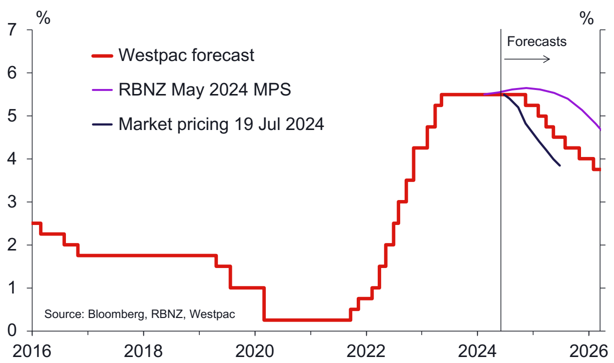
WEEKLY ECONOMIC COMMENTARY

22 Jul 2024 | **Westpac Economics Team** | **westpac.co.nz/economics** | economics@westpac.co.nz

RBNZ to deliver some pre-Christmas cheer in November

We have brought our forecast for Official Cash Rate reductions from the Reserve Bank of New Zealand forward by a few months. We now expect the RBNZ to cut the OCR by 25bp at the November Monetary Policy Statement. Thereafter we expect 25bp cuts at each of the first three meetings of 2025 (February, April, and May) which will take the OCR to 4.5% by mid-2025. After that, we think the RBNZ will take a more cautious data-dependent approach and reduce the OCR gradually to a terminal rate of 3.75% in early 2026.

Official Cash Rate forecasts – easing coming in November



OCR cuts set to come much earlier than the RBNZ previously signalled.

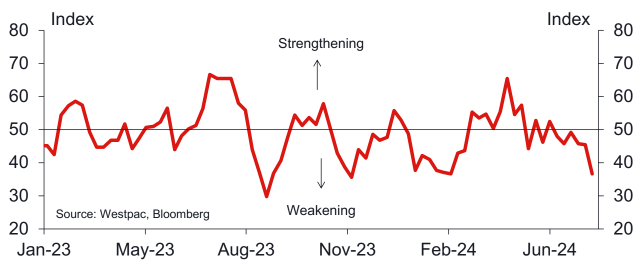
Previously, we had forecast that the RBNZ would remain on hold until February 2025. However, with both activity and inflation turning down, and a dovish tilt from the RBNZ themselves, we now expect that policy easing will begin sooner than previously anticipated, with rate cuts now expected to begin in November of this year.

The RBNZ indicated in their July policy review, unexpectedly, a willingness to consider "tempering" the degree of policy restriction. That was a marked shift in

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
31 Jul 24	FOMC Meeting (Announced 1 Aug NZT)
6 Aug 24	RBA Monetary Policy Decision & SMP
7 Aug 24	Labour market statistics, June quarter
8 Aug 24	RBNZ Survey of Expectations, June quarter
14 Aug 24	RBNZ OCR Review & Monetary Policy Statement
15 Aug 24	NZ Selected price indexes, July
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

tone from their previous policy update just six weeks earlier where they had signalled no rate cuts until August 2025 and a slight chance of another rate hike. As we indicated in our review note, we thought the RBNZ's stark change in tone reflected the much weaker data flow seen in the last few months. The RBNZ also sounded more confident about the outlook for inflation, noting that it is expected to return within the target range "in the second half of the year." Previously, the RBNZ noted that this was expected to occur "by the end of 2024."

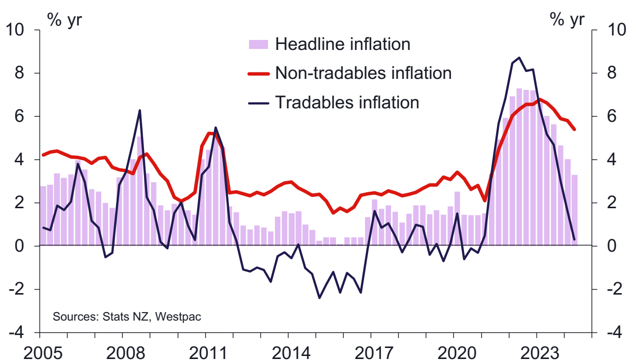
Inflation has dropped back and is set to continue falling.

With that change in tone from the RBNZ, the softer than expected June quarter inflation report was a critical development. Consumer prices rose by 0.4% in the June quarter – lower than the 0.6% rise that we and the RBNZ had expected. That saw the annual inflation rate fall from 4% in the March quarter to 3.3%.

The details of the inflation report were not a clear green light for immediate rate cuts. The drop in inflation has mainly been a result of lower prices for imported retail goods, like household furnishings and apparel. However, domestic inflation pressures remain strong. And that's not just due to the costs for items like insurance or council rates –prices for domestic services more generally are continuing to rise at a solid pace.

Even so, underlying inflation pressures have been softening, with core inflation measures dropping back from over 4% earlier in the year to around 3.5% now. Looking forward, the trajectory for inflation over the remainder of this year is downwards. And combined with the lower-than-expected June quarter result, the RBNZ will now be feeling more confident that inflation will fall back inside the 1% to 3% target band sooner than they previously anticipated.

Domestic components of inflation still strong



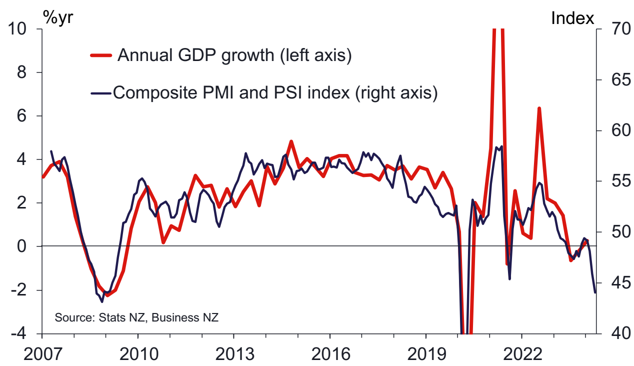
Economic momentum is flagging.

There has been a marked downturn in economic activity in recent months:

- In the household sector, New Zealand families have been winding back their spending in response to cost-of-living pressures, high interest rates and a softening labour market. That's seen retail spending falling for the past five months, including a 0.6% decline in June.
- Similarly, businesses across the economy are reporting a softening in demand and orders, with both the PMI and PSI dropping to low levels in June.
- Against that backdrop, job growth has stalled, falling behind the rate of population growth. The number of job advertisements has also fallen.

Considering those developments, we now see downside risk to our forecast of a 0.2% fall in June quarter GDP, with the related risk that unemployment rises by more than our forecast of a lift to 4.6%. We will be reviewing our forecasts in the soon to be released August Economic Overview. The RBNZ is also likely be revising down its near-term economic view.

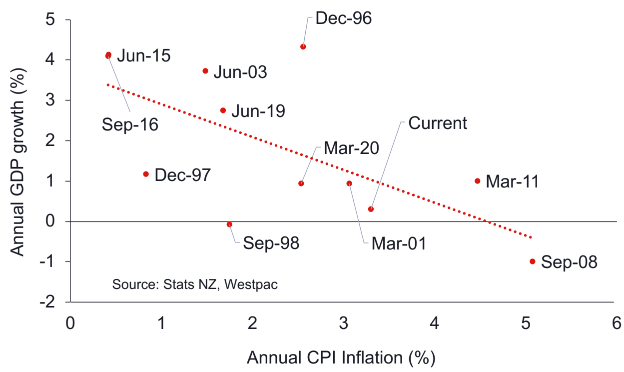
PMI indicators point to weak outlook for GDP



What to watch

This lower inflation/growth combination looks consistent with some past episodes where the RBNZ has begun easing even while inflation was outside of the target range. These have been episodes where growth was weak, and hence there was confidence that inflation would trend significantly lower over time. We think that the RBNZ is close to meeting this threshold now.

YoY GDP and CPI at time of first RBNZ cut



The RBNZ will release new forecasts as part of its upcoming Monetary Policy Statement on 14 August. We would expect those forecasts will incorporate a significant downgrade in its inflation and OCR forecasts. In the case of the OCR, we expect something closer to the scenario they presented in May 2023. This implied a probability of an easing in October and a very likely easing at the November Statement.

Our central forecast is for a November rate cut but there is around a 30% chance of an earlier cut in October. In contrast, financial markets have priced in a roughly 40% chance of a rate cut in August and have more than fully priced in a cut by the time of the October meeting.

We've updated our financial forecasts to reflect these shifting (and differing) views – see our regular tables later in the report. We expect further declines in swap rates over the year ahead, as the RBNZ enters its easing phase. While markets will likely continue to price in a more protracted RBNZ easing cycle, we expect market pricing to bottom out through 2025 as the RBNZ makes it clear that this move is aimed at tempering the tightness of monetary policy rather than moving into full-blown easing.

In keeping with the lower interest rate profile, we have also shaded down our New Zealand dollar forecasts. We expect a more gradual uplift in the NZD over the next couple of years (within the context of a lower US dollar across the board), with NZD/USD reaching 0.63 by the end of 2025, compared to our previous forecast of 0.65. NZs relatively large structural fiscal deficit and wide current account deficit also point to caution regarding the relative strength of the NZD while growth momentum is weak.

We think the RBNZ will be very data-driven in terms of the timing of the first rate cut. It's important to keep in mind the RBNZ's message in the MPR was one of "tempering restriction" as opposed to quickly removing their foot from the brake. Hence, we are not in the camp expecting an August easing. Upcoming labour market data will be a key focus in determining the timing and extent of this tempering (the June quarter update is out on 7 August). Importantly, the RBNZ's new forecasts presented in the August Monetary Policy Statement will be a critical indicator of what "tempering" means to the RBNZ right now.

We'll also be keeping a close eye on the June quarter GDP report, as well as higher frequency indicators of economic activity like the PMIs, retail sales and business confidence surveys. The latter indicators will give us a sense of whether the weak June indicators are seasonal blips or indicative of a weak trend. They will also give us a read on the extent to which the RBNZ's dovish tilt and tax cuts will help improve sentiment and business conditions. Finally, Stats NZ's recently introduced monthly Selected Price Indices (which provide timely updates on 45% of the CPI basket) will also merit close attention.

Kelly Eckhold, Chief Economist

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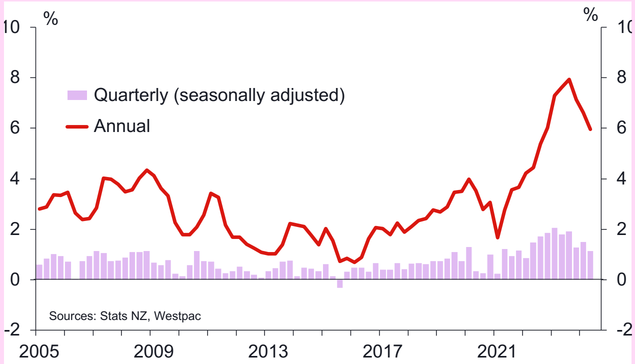
Chart of the week.

Inflation has fallen to a three-year low and we expect that it will drop below 3% through the back part of the year. However, even with inflation trending down, a return to the 2% midpoint of the RBNZ's target band is still some way off. That's because although we've seen a sharp fall in imported inflation, domestic inflation remains strong, with non-tradable prices up 5.4% over the past year. Importantly, that's not just because of the continued large increases in the cost of items like insurance or local council rates, which tend to be less responsive to interest rates. Prices for a wide range of other domestic services have continued to rise at a rapid pace long after the RBNZ first hiked the Official Cash Rate. While we do expect that domestic inflation pressures will cool over time, their lingering strength to date will likely make the RBNZ cautious, consistent with them "tempering" the degree of restriction as opposed to taking their foot off the brake.

Lingering strength in domestic prices means a return to 2% inflation is still a long way away

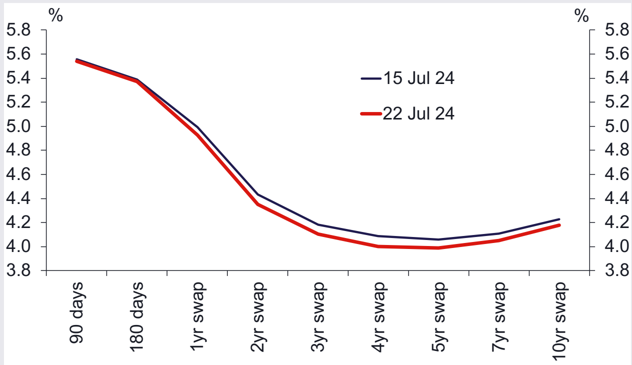


Fixed versus floating for mortgages.

The RBNZ left the OCR on hold in July. However, there was a dovish shift in the accompanying commentary, indicating that the RBNZ is now looking at rate cuts sooner than previously signalled. We are forecasting the first OCR cut in February, but market pricing is consistent with cuts coming as soon as October.

Some fixed mortgage rates have fallen in the wake of the RBNZ's July policy statement. For borrowers who favour certainty, fixing for as long as two years could be attractive at current rates. However, for borrowers with more flexibility, fixing for a shorter term could be advantageous with the potential for downward pressure on mortgage rates over the coming months.

NZ interest rates



Global wrap

North America.

Last week's US dataflow was mostly firmer than expected and GDP nowcasts have been revised up. Excluding autos, retail sales lifted a welcome 0.4%m/m in June, while housing starts and permits increased 3%m/m and industrial production increased 0.6%m/m. Looking ahead to the coming week, as far as data is concerned the highlights will be Thursday's advance Q2 GDP estimate and Friday's June core inflation reading. We estimate a 2.2% (annualised) lift in GDP, up from just 1.4% in Q1. Meanwhile, the core PCE deflator will likely post a modest 0.1%mm lift, lowering annual inflation to 2.5%. With the next payrolls report looming, Thursday's jobless claims report will also be of interest. Considering President Biden's weekend withdrawal from the 2024 race, politics is sure to be the other key focus for US markets this week.

Europe.

As widely expected, the ECB made no change to its policy settings last week. However, President Lagarde indicated that risks to growth were tilted to the downside and that the September meeting is "wide open". Prospects for a further easing step will depend on key wage and inflation reports due between now and then. This week's flash PMI reports for July, released Wednesday, will also have a bearing on market expectations for this meeting. In the UK, CPI inflation remained steady at 2.0%y/y in June, slightly disappointing market expectations. Labour market data provided no surprises, with the unemployment rate remaining at 4.4% and earnings growing at a still sturdy pace of 5.7%y/y in May. Late in the week saw a larger than expected pullback in retail sales, with spending down 0.2%y/y. This week, Wednesday's flash PMI reports will cast further light on the economy as markets continue to look forward to next month's BoE policy meeting

Asia-Pacific.

With ongoing weakness in the property sector weighing down on consumer spending, China's economy grew a disappointing 0.7%q/q in Q2 – less than half the pace of Q1 – causing annual growth to slow to 4.7% from 5.3% previously. Given the ongoing challenges in China, Westpac has downgraded its forecast for GDP growth by 0.2ppts per annum to 5.0% this year and 4.8% next year. Closer to home, Australia reported a larger than expected 50k lift in employment in June. While employment is up a sturdy 2.8%y/y, ongoing strong growth in the labour force meant that the unemployment nudged back up to its cyclical high of 4.1%. The coming week's diary is quiet with no top tier economic reports due in China or Australia.

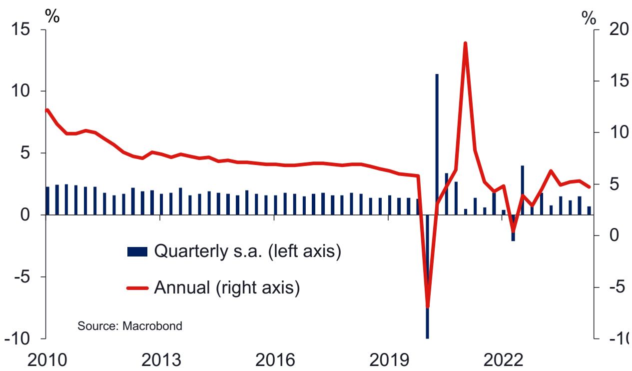
Trading partner real GDP (calendar years)

	Annual average % change			
	2023	**2024**	**2025**	**2026**
Australia	2.0	1.3	2.2	3.1
China	5.2	5.0	4.9	4.8
United States	2.5	2.5	1.5	1.6
Japan	1.9	0.4	1.0	0.9
East Asia ex China	3.3	4.2	4.2	4.1
India	7.8	6.9	6.7	6.5
Euro Zone	0.4	0.6	1.5	1.3
United Kingdom	0.1	0.6	1.3	1.3
NZ trading partners	3.4	3.3	3.4	3.4
World	3.2	3.3	3.3	3.2

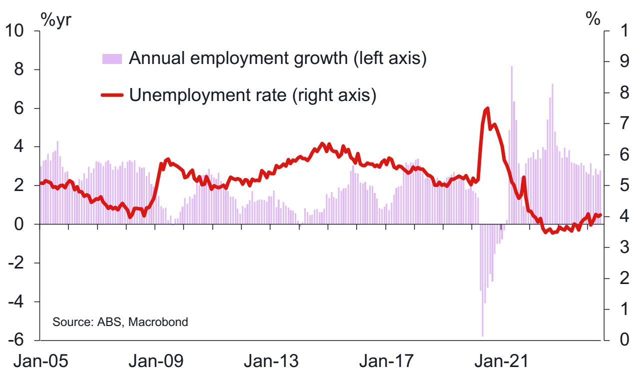
Australian & US interest rate outlook

	19-Jul-24	Sep-24	Dec-24	Dec-25
Australia				
Cash	4.35	4.35	4.10	3.10
90 Day BBSW	4.47	4.42	4.19	3.30
3 Year Swap	4.07	4.10	4.00	3.50
3 Year Bond	4.01	3.90	3.80	3.30
10 Year Bond	4.29	4.30	4.25	4.00
10 Year Spread to US (bps)	8	-10	-5	0
US				
Fed Funds	5.375	5.125	4.875	3.875
US 10 Year Bond	4.21	4.40	4.30	4.00

China GDP growth



Australian labour market



Financial markets wrap

Interest rates.

NZ swap rates fell further last week, continuing to respond to the RBNZ's dovish signal at its MPR two weeks ago. The headline Q2 CPI data last week was softer than expected, vindicating the RBNZ's pivot. Markets have stuck with the view that there is a 50% chance of a rate cut at the next meeting in August, while October remains fully priced. Westpac economics shifted its 25 bp rate cut from February 2025 to November 2024.

The 2yr swap has fallen 75bp over the past few weeks to 4.33% - the lowest level since September 2022. That's a very sharp move and given there's little major NZ data out until Q2 unemployment on 7 August, further downside this week may be hard to come by.

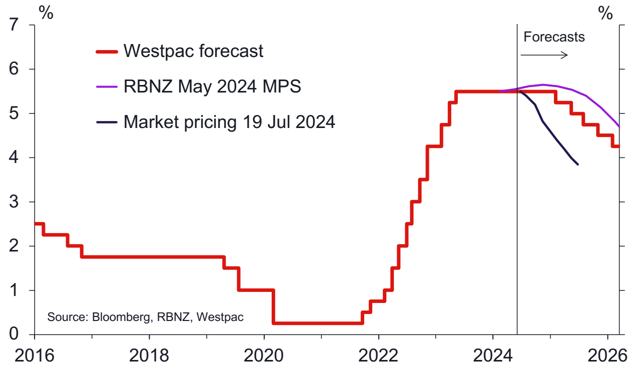
Foreign exchange.

NZD/USD retains near-term downward momentum and could reach the high 0.59s this week. Lower NZ swap rates will weigh on the NZD, while the US dollar is likely to remain volatile amid US political developments ahead of the election. US PCE inflation data this week will be a focal point for markets.

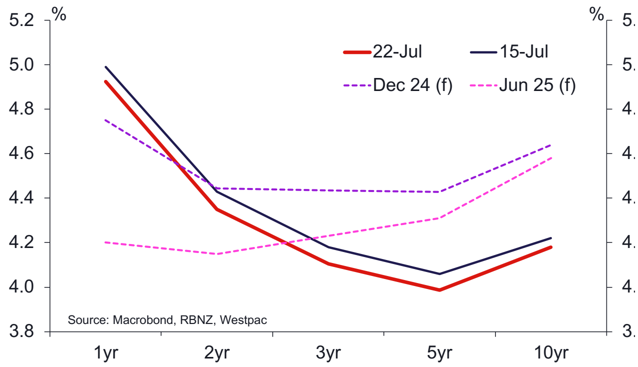
Multi-month, we retain out moderately bullish outlook, assuming the Fed will start cutting in September, earlier than the RBNZ in November. That should at least stabilise yield spreads, and support NZD/USD towards 0.6200.

NZD/AUD has fallen 3c over the past month, the hawkish RBA combined with the newly dovish RBNZ a major factor. Longer term fundamentals, such as Australia's superior current account and fiscal account, argue for further downside below 0.8975 during the month ahead.

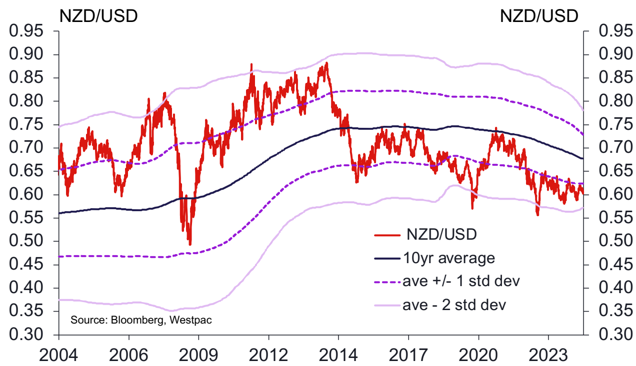
Official Cash Rate forecasts



Swap rates



NZD/USD vs rolling 10yr average

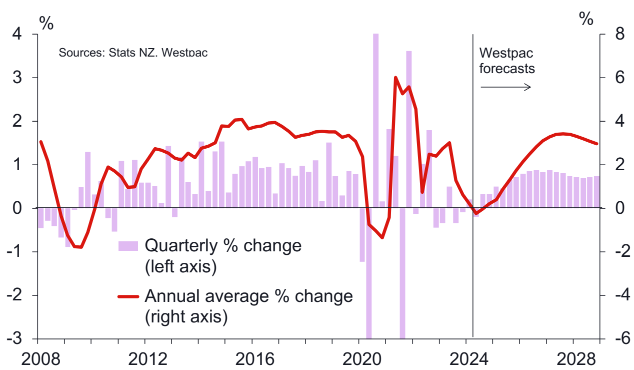


Economic and financial forecasts

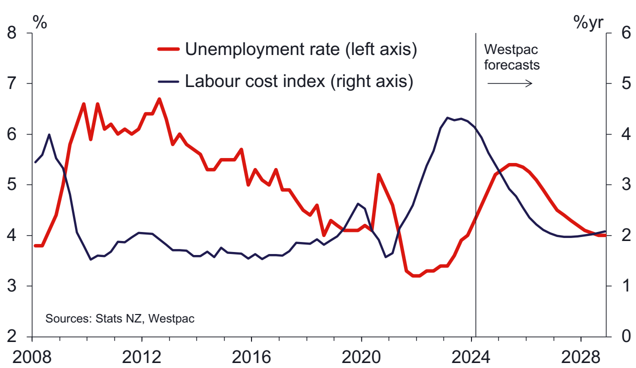
Economic indicators	Quarterly % change				Annual % change			
	Mar-24	Jun-24	Sep-24	Dec-24	2023	2024	2025	2026
GDP (production)	0.2	-0.2	0.3	0.3	0.6	0.2	1.7	3.2
Consumer price index	0.6	0.4	1.1	0.4	4.7	2.5	2.1	2.2
Employment change	-0.2	0.2	0.1	0.1	2.7	0.1	0.9	1.8
Unemployment rate	4.3	4.6	4.9	5.2	4.0	5.2	5.4	4.7
Labour cost index (all sectors)	0.9	0.9	0.8	0.8	4.3	3.4	2.5	2.0
Current account balance (% of GDP)	-6.8	-6.4	-5.9	-5.3	-6.9	-5.3	-4.6	-4.3
Terms of trade	5.1	4.0	2.2	0.6	-10.7	12.3	0.7	2.3
House price index	0.5	0.0	0.5	1.0	0.6	2.0	6.1	5.1

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	5.50	5.25	5.50	5.25	4.00	3.75
90 day bank bill	5.66	5.63	5.50	5.25	5.65	5.25	4.00	3.85
2 year swap	4.91	5.01	4.30	4.20	5.28	4.20	3.90	4.00
5 year swap	4.40	4.53	3.95	3.90	4.85	3.90	4.00	4.25
10 year bond	4.69	4.74	4.40	4.35	5.09	4.35	4.30	4.35
TWI	71.6	71.4	70.8	71.1	70.8	71.1	70.6	69.8
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	0.55	0.56
NZD/GBP	0.48	0.48	0.47	0.48	0.49	0.48	0.48	0.49

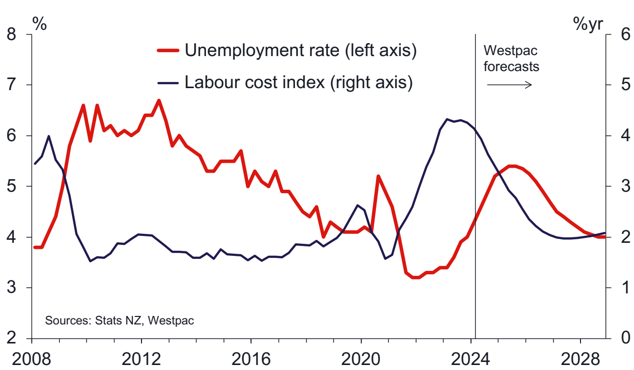
GDP growth



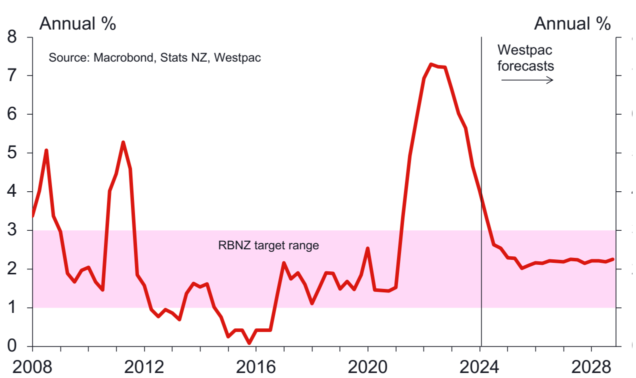
House prices



Unemployment and wage growth



Consumer price inflation



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 22					
NZ	Jun Trade Balance, $mn	204	–	100	Exports are moving past their seasonal peak.
US	Jun Chicago Fed Activity Index, pts	0.18	–0.06	–	The economy has moved into balance.
Tue 23					
Eur	Jul Consumer Confidence, pts	–14.0	–13.8	–	Rate cuts are supporting confidence.
US	Jul Richmond Fed Index, pts	–10	–7	–	Manufacturing conditions remain weak across the board.
	Jun Existing Home Sales, %mth	–0.7	–2.7	–	Low inventory is weighing on sales.
Wed 24					
Jpn	Jul Jibun Bank Manufacturing PMI, pts	50	–	–	Japan's manufacturers are losing competitive advantage...
	Jul Jibun Bank Services PMI, pts	49.4	–	–	... despite the weak Yen which is aiding services.
Eur	Jul HCOB Manufacturing PMI, pts	45.8	46.3	–	Europe's manufacturing sector is also experiencing tough...
	Jul HCOB Services PMI, pts	52.8	53	–	... conditions, but tourism is attracting robust demand.
UK	Jul S&P Global Manufacturing PMI, pts	50.9	51.2	–	Election result provides greater certainty over political...
	Jul S&P Global Services PMI, pts	52.1	52.5	–	... outlook and chances of fiscal support if necessary.
US	Jul S&P Global Manufacturing PMI, pts	51.6	–	–	Mixed conditions are being seen across industry sectors.
	Jul S&P Global Services PMI, pts	55.3	–	–	Political certainty and monetary easing necessary.
	Jun Wholesale Inventories, %mth	0.6	–	–	Uncertain demand, a challenge for inventory management.
	Jun New Home Sales, %mth	–11.3	3.4	–	New builds dissuaded by high financing costs.
	Fedspeak	–	–	–	Bowman, Logan
Thu 25					
Eur	Jun M3 Money Supply, %yr	1.6	1.8	–	Easing policy should support M3 growth.
Ger	Jul IFO Business Climate Survey, pts	88.6	89	–	Confidence returning, but slowly.
US	Q2 GDP (Annualised), %qtr	1.4	1.8	2.2	Growth has slowed to near trend in H1 2024.
	Jun Durable Goods Orders, %mth	0.1	0.5	–	Investment outlook challenged by politics and cycle.
	Jul Kansas City Fed Index, pts	–8	–6	–	Regional surveys showing considerable volatility.
	20 Jul Initial Jobless Claims, 000's	243	–	–	To remain low, for now.
Fri 26					
NZ	Jul ANZ Consumer Confidence, pts	83.2	–	–	Household budgets remain under pressure.
Jpn	Jul Tokyo CPI, %yr	2.3	2.3	–	Momentum in inflation abating.
US	Jun Personal Income, %mth	0.5	0.4	0.3	Softer labour market to weigh on income growth...
	Jun Personal Spending, %mth	0.2	0.2	0.2	... and, in time, on consumption...
	Jun PCE Deflator, %mth	0	0.1	0.1	... allowing inflation to converge with target.
Eur	Jul Uni. of Michigan Sentiment, pts	66	–	–	Final estimate.

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