Weekly Commentary

10 October 2011

Puttering along

Market sentiment about prospects for Eurozone economies continues to be swayed by political developments. But, so far, financial market volatility has had a relatively muted effect on NZ business confidence. Surveys are consistent with modest underlying GDP growth heading into the second half of the year. And while the Rugby World Cup is providing the much anticipated boost to visitor spending, it is also displacing some domestic activity.

Headlines out of the Eurozone pushed markets one way then the other last week. Delays to the ratification of the extension of the European Financial Stability Facility (EFSF) to 440bn Euros triggered a negative tone. Later in the week comments by Germany's President Merkel (amongst others) supporting plans for European bank recapitalisation measures together with announcements by the ECB and the Bank of England that they were introducing further measures to improve liquidity, meant the markets ended the week on a more positive tone. Nonetheless, volatility remains the order of the day as political leaders continue to search for a plan to get Eurozone economies and banks back on more stable footing.

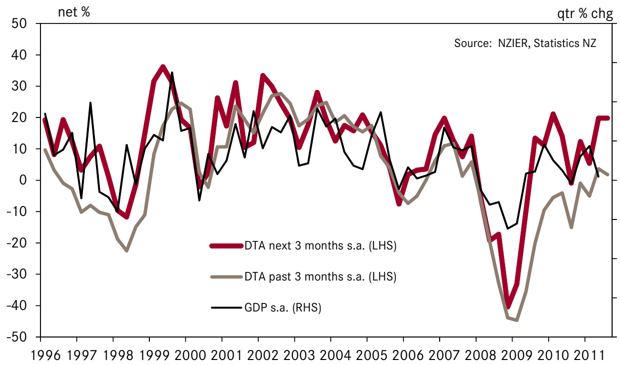
Domestically, we had further evidence last week that NZ business confidence has demonstrated some resilience, though not immunity, to the heightened risks around global growth. In the September *Quarterly Survey of Business Opinion* (QSBO) firms reported that their own activity eased slightly over the last 3 months. But even then, the level of reported activity remains relatively high (the second highest since 2008). When firms switched their focus from the past to the future, expectations of their own activity in the coming 3 months were unchanged from the previous quarter although their confidence about the general economic situation fell significantly.

Traditionally, it is the measure of firms' own activity over the past three months which provides one of the most useful early leads on GDP growth (even if it missed the recent quarterly variation). On its own it suggests a middling pace of growth heading into the second half of the year. However, we are suspicious that the survey (with responses submitted in September) understates the impact of the Rugby World Cup. Partly because firms hadn't yet observed the impact on demand from arriving visitors when they completed the survey, but also partly for technical reasons (tickets purchased for the event months ago aren't consumed until the event takes place). All in all we expect the economy continued its patchy recovery in Q3.

There are a few reasons why businesses might be feeling a little sheltered from the chill winds currently blowing in from offshore. Firstly, NZ's commodity export prices have, to date, held up relatively well. However we expect this is only temporary relief. Our own forecast is that commodity prices (including food prices) have further to fall yet as the pace of growth in China and other Asian economies slows. With this slowdown a consequence of both tighter domestic policy and spillover effects from markedly slower growth in the Eurozone. Broadly in line with this, dairy prices continued to slide in last week's Fonterra GlobalDairyTrade auction (on average dairy prices slipped 1.6%). Softer dairy prices were also a factor behind the 1.3% fall in the broader ANZ commodity price index in September. Ten of the 17 commodities in the index recorded falls in the month, 4 were unchanged and prices of 3 products rose. We've seen modest falls in commodity prices over the last few months but they remain high (over 17% above levels of a year ago), and along with excellent spring pasture conditions, continue to provide strong support rural incomes.

A second possible reason for optimism is that one of the key drivers of growth over the coming years, rebuilding in the Canterbury region, is effectively independent of the global slowdown. While the massive re-building task faces its own challenges such as insurance, aftershocks and resource constraints to name a few, its prospects do not depend on the pace of global growth. This was clearly reflected in the QSBO where business confidence remained the highest, even improving further, in Canterbury and pricing power was also particularly strong in the building industry.

Domestic trading activity



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With the first data on economic activity last month now beginning to trickle through, we are increasingly aware of the extent to which increased activity in some sectors during the Rugby World Cup has displaced activity in other areas. Overall, the impact on spending in September appeared quite muted in the Paymark electronic card transactions data. Spending on cards rose just 0.3% (s.a.) in September. While the detail clearly showed the impact of RWC visitors (spending by overseas card holders was 30% higher than a year earlier, and one of the strongest performing sectors was restaurant and hospitality spending) the total lift in spending was on the soft side – especially when you consider that as well as 40,000 additional tourists in the country, there were at least 30,000 more kiwis staying home during the month. It's still too early to tell if it's simply the timing of domestic activity which has shifted (for example switching school holidays from September to October may explain part of the domestic spending weakness) implying some catch-up in the coming months, or if some activity now simply won't take place.

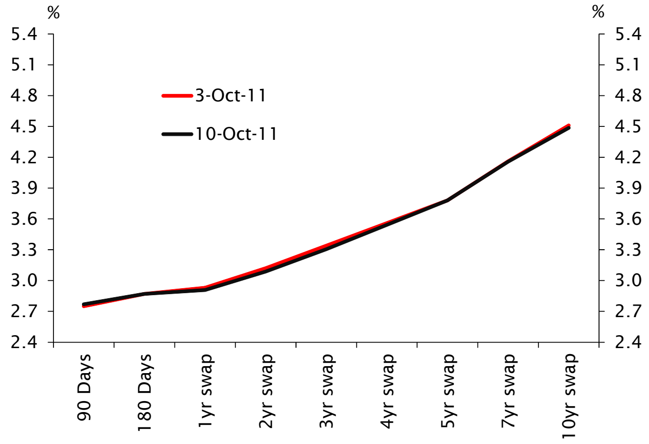
Of course Paymark data isn't the final word on the matter. Stats NZ figures on electronic card spending data out this week will provide a more comprehensive read on card spending, while quarterly retail sales data (which unfortunately is not out until mid November) delves even deeper into the detail.

Besides the Rugby World Cup, another factor contributing to softer spending by New Zealanders in September may have been the slowing housing market. This week nationwide data for September is due to be released by both REINZ and QV. This is likely to show momentum slowed further after Barfoot and Thompson (the biggest agency in Auckland) earlier reported further cooling in the Auckland market during the month. Their sales volumes fell 10% (s.a.) following smaller falls in July and August. While extent of the slowdown in sales may well have been exacerbated by the arrival of the Rugby World Cup band wagon, the data confirms the cooling in the NZ housing market over in recent months and is consistent with our own forecasts of 4% growth in house prices this year, and flat house prices in 2012.

As well as housing data, second tier data released this week includes an update on consumer confidence, food prices and New Zealand's PMI in September.

Fixed vs. floating: In its recent *Monetary Policy Statement*, the Reserve Bank confirmed it is in no hurry to raise rates while conditions in financial markets and the Eurozone remain this volatile. It also noted that if current conditions in bank funding markets persist, banks will face higher funding costs, which in turn, raises the possibility of higher mortgage rates in the future, independent of changes in the OCR. The recent ratings downgrades are likely to have reinforced that view, and floating rate borrowers may prefer to take a wait and see approach in this environment. Yet the trend of rising rates over the longer term remains intact. Based on our current forecasts of the OCR rising to 6% over the next three years, fixing for two or three years is likely to result in a lower overall interest bill than remaining on floating.

NZ interest rates



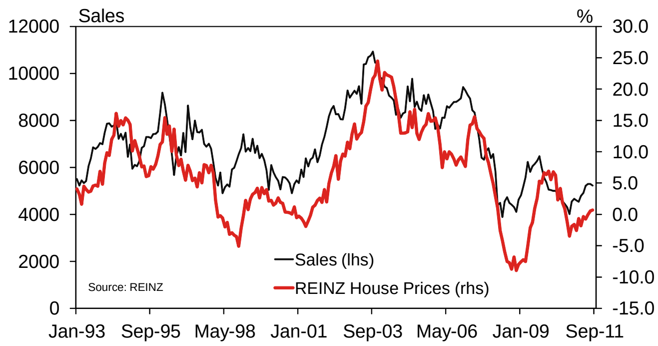
Key Data Previews

NZ Sep REINZ house prices and sales

Oct 10-14, Sales last: -1.4%, Prices last: -0.1%

- New Zealand's housing market started the year strong, but the momentum in sales has been slowing in the last few months, while prices have remained flat.
- September figures from Barfoot & Thompson showed a 10% drop in sales in Auckland, the region that led the broader upswing earlier in the year. However, nationwide mortgage approvals were about flat, which suggests some ongoing catch-up in other parts of the country.
- As with retail spending, the Rugby World Cup and the delayed school holidays may have disrupted the timing of house sales.

REINZ House prices and sales

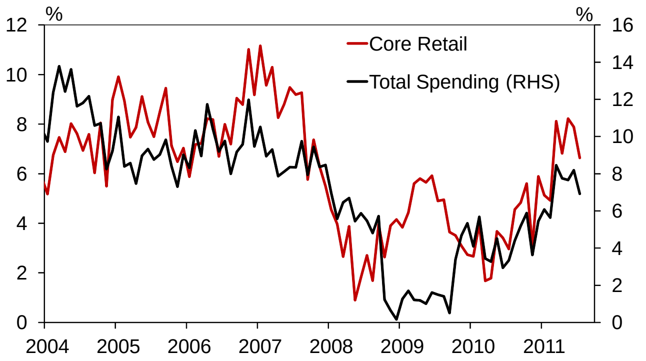


NZ Sep electronic card spending

Oct 11, Last: -0.5%, WBC f/c: 0.3%

- Card spending fell in August after a sharp jump in June which was maintained through July. Durable goods and apparel were largely behind the rise and fall.
- While retailers were upbeat in business surveys, preliminary spending data for September was notably subdued. Spending on overseas-issued cards was as strong as expected, given the influx of visitors for the first half of the Rugby World Cup. But spending on domestic cards appears to have softened further. It may be that some spending has simply been displaced into later months (notably, school holidays were shifted from September to October this year).
- Higher prices for fuel, and probably for food, over the month means that the September spending figures will be even less flattering in volume terms.

Card transactions, annual % change

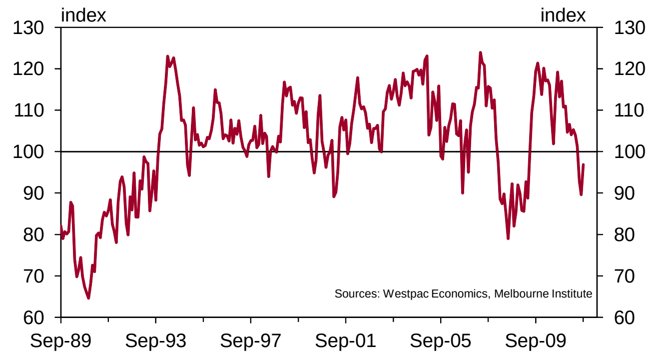


Aus Oct Westpac-MI Consumer Sentiment

Oct 12, Last: 96.9

- Consumer sentiment posted a surprisingly solid 8.1% rebound in Sep despite ongoing turmoil in global financial markets, further signs of softening in the domestic labour market and an associated sharp deterioration in consumers' sense of job security. The proximate cause of the uptick was the shifting view on domestic interest rates, with the RBA leaving rates on hold and significantly downgrading its hawkish rhetoric.
- The Oct survey is in the field to Oct 9 and will see a similar mix of influences. Financial turbulence remains intense, with the ASX down 3% since the last survey but off over 8% at one stage; the AUD is 7c lower vs the USD, but was down a whopping 9½c between Sep 9 and Oct 3. Both have rallied in recent sessions, but the extreme volatility is itself unnerving. Against this, the RBA again left rates unchanged at its Oct meeting and showed clear signs of shifting to an easing bias.

Aus consumer sentiment

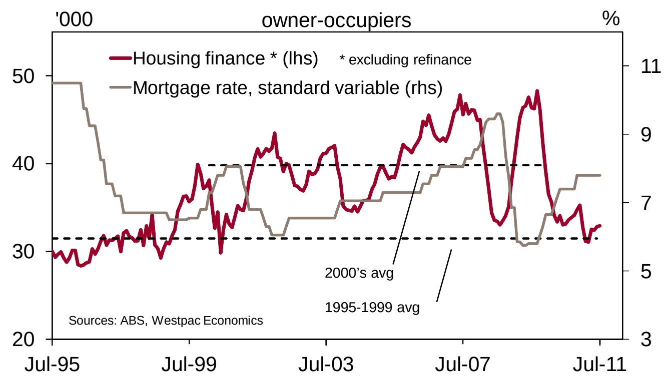


Aus Aug housing finance

Oct 12, Last: 1.0%, WBC f/c: 1.8%
Mkt f/c: 1.0%, Range: 0% to 2.0%

- After a weak start to the year, housing finance demand has made a partial recovery - a trend that continued in August.
- We're forecasting the number of loans to owner-occupiers to rise by almost 2% in the month.
- As at July, finance was down -3.2% for the year so far, with a decline in new lending (ie ex refinancing) of -6.6%. This weakness reflects the impact of the November 2010 rate hike, the Qld floods disruption, stretched housing affordability and consumers' desire to pay down debt.
- Housing finance is relatively weak, with the level of lending to owner-occupiers only a little above that prevailing over the second half of the 1990s.

Aus owner-occupier finance & the rate cycle

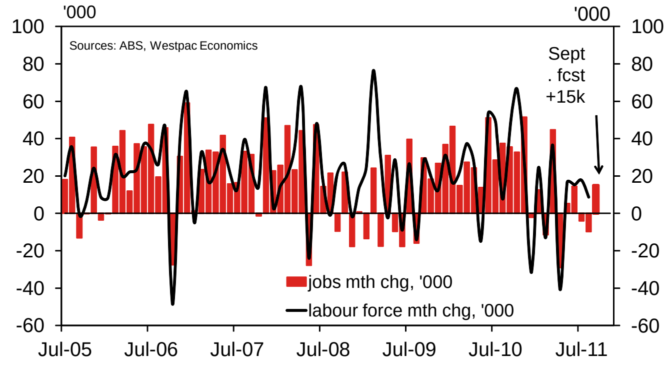


Aus Sep labour force - employment '000 mth

Oct 13, Last: –9.7k, WBC f/c: 15k
Mkt f/c: 10k, Range: –10k to 23k

- In August, the ABS reported a fall in total jobs of 9.7k while July was revised from basically flat to –4.1k. Employment has fallen an average of 6.9k per month over the last two months. Contrast this with our analysis of the various leading indicators: both job ads and the business surveys are pointing to an average monthly gain of between 15k and 17k.
- More critically, the jobs market is experiencing a significant structural shift with significant weakness in the two (non-mutually exclusive) categories of male and full-time employment. The benefits of the mining boom are not spreading as widely as many had expected them to.
- The labour market is yet to turn the corner, but three negatives in a row is statistically rare: the post GST collapse in late 2000 was the last time, so we forecast a modest +15k.

Aus labour force vs. jobs growth

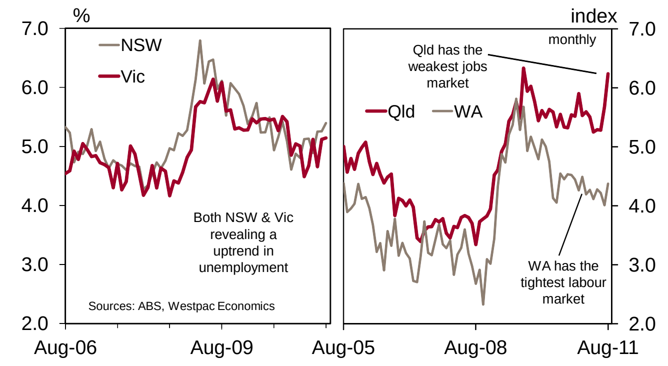


Aus Sep labour force - unemployment rate %

Oct 13, Last: 5.3%, WBC f/c: 5.3%
Mkt f/c: 5.3%, Range: 5.2% to 5.4%

- Since April, the unemployment rate has lifted from 4.9% to 5.3% as the Australia economy added just 5.8k jobs while the labour force grew by 58.4k. There has been a small lift in the participation rate, from 65.5% to 65.6%, but the labour force would have grown even faster if the population growth rate had not slowed from a monthly annualise pace of 1.3% in April to 1.0%yr in August.
- While we think that participation should stabilise from here (and possibly fall a touch in the coming months), at a 1% annualised pace, we believe that population growth can't slow much more from here. So while we are cognisant that a large part of the August rise in unemployment was concentrated in Qld, we expect the labour force to grow at least as fast as employment. This suggests a flat unemployment rate.

Aus - big jump in Qld but weakness overall

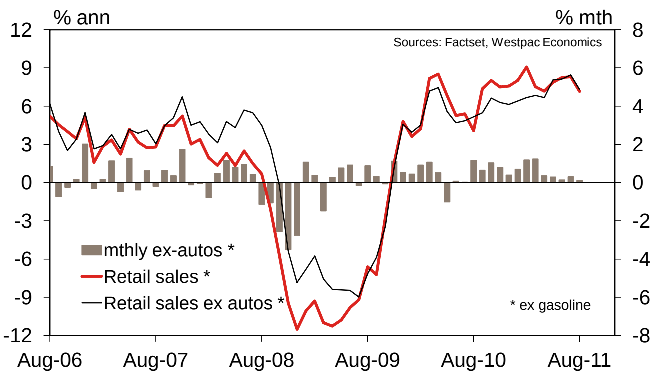


US retail sales to rise in Sep on autos

Oct 14, Last: 0.0%, WBC f/c: 0.6%

- Modestly lower auto sales offset a small rise in gasoline sales and subdued core spending growth (ex autos & gas up 0.1%) in Aug. Clothing (–0.7%) and furniture (–0.2%) were amongst the weakest components, the latter having posted just one gain (0.4% in Jul) in the past five months. Broad-based softness in August and the decelerating underlying trend (core retail 3.4% annualised in Jun-Aug vs 7.7% in Mar-May) are consistent with consumer spending losing momentum.
- Unit auto sales jumped 8% in Sep and gasoline prices were little changed. Consumer confidence fell sharply in Q3 and our forecast for weak Sep jobs growth means we expect Sep retailing outside of autos to be constrained by minimal income growth and ongoing consumer caution.
- We expect a 0.6% Sep retail gain, but just 0.1% ex autos & gas.

US retail sales



Key Data and Events

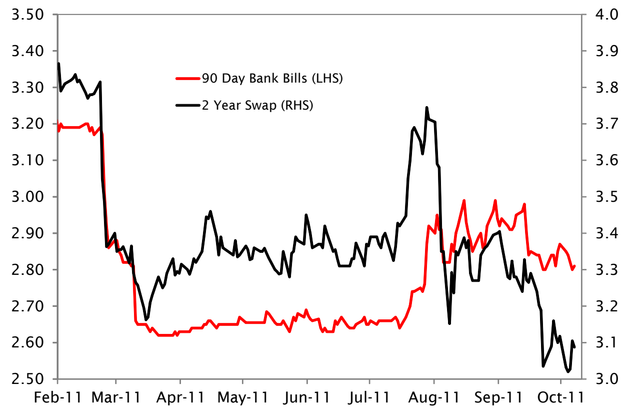
		Last	Market median	Westpac forecast	Risk/Comment
Mon 10					
NZ	Aug REINZ house sales s.a.	-1.4%	–	–	Due this week. Sales momentum appears to be fading, particularly in
	Aug REINZ house price index s.a	-0.1%	–	–	previously hot Auckland market.
Aus	Sep TD-MI inflation gauge	-0.1%	–	–	Recent outcomes indicate early 2011 inflationary pressures abating.
	Sep ANZ job ads	-0.6%	–	–	Leading indicators have outperformed labour market actuals of late.
Eur	Sentix investor confidence	-15.4	–	-20	Greek news gets worse each week, debt restructure looms.
Ger	Aug exports	-1.9%	1.3%	–	The engine of European growth faltering?
UK	Sep consumer confidence	48	–	46	Tentative date for Nationwide index, due 10-14/10
Tue 11					
NZ	Sep Card Spending	-0.5%	–	0.3%	Retail spending soft, despite the influx of RWC visitors.
Aus	Sep NAB business survey	-3	–	–	Weakness in August: conditions -2pts to -3 & confidence -9pts to -8.
Chn	Sep foreign exchange reserves USDbn	–	–	–	Tentative date: Mixed trends in both trade and capital flow over quarter.
	Sep new loans RMBbn	548.5	550	–	Tentative date: shadow banking undermining generality of this series.
	Sep M2 money supply %yr	13.5%	14%	–	Tentative date: Wallowing well below nominal GDP growth.
Jpn	Aug current account total ¥bn s/a	753	510	–	Trade position not helping, income surplus pressured on many fronts.
Eur	Aug industrial production	0.9%	-0.7%	0.3%	German data due 7/10 will provide further guidance.
UK	Sep BRC retail survey %yr	-0.6%	–	–	Same store sales have been weak compared to yr ago for four months.
	Sep RICS house price balance	-23%	–	–	Still a sizeable majority of surveyors reporting lower prices.
	Aug house prices %yr	-1.5%	–	–	DCLG (government) index.
	Aug industrial production	-0.2%	0.1%	-0.2%	IP has not posted a rise since May.
	Aug visible trade balance £bn	-8.9	–	–	Jul's deficit second widest on record.
US	Sep NFIB small business optimism	88.1	–	87.5	Continued slippage as concerns about economy intensify.
	Oct IBD/TIPP economic optimism	39.9	–	37.0	Weekly indicators suggest renewed decline.
Can	Sep housing starts	185k	186k	–	Aug was lowest level for starts since Feb.
Wed 12					
Aus	Oct Westpac–MI Consumer Sentiment	96.9	–	–	Less pessimistic in Sep on reduced threat of rate hikes.
	Aug housing finance (no.)	1.0%	1.0%	1.8%	After a weak start to the yr, a partial recovery - which continued in Aug.
	RBA Assistant Gov Debelle speaking	–	–	–	"High Frequency Trading in Foreign Exchange Markets" 3:00PM AEDT
Jpn	Aug machinery orders	-8.2%	3.9%	–	Domestic strength, foreign weakness. Latter more likely to persist.
UK	Sep unemployment change	20k	19k	25k	Slowing economy driving up joblessness.
US	Sep 20-21 FOMC meeting minutes	–	–	–	More insight into the debate about further stimulus.
	Sep federal budget $bn	-134.2	-65.0	–	When will the debt ceiling issue arise again?
	Fedspeak	–	–	–	Pianalto. Plosser.
Can	Aug new home prices	0.1%	0.1%	–	Price growth slowed in Jul after rapid gains in Q2.
Thu 13					
Aus	Oct Westpac–MI unemploy expectations	146.6	–	–	Households are increasingly worried about the jobs market.
	Oct MI inflation expectations	2.8%	–	–	Inflation expectations have remained stable of late.
	Sep Employment change	-9.7k	10k	15k	Three -'ve's in a row statistically rare; +15k pace modest pace of gth.
	Sep Unemployment rate	5.3%	5.3%	5.3%	Labour force to grow at least as fast as employment = stable unemp rate.
	RBA Head of Fin. Stability, Ellis speaking	–	–	–	"The Platypus Moment: Rents, Risks and the Right Responses" 9:50AM AEDT
NZ	Sep Food prices	-1.3%	–	0.5%	Seasonal price increases, but annual growth has passed its peak.
Chn	Sep trade balance USDbn	17.8	16.9	–	Expect a sharp rebound as imports recede from August spurt.
Jpn	Aug tertiary industry index %mth	-0.1%	-0.3%	–	The recovery trajectory is levelling out.
Eur	Sep CPI final %yr	3.0% a	3.0%	3.0%	Sharp spike in Sep. Aug core rate was 1.2%yr.
US	Aug trade balance $bn	-44.8	-46.0	-47.0	Jul's 3.6% export jump unsustainable.
	Initial jobless claims w/e 7/10	401k	–	415k	Seasonal distortions may have held claims down in late Sep.
	Fedspeak	–	–	–	Kocherlakota.
Can	Aug trade balance C$bn	-0.75	-0.90	–	Last surplus was back in Jan.
Fri 14					
Chn	Sep consumer price index %yr	6.2%	6.1%	–	July was the likely peak, but ex-food ex-shelter looking sticky.
	Sep producer price index %yr	7.3%	6.9%	–	Easing in the ferrous space will cascade downstream through year end.
Jpn	Sep domestic CGPI %yr	2.6%	2.5%	–	Yen strength, raw material price decline pushing this indicator lower.
Eur	Aug trade balance €bn sa	-2.5	–	–	Surpluses now relatively rare.
US	Sep retail sales	0.0%	0.4%	0.6%	Auto unit sales up 8% in Sep but low confidence and weak household
	Sep retail sales ex autos & gas	0.1%	0.2%	0.1%	income suggest core sales will be sluggish again.
	Oct UoM consumer sentiment	59.4	60.0	57.0	Weekly indicators suggest renewed decline.

New Zealand Economic and Financial Forecasts

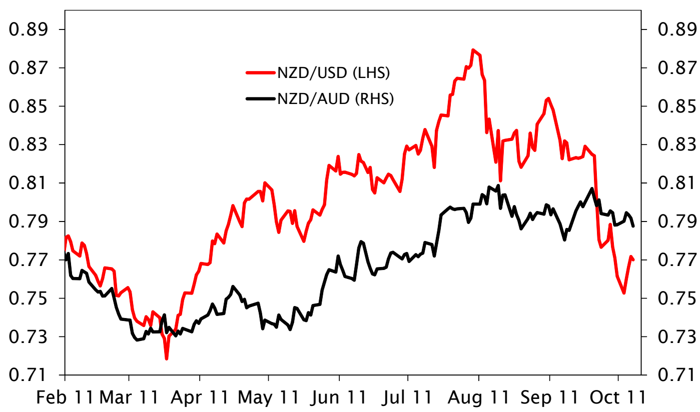
Economic Growth Forecasts	March years				Calendar years			
% change	2010	2011e	2012f	2013f	2010	2011f	2012f	2013f
GDP (Production) ann avg	-0.7	1.6	2.6	3.9	1.6	2.2	3.9	3.1
Employment	-0.1	1.8	1.7	3.2	1.3	2.3	3.1	2.8
Unemployment Rate % s.a.	6.1	6.5	6.3	5.2	6.7	6.4	5.4	4.3
CPI	2.0	4.5	3.0	3.4	4.0	3.3	2.9	3.1
Current Account Balance % of GDP	-1.9	-3.6	-4.4	-6.0	-3.5	-3.9	-6.0	-5.1

Financial Forecasts	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Cash	2.50	2.75	3.00	3.25	3.50	4.00
90 Day bill	2.80	3.00	3.30	3.60	4.00	4.50
2 Year Swap	3.30	3.50	3.90	4.30	4.70	5.20
5 Year Swap	4.00	4.30	4.60	4.90	5.40	5.80
10 Year Bond	4.40	4.70	5.00	5.20	5.60	6.00
NZD/USD	0.73	0.71	0.69	0.74	0.77	0.78
NZD/AUD	0.77	0.76	0.76	0.77	0.79	0.80
NZD/JPY	55.5	54.0	52.4	57.7	62.4	65.5
NZD/EUR	0.56	0.56	0.57	0.58	0.60	0.61
NZD/GBP	0.48	0.47	0.46	0.48	0.49	0.49
TWI	66.0	65.2	64.2	67.5	70.0	71.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 10 October 2011

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.50%	2.50%	2.50%
30 Days	2.77%	2.77%	2.78%
60 Days	2.82%	2.79%	2.81%
90 Days	2.81%	2.84%	2.95%
2 Year Swap	3.09%	3.05%	3.28%
5 Year Swap	3.78%	3.66%	4.02%

NZ foreign currency mid-rates as at Monday 10 October 2011

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.7675	0.7789	0.8213
NZD/EUR	0.5747	0.5754	0.6041
NZD/GBP	0.4935	0.5025	0.5187
NZD/JPY	58.895	59.574	63.591
NZD/AUD	0.7886	0.7919	0.7871
TWI	68.620	69.230	71.840

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2007	2008	2009	2010	2011f	2012f
Australia						
Real GDP % yr	4.6	2.6	1.4	2.7	1.2	2.5
CPI inflation % annual	3.0	3.7	2.1	2.7	3.6	3.1
Unemployment %	4.4	4.3	5.6	5.2	5.1	5.6
Current Account % GDP	-6.3	-4.5	-4.2	-2.7	-2.2	-3.4
United States						
Real GDP %yr	1.9	-0.3	-3.5	3.0	1.6	1.3
Consumer Prices %yr	2.9	3.8	-0.3	1.6	3.1	2.0
Unemployment Rate %	5.8	5.8	9.3	9.6	9.1	9.4
Current Account %GDP	-5.3	-4.7	-2.7	-3.2	-3.4	-3.1
Japan						
Real GDP %yr	2.2	-1.5	-6.6	4.3	-0.4	3.2
Consumer Prices %yr	0.1	1.4	-1.3	-0.7	0.2	0.6
Unemployment Rate %	3.9	4.0	5.1	5.1	4.6	4.5
Current Account %GDP	4.8	3.3	2.8	3.6	2.0	2.1
Euroland						
Real GDP %yr	2.8	0.3	-4.0	1.7	1.6	-0.6
Consumer Prices %yr	2.1	3.3	0.3	1.7	2.5	1.0
Unemployment Rate %	7.5	7.5	9.5	10.0	10.3	11.0
Current Account %GDP	0.2	-0.8	-0.7	-0.5	-0.5	0.0
United Kingdom						
Real GDP %yr	2.7	-0.1	-4.9	1.4	0.8	0.3
Consumer Prices %yr	2.3	3.6	2.2	3.2	4.0	2.2
Unemployment Rate %	5.3	5.6	7.6	7.8	8.0	8.2
Current Account %GDP	-2.6	-1.6	-1.3	-2.4	-2.0	-1.5

Forecasts finalised 10 October 2011

Interest Rate Forecasts	Latest (Oct 10)	Dec-11	Mar-12	Jun-12	Sep 12	Dec 12
Australia						
Cash	4.75	4.50	4.25	4.00	3.75	3.75
90 Day Bill	4.71	4.50	4.25	4.00	3.75	3.80
10 Year Bond	4.26	4.30	4.30	4.40	4.50	4.70
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.07	2.10	2.20	2.40	2.50	2.60
ECB Repo Rate	1.50	1.00	0.75	0.75	0.75	0.75

Exchange Rate Forecasts	Latest (Oct 10)	Dec-11	Mar-12	Jun-12	Sep 12	Dec 12
AUD/USD	0.9731	0.95	0.93	0.91	0.96	0.98
USD/JPY	76.73	76	76	76	78	81
EUR/USD	1.3356	1.30	1.26	1.22	1.27	1.28
AUD/NZD	1.2680	1.30	1.31	1.32	1.30	1.27