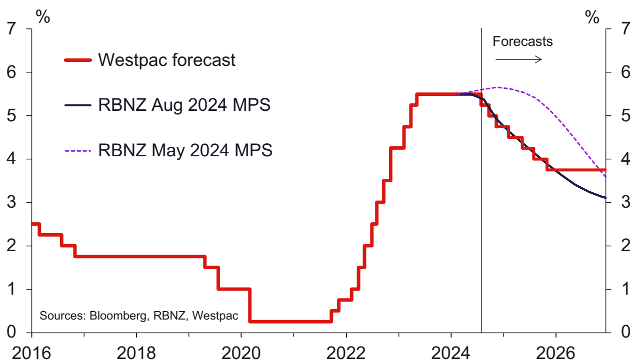
WEEKLY ECONOMIC COMMENTARY

19 Aug 2024 | **Westpac Economics Team** | **westpac.co.nz/economics** | economics@westpac.co.nz

RBNZ turns 180 degrees from May

The RBNZ surprised us by cutting the OCR 25bps at the *August Monetary Policy Statement*. The surprise was compounded by a relatively dovish forward OCR forecast track that was just contained within the range of scenarios we thought likely when we issued our preview. The RBNZ now projects the OCR to fall much more quickly through 2025 and 2026 than suggested in May, and gets closer to their long-run neutral OCR level of 2.75-3.00% earlier than previously expected.

Official Cash Rate forecasts

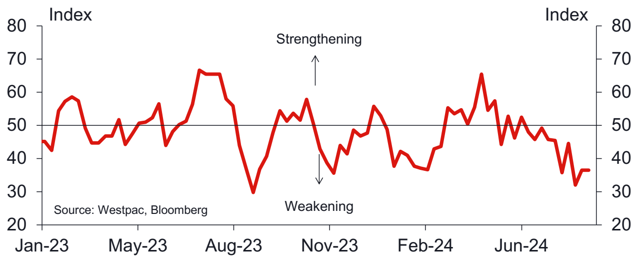


Two things have occurred at the RBNZ to generate this significant shift in view. First, and importantly, even though many of the highest profile activity indicators for Q1 printed in line with their May forecasts, the RBNZ has responded to recent weaker higher frequency activity and employment indicators by significantly revising down their GDP forecasts for Q2 and Q3. The RBNZ now sees a much more deeply negative output gap in the coming 6-9 months than they anticipated in May. Indeed, at its deepest point, the RBNZ's current output gap projections are the weakest seen in any *Monetary Policy Statement* since late 2022. This downgrade generates weaker underlying medium-term inflation forecasts, giving room for a faster reduction of policy restriction.

Key views

	Last 3 months	Next 3 months	Next year
Global economy	→	→	↗
NZ economy	↘	→	↗
Inflation	↘	↘	↓
2 year swap	↓	→	↗
10 year swap	↓	→	↗
NZD/USD	→	→	↗
NZD/AUD	↘	→	↘

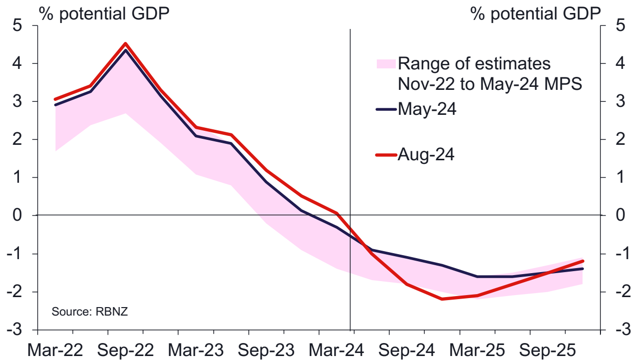
Westpac New Zealand Data Pulse Index



Key data and event outlook

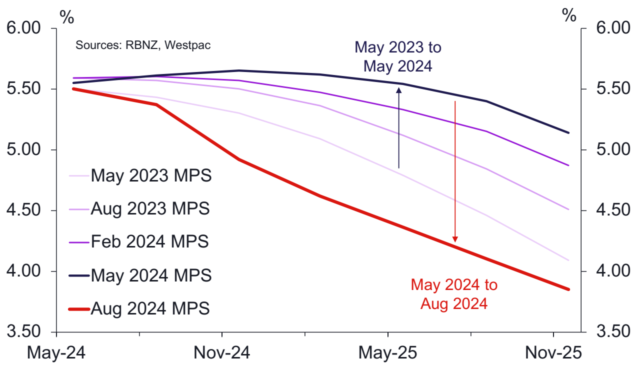
Date	Event
12 Sep 24	NZ Selected price indexes, August
18 Sep 24	FOMC Meeting (Announced 19 Sep NZT)
19 Sep 24	NZ GDP, June quarter
24 Sep 24	RBA Monetary Policy Decision
1 Oct 24	NZIER QSBO survey, September quarter
9 Oct 24	RBNZ OCR Review
11 Oct 24	NZ Selected price indexes, September
16 Oct 24	NZ CPI, September quarter
5 Nov 24	RBA Monetary Policy Decision
27 Nov 24	RBNZ OCR Review & Monetary Policy Statement

Range of RBNZ output gap estimates since end 2022



Second, the RBNZ has included the impact of the weaker than expected June quarter CPI, and lower pricing intentions and inflation expectations indicators that have emerged since May, into their policy view. The impact of these adjustments has made the RBNZ more comfortable with removing policy restriction much earlier and more quickly than previously signalled. With aggregate CPI inflation forecast to remain well within the 1-3% target range from Q3 2024, the RBNZ feels much more freedom to react to weaker output indicators seen lately with less restrictive interest rate settings.

RBNZ OCR forecast profiles since May 2023



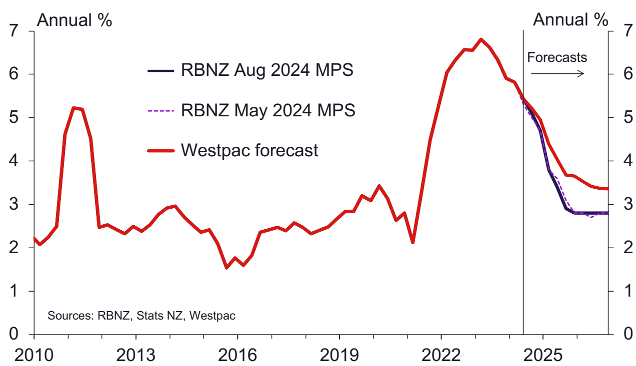
Having said this though, there is more to the RBNZ's change in view than just updates related to recent data. There is a change in strategy implicit in their August projections which was difficult to foresee based on their projections in the last year or so. This can be seen most clearly in the much lower forward OCR profile compared to recent forecasts. Certainly, the data and the economic view is weaker than it has generally been in the last year or so. But the forecasts for interest rates are much lower through 2025 and early 2026. This really reflects a change in the weights within the RBNZ's reaction function where now they are putting less weight on getting inflation down as they are more confident that inflation will be inside the 1-3% target range.

We adjusted our OCR forecasts to reflect the RBNZ's change in strategy. We didn't see much in the RBNZ's policy statement and forecasts that changed our thinking too much. Hence, we have shifted forward our OCR profile by one meeting to reflect the earlier start to easing but have retained the same terminal OCR forecast of 3.75% (which will now be achieved at the end of 2025 as opposed to early 2026). We expect the pace of policy easing to slow down in 2025. We think the RBNZ will adopt a very measured and data dependent approach while continuing to reduce the degree of restriction at each *Monetary Policy Statement* in 2025.

There will naturally be risks around this new central expected policy path, which means that any forecasts in 2025 remain necessarily indicative. We see these as two-sided and highly dependent on the extent of the bounce-back in activity and housing market indicators over the second half of 2024 and through early 2025, as well as the path of core inflation pressures. Perhaps the most significant deviation between the RBNZ's forecasts and our own is the speed at which non-tradables inflation falls from the end of 2024. We expect that disinflation to proceed more gradually than the RBNZ does, and as such it will likely increase risks that the RBNZ eases more carefully, or perhaps stops easing sooner, through 2025. RBNZ Assistant Governor Silk was channelling this risk when she noted to Bloomberg on Friday that developments in wage and price setting will be key in driving the appropriate pace of future interest rate cuts.

On the dovish side, a critical near-term risk to the OCR path will be the level of economic activity and the rate of unemployment. Should activity continue to be as weak as experienced in the June month, then prospects for an even more front-loaded easing cycle would increase, with the potential for the RBNZ to take interest rates below our neutral OCR estimate of 3.75% in the latter part of 2025. Similarly, if other factors seem set to drive tradables sector inflation persistently below historical norms such that inflation expectations shift significantly below 2%, then this could open the policy path to a period of below neutral rates.

Non-tradables inflation



We have also adjusted our long-term wholesale interest rate forecasts to reflect the changed short-term interest rate profile. We now see 2- and 5-year swap rates bottoming out around current levels over the next few months and then gradually increasing. Our view is that markets will continue to price in a lower terminal OCR for the next 6-12 months but will gradually adjust those views upwards from the current market pricing of below 3% to something closer to our estimate of 3.75% later in 2025 when it should be apparent that the economy is responding to lower interest rates and inflation will settle at or slightly above 2%.

We affirm the exchange rate forecasts included in the August **Economic Overview**. The key story there was an expectation of NZD underperformance – notably against the Australian dollar – as the macro picture and interest rate cycles are clearly diverging in ways that should undermine the NZD/AUD in the period ahead.

Given the RBNZ's current sensitivity to high-frequency data on activity, both the past week and the upcoming one offer up some valuable pointers. Last week saw the manufacturing PMI rise from 41.2 to 44.0 and the services sector PMI rise from 40.7 to 44.6 in July – still below the 50 mark, indicating that activity is still contracting, but to a lesser extent. The ANZ Truckometer for July recovered some of its sharp June fall, and electronic card spending was down for a sixth straight month for retail stores, though it has been picking up again for non-retail spending such as travel.

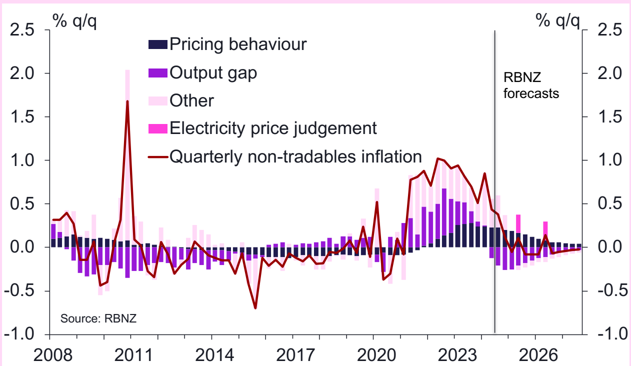
Overall, with the September quarter coming from a weak starting point, it looks likely that we'll see another soft GDP print – the RBNZ's forecast of a 0.2% decline is in line with our own. But it will be important to keep watching the data for any signs of renewed momentum, or of an extended decline.

Kelly Eckhold, Chief Economist

Chart of the week.

A remarkable aspect of the RBNZ's abrupt about-turn on interest rates in the *August Monetary Policy Statement* was their significantly more relaxed perspective on future core inflation pressures. Our chart of the week replays the key piece of evidence in support of their view that it's now more appropriate to put more weight on activity stabilisation as opposed to inflation control. The RBNZ played up the idea that, now headline inflation is likely within the 1-3% target range, pricing behaviour will adjust and mean that non-tradable inflation will quickly revert to levels better consistent with at-target inflation. Improved pricing behaviour certainly is part of the forecasted decline in inflation. However, it plays a relatively small role compared to the assumption that the "other" factors (i.e. unknown inflation drivers) explaining unexpectedly high non-tradable inflation quickly recede. These unknown factors are not expected to contribute to inflation after the December quarter 2024. Progress on this score is likely to remain important for the RBNZ as they consider policy settings in the first half of 2025.

RBNZ forecasts for non-tradable inflation

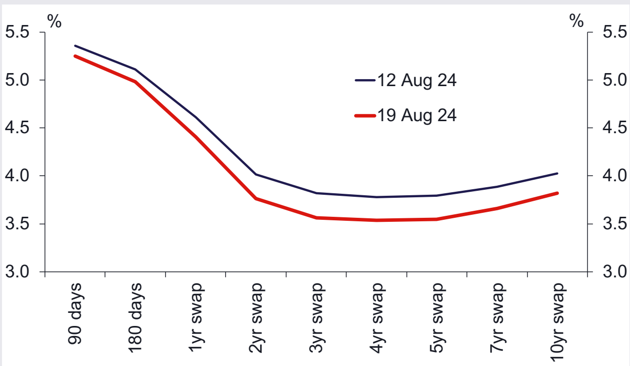


Fixed versus floating for mortgages.

Softer economic conditions have prompted the RBNZ to begin reducing the OCR. We expect further 25bp cuts at the October and November reviews, with easing continuing at a more gradual pace through 2025. However, market interest rates have factored in a much faster and deeper easing cycle than we are expecting.

With a significant amount of OCR easing already factored into longer-term mortgage rates, this suggests that it's now more attractive to fix for longer periods than it has been for a while – perhaps even for terms as long as two to three years. Mortgage rates for shorter terms of up to a year are substantially higher at the moment but are likely to fall in the coming months, and would offer room to participate in a deeper easing cycle if the economy were to deteriorate by more than the RBNZ (and we) expect.

NZ interest rates



Global wrap

North America.

Last week's US dataflow reassured markets with inflation easing and key activity indicators firming. First up, the core PPI was flat in July, unexpectedly causing annual inflation to fall to 2.4%. More importantly, the core CPI rose 0.2%m/m, lowering annual inflation to 3.3%y/y. These outcomes suggest that the Fed's preferred inflation metric – the core PCE deflator – will post a subdued rise later this month. On the activity front, retail sales posted larger than expected 1.0% rebound in July, while weekly initial jobless claims fell to a one-month low. This news dominated a 0.6%m/m decline in industrial production and some downbeat regional manufacturing surveys. Finally, the University of Michigan reported that consumer sentiment edged higher while inflation expectations were steady, with the 1-year measure sitting at 2.9%. The coming week is quiet on the US data front, leaving the focus on the Fed's Jackson Hole symposium. Chair Powell will give the keynote address on Friday, likely further paving the way for a 25bps rate cut at next month's FOMC meeting.

Europe.

The ZEW survey showed declining business sentiment in both Germany and the euro area in August. In the UK, the first estimate indicated that GDP grew 0.6%q/q in Q2, following a 0.7%q/q lift in Q1, boosted by government spending. The unemployment rate unexpectedly fell back to 4.2% in June, but wage growth slowed to 4.5%y/y – the least since late 2021 – and core inflation slowed to a less-than-expected 3.3%y/y in July. Over the coming week most interest in Europe will centre on Thursday's flash PMI readings for August, especially given last week's ZEW readings.

Asia-Pacific.

China data continued to highlight pressures in the consumer sector. Credit growth was very subdued in July, while retail spending grew just 2.7%y/y, house prices fell 4.9%y/y and IP growth slowed to 5.1%y/y. In better news, Japan's preliminary report indicated that GDP rebounded a stronger-than-expected 0.8%q/q in Q2 following a 0.6%q/q contraction in Q1.

The focus in Australia was mainly on the labour market. Wages grew a relatively subdued 0.8% in Q2, pointing to some moderation in momentum over the first half of this year. Employment grew a firmer than expected 58k in July, but the unemployment rate still inched up to 4.2%. Consumer confidence lifted modestly but remains low while business conditions nudged higher in July and the employment index bounced after a steep decline in June.

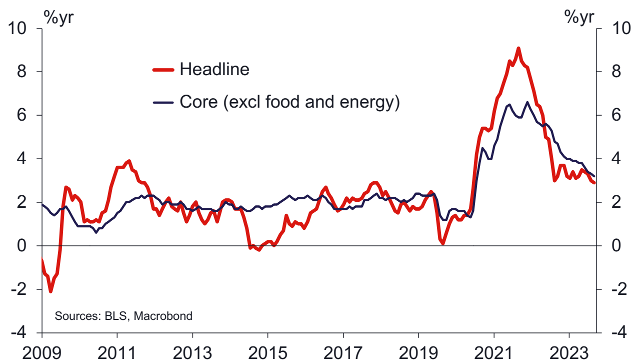
Trading partner real GDP (calendar years)

	Annual average % change			
	2023	**2024**	**2025**	**2026**
Australia	2.0	1.3	2.2	3.1
China	5.2	5.0	4.9	4.7
United States	2.5	2.5	1.7	1.7
Japan	1.9	0.3	1.1	0.9
East Asia ex China	3.3	4.2	4.2	4.1
India	7.8	7.0	6.8	6.5
Euro Zone	0.4	0.6	1.5	1.3
United Kingdom	0.1	0.6	1.3	1.4
NZ trading partners	3.4	3.3	3.4	3.4
World	3.2	3.3	3.3	3.2

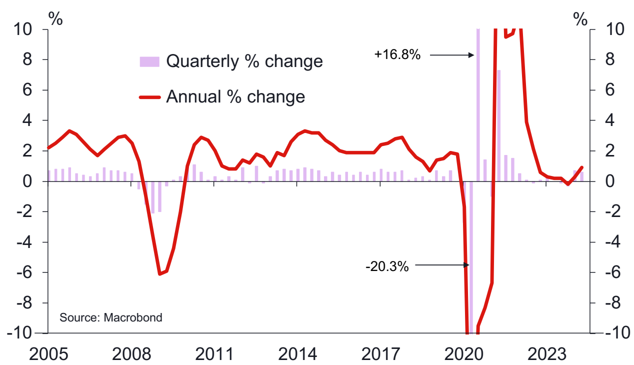
Australian & US interest rate outlook

	16-Aug-24	Sep-24	Dec-24	Dec-25
Australia				
Cash	4.35	4.35	4.35	3.35
90 Day BBSW	4.37	4.42	4.42	3.50
3 Year Swap	3.63	3.75	3.70	3.50
3 Year Bond	3.57	3.70	3.65	3.35
10 Year Bond	3.94	4.00	3.90	4.05
10 Year Spread to US (bps)	4	15	15	5
US				
Fed Funds	5.375	5.125	4.625	3.375
US 10 Year Bond	3.90	3.85	3.75	4.00

US CPI inflation



UK GDP growth



Financial markets wrap

Interest rates.

NZ swap rates fell further last week to levels last seen in 2022. The catalyst was the RBNZ MPS which cut the OCR by 25bp to 5.25%, surprising a market which had not fully priced that outcome (it was seen as a 60% chance). In addition, the RBNZ's OCR forecast was reduced substantially, to indicate the total magnitude of the easing cycle could be worth around 250bp, taking the OCR to 3.0%.

Given the abrupt reversal in RBNZ stance from the May MPS, markets are now pricing an even more aggressive easing cycle, predicting the OCR will bottom at around 2.7%. Moreover, markets are braced for the possibility of a 50bp cut (rather than the typical 25bp) at each of the next three meetings in October, November and February.

With so much of the easing cycle already priced in, it will require fresh downside news surprises for forward starting swap rates to fall much further. For example, a 2yr swap starting in one year is now at 3.15%, implying a terminal OCR of 3.00%, and will be attractive to some considering hedging. Spot starting swaps will gradually converge to the forward starting rates as the rate cuts are realised. The 2yr is currently at 3.78%.

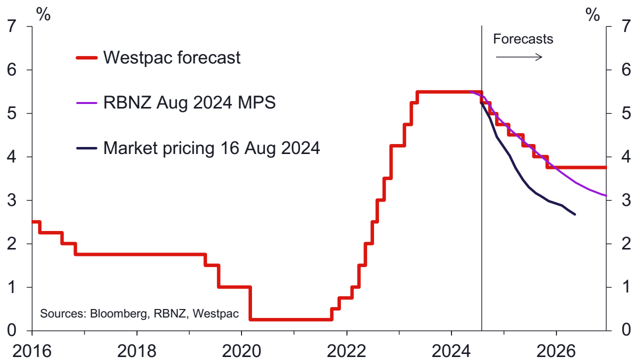
Foreign exchange.

NZD/USD was dented last week by the RBNZ OCR cut and dovish guidance, falling to 0.5975, but global events have taken over, causing a rebound to 0.6050. For the weeks ahead, we see potential to test 0.6100, with any rally likely capped by 0.6200.

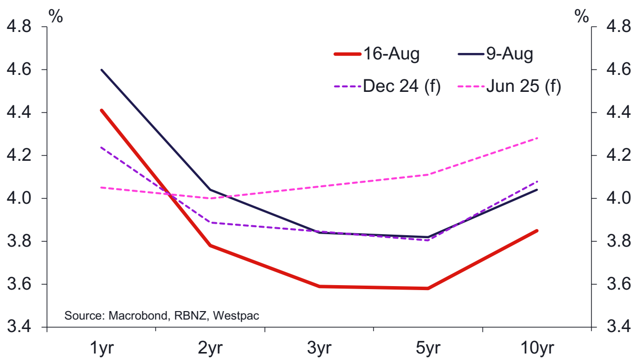
The US dollar has resumed the decline which started in early July, partly due to confident expectations the Fed will start its easing cycle in September, and partly to improved (mostly) risk sentiment. This week's event highlight will be in that spirit, Fed Chair Powell's speech a t the Jackson Hole Symposium expected to signal that easing will start soon. NZ-US yield spreads, which have fallen to multi-year lows and are now slightly negative, could start a recovery which would be NZD/USD supportive.

Yield spreads are less likely to rebound in the case of NZD/AUD though. The RBA maintains a slightly hawkish stance, in stark contrast to the RBNZ's dovish stance. We don't expect that dynamic to change much during the next month or two, such that the cross could test 0.8900.

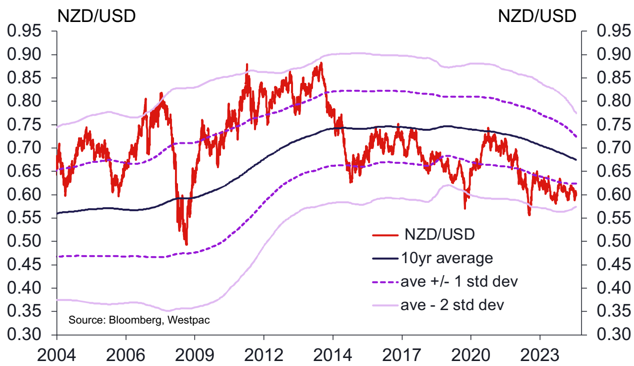
Official Cash Rate forecasts



Swap rates



NZD/USD vs rolling 10yr average



FX recent developments

	Historical data				F'cast
	Spot	3mth range	5yr range	5yr avg	Dec-24
USD	0.605	0.586-0.620	0.555-0.743	0.646	0.61
AUD	0.905	0.897-0.929	0.873-0.992	0.930	0.91
EUR	0.547	0.542-0.573	0.517-0.637	0.581	0.55
GBP	0.467	0.456-0.484	0.456-0.535	0.504	0.47
JPY	89.2	86.1-98.6	61.3-98.6	80.1	91.5

The week ahead

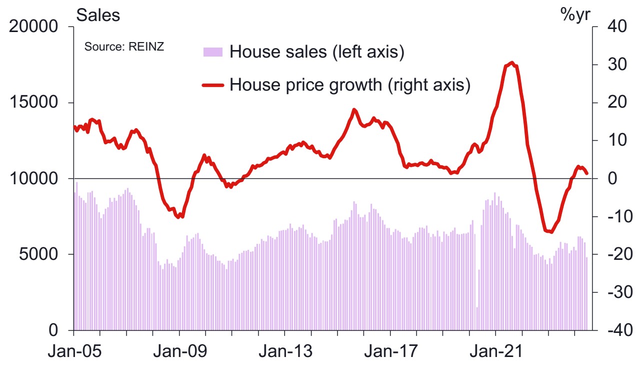
Jul REINZ house sales and prices

Aug 20, Sales last: -16.7% mth, -25.6% annual
Aug 20, Prices last: -0.1% mth, +1.3% annual

The housing market remained soft in June, with prices edging lower and sales dropping sharply. It's possible that the latter was affected by the Matariki public holiday – there is some evidence that this impacted a range of economic activity indicators over June.

July saw some falls in mortgage rates as the prospect of OCR cuts came on to the horizon. Lower interest rates may help to lift housing turnover on the months ahead, though we suspect that any meaningful impact on prices will be more of a 2025 story.

REINZ house prices and sales



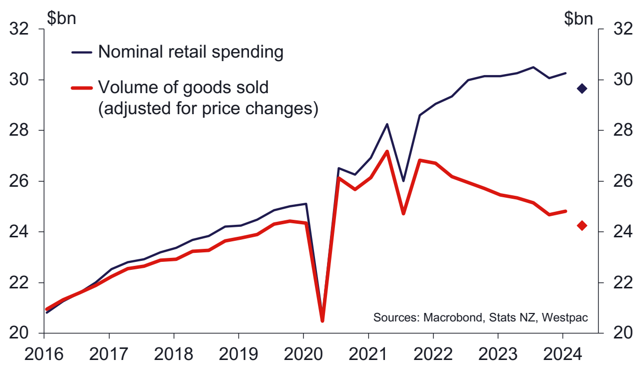
Q2 retail spending

Aug 23, Volumes – Last: +0.5%, Westpac forecast: -2.2%

Conditions in the retail sector have remained weak. Despite a bounce in the March quarter, nominal spending levels have effectively been flat for a year, and the volume of goods that households have been taking home has been trending down for two years now.

We're forecasting a sharp 1.9% fall in nominal spending in the June quarter and a similar sized fall in the volume of goods sold. Nominal monthly spending levels fell sharply over the quarter, with continued financial pressures squeezing households spending appetites.

Retail sales survey

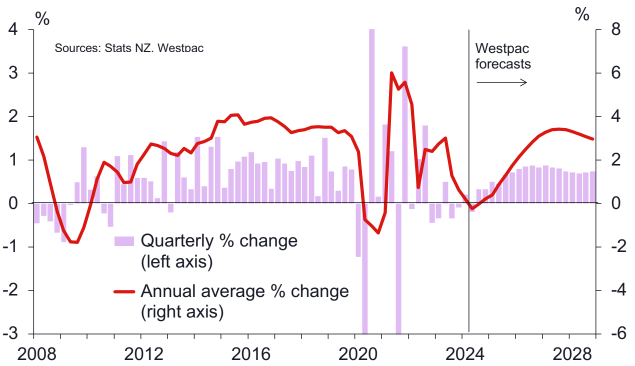


Economic and financial forecasts

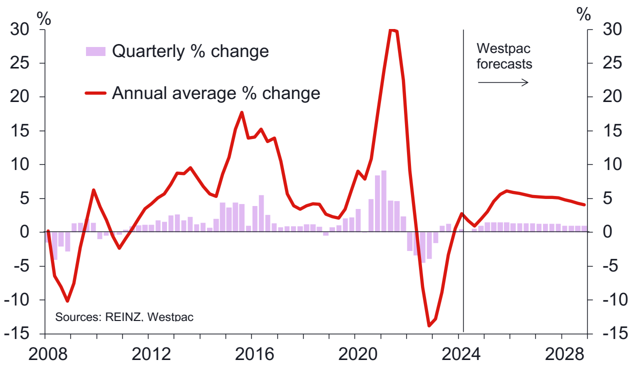
Economic indicators	Quarterly % change				Annual % change			
	Mar-24	Jun-24	Sep-24	Dec-24	2023	2024	2025	2026
GDP (production)	0.2	-0.6	-0.2	0.4	0.6	-0.3	1.3	2.3
Consumer price index	0.6	0.4	1.1	0.3	4.7	2.5	2.2	2.1
Employment change	-0.3	0.4	-0.4	-0.2	2.9	-0.4	-0.1	1.5
Unemployment rate	4.4	4.6	5.0	5.3	4.0	5.3	5.6	4.9
Labour cost index (all sectors)	0.9	1.2	0.7	0.7	4.3	3.5	2.3	1.9
Current account balance (% of GDP)	-6.8	-6.5	-6.0	-5.3	-6.9	-5.3	-4.0	-4.2
Terms of trade	5.1	3.2	1.7	-0.5	-10.7	9.8	2.4	1.8
House price index	0.4	-0.4	0.0	0.5	0.6	0.5	6.4	4.1

Financial forecasts	End of quarter				End of year			
	Mar-24	Jun-24	Sep-24	Dec-24	2023	2024	2025	2026
OCR	5.50	5.50	5.25	4.75	5.50	4.75	3.75	3.75
90 day bank bill	5.66	5.63	5.05	4.75	5.65	4.75	3.85	3.85
2 year swap	4.91	5.01	3.80	3.90	5.28	3.90	4.00	4.00
5 year swap	4.40	4.53	3.65	3.80	4.85	3.80	4.25	4.25
10 year bond	4.69	4.74	4.20	4.20	5.09	4.20	4.40	4.35
TWI	71.6	71.4	70.4	70.8	70.8	70.8	70.6	69.9
NZD/USD	0.61	0.61	0.60	0.61	0.60	0.61	0.63	0.64
NZD/AUD	0.93	0.92	0.91	0.91	0.93	0.91	0.89	0.88
NZD/EUR	0.56	0.56	0.55	0.55	0.56	0.55	0.56	0.56
NZD/GBP	0.48	0.48	0.47	0.47	0.49	0.47	0.48	0.48

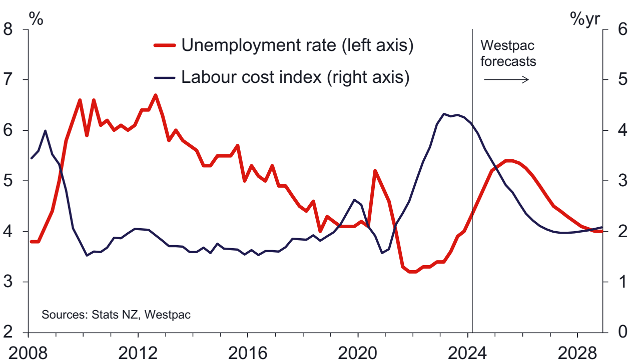
GDP growth



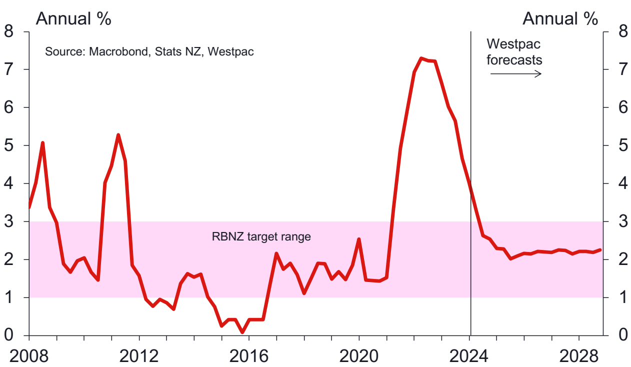
House prices



Unemployment and wage growth



Consumer price inflation



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 19					
NZ	Jul BusinessNZ PSI	40.2	–	–	Should see some pickup from a remarkably weak June.
Jpn	Jun Machinery Orders, %mth	–3.2	0.9	–	Pointing to a softer investment pulse in H2 2024.
US	Jul Leading Index, %mth	–0.2	–0.3	–	Speaks to risks around the outlook.
Tue 20					
NZ	Jul REINZ House Price Index, %yr	1.3	–	–	Prices have been nudging down, with listings rising…
	Jul REINZ House Sales, %yr	–25.6	–	–	… and sales still low.
	Jul Trade Balance, $mn	699	–	–155	Imports likely to have lifted from a more than 3-year low.
Aus	Aug RBA Minutes	–	–	–	To provide more colour on the Board's deliberations.
Eur	Jul CPI, %yr	2.5	2.6	–	Final estimate to provide more colour on services.
Wed 21					
NZ	GlobalDairyTrade Auction	0.5	–	–	Milk powder futures prices higher since last auction.
Aus	Jul Westpac–MI Leading Index, %yr	–0.13	–	–	Consistent with lacklustre growth momentum.
US	Jul FOMC Minutes	–	–	–	Participants will closely assess views on risks.
Thu 22					
Jpn	Aug Jibun Bank Manufacturing PMI	49.1	–	–	Industry still faces a soft underlying pulse for demand…
	Aug Jibun Bank Services PMI	53.7	–	–	… but robust services sector is a welcome offset.
Eur	Aug Consumer Confidence	–13.0	–	–	Confidence's recovery is slow but steady.
	Aug HCOB Manufacturing PMI	45.8	45.6	–	Weak demand has European manufacturing in dire straits…
	Aug HCOB Services PMI	51.9	51.0	–	… pointing to downside risk to the recovery in H2 2024.
UK	Aug S&P Global Manufacturing PMI	52.1	–	–	Conditions in the UK are on relatively firmer footing…
	Aug S&P Global Services PMI	52.5	–	–	… consistent with other evidence of an economic upturn.
US	Aug S&P Global Manufacturing PMI	49.6	–	–	Offers a similar sectoral perspective to the ISMs…
	Aug S&P Global Services PMI	55.0	–	–	… but has pointed to stronger conditions.
	Aug Chicago Fed Activity Index	0.05	–	–	Consistent with growth around trend.
	Aug Kansas City Fed Index	–13	–	–	Regional surveys highly volatile and generally weak.
	Jul Existing Home Sales, $mth	–5.4	0.3	–	Affordability and supply headwinds impacting.
	Aug 17 Initial Jobless Claims, 000s	227	–	–	To remain low, for now.
	Jackson Hole Symposium	–	–	–	On "The Effectiveness & Transmission of Monetary Policy".
Fri 23					
NZ	Q2 Real Retail Sales, %qtr	0.5	–0.9	–2.2	Card spending was down sharply over the June quarter.
Jpn	Jul CPI, %yr	2.8	2.7	–	Path to sustainable at-target inflation is in sight.
UK	Aug GfK Consumer Sentiment	–13	–	–	Sentiment has recovered to pre-pandemic levels.
US	Jul New Home Sales, %mth	–0.6	2.3	–	Affordability and supply headwinds impacting.

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