Economic Weekly

09 August 2021

Don’t Look Back in Anger: the case for a fast start

As well as a Britpop banger with nonsensical lyrics, our title is also a tidy re-phrasing of the Reserve Bank’s favoured ‘least regrets’ framework. That is, the future’s all a bit murky so choose the path likely to cause you the least amount of future cringe. Sensible advice, and not just for monetary policy…

Anyway, the least regrets idea has had a big influence on policy setting during the COVID era. If in doubt, throw the kitchen sink at it, because things look awful. But things have changed. The path of ‘least regret’ has flipped 180 degrees to the RBNZ not reducing stimulus fast enough. The Bank confirmed as much in July. This is important in framing the risks around policy making over the remainder of the year.

The RBNZ has already met its inflation and employment objectives. Actually, we now know it probably met them a couple of months ago. There’s still debate about the permanence of the upcoming spike in headline inflation. But core inflation is likely to remain above 2%. Further, last week’s labour market data confirmed we’re at, or above, Maximum Sustainable Employment. Sub 4% unemployment beckons next quarter and we expect wage growth to accelerate further. And yet, the Official Cash Rate is still at 0.25%.

Last week we changed our call to expect 25bps rate hikes at each of the next three available RBNZ meetings, which would get the OCR back to its pre-pandemic level by year-end. As Lisa Carrington has shown the world, a fast start can pay dividends. And so it would also be worth the RBNZ considering the pros and cons of starting with a 50bps lift. The traditional argument against is that a double-up can spook markets and cause volatility. But markets are already pricing a 12% chance of a 50bps raise, and we doubt a 50bp lift would surprise the economic consensus.

Yes, there are risks from the spreading Delta variant. The Australian outbreak is too close for comfort. But the clear and present danger is that economy continues to overheat, allowing inflation to get away. If things change down the track (*touch wood*), the RBNZ can always back off, just like we saw from the Reserve Bank of Australia last week.

The other reason to get a fast start is housing. We never bought into the dire predictions for house prices we saw in the wake of the Government’s tax changes. And, indeed, momentum has slowed a little, but not enough. Annual house price inflation is still chugging along at a 15-20% annualised pace. This week’s only notable economic data release – REINZ housing figures for July – is likely to highlight the point.

The RBNZ is frustrated with continued “risky lending” and is going back to the macroprudential tool-shed to find a bigger hammer. Ideally it wouldn’t have to. Using interest rates to douse the housing market is cleaner and potentially less distortionary. Making a fast start with interest rates – whether it’s three 25bps hikes in a row or an initial 50bps – might avoid having to play catch up down the line. With one eye on COVID, it seems to be the path of lesser regret.
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Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7012	0.6961	0.6933	0.6662	FLAT	0.6900	0.7100
NZD/AUD	0.9529	0.9485	0.9340	0.9255	UP	0.9450	0.9650
NZD/JPY	77.28	76.34	76.34	70.34	FLAT	76.00	78.50
NZD/EUR	0.5962	0.5864	0.5862	0.5630	FLAT	0.5850	0.6050
NZD/GBP	0.5052	0.5008	0.5037	0.5080	FLAT	0.4960	0.5140
TWI	74.6	73.6	73.3	72.22	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

The NZD lifted strongly against all the major crosses on Wednesday, following a couple of events which endorsed our view that the start tightening cycle is now imminent. On Tuesday, the RBNZ made a surprise announcement that it would be tightening mortgage lending standards later this year, apparently frustrated with continued "risky" lending. Financial market participants took this as evidence the RBNZ has had enough of waiting for the housing market to cool and will thus use both tighter macro-prudential policy and a higher OCR to rein things in. Meanwhile, the Q2 labour market data also confirmed the labour market is now very tight, which heightens the risk of inflation becoming persistently higher going forward. The RBNZ is widely expected to lift the OCR from emergency settings at next week's OCR review and Monetary Policy Statement. The only question is how fast the RBNZ will lift the OCR and how high it will initially go before pausing to assess the impact of higher rates on the NZ economy.

Throughout the rest of the week the NZD hung onto most of its gain against the AUD and EUR but unwound some of the lift against the USD and the GBP (to a lesser extent).

Dairy prices continued to fall at the last week's Global Dairy Trade auction – posting the 8th consecutive fall. Many global commodity prices are starting to ease over the past month or so, following strong gains earlier this year.

Comments by Fed officials suggest increased concern on the US inflation outlook, with Fed Vice Chair Richard Clarida commenting that there were upside risks to the inflation outlook and St Louis Fed President James Bullard also noting the risk inflation may prove more sustained than expected.

The NZD continues to face mixed forces – on one hand the relative interest rate outlook remains supportive to the NZD. On the other, softening commodity prices and the continued theme of USD strength will provide headwinds. The NZD/USD saw strong resistance at the 0.7100 level last week. Meanwhile, the ever-widening divergence between the RBNZ's and RBA's outlooks suggests NZD/AUD could re-test its December 2020 high of 0.9599.

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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	0.65	0.50	0.34	0.30	UNCH	UP
2-year swap	1.26	1.05	0.86	0.20	UNCH	UP
5-year swap	1.59	1.45	1.34	0.29	UNCH	UP
10-year swap	1.91	1.80	1.76	0.64	UNCH	UP
10-year govt bond yield	1.77	1.54	1.54	0.77	UNCH	UP
Curve Slope (2s10s swaps)	0.65	0.75	0.90	0.44	UNCH	DOWN

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

Market recap

NZ yields across the curve are around 10-20bps higher than they were this time last week. NZ short-term yields jumped following the release of much stronger than expected Q2 NZ labour market data, which saw the unemployment rate fall to 4%, measures of labour utilisation tighten and wage inflation rise. ASB has tweaked its OCR view and now expects 75bps of OCR hikes over 2021 (+50bps prior). The 2-year swap yield has held onto its post-labour market lift and is trading close to post-pandemic highs (1.24%), with NZ 10-year swap yields back to late June levels (1.91%).

Longer-term yields were also pressured higher by the lift in global yields. US 10-year Treasury yields (1.30%) were around 10bps higher than a week ago, supported by strong US labour market prints and increased optimism by some Fed members (Clarida, Daly and Kaplan) on the economic outlook and subsequent winding back of policy stimulus. Despite the delta variant lockdown and tightening restrictions, Australian yields edged higher last week. The RBA was not as dovish relative to market expectations, holding the line on QE tapering in September and 'looking through' the disruption caused by delta variant outbreaks. The RBA's medium-term economic forecasts were also upgraded.

Near-term interest rate outlook

Market pricing has 28bps of hikes by August, with around 65bps of OCR hikes priced in by November. This looks a tad light given our core economic view and the non-negligible risk of a 50bp hike in August. Increases in short-term yields have been sizeable (up 30bps over the last month) and, short of a delta variant outbreak in NZ, there looks to be more upside risk than downside. NZ inflation expectations from the RBNZ survey (August 12) is the last key domestic data release prior to the August RBNZ Statement (August 18), with one and two-year ahead forecasts for CPI inflation expected to ratchet higher. Given the RBNZ is expected to be towards the front of the policy interest rate hike queue, we expect NZ yields to remain above global counterparts and maintain the widening in differentials observed in recent months. This should be NZD supportive.

Our bias is for longer-term global yields to continue to move higher as markets start to 'look through' the impacts of the global pandemic and increasingly focus on improving prospects. Forthcoming CPI prints for the US and China are expected to ease as transitory influences fade, but the risk is that inflation prints over the next few months do not cool to the extent expected. Australian data this week will likely soften on account of the lockdowns, but markets are likely to largely ignore this.

Medium-term outlook

We expect the RBNZ to raise the OCR by 25bps in August (to 0.50%), October (+0.75%) and November (1.0%), which would quickly return settings to pre-COVID-19 levels. We then expect a further 50bps of hikes over 2022 (likely May and November), with the OCR peaking at 1.50%. Our CBA colleagues expect RBA cash rate hikes from May 2023, 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, with the yield curve flatter. mark.smith4@asb.co.nz

Domestic events

Data	Date	Time (NZT)	Market	ASB
Electronic Card Transactions, Retail, Jul, % mom	10/08	10:45 am	-	1.0
RBNZ Survey of Expectations, CPI inflation 2 yr ahead- Q3	12/08	3:00pm	-	2.30
Food Price Index, Jul, % mom	13/08	10:45 am	-	0.5

We expect a solid increase in monthly total and retail card spending in July. The July month saw increases in income support payments announced in Budget 2021, with the next increase occurring in April 2022. Much of this four-yearly $3.3bn package will likely be converted to consumer spending. MBIE data suggest the July school holidays provided a much-needed boost to spending in some regions, although the delta variant outbreak in Australia and subsequent Trans-Tasman border restrictions significantly impacted overseas retail spend in NZ. **Momentum in retail activity is picking up, but we suspect this to moderate over the year ahead.** Domestic retail sales are expected to be supported by rising labour/producer incomes, strong household balance sheets, and the lack of overseas travel for NZ households. Conversely, higher debt servicing costs, the impacts of the border restrictions, rising retail prices and risks of another potential delta variant outbreak will act to slow/disrupt retail activity.

A moderate July month for food spending beckons given the likely pullback in fruit & vegetable prices from their June spike. Modest monthly movements are expected for other food categories in July, although we expect Q3 food prices to rise roughly 1.5% over Q3, (+0.2 percent-point contribution to the Q3 CPI). **Elevated global food commodity prices point to a strengthening outlook for retail food prices over 2021.**

Shorter-term inflation expectations from the RBNZ survey are expected to ratchet higher, given higher headline inflation (up to 3.3% in Q2 and on track to approach 4% in H2 this year), increasing capacity constraints, and the uptick in cost and price expectations in various business surveys. The one- and two-year-ahead readings for CPI inflation should move well above 2% (from 1.87% and 2.05% in Q2), with more sizeable increases expected for the 1-year ahead measure. Our focus will also be on whether longer-term inflation expectations (currently 2.06% and 2.02% for 5 and 10-years ahead) move higher as well. Contained readings for expected inflation reduce the risk of the RBNZ falling behind the curve and having to play catch-up with more OCR hikes further down the track.

Major International Events for the week ahead

Data	Date	Time (NZT)	ASB
China CPI, July, %yoy	09/08	1:30 pm	1.0
Japan Current Account Surplus, June, ¥bn	09/08	11.50 am	1,400
US CPI, July, %mom	11/08	12:30 am	0.4
UK GDP, Q2, %qoq	12/08	6:00 pm	5.0

** Forecasts and commentary originally published by CBA Global Markets Research Friday 6 August at 1:28pm*

We forecast **China's CPI inflation** to ease to 1.0%yoy in July because of falling pork prices. However, fresh vegetable prices have risen in late July following a severe flood in central China. We expect PPI inflation to lift to 8.9%yoy in July amid rising material costs.

We estimate **Japan's current account surplus** eased to ¥ 1,400bn in June, driven by the goods trade deficit.

We estimate the monthly pace of **US CPI** growth moderated in July. A combination of base effects (weak inflation a year ago) and re-opening frictions has driven prices sharply higher in recent months. However, base effects and re-opening frictions are beginning to fade. For example, the Manheim Used Car Price index fell in July suggesting that the prices of used cars may have peaked. We expect annual CPI to trend lower over the remainder of the year.

UK GDP expanded strongly in Q2 because of the gradual removal of restrictions. For example, retail sales jumped by 11%qoq in the quarter.

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	0.7	0.7	0.3	-0.6	1.4	0.6	0.6
GDP real - A%	2.4	15.6	2.0	3.3	1.0	1.7	3.4	2.6
GDP real - AA%	-2.3	4.0	4.5	5.5	5.2	2.0	2.3	2.6
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%	0.6	1.1	0.6	0.3	0.3	0.3	0.3	0.3
HLFS employment growth - A%	0.3	1.7	2.9	2.5	2.2	1.5	1.1	1.2
Unemployment rate - %sa	4.6	4.0	3.7	3.6	3.5	3.4	3.5	3.8

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	1.00	1.00	1.25	1.50	1.50
NZ 90-day bank bill	0.35	0.35	0.65	1.25	1.35	1.50	1.75	1.75
NZ 2-year swap rate	0.47	0.78	1.25	1.40	1.50	1.60	1.85	2.05
NZ 5-year swap rate	1.12	1.36	1.60	1.70	1.80	1.90	2.05	2.25
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/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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