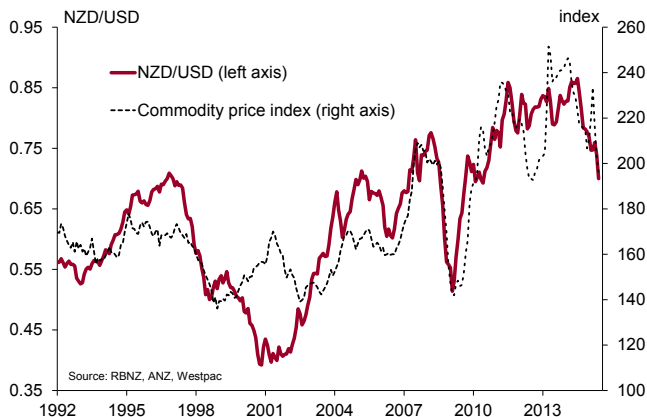
We also have to concede to the general dovishness of the latest *Monetary Policy Statement*. The RBNZ still views the New Zealand dollar as overvalued (given its forecast of a further fall in the terms of trade), it doesn't appear to feel at all constrained by the rampant Auckland housing market, and it is placing much more weight than before on returning inflation to firmly within the target range. That last point was underscored by an unusual public rebuke from the Minister of Finance last week, who noted that the RBNZ Governor has been "out of the zone for years now... He's meant to be following the Policy Targets Agreement, and one day somebody will start asking the Minister of Finance questions about whether he's actually following the agreement or not."

There are two other factors that will be crucial to the interest rate outlook: dairy prices and the exchange rate. The RBNZ is clearly concerned about the ongoing weakness in world dairy prices and the prospect of a second season of low returns for dairy farmers, and has a strong desire for a lower exchange rate in order to soften the blow, as well as generating some imported inflation.

Last week's GlobalDairyTrade auction was somewhat inconclusive. The overall price index fell by 1.3%, but this was largely concentrated in one product (anhydrous milk fat), while milk powder prices were steady. This was the smallest decline in the index in the last three months; to the extent that there's some inertia in dairy prices, one might be able to read this is a sign that prices are close to stabilising. But there's still a huge degree of uncertainty as to how prices will perform over the course of the season.

In contrast, the exchange rate is clearly heading in a direction that will please the RBNZ. Our strategists aptly described the New Zealand dollar as "the Frankenstein of FX, being pursued by villagers with torches and pitchforks". From a high of 0.88 last year, the NZD/USD exchange rate has fallen as low as 0.69 after the weak GDP result, and we expect it to continue tracking down to 0.64 over the next few months.

NZD and commodity prices, inflation-adjusted



However, this is far from cause for alarm. We've noted many times in the past that a floating exchange rate provides an important buffer against changing international conditions, such as swings in commodity prices. And as it turns out, the fall in the NZD to date is bang in line with the fall in prices for New Zealand's commodity export basket.

Of course, there is substantial variation within that basket, which can't be remedied through the exchange rate. Dairy prices are weak, but lamb and wood prices are around average, while beef and wool prices remain strong. If the RBNZ is placing a particularly high weight on the dairying sector, it will probably welcome further currency weakness from here. Or to put it another way, the RBNZ won't want to set monetary policy in a way that hinders the NZD's decline. With financial markets already building in a 75% chance of an OCR cut in July, the choice seems straightforward.

Fixed vs Floating for mortgages

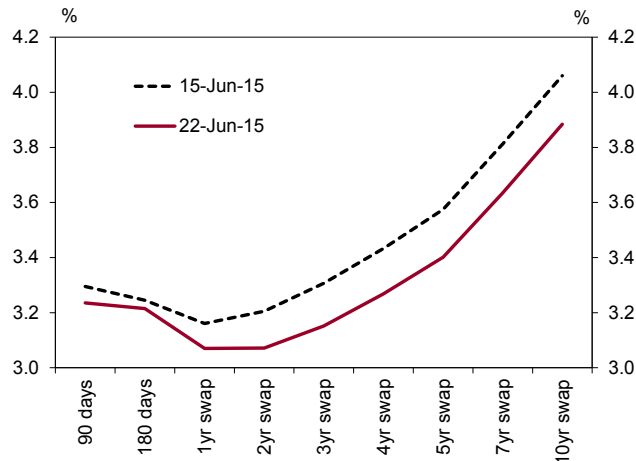
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability, but given last week's drop in wholesale rates, even those looking to fix may want to wait a while longer.

For borrowers with a deposit of 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 narrowed.

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

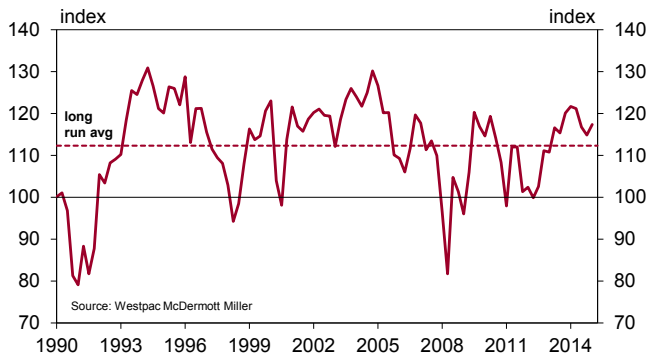


NZ Q2 Westpac-MM Consumer Confidence

June 22, Last: 117.4

- Consumer confidence rose over the March quarter, as petrol prices and fixed mortgage rates fell, house and share prices continued to rise, and drought concerns receded in rural New Zealand. However confidence remained below the heady levels seen in early 2014.
- We were somewhat surprised at the time not to see greater consumer exuberance in urban parts of New Zealand, notably Auckland, but with hindsight this looks consistent with the relatively unspectacular growth in personal consumption observed in the March quarter GDP statistics.
- The June quarter survey was in the field over 2-13 June.

Westpac-McDermott Miller consumer confidence



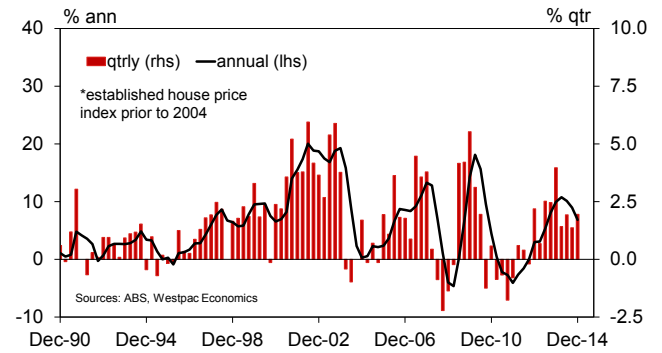
Aus Q1 residential property price index

Jun 23, Last: 1.9%, WBC f/c: 1.5%

Mkt f/c: 2.1%, Range: 0.9% to 2.5%

- This 'official' measure has become awkwardly dated. With the ABS pushing the release schedule back 6wks the publication of Q1 estimates is now coming out at a time when most private sector measures will have already released their Q2 data.
- For what it's worth the Q1 wash up of private sector data showed 'all dwelling' measures with gains ranging from 1.4%qtr, 7.6%yr (Residex), to 1.9%qtr, 7.4%yr (APM) and 3.0%qtr, 7.5%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 solid 1.5% gain keeping annual price growth at 7%. Private sector measures suggest price growth slowed in Q2, particularly across the 'resource state' capital cities.

Residential property price index, ABS measure

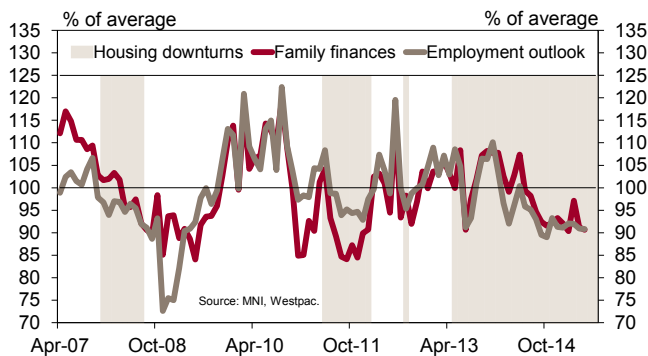


Chn Jun Westpac MNI Consumer Sentiment

Jun 24, Last: 111.1

- The headline index was unchanged at 111.1 in May, which was 8.4% lower than a year ago and 8.7% below the long run average. Chinese consumers remain anxious about their personal financial wellbeing and the economy more broadly.
- Note that the May rate cut occurred near the end of the sampling period of the prior survey, so there may be some residual impact of that move captured in the June survey. Also, the extreme weakness in the 55-64 age cohort in May fully offset a 1.9pts increase in the 18-54 group (~85% of the sample) from 111.8 in April to 113.8 in May. We remain alert to further volatility emanating from the older cohort.
- Other potential influences on confidence are that the official data flow was mixed, but on net it improved a little through May; house prices are now recovering (albeit unevenly across the nation); inflation remains low; & net capital outflows ceased.

Westpac MNI China CSI & housing downturns



Data calendar

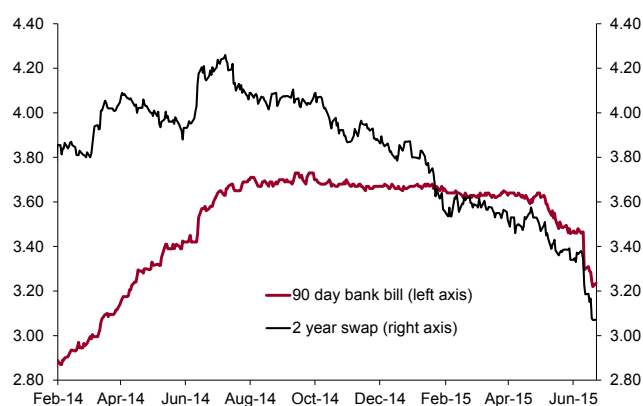
		Last	Market median	Westpac forecast	Risk/Comment
Mon 22					
NZ	Q2 Westpac-MM consumer confidence	117.4	–	–	Survey was in the field over 2-13 June.
	May net migration	4,740	–	4,600	Migration to ease as Canterbury rebuild peaks, Aus jobs recover.
US	May Chicago Fed National Activity Index	–0.15	–	–	Aggregate measure of momentum comprised of 85 individual indicators.
EU	Euro Summit meeting	–	–	–	Emergency high-level meeting to discuss situation in Greece.
Tue 23					
Aus	Q1 ABS residential property price index	1.9%	2.1%	1.5%	Now released 6wks later than previously, making figs seriously out of date.
Chn	Jun Markit manufacturing PMI - flash	49.2	49.4	–	Manuf stabilising at a weak level, orders/stocks ratio points to gain.
Eur	Jun Markit manufacturing PMI - flash	52.2	52.0	–	Regional growth has broadened in ytd, but global trade has softened.
	Jun Markit services PMI - flash	53.8	53.7	–	Implying a solid rate of expansion in domestic demand.
	Jun Markit composite PMI - flash	53.6	53.7	–	May's 53.6 is consistent with about +0.4%qtr for regionwide GDP.
US	May existing home sales %mth	–3.3%	4.7%	–	Rebounding from April drop. Pending sales rose 3.4% in prior month.
	May durable goods orders	–1.0%	–0.5%	–	Ex def & aircraft –0.3% in April. Equipment capex still modest at best.
	Apr FHFA house price index %mth	0.3%	0.5%	–	Yellen still citing housing as a headwind but one she expects to lessen.
	Jun Markit manufacturing PMI	54.0	54.1	–	Equivalent US measure to closely-watched PMIs in Europe, China etc.
Wed 24					
Chn	Jun Westpac MNI Consumer Sentiment	111.1	–	–	Housing improving, equities booming, but job security sub par.
Ger	Jun IFO business climate	108.5	108.0	–	Greek uncertainty will be a major factor.
US	May new home sales %mth	6.8%	0.6%	–	Up in Apr but still x% below Feb's post-GFC.
	Jun Richmond Fed manufacturing index	1	1	–	Sample size of ~100 - labour market components firmed in May.
	Q1 GDP annualised %qtr - final	–0.7%	–0.2%	–	Fed wrote off Q1 due to transitory headwinds, forging ahead regardless.
Thu 25					
NZ	May merchandise trade \$m	123	–50	100	Dairy export prices received a temporary bump.
US	May personal income %mth	0.4%	0.5%	–	Timely data on income from various surveys hints at modest pick-up.
	May personal spending %mth	flat	0.7%	–	Consensus assuming a decline in the savings rate on higher prices.
	May core PCE deflator %mth	0.1%	0.1%	0.1%	Headline to pick up to 0.4% from zero as gasoline rebounds.
	Jun initial jobless claims '000 (Jun 20)	267	–	–	Cumulative improvement in the labour market continues.
	Jun Markit services PMI	56.2	56.5	–	Running >59 as recently as March, but still relatively buoyant >56.
Fri 26					
Eur	May M3 money supply %yr	5.3%	5.4%	–	Broken credit mechanism - narrow M outgrowing broad by wide margin.
US	Jun UoM consumer sentiment - final	94.6	94.6	–	Well above long run average. Includes 1 & 5 year inflation expectations.

New Zealand forecasts

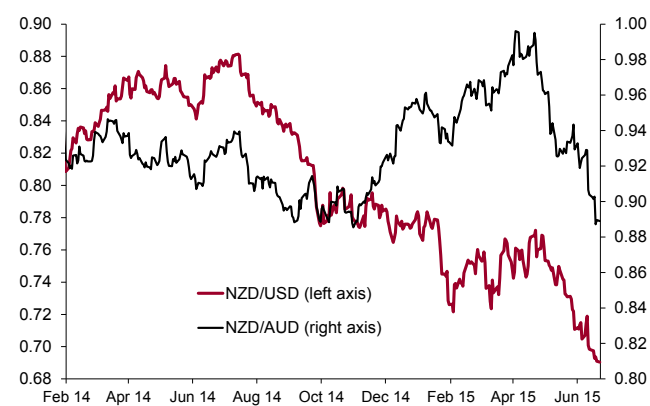
Economic Growth Forecasts	March years				Calendar years			
	2014	2015	2016f	2017f	2013	2014	2015f	2016f
% change								
GDP (Production) ann avg	2.5	3.2	2.4	3.3	2.2	3.3	2.4	3.1
Employment	3.8	3.2	3.0	2.3	2.9	3.6	2.8	3.0
Unemployment Rate % s.a.	6.0	5.8	4.9	4.4	6.1	5.8	5.2	4.3
CPI	1.5	0.1	1.8	1.9	1.6	0.8	0.9	2.2
Current Account Balance % of GDP	-2.6	-3.2	-4.6	-4.3	-3.3	-3.3	-3.8	-4.4

Financial Forecasts	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Cash	3.25	2.75	2.75	2.75	2.75	2.75
90 Day bill	3.20	2.85	2.85	2.85	2.85	2.85
2 Year Swap	3.00	2.90	2.90	2.90	3.00	3.10
5 Year Swap	3.40	3.30	3.30	3.40	3.50	3.60
10 Year Bond	3.50	3.40	3.50	3.60	3.70	3.80
NZD/USD	0.69	0.65	0.64	0.64	0.65	0.65
NZD/AUD	0.88	0.89	0.89	0.89	0.90	0.89
NZD/JPY	84.2	80.6	80.6	80.6	82.6	83.2
NZD/EUR	0.63	0.62	0.62	0.62	0.63	0.63
NZD/GBP	0.46	0.45	0.45	0.44	0.44	0.43
TWI	73.2	71.0	70.5	70.4	71.5	71.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 22 June 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.25%	3.50%	3.50%
30 Days	3.34%	3.50%	3.56%
60 Days	3.29%	3.50%	3.52%
90 Days	3.24%	3.48%	3.49%
2 Year Swap	3.07%	3.36%	3.38%
5 Year Swap	3.40%	3.69%	3.64%

NZ foreign currency mid-rates as at Monday 22 June 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6904	0.7040	0.7314
NZD/EUR	0.6068	0.6345	0.6648
NZD/GBP	0.4352	0.4615	0.4726
NZD/JPY	84.95	88.41	88.88
NZD/AUD	0.8890	0.9235	0.9345
TWI	71.72	74.11	76.02

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	2.5	2.5
Unemployment %	5.2	5.3	5.8	6.2	6.5	6.3
Current Account % GDP	-2.8	-4.4	-3.3	-2.8	-3.4	-3.4
United States						
Real GDP %yr	1.6	2.3	2.2	2.4	2.0	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	1.3	1.8
Euroland						
Real GDP %yr	1.6	-0.8	-0.4	0.8	1.4	1.2
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	3.4	3.4	3.2	4.0
Forecasts finalised 10 June 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	2.14	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.87	3.05	3.00	3.10	3.25	3.40
International						
Fed Funds	0.125	0.125	0.375	0.625	0.875	1.125
US 10 Year Bond	2.31	2.50	2.60	2.80	3.00	3.20
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	0.7767	0.77	0.73	0.72	0.72	0.72
USD/JPY	123.07	124	126	128	128	129
EUR/USD	1.1355	1.12	1.08	1.07	1.07	1.07
AUD/NZD	1.1220	1.12	1.12	1.13	1.13	1.11

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