

WESTPAC WEEKLY ECONOMIC COMMENTARY

Inflation – a business perspective.

17 April 2023



Southern rātā

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We expect data this week to show that inflation was still running red hot over the March quarter. For the record, we have pencilled in a 1.6% CPI lift over the quarter and a 7.0% lift over the year. Note, with March food price data due this morning, we may tweak our forecast a little either way ahead of the CPI data release on Thursday. Ahead of finalising our forecast, we thought we would look at inflation from a different perspective. That is, instead of the usual consumer price view, we take a look from the business perspective.

The first thing we note is like consumer inflation, business inflation is also running hot. For the December year, both business input and output inflation (essentially the prices firms pay for inputs and charge for their goods and services) were running at around 8%. Both sets of inflation are at their highest level for 15 years.

Secondly, we note that business margins have been squeezed. In this case, we observe that the gap between output and input prices began narrowing in 2021 and then closed even further over 2022. And since then, firms have reported that this squeeze has continued, if not intensified.

And it's this squeeze that we expect will contribute to the slowdown in business activity and economic growth over the year. Specifically, we expect firms back off or slow their hiring and investment plans on the back of those tighter margins and the subsequent deteriorating profit outlook.

It's not necessarily all doom and gloom, though. The business inflation data also suggest that inflation has passed its

peak. In fact, business input price inflation likely peaked at 9.7% in June 2022, and has since fallen to 8%, suggesting the worst of the input price inflation is behind us. And if the historical relationship holds, then falling business input prices should translate into falling consumer price inflation over coming quarters.

The business inflation breakdown by industry also reveals some interesting patterns. Four industries – transport, postal and warehousing; mining; agriculture, forestry and fishing; and construction – all stand out as having input inflation significantly higher than the other industries. Relative to overall business input inflation of 8%, these industries are all recording annual increases of 12.5% or more.

So, then we can ask is there anything particular to these industries keeping inflation high and or has anything changed? The construction industry is a case in point. We know construction is slowing, highlighted by the 20% plunge in building consents over the past three months. With construction demand slowing rapidly, we can then expect that

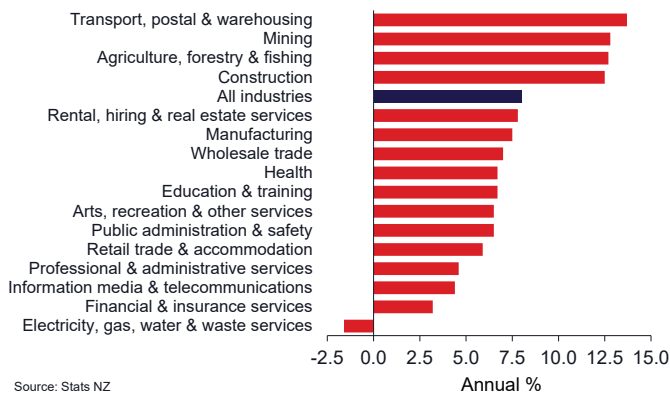
heat will come out of construction industry inflation. Similarly, we expect inflation to fall in the broader transport industry, following the dip in petrol and diesel prices, while noting that that has partly been driven by the government's reduction to fuel excises and road user charges.

Looking specifically at agriculture, it has been buffeted by a range of factors. Notably, the weather has battered farmers and growers in many parts of the country, with a wet and cold spring preceding the summer floods and then Cyclone Gabrielle. Meanwhile, surging fuel and fertiliser prices as well as rising debt servicing costs have combined to push annual farm expense inflation (data calculated specifically for farms and orchards) up to over 15% in the December quarter. In the case of dairy farm expense inflation, it's even higher at 17.3% over the same period.

The storms, however, do come with a silver lining. That is, the wet weather has supercharged pastures over autumn, heading into winter at a time when many farmers often struggle for feed. Instead, farmers now have ample feed for winter, and this is putting downward pressure on feed prices, with feed costs usually the largest expenditure component for livestock farmers. Along with lower fuel and fertiliser prices, we then anticipate that annual farm expense inflation will slow to around 4% by the end of the year, some 11 percentage points lower than the December 2022 number.

With that in mind, we expect food price inflation may be near its zenith. So, while we anticipate an unsightly 11% annual increase for March, we expect food prices to moderate steadily over the remainder of the year. And with food representing close to 20% of the CPI basket, it will go a long way to helping CPI inflation moderate as well.

Business input inflation by industry, Dec 2022



Nathan Penny, Senior Agri Economist

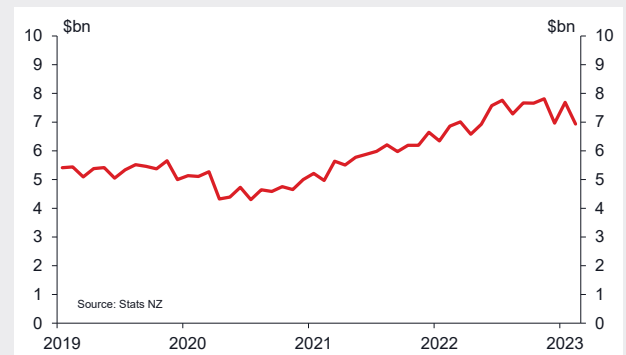
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Chart of the week

One key to putting a lid on inflation will be cooling demand. On that front, we are seeing one clear sign that this process is under way. Import demand has cooled rapidly over the past year. At one stage in early 2022, import values were growing in excess of 30% in annual terms. That has now materially slowed to just 1.1% in the most recent data for February. Accordingly, as an indicator for broader demand, cooling import demand bodes well for lowering inflation over the course of the year.

Goods import values

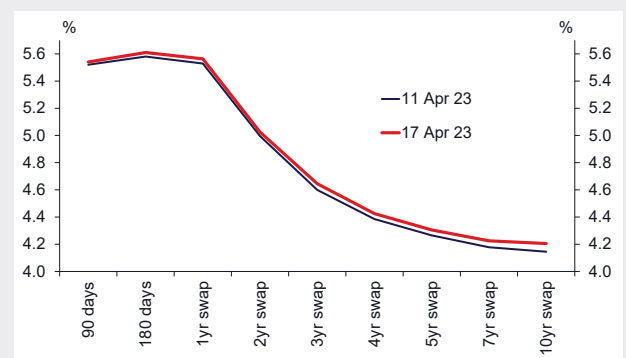


Fixed vs floating for mortgages

We expect the Official Cash Rate to reach a peak of 5.50% in May, though there's a risk of further increases in the following months. As inflation pressures recede, we see scope for rate cuts in 2024 and 2025, although not as quickly as the market is pricing in.

As a result, we now see value in fixing for terms as long as three years. While there isn't a lot of difference between the expected cost of fixing for shorter vs longer periods, a longer period provides more certainty around the size of repayments. We would still regard fixing beyond three years as relatively expensive.

NZ interest rates



The week ahead

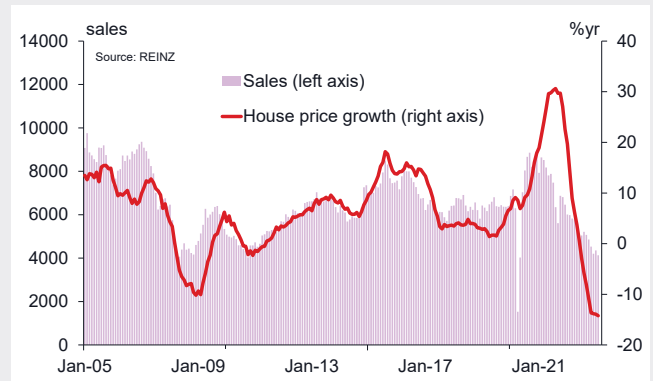
NZ Mar REINZ house sales and prices

Apr 18, Sales last: -5.1% m/m, -31.1% y/y
Prices last: -1.5% m/m, -14.2% y/y

The housing market continued its decline in the early part of this year. Nationwide house prices have now fallen by around 17% from their peak, taking them back to where they were in early 2021.

We expect house prices to continue to fall in the coming months. Fixed-term mortgage rates may have reached their peaks and are even coming down in some instances. However, the market is still adjusting to the higher level of interest rates, with low listings and turnover slowing the price discovery process.

REINZ house prices and sales



NZ GlobalDairyTrade auction, whole milk powder prices

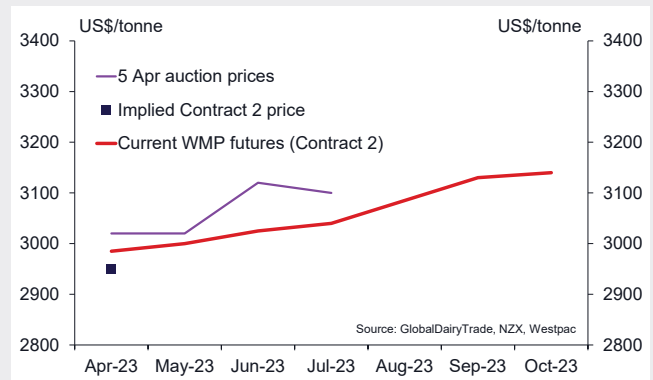
Apr 19, Last: -5.2%, Westpac: -1%

We expect whole milk powder prices (WMP) to fall by around 1% at the upcoming auction. Our pick is roughly similar to futures market pricing and last week's mini (GDT pulse) auction result.

Over the year, we expect that rebounding Chinese dairy demand and very subdued global supply will lead global dairy prices higher.

But for now, some key buyers are well-supplied and we anticipate that as they work through these stocks prices will remain soft.

Whole milk powder prices



NZ Q1 Consumer Price Index

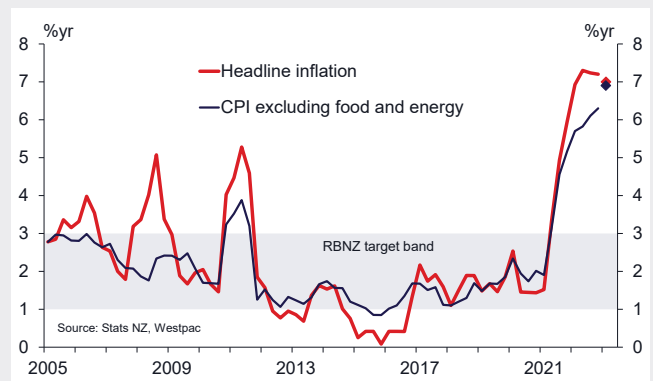
Apr 20, Qty. - Last: 1.4%, Westpac: 1.6%, Market f/c: 1.6%
Annual - Last: 7.2%, Westpac: 7.0%, Market f/c: 7.0%

We estimate that consumer prices rose by 1.6% in the March quarter. Food prices will account for a large part of the quarterly increase, with disruptions to food production that are only partly due to Cyclone Gabrielle. Rising homebuilding costs and rents, and the annual increase in tobacco excise, will also make sizeable contributions.

Our forecast would see annual inflation dip to 7%, from 7.2% in December. However, this is entirely due to fuel prices, which are now lower than they were a year ago (when the Russian invasion of Ukraine sent oil prices soaring). Elsewhere, price rises remain widespread, and increasingly in the services sectors where wage costs play a greater role.

Our forecast is below the Reserve Bank's estimate of a 1.8% rise for the quarter (which would see annual inflation rise to 7.3%). While we think that headline inflation has passed its peak, it will still take a substantial amount of time for tighter monetary policy to bring inflation back to the 1-3% target range.

NZ consumer price inflation



The week ahead

Aus Mar Westpac-MI Leading Index

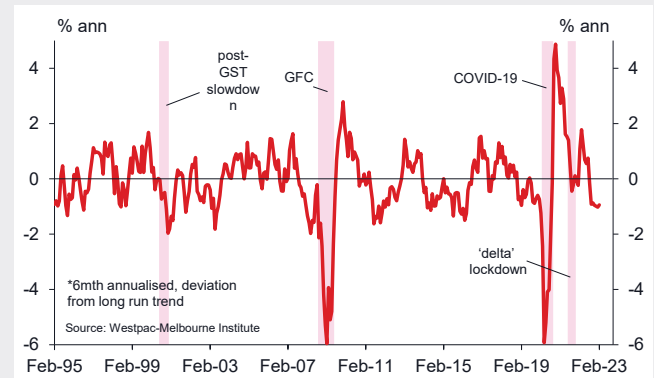
Apr 19, Last: -0.94%

The Leading Index continued to send a weak signal in Feb, the six-month annualised growth rate lifting only slightly to -0.94% from -1.04%, in Jan. The deeply negative readings remain consistent with momentum running well below trend in 2023.

The March report should see some improvement with better reads on several components, most notably the Westpac-MI Consumer Expectations Index which surged 9.4% in April. Dwelling approvals and US industrial production also posted monthly gains.

However, most other components remained soft, the ASX200 down a further -1.1%, commodity prices down a further -1.6% in AUD terms and the yield narrowing sharply on a mix of higher short term rates and sharply lower bond rates.

Aus Westpac-MI Leading Index



China Q1 GDP

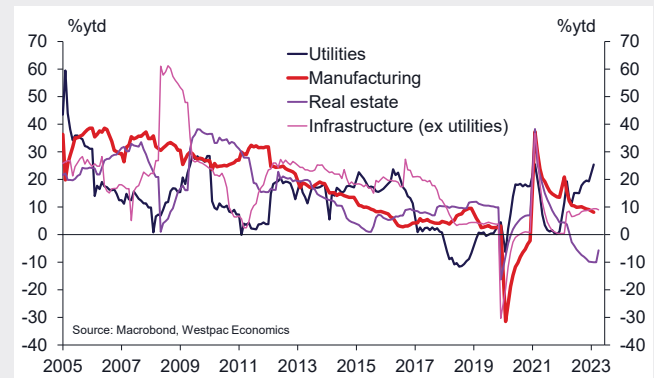
Apr 18: %y/y, Last: 2.9%, Mkt f/c: 3.8%, WBC: 3.8%

China's economy has shown considerable strength in the immediate rebound from COVID-zero. Q1 GDP and the accompanying monthly activity data for March will provide full detail on the first three months without restrictions.

This detail is likely to confirm the key themes we have been highlighting over the past year: (1) while shaken, the consumer is in good shape; (2) businesses are ready and willing to invest in pursuit of new markets and continued efficiency gains; and (3) with the full support of authorities, housing will quickly swing from headwind to tailwind, albeit with less strength than in prior cycles.

We remain of the view that year-average growth for 2023 will be above 6% and, in 2024, able to sustain around 5.5%.

China GDP

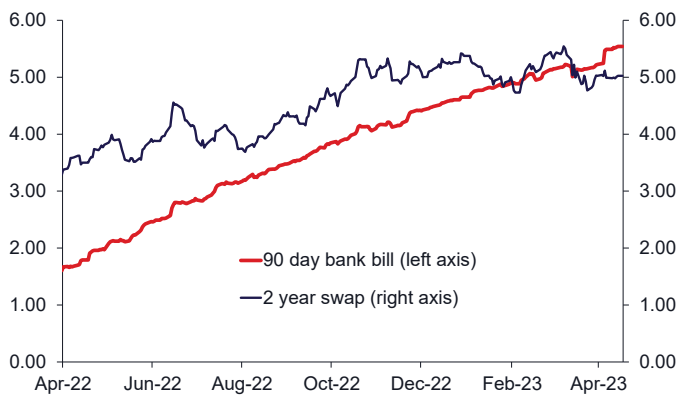


New Zealand forecasts

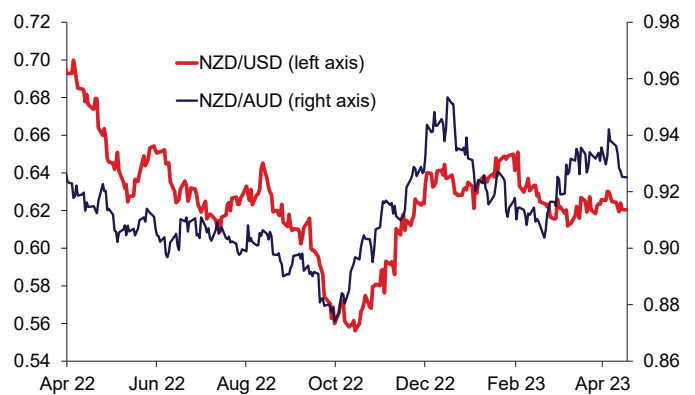
Economic forecasts	Quarterly				Annual			
	2022		2023		2021	2022	2023f	2024f
% change	Sep	Dec	Mar	Jun				
GDP (Production)	1.7	-0.6	0.2	0.2	6.0	2.4	1.1	-0.5
Employment	1.3	0.1	0.3	0.2	3.3	1.3	0.5	-0.3
Unemployment Rate % s.a.	3.3	3.4	3.5	3.6	3.2	3.4	4.0	5.1
CPI	2.2	1.4	1.6	1.3	5.9	7.2	5.3	2.9
Current Account Balance % of GDP	-8.5	-8.9	-8.5	-8.1	-6.0	-8.9	-6.7	-4.5

Financial forecasts	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Cash	5.50	5.50	5.50	5.50	5.25	4.75	4.25
90 Day bill	5.60	5.60	5.60	5.50	5.05	4.55	4.25
2 Year Swap	5.10	4.80	4.50	4.20	3.90	3.70	3.50
5 Year Swap	4.40	4.25	4.10	4.00	3.90	3.80	3.70
10 Year Bond	4.20	4.10	4.00	3.85	3.70	3.60	3.50
NZD/USD	0.64	0.66	0.67	0.68	0.68	0.68	0.68
NZD/AUD	0.93	0.92	0.91	0.90	0.89	0.89	0.88
NZD/JPY	83.2	85.1	85.8	85.7	85.1	84.4	84.3
NZD/EUR	0.58	0.59	0.60	0.60	0.59	0.59	0.59
NZD/GBP	0.52	0.53	0.54	0.54	0.53	0.53	0.53
TWI	71.4	72.5	72.7	72.5	71.7	71.1	71.0

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 17 April 2023

Interest rates	Current	Two weeks ago	One month ago
Cash	5.25%	4.75%	4.75%
30 Days	5.33%	5.09%	4.94%
60 Days	5.44%	5.17%	5.01%
90 Days	5.54%	5.24%	5.13%
2 Year Swap	5.03%	5.04%	4.88%
5 Year Swap	4.31%	4.37%	4.32%

NZ foreign currency mid-rates as at 17 April 2023

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6204	0.6254	0.6250
NZD/EUR	0.5645	0.5753	0.5843
NZD/GBP	0.5001	0.5058	0.5113
NZD/JPY	83.02	83.34	82.05
NZD/AUD	0.9251	0.9297	0.9333
TWI	70.49	71.51	71.33

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 17					
NZ	Mar BusinessNZ PSI	55.8	-	-	Has remained resilient, but headwinds mounting.
	Mar food price index	1.5%	-	1.1%	Price rises widespread, boosted by poor weather.
US	Apr Fed Empire state index	-24.6	-18.0	-	Regional investment detail points to sustained weakness.
	Apr NAHB housing market index	44	45	-	Mortgage rates off peak; but outlook remains uncertain.
	Feb total net TIC flows \$bn	183.1	-	-	US yields attractive for investors.
Tue 18					
NZ	Mar REINZ house sales %yr	-31.1%	-	-	Subdued sales and listings suggest that the market... is still adjusting to higher interest rates.
	Mar REINZ house prices %yr	-14.2%	-	-	
Aus	RBA minutes	-	-	-	Key focus is on the near-term path for policy.
Chn	Q1 GDP %yr	2.9%	3.8%	3.8%	China's economy showed great resilience during... COVID-zero; now free from restriction...
	Mar industrial production ytd %yr	2.4%	2.6%	-	... the domestic economy is set to rebound strongly...
	Mar retail sales ytd %yr	3.5%	3.7%	-	... as industry also benefits from expansion in new markets.
	Mar fixed asset investment ytd %yr	5.5%	5.7%	-	
Eur	Apr ZEW survey of expectations	10	-	-	Sentiment has improved drastically, but challenges remain.
	Feb trade balance €bn	-11.3	-	-	Falling energy costs to further support the recovery.
UK	Feb ILO unemployment rate	3.7%	3.8%	-	Labour market remains in robust shape.
US	Mar building permits	15.8%	-6.1%	-	Housing sector to remain under stress given affordability... and uncertainty. Multi-family still a strong proposition.
	Mar housing starts	9.8%	-3.1%	-	
	Fedspeak	-	-	-	Bowman.
Wed 19					
NZ	GlobalDairyTrade auction (WMP)	-5.2%	-	-1.0%	Buyers still working through existing stockpiles.
Aus	Mar Westpac-MI Leading Index	-0.94%	-	-	Momentum running well below trend.
Eur	Mar CPI %yr	6.9%	6.9%	-	Final estimate.
UK	Mar CPI %yr	10.4%	9.8%	-	BoE not concerned by recent upside surprise.
US	Federal Reserve Beige Book	-	-	-	To provide an update on conditions across the 12 Fed districts.
Thu 20					
NZ	Q1 CPI	1.4%	1.6%	1.6%	Strong and widespread price increases... with only lower fuel prices bring the annual rate down.
	Q1 CPI %yr	7.2%	7.0%	7.0%	
Eur	Apr consumer confidence	-19.2	-	-	Cost-of-living pressures limiting the up-turn in confidence.
US	Initial jobless claims	239k	-	-	Likely to remain low versus history.
	Apr Philly Fed index	-23.2	-19.4	-	Regional investment detail points to sustained weakness.
	Mar existing home sales	14.5%	-1.8%	-	Supply still a bigger concern than demand.
	Mar leading index	-0.3%	-0.4%	-	Growth to remain well below trend.
	Fedspeak	-	-	-	Williams, Waller, Mester, Bowman, Bostic.
Fri 21					
Eur	Apr S&P Global manufacturing PMI	47.3	47.9	-	Easing supply issues are doing little to support manufacturing... while services continues to run at a very high capacity.
	Apr S&P Global services PMI	55.0	54.5	-	
UK	Apr GfK consumer sentiment	-36	-	-	Consumers are facing strong headwinds... household spending to be hit.
	Mar retail sales	1.2%	-	-	
	Apr S&P Global manufacturing PMI	47.9	-	-	Similar to Europe with lasting pressure in manufacturing... but continued resilience within services.
	Apr S&P Global services PMI	52.9	-	-	
US	Apr S&P Global manufacturing PMI	49.2	49.2	-	Further weakness likely in coming months... as growth slowdown and rates impact.
	Apr S&P Global services PMI	52.6	51.5	-	
	Fedspeak	-	-	-	Cook.

International forecasts

Economic Forecasts (Calendar Years)	2019	2020	2021	2022f	2023f	2024f
Australia						
Real GDP %yr	1.9	-1.8	5.2	3.7	1.6	1.0
CPI inflation %yr	1.8	0.9	3.5	7.8	3.9	3.0
Unemployment rate %	5.2	6.8	4.7	3.5	4.5	5.0
Current account % of GDP	0.7	2.4	3.1	1.2	0.8	-0.1
United States						
Real GDP %yr	2.3	-3.4	5.7	2.1	0.9	0.7
CPI inflation %yr	1.9	1.2	7.2	6.4	2.5	2.0
Unemployment rate %	3.7	8.1	5.4	3.7	4.8	5.5
Current account % of GDP	-2.6	-2.5	-2.4	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	-0.4	-4.6	1.7	1.6	1.3	1.0
Euro zone						
Real GDP %yr	1.6	-6.1	5.2	3.5	0.6	1.4
United Kingdom						
Real GDP %yr	1.7	-9.3	7.4	4.0	-0.5	1.5
China						
Real GDP %yr	6.0	2.2	8.4	3.0	6.2	5.5
East Asia ex China						
Real GDP %yr	3.8	-2.3	4.2	4.6	4.1	4.4
World						
Real GDP %yr	2.8	-3.0	6.0	3.3	3.0	3.1

Forecasts finalised 6 April 2023

Interest rate forecasts	Latest	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Australia								
Cash	3.60	3.85	3.85	3.85	3.60	3.35	3.10	2.85
90 Day BBSW	3.65	3.95	3.95	3.97	3.72	3.47	3.22	2.97
10 Year Bond	3.33	3.40	3.30	3.20	3.00	2.80	2.70	2.50
International								
Fed Funds	4.875	4.875	4.875	4.875	4.375	3.875	3.375	2.875
US 10 Year Bond	3.44	3.50	3.40	3.30	3.10	2.90	2.80	2.60

Exchange rate forecasts	Latest	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
AUD/USD	0.6787	0.69	0.72	0.74	0.75	0.76	0.76	0.77
USD/JPY	132.37	130	129	128	127	126	125	124
EUR/USD	1.1071	1.10	1.11	1.12	1.13	1.14	1.15	1.16
GBP/USD	1.2544	1.23	1.24	1.25	1.26	1.27	1.28	1.29
USD/CNY	6.8361	6.70	6.60	6.50	6.40	6.30	6.20	6.10
AUD/NZD	1.0753	1.08	1.09	1.10	1.11	1.13	1.13	1.13

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- (v) documented and well defined procedures for dealing with conflicts of interest;
- (vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

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