Economic Weekly

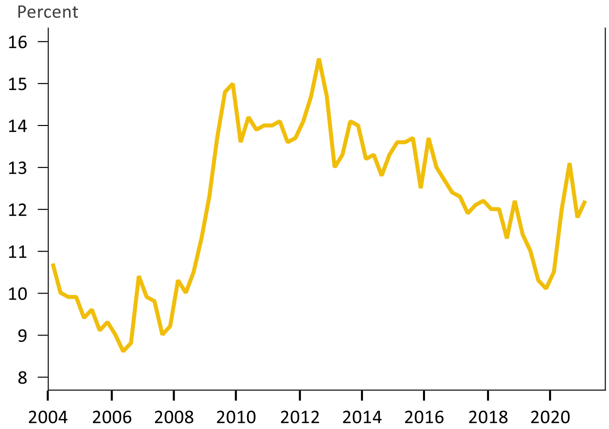
02 August 2021

Wage inflation is set to rise

The NZ labour market is back in the spotlight this week, with StatsNZ releasing the Q2 labour market statistics on Wednesday morning (see our preview here). Over the past 6 months, the labour market has tightened significantly as the NZ economy has continued to grow, but with labour supply constrained by international border restrictions. Following the release of the NZIER Quarterly Survey of Business Opinion, the strength of the labour market recovery no longer looks to be in doubt. We expect the Q2 labour market data to confirm this strength. We expect to see the unemployment rate to fall to 4.4%, from 4.7%, with further declines to come over the year ahead.

From the RBNZ's perspective, it will be looking for confirmation the labour market is at, or very close to, maximum sustainable employment. This should clear the path for the RBNZ to start returning the Official Cash Rate to pre-COVID levels, and we expect the first move to be later this month. To assess maximum sustainable employment, the RBNZ looks at a range of measures beyond the headline unemployment rate. Of particular focus will be the labour market underutilisation rate, which has shown limited improvement thus far. This is due to the high number of underemployed actively looking for additional hours. In addition, the unemployment rate of 20–24-year-old has also been heavily impacted by COVID-19 and, as of Q1, yet to see material improvement.

Underutilisation Rate



Source: Macrobond, ASB

The key consequence of the tightening labour market will be the inflationary pressure it generates. Wage inflation tends to result in more persistent inflation forces within the economy. The higher cost of goods over the past year, due to COVID-19 related production shortages and shipping delays, are much easier for firms to pass on if workers are also receiving solid income growth to offset the higher cost of living. We expect to see the first material increase in wage growth over Q2 – with annual LCI wage inflation lifting to 2.1%. And we expect wage inflation to continue to build over the coming year – rising to around 3% by the end of the year.

The RBNZ will want to get in front of this potential wage/price spiral and get the OCR off emergency settings sooner rather than later. The economy is at capacity (though capacity is lower than what it would otherwise have been if it wasn't for COVID-19) and inflation pressures are set to build rapidly over the coming year. The lessons from the 2004-2007 tightening cycle is that if inflation pressures get ahead of the central bank, then it ends up lifting interest rates by even more than would have been the case if it had acted sooner. Much like our lesson from containing COVID-19 infections, a hard and early approach can prevent a longer, more painful lockdown later on. jane.turner@asb.co.nz

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.6971	0.6966	0.6968	0.6703	FLAT	0.6900	0.7100
NZD/AUD	0.9503	0.9478	0.9328	0.9287	UP	0.9420	0.9600
NZD/JPY	76.46	76.85	77.74	69.90	FLAT	76.00	80.00
NZD/EUR	0.5873	0.5913	0.5882	0.5635	FLAT	0.5840	0.6100
NZD/GBP	0.5015	0.5064	0.5059	0.5105	FLAT	04985.	0.5250
TWI	74.0	73.9	73.5	72.57	FLAT	N/A	N/A

*^ Weekly support and resistance levels * Current as at 9.30am today; week ago as at Monday 5pm*

NZD Recap and Outlook

There wasn't anything particularly new or exciting to for currency markets last week. The NZD/USD continued to shuffle sideways in the now familiar 0.6900-0.7100 range, while NZD/AUD continued to creep higher as expected. The latter's breach of 0.9500 puts it at seven-month highs.

The situation and outlook for the NZD is still best summarised by the paragraph we wrote last week: "The kiwi dollar continues to track an awkward middle ground between domestic fundamentals that suggest the currency should be significantly higher, and the more immediate headwinds from the strong USD/weak AUD double-act. In the short-term we suspect the latter will continue to win out, meaning the NZD/USD will continue to face resistance on rallies into the 0.7000-0.7050 window. By contrast, with the Australian COVID situation worsening, the way is clear for further NZD/AUD upside."

The divergence between global and domestic drivers of the currency will be brought into sharper focus by this week's economic data. Tomorrow's RBA meeting is expected to see last month's tapering decision reversed as the Aussie economy suffers under the weight of longer/broader lockdowns. Many Aussie analysts (including our friends at CBA) have pushed RBA rate hike calls back into 2023. US employment data on Friday should keep the USD well supported. According to the consensus, 900k jobs were added in July, enough to push the unemployment rate down further to 5.7%, from 5.9%.

Meanwhile, in NZ, Wednesday's labour market data is expected to further make the case for higher interest rates in NZ. Unemployment is expected to fall to 4.4% by ourselves and the consensus. Measures of wage growth should all track higher reflective of extreme skill shortages. We reckon the risks are for a larger-than-expected fall in unemployment, something that would push the NZD higher against the majors (particularly the AUD).
Further ahead, we remain of the view a topside range break for NZD/USD is more likely than a break to the downside. But the timing of such is uncertain and, in the least, would probably require a settling of the Australian COVID situation. The RBNZ delivering a rate hike later this month could be a catalyst. mike.jones@asb.co.nz

ASB foreign exchange forecasts	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Mar-23	Mar-24
(end of quarter)		<< actual	forecast >>					
NZD/USD	0.70	0.70	0.69	0.67	0.68	0.69	0.72	0.72
NZD/AUD	0.92	0.93	0.93	0.92	0.94	0.92	0.92	0.92
NZD/JPY	77	77	78	76	79	81	85	85
NZD/EUR	0.60	0.59	0.59	0.59	0.61	0.61	0.60	0.55
NZD/GBP	0.51	0.51	0.51	0.50	0.50	0.51	0.51	0.51
NZD/CNY	4.6	4.5	4.5	4.4	4.4	4.4	4.5	4.5
NZD TWI	73.9	73.7	73.2	71.3	72.8	73.0	74.4	73.8

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	0.25	0.25	0.25	0.25	UNCH	UP
90-day bank bill	0.48	0.45	0.35	0.30	UNCH	UP
2-year swap	1.05	1.06	0.80	0.19	UNCH	UP
5-year swap	1.46	1.45	1.37	0.28	UNCH	UP
10-year swap	1.81	1.79	1.85	0.63	UNCH	UP
10-year govt bond yield	1.67	1.50	1.70	0.75	UNCH	UP
Curve Slope (2s10s swaps)	0.76	0.73	1.04	0.44	UNCH	DOWN

** Current as at 9.30am today; week ago as at Monday 5pm. Key UNCH = Broadly unchanged*

Market recap

Last week saw a modest scaling back in RBNZ market pricing, but with yields grinding higher for longer-terms and with a curve steepening bias. The worsening delta variant outbreak in Sydney has dampened Australian yields and has resulted in our CBA colleagues shifting back the start date for RBA cash rate hikes by 6 months (to May 2023) and acknowledging the risk that the RBA Board holds off with QE tapering from September. Australian Q2 CPI printed in line with the market consensus, with very little market reaction to the data.

Rising delta variant cases, month end demand and low issuance has dampened US Treasury yields and flattened the yield curve, with 10-year yields (1.22% down 6bps for week) about 50bps lower than in late March. The US Federal Open Market Committee left the Fed Funds rate and asset purchases unchanged. The statement alluded to the 'progress' in the FOMC meeting its policy objectives (signalling pending QE tapering), and while Chair Powell reiterated that the US economy was on the right track, there was no imminent need to tighten settings.

Near-term interest rate outlook

Market pricing has an August hike roughly 65% priced in, with around 45bps of hikes by November and around 75bps priced in by mid-2022. This looks a tad light given our core economic view. Our Q2 NZ labour market picks (data due Wednesday) point to a tightening labour market and escalating wage pressure, suggesting more upside for NZ market pricing. Still, with a global pandemic raging and other central banks a long way from hiking, markets are unlikely to fully price in a hike at the August MPS decision (August 18). NZ inflation expectations from the RBNZ survey (August 12) are the last key domestic data releases prior to this.

This is expected to contrast with cautious messages across the Tasman that may dampen Australian yields. The RBA Decision is tomorrow, with the Statement of Monetary Policy out on Friday. Our CBA colleagues expect the cash rate to be held at 0.1%, but for the RBA to reverse their announcement of a tapering to the bond buying program from mid-September. Activity data for Australia should show decent momentum in Q2, but we are wary of a slowdown in Q3 given tightening restrictions.

NZ longer-term yields are expected to start this week lower following offshore moves. Falls in Treasury yields have been sizeable in recent months, but we see few catalysts this week to reverse the declining trajectory. This week's data - July PMIs, US ISM reports and July payrolls - are expected to show solid global momentum but will largely be downplayed. The Bank of England Monetary Policy Committee is widely expected to make no changes to monetary policy settings.

Medium-term outlook

We expect the RBNZ to raise the OCR by 25bps in August (to 0.50%), which will be followed by 25bp hikes in November (0.75%) and February 2022 (1.00%). We then expect a further 50bps of hikes, with the OCR peaking at 1.50% by mid-2023. Our CBA colleagues now expect that the RBA to delay cash rate hikes to May 2023 (previously November 2022), with a 1.25% endpoint. The US FOMC is expected to taper monthly asset purchases from October and start increasing the Fed Funds rate in March 2023 (1.50% in 2024). Longer-term yields are expected to remain capped at historically-low levels. mark.smith4@asb.co.nz

Domestic events

Data	Date	Time (NZT)	Market	ASB
HLFS Unemployment Rate, %, Q2	04/08	10:45am	-	4.4

We expect the unemployment rate to fall to 4.4% over the June quarter (from 4.7% in Q4) on the back of strong employment growth. The key focus of the Q2 labour market data release will be on the inflationary impacts of a tight labour market. In particular, the wage inflation figures and the RBNZ's measures of labour market underutilisation. We expect the benchmark measure of wage inflation, the Private Sector Ordinary Time Labour Cost Index lifted by 0.8% qoq in Q2, bringing annual wage inflation up to 2.1%.

Major International Events for the week ahead

Data	Date	Time (NZT)	ASB
RBA Interest Rate Announcement, %	03/08	4:30 pm	0.1
Australia Building Approvals, June, %mom	03/08	1:30 pm	-5.0
US ISM Manufacturing Index, July, points	03/08	12:30 am	61
Australia Retail Trade, June, %mom	04/08	1:30 pm	-1.8
Australia Trade Balance, June, A$bn	05/08	1:30 pm	11.5
BoE Interest Rate Announcement, %	05/08	11:00 pm	0.1
RBA Statement of Monetary Policy	06/08	1:30 pm	-
US Non-farm Payrolls, July, 000s	06/08	12:30 am	800

** Forecasts and commentary originally published by CBA Global Markets Research Friday 30 July at 1:40pm*

We expect the Reserve Bank of Australia (RBA) to maintain current monetary policy settings by keeping the cash rate at 0.1% and retaining the Apr 24 AGS yield target at 0.1%. However, we do expect the RBA to announce a reversal of the planned mid-September tapering in the bond buying program, notably because the Greater Sydney lockdown is likely to cause a contraction in Q3 GDP. The statement accompanying the meeting will highlight the RBA's latest view on the economy and will preview the full set of economic forecasts to be released in the Statement of Monetary Policy on Friday.

Australian building approvals declined 7% in May and we expect another fall in June. The fall is largely driven by an anticipated drop in detached housing approvals, as they continue to ease from very high levels after more than a year of strong growth due to HomeBuilder and other state-based housing construction grants. HomeBuilder was closed to new applications in April.

The preliminary read for **Australian retail trade** printed below consensus and our estimates at -1.8% in the month. The weakness owed to lockdowns in various states across Australia. The print captured the Victoria lockdown, which began in May and gradually eased from mid-June and the first few days of the current lockdown in Greater Sydney. The July print will be worse.

We expect **Australia's trade surplus** to lift to A$11.5bn from A$9.7bn the previous month. The larger trade surplus will be driven by exports, which has been supported by continued strength in iron ore and other commodity prices. Goods exports prices rose 13.2% in Q2 as Chinese demand drove up iron ore prices.

We expect a preview of the **RBA's** updated forecasts in the statement accompanying the RBA Board meeting on Tuesday. The full set will be released in the **Statement of Monetary Policy (SMP)** and may also include an upside and downside scenario as has been the case in past publications. We expect downgrades to the near-term activity forecasts given the prolonged Greater Sydney lockdown and snap lockdowns elsewhere.

Already-released **US** regional **manufacturing surveys** suggest that activity remained near record highs in July. Once again, the ISM survey will be closely analysed for any signs that supply bottlenecks are starting to ease in the industry. US Q2 21 GDP highlighted that production is struggling to keep pace with final demand.

The **Bank of England (BoE) is widely expected to make no changes to monetary policy**. The economy is improving now that most restrictions on activity have been removed. Therefore, the BoE may adopt a less dovish stance about policy.

We expect another solid month of **US employment** in July, buoyed by strong economic momentum. However, there is the risk of some disruption to July's data because 25 US states ended supplementary unemployment benefits in June. As a result, labour supply may have jumped in July. If these people quickly found employment, the rise in new employment could outpace our expectations.

ASB

Key Forecasts

ASB NZ economic forecasts	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Mar-23	Mar-24
	<< actual	forecast >>						
GDP real - Q%	1.6	0.6	0.7	0.3	-0.6	1.4	0.6	0.6
GDP real - A%	2.4	15.5	2.0	3.3	0.9	1.7	3.5	2.7
GDP real - AA%	-2.3	4.0	4.4	5.5	5.1	2.0	2.4	2.7
NZ House Prices (QV Index) - A%	17.4	21.6	18.8	14.6	10.1	7.0	2.3	5.3
CPI - Q%	0.8	1.3	1.3	0.5	0.6	0.5	0.4	0.5
CPI - A%	1.5	3.3	4.0	4.0	3.8	3.0	2.1	2.3
HLFS employment growth - Q%	0.5	1.0	0.5	0.4	0.4	0.3	0.3	0.4
HLFS employment growth - A%	0.3	1.5	2.6	2.4	2.3	1.5	1.3	1.4
Unemployment rate - %sa	4.7	4.4	4.1	3.9	3.6	3.6	3.6	3.7

Q% = percentage change on previous quarter
A% = percentage change since same quarter the previous year
AA% = percentage change for year ending quarter since the previous year

ASB interest rate forecasts	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Mar-23	Mar-24
(end of quarter)		<< actual	forecast >>					
NZ OCR	0.25	0.25	0.50	0.75	1.00	1.00	1.25	1.50
NZ 90-day bank bill	0.35	0.35	0.65	0.90	1.00	1.15	1.50	1.75
NZ 2-year swap rate	0.47	0.78	1.10	1.20	1.30	1.40	1.65	1.85
NZ 5-year swap rate	1.12	1.36	1.55	1.65	1.75	1.85	2.00	2.20
NZ 10-year swap rate	1.96	1.88	1.90	1.95	2.00	2.05	2.20	2.40
NZ 10-year Bond	1.78	1.77	1.80	1.85	1.90	1.95	2.10	2.30

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NZD/AUD	0.92	0.93	0.93	0.92	0.94	0.92	0.92	0.92
NZD/JPY	77	77	78	76	79	81	85	85
NZD/EUR	0.60	0.59	0.59	0.59	0.61	0.61	0.60	0.55
NZD/GBP	0.51	0.51	0.51	0.50	0.50	0.51	0.51	0.51
NZD/CNY	4.6	4.5	4.5	4.4	4.4	4.4	4.5	4.5
NZD TWI	73.9	73.7	73.2	71.3	72.8	73.0	74.4	73.8

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