ASB

Economic Weekly

12 July 2021

The outlook for ~~Thursday~~ Wednesday

The RBNZ will face into an interesting set of crosswinds when it meets this Wednesday.

The domestic economy has clearly continued to run hotter than the RBNZ's wintry forecasts. The mercury-busting capacity indicators from last week's QSBO confirm the economy is overheating, a risk we've warned of before. The economy is at or close to full employment and labour shortages are rife. What's more, we think capacity indicators will tighten further. The tailwinds for consumer price inflation and wage growth are thus much stronger than the RBNZ previously forecast.

In short, the economy no longer needs its winter warmers. Accordingly, we brought forward our forecast for the first RBNZ rate hike to this November (from May 2022) last week. It's since quickly become the consensus. But the question has to be asked, if we're all so sure rock-bottom interest rates are no longer needed, why wait? After all, November is still four months away and the RBNZ's favoured "least regrets" analysis much have surely flipped 180 degrees from "chuck the kitchen sink at it" to "woooah back!"

We don't buy the argument that the debt-laden housing market can't handle higher rates. Our own research finds households have plenty of buffer to cope with higher mortgage rates. Instead, the key restraining factor is probably the odd polar blast shooting across NZ from the global economy. There's growing unease about the spreading delta variant, and the attendant health and economic risks. It's proving frustratingly difficult to contain even in highly vaccinated countries, or those back in lockdown. There's also the fact that central banks globally – and importantly the US Federal Reserve and RBA – remain reluctant to ease off the accelerator. This means the RBNZ would be going it alone, at least at first. The RBA is still talking about leaving rates where they are until 2024. A three-year gap in NZ-AU tightening cycles would be unprecedented...and seems unlikely to occur one way or the other.

Waiting would give the RBNZ time to assess the above. But that would bring its own risks. The economy's potential to supply could fall further behind demand, forcing the RBNZ to play catch-up. For this reason, we favour the stitch in time approach of getting started sooner. We wouldn't rule out the possibility of the Bank making a start as soon as August, using this week's meeting as a possible set-up. In the least, we think the Bank will move to an explicit tightening bias on Wednesday. Any signal about an end-date for its asset purchase (quantitative easing) programme would confirm this.

This week's economic data are expected to support the case for higher interest rates. Tomorrow morning's June REINZ data will likely show the housing market remaining stubbornly strong. We think house prices likely recorded another 1-2% gain over the month, even as annual house price inflation cools a little from last month's 30% record. On Friday, annual CPI inflation is expected to print at an above-market 2.8%, a big jump from last quarter's 1.5% and a 10-year high. Above-3% inflation beckons by the end of the year. Mike.jones@asb.co.nz

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.6996	0.7019	0.7194	0.6547	FLAT	0.6750	0.7250
NZD/AUD	0.9351	0.9336	0.9274	0.9443	FLAT	0.9250	0.9400
NZD/JPY	77.06	78.00	78.70	70.01	FLAT	76.00	78.00
NZD/EUR	0.5892	0.5919	0.5902	0.5808	FLAT	0.5750	0.6000
NZD/GBP	0.5035	0.5077	0.5073	0.5203	FLAT	0.4950	0.5100
TWI	74.0	73.8	74.3	72.26	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 was largely steady against the major crosses over the past week. The NZD saw a brief lift following the release of the Q2 NZIER Quarterly Survey of Business Opinion on Tuesday morning. The business survey revealed that the NZ economy was more capacity constrained than previously believed and prompted economists (including ourselves) to bring forward the expected timing of OCR increases to November this year. However, gains against the USD were short lived and were unwound the next day. Meanwhile, the lift against the AUD was unwound by the end of the week.

Financial market sentiment was relatively downbeat for much of the week, although US share markets were led higher on Friday by banking stocks. It was also a relatively quiet week in terms of offshore economic data and events. The release of the Federal Reserve meeting minutes offered no new insights following on from the Fed's hawkish shift a few weeks ago. The minutes confirmed that, while members of the Fed Monetary Committee were worried about upside risks to inflation, they still felt the current lift will be transitory.

Meanwhile, the RBA announced it would taper bond purchases from September and maintained the April 24 bond as the target bond for yield curve control. The New South Wales outbreak continued to spread over the past week and stricter lockdown measures were announced over the weekend. The current Sydney outbreak appears to be on similar trajectory to the Melbourne outbreak last year, which suggests it could take many weeks to get on top of the outbreak and there could be a material hit to Australian Q3 GDP growth this year.

The week ahead is a big one for the NZD for event risk, with the RBNZ OCR update on Wednesday followed by the eagerly anticipated Q2 CPI result on Friday (we will finalise our CPI forecast on Tuesday this week). Interest rate markets have shifted over the past week and now suggest a 20% chance of a rate hike as soon as August. As a result, we feel there could be some scope for the RBNZ to disappoint market expectations. Although the RBNZ will be increasingly wary of growing inflation risks, on the other hand it will also be keeping half an eye on the Sydney outbreak and the additional challenge the Delta variant poses should it breach NZ's international border.

Our colleagues at CBA have revised the FX forecasts, and now expect the current USD strength to continue for longer. This will see the NZD sticking at current levels until mid-2022 – despite strong commodity prices and a lift in relative interest rates. jane.turner@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	0.69	0.67	0.68	0.69	0.72	0.72
NZD/AUD	0.91	0.93	0.92	0.94	0.92	0.92	0.92
NZD/JPY	80	78	76	79	81	85	85
NZD/EUR	0.59	0.59	0.59	0.61	0.61	0.60	0.55
NZD/GBP	0.51	0.51	0.50	0.50	0.51	0.51	0.51
NZD/CNY	4.7	4.5	4.4	4.4	4.4	4.5	4.5
NZD TWI	75.5	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	0.34	0.34	0.32	0.31	UNCH	UP
2-year swap	0.88	0.81	0.52	0.22	UNCH	UP
5-year swap	1.37	1.34	1.17	0.35	UP	UP
10-year swap	1.78	1.80	1.78	0.74	UP	UP
10-year govt bond yield	1.68	1.66	1.65	0.98	UP	UP
Curve Slope (2s10s swaps)	0.90	0.99	1.26	0.52	UP	DOWN

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

Market Recap

Local short-term yields have pushed higher as markets brought forward the adjudged timing of RBNZ monetary policy tightening. The catalyst was the Q2 NZ QSBO report, highlighting resilient demand, intensifying capacity issues and growing pricing pressures. ASB and the other main NZ banks shifted to forecasting a November 2021 start for OCR hikes. Yields on the 2-year NZ swap rate briefly pushed above 0.90%, and ended the week at 0.86%. By contrast, NZ yields for longer-term tenors have followed global counterpoints lower, flattening the yield curve. Last week, US 10-year Treasury yields dropped to 4½ month lows (1.25%), reflecting likely market positioning and concerns over the impacts of the rapidly spreading delta variant, ending the week at 1.36% (up 7bps). Last Friday the People's Bank of China confirmed it will cut the reserve requirement ratio by 50bps from 15 July to support the economy. The RBA announced it would continue to target the April 2024 government bond for its yield curve control and taper its bond purchases from September. However, the RBA kept its 2024 timeframe for hiking the cash rate, with RBA Governor Lowe viewing unemployment in the low 4's as necessary to fuel wage growth and lift inflation.

Near-term interest rate outlook

We have switched to a neutral bias for short-term local yields. There are about 20% odds of a 25bp OCR hike in August, 80% odds by November and 50bps of hikes by May 2022; that looks reasonable to us. A delta variant outbreak in NZ remains a clear downside risk. Focus on Wednesday's RBNZ Monetary Policy Review (MPR, our preview here) is whether the policy assessment still views that the medium-term growth outlook is similar to the May view, that medium-term inflation and employment would likely remain below its *Remit* targets and whether the RBNZ explicitly flags the possibility of impending OCR hikes. This will likely overshadow the Q2 NZ CPI report (ASB: +0.8% qoq, 2.8% yoy), where we see modest upside risk to the market consensus (+0.7% qoq, 2.7% qoq) and RBNZ forecasts (+0.6% qoq, 2.6% yoy). Signs of a lift in core inflation (including the RBNZ's Core inflation measures) could firm near-term market pricing.

We see modest upside to longer-term NZ yields. The decline in longer-term global yields is not consistent with improving global prospects and looks to be related to positioning. It signals future rate hikes will be modest, rising inflation will be temporary and capacity and other supply-side frictions will sort themselves out. We are not so sure. The July MPR might provide clues for whether the RBNZ will accelerate asset purchase tapering, given our expectation of LSAP purchases being paused prior to OCR hikes in November. This will pressure yields higher at the margin. This week's NZ Government bond tender will offer $500m, well above the $200m of LSAP purchases signalled by the RBNZ.

The Bank of Canada (BoC) will meet on Wednesday and the Bank of Japan will meet on Friday. We expect the BoC to keep the overnight rate at 0.25% and reiterate the guidance to keep the rate steady until "some time in the second half of 2022". In the meantime, we expect that the BoC will taper bond purchases further. Despite the worsening Covid-19 outbreak in Sydney, our CBA colleages note labour market leading indicators point to another strong Aussie jobs report (+45k employment, unemployment rate 4.9%). In the US the Beige book, the CPI for June and retail sales for June are all scheduled in the week ahead.

Medium-term outlook

We now expect the RBNZ to raise the OCR from November 2021, which will be followed by gradual tightening and a late 2023 1.50% OCR peak. 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
NZ Food Prices, June, %mom	13/07	10:45am	-	0.0
NZ Consumers Price Index, 2020Q2, % qoq	16/07	10:45am	-	0.8

The June food price and dwelling rental data outturns are the last inputs into our Q2 CPI pick. **Our expectation is for June food prices to be little changed on May levels,** notwithstanding likely seasonal increases in fruit & vegetable prices. Rising NZD-denominated food commodity prices point to a subsequent uplift in retail food prices. **Dwelling rents for the June month are expected to continue to move up** given strong demand for rental properties by tenants and anecdotes suggesting a hike in rents following policy changes to phase out interest rate deductibility of investor mortgages.

Our provisional Q2 Consumer Price Index pick is for a 0.8% quarterly increase, with the annual rate of inflation rate expected to climb to 2.8% - its highest in a decade**. A combination of rising costs, capacity frictions and reduced consumer resistance to having to pay higher prices is expected to contribute to a generalised strengthening in prices**, with annual tradable and non-tradable inflation rates both nearing 3%. Solid quarterly positive contributions are expected to come from the housing, food prices and transport groups, but we will be also looking at the wider CPI basket for signs of uplift. We expect inflation readings from the core measures produced by Statistics NZ and estimated by the RBNZ to remain more contained, staying closer a 2% annual rate. Solid demand, stretched capacity, less consumer resistance to higher consumer prices and firming cost and wage pressures are expected to nudge annual headline and core inflation rates higher still. We see annual headline CPI inflation ending 2021 at above 3%. The time for emergency OCR settings is over and ASB expects a gradual pace of OCR hikes to commence before the end of the year (likely November).

Major International Events for the week ahead

Data	Date	Time (NZT)	ASB
China Trade Balance, June, US$bn	13/07	-	45
UK CPI, June, %yoy	14/07	6:00 pm	-
US Beige Book	15/07	6:00 am	-
Australia Unemployment Rate, June, %	15/07	1:30 pm	4.9
China Retail Sales, June, %yoy	15/07	2:00 pm	11.0

UK Unemployment, May, %	15/07	6:00 pm	-
Bank of Japan, Interest Rate Announcement, %	16/07	-	0.0
US Retail Sales, June, %mom	16/07	12:30 am	-0.2

** Forecasts and commentary originally published by CBA Global Markets Research Friday 9 July at 1:26 pm*

We expect **China's export growth** to ease to 23%yoy because of easing new export orders in the manufacturing PMI. However, the current rising virus wave in Asia outside China implies reduced competition for Chinese exports. High commodity prices supported Chinese imports. We expect import growth to slow to 30%yoy. The trade surplus may stay steady at US$ 45bn.

The leading indicators of the **Australian labour market** are very strong. We expect another large lift in employment (+45k) in June. Alongside a tick up in the participation rate to 66.3% this would see the unemployment rate fall to 4.9%. With a strong economy alongside international border closures limiting the import of additional labour, we are seeing the labour market tighten quickly.

We expect **China's growth momentum** to ease, partly because of fading base effects. Growth in retail sales may ease to 11%yoy because of lingering consumer fear and lockdowns. We expect industrial production to slow slightly to 8.5%. Growth in YTD fixed asset investment may decelerate to 12.5%yoy because of waning support from infrastructure and property. We expect GDP growth to decelerate to 8.5%yoy in Q2 2021.

We expect the **Bank of Japan (BoJ)** to maintain the status quo at the July. However, the BoJ is likely to downgrade the economic outlook to reflect the economic costs of a third State of Emergency (SoE). The outlook remains bleak. Japanese PM Suga just announced a fourth State of Emergency for Tokyo just before the Olympics games. Tokyo accounts for 20% of Japanese GDP. There is also a possibility the BoJ follows other central banks by seeking to mitigate climate change with its asset purchases.

The Beige book is the US Federal Reserve's qualitative survey of business conditions. Financial market participants will be interested in views on supply chains and labour costs.

UK inflation is on track to modestly exceed the Bank of England's (BoE) Q2 forecast of 1.7%. UK headline CPI inflation is expected to remain sticky above 2% in June because of higher prices for transport, recreation and clothing. The BoE anticipates inflation to peak in 2021 Q4 at around 2.5%.

The **UK unemployment** rate dipped to 4.7% in the three months to April and is printing better than the Bank of England's projection of 5.2% over Q2. Rising job vacancies suggests labour market slack will continue to diminish at an encouraging pace.

US retail sales may be soft again for another month. However, the softness mainly reflects a shift in spending from goods to services.

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	0.6	0.8	-0.1	-0.7	0.4	0.6
GDP real - A%	2.4	15.5	2.1	2.9	0.5	4.0	2.5
GDP real - AA%	-2.3	4.0	4.5	5.4	4.9	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	1.0	0.7	0.7	0.4	0.5
CPI - A%	1.5	2.8	3.1	3.4	3.2	2.0	2.2
HLFS employment growth - Q%	0.5	0.5	0.3	0.3	0.3	0.4	0.4
HLFS employment growth - A%	0.3	1.0	2.0	1.6	1.4	2.0	1.5
Unemployment rate - %sa	4.7	4.5	4.5	4.3	4.2	3.8	3.9

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

(end of quarter)	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Mar-23	Mar-24
	<< actual	forecast >>					
NZ OCR	0.25	0.25	0.50	0.50	0.75	1.00	1.50
NZ 90-day bank bill	0.35	0.50	0.65	0.75	0.90	1.25	1.70
NZ 2-year swap rate	0.78	1.00	1.10	1.20	1.30	1.60	2.00
NZ 5-year swap rate	1.36	1.50	1.60	1.70	1.80	2.10	2.35
NZ 10-year swap rate	1.88	1.90	2.00	2.10	2.20	2.45	2.65
NZ 10-year Bond	1.77	1.80	1.90	2.00	2.10	2.35	2.55

ASB foreign exchange forecasts

(end of quarter)	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Mar-23	Mar-24
	<< actual	forecast >>					
NZD/USD	0.73	0.69	0.67	0.68	0.69	0.72	0.72
NZD/AUD	0.91	0.93	0.92	0.94	0.92	0.92	0.92
NZD/JPY	80	78	76	79	81	85	85
NZD/EUR	0.59	0.59	0.59	0.61	0.61	0.60	0.55
NZD/GBP	0.51	0.51	0.50	0.50	0.51	0.51	0.51
NZD/CNY	4.7	4.5	4.4	4.4	4.4	4.5	4.5
NZD TWI	75.5	73.2	71.3	72.8	73.0	74.4	73.8

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