

WESTPAC WEEKLY ECONOMIC COMMENTARY

Dairy's back on the horse.

13 June 2022



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After a period of weakness, global dairy prices got back on the horse last week. From here, we expect dairy prices to build on last week's bounce due to the further easing in Covid restrictions in the key Chinese market and ongoing weakness in global dairy supply. Meanwhile, the Primary Sector Climate Action Partnership, He Waka Eke Noa, recommended a levy at the farmer level, and therefore proposed that agriculture will remain outside the Emissions Trading Scheme.

Global dairy prices bounced last week. Weighted average auction prices jumped 5.1%, while key whole milk powder prices surged 5.7% (again in weighted average terms). Moreover, that price strength was broad based, with five out of the six products that we monitor posting price gains. WMP prices posted the largest gain, but butter prices were a close second (up 5.5%). Only cheddar prices fell. The dairy price lift follows a period of around three months when prices were in a funk. At one stage, WMP prices had fallen around 17% from their March highs. Indeed, we revised our 2021/22 farmgate milk price forecast lower by 30 cents to \$9.30/kg because of the weakness.

That said, we always expected this price weakness to prove temporary. The key catalyst for the price falls was the Omicron outbreak in China and the associated tightening of Covid restrictions. Given the experience in other countries, we anticipated that the Omicron wave would pass and Covid restrictions would in turn ease. And to date, this has proved the case. Covid restrictions are lifting, notably in Shanghai. The global dairy market has taken these events on board and has pushed prices higher.

From here, we expect global dairy prices to recover more of their lost ground. WMP prices are still 12% lower than the recent peak in March. We assume that Covid restrictions in China will ease further over coming weeks, taking dairy demand higher as a result. At the same time, we expect global dairy supply to remain very tight, further underpinning prices. Indeed, New Zealand production for the season just gone (year to May) is likely to be down over 4% compared to the season prior. Meanwhile, European and US production is roughly flat for the year to March versus the same period a year ago.

These factors bode well for the new season. Our 2022/23 milk price forecast stands at \$9.25/kg. At this level, the milk price will be the second highest on record behind 2021/22. But it is very early days, and we wouldn't rule out the new season's milk price surpassing the one that's just finished.

In other agriculture news, the Primary Sector Climate Action Partnership, He Waka Eke Noa, has released its recommendations on how the sector will make its contribution to reducing greenhouse gas emissions, in agriculture's case

mainly methane and nitrous oxide. The key plank of the proposals is a levy at the farmer level, and therefore agriculture will remain outside the Emissions Trading Scheme (ETS).

A second plank of the plan is the use of a split-gases approach. In other words, the Partnership proposes pricing methane and nitrous oxide differently to how carbon is priced under the ETS. Other components of the proposed plan include incentives to mitigate emissions, such as tree planting and for using eligible technologies, including animal feed additives. The plan also includes support for farmers (note that costs to the horticulture sector are minimal) to understand and measure their emissions and investment into research and technology development.

At first glance, we are supportive of the plan. Placing the cost directly on farmers gives a clear signal to reduce emissions. And we think the split-gases approach is a sensible compromise given the differences between carbon and the other shorter-lived gases like methane.

The overall costs also generally look manageable. Firstly, the costs are small relative to the rest of a farmer's costs. In addition, we note that the plan places costs on farmers and therefore over time leads to lower dairy supply, or effectively no growth in supply in the case of meat production. This fact will put upward pressure on dairy prices in particular, and meat prices to a lesser degree. So, farmers in aggregate will receive an additional offset to the cost of the levies in the form of higher farmgate prices. However, on a farm-by-farm basis there will be some devil in the detail as to how they can apply the methane reduction incentives and the sequestration savings (via things like tree plantings).

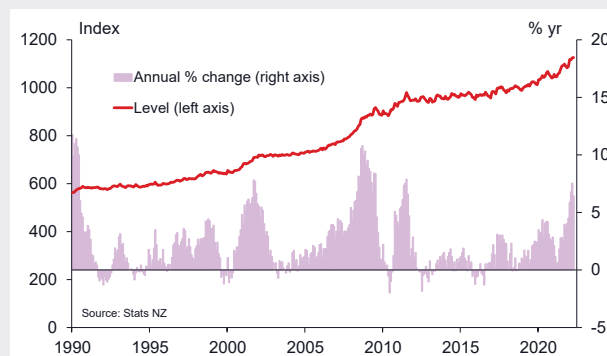
Within that broad view, we note that the net costs may fall more on sheep and beef farmers than on dairy farmers. As mentioned, lower supply will give a greater boost to dairy prices than meat prices. This fact is due to New Zealand dairy's larger share of global exports, relative to New Zealand sheep and beef's red meat share, and the fact that red meat has more competition from things like chicken, pork and seafood. Secondly, dairy's conversion of feed to milk is more methane-efficient than sheep and beef's conversion to meat. That is, for a given unit of output, dairy will have fewer emissions to pay for than meat will.

There are a few outstanding questions though, the most important being whether the Government will accept the Partnership's recommendations. This partly depends on whether the Government believes that the plan is credible in terms of delivering the required emissions reductions. To some degree the Government's decision will also be around balancing political pressures. It has invested political capital (and departmental support) in giving the agricultural sector the power of self-determination around its emissions plan. So pushing back too far on the recommendations could risk alienating farmers. At the same time, the Government will be aware that the rest of the electorate may support a tough stance on agriculture given its over-sized share of New Zealand's greenhouse gas emissions. Either way, we will be keenly watching the response to the recommendations later this year.

Chart of the week

Local food price inflation has built up a head of steam. In March it hit 7.6% in annual terms. From here, we expect it to remain hot over the remainder of the year. Heading into 2023, we expect agricultural incomes to remain at very high levels, and thus for demand for agricultural inputs to remain strong. On this basis, we expect food price inflation to remain firm, and it may linger at a higher level than for inflation more generally.

Food price inflation

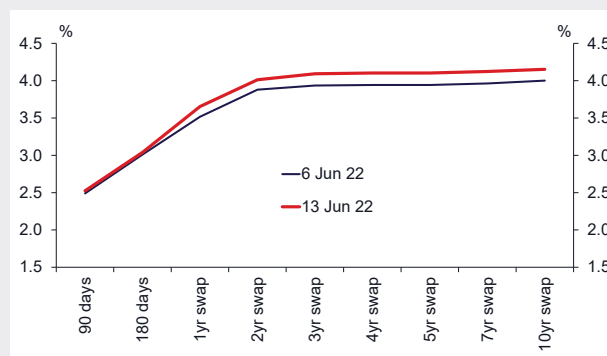


Fixed vs floating for mortgages

Wholesale interest rates remain above our forecast of a 3.5% peak in the Official Cash Rate this year. That suggests to us that there is no cost advantage to fixing for longer terms.

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

NZ interest rates



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The week ahead

NZ May REINZ house sales

Jun 14 (TBC), Sales last: -4.0%

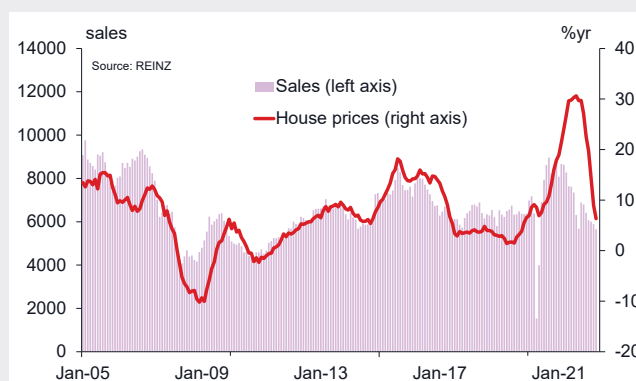
Prices last: -1.1% mom (seasonally adjusted), +6.3%yooy

Both house prices and sales continued to cool in April as mortgage rates rose. Nationwide prices are now down 5% from their peak in November, with larger declines in Auckland and Wellington. Similarly, sales have fallen below pre-pandemic levels.

We expect that May will see a further cooling in house prices. Mortgage rates have continued to push higher over the past month and the average number of days to sell has been rising. Similarly, auction clearance rates remain low.

There are tentative signs that the downtrend in sales is flattening off following recent price declines. Even so, the level of sales remains low.

REINZ house prices and sales



NZ Q1 Current Account Balance, % of GDP

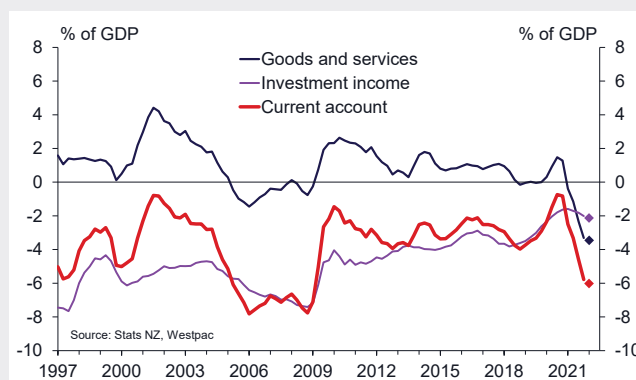
Jun 15, Last: -5.8%, Westpac: -6.0%

We expect the annual current account deficit to widen to 6.0% of GDP in the March quarter, from 5.8% in the December quarter.

The widening of the deficit beyond the average level of recent years essentially reflects the hot New Zealand economy since late 2020 – we have been, at least temporarily, living beyond our means.

Looking ahead, we expect the current account to widen further on the strength of the domestic economy and as tourism exports take time to lift. We expect the annual deficit to reach its widest point of around 7.0% in the second half of the year, before narrowing.

NZ annual current account balance



NZ Q1 GDP

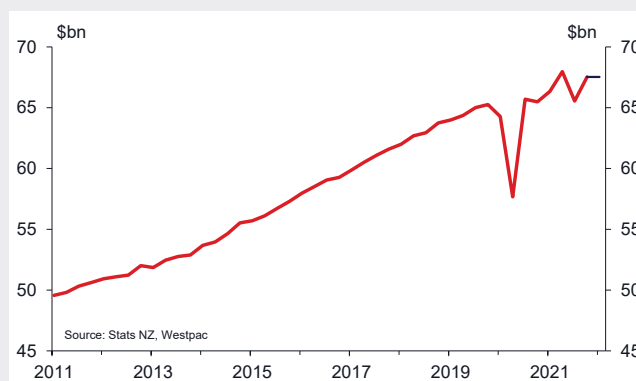
Jun 16, Last: 3.0%, WBC f/c: 0.0%, Mkt f/c: 0.6%

We estimate that GDP was flat in the March quarter. This is a downgrade from our earlier forecast of a 0.6% rise, due to some softness in the final batch of sectoral data releases.

Covid continued to act as a handbrake on the economy. While the December quarter was marked by ongoing Government-mandated restrictions, the March quarter included the peak of the Omicron wave, with worker absenteeism being a substantial issue.

We expect a stronger pickup in the June quarter, and our forecast for growth in 2022 overall remains broadly unchanged.

NZ production-based GDP



The week ahead

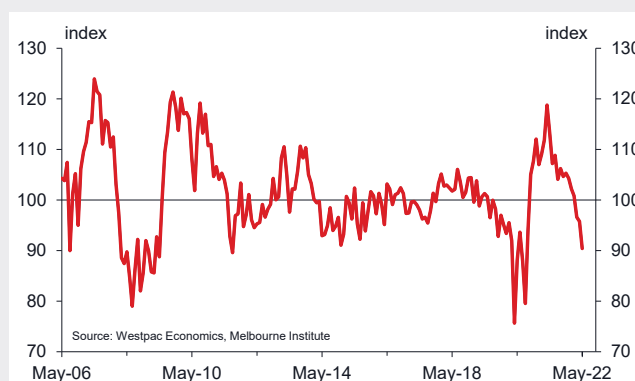
Aus Jun Westpac-MI Consumer Sentiment

Jun 15, Last: 90.4

Consumer Sentiment fell 5.6% to 90.4 in May, hit by rising cost of living pressures and the RBA's 25bp interest rate hike – the first since 2010.

The RBA's 50bp rate hike is likely to see interest rate concerns dominate again in June. Other factors that may influence sentiment include: the Federal election result, which saw a new ALP government come into office; a renewed rise in petrol prices (through \$1.90/litre nationally); a reasonably solid Q1 national accounts update; but more signs that housing markets have moved into a correction phase.

Aus Consumer Sentiment Index



Aus May overseas arrivals and departures, preliminary

Jun 15, Arrivals, Last: 575.5k

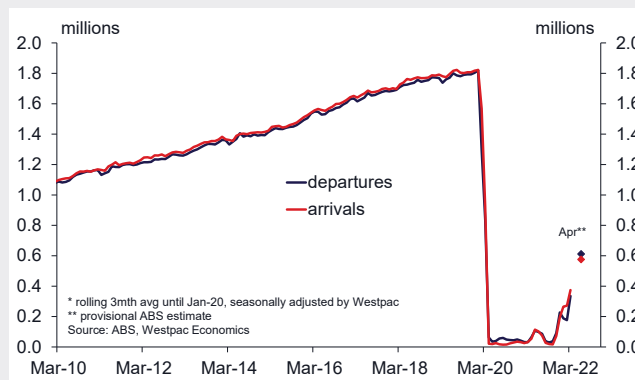
Jun 15, Departures, Last: 611.0k

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.

The April estimate indicated a clear acceleration in the recovery of overseas travel, with arrivals lifting to 575.5k and departures nearly doubling to 611.0k. This result was accompanied by promising trade data, with tourism related services exports leaping 27% in April, suggesting the March border reopening is starting to see some material impacts.

For the May preliminary estimate, we are hopeful that the pace of recovery continues to forge ahead. With nascent strength in short-term visitor arrivals to boost demand, and robust growth in visa arrivals to gradually alleviate the undersupply of labour, the broader net migration picture will play a critical role in understanding the near-term strength and the long-term health of the Australian economy.

Aus total overseas arrivals and departures



Aus May Labour Force Survey, employment '000

Jun 16, Last: 4.0k, WBC f/c: 5k

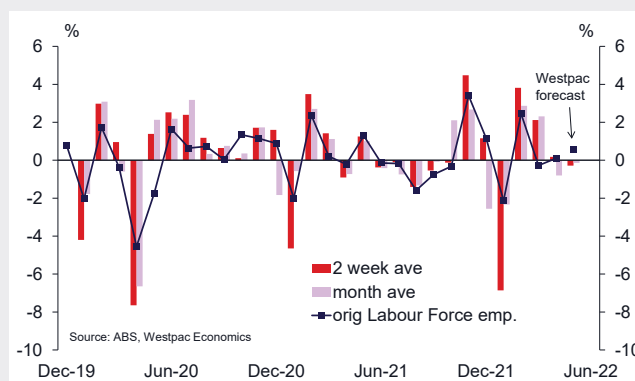
Mkt f/c: 25k Range: flat to 40k

Total employment lifted 4k in April, softer than Westpac's 20k estimate and well short of the market estimate of 30k. Weekly payrolls had pointed to softer activity and we thought it might appear more in hours worked than employment. In the end it was the other way around with soft employment print and a robust 1.3% rise in hours worked. April was the sixth consecutive monthly gain in employment for a total gain of 566.0k since October 2021.

We had thought that the April recovery in hours worked was a prelude to a stronger recovery in employment in May. However, Weekly Payrolls jobs to 14th of May were very weak. Comparing the May to April reference weeks Payrolls are down 0.3%; it is usually a seasonally strong month with a positive change in the ABS seasonal factors.

Using the ABS seasonal factors our forecast 5k gain in employment is a 0.6% rise in original terms so stronger than the -0.3% in Payrolls. We do think some of the weakness will appear in hours worked but clearly there is a risk of a negative print in employment.

Aus Payrolls vs Labour Force Employment



The week ahead

Aus May Labour Force Survey, unemployment %

Jun 16, Last: 3.9%, WBC f/c: 3.8%

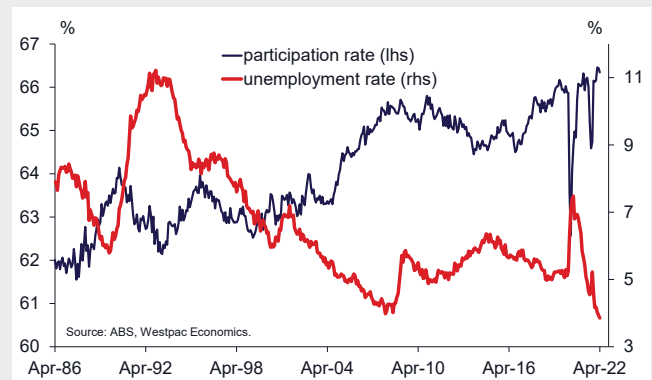
Mkt f/c: 3.8% Range: 3.8% to 4.0%

In April there was a 0.1ppt dip in the participation rate to 66.3% (66.44% to 66.34% at two decimal places). At the time we thought this could be more to do with poor weather and soft employment leading the marginally attached to not look for work, than a sign participation rate has peaked noting the strong lift in hours worked.

This was enough, so +4.0k on employment generated a 11.0k fall in unemployment and the unemployment rate falling to 3.9%, the lowest the unemployment rate has been in the monthly survey (since February 1978). The last time the unemployment rate was lower than this was in August 1974, when the survey was quarterly.

We think it is possible this will be repeated in May given the soft Payrolls update. We also note the April unemployment was 3.85% at two decimal paces so rounded up to 3.9%. With a very small fall in participation (from 66.34% to 66.30%) this is enough to see unemployment round down to 3.8% (3.84%).

Aus labour market



US Jun FOMC meeting

Jun 14-15, fed funds rate, Last: 0.875%, WBC f/c: 1.375%,

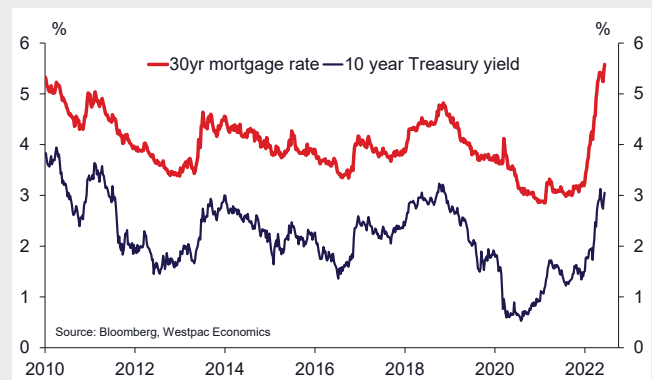
Mkt f/c: 1.375%

At the June FOMC meeting, the second of three consecutive 50bp increases in the fed funds rate is expected to be delivered, taking the cash rate to 1.375%, on the way to 1.875% in July. These moves have been well telegraphed by the Committee.

What comes next is less certain however, and is likely to be the focus of questioning by the journalists at Chair Powell's post-meeting press conference.

In our view, we are likely to see a more balanced assessment of the risks pertaining to inflation and growth through Q3, culminating in the throttling back of rate hikes to a 25bp pace from September. This shift will be all the more apparent in Q4 as the FOMC ends the tightening cycle at 2.625% in December.

US household financial conditions

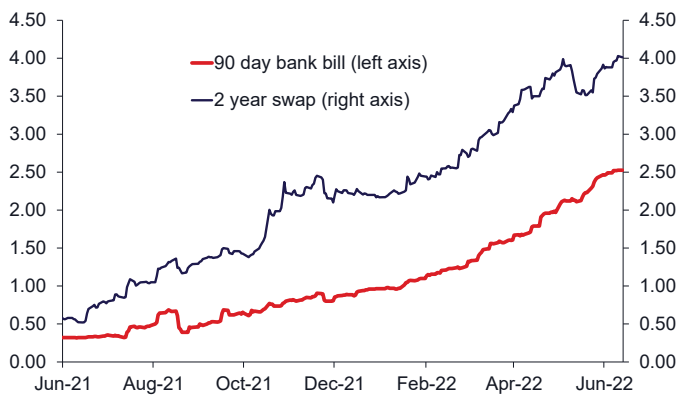


New Zealand forecasts

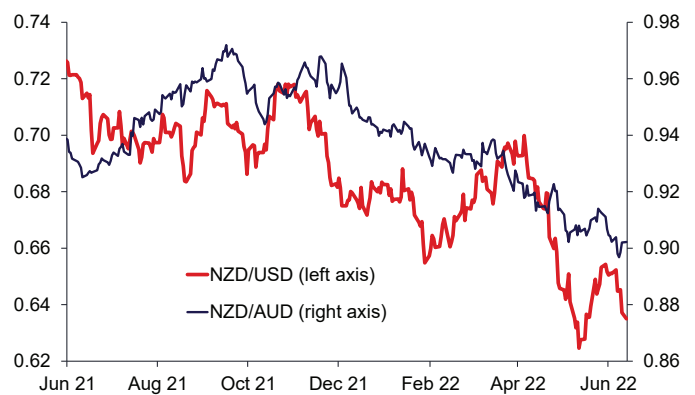
Economic forecasts	Quarterly				Annual			
	2021	2022						
% change	Dec (a)	Mar	Jun	Sep	2020	2021	2022f	2023f
GDP (Production)	3.0	0.0	1.3	0.7	-2.1	5.6	2.6	3.4
Employment	0.0	0.1	0.3	0.2	0.6	3.5	0.8	0.9
Unemployment Rate % s.a.	3.2	3.2	3.1	3.0	4.9	3.2	3.0	3.3
CPI	1.4	1.8	1.1	1.2	1.4	5.9	4.5	2.7
Current Account Balance % of GDP	-5.8	-6.0	-6.9	-7.1	-0.8	-5.8	-6.8	-5.6

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	4.00	3.90	3.70	3.50	3.30	3.10	2.90
5 Year Swap	4.00	3.90	3.70	3.50	3.35	3.20	3.05
10 Year Bond	3.70	3.50	3.30	3.20	3.10	3.00	2.90
NZD/USD	0.67	0.69	0.70	0.71	0.72	0.72	0.72
NZD/AUD	0.91	0.91	0.91	0.91	0.91	0.90	0.90
NZD/JPY	87.1	88.3	88.2	88.0	87.2	87.1	86.1
NZD/EUR	0.61	0.63	0.63	0.63	0.63	0.63	0.62
NZD/GBP	0.53	0.54	0.55	0.55	0.54	0.54	0.53
TWI	73.2	74.2	74.3	74.7	74.5	74.7	74.2

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 13 June 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	2.00%	2.00%	1.50%
30 Days	2.08%	2.03%	1.87%
60 Days	2.31%	2.24%	2.00%
90 Days	2.53%	2.46%	2.13%
2 Year Swap	4.01%	3.87%	3.53%
5 Year Swap	4.10%	3.81%	3.70%

NZ foreign currency mid-rates as at 13 June 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6350	0.6543	0.6278
NZD/EUR	0.6040	0.6073	0.6017
NZD/GBP	0.5152	0.5176	0.5119
NZD/JPY	85.30	83.35	81.19
NZD/AUD	0.9022	0.9111	0.9069
TWI	71.36	72.56	70.94

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 13					
NZ	Apr net migration	1177	-	-	Starting to lift following easing in border restrictions.
UK	Apr trade balance £bn	-11552	-	-	Deficit to remain wide on import strength.
US	Fedspeak	-	-	-	Brainard discusses Community Investment Act.
Tue 14					
NZ	May food price index	0.1%	-	0.8%	Supply and staff shortages adding to cost pressures.
	May REINZ house sales	-4.0%	-	-	Due this week. Slowdown in the market to continue...
	May REINZ house prices %yr	6.3%	-	-	...in response to higher mortgage rates.
Aus	May NAB business survey	20	-	-	Federal election campaign, RBA rate hike - any adverse impacts?
Eur	Jun ZEW survey of expectations	-29.5	-	-	Confidence on par with pandemic lows.
UK	Apr ILO unemployment rate	3.7%	3.7%	-	Unemployment to hold below pre-pandemic levels.
US	May NFIB small business optimism	93.2	93.0	-	Cost pressures and labour shortages are key concerns.
	May PPI	0.5%	0.8%	-	Supply issues to keep producer prices elevated in near-term.
Wed 15					
NZ	Q1 current account % of GDP	-5.8%	-	-6.0%	Deficit widening on strong domestic demand.
Aus	Jun Westpac-MI Consumer Sentiment	90.4	-	-	RBA's 50bp rate hike to dominate.
	May overseas arrivals, prelim. 000's	575.5	-	-	Acceleration in April, hopefully more to come in May.
Chn	May retail sales ytd %yr	-0.2%	-1.7%	-	Weakness in consumption to continue near term...
	May fixed asset investment ytd %yr	6.8%	6.1%	-	... but building momentum for investment...
	May industrial production ytd %yr	4.0%	3.1%	-	... and lingering strength in trade are providing resilience.
Eur	Apr trade balance €bn	-17.6	-	-	Deficit to remain wide on energy prices.
	Apr industrial production	-1.8%	0.7%	-	Supply issues an ongoing headwind.
US	May retail sales	0.9%	0.2%	-	Inflation and higher rates affecting capacity to spend.
	Jun Fed Empire state index	-11.6	3.0	-	Volatile, but the firm order pipeline will support NY mfg.
	May import price index	0.0%	1.2%	-	Import prices to remain at an elevated level.
	Apr business inventories	2.0%	1.2%	-	Businesses rebuilding inventory at robust pace.
	Jun NAHB housing market index	69	68	-	Affordability, rising input costs and interest rates are concerns.
	FOMC policy decision, midpoint	0.875%	1.375%	1.375%	Second of three consecutive 50bp rate hikes inbound.
Thu 16					
NZ	Q1 GDP	3.0%	0.6%	0.0%	Demand strong but Covid continues to be a handbrake.
Aus	Jun MI inflation expectations	5.0%	-	-	To remain at an elevated level, mirroring official Q1 CPI.
	May employment	4.0k	25.0k	5.0k	Elevated vacancies point to robust labour demand but...
	May unemployment rate	3.9%	3.8%	3.8%	...Payrolls remain soft. Unemployment to round down.
	June RBA Bulletin	-	-	-	Quarterly Bulletin includes RBA research articles.
UK	BoE policy decision	1.00%	1.25%	1.25%	Rate hikes needed to tame inflation despite weak growth.
US	May housing starts	-0.2%	-0.6%	-	Labour market and limited supply to provide...
	May building permits	-3.2%	-1.8%	-	...underlying support for resi construction into medium term.
	Jun Philly Fed index	2.6	5.0	-	Inflation and supply chain concerns are front of mind.
	Initial jobless claims	229k	-	-	To remain at a low level.
Fri 17					
NZ	May manufacturing PMI	51.2	-	-	Economic conditions have been firming.
Eur	May CPI, %yr (final)	7.4%	8.1%	-	Price pressures are intensifying and broadening.
UK	May retail sales	1.4%	-	-	Cost-of-living pressures to weigh on spending.
US	May industrial production	1.1%	0.5%	-	Volatility to linger as firms navigate supply issues.
	May leading index	-0.3%	-0.4%	-	Pointing to a slowing of economic momentum.
	Fedspeak	-	-	-	Chair Powell provides opening remarks at Dollar conference.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021f	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	3.2	3.5
Current account % of GDP	-2.1	0.7	2.6	3.5	1.4	-1.3
United States						
Real GDP %yr	3.0	2.2	-3.4	5.7	2.5	1.6
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	3.6	4.0
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	1.7	1.8
Euro zone						
Real GDP %yr	1.9	1.3	-6.6	4.9	2.2	1.5
United Kingdom						
Real GDP %yr	1.3	1.4	-9.9	7.2	3.7	0.0
China						
Real GDP %yr	6.7	5.8	2.3	8.1	5.3	5.5
East Asia ex China						
Real GDP %yr	4.4	3.7	-2.4	4.2	4.5	4.6
World						
Real GDP %yr	3.6	2.8	-3.3	5.5	3.4	3.3

Forecasts finalised 10 June 2022

Interest rate forecasts	Latest	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Australia								
Cash	0.85	1.60	2.10	2.35	2.35	2.35	2.35	2.35
90 Day BBSW	1.48	2.05	2.47	2.55	2.55	2.55	2.55	2.55
10 Year Bond	3.64	3.15	2.90	2.65	2.50	2.40	2.30	2.20
International								
Fed Funds	0.875	2.125	2.625	2.625	2.625	2.625	2.625	2.625
US 10 Year Bond	3.05	2.80	2.60	2.40	2.30	2.20	2.10	2.05

Exchange rate forecasts	Latest	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
AUD/USD	0.7089	0.74	0.76	0.77	0.78	0.79	0.80	0.80
USD/JPY	134.14	130	128	126	124	122	121	120
EUR/USD	1.0619	1.09	1.10	1.12	1.13	1.14	1.15	1.16
GBP/USD	1.2490	1.26	1.27	1.28	1.30	1.32	1.34	1.35
USD/CNY	6.6925	6.50	6.35	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.1102	1.10	1.10	1.10	1.10	1.10	1.11	1.11

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