Kea. Arthurs Pass National Park.

In this issue

Finest cheddar, made better

The latest update from Fonterra has provided some reassurance that conditions in the dairying industry won't be quite as tough as expected this season. But we're still cautious on the scope for further upside in dairy prices.

In announcing its annual results, Fonterra upgraded its forecast milk price for the current season from $3.85 to $4.60 per kilo of milk solids, equating to around $1.4bn of extra revenue for the industry. While this is still below the break-even price for the majority of dairy farmers in New Zealand, the increase will mean less need for additional borrowing and for drastic cost-cutting measures than previously thought.

The sharp rebound in world dairy prices – up nearly 50%, albeit from very low levels, in the last three GlobalDairyTrade auctions – appears to have been sparked by Fonterra's predictions that its milk collection will be lower this season. As we've noted in the past, world prices are very sensitive even to small unanticipated changes in supply. In the short term, many buyers of dairy ingredients don't have a lot of flexibility in their requirements, and are willing to bid prices up in order to secure supply.

Fonterra initially forecast a 2% decline in milk volumes; in last week's update that was revised to a decline of 5% or more, which is in line with the shortfall for the season to date (since June). That announcement itself all but ensures a further sharp rise in prices over coming auctions. We will update our payout forecast after the next auction in early October, but a milk price of $5 or more is now looking plausible for this season.

That said, we're wary of extrapolating too far from recent price movements. For one thing, the outlook for milk volumes is highly uncertain at this early point of the season, and the interaction between volumes and prices works both ways. At a milk price of $5/kg or more, it's not clear that farmers would be making the same kinds of decisions as they would have under a $3.85/kg price. While some decline in volume seems likely given the extent of culling of dairy cows to date, we're not convinced that it will continue to decline as steeply as it has to date.

Finest cheddar, made better continued

Another issue is that New Zealand's position as the 'swing factor' in the international dairy market is not a strong as it once was. Milk production in the Northern Hemisphere has grown substantially in recent years, in part incentivised by years of higher prices. And with domestic consumption of dairy products more or less flat in the Western world, all of this growth has been destined for the export market.

The removal of the EU's production quota system in April has led to a fresh wave of milk production, which will be hitting the global market over coming months. Production in regions such as Ireland, the UK and the Netherlands is now growing at double-digit annual rates. As the relatively lower-cost producers within Europe, they are looking to claim the greater market share that the quota system prevented them from doing until now. However, we have yet to see a corresponding scaling-back of milk production among the higher-cost nations, who won't be competitive over the long term in this environment.

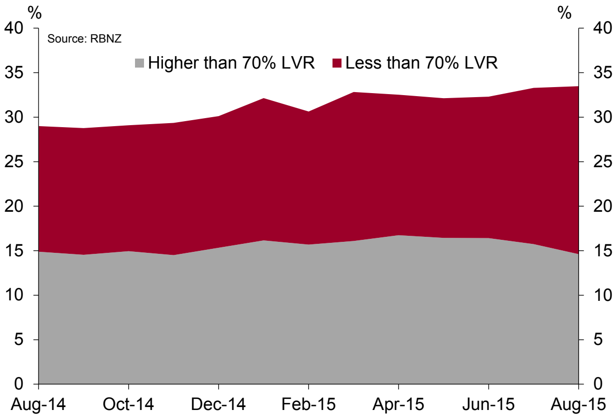
Meanwhile, Chinese demand for dairy imports remains subdued as its excess stocks are run down, and Russia's ban on food imports has reportedly been extended until August 2016 (and at this point should probably be treated as permanent). So even with a drop in New Zealand's milk production, it's not obvious that the global dairy market is moving closer to addressing the supply glut that drove prices down in the first place.

Nevertheless, the improved outlook for the dairy payout supports our view that the Reserve Bank won't be rushed into delivering its next interest rate cut. We expect the Reserve Bank to pause at the October OCR review, before delivering a cut at the next full *Monetary Policy Statement* in December.

The remainder of last week's data also supported a cautious stance towards further rate cuts. Net immigration shows little sign of slowing, with the annual balance passing the 60,000 mark in August. The balance has been boosted by a surge in temporary migrants from offshore – mostly migrant workers and international students – and a plunge in the number of New Zealanders leaving, mainly to Australia.

Meanwhile, the merchandise trade figures for August showed that there is still some life in New Zealand's exports – up 4% in seasonally adjusted terms, led by higher prices and volumes for meat. While the trade deficit was wider than expected, this was largely due to another large plane import.

Investors as a share of new mortgage lending



Finally, the latest lending figures compiled by the Reserve Bank suggest that the housing market remains lively, with weekly loan approvals up 41% on the same time last year. Some of the market's recent buoyancy is likely to reflect investors getting in before a range of new restrictions come into effect. From October, a capital gains tax will apply to investment properties bought and sold within two years, and foreign buyers will be required to register for tax. We expect this will have only a modest impact on house prices.

Then from November, investment property loans within Auckland will be effectively capped at a loan-to-value ratio (LVR) of 70%. Interestingly, the Reserve Bank's lending figures show how the market is already adapting. In August, 44% of all investor loans were at LVRs above 70%, compared to 51% in May when the restriction was announced. (Note this is nationwide, not just Auckland.) Yet investor lending as a whole has shown no signs of slowing: 33.5% of new lending was to investors in August, the highest since this series was first reported a year ago. This suggests – as we anticipated – that the 70% LVR cap won't be terribly binding, as many investors will be able to drum up a larger deposit if needed.

Fixed vs Floating for mortgages

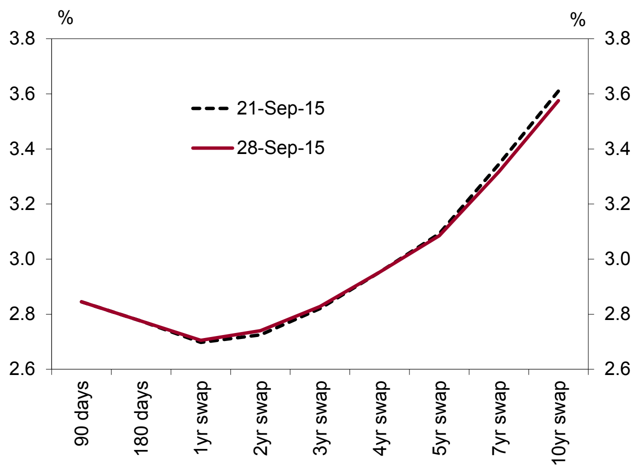
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability, but 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.

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



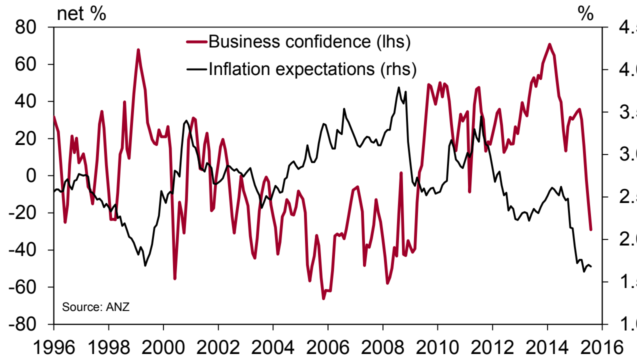
The week ahead

NZ Sep business confidence

Sep 30, Last: -29.1%

- Business confidence has fallen sharply in recent months, with firms noting concern about the general economic outlook and their own trading conditions. Confidence has fallen particularly sharply in the agricultural sector, but is low across all sectors of the economy.
- Although the September confidence survey pre-dated the latest payout announcement from Fonterra, there has been a rebound in dairy prices in recent weeks. Consequently, it wouldn't be surprising to see some pick-up in confidence in September. Nevertheless, business confidence is expected to remain at low levels.
- We'll be closely watching the survey's inflation gauges to see how firms' pricing intentions are evolving in the wake of the fall in the NZD.

NZ business confidence, inflation expectations

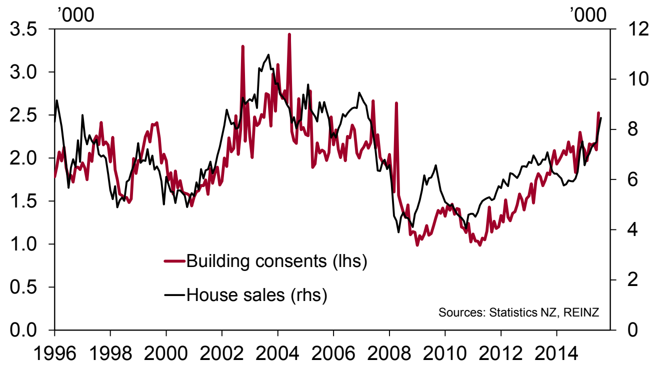


NZ Aug building consents

Sep 30, Last: 20.4%, Westpac f/c: -14.6%

- Month-on-month seasonally-adjusted building consents are expected to moderate in August. Monthly consent numbers are subject to significant volatility due to the lumpiness of high-density (apartments, townhouses, etc) consents. This was a big part of the reason for the huge 20.4% rise in July.
- Even as residential activity in Canterbury begins to fall away, we expect stronger growth in Auckland. The net upward trend in consents is expected to continue for the next several quarters although monthly data will remain subject to fluctuations.

NZ housing activity

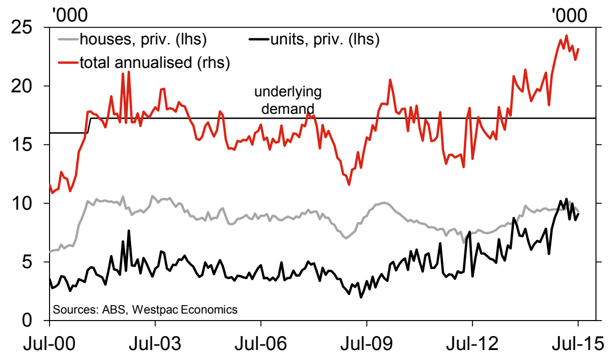


Aus Aug dwelling approvals

Sep 30 Last: 4.2%, WBC f/c: –1.0%
Mkt f/c: –2.0%, Range: –4.5% to 2.5%

- Dwelling approvals posted a partial rebound in July from a fall in June, the volatility driven by swings in high-rise approvals. Approvals are 4.7% below their March peak.
- Volatility continues to affect much of the survey detail making trends difficult to pinpoint both at the national level and across states.
- The August update will hopefully give a bit more clarity. A 1% decline in approvals would be consistent with an underlying downtrend running at a modest 3-3½% annualised pace.
- More volatility in high rise approvals could easily knock the headline monthly moves around though.

Dwelling approvals

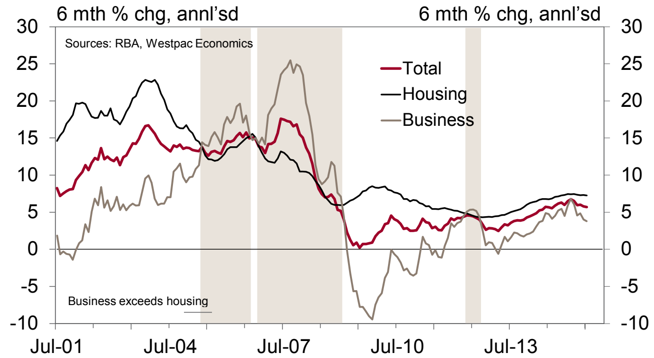


Aus Aug private sector credit

Sep 30, Last: 0.6%, WBC f/c: 0.5%
Mkt f/c: 0.5%, Range: 0.4% to 0.6%

- Credit to the private sector grew by 0.5% per month, on average, over 2015 H1 and as at July was 6.1% higher than a year ago.
- For August, credit growth is forecast to be 0.5%, following an increase of 0.6% in July.
- Business credit has been choppy over recent months, following a strong six months to February. With new lending (commercial finance) rebounding of late we expect business credit to advance in coming months. However, for August, there is the risk of a consolidation after a rise of 0.7% in July, well in excess of the six month average of 0.3%.
- Housing credit grew by 0.6%, 7.4%yr in July. Low and falling interest rates and strong investor interest have been driving the sector forward. A similar outcome is likely in August.

Credit momentum



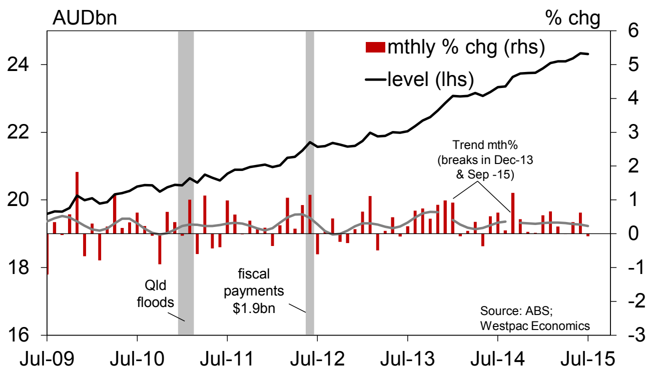
The week ahead

Aus Aug retail trade

Oct 2, Last: –0.1%, WBC f/c: 0.7%
Mkt f/c: 0.4%, Range: 0.0% to 0.7%

- Retail sales were weaker than expected in July, declining 0.1% with June's 0.7% rise pared back to a 0.6%. The main driver was a reversal in household goods retail, down 1.9% after a 2.4% surge in June. Some of this in turn related to Budget measures encouraging small business investment spending ahead of the end of financial year. Food retail was also flat in the month, possibly due to aggressive pricing as much as soft demand.
- August should see a better result. Consumer confidence recovered and business surveys showed a lift in conditions for retail and consumer service sectors. Some of this may also reflect shifts in net tourist flows following the AUD fall (both increased inbound and fewer Australians holidaying overseas).
- On balance, we expect sales to post a solid 0.7% rise in August.

Retail sales

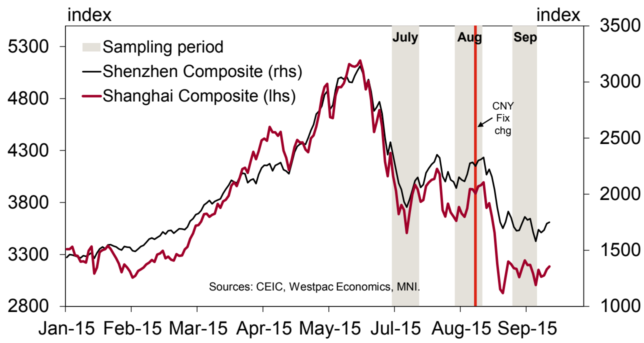


Chn Sep Westpac MNI China Consumer Sentiment

Sep 30, Last: 116.5

- The Westpac MNI China Consumer Sentiment Indicator increased 1.8pts from 114.5 in July to 116.5 in August, to be up 2.8% on a year ago but still 3.2% below the long run average. The gain came despite ongoing concerns about the Chinese economy and additional 'shocks' from the CNY devaluation and the Tianjin explosion. While China's equity markets were more stable before and during the August survey, sentiment has shown a steady improvement throughout the market slump since May. All of this suggests the factors foreign observers have found so disconcerting are of much less import for Chinese consumers.
- Equity markets saw a renewed sell-off between the August and September surveys. However, China's housing markets have continued to show signs of stabilisation.

Equities, CNY & the CSI sampling period

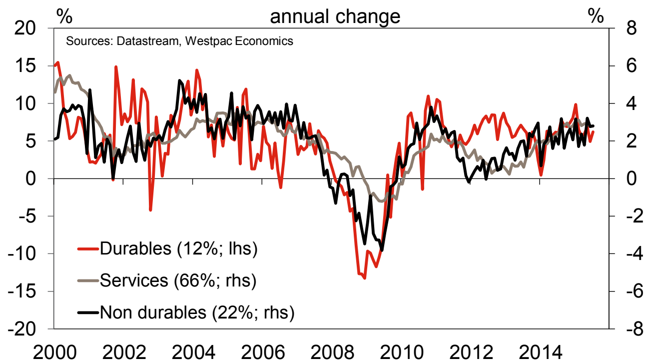


US August personal income and spending

Sep 28, personal income, Last: 0.4%, WBC f/c: 0.3%
Sep 28, personal spending, Last: 0.3%, WBC f/c: 0.3%
Sep 28, PCE deflator, Last: 0.1%, WBC f/c: 0.0%

- US households continue to experience solid, albeit not rapid, growth in incomes. The 0.4% gain experienced in July follows similar sized gains over the previous three months, leaving annual growth at 5.2%. Wages are a little softer at 4.4%yr. Robust job gains point to this momentum continuing in Aug.
- For spending, services continue to provide baseline momentum, with gains for durables partly offset by oil-induced non-durables weakness. Aug is likely to see these trends persist, producing another modest headline gain, circa 0.3%.
- Headline inflation is weak at 0.3%yr, and core is subdued at 1.2%yr. Based on the CPI, the Aug deflator will be flat at best owing to oil price weakness, keeping a lid on the annual rate.

Consumer offsetting investment & global uncertainty

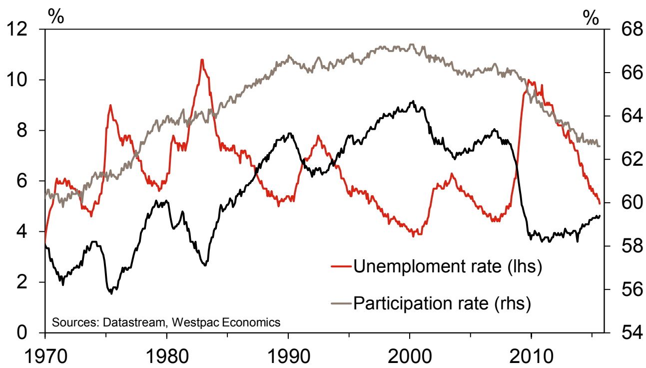


US September nonfarm payrolls & unemployment

Oct 2, nonfarm payrolls, Last: 173k, WBC f/c: 190k
Oct 2, unemployment rate, Last: 5.1%, WBC f/c: 5.1%

- The pace of nonfarm payrolls growth has slowed of late. Yet including revisions, growth is still in excess of 200k per month – 217k in Aug and a 212k average for 2015.
- At 1.8% annualised, employment continues to outpace growth in the population (1.2%) and the labour force (0.9%). Sep is likely to see this trend persist: a forecast 190k gain, with upside risk from further revisions.
- Continued robust employment growth and a broadly stable participation rate should see the unemployment rate unchanged at 5.1% in Sep. At that level, the economy is best regarded as nearly having attained full employment of available labour. In time, wages should gain strength from this.

Unemployment rate at lowest level since 2008



Data calendar

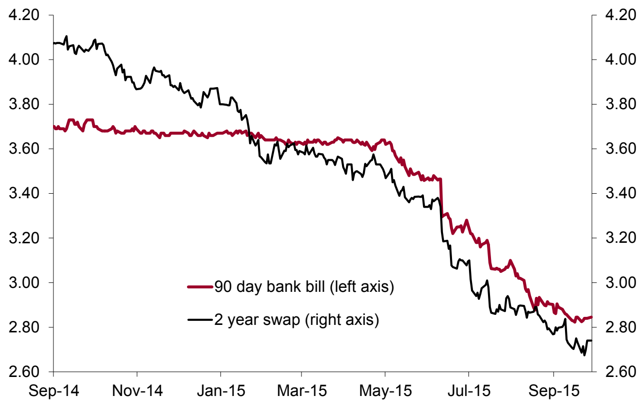
		Last	Market median	Westpac forecast	Risk/Comment
Mon 28					
NZ	Q3 Westpac MM employ' confidence	102.8	–	–	Employment confidence fell through the first half of the year.
US	Aug personal income	0.4%	0.4%	0.3%	Enduring momentum in incomes, albeit of the modest variety.
	Aug personal spending	0.3%	0.3%	0.3%	Oil price weighing on non-durable goods spending.
	Aug PCE deflator	0.1%	0.0%	0.0%	Weak oil price to keep headline outcome flat (at best).
	Aug pending home sales	0.5%	0.4%	–	Up 7.2%yr, a robust pace.
	Sep Dallas Fed manufacturing survey	–15.8	–9.5	–	Has pulled back, points to modest factory sector activity.
	Fedspeak	–	–	–	Dudley & Evans on policy; Williams on economic outlook.
Tue 29					
Eur	Sep economic confidence	104.2	104.1	–	Confidence supported by ECB's intent.
	Sep consumer confidence	–7.1	–	–	Consumer confidence above average, aiding discretionary spend.
	Sep business climate indicator	0.21	0.22	–	Business happier, but still not interested in real investment.
Ger	Sep CPI (provisional)	0.0%	–0.2%	–	Annual headline inflation at just 0.1%yr.
UK	Aug net lending secured on dwellings	2.7b	2.9b	–	Lower mortgage rates have boosted the housing market.
	Aug mortgage approvals	68.8k	70.0k	–	Housing market conditions have been strengthening.
US	Jul S&P/C-S 20 city house prices	–0.1%	0.0%	–	Recent times have seen more modest (but still solid) growth.
	Sep consumer confidence	101.5	96.0	–	Conference Board measure; likely to take hit from markets.
Wed 30					
NZ	Aug building permits	20.4%	–	–14.6%	Apartment consents are expected to retrace last month's spike.
	Sep business confidence	–29.1	–	–	Business confidence has fallen sharply in recent months.
Aus	Aug dwelling approvals	4.2%	–2.0%	–1.0%	Approvals have passed their peak but pace of softening unclear.
	Aug private sector credit	0.6%	0.5%	0.5%	Business credit volatile - consolidation likely in Aug after +0.7% in July.
Chn	Sep Westpac–MNI consumer sentiment	116.5	–	–	Three straight gains despite equity turmoil.
Eur	Aug unemployment rate	10.9%	10.9%	–	Labour market showing positive signs of healing (at margin).
	Sep CPI	0.2%	0.0%	0.0%	Deflation concerns have abated; but only just.
UK	Aug UK consumer confidence	7.0	5.0	–	Consumer confidence has been trending upwards.
	Sep nationwide house prices	0.3%	0.4%	–	Annual house price inflation has moderated.
	GDP (final)	0.7%	0.7%	0.7%	Initial estimate showed a rebound in growth.
US	Sep ADP employment change	190k	188k	180k	Has underperformed payrolls in 2015.
	Sep Chicago PMI	54.4	53.1	–	Has picked up, but remains moderate.
	Fedspeak	–	–	–	Fed's Dudley speaks on market liquidity in New York.
	Fed Chair Yellen	–	–	–	Fed's Yellen and Bullard speak on community banking in St Louis.
Can	Jul GDP %mth	0.5%	0.2%	–	A softening in growth is expected after last month's spike.
Thu 1					
NZ	Sep QVNZ house prices (%yr)	11.3%	–	–	House prices have risen strongly ahead of regulatory changes.
Aus	Sep CoreLogic RP Data House prices	0.3%	–	0.1%	Price growth has cooled after Q2's strong burst.
	Sep AiG PMI	51.7	–	–	Manufacturing index > 50, up from 47 in Q1, on housing & lower AUD.
Chn	Sep NBS manufacturing PMI	49.7	–	–	Orders-inventory ratio unchanged in August: lower orders & lower stox.
	Sep NBS non–manufacturing PMI	53.4	–	–	Historic average just shy of 57, so don't get excited by a 53 handle.
	Sep Caixin PMI manufacturing - final	47.0(p)	–	–	Flash estimate edged lower to 47.0 from 47.3 in Aug.
	Sep Caixin PMI services	51.5	–	–	Finance and trade logistics lower, real estate & consumer firmer.
Eur	Sep Markit manufacturing PMI (final)	52.0	52.0	–	Moderate momentum; global economy weighing.
Ger	Sep Markit manufacturing PMI (final)	52.5	52.5	–	Moderate momentum; global economy weighing.
UK	Sep Markit manufacturing PMI	51.5	51.3	–	Sluggish global trade is resulting in headwinds for manufacturing.
US	Initial jobless claims	267k	–	–	Claims remain very low.
	Sep Markit manufacturing PMI	53.0	53.0	–	Final estimate for September; outperforming ISM.
	Sep ISM manufacturing	51.1	50.6	–	USD has had a material impact; signalling limited momentum.
	Fedspeak	–	–	–	Fed's Brainard speak on community banking in St Louis.
	Fedspeak	–	–	–	Fed's Williams gives outlook speech in Salt Lake City.
Fri 2					
NZ	Sep commodity price index	–5.2%	–	8.0%	Strong rebound in world dairy prices.
Aus	Aug retail trade	–0.1%	0.4%	0.7%	Rebound, Con' Sent' up & business surveys report improved conditions.
Chn	National Day holiday	–	–	–	Holiday, October 2 to October 7
UK	Sep Markit construction PMI	57.3	57.5	–	Has remained robust through the second half of the year.
US	Sep non-farm payrolls	173k	200k	190k	1.8% annualised pace sees employ g'th well in exces of pop'n g'th.
	Sep unemployment rate	5.1%	5.1%	5.1%	Robust jobs gains have left u/e rate near full employment.
	Sep New York ISM	51.1	–	–	Business conditions have moderated.
	Aug factory orders	0.4%	–1.0%	–	Underlying investment trend remains weak.
	Fedspeak	–	–	–	Fed's Fischer addresses Boston Fed conference on monetary policy.

New Zealand forecasts

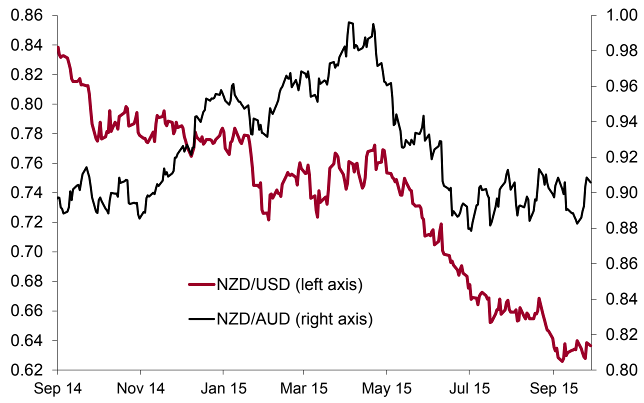
Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016f	2017f	2013	2014	2015f	2016f
GDP (Production) ann avg	2.5	3.2	1.8	2.0	2.3	3.3	2.1	1.7
Employment	3.8	3.2	0.5	2.1	2.9	3.6	0.9	1.8
Unemployment Rate % s.a.	6.0	5.8	6.5	6.3	6.1	5.7	6.4	6.3
CPI	1.5	0.3	1.5	1.6	1.6	0.8	0.7	1.9
Current Account Balance % of GDP	-2.6	-3.4	-5.6	-4.7	-3.2	-3.1	-4.8	-5.2

Financial Forecasts	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
Cash	2.75	2.50	2.00	2.00	2.00	2.00
90 Day bill	2.80	2.40	2.10	2.10	2.10	2.10
2 Year Swap	2.70	2.50	2.30	2.20	2.20	2.20
5 Year Swap	3.10	3.10	3.10	3.10	3.20	3.20
10 Year Bond	3.20	3.40	3.40	3.60	3.70	3.70
NZD/USD	0.63	0.62	0.61	0.61	0.62	0.63
NZD/AUD	0.90	0.91	0.92	0.92	0.92	0.92
NZD/JPY	76.2	76.3	75.0	75.6	77.1	79.9
NZD/EUR	0.56	0.57	0.57	0.57	0.57	0.58
NZD/GBP	0.42	0.42	0.42	0.42	0.42	0.42
TWI	67.8	67.9	67.8	67.8	68.2	69.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 28 September 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.75%	2.75%	3.00%
30 Days	2.85%	2.85%	3.04%
60 Days	2.85%	2.83%	2.93%
90 Days	2.85%	2.85%	2.92%
2 Year Swap	2.74%	2.73%	2.79%
5 Year Swap	3.09%	3.10%	3.13%

NZ foreign currency mid-rates as at Monday 28 September 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6365	0.6312	0.6458
NZD/EUR	0.5694	0.5568	0.5781
NZD/GBP	0.4190	0.4089	0.4192
NZD/JPY	76.72	76.03	78.56
NZD/AUD	0.9058	0.8910	0.9028
TWI	69.52	68.49	69.95

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	2.2	2.7
CPI inflation % annual	3.0	2.2	2.7	1.7	2.2	2.2
Unemployment %	5.2	5.3	5.8	6.2	6.5	6.3
Current Account % GDP	-2.8	-4.4	-3.4	-3.0	-4.3	-4.6
United States						
Real GDP %yr	1.6	2.3	1.5	2.4	2.4	2.8
Consumer Prices %yr	3.1	2.1	1.5	1.6	0.2	2.0
Unemployment Rate %	8.9	8.1	7.4	6.2	5.4	5.1
Current Account %GDP	-2.9	-2.9	-2.2	-2.2	-2.3	-2.3
Japan						
Real GDP %yr	-0.5	1.8	1.6	-0.1	0.6	1.3
Euroland						
Real GDP %yr	1.6	-0.8	-0.3	0.9	1.3	1.1
United Kingdom						
Real GDP %yr	1.6	0.7	1.7	3.0	2.5	2.5
China						
Real GDP %yr	9.3	7.8	7.8	7.3	7.0	6.8
East Asia ex China						
Real GDP %yr	4.4	4.5	4.3	4.1	3.5	4.0
World						
Real GDP %yr	4.2	3.4	3.4	3.4	3.1	3.6
Forecasts finalised 4 Sep 2015						

Interest Rate Forecasts	Latest	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.19	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.70	2.85	3.10	3.25	3.40	3.60
International						
Fed Funds	0.125	0.125	0.375	0.625	0.875	1.125
US 10 Year Bond	2.14	2.40	2.80	3.00	3.20	3.40
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
AUD/USD	0.7000	0.70	0.68	0.66	0.66	0.67
USD/JPY	120.20	121	123	123	124	125
EUR/USD	1.1170	1.12	1.09	1.07	1.07	1.07
AUD/NZD	1.1060	1.11	1.10	1.08	1.08	1.09

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Disclaimer continued

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