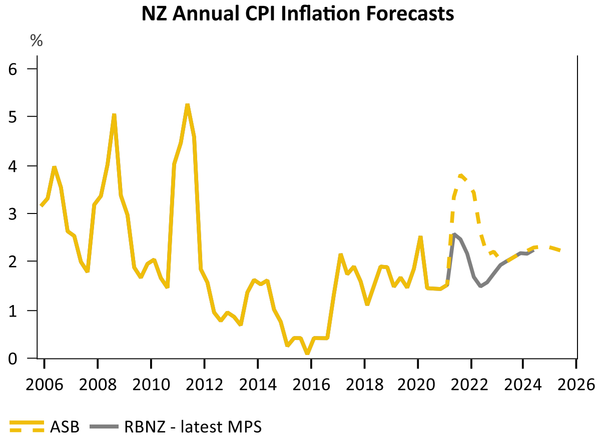
Economic Weekly

19 July 2021

Heading off the inflation sucker punch

When asked about strategy in the ring, the great Mike Tyson – up there with Adam Smith and J.M. Keynes as one of history's great Economic sages – once said, "everybody's got a plan until they get punched in the mouth.".



Source: Macrobond, ASB

Until relatively recently, major central banks had similar plans for how they expected the next couple of years to play out. While the pandemic fallout hadn't been as bad as feared in many parts of the world, the recovery would be a fragile thing and monetary policy would need to remain highly accommodative for some time as the labour market wended its way back to health. 'Transitory' factors would see inflation tick up over the short term, before once again abating. Rate hikes would come slowly and at a gradual pace. The RBNZ was very much part of this cohort.

Over the past couple of months, a succession of left and right jabs has meant those plans have gone out the window. For the RBNZ, the left punch here has been the resilience in the labour market, with the economy looking closer to full employment, much earlier than the Bank previously forecast. The right hook has been the continuing build up in inflationary pressures, culminating in the monster CPI result on Friday, which saw annual inflation hitting 3.3% (versus the RBNZ's expectations of a 2.8% lift). Neither factor looks likely to throw in the towel any time soon – in particular, we expect headline inflation to approach 4% over the second half of the year as stretched capacity pressures linger.

Sure enough, we saw the RBNZ change tack and make a sharp hawkish turn at last Wednesday's Monetary Policy Review (after some hints back in May), announcing the end of the Large-Scale Asset Purchase programme and excising wording around the 'considerable time and patience' the recovery would need. We now expect a swift one-two of 25bps OCR hikes in August and November.

Still, despite the change of plan, not all of our views have shifted dramatically. While there is some risk the Bank moves to quickly normalise policy, we still think it's more likely to stick to a gradual pace given the lingering uncertainty – NSW's mishandled outbreak of the Delta COVID variant shows there are clearly still downside risks remaining. And we continue to expect a relatively low OCR endpoint of 1.50%.

Still, the direction of travel is clear – wholesale and retail rates are past their lows and are likely to head higher, sooner than previously expected. For borrowers and savers, it's a prudent time to review interest rate exposures and check you've got the right mix for your financial needs. nathaniel.keall@asb.co.nz

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7003	0.6985	0.6981	0.6546	FLAT	0.6915	0.7100
NZD/AUD	0.9459	0.9342	0.9278	0.9366	FLAT	0.9390	0.9500
NZD/JPY	77.07	76.95	76.91	70.16	FLAT	76.00	78.00
NZD/EUR	0.5930	0.5885	0.5861	0.5748	FLAT	0.5750	0.6000
NZD/GBP	0.5085	0.5028	0.5021	0.5208	FLAT	0.4950	0.5150
TWI	74.4	73.6	73.2	72.08	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

Big week last week! The RBNZ acknowledged super-easy monetary policy has overstayed its welcome and surging local inflation figures confirmed this picture of an overheated economy. Local interest rates soared as OIS markets moved to price nearly two RBNZ rate hikes by the end of 2021.

But despite all this the NZD/USD is barely higher than where it began the week. This speaks to the current strength of the USD, which is being bolstered by the outperforming US economy and expectations the Fed will start tapering asset purchases in coming months.

The USD may receive an additional boost from relative monetary policy expectations this week, as we expect the European Central Bank (ECB) to present a more dovish policy framework when it meets on Thursday. The firm greenback should serve to cap further gains in the NZD/USD to the 0.7050-0.7100 resistance window in the short term.

It’s been against the NZD crosses where NZ’s economic and interest rate outperformance has been most evident. NZD/AUD rocketed to a 5-month high above 0.9450 last week and we think additional gains could be in store for the cross. While NZ desperately needs higher interest rates, the near-term economic outlook in Australia has deteriorated sharply because roughly half of Australia’s population and economy is locked-down. The Covid-19 outbreak, and associated disruption to the economy, risks the RBA delaying tapering its asset purchases.

Our short-term NZD/AUD valuation model has revalued ‘fair-value’ in the cross around a cent higher following the events of last week, with higher NZ-AU interest rate differentials driving most of the change. It now estimates a 0.9150-0.9550 fair-value range, suggesting NZD/AUD can continue to move up into the ‘0.9500s’ without looking expensive.

The week ahead looks much quieter as far as event risk goes. Aside from the ECB meeting already mentioned, July PMIs will be the global highlight. We might expect a small pullback reflecting the growth-restraining impact of the spreading Delta variant. Locally, there’s just the GDT dairy auction for which we expect WMP prices might fall a bit.
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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	0.73	0.69	0.67	0.68	0.69	0.72	0.72
NZD/AUD	0.92	0.91	0.93	0.92	0.94	0.92	0.92	0.92
NZD/JPY	77	80	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	4.7	4.5	4.4	4.4	4.4	4.5	4.5
NZD TWI	73.9	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	0.46	0.32	0.33	0.30	UNCH	UP
2-year swap	1.08	0.84	0.68	0.21	UNCH	UP
5-year swap	1.49	1.34	1.34	0.33	UNCH	UP
10-year swap	1.85	1.77	1.90	0.70	UNCH	UP
10-year govt bond yield	1.75	1.53	1.79	0.90	UNCH	UP
Curve Slope (2s10s swaps)	0.77	0.93	1.22	0.49	UNCH	DOWN

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

NZ Interest Recap and Outlook

NZ short-term interest rates lifted over the past week as an OCR hike from the RBNZ in August now appears to be a done deal, while moves in the longer-term rates were more modest seeing the yield curve flatten.

When the economic backdrop shifts, it tends to do so fast. And that has been the case over the past two weeks for the OCR outlook. Just two weeks ago, following the NZIER Quarterly Survey of Business Opinion we brought forward the timing of RBNZ policy normalisation from mid-2022 to late-2021 – with other economists also following our lead. However, following the RBNZ OCR review on Wednesday and the red-hot Q2 CPI print on Friday, we led the shift in the consensus again, and now expect the RBNZ to hike in August with debate now shifting to how hard and how fast the RBNZ needs to go.

By the close of Friday, the 1-year swap rate has lifted 29 basis points compared to Monday, while the 2-year lifted 25 basis points. Longer-term interest rates remained anchored, however, influenced by moves offshore, with the 5-year swap up just 17 basis points and the 10-year up just+ 8bp.

At the start of last week, market OIS pricing had a 25 bp hike almost fully priced in for November this year and the OCR reaching 1% by November 2022. By Friday, market pricing had shifted and was consistent with 88% chance of a move in August and OCR returning to 1% by May next year.

We now expect the RBNZ to hike 25bp a-piece in August, November and February. The risk is the RBNZ does hike harder and faster than this profile. The next key pieces of data include the Q2 labour market data on Wednesday 4th of August and the RBNZ's inflation expectations survey on the 12th of August. While stronger data could up the risk of a 50bp move or a faster return to 1%, the RBNZ may also be mindful of the risks of moving too far too fast. In particular, other central banks are unlikely to be hiking quite yet. And there are also lingering uncertainties about the COVID-19 backdrop and how NZ's fortunes could pan out when borders are more open once vaccination rates are high, and what that in turn means about the risks of COVID-19 in NZ. In addition, the RBNZ needs to remain mindful of the lessons of the 2014 tightening cycle when the RBNZ went too hard too fast and missed signs of the underlying structural shift in the NZ and global economy which had taken place in the wake of the 2008/09 Global Financial Crisis. These hikes had to be unwound over 2015 and 2016.

Offshore, it was a mixed week for global financial market sentiment and US interest rates. The US 10-year bond yields lifted early in the week but ultimately finished the week lower. The stronger-than-expected US June CPI inflation data out Tuesday night drove US rates higher, with US fixed interest markets bringing forward the first Federal Funds rate hike to late 2022. But US rate expectations were subsequently tempered by testimony from Fed Chair Powell who said it was too soon to start tapering asset purchases. Over the weekend financial market sentiment started to deteriorate on concerns about rising COVID-19 infection rates and signs of softening US consumer confidence.

It is a quiet week ahead, both domestically and abroad. In Australia, the RBA meeting minutes are released on Tuesday, but we are not expecting the minutes to contain any new information. Meanwhile, the ECB meets on Thursday and is widely expected to make no policy changes. jane.turner@asb.co.nz

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	2.0
Australia Unemployment, June, %	15/07	1:30 pm	4.9
China GDP, Q2, %yoy	15/07	2:00 pm	8.5
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 16 July at 10:58am*

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 reduce 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%. 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. Japan 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.

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	Jun-22	Mar-23	Mar-24
	<< actual	forecast >>						
GDP real - Q%	1.6	0.6	0.3	0.1	-0.7	1.7	0.4	0.6
GDP real - A%	2.4	15.5	1.6	2.7	0.3	1.3	3.8	2.5
GDP real - AA%	-2.3	4.0	4.3	5.2	4.7	1.5	2.5	2.5
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	1.2	0.3	0.6	0.5	0.4	0.5
CPI - A%	1.5	3.3	3.9	3.7	3.5	2.7	2.0	2.2
HLFS employment growth - Q%	0.5	0.5	0.1	0.3	0.3	0.5	0.4	0.4
HLFS employment growth - A%	0.3	1.0	1.8	1.5	1.2	1.3	2.0	1.5
Unemployment rate - %sa	4.7	4.5	4.6	4.5	4.4	4.1	4.0	4.1

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	0.75	1.00	1.00	1.25	1.50
NZ 90-day bank bill	0.35	0.35	0.65	0.90	1.00	1.15	1.50	1.75
NZ 2-year swap rate	0.47	0.78	1.10	1.20	1.30	1.40	1.65	1.85
NZ 5-year swap rate	1.12	1.36	1.55	1.65	1.75	1.85	2.00	2.20
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/EUR	0.60	0.59	0.59	0.59	0.61	0.61	0.60	0.55
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NZD TWI	73.9	75.5	73.2	71.3	72.8	73.0	74.4	73.8

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