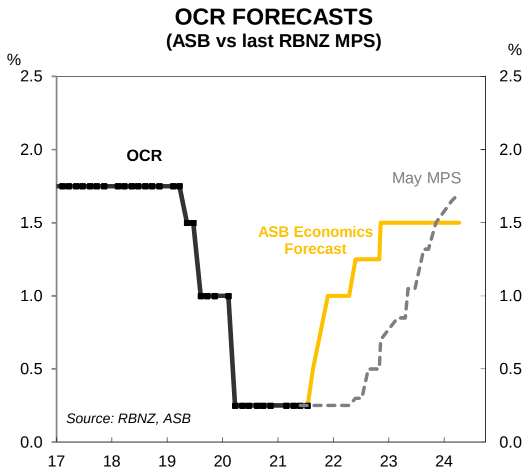
ASB

Economic Weekly

16 August 2021

Ready. Set. GO



We've spilt a lot of digital ink over the past month or so writing about the coming RBNZ meeting and all of its attendant implications. This week, the wait is finally over – put the jug on and make a brew for the usual 2:00pm Wednesday kick-off. In case the point isn't quite drilled in yet, we expect the Bank to respond to sustained inflationary pressure and the hot labour market with a 25bps OCR hike to 0.50%. We expect that move to kick off a tightening cycle that will see the OCR reach 1% by the end of the year.

With the OCR at an all-time low even prior to COVID's emergency 75bps cut, this'll be the first hike in a very long time. Indeed, with the exception of a handful of short-lived hikes in 2010 and 2014, the OCR has been on a downward trend for well over a decade. Your 26-year-old columnist can't quite believe the OCR can go up as well as down.

During the post-global financial crisis era, the RBNZ began reducing stimulus on a couple of occasions (those aforementioned 2010 and 2014 rate hikes), only to have to begin reversing course less than a year later as it became apparent the economic recovery was proving more sluggish than anticipated and inflation was more likely to undershoot than overshoot the target band.

While it's certainly conceivable the Bank might need to perform a similar U-turn once again – particularly in the event of a Sydney-style delta variant outbreak – this time around, we actually think the risks are skewed towards both a faster pace *and* greater scale of OCR hikes than our core forecasts imply. The reasons for this divergence in outlook from the latest recovery are manyfold. Global demand is recovering much faster, supported by wide-scale fiscal and monetary stimulus. The NZ border closure and lack of inward migration has seen the labour market hit capacity much earlier than in previous recoveries. The tight labour market is working in tandem with logistics disruption overseas to boost supply-side inflationary pressures at a speedier clip than is usual at this point in the economic cycle.

As we noted last week, the uptick in inflationary pressure and the strength of the labour market have been such that we wouldn't entirely rule out the RBNZ seeking to get ahead of things with a double-bubble 50bps hike. Similarly, there's plenty of scope for the OCR to finish up at a higher endpoint than the 1.5% we expect it to hit in the latter half of 2022. While both wholesale and retail rates have pre-emptively moved higher over the past month or so, we still see more upside risk than downside and it's a prudent time for borrowers of any shape and size to be reviewing their interest rate exposures. nathaniel.keall@asb.co.nz

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7042	0.7018	0.7019	0.6533	FLAT	0.6900	0.7100
NZD/AUD	0.9552	0.9542	0.9435	0.9138	UP	0.9420	0.9600
NZD/JPY	77.20	77.35	77.21	69.82	FLAT	76.00	80.00
NZD/EUR	0.5969	0.5966	0.5943	0.5530	FLAT	0.5840	0.6100
NZD/GBP	0.5077	0.5060	0.5072	0.5002	FLAT	0.5000	0.5200
TWI	74.9	74.4	74.1	70.92	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/USD continues to shuffle sideways in its now familiar 0.6900-0.7100 range. Last week the kiwi's range was even tighter at around 0.6980-0.7060. There's heightened potential for a range break one way or the other this week given the RBNZ meeting locally, and the release of the FOMC Minutes in the US.

Even though the NZD/USD is stuck in a sideways range, the currency has actually been outperforming. The NZD sits top of the G10 currency rankings for August, NZD/AUD is at 8-month highs around 0.9550, and the trade-weighted NZD has also been grinding higher since June. All of this reflects the fact domestic NZD fundamentals remain supportive, a point we have frequently emphasised. The big mover on this front has been interest rate differentials. NZ-US 2-year swap differentials have soared to 103bps from 40bps as recently as June. This reflects expectations the RBNZ will begin lifting the OCR this week, and lift it a further two times before the year is out.

Assuming the RBNZ lifts the OCR 25bps on Wednesday (per our forecast), the NZD reaction will depend on what the RBNZ signals regards the pace of future tightening. We don't think a 50bps hike (20% chance priced) would necessarily send the NZD soaring, as the market would likely just view it as a front-loading, with the implication being the Bank will pause at the next meeting in October. Overall, we view the event risk from the RBNZ as a mild currency positive, but there's already plenty priced in.

Offshore, the most notable event is the release of the US Federal Open Market Committee (FOMC) minutes on Thursday morning. Our friends at CBA reckon there's some USD upside risk emanating from these. We expect the FOMC to announce it is tapering monthly asset purchases next month, assuming August employment figures are decent. So, if this week's Minutes show the FOMC discussing the possibility of announcing a taper in September, the USD could lift. Fed chair Powell, speaking Wednesday, could provide some hints along these lines.

In Australia, COVID news continues to worsen. By association, the contrast in relative monetary policy stances between the RBNZ and RBA continues to widen. This should keep NZD/AUD underpinned this week, with the RBNZ meeting serving to highlight the gulf. We'd expect NZD/AUD to keep grinding higher until we see some evidence the Aussie COVID situation is stabilising. Our short-term valuation model estimates a 0.9170-0.9570 'fair-value' range.
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ASB foreign exchange forecasts (end of quarter)	Mar-21	Jun-21 <<actual	Sep-21 forecast >>	Dec-21	Mar-22	Jun-22	Mar-23	Mar-24
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	0.67	0.65	0.46	0.30	UNCH	UP
2-year swap	1.34	1.27	1.09	0.13	UNCH	UP
5-year swap	1.67	1.61	1.50	0.22	UNCH	UP
10-year swap	1.98	1.94	1.85	0.61	UNCH	UP
10-year govt bond yield	1.84	1.62	1.64	0.67	UNCH	UP
Curve Slope (2s10s swaps)	0.65	0.67	0.76	0.48	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 have continued to grind higher with a modest curve flattening bias. Last week saw short-term NZ yields lift, market pricing for OCR hikes firm, and with 90-day bank bill rates, the 2-year NZ swap and yields in the belly of the curve at post-pandemic highs. NZ 10-year swap yields hit a two-month high. Local data were supportive, with resilience still evident in housing market data and sentiment measures holding up (NZ PMI and PSI). However, NZ yields dipped and market pricing for OCR hikes were slightly pared back after longer-term inflation expectations from the RBNZ survey were little changed.

Global yields have been largely directionless. Last week's passage of the USDD1 trillion infrastructure bill through the US Senate and Senate Democrats outlining a USD3.5bn spending plan provided a lift to Treasury yields. A number of Federal Open Market Committee (FOMC) members continued to push for the tapering of the USD120bn in monthly asset purchases. However, worsening delta variant cases overseas (lockdowns were extended to New South Wales), and weaker US data (consumer sentiment) pushed yields lower at the end of last week. Yields eased after CPI data hinted inflationary pressures may have already peaked and were likely to cool.

Near-term interest rate outlook

Close to 30bps of OCR hikes are priced in for August, 65bps by November, and a terminal OCR cash rate of close to 1.60%. This is close to our core economic view. We expect the RBNZ to take a 'least regrets' approach on Wednesday and start to reduce OCR stimulus. Market reaction to the statement will hinge on the OCR decision, tone of the statement and published OCR track. We see the risk of the RBNZ delivering a more forthright statement than generally expected, including giving serious consideration to the pros and cons of a 50bp hike, a more frontloaded OCR track, and with a higher endpoint than the May MPS track (1.78%). COVID-19 remains a wild card and a community outbreak of the delta variant in NZ would push NZ yields lower as markets seek to take out pending RBNZ hikes.

Our bias is for longer-term global yields to move higher as markets 'look through' COVID-19 impacts and increasingly focus on improving prospects. However, with delta variant cases surging, the dampening impact of the pandemic on global yields could have further to run. This week's Fed Minutes of the July Fed meeting will be closely scrutinised for more details around what further progress Committee members want to see ahead of a taper. This week's data – including the monthly data dump from China, US retail sales, and Australian wage and employment - should likely attract less than usual market reaction as should the RBA Meeting Minutes,

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%), returning OCR 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 given larger rises in shorter-term yields. mark.smith4@asb.co.nz

Domestic events

Data	Date	Time (NZT)	Market	ASB
RBNZ Monetary Policy Statement, OCR	18/08	2:00 am	-	0.50

We expect the RBNZ to lift the OCR by 25bps to 0.50% at next week's August Monetary Policy Statement. Recent data has shown the labour market rapidly heading back towards full employment and sharp lifts in inflationary pressures. We expect the RBNZ will judge there is a greater risk of inflation exceeding the target band for a prolonged period than of snuffing out the recovery with premature tightening, paving the way for the next tightening cycle. The RBNZ's decision to wind up the Large-Scale Asset Purchase programme at its last meeting was a precursor. We expect the OCR to reach 1.00% by the end of the year. There is some risk of a faster pace of hikes, and a 50bps hike to 0.75% on Wednesday can't be ruled out.

Major International Events for the week ahead

Data	Date	Time (NZT)	ASB
Japan GDP, Q2, %qoq	16/08	11:50 am	0.3
RBA Meeting Minutes,	17/08	1:30 pm	-
US Retail Sales, July, %mom	17/08	12:30 am	-0.2
UK ILO Unemployment, June, %	17/08	6:00 pm	4.8
Australia Wage Price Index, Q2, %qoq	18/08	1:30 pm	0.6
UK CPI, July, %yoy	18/08	6:00 pm	2.7
US Federal Reserve Meeting Minutes	19/08	6:00 am	-
UK Retail Sales, July, %mom	20/08	6:00 pm	0.4

** Forecasts and commentary originally published by CBA Global Markets Research Friday 13 August at 11:48am*

We expect the Japanese economy to grow by 0.3%qoq in Q2 2021. The intermittent emergency measures weighed on consumption. However, industrial production expanded strongly by 1.1%qoq.

There is unlikely to be new information in the **Reserve Bank of Australia's August Meeting Minutes** with the release of the Statement on Monetary Policy and Lowe's testimony to Parliament taking place since the Meeting. The RBA's updated forecasts are too optimistic on the economy in the near term. The RBA's implied profile indicates they expect the economy to expand by 1.4% over H2 21 despite the extended lockdown in Greater Sydney.

Australia's Q2 21 Wage Price Index (WPI) is an important data release. It will give us an indication of how wages growth was tracking as the labour market was tightening (recall the unemployment rate was 4.9% in June). Private surveys suggest that wages growth accelerated over Q2 21. We expect the WPI to increase by 0.6% over Q2 21 which would take the annual rate to 1.8%.

We expect **US retail sales** eased in July. However, we expect this was driven by a redirection of spending towards services, rather than a moderation in spending more broadly. The economic re-opening is making it increasingly easier for consumers to access services. At the same time, high household savings can prop-up consumer spending.

We expect the **UK unemployment rate** remained steady at 4.8% in the three months to June. The furlough worker scheme has been an important source of support to the UK's labour market during the covid 19 pandemic. However, there is a risk that the unemployment rate lifts into year end with the furlough worker scheme expiring in September.

We expect **UK inflation** accelerated sharply over the last 12 months because of base effects (weak inflation a year ago) and re-opening frictions. Nevertheless, the Bank of England (BoE) expects the sharp rise in inflation to be transitory. As a result, we see few implications for UK monetary policy from another strong inflation print. We don't expect the BoE to raise interest rates until at least Q3 2023.

At its July policy meeting the **US Federal Reserve** provided the first concrete signal that the central bank was considering tapering asset purchases. The **minutes** will be closely scrutinised for more details around what further progress committee members want to see ahead of a taper. Any preliminary debates around timing of an announcement and implementing the taper will also be relevant for market participants. Our base case is for the US Fed to announce a taper in September.

Economic freedoms and high household savings likely provided a solid base for ongoing **retail sales growth in the UK** in July. 'Freedom day' on 19 July saw the last major coronavirus restrictions unwound. However, the already-released Retail Sales Monitor suggests the pace of growth moderated slightly in July after growth hit a near 3-year high in June.

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

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

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