

WESTPAC WEEKLY ECONOMIC COMMENTARY

This commodity price cycle is different.

11 April 2022



Mount Cook buttercup

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This New Zealand commodity price cycle is different. Indeed, this price cycle is shaping up as more boom and echo boom than the boom and bust of previous cycles that we've previously come to know. With this in mind, we have revised up our farmgate price forecasts for meat and dairy.

First up for dairy, we have upgraded our 2022/23 farmgate milk price forecast by 75 cents to \$9.25/kg. At the same time, we have tweaked our 2021/22 forecast up by 10 cents to \$9.60/kg. This latter move reflects fine-tuning of our forecast, rather than an underlying change in our dairy market view. If we are proved correct, give or take, then these forecasts would represent the highest and second highest milk prices on record.

These milk price forecasts are in stark contrast to the previous price cycle. Back then, the milk price peaked at \$8.40/kg and then nearly halved the following season.

For meat, we have also revised up forecasts across the board. Crucially for lamb, we now expect the farmgate price to crack \$10.00/kg next season. Meanwhile, for beef and mutton, we expect both farmgate prices to crack \$7.00/kg next season as well. All three forecasts, again if proved correct, would represent record highs.

So why is this cycle different?

Firstly, dairy production is in a deep hole. We expect production to fall 4.75% this season – the biggest ever

season-on-season fall. And next season we expect the rebound to be a modest 3%. In other words, production is unlikely to recover to the level that it was back in 2020/21 for at least a few more seasons.

Similarly, this production cycle is very different to the last cycle. After a drought in 2013, dairy production surged the next season by a whopping 11%.

And underlying that surge was a rapid dairy land and dairy herd expansion. All up, the dairy herd grew by over a million head between 2007 and 2016.

Now, the opposite is happening: the herd is shrinking. We project that the dairy herd has shrunk by around 400,000 cows between 2016 and 2022.

The reasons for the consolidation are varied. Environmental regulations and other compliance, competition for resources from other users, labour constraints and tight credit have all played a role. But essentially it is almost too hard for farmers to convert land to dairy use these days.

How are New Zealand commodities different to other commodities?

Using Australian hard commodities as an example, prices have boomed at the same time as New Zealand commodities have. But the key difference is the supply response to the price boom. In Australia, resource companies have been relatively free from constraints and have therefore been free to increase production (or extraction) of minerals like iron ore. So, in Australia, it's been a case of a commodity price boom followed by a commodity supply boom, with a commodity price moderation now likely to follow. Indeed, our Australian team expects iron ore prices to roughly halve by 2023 from current levels.

What are some of the broader implications?

From an inflationary point of view, the New Zealand agriculture sector is going to be an ongoing source of demand and therefore inflation. On that front, the agriculture sector is likely to perform similarly to how the hot New Zealand construction sector has performed over recent years. At the same time, agriculture is going to contrast the household sector, which is waning as a driver of growth. We expect household demand to cool this year as cost-of-living pressures and house price falls bite on household confidence and budgets.

Meanwhile, very high commodity prices are going to provide ongoing support for the New Zealand dollar. Already, over recent months, the NZD/USD has climbed from its 2022 lows of around US\$0.65 to around US\$0.69 recently. From here, we expect the NZD to kick on and for it to reach US\$0.72 by early 2023.

Lastly, the extended commodity price boom is likely to lead to a two-speed New Zealand economy. That is, in rural New Zealand, economic activity is likely to charge ahead as very strong farm incomes spill over into investment and household spending even with the pressures on living costs and house prices. Whereas in the large urban areas, there's little income relief on the horizon. As such, we expect a flat patch in spending activity for these areas over the rest of the year and into 2023, notwithstanding the boost that some centres will receive as international tourists gradually return.

Nathan Penny, Senior Agri Economist

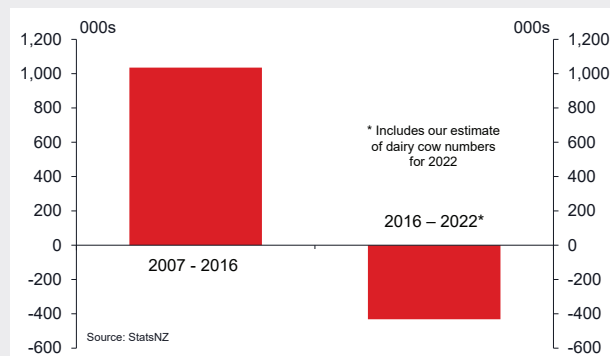
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Chart of the week

A key reason why this milk price cycle is different is that supply constraints, notably environmental regulations and competition for land and other resources, are now binding. Between 2007 and 2016 when constraints were not binding, on a season-to-season basis, the dairy herd grew by over a million head. However, as supply constraints have kicked in, this trend has reversed, so that the herd has shrunk by over 400,000 cows since 2016.

Change in New Zealand dairy herd

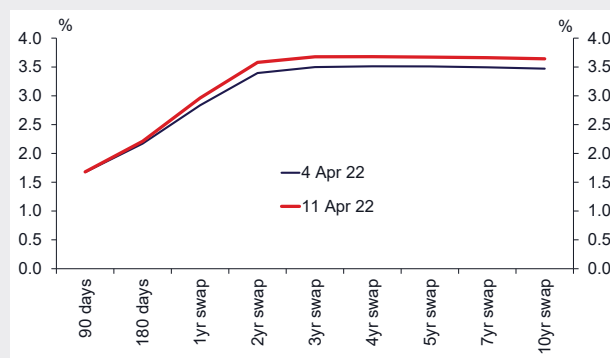


Fixed vs floating for mortgages

Wholesale interest rates have now moved beyond our forecast of a 3% cash rate by mid-2023. That suggests to us that there is no advantage to fixing for longer terms.

While the one-year mortgage rate is likely to rise further in the next couple of years, fixing and rolling for this term is likely to produce a lower borrowing cost on average over the next few years. Longer fixed terms are only suited to those who want certainty in their repayments.

NZ interest rates



The week ahead

NZ Mar retail card spending

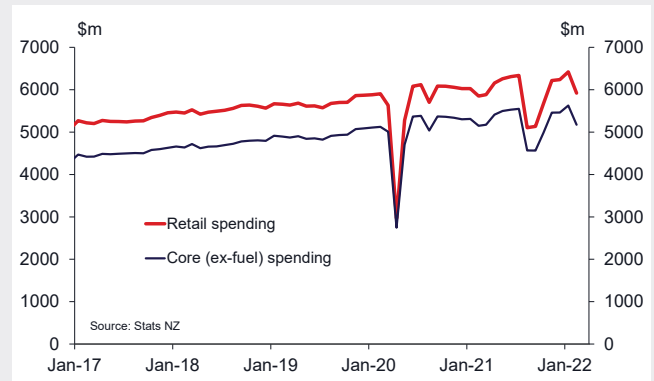
Apr 11, Last: -7.8%, Westpac: +0.2%

Retail spending fell sharply in February, falling by 7.8% over the month. Spending was weighed down by New Zealand's Omicron outbreak. That has been a major drag on spending in the hospitality sector. However, spending was down across all categories in February.

We are expecting the March report to show that spending has remained subdued and have pencilled in only a 0.2% rise. Omicron cases peaked over the month, and the related public health concerns continued to be a significant drag on spending in the hospitality sector.

March also saw a sharp rise in petrol prices, and increased spending on fuel was a constraint on spending in other areas. Coming on top of the Omicron outbreak, we are expecting a fall in core (ex-fuel) spending.

NZ retail card spending



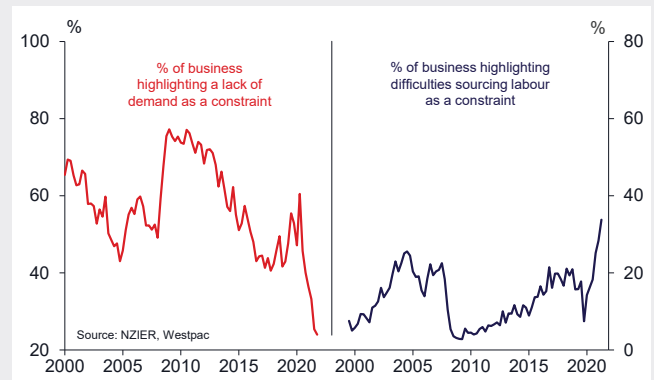
NZ NZIER Quarterly Survey of Business Opinion

Apr 12, Domestic Trading Activity (past 3mths) last: -1.3

Business confidence and indicators of trading activity fell sharply in late 2021, dropping to low levels. We expect the March quarter survey to show a further deterioration. Recent weeks have seen businesses continuing to grapple with shortages of materials and labour. Those challenges have been compounded by the Omicron outbreak and continued increases in operating costs.

The survey's various price and cost gauges are all expected to point to continued strong and widespread inflation pressures. That will be of interest for the RBNZ ahead of the April policy decision. The central bank highlighted inflation expectations as a key reason for their hawkish lurch in February.

Factors constraining business activity



RBNZ Monetary Policy Review

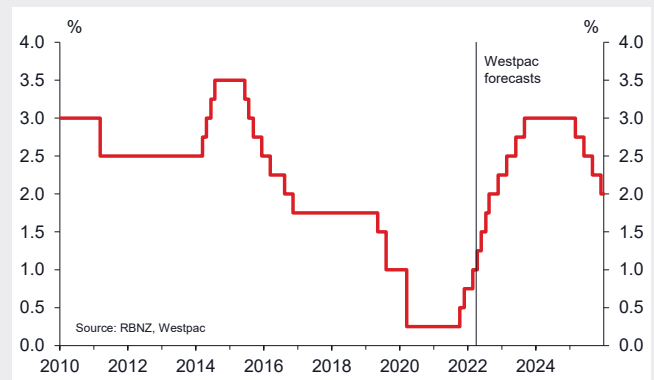
Apr 13, Last: 1.00%, WBC f/c: 1.25%, Market f/c: 1.25%

We expect the Reserve Bank to raise the Official Cash Rate by another 25 basis points to 1.25% next week. As in February, it's likely to be a tough call between a 25bp and a 50bp hike.

That decision won't be helped by the unusually light data flow between reviews. The data that we have had suggests that near-term inflation is a growing headache for businesses and households. But it also shows that monetary policy moves to date are getting the intended traction via the housing market.

The RBNZ has given little guidance as to how it might view recent developments. But its decisions to date suggest to us that the hurdle for larger OCR hikes is quite high.

RBNZ Official Cash Rate



The week ahead

NZ Mar REINZ house sales and prices

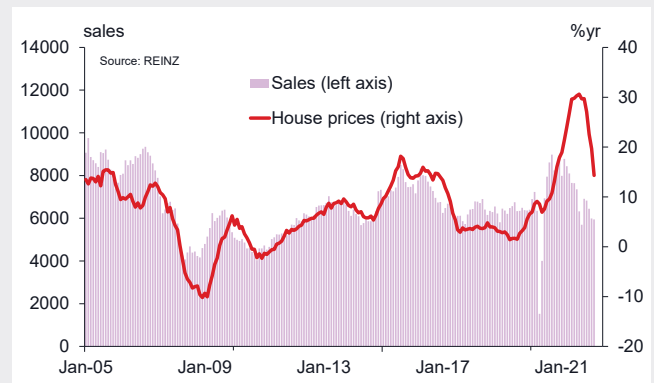
Apr 14 (TBC), Sales last: -0.7%, Prices last: +14.3%/yr

The housing market is now clearly cooling. Sales have fallen below pre-pandemic levels, the number of unsold homes continues to rise, and the REINZ house price index has fallen modestly for the last three months.

Our view is that higher mortgage rates have been the main driver of this slowdown, and as such, it is likely to persist for some time. We are forecasting house prices to drop by almost 10% over the next couple of years. This would still only take prices back to where they were in early 2021.

A tightening of loan-to-value limits, and more prescriptive responsible lending rules, also weighed on the housing market at the start of the year. However, these are likely to be less of a factor in the coming months, now that the changes have been bedded down.

REINZ house prices and sales



Aus March overseas arrivals and departures, preliminary

Apr 12, Arrivals, Last: 272.3kde

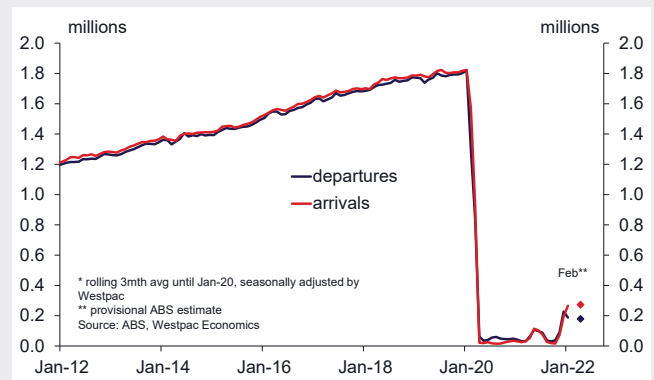
Apr 12, Departures, Last: 178.7kr

Prior to the pandemic, arrivals and departures averaged 1.8mn and 1.7mn per month respectively. The border closure in early 2020 saw sharp declines in both, to near zero for much of 2020-21.

Despite the international border reopening to fully vaccinated individuals, February's preliminary estimate did not capture a significant change in overseas travel, with arrivals lifting only slightly to 272.3k and departures moderating to 178.7k.

The March preliminary estimate should show more of a strengthening with remaining restrictions removed on February 21. Short-term travel for Australian residents should continue to run ahead of the rest given fully vaccinated Australians have been allowed to travel since December. The key focus will be on the rebound of visitor arrivals and the visa detail breakdown – the latter having already shown a notable lift in foreign student arrivals.

Aus total overseas arrivals and departures



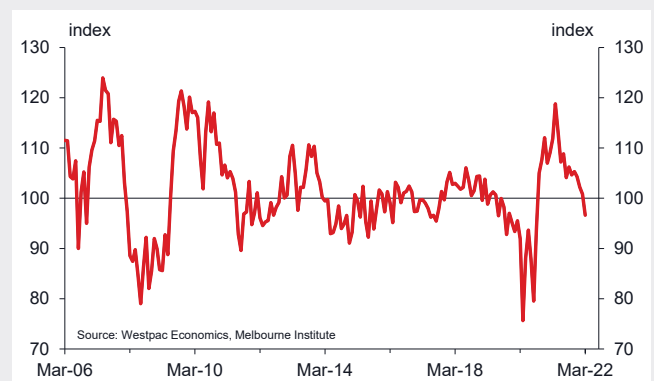
Aus Apr Westpac-MI Consumer Sentiment

Apr 13, Last: 96.6

Consumer Sentiment fell 4.2% to 96.6 in March – the lowest level since September 2020 and the first sub-100 'pessimistic' read since then as well. The detail showed the weakening was due to a variety of factors including: Russia's invasion of Ukraine; floods in south-east Queensland and Northern NSW; and ongoing concerns about rising inflation and a prospective rise in interest rates.

Those negatives will remain prominent in April, with concerns around inflation and interest rates likely to ratchet higher given the Fed's latest moves and rising expectations that the RBA will soon be moving rates higher as well. Against this, the April update will also be the first reading since the Federal Budget which saw several 'cost of living' support measures including a temporary halving in fuel excise costs that has already significantly lowered petrol costs (avg pump prices down 23c/litre since last month).

Aus Consumer Sentiment Index



The week ahead

Aus Mar Labour Force Survey, employment '000

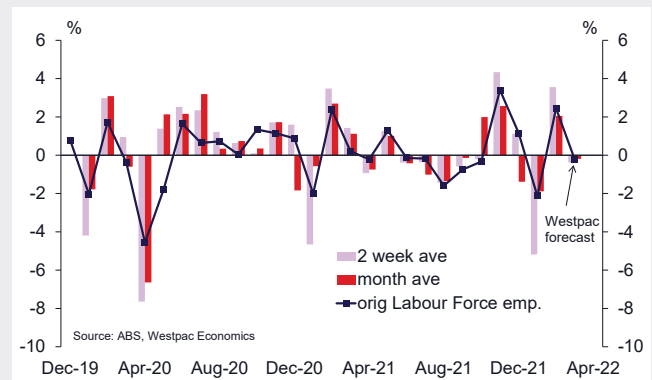
Apr 14, Last: 77.4k, WBC f/c: 25k
Mkt f/c: 30k, Range: -25k to 60k

February was the fourth consecutive upside surprise for employment lifting 77.4k much stronger than the market forecast of +37k, even stronger than Westpac's top of the range forecast for +60k. There was also the expected strong reversal in hours worked which lifted 8.9% following the Omicron hit of -8.6% in January when an unusually high number of people were sick or on leave.

Comparing reference weeks in March to February, payroll jobs fell 0.4% in March. Our 25k forecast rise in seasonally adjusted employment is a 0.2% decline in original terms. Back in March 2021 payrolls lifted 1.4% while employment gained 0.2%. So, while the extreme weather events may have slowed employment growth, it did not make it stall.

Given how close our forecast is to our March estimate for rise in payroll jobs we confirm our March Labour Force employment forecast at +25k.

Aus Payrolls vs Labour Force Employment



Aus Mar Labour Force Survey, unemployment %

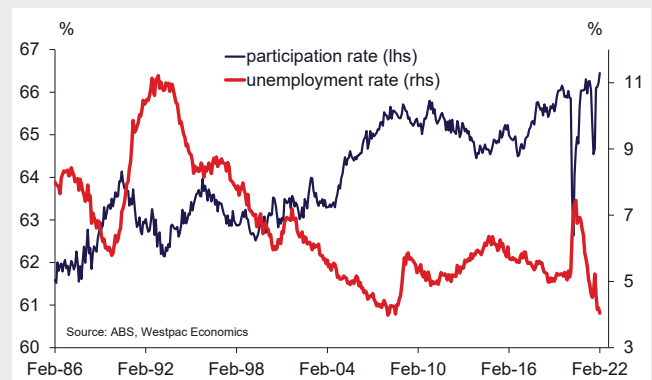
Apr 14, Last: 4.0%, WBC f/c: 4.0%
Mkt f/c: 3.9% Range: 3.8% to 4.1%

As we had expected, Feb showed a robust 0.2ppt rise in the participation rate to 66.4% (market was looking for a softer 0.1ppt rise) which drove a 58.9k rise in the labour force. However, as the rise in the labour force was less than the rise in employment there was a larger than expected fall in the unemployment to 4.0% from 4.2% – both the market and Westpac were forecasting an unemployment rate of 4.1%.

February was the lowest unemployment rate since August 2008 and only the third time in the history of the monthly survey that the unemployment rate has been below 4.0% (February 2008, August 2008, February 2022). There was a lower unemployment rate back in November 1974 but back then the survey was quarterly.

We believe there is still some scope for participation to drift higher and a 0.1ppt rise to 66.5% would see the unemployment rate holding flat at 4.0%.

Aus labour market

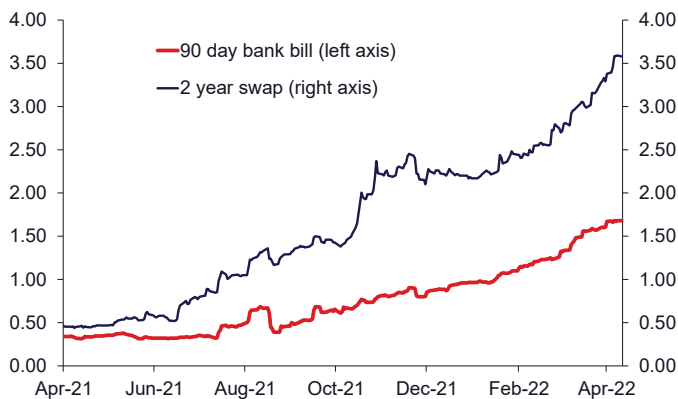


New Zealand forecasts

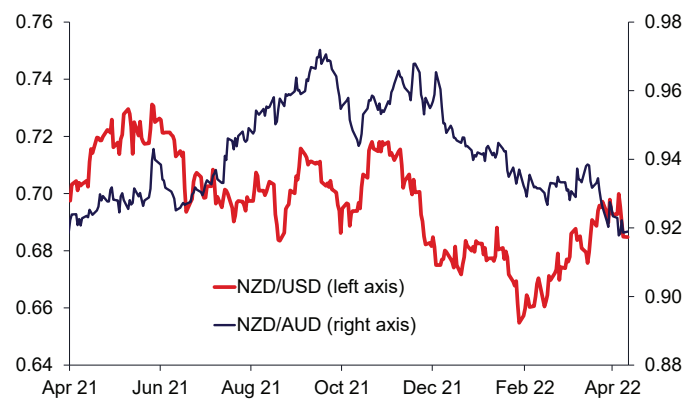
Economic forecasts	Quarterly				Annual			
	2021	2022						
% change	Dec (a)	Mar	Jun	Sep	2020	2021	2022f	2023f
GDP (Production)	3.0	0.3	0.7	2.3	-2.1	5.6	3.4	4.8
Employment	0.1	0.5	0.2	0.1	0.6	3.7	0.9	1.0
Unemployment Rate % s.a.	3.2	3.1	3.0	3.0	4.9	3.2	3.0	3.3
CPI	1.4	1.7	0.9	1.1	1.4	5.9	4.0	2.7
Current Account Balance % of GDP	-5.6	-5.8	-6.5	-6.5	-0.8	-5.6	-6.1	-5.5

Financial forecasts	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Cash	1.50	2.00	2.25	2.50	2.75	3.00	3.00
90 Day bill	1.90	2.20	2.45	2.70	2.95	3.10	3.10
2 Year Swap	3.30	3.30	3.25	3.20	3.15	3.10	3.00
5 Year Swap	3.45	3.45	3.40	3.35	3.30	3.25	3.15
10 Year Bond	3.40	3.40	3.20	3.15	3.10	3.05	3.00
NZD/USD	0.69	0.70	0.71	0.72	0.72	0.73	0.73
NZD/AUD	0.93	0.93	0.93	0.93	0.92	0.92	0.91
NZD/JPY	85.6	86.1	86.6	86.5	86.4	86.3	86.9
NZD/EUR	0.63	0.63	0.63	0.63	0.63	0.63	0.63
NZD/GBP	0.52	0.52	0.53	0.53	0.53	0.53	0.54
TWI	74.0	74.6	75.1	75.0	74.9	75.1	75.3

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 11 April 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	1.00%	1.00%	1.00%
30 Days	1.38%	1.23%	1.05%
60 Days	1.53%	1.42%	1.27%
90 Days	1.68%	1.60%	1.49%
2 Year Swap	3.58%	3.28%	3.03%
5 Year Swap	3.67%	3.49%	3.25%

NZ foreign currency mid-rates as at 11 April 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6848	0.6933	0.6795
NZD/EUR	0.6277	0.6309	0.6199
NZD/GBP	0.5254	0.5270	0.5211
NZD/JPY	84.96	86.16	80.21
NZD/AUD	0.9189	0.9219	0.9380
TWI	73.92	74.68	73.51

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 11					
NZ	Mar card spending	-7.8%	-	0.2%	Omicron and high fuel prices weighing on spending.
Chn	Mar PPI %yr	8.8%	8.1%	-	Elevated commodity prices buoying producer inflation...
	Mar CPI %yr	0.9%	1.4%	-	... but pass through to consumers limited.
UK	Feb trade balance £bn	-16159	-	-	Data measurement change; figures should normalise in Feb.
US	Fedspeak	-	-	-	Bostic, Bowman, Waller at Fed Listens event. Evans too.
Tue 12					
NZ	Q1 QSBO business opinion	-1.3	-	-	Confidence to remain low, while inflation gauges surge.
	Feb net migration	-558	-	-	Borders remained largely closed until March.
Aus	Mar NAB business survey	9	-	-	Hospitality further upside vs hit from severe floods NSW, Qld.
	Mar overseas arrivals, prelim. '000s	272.3	-	-	Gauging the border reopening; pre-Covid avg -1.8mn/month.
Eur	Apr ZEW survey of expectations	-38.7	-	-	Russia-Ukraine conflict clouding the outlook.
UK	Feb ILO unemployment rate	3.9%	3.8%	-	Unemployment now at pre-Covid level.
US	Mar NFIB small business optimism	95.7	94.9	-	Rising prices are the key concern...
	Mar CPI	0.8%	1.2%	1.3%	... with annual inflation at 40-year highs.
	Fedspeak	-	-	-	Brainard.
Wed 13					
NZ	Mar food price index	-0.1%	-	0.5%	Ongoing boost from grocery food price rises.
	RBNZ policy decision	1.00%	1.25%	1.25%	Tight call between 25 and 50bp as inflation concerns mount.
Aus	Apr WBC-MI Consumer Sentiment	96.6	-	-	Any post-Budget improvement?
Chn	Mar trade balance USDbn	94.46	21.20	-	Lockdowns hindering exports in some regions.
Eur	Feb industrial production	0.0%	-	-	Supply pressures are an ongoing concern.
UK	Mar CPI	0.8%	-	-	Energy inflation remains a key driver.
US	Mar PPI	0.8%	1.2%	-	Ongoing supply issues are supporting producer prices.
	Fedspeak	-	-	-	Barkin.
Thu 14					
NZ	Mar manufacturing PMI	53.6	-	-	Activity held up surprisingly well during the Omicron peak.
	Mar REINZ house sales	-0.7%	-	-	Due this week. Mortgage rates and tighter lending rules...
	Mar REINZ house prices %yr	14.3%	-	-	... likely continued to weigh on the market in March.
Aus	Apr MI inflation expectations	4.9%	-	-	Will falling petrol prices lead to a decline in expectations.
	Mar employment, '000 chg	77.4	30.0	25.0	Weekly payrolls suggest employment continued to expand...
	Mar unemployment rate	4.0%	3.9%	4.0%	...through the extreme weather events on the east coast.
Eur	ECB policy decision, deposit rate	-0.50%	-0.50%	-0.50%	Focus on rhetoric around risk views and policy normalisation.
US	Mar retail sales	0.3%	0.5%	0.7%	Fuel price surge to crimp retail sales in the near-term.
	Mar import price index	1.4%	2.5%	-	Import prices set to remain elevated.
	Initial jobless claims	166k	-	-	To remain at a very low level.
	Feb business inventories	1.1%	1.3%	-	Businesses rebuilding inventory at robust pace.
	Apr Uni. of Michigan sentiment	59.4	58.8	-	Inflation and interest rate concerns have hit confidence hard.
	Fedspeak	-	-	-	Mester.
Fri 15					
Aus, NZ	Good Friday	-	-	-	Public holiday, markets closed.
US	Apr Fed Empire state index	-11.8	2.0	-	To provide a timely update on NY manufacturing sector.
	Mar industrial production	0.5%	0.4%	-	Volatility lingers as firms navigate supply issues.
	Fedspeak	-	-	-	Harker.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021f	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.2	4.7	5.2	3.9
CPI inflation %yr	1.8	1.8	0.9	3.5	4.3	2.3
Unemployment rate %	5.0	5.2	6.8	4.7	3.2	3.4
Current account % of GDP	-2.1	0.7	2.6	3.5	3.7	-0.4
United States						
Real GDP %yr	3.0	2.2	-3.5	5.7	3.1	1.8
CPI inflation %yr	2.4	1.9	1.3	7.1	3.7	2.3
Unemployment rate %	3.9	3.7	8.1	5.4	3.7	4.1
Current account % of GDP	-2.3	-2.6	-2.5	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	0.6	0.3	-4.8	1.8	2.2	1.4
Euro zone						
Real GDP %yr	1.9	1.3	-6.6	4.9	3.0	2.3
United Kingdom						
Real GDP %yr	1.3	1.4	-9.9	7.2	3.7	2.0
China						
Real GDP %yr	6.7	5.8	2.3	8.1	5.7	5.6
East Asia ex China						
Real GDP %yr	4.4	3.7	-2.4	4.2	4.7	4.6
World						
Real GDP %yr	3.6	2.8	-3.3	5.5	3.7	3.5

Forecasts finalised 8 April 2022

Interest rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Australia								
Cash	0.10	0.25	0.75	1.25	1.50	2.00	2.00	2.00
90 Day BBSW	0.29	0.45	0.95	1.45	1.70	2.20	2.20	2.20
10 Year Bond	2.95	3.00	3.00	2.70	2.50	2.35	2.25	2.20
International								
Fed Funds	0.375	1.375	1.875	2.375	2.375	2.375	2.375	2.375
US 10 Year Bond	2.63	2.60	2.60	2.30	2.20	2.15	2.10	2.10

Exchange rate forecasts	Latest	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
AUD/USD	0.7480	0.74	0.75	0.76	0.77	0.78	0.79	0.80
USD/JPY	123.85	124	123	122	121	120	119	119
EUR/USD	1.0871	1.10	1.11	1.12	1.13	1.14	1.15	1.15
GBP/USD	1.3074	1.33	1.34	1.35	1.36	1.37	1.37	1.36
USD/CNY	6.3605	6.30	6.30	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.0868	1.07	1.07	1.07	1.08	1.08	1.09	1.10

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