WESTPAC WEEKLY ECONOMIC COMMENTARY

A stitch in time.

19 April 2022

Mount Cook buttercup

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The Reserve Bank has stepped up the pace in its fight against inflation, raising the Official Cash Rate by 50 basis points to 1.50%. We expect further rate hikes to a peak of 3% by the end of this year. But we think that by that point, the RBNZ will be pleasantly surprised by how much traction it's getting on economic conditions.

The decision to hike by 50bp in one go can be chalked up as a surprise to the extent that most economists (including us) felt that they would come down on the side of a smaller 25bp increase. But it's certainly no surprise that the option was on the table. Large moves like this are usually reserved for extraordinary circumstances, and right now we're in the most challenging environment for inflation that we've seen in decades.

Consumer prices have surged over the last year, and this Thursday's CPI release for the March quarter is going to be a monster. We expect a 1.9% rise in prices for the quarter, which would lift the annual inflation rate to 7%. Our call is higher than the 1.4% quarterly increase that the RBNZ forecast in its February *Monetary Policy Statement*. However, given developments over the last couple of months, this week's OCR decision was no doubt made with a higher inflation number in mind.

Inflation has been driven by a number of forces all hitting at the same time: global supply disruptions resulting from Covid, strong demand in the local economy, and more recently a surge in oil and other commodity prices in reaction to the Ukraine invasion. Many of these are supply-side shocks that the RBNZ can't do anything about directly. Their concern instead is about what this could mean going forward.

In an economy that's already stretched to capacity, there's a greater risk that these initial price rises could feed into local price- and wage-setting decisions on an ongoing basis. If this pattern becomes established, it would be much more difficult and costly for the RBNZ to bring inflation under control again. And worryingly for the RBNZ, the past year has already seen short- and long-run inflation expectations pushing higher.

Concerns about inflation expectations are not new, however. Indeed, they featured strongly in the RBNZ's February statement. So what was different in last week's decision was a change of tactics. The RBNZ has decided that its 'least regrets' approach now calls for assertive action now to reduce the risk of having to do even more in the longer term – that is, a stitch in time will hopefully save nine.

Importantly, the RBNZ stated that it remains comfortable with its projected OCR track from the February *MPS*, which peaked at around 3.4% by the end of 2024. That's a notable contrast with financial market pricing, which had been heading towards pricing in a peak in the OCR closer to 4% in recent weeks. In the absence of any substantial new data or any guidance from the RBNZ, the local market has been led around by offshore developments, where the trend has been towards pricing in more and faster interest rate hikes.

There's a crucial difference though: most overseas central banks are only just starting their tightening cycles or have yet to begin. And to the extent that inflation is being driving by common factors globally, those central banks are at more risk of falling behind the curve and having to tighten much further than they intended.

The RBNZ's statement was meant as a reminder that it sets New Zealand policy for New Zealand conditions, and that it's already quite a way down the monetary tightening path. And that message was heeded: beyond the next couple of reviews, market expectations for the OCR have been pegged back, and swap rates actually fell after the announcement.

Given the new starting point for the OCR after the RBNZ's decision, we've adjusted our forecasts accordingly. We expect a follow-up 50 basis point hike at the May *MPS*, with further 25 basis point hikes at the four remaining reviews this year. This would see the OCR reach a peak of 3% by November, instead of mid-2023 as in our previous forecast.

Our forecast for May reflects the fact that the RBNZ will have a lot of fresh data to contemplate before then (in contrast to the relative data drought ahead of the April review), and we expect that much of it will go in the direction of exacerbating concerns about inflation. That includes this week's CPI release, the RBNZ's survey of inflation expectations, and the March quarter labour market surveys.

The exception to this will be the housing market. The REINZ housing report for March (released after the RBNZ's decision) showed that house prices have now been falling for the last four months, to be down almost 5% from their peak. The April figures will also be published before the next RBNZ policy review, and we'd expect to see a further decline in prices.

Property owners are coming under increasing pressure: the cost of living is rising rapidly, pay rates aren't keeping up, mortgage interest payments are rising, and the house is no longer doing the saving for them. These forces will have a significant braking effect on consumer spending, and ultimately the extent of demand-driven inflation pressures in the economy.

Both we and the RBNZ were already expecting house prices to fall as mortgage rates rose. But the last few months show that this is happening a little sooner and faster than expected. That's crucial to the outlook for interest rates – we've always placed more emphasis than the RBNZ does on the housing channel for monetary policy, and we think that as the year progresses the RBNZ will be pleasantly surprised at how much traction it's getting. For that reason, we're comfortable with keeping our peak OCR forecast at 3%, rather than moving towards the RBNZ's higher estimate.

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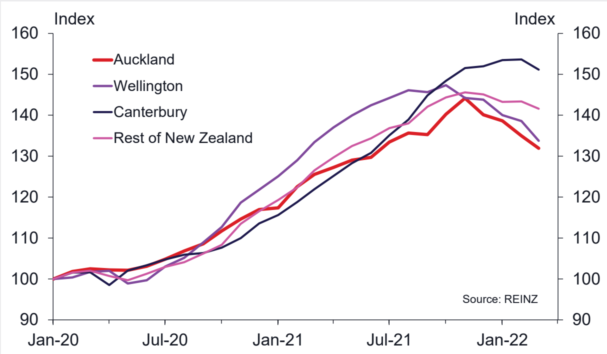
Chart of the week

House prices are now falling in almost every part of the country. The biggest decline has been in Wellington, which was arguably the most overheated market during the runup in 2020-21. Auckland has also seen a large decline. Prices in the Canterbury region, which had become relatively undervalued in recent years, held up at the start of 2022, but are now falling as well.

REINZ house price index (Jan 2019 = 100)

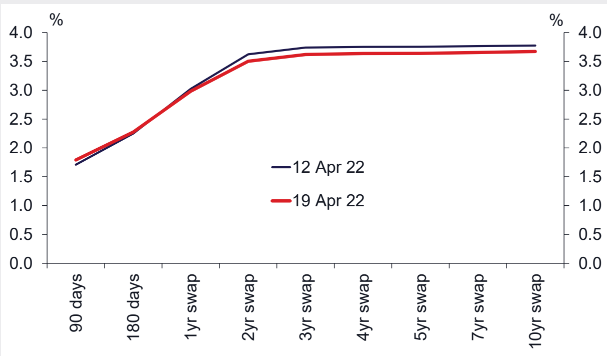


Fixed vs floating for mortgages

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 GlobalDairyTrade auction, whole milk powder prices

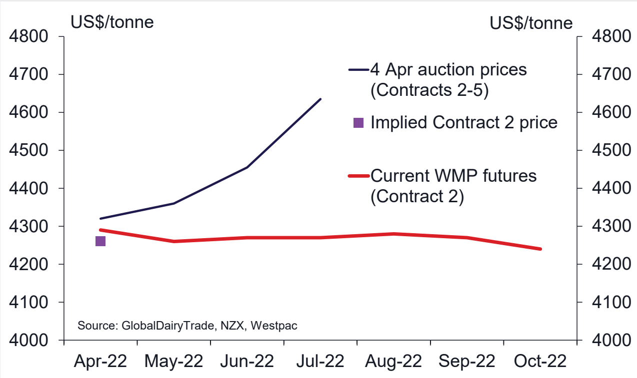
Apr 20, Last: -1.5%, Westpac: -2%

We expect whole milk powder prices (WMP) to fall 2% at the upcoming dairy auction. Prices have softened over the last two auctions by a combined 3.6% as global dairy markets have reacted to the Covid outbreak in Shanghai.

Our pick is similar to futures market pricing.

Looking beyond the next few auctions, we expect prices to remain high on strong market fundamentals. However, Shanghai's Covid outbreak has introduced some uncertainty as to when Chinese dairy demand will rebound to the level seen prior to the outbreak.

Whole milk powder prices



NZ Q1 Consumer price inflation

Apr 21, Last: +1.4%, Westpac: +1.9%, Market f/c: +2.0%

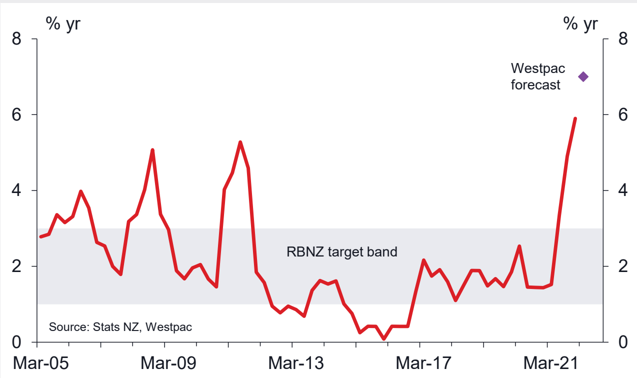
Price pressures are bubbling over in every corner of the New Zealand economy, boosted by a potent cocktail of supply-side cost pressures (including rising wages) and firm consumer demand.

We expect the upcoming Consumers Price Index will show that New Zealand consumer prices rose by 1.9% in the March quarter.

That would take annual inflation to 7%, up from 5.9% at the end of last year and the highest annual inflation rate in more than three decades.

Our forecast is stronger than the RBNZ assumed in their last set of published forecasts. However, those forecasts were finalised several months ago, and we expect the RBNZ is already braced for a stronger result.

NZ Consumer Price Inflation



Aus Mar Westpac-MI Leading Index

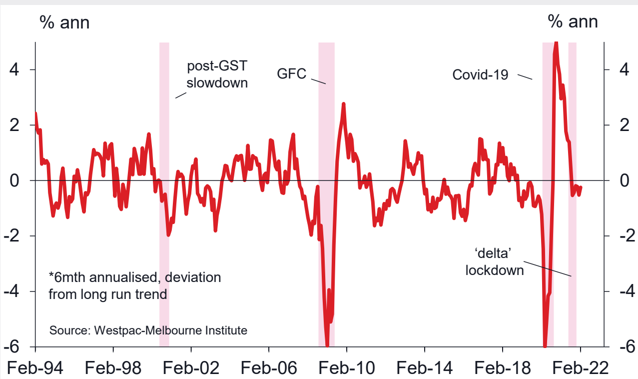
Apr 20, Last: -0.25%

The six-month annualised growth rate rose from -0.5% in January to -0.25% in February, in slight negative territory.

Component-wise, the March update will include some positive monthly updates around equity markets (ASX200 up 6.4%); commodity prices (up a further 3.9% in AUD terms); and dwelling approvals (+43.5% after hitting a big air pocket the previous month) which will more than offset a weather-impacted dip in total hours worked (-0.6%).

However the more important dynamic will be the cycling of last year's 'delta' disruptions – the headline Leading Index growth rate is a six-month measure and with last year's disruptions now moving into the base of the calculations.

Aus Westpac-MI Leading Index

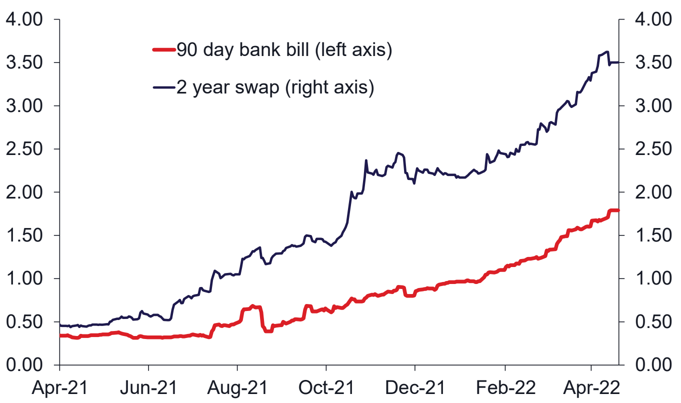


New Zealand forecasts

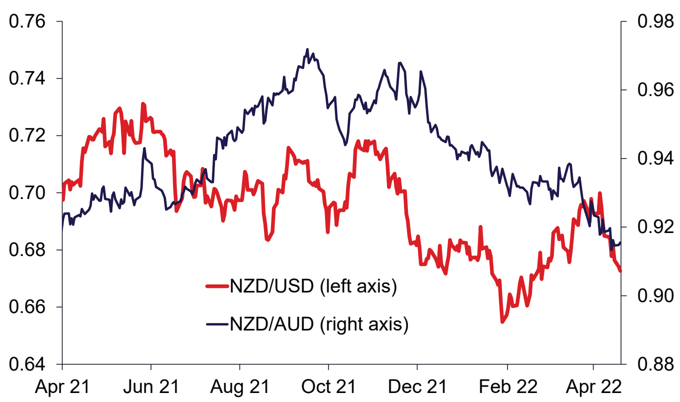
Economic forecasts	Quarterly				Annual			
	2021	2022						
% change	Dec (a)	Mar	Jun	Sep	2020	2021	2022f	2023f
GDP (Production)	3.0	0.3	0.7	2.3	-2.1	5.6	3.4	4.8
Employment	0.1	0.4	0.3	0.1	0.6	3.7	0.9	1.0
Unemployment Rate % s.a.	3.2	3.1	3.0	3.0	4.9	3.2	3.0	3.3
CPI	1.4	1.9	1.0	1.1	1.4	5.9	4.5	2.7
Current 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	2.00	2.50	3.00	3.00	3.00	3.00	3.00
90 Day bill	2.40	2.90	3.10	3.10	3.10	3.10	3.10
2 Year Swap	3.50	3.50	3.45	3.40	3.30	3.15	3.00
5 Year Swap	3.60	3.60	3.55	3.50	3.40	3.30	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 19 April 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	1.50%	1.00%	1.00%
30 Days	1.57%	1.35%	1.19%
60 Days	1.68%	1.51%	1.39%
90 Days	1.79%	1.66%	1.59%
2 Year Swap	3.50%	3.46%	3.16%
5 Year Swap	3.64%	3.55%	3.40%

NZ foreign currency mid-rates as at 19 April 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6727	0.6999	0.6940
NZD/EUR	0.6240	0.6380	0.6307
NZD/GBP	0.5171	0.5332	0.5253
NZD/JPY	85.41	86.02	83.89
NZD/AUD	0.9155	0.9178	0.9345
TWI	73.07	75.12	74.71

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 18					
NZ	Easter Monday	–	–	–	Public holiday. Markets closed.
Chn	Q1 GDP %yr	4.0%	4.3%	4.9%	Focus will be on consumer demand ...
	Mar retail sales ytd %yr	6.7%	2.5%	–	... given rolling Covid-19 outbreaks across nation.
	Mar industrial production ytd %yr	7.5%	6.0%	–	In Jan/Feb, production and investment ...
	Mar fixed asset investment ytd %yr	12.2%	8.4%	–	... surprised to the upside; credit points to ongoing momentum.
UK	Apr Rightmove house prices	1.7%	–	–	Strong in early 2022, but rate hikes likely to soften demand.
US	Apr NAHB housing market index	79	77	–	Demand strong; supply of labour and inputs still of concern.
	Fedspeak	–	–	–	Bullard.
Tue 19					
NZ	Mar BusinessNZ PSI	48.6	–	–	Omicron drag easing, but conditions still subdued.
Aus	RBA minutes	–	–	–	
US	Mar housing starts	6.8%	–1.4%	–	Strength of labour market and limited supply...
	Mar building permits	–1.9%	–1.4%	–	... to support residential construction into the medium term.
	Fedspeak	–	–	–	Evans.
Wed 20					
NZ	GlobalDairyTrade auction prices WMP	–1.5%	–	–2%	China's Omicron outbreak continues to weigh on prices.
Aus	Mar Westpac–MI Leading Index	–0.25%	–	–	Likely to ‘pop’ higher as delta effects move into base of calc.
Eur	Feb trade balance €bn	–7.7	–	–	Hit by energy prices in recent months.
US	Mar existing home sales	–7.2%	–4.1%	–	Supply the most pressing issue for established home mkt.
	Federal Reserve's Beige book	–	–	–	Qualitative assessment of conditions across the 12 districts.
	Fedspeak	–	–	–	Daly and Evans.
Thu 21					
NZ	Q1 CPI	1.4%	2.0%	1.9%	Cost pressures widespread and demand has been firm.
Eur	Mar CPI %yr	7.5%	–	–	Energy prices driving headline inflation; flash Mar core at 3.0%yr.
	Apr consumer confidence	–18.7	–	–	Inflation pressuring real spending capacity and sentiment.
US	Apr Phily Fed index	27.4	21.4	–	Down from highs but still at robust level.
	Initial jobless claims	–	–	–	To remain at record lows.
	Mar leading index	0.3%	0.3%	–	Pointing to growth a touch above trend.
	Fedspeak	–	–	–	FOMC Chair Powell and ECB President Lagarde on IMF panel.
Fri 22					
Eur	Apr S&P Global manufacturing PMI	56.5	–	–	April likely to see material hit from Russia’s invasion of Ukraine...
	Apr S&P Global services PMI	55.6	–	–	... across manufacturing and services.
UK	Apr GfK consumer sentiment	–31	–	–	Near lows back to 2008.
	Mar retail sales	–0.3%	–	–	End of Covid-19 restrictions and cost of living weighing.
	Apr S&P Global manufacturing PMI	55.2	–	–	The UK is better positioned than Europe to weather headwinds...
	Apr S&P Global services PMI	62.6	–	–	... from Ukraine conflict, but hit to activity likely.
US	Apr S&P Global manufacturing PMI	58.8	57.8	–	Continues to point to robust momentum across...
	Apr S&P Global services PMI	58.0	58.6	–	... both sectors.

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	0.7451	0.74	0.75	0.76	0.77	0.78	0.79	0.80
USD/JPY	125.60	124	123	122	121	120	119	119
EUR/USD	1.0890	1.10	1.11	1.12	1.13	1.14	1.15	1.15
GBP/USD	1.3119	1.33	1.34	1.35	1.36	1.37	1.37	1.36
USD/CNY	6.3682	6.30	6.30	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.0962	1.07	1.07	1.07	1.08	1.08	1.09	1.10

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