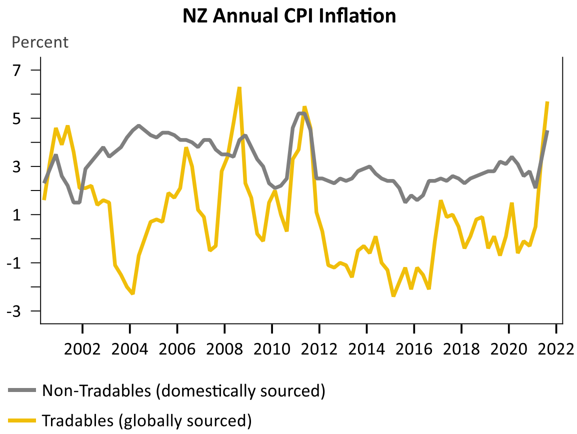
Economic Weekly

18 October 2021

COVID's impact on NZ's inflation surge

The Q3 Consumer Price Index, released this morning, revealing a stronger than expected lift in annual CPI inflation, to 4.9% - a full note covering the data will be released this morning. The key question going forward is how high will annual CPI inflation peak and how persistent will above-target inflation be.

There are multiple factors driving higher inflation pressure – much of the lift in inflation pressures over the past year has been internationally sourced (see chart opposite). Recovering global economic demand has pulled commodity prices higher, while at the same time a supply shock from supply chain disruptions has contributed to cost-push inflation. There isn't much the RBNZ can do about globally-sourced inflation pressure but monitor and react to the impact on NZ wage and price setting behaviours. Already, inflation pressures have led to a lift in the RBNZ's much watched 2-year-ahead inflation expectations measure above the 2% inflation target midpoint, to 2.3%. This increase is likely a contributing factor to the RBNZ's determination to unwind policy stimulus despite current COVID uncertainties.



Source: Macrobond, ASB

Going forward over the next year, the key driver of inflation pressures was expected to shift towards domestic drivers, as the labour market was extraordinarily tight prior to the NZ Delta community outbreak (indeed domestically driven inflation lifted by much more than we expected in Q3). However, going forward the labour market outlook is less clear. Since the August outbreak, the numbers on job seeker benefits have lifted, albeit a mere fraction of the lift seen in the March 2020 outbreak – which suggests firms are making a strong effort to hold onto staff. However, the longer Alert level 3 restrictions drag on in Auckland, the slower and less complete the NZ economic recovery will be – and this will also be reflected in the labour market. We believe the restrictions are likely having a disproportionate impact on small business owners. Without further support to those locked out of their businesses for over 2 months, there is a concern that many of these small business owners can't hang on much longer.

Finally, we are potentially only months away from border restrictions being eased, possibly allowing more NZer's to come home. NZ could see a perfect storm of softening labour demand, but an increase in labour supply from early next year and *if* this was to happen it would relieve some of the domestic inflation risks for the RBNZ. However, the key word here is if – there remains a significant degree of uncertainty over the next 3-6 months as the world continues to learn how to manage Delta. jane.turner@asb.co.nz

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Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7092	0.6930	0.7078	0.6593	FLAT/UP	0.6900	0.7175
NZD/AUD	0.9546	0.9470	0.9687	0.9315	FLAT	0.9485	0.9700
NZD/JPY	81.07	78.09	77.74	69.38	UP	79.00	82.00
NZD/EUR	0.6113	0.5988	0.6011	0.5633	FLAT/DOWN	0.6000	0.6150
NZD/GBP	0.5154	0.5081	0.5126	0.5113	FLAT	0.5000	0.5200
TWI	75.4	73.8	75.0	71.0	FLAT/UP	N/A	N/A

*^ Weekly support and resistance levels * Current as at 11.45am today; week ago as at Monday 5pm*

NZD Recap and Outlook

The NZD was the top of the pops last week. Against a backdrop of a broadly weaker USD, the NZD/USD rose by the most of all the G10 currency pairs (1.8%). It currently trades around 0.7090, having just received an additional boost from this morning's booming CPI outturn.

Both global and domestic drivers are swinging in behind the kiwi. Globally, the prior week's stagflation fears flicked back to more of a reflation vibe with global growth indicators holding firm amid still-mounting inflation pressures. Commodity prices globally are soaring, bond yields appear to be trending higher again, and risk appetite is back on a firm footing. Evidence of the latter can be found in the fact the VIX index is back down around its recent post-COVID lows around 16%.

Domestically, the seemingly relentless rise in local wholesale interest rates continues to fatten NZ-US yield differentials, another source of fundamental support for the currency. The local 2-year swap yield hit a fresh 2½ year high of almost 1.7% last week, widening the differential to the US equivalent to 5-year highs around 115bps.

Overall, last week's NZD rebound highlights the risk we continue to flag (including in the most recent CHT) that the NZD is likely to outperform in any episodes of USD weakness given its superior (interest rate and commodity price) fundamentals. Should the USD remain on the back-foot this week, the NZD/USD can make further progress to the topside. Still, this is all within the confines of the broader sideways range, which we expect to hold. We doubt the NZD/USD will be able to push through stiff resistance in the 0.7150-0.7170 window this week.

We're slightly more positive on NZD/JPY, which continues to follow gyrations in global risk appetite very closely. The recent flick back toward more positive global sentiment promises to keep the NZD/JPY on the ascendancy, following on from the strong performance last week. Key event risk for currencies this week comes from this afternoon's Chinese activity updates, Tuesday night's GDT auction, and another round of global inflation data.

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Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	0.50	0.50	0.25	0.25	UNCH	UP
90-day bank bill	0.74	0.66	0.68	0.28	UNCH	UP
2-year swap	1.80	1.49	1.50	0.03	UNCH	UP
5-year swap	2.22	1.96	1.82	0.10	UNCH	UP
10-year swap	2.49	2.35	2.12	0.46	UNCH	UP
10-year govt bond yield	2.38	2.12	1.88	0.54	UNCH	UP
Curve Slope (2s10s swaps)	0.68	0.87	0.62	0.43	UNCH	DOWN

** Current as at 11.45am today; week ago as at Monday 5pm. Key UNCH = Broadly unchanged*

Market recap

Local yields spiked this morning after Q3 NZ CPI data significantly surprised the market consensus and the RBNZ to the upside. Swap yields have jumped 10-20bp since the CPI release to fresh post-pandemic highs, with the bellwether 2-year swap yield (1.79%) at its highest level since March 2019. The rise in yields has been despite mushrooming community cases of the delta variant in Auckland and the indication that current restrictions are unlikely to be relaxed soon. Interest rate markets have been selective to other data, with little reaction to most local and global data and only fleeting reaction from data surprises, including stronger than expected business confidence from the ANZ October survey. After peaking early last week, local longer-term yields followed global counterpoints lower but since have firmed in step with global peers at the end of last week and jumped after today's CPI release.

Global short terms yields and those in the belly of the curve have moved up. US 2-year Treasury yields touched their highest level (0.40%) since March 2020, helped by firm US inflation data, improved risk sentiment, and with the FOMC Minutes signalling the pending withdrawal of policy stimulus. Australian yields have ground higher, with the 3-year bond yield hitting 0.60% last week, a close to 30bp rise over the past month. **Global longer-term yields are lower than a week ago,** with US 10-year Treasury yields (1.57%) and Australian 10-year government bond yields (1.64%) down around 4-7bps over the week despite firming towards the end the last week on improving risk sentiment.

Near-term interest rate outlook

Market pricing has 35bps of hikes in November, with roughly 60bps of hikes out to February and roughly 130bps of hikes out to late 2022. **Given our wariness around the inflation outlook, the path of least resistance had earlier been for short-term yields to push higher**. This could have further to run, and we would not rule out a 50bp OCR hike at some stage, notwithstanding the 'considered steps' RBNZ view. By the same token, our circa 1.50%-1.75% neutral OCR view and the risks of scarring from the delta outbreak suggests some risk of a pullback.

Our bias is for global yields to move higher as markets increasingly focus on improving prospects. Elevated inflation readings are expected in the UK and Canada. Surging energy prices (near-term contract oil prices at around 7-year highs), and last week's FOMC signal of an end of year taper to its USD120bn in monthly asset purchases (cessation of net purchases by mid-2020) should be supportive. We don't expect much reaction from tomorrow's RBA Minutes.

Nevertheless, we have maintained our long-held curve flattening bias. There is still scope for local short-term yields move higher, even though moves in global counterparts look a tad overdone. There are other risks on the horizon – US fiscal policy gridlock, wobbly equities, and risks of financial contagion – that could drive a period of increased volatility and risk aversion.

Medium-term outlook

We have pencilled in 25bp hikes in November and February, with the OCR peaking at 1.50% by late 2022. Uncertainty is high and the OCR could follow a number of different paths. Our CBA colleagues expect RBA cash rate hikes from May 2023, with a 1.25% endpoint. The US FOMC is expected to implement tapering asset purchases from December 2021 (ending by July 2022), with rate hikes from late 2022 (1.50% by late 2023). Longer-term yields are expected to peak at low levels, with the yield curve flatter given larger rises in shorter-term yields. mark.smith4@asb.co.nz

Major International Events for the week ahead

Data	Date	Time (NZT)	ASB
China GDP, Q3, % YTD yoy	18/10	3:00 pm	12.7
China Retail Sales, September, YTD yoy	18/10	3:00 pm	18.1
China Industrial Production, September, YTD yoy	18/10	3:00 pm	13.1
US Industrial Production, September, %/mth	19/10	2:15 am	0.2
Bank of Canada Business Outlook Survey	19/10	3:30 am	-
RBA Minutes of October Meeting	19/10	1:30 pm	-
UK CPI, September	20/10	7:00 pm	-
Canada CPI, September, %/yr	21/10	1:30 am	4.3 core, 2.6 headline
Panel Participation by RBA Governor Lowe	22/10	8:00 am	-
Japan CPI, September, %/yr	22/10	12:30 pm	0.1 core, 0.2 headline
UK Retail Sales, September	22/10	7:00 pm	
Eurozone PMIs, September	22/10	9:00 pm	-
UK PMIs, September	22/10	9.30 pm	-
Canada Retail Sales, August, %/mth	23/10	1:30 am	2.1

** Forecasts and commentary originally published by CBA Global Markets Research Friday 11th October*

A glut of **Chinese data** is released this week. We expect sequential retail sales growth to rebound in September. Annual growth might have lifted to 4.5%/yr. We predict industrial production growth to slow to 4%/yr on waning demand and restrictions on production. Year-to-date fixed asset investment growth may have eased slightly to 8.2%/yr. We expect GDP growth to slow to 0.6%/qtr in Q3 2021 because of easing growth momentum and the disruption of virus outbreaks.

We expect a muted 0.2%/mth increase in **US industrial production** in September. Overall, demand remains strong. But supply shortages, particularly in the vehicle and parts sector, are likely to have continued to constrain production. The closure of Gulf Coast crude production in the first half of September following Hurricane Ida likely also weighed on industrial production.

The **Bank of Canada Business Outlook Survey** indicator rose to a record high in Q2. Business sentiment broadened amid rising vaccination rates and easing restrictions. Nevertheless, the resurgence of Covid-19 infections likely dampened sentiment in Q3. Attention will be on indicators of capacity pressures and labour shortages which intensified in the last quarter. The tightening labour market and persistent supply-side constraints are an upside risk to Canada's consumer price inflation and could bring forward the BoC's first rate hike.

We do not anticipate any new information in the latest **RBA Minutes**, with the comprehensive Financial Stability Review (FSR) released after the meeting. The FSR went into detail about the RBA's view on the housing market and the introduction of new macro prudential measures through the lift in the serviceability buffer. The rest of this year should remain low key for RBA policy watchers, with policy changes not expected till early 2022 when the next taper of bond purchases is due to be reviewed.

UK headline and core CPI inflation quickened more than expected in August to be above 3% on an annual basis. The Bank of England projects inflation to rise over the rest of the year, reaching 4% in Q4, before returning to 2% in late 2023, as energy and core goods inflation strengthens further and then falls back.

Canadian headline CPI inflation surged to the highest level since March 2003 in August. We expect CPI to press higher to 4.3%/yr in September. Gasoline and housing costs will have further added to price pressures. We expect the average of the three measures of core inflation preferred by the BoC to remain well above target at 2.6%/yr in September.

RBA Governor Lowe is due to speak on a panel Universidad de Chile's Conference on Central Bank Independence.

There is unlikely to be anything policy relevant.

We forecast **Japanese CPI inflation** to rebound to 0.2%/yr because of higher energy prices and recovering demand. Core inflation, excluding food and energy, may have lifted to 0.1%/yr.

UK retail sales volumes were up 0.3% in the three months to August compared with the previous three months. High-frequency indicators of mobility and card spending point to a levelling off in retail sales activity.

Eurozone PMIs will show if the risk of stagflation is easing or increasing. In September, the composite PMI fell to a five-month low of 56.1 and firm's input price gauge hit a 21-year high, indicative of slower economic growth momentum and steeply rising prices.

UK PMIs will show if the risk of stagflation is easing or increasing. In September, the composite PMI fell to a seven-month low of 54.1 and firm's input price gauge surged to a record high, indicative of slower economic growth momentum and steeply rising prices.

We forecast **Japanese CPI inflation** to rebound to 0.2%/yr because of higher energy prices and recovering demand. Core inflation, excluding food and energy, may have lifted to 0.1%/yr.

Statistics Canada's advance estimate suggests **Canadian retail sales** increased by 2.1%/yr in August. However, the risks are skewed to a weaker print. Covid-19 infections picked up rapidly in August. Virus concerns could have weighed on consumer spending.

Key Forecasts

ASB NZ economic forecasts	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Mar-23	Mar-24
	<< actual	forecast >>						
GDP real - Q%	2.8	-8.4	6.2	1.0	1.5	1.2	0.4	0.7
GDP real - A%	17.4	-5.6	1.2	0.8	-0.4	10.1	3.6	2.5
GDP real - AA%	5.1	3.3	3.6	3.0	-1.0	2.8	4.2	2.2
NZ House Prices (QV Index) - A%	28.2	27.8	22.1	14.9	8.8	4.3	2.6	6.8
CPI - Q%	1.3	1.6	0.8	0.7	0.6	0.8	0.5	0.5
CPI - A%	3.3	4.3	4.6	4.4	3.6	2.8	2.3	2.3
HLFS employment growth - Q%	1.1	-0.4	-0.2	0.2	0.6	0.5	0.2	0.4
HLFS employment growth - A%	1.7	1.9	1.0	0.6	0.1	1.0	1.6	1.3
Unemployment rate - %sa	4.0	4.1	4.5	4.5	4.3	4.1	4.2	4.2

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	Sep-22	Mar-23	Mar-24
(end of quarter)		<< actual	forecast >>					
NZ OCR	0.25	0.25	0.75	1.00	1.25	1.25	1.50	1.50
NZ 90-day bank bill	0.35	0.65	1.00	1.25	1.50	1.60	1.75	1.75
NZ 2-year swap rate	0.78	1.42	1.57	1.67	1.77	1.87	2.02	2.22
NZ 5-year swap rate	1.36	1.87	1.97	2.07	2.17	2.22	2.32	2.52
NZ 10-year swap rate	1.88	2.24	2.29	2.34	2.39	2.44	2.54	2.74
NZ 10-year Bond	1.77	1.97	2.19	2.24	2.29	2.34	2.44	2.64

ASB foreign exchange forecasts	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Mar-23	Mar-24
(end of quarter)		<< actual	forecast >>					
NZD/USD	0.70	0.69	0.67	0.68	0.69	0.70	0.72	0.72
NZD/AUD	0.93	0.96	0.92	0.94	0.92	0.91	0.92	0.92
NZD/JPY	77	77	76	79	81	83	85	85
NZD/EUR	0.59	0.59	0.59	0.61	0.61	0.60	0.60	0.55
NZD/GBP	0.51	0.51	0.50	0.50	0.51	0.51	0.51	0.51
NZD/CNY	4.5	4.4	4.4	4.4	4.4	4.4	4.5	4.5
NZD TWI	73.7	73.7	71.6	73.1	73.3	73.5	74.6	73.9

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