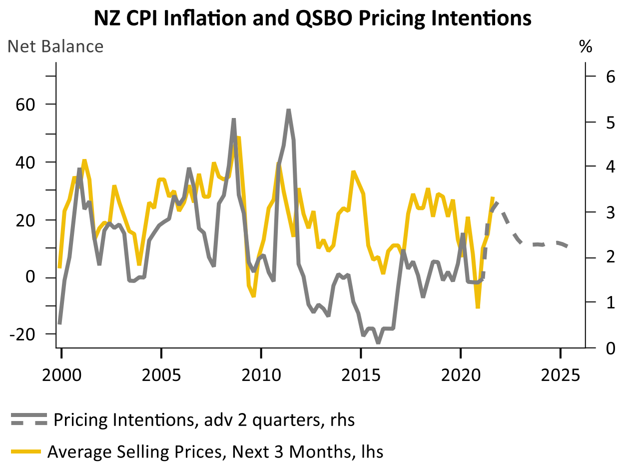
Economic Weekly

05 July 2021

Focus turns to inflation

The NZ economy has performed well throughout the COVID-19 pandemic, particularly compared to most of its international peers. But the economic bounce back has not been evenly shared across NZ, as highlighted by Nat Keall in our most recent [Regional Scoreboard](), released today. The North-South divide has widened further over Q1 2021, as the South Island appears to have taken the brunt of the impact of international border closures. Tourism hubs like Queenstown continue to face significant challenges, with employment numbers down 5.2% from the beginning of last year. In fact, in Q1 this year Otago was below the national average on every other metric we measure, posting a huge 27% fall in construction. Rural regions generally outperformed the major urban centres on the Scoreboard, with the resilience of the country's primary sector helping support the broader New Zealand economy through the pandemic.

With NZ's economic recovery well established, and the global economic recovery now firing, focus is now shifting to the rapid lift in costs and inflationary pressure. The recovery in demand in NZ over the past 6 months has come at a time when resource constraints are becoming more acute. In NZ, we are predicting annual CPI inflation to lift sharply from the second quarter of 2021, to reach 3.2% by the end of this year. This week's NZIER Quarterly Survey of Business Opinion (6th July) will provide an indication of how much of the rise in cost pressures is being passed onto consumers, with further confirmation to come in the following week's Q2 CPI release (16th July).



Source: Macrobond, ASB

Central banks have become more wary of leaving monetary settings too stimulatory in an environment of improving demand and a quickly building on inflationary pressures. The RBNZ adopted an explicit tightening bias in May, with a number of US Federal Reserve officials recently noting that the time to normalise interest rates may be sooner than previously indicated. This week the focus shifts to the Reserve Bank of Australia.   At Tuesday's board meeting the RBA will provide an update on its yield curve control and the bond buying program. Despite the current COVID-19 outbreak in Sydney, our colleagues at CBA expect the RBA to start tapering the pace of bond purchases from September, either via scaling back the amounts being purchased or spreading out the purchases over a longer period of time. The RBA may also use the opportunity to move to a more flexible programme. CBA recently updated its Australian interest rate view, and now expect the RBA to start lifting the 0.1% cash rate in November 2022. Nevertheless, we still expect the RBNZ to be towards the front of the rate hike queue, starting with a 25bp hike in the OCR in May next year or possibly sooner if the economy continues to perform well

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Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7032	0.7069	0.7147	0.6512	FLAT/UP	0.6900	0.7100
NZD/AUD	0.9342	0.9312	0.9333	0.9402	FLAT	0.9280	0.9400
NZD/JPY	78.09	78.20	78.80	70.01	UP	76.50	80.00
NZD/EUR	0.5926	0.5927	0.5900	0.5800	UP	0.5840	0.5950
NZD/GBP	0.5083	0.5088	0.5072	0.5226	FLAT	0.5010	0.5150
TWI	74.1	74.1	74.3	72.09	FLAT/UP	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

For much of last week, market sentiment continued to improve in the aftermath of the Fed's less dovish (or rather, more hawkish) turn a fortnight ago. The VIX index (a measure of volatility), ticked down further over the week, suggesting waning risk aversion among markets. Sharemarkets rallied, with the S&P500 hitting a new all-time high. Commodity prices went from strength to strength, as indicated by both Bloomberg and ASB's Commodity Indices making lifts over the week.

Traditionally, such a frothy environment would be a boon for pro-cyclical commodity currencies and a drag for the countercyclical USD. Yet for most the week, NZD/USD trended steadily lower, bottoming out south of 0.6950 on Friday evening. USD strength was once again in the driver's seat (a risk we've highlighted over recent updates), with the DXY Index (a typical measure of USD strength) lifting for most of the week. It looked like an endorsement of the 'USD smile theory,' which stipulates the USD behaves more like a 'normal' currency when the US economy is charging ahead at a swift pace.

Then, a mixed bag of US labour market data threw a cat among the pigeons late on Friday night. While job growth shattered market expectations (lifting by 850,000 instead of the predicted 720,000), the US unemployment rate ticking up more than anticipated to 5.9%. The takeaway for currency markets seemed to be 'the US economy is doing well, but the Fed may still see reason to push out the timetable for rate hikes.' Sure enough, we saw NZD/USD reverse some of its gains earlier in the week, closing just south of 0.7030.

In the near term, we see some scope for further USD strength. The FOMC minutes out on Thursday will remind markets of the Fed's more hawkish shift of late, and could hint the bank is less confident inflationary pressures will prove transitory than it once was. We suspect that the week's big domestic data release - the Q2 Quarterly Survey of Business Opinion - will play second fiddle to those offshore developments, even as it confirms the lift in NZ economic activity and pricing pressures.

This week, NZD/AUD will be in the spotlight, with the next RBA meeting on Tuesday afternoon at 4.30pm NZT. Our CBA friends suspect the Bank will announce its intention to start tapering its bond purchases in September and announce a further $A50bn of bond purchases over the next six months (down from $A100bn). Still, with COVID restrictions back in place across parts of Australia, the risk of a more dovish statement remains a distinct possibility, which would be a bullish sign for NZD/AUD. nathaniel.keall@asb.co.nz

ASB foreign exchange forecasts	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Mar-23	Mar-24
(end of quarter)	<<actual	forecast >>					
NZD/USD	0.73	0.74	0.74	0.74	0.74	0.73	0.73
NZD/AUD	0.91	0.89	0.91	0.94	0.95	0.95	0.95
NZD/JPY	80	83	84	85	86	88	88
NZD/EUR	0.59	0.59	0.58	0.57	0.56	0.54	0.54
NZD/GBP	0.51	0.51	0.51	0.50	0.50	0.48	0.48
NZD/CNY	4.7	4.7	4.7	4.7	4.6	4.5	4.5
NZD TWI	75.5	75.6	75.7	75.7	75.7	74.6	74.6

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	0.35	0.34	0.32	0.31	UNCH	UP
2-year swap	0.81	0.80	0.58	0.22	UP	UP
5-year swap	1.35	1.41	1.30	0.36	UP	UP
10-year swap	1.80	1.94	2.00	0.76	UP	UP
10-year govt bond yield	1.82	1.84	1.85	0.96	UP	UP
Curve Slope (2s10s swaps)	0.99	1.15	1.42	0.55	UNCH	DOWN

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

Market Recap

Market pricing for OCR hikes has continued to firm, and local short-term yields have pushed higher with a curve-flattening bias as markets bring forward the adjudged timing of RBNZ monetary policy tightening. Yields on the 2-year NZ swap (0.815%) hit post-pandemic highs. However, medium to longer-term local yields have followed global counterpoints lower. Australian yields were weighed by the worsening COVID-19 outbreak in Australia and the tightening in restrictions. US 10-year Treasury yields were down about 10bps last week, with short to medium yields falling after the surprise rise in the US unemployment rate (5.9%) reaffirmed the FOMCs patient stance.

Near-term interest rate outlook

We have retained our upward bias for local yields. A 25bp OCR hike is fully priced in by February 2022 and we suspect market pricing could firm leading into the RBNZ Review (July 14) and Q2 CPI report (July 16). A shift up in pricing intentions and intensification in capacity pressures from tomorrow's Q2 NZIER Quarterly Survey of Business Opinion would add pressure on the RBNZ to pull the OCR trigger.

This week is the first NZDM tender for 2021/22, with $550m on offer. The RBNZ has maintained its trimmed-down weekly $200m pace of LSAP purchases and we expect that it will resume policy tapering in the coming weeks and then cease asset purchases altogether prior to lifting the OCR. This will pressure yields higher at the margin.

Tomorrow's RBA decision is the key offshore event. Our core economic view is closely aligned to the Australian view of our CBA colleagues. The COVID-19 outbreak has dampened Australian yields, but our CBA colleagues are of the view that the RBA will start to unwind policy policy stimulus, likely via tapering in next 6-monthly round of QE from AUD100bn to AUD50bn. The April 24 bond is expected to remain the target bond for yield curve control (i.e. not shift to the November 24 bond). RBA Governor Lowe's speech on Thursday will also be worth keeping tabs on.

Further afield, markets will be closely scrutinising the Fed Minutes (Thursday 6am NZT) for signs of whether the FOMC's tolerance for an inflation overshoot is waning and whether QE tapering is imminent. Global data this week (global PSI's, Chinese CPI) will likely be ignored, but should depict a solid pace of global expansion.

Medium-term outlook

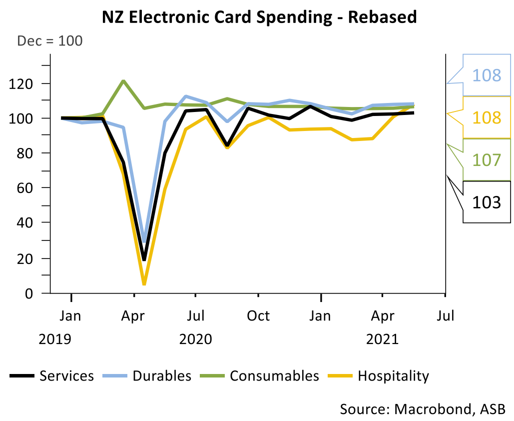
We expect the RBNZ to raise the OCR from May 2022, with the OCR expected to peak at just 1.25% in late 2023. Risks are tilted towards OCR hikes occurring sooner and for yields to push higher, particularly for short to medium-term tenors. Our CBA colleagues expect that the RBA will hike the cash rate in November 2022 (peaking at 1.25% in late 2023), with the FOMC to 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
NZIER Quarterly Survey of Business Opinion, Q2	06/07	10:00 am	-	-
Electronic Card Transactions, Retail, June, % mom	12/07	10:45 am	-	0

Business sentiment has been an improving trajectory as the economic outlook has brightened. **We expect more of the same from the Q2 Quarterly Survey of Business Opinion (QSBO).** Observed and expected domestic trading activity readings from the survey are expected to climb towards historical averages. Improvement should also be evident from investment and employment intentions of the survey. However, the survey is likely to continue to flag further upside to pricing pressures, with readings for expected selling prices and average costs to move higher. **We expect capacity metrics to firm from elevated levels, highlighting little (if any) spare capacity within the NZ economy.** Firms are expected to flag increasing difficulty in obtaining skilled and unskilled staff, surveyed capacity utilisation is expected to remain well above historical averages, and capacity and labour shortages will be increasingly cited as factors constraining the expansion.

We expect little overall change in June card spending that follows a strong few months. MBIE card spending for June was down about 1% on the previous month, weighed by a fall in overseas card spending as the trans-Tasman travel bubble was paused following COVID-19 outbreaks in Australia. Card spending for the Wellington region was lower as restrictions were temporarily tightened. Our expectation is that retail prices climbed in June (petrol prices were up around 4% according to our estimates), which implies retail volumes declined modestly over the month. We have retained our positive outlook for consumer spending over the second half of 2021, given Budget-related increases in income support payments from July, tight labour markets, the elevated terms of trade, and increased saving by households (household deposits are $20bn above pre-COVID levels). Increased consumer demand is a key support to the NZ economy.



Major International Events for the week ahead

Data	Date	Time (NZT)	ASB
Australia Building Approvals, May, %mom	05/07	1:30 pm	-5.0
Australia Retail Trade, May, %mom	05/07	1:30 pm	0.1
RBA Interest Rate Announcement, %	06/07	7:30 pm	-
RBA Governor Lowe Speech	08/07	9:00 pm	-
US Fed June Meeting Minutes	08/07	9:00 pm	-
China CPI, June, %yoy	09/07	4:30 am	1.2
UK GDP, May, %yoy	09/07	9:00 pm	-

** Forecasts and commentary originally published by CBA Global Markets Research Friday 2 July at 12:12 pm*

We expect a 5% fall in **Australian building approvals** in May. This follows an 8.6% fall in April. The data are usually volatile, thrown around by large multi-unit approvals. Given HomeBuilder applications closed in April we expect the fall in approvals over May to be driven by private houses.

The preliminary estimate of **Australian retail trade** lifted by 0.1% in May and we expect the final estimate to match that. The strict lockdown in Vic in May led to the weak result. Ex-Vic retail trade rose by 0.7%. June and July retail trade will be impacted by lockdowns in NSW, QLD, NT and WA.

At the July Board meeting, we expect the Reserve Bank of Australia (RBA) to announce it will continue to target the April 24 bond in its yield curve control program. We also expect the RBA to announce a taper of its bond purchase program to $A50bn. However, we recognise the RBA could take a more flexible approach, particularly given the current lockdowns in place.

RBA Governor Lowe will deliver remarks at 4pm on Tuesday explaining the July monetary policy decision.

High commodity prices are pushing up **Chinese producer inflation** to high levels. But still soft Chinese consumer spending, in part because of intermittent regional lockdowns, is a headwind to a pick-up in consumer inflation in June.

The **US Federal Reserve's meeting minutes** correspond with the Fed meeting where members brought forward expectations for rate hikes and talked about talking about tapering asset purchases. Any indications around the timing of tapering asset purchases will be important. At the same time, market participants will look for more evidence that the US Fed's tolerance for an inflation overshoot is waning.

UK real GDP expanded by 2.3% in April, the fastest monthly growth since July 2020. Services output was the main engine of growth in April as coronavirus restrictions eased. Overall, UK economic slack is diminishing rapidly with the level of GDP just 3.8% below the levels seen in February 2020. The composite Markit PMI points to another solid GDP growth print in May.

ASB

Key Forecasts

ASB NZ economic forecasts	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Mar-23	Mar-24
	<< actual	forecast >>					
GDP real - Q%	1.6	0.5	1.1	-0.2	-0.7	0.4	0.6
GDP real - A%	2.4	15.4	2.3	3.1	0.7	4.0	2.5
GDP real - AA%	-2.3	4.0	4.5	5.5	5.0	2.6	2.5
NZ House Prices (QV Index) - A%	17.4	21.6	18.8	14.6	10.1	2.3	5.3
CPI - Q%	0.8	0.8	0.9	0.6	0.6	0.5	0.5
CPI - A%	1.5	2.8	3.1	3.2	3.0	2.3	2.3
HLFS employment growth - Q%	0.5	0.4	0.4	0.3	0.3	0.4	0.4
HLFS employment growth - A%	0.3	1.0	2.0	1.7	1.4	2.0	1.5
Unemployment rate - %sa	4.7	4.6	4.6	4.5	4.5	4.0	4.0

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	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	0.25	0.25	0.50	0.75	1.25
NZ 90-day bank bill	0.35	0.35	0.35	0.55	0.70	1.10	1.50
NZ 2-year swap rate	0.60	0.65	0.70	0.80	0.90	1.20	1.55
NZ 5-year swap rate	1.35	1.40	1.50	1.60	1.70	1.95	2.15
NZ 10-year swap rate	2.00	2.05	2.10	2.15	2.20	2.35	2.55
NZ 10-year Bond	1.85	1.90	1.95	2.00	2.05	2.20	2.40

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(end of quarter)	<< actual	forecast >>					
NZD/USD	0.73	0.74	0.74	0.74	0.74	0.73	0.73
NZD/AUD	0.91	0.89	0.91	0.94	0.95	0.95	0.95
NZD/JPY	80	83	84	85	86	88	88
NZD/EUR	0.59	0.59	0.58	0.57	0.56	0.54	0.54
NZD/GBP	0.51	0.51	0.51	0.50	0.50	0.48	0.48
NZD/CNY	4.7	4.7	4.7	4.7	4.6	4.5	4.5
NZD TWI	75.5	75.6	75.7	75.7	75.7	74.6	74.6

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