WESTPAC WEEKLY ECONOMIC COMMENTARY

Stepping up to the plate, still swinging hard.

11 July 2022

Mānuka

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The RBNZ steps up to the plate this week, with the Official Cash Rate up for review again on Wednesday. We expect the RBNZ will still swing hard and deliver a third consecutive 50 basis-point increase. In other words, we expect the RBNZ to largely stay on the path it laid out back in May.

A 50 basis-point hike is more or less a unanimous view in the market, although pricing has flirted with the idea of a 75 basis-point increase at times. Moreover, a 50 basis-point rise would also be in line with the path that the RBNZ projected in its May *Monetary Policy Statement*. That projection showed the OCR reaching about 3.5% by the end of this year, and then peaking at near 4% next year.

Earlier this year, the RBNZ's shift to larger OCR hikes and a higher forecast OCR peak came as something of a surprise. Indeed, it didn't seem to be prompted by the flow of economic data. Instead, it was what the Governor described as a "behavioural change" within the RBNZ itself. In other words, there was a belated recognition that small, steady (25 basis-point) OCR hikes were not cutting the mustard with an inflation problem of this scale. The OCR was making limited headway in slowing the economy down, and risks were growing that inflation expectations could become entrenched above the RBNZ's target.

At some point, we expect another "behavioural change" at the RBNZ. There will come a point where the pace of hikes will slow. At that point, the pace of further rate hikes (or reductions) will become dependent on what the data shows. But for now, with inflation elevated, the labour market highly stretched and output running well above trend, we expect the RBNZ to continue on the path of rate hikes that it previously laid out.

On the data front, developments since the May statement have been mixed. The risks around near-term inflation look to be to the upside of the RBNZ's already-hefty forecasts, largely due to the second wave of fuel price rises. However, the surprise for the RBNZ hasn't been from crude oil prices per se, but from a blowout in refining margins. Blowouts of that sort are more likely to prove transitory, so we expect the RBNZ to largely look through this source of inflation.

On the other hand, near-term activity is looking softer than the RBNZ expected. March quarter GDP fell by 0.2%, well below the RBNZ's estimate of a 0.7% rise. While Omicron disruptions were the likely suspect behind the March quarter decline, it doesn't look like June quarter activity will make up that lost ground to the extent that the RBNZ was forecasting.

Looking further ahead, the RBNZ still needs to see some further slowdown in activity in order to bring inflation pressures into line. But at this stage the evidence of a softening in economic conditions, let alone a recession, is mostly anecdotal. That said, the lags involved with monetary policy – many borrowers are only just starting to feel the impact of the OCR hikes to date – mean that the risk of overdoing it is a genuine concern.

Market thinking on the extent of OCR hikes that will be required has knee-jerked one way and then the other. Little more than a month ago, the concerns were centred on inflation getting out of control and central banks having to lift their policy rates even more aggressively than they originally thought. That was egged on by the US Federal Reserve's decision to lift its policy rate by 75bps in June, having effectively dismissed the idea just weeks earlier. By that point, New Zealand interest rate markets were pricing in an OCR peak of 4.5% or more, compared to the RBNZ's projection of a 3.9% peak.

However, sentiment has turned back around rapidly in the last few weeks. That's seen sharp declines in share prices and interest rates around the world as markets have become concerned that rapid monetary policy tightening could drive the global economy into recession. But while the speed of the adjustment has been dramatic, bear in mind that market expectations of the OCR have simply come back to be in line with the RBNZ's projections, and are close to where they were at the time of the May *MPS*.

Given where market pricing currently lies, if the RBNZ did become concerned about the risk of a recession, it has a very powerful tool at its disposal: it could simply stop hiking. For example, if it signalled that it was likely to stop the OCR once it had reached 3%, we think that could see wholesale interest rates drop by as much as 50 basis points immediately (and as much as 100 basis points from their recent peaks). Mortgage rates would follow in turn.

But doing that now would risk undermining the good work that the RBNZ has done to date to bring inflation pressures under control. For that reason, we think that the RBNZ will carry through with the OCR tightening path that it laid out in May, without bowing to the speculation about recession risks.

The August *Monetary Policy Statement*, on the other hand, could be a different matter. We expect a fourth 50bp hike at that date, which would bring the OCR up to 3%. That's getting much closer to the RBNZ's projected peak of 3.9% (and our forecast of a 3.5% peak) and is more plausibly in the range of 'tight' monetary policy settings. At that point, we think the RBNZ could shift its tone and signal that it's getting on top of the situation. And from there, the RBNZ could assert that further OCR hikes are likely but that the extent of them will be data-dependent.

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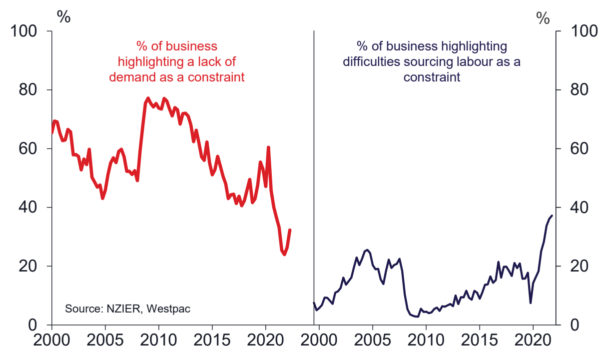
Chart of the week

Signs that the economy is losing steam have appeared. However, the slowdown is in its early days, and those signs are still largely anecdotal. For example, consumer and business sentiment have turned down. Hard data, on the other hand, still show demand in the economy running well above trend and an incredibly tight labour market. Against that backdrop, the RBNZ will still need to raise the OCR further to bring current rampant inflation pressures back into line.

Factors constraining business activity

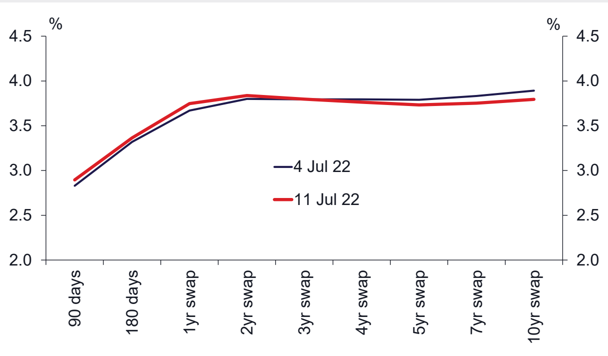


Fixed vs floating for mortgages

Wholesale interest rates have fallen sharply in the last couple of weeks, as markets have reassessed the prospects for the global economy. As we anticipated last week, that has seen some fixed-term mortgage rates fall from their highs.

Even so, market pricing remains higher than what would be consistent with our forecast of a 3.5% peak in the Official Cash Rate this year. This suggests to us that fixing for a short period and rolling is still likely to produce a lower borrowing cost on average over the next few years. Fixing for a longer term could prove more expensive, but may suit those who want more certainty in their repayments.

NZ interest rates



The week ahead

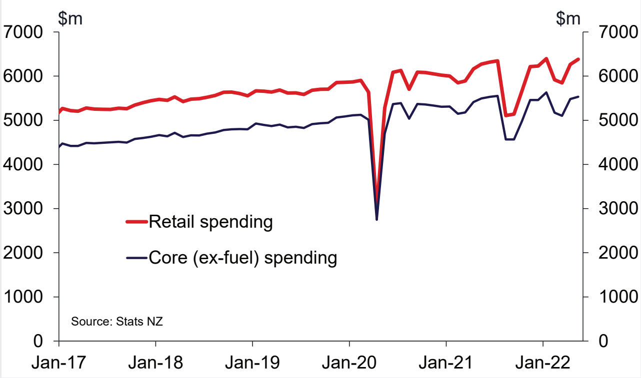
NZ Jun retail card spending

Jul 11, Last: +1.9%, Westpac: -0.5%

Retail spending rose by 1.9% in May. In part, that was due to the continued march higher in consumer prices, with increased spending on fuel accounting for much of the rise. Spending was also boosted by the easing of Covid related disruptions which supported spending in areas like hospitality.

We're forecasting a small easing in spending levels in June. However, that's masking some important details. Retail prices have continued to push higher, with sizeable increases in the price of petrol. Those price increases are crowding out spending in other areas. In fact, we expect that ex-fuel spending will be down 1% over the month. The strength in prices also means that, although nominal spending has been fairly resilient in recent months, the actual volume of goods that consumers can afford is being squeezed.

NZ retail card spending



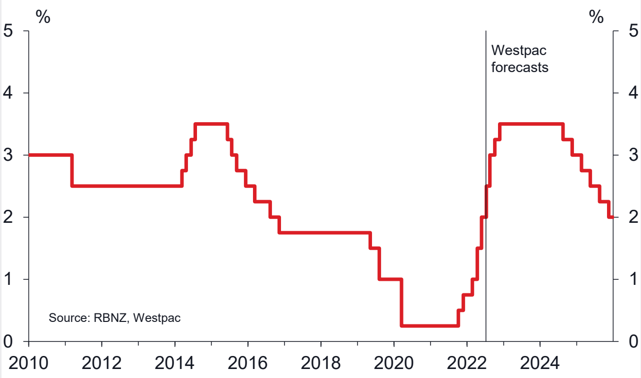
NZ RBNZ Monetary Policy Review

Jul 13, Last: 2.00%, Westpac: 2.50%, Mkt: 2.50%

We expect the RBNZ will raise the Official Cash Rate by another 50 basis points to 2.50% at its July meeting. Recent developments have been mixed for the monetary policy outlook. Near-term inflation is still running hot, but the risks of a global slowdown have increased and early signs of a cooling in domestic activity have started to emerge. For now, the RBNZ will need to carry through with the interest rate hikes it has signalled, or risk undoing its good work so far on bringing inflation pressures under control.

Looking further ahead, the evidence for a softening in activity is more anecdotal than definitive at this stage. However, at some point in the coming months it will be appropriate to signal that the end of the tightening cycle is near.

RBNZ Official Cash Rate



NZ Jun REINZ house sales and prices

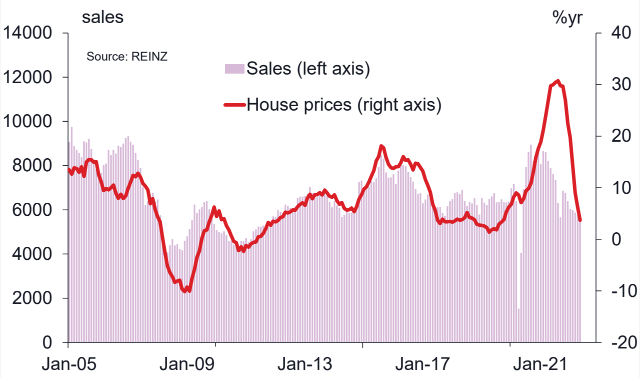
Jul 14 (TBC), Sales last: -4.6%
Prices last: -0.8% m/m, +3.7%y/y

The REINZ house price index has fallen for the last six months, and is down 6% from its peak. The pace of monthly declines has eased in the last couple of months, which may reflect a fading impact from the imposition of consumer credit regulations and loan-to-value restrictions in late 2021.

Notwithstanding the recent trend, we expect to see further price declines in the coming months on the back of higher interest rates. Fixed-term mortgage rates have risen sharply in recent months, and are at their highest levels since 2015.

House sales have fallen below pre-Covid levels, and the average time to sell has been trending higher. We expect a further softening in these measures as well.

REINZ house prices and sales



The week ahead

Aus Jun Westpac–MI Consumer Sentiment

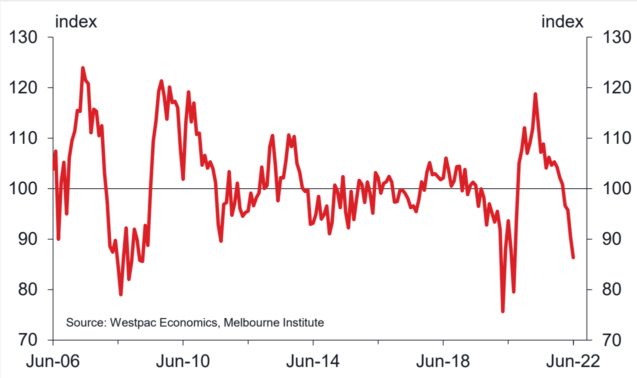
Jul 12, Last: 86.4

The Westpac–MI Consumer Sentiment index will from now be released on the second Tuesday of each month, a week after the RBA meeting – the release time has been brought forward by a day from previously. The exception, in January (when there is no RBA meeting), the release will be on the third Tuesday of the month.

Consumer Sentiment fell 4.5% to 86.4 in June, the RBA's surprise 50bp rate having a clear impact. Over the 46-year history of the survey, we have only seen Index reads at or below this level during major economic dislocations.

Interest rate and inflation concerns are likely to dominate again with the RBA putting through another 50bp rate hike at its July meeting, petrol prices pushing through $2/litre, and sharemarkets globally continuing to sell off sharply. Labour markets are the key remaining support for sentiment locally.

Aus Consumer Sentiment



Aus Jun overseas arrivals and departures, prelim'

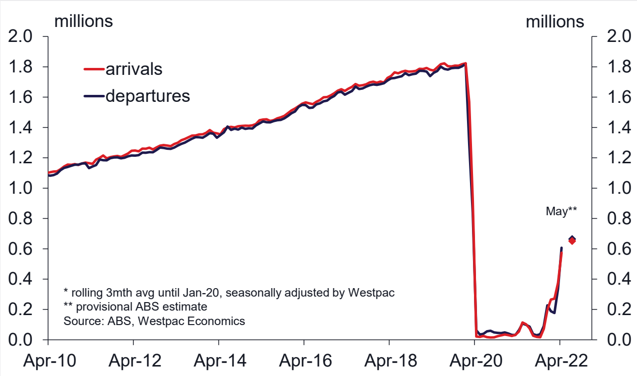
Jul 12, Arrivals, Last: 651.1k
Jul 12, Departures, Last: 664.0k

The headline pace of growth in overseas travel pulled back slightly in May, although a strong recovery has been observed so far this year. Both arrivals and departures are currently sitting above a third of their pre-pandemic levels, having advanced to 651.1k and 664.0k respectively.

For the June preliminary estimate, we anticipate that the pace of recovery continues to forge ahead. The border reopening and associated lifts in short-term visitor arrivals are starting to have a material impact on the economy, as evinced by the recent strong partial rebound in Australia's tourism related service exports.

While strength on the demand-side is welcome, concerns around the undersupply of labour remain front of mind for many businesses. The prospective return of student and temporary worker visa applications towards pre-pandemic levels is promising.

Aus total overseas arrivals and departures



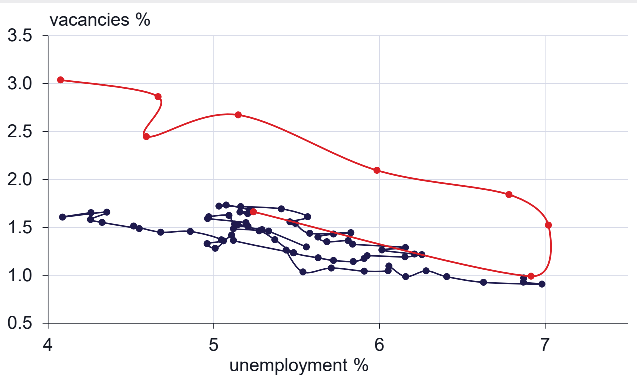
Aus Jun Labour Force Survey, empl. chg '000

Jul 14, Last: 60.6, WBC f/c: 35
Mkt f/c: 30 Range: –10 to +45 t

Total employment surged 60.6k (0.5%) in May, significantly stronger than the market estimate of 25k. Weekly payrolls had pointed to a decline in employment but in the end there was a strong lift in employment matched by a robust 0.9% gain in hours worked.

Vacancies and business surveys suggest that labour demand remains very robust. We have pencilled an around trend increase of +35k for June. It is seasonally a soft month in original terms, so if we are still on a positive growth trend then that would suggest upside risks. However, we note the number unemployed to vacancies is down to a record low of 1.3, in the year before COVID it averaged 3.1 and normally ranges between 3 and 5, highlighting very tight supply.

Australian Beveridge Curve



The week ahead

Aus Jun Labour Force Survey, unempl. rate %

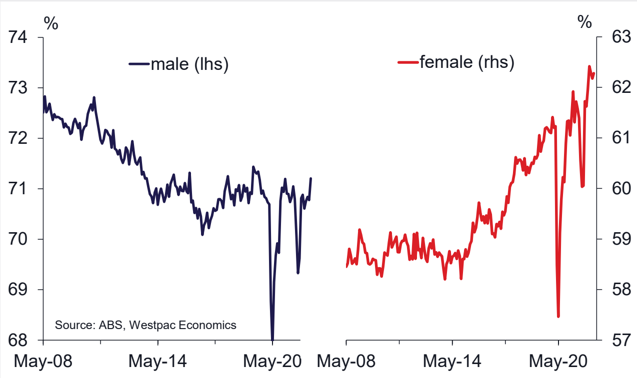
Jul 14, Last: 3.9%, WBC f/c: 3.8%
Mkt f/c: 3.8% Range: 3.7% to 4.0%

In May the labour force very modestly outpaced the rise in employment, lifting 68.4k with the participation rate rising to 66.7% (a new record high) from 66.4%.

With gains in employment being matched by gains in the labour force, the unemployment rate was flat at 3.9%, a small fall at two decimal places to 3.86% from 3.90%. At 3.9%, unemployment is at a record low for the monthly survey which started in February 1978. The last time the unemployment rate was lower than this was in August 1974, when the survey was quarterly.

A strong gain in male employment (54.5k) in May was matched by a rise in male participation (0.4ppt to 71.2%). A long run trend decline in male participation, associated with an aging population, has been arrested for now but a lot still depends on if female participation can rise to supply the needed labour due to limited immigration. With an expected flat participation rate in June, the unemployment rate rounds down to 3.8%.

Australian participation rates by gender



China Q2 GDP

Jul 15, GDP %yr, Last: 4.8%, Mkt f/c: 1.2%

China's COVID–zero policy created a large headwind for the economy throughout Q2. The sudden drop in momentum from the Q1 actual to the Q2 consensus forecast highlights this.

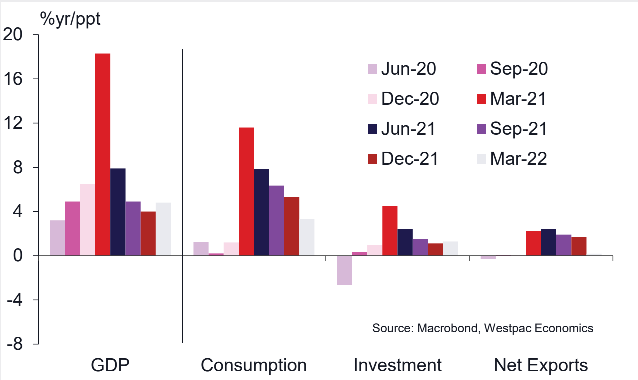
However, in coming to this forecast, the market has had to rely on volatile nominal partial data for consumption and investment which, even in quiet times, only provides part of the story.

In this particular instance, public consumption is likely to provide a significant offset to private sector weakness. Support from international trade is also likely to be material.

We continue to expect a material upside surprise for GDP on release.

The June partial data will also be critical to assess, due for release with GDP.

China Q2 GDP

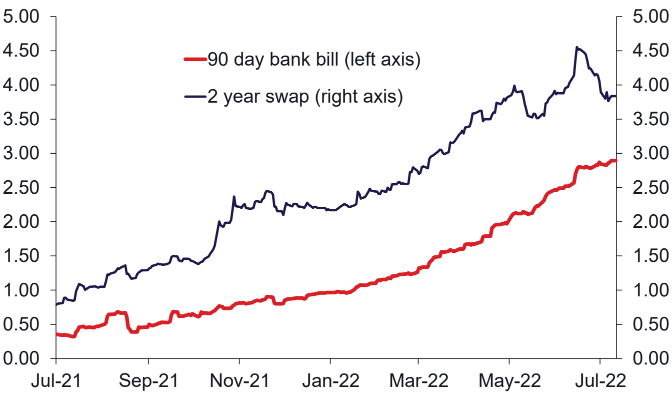


New Zealand forecasts

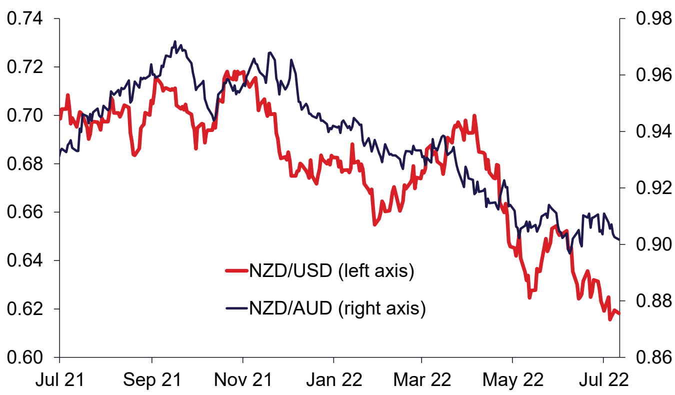
Economic forecasts	Quarterly				Annual			
	2022							
% change	Mar (a)	Jun	Sep	Dec	2020	2021	2022f	2023f
GDP (Production)	-0.2	1.0	0.7	1.2	-2.1	5.6	2.1	3.3
Employment	0.1	0.2	0.2	0.2	0.6	3.5	0.8	0.9
Unemployment Rate % s.a.	3.2	3.1	3.0	3.0	4.9	3.2	3.0	3.3
CPI	1.8	1.1	1.4	-0.1	1.4	5.9	4.3	3.0
Current Account Balance % of GDP	-6.5	-7.5	-7.8	-7.5	-0.8	-5.8	-7.5	-6.1

Financial forecasts	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Cash	3.00	3.50	3.50	3.50	3.50	3.50	3.50
90 Day bill	3.40	3.60	3.60	3.60	3.60	3.60	3.60
2 Year Swap	4.30	4.10	4.00	3.80	3.50	3.20	2.90
5 Year Swap	4.30	4.10	3.95	3.75	3.50	3.30	3.05
10 Year Bond	4.00	3.80	3.60	3.40	3.20	3.00	2.90
NZD/USD	0.65	0.68	0.70	0.71	0.72	0.72	0.72
NZD/AUD	0.90	0.91	0.91	0.91	0.91	0.90	0.90
NZD/JPY	85.8	87.7	88.9	88.0	87.2	87.1	86.4
NZD/EUR	0.61	0.62	0.63	0.63	0.63	0.63	0.62
NZD/GBP	0.52	0.54	0.55	0.55	0.54	0.54	0.53
TWI	71.6	73.3	74.4	74.7	74.5	74.7	74.5

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 11 July 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	2.00%	2.00%	2.00%
30 Days	2.46%	2.33%	2.11%
60 Days	2.68%	2.57%	2.34%
90 Days	2.90%	2.81%	2.57%
2 Year Swap	3.84%	4.14%	4.14%
5 Year Swap	3.73%	4.13%	4.25%

NZ foreign currency mid-rates as at 11 July 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6182	0.6314	0.6301
NZD/EUR	0.6077	0.5965	0.6019
NZD/GBP	0.5143	0.5143	0.5164
NZD/JPY	84.10	85.39	84.72
NZD/AUD	0.9017	0.9106	0.9042
TWI	70.32	71.01	70.93

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 11					
NZ	Jun card spending	1.4%	–	–0.5%	Price rises and borrowing costs squeezing spending.
US	Fedspeak	–	–	–	Williams.
Tue 12					
NZ	May net migration	–80	–	–	Set to remain low as arrivals and departures both rise.
Aus	Jul Westpac–MI Consumer Sentiment	86.4	–	–	Sentiment weak, sub-90, even before RBA's July rate hike.
	Jun NAB business survey	16	–	–	May: conditions elevated, at +16; confidence cools, -4pts to +6.
	Jun overseas arrivals, prelim. 000's	651.1	–	–	Currently above a third of pre-pandemic levels.
Eur	Jul ZEW survey of expectations	–28	–	–	Confidence on par with pandemic lows.
US	Jun NFIB small business optimism	93.1	93.0	–	Cost pressures and labour shortages remain as key concerns.
	Fedspeak	–	–	–	Barkin.
Wed 13					
NZ	RBNZ policy decision	2.00%	2.50%	2.50%	Inflation still elevated, labour market tight.
	Jun food price index	0.7%	–	1.0%	Seasonal rise in veg prices adding to other price pressures.
Chn	Jun trade balance USDbn	78.76	76.85	–	Trade has been a key support through the lockdowns.
Eur	May industrial production	0.4%	0.0%	–	Supply issues are a headwind to production.
UK	May trade balance £bn	–8503	–	–	Deficit to remain wide on import strength.
US	Jun CPI	1.0%	1.1%	–	Annual inflation soon to crest.
	Federal Reserve's Beige book	–	–	–	Qualitative assessment of conditions across the 12 districts.
Thu 14					
NZ	Jun REINZ house sales	–4.4%	–	–	Due this week. Slowdown in the market to continue...
	Jun REINZ house prices %yr	3.7%	–	–	... in response to higher mortgage rates.
Aus	Jun employment, '000 chg	60.6	30.0	35.0	Labour demand remains robust, job vacancies are very high.
	Jun unemployment rate	3.9%	3.8%	3.8%	Un' rate ticks lower - holding participation steady at record high.
	Jul MI inflation expectations	6.7%	–	–	Well up from 3.5% at the start of 2021, mirroring actual inflation.
US	Jun PPI	0.8%	0.8%	–	Producer prices remain elevated amid supply issues.
	Initial jobless claims	235k	–	–	To remain at a low level.
	Fedspeak	–	–	–	Waller.
Fri 15					
NZ	Jun manufacturing PMI	52.9	–	–	Has been resilient, but downside pressures are mounting.
Chn	Q2 GDP %yr	4.8%	1.0%	–	COVID-zero lockdowns to weigh on activity.
	Jun retail sales ytd %yr	–1.5%	–1.2%	–	Weakness in consumption to hold in near-term...
	Jun fixed asset investment ytd %yr	6.2%	6.0%	–	... but building momentum for investment...
	Jun industrial production ytd %yr	3.3%	3.5%	–	... and ongoing strength in trade are providing resilience.
Eur	May trade balance €bn	–31.7	–	–	Deficit to remain wide on energy prices.
US	Jul Fed Empire state index	–1.2	–2.6	–	Volatile, but firm order pipeline to support NY mfg.
	Jun retail sales	–0.3%	0.9%	–	Inflation and higher rates affecting spending capacity.
	Jun import price index	0.6%	0.7%	–	Import prices to remain at an elevated level.
	Jun industrial production	0.1%	0.0%	–	Volatility to linger as firms navigate supply issues.
	May business inventories	1.2%	1.1%	–	Businesses rebuilding inventory at a robust pace.
	Jul Uni. of Michigan sentiment	50.0	49.0	–	Inflation and rate concerns still front of mind.
	Fedspeak	–	–	–	Bostic.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.1	4.8	4.5	2.7
CPI inflation %yr	1.8	1.8	0.9	3.5	6.6	3.0
Unemployment rate %	5.0	5.2	6.8	4.7	3.3	3.5
Current account % of GDP	-2.1	0.7	2.6	3.5	1.7	-1.2
United States						
Real GDP %yr	2.9	2.3	-3.4	5.7	2.0	0.8
CPI inflation %yr	2.4	1.9	1.2	5.1	7.1	2.5
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	-0.2	-4.5	1.6	1.7	1.8
Euro zone						
Real GDP %yr	1.8	1.6	-6.4	5.3	2.2	1.5
United Kingdom						
Real GDP %yr	1.7	1.7	-9.3	7.4	3.3	0.0
China						
Real GDP %yr	6.8	6.0	2.2	8.1	5.3	5.5
East Asia ex China						
Real GDP %yr	4.5	3.8	-2.3	4.1	4.5	4.6
World						
Real GDP %yr	3.6	2.9	-3.1	6.1	3.4	3.2

Forecasts finalised 8 July 2022

Interest rate forecasts	Latest	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Australia								
Cash	1.35	1.85	2.35	2.60	2.60	2.60	2.60	2.60
90 Day BBSW	1.93	2.30	2.72	2.80	2.80	2.80	2.80	2.80
10 Year Bond	3.50	3.90	3.60	3.30	3.00	2.70	2.50	2.35
International								
Fed Funds	1.625	2.875	3.375	3.375	3.375	3.375	3.125	2.875
US 10 Year Bond	2.99	3.30	3.10	2.90	2.70	2.50	2.30	2.20

Exchange rate forecasts	Latest	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
AUD/USD	0.6839	0.72	0.75	0.77	0.78	0.79	0.80	0.80
USD/JPY	135.98	134	132	130	127	125	123	121
EUR/USD	1.0164	1.05	1.09	1.11	1.13	1.14	1.15	1.16
GBP/USD	1.2021	1.23	1.26	1.28	1.30	1.32	1.34	1.35
USD/CNY	6.7006	6.55	6.35	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.1083	1.11	1.10	1.10	1.10	1.10	1.11	1.11

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