Economic Weekly

28 February 2022

Russia’s invasion adds to the world’s challenges

After weeks of military build-up, Russia invaded the Ukraine last week, the biggest European conflict since World War 2 ended. Economic ripples are starting to be felt, and longer-term geopolitical shifts will also follow.

Economically, the most immediate effects are from the potential disruptions of global supplies of key goods that both Russia and the Ukraine supply. Russia is a major exporter of oil and gas, and Europe has a particular Archilles heel through its heavily reliance on piped gas. Oil prices had been lifting even ahead of the invasion as the perceived risk grows of energy supply disruption. The Ukraine and Russia are both significant grain exporters, so prices of various grains (such as wheat) have been pushed up.

NZ’s direct trade ties to Russia and the Ukraine are relatively small. The main economic impacts on NZ will come from higher global energy prices, on NZ’s cost structure and purchasing power and through the various impacts on global growth. Other impacts will be on NZ’s export commodity demand, though some export commodity prices could even firm. In contrast to the plunge in dairy prices that occurred when Russia annexed the Crimean Peninsula, dairy prices are likely to be resilient. And if livestock feed prices rise as a result of the invasion, NZ’s grass-fed dairy and meat producers would have a cost advantage over grain-fed competitors. You can read more on the dairy implications in last week’s Commodity prices report. This week’s GlobalDairyTrade will be a bellwether of the dairy price impact.

There may be a number of people out there eyeing up fluctuations in the values of their KiwiSaver or share portfolios. As was the case when the COVID pandemic broke out in 2020, this is one of those times to avoid making kneejerk investment decisions. It is important to reflect on your long-term investment goals and whether they have shifted. If you have any concerns about your investments, before taking any action it is worth checking in with your KiwiSaver provider or investment advisor to check that your choice of fund or investment portfolio remains consistent with your investment objectives. Markets do move around: in the period of fear in early 2020 global sharemarkets plunged, only to rebound strongly shortly after. Sharemarket movements to date have generally been small, though European markets are weaker in reflection of Europe’s greater economic ties and vulnerabilities to Russia.

The other news last week was the RBNZ’s widely-anticipated 25bp Official Cash Rate increase, taking the OCR back to its 1% pre-pandemic level. What was very noteworthy was that the RBNZ saw a 25bp vs. 50bp increase as “finely balanced”. The RBNZ was more concerned that high rates for actual inflation could become engrained into people’s expectations of where future inflation will track, a development that would make the RBNZ’s job of containing inflation harder. The probability of a 50bp increase at some point this year is real, should the RBNZ feel it is getting behind on its job of containing inflation. But nothing is simple at the moment. The war in the Ukraine will boost NZ inflation slightly further in the short term through higher fuel prices, compounding the RBNZ’s concerns about people’s inflation expectations. Yet the war and its ramifications could escalate from here. And NZ is just now (rapidly) entering the disruptive and challenging part of its Omicron wave. 25bp OCR lifts seem the most likely moves for the next RBNZ meeting or two. nick.tuffley@asb.co.nz

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.6685	0.6718	0.6576	0.7364	FLAT/DOWN	0.6590	0.6800
NZD/AUD	0.9310	0.9321	0.9350	0.9373	FLAT	0.9280	0.9470
NZD/JPY	77.34	77.22	75.89	78.12	FLAT/DOWN	75.90	79.20
NZD/EUR	0.5983	0.5911	0.5897	0.6055	FLAT	0.5850	0.6100
NZD/GBP	0.5007	0.4932	0.4906	0.5266	FLAT	0.4900	0.5100
TWI	71.8	71.2	70.4	76.1	FLAT/DOWN	N/A	N/A

*^ Weekly support and resistance levels * Current as at 12.30pm today; week ago as at Monday 5pm*

NZD Recap and Outlook

With the risk of stating the obvious, events in financial markets last week were dominated by Russia's invasion of Ukraine. The likelihood that some form of conflict would break had been well signposted, but the scale of the conflict was arguably on the more pessimistic side of expectations. Airstrikes and incursions have occurred right across the country and the Ukrainian capital, Kyiv, is under direct assault in a manner that many analysts thought was nigh-unthinkable just weeks ago. Overnight, the Russian President Vladimir Putin placed Russia's nuclear deterrence forces on high alert, so we can now add 'nuclear brinkmanship' to the seemingly endless list of things to make us anxious.

Western sanctions are by no means all-consuming but do appear a bit toothier than some were expecting too. The US, EU, Canada and UK have committed to blocking large Russian banks from the SWIFT network (a key part of the global payments infrastructure) and deploying measures designed to paralyse the Central Bank of Russia.

Judging by moves among asset classes last week, markets hadn't totally priced the risk of a wide-scale conflict and a tough sanctions package. The end result saw Russian assets take a massive hammering (Moscow Stock Exchange down 21%, bond yields up 200+ bps, a big devaluation in the Rouble against major crosses).

The usual safe-haven assets (USD, Swiss Franc, Yen and US Treasuries) all gained in the aftermath of the initial assault, but as the week drew to a close and investors re-calibrated their expectations, the impact on currency markets had actually become a bit more nuanced. The weakest performers among the majors were sterling and the euro, which is unsurprising given the economic and geographic proximity of the UK and the Eurozone to the conflict. But rather than the safe havens, it was actually the commodity currencies who had the strongest week. Given Russia's status as a significant player in global oil and gas supply, energy commodity prices spiked in the aftermath of the invasion as supply disruptions became ever-more likely, boosting NOK (especially) and CAD among others.

Gains for the agri commodities were a bit softer, but still notable (remember Ukraine is a major grain producer, and there is a correlation between oil and dairy prices). Beyond those modest gains in agri prices, the RBNZ's decision on Wednesday to hint at its openness to hiking the OCR in 50bps increments provided NZD with some support. NZD/USD ultimately managed a half-cent gain over the week, after being down by a similar magnitude at one point.

Future developments in Eastern Europe loom large over the future outlook for currency markets. Other events this week – like the RBA and the Bank of Canada policy decisions – are likely to get lost in the ether somewhat. We are not geopolitical analysts or Kremlinologists and cannot predict the future direction of the conflict. However, the protracted nature of the conflict, the potential for escalation and the lack of clear off-ramps for Putin all seem to point towards the likelihood of further bouts of risk aversion. There's scope for the NZD to underperform both the safe havens and the (energy) commodity currencies over the short term given the dynamics of the conflict thus far. NZD/USD support at 0.6600 could well be tested. Given exchange rates are relative prices, shifts in NZD/AUD should be more modest, with AUD also likely to be crimped by market jitters.

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Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.00	0.75	0.75	0.25	UP	UP
90-day bank bill	1.24	1.24	1.10	0.31	UP	UP
2-year swap	2.74	2.54	2.48	0.48	FLAT	UP
5-year swap	2.99	2.87	2.80	1.20	FLAT	UP
10-year swap	3.02	2.96	2.83	1.99	FLAT	UP
10-year govt bond yield	2.77	2.74	2.59	1.90	FLAT	UP
Curve Slope (2s10s swaps)	0.28	0.41	0.36	1.51	FLAT	FLAT

** Current as at 12.30pm today; week ago as at Monday 5pm. Key UNCH = Broadly unchanged*

Market recap

Local yields jumped after the RBNZ hiked the OCR by 25bps (a 30bp hike was priced in) but delivered a more hawkish than expected statement. The decision to hike by 25bp (rather than 50bps) was 'finely balanced' and the MPC also affirmed its willingness to subsequently hike by more than 25bp if need be. The published OCR track was lifted, with a 3.35% peak in late 2024/early 2025 (2.6% prior). Governor Orr's speech on Friday signalled a change from gradualism, with the RBNZ to reduce stimulus "as quickly as possible" and by possibly more than 25bp increments to limit subsequent tightening needed. The Monetary Policy Statement decision and subsequent comments have seen NZ yields jump, with an extra 25bps or so added to market pricing, the 2-year swap yield up around 25bps and with the yield curve flattening. The RBNZ also signalled it will be running down its $50bn+ LSAP holdings from July, with all NZGB bond holdings sold by the end of 2027.

The jump in NZ yields has outpaced that of global yields that have been bumped around by the Ukrainian conflict, with large swings in equities and with oil prices earlier hitting 8-year highs. US Treasury yields ended the week modestly higher, with outsized gains in shorter maturities on concerns rocketing inflation will drive more FOMC rate hikes (more than six hikes for 2022 are fully priced in). New Fed Governor Waller supported 100bp of increases in the Funds rate by mid-year, including a 'strong case' for a 50bp hike in March. Australian yields were slightly higher than a week ago, with wage inflation data in line with expectations, suggesting no imminent need for RBA hikes.

Near-term interest rate outlook

The Ukrainian situation looks set to contribute to added bouts of volatility and a further escalation in the conflict could push Government bond yields lower, flatten curves and widen bank bill-OIS spreads. Still, the impact from the conflict will likely add to inflationary pressures in NZ and globally. With inflation in the spotlight we are unlikely to see much retracement in near-term market pricing (70bp of hikes are priced in for the next two meetings). There is still upside risk to our published forecasts of a sequence of consecutive 25bp OCR hikes and a 2.75% OCR endpoint. Rocketing Omicron cases in NZ will create significant disruption, albeit with a minor impact on the local rates market.

With the Ukraine conflict adding to uncertainty and dominating the market and political narrative, activity data locally and globally will mostly attract limited market reaction (Q4 Australian GDP, US manufacturing/services ISM, Non-farm Payrolls, global PMIs/PSIs). Markets should remain more sensitive to upward inflation surprises (Eurozone CPI) and developments. Little market reaction is expected from the RBA rates decision, with our CBA colleagues expecting cash rate hikes from June. We still expect longer-term local and global yields to be capped, but this is on the proviso markets are confident that low inflation will eventually return.

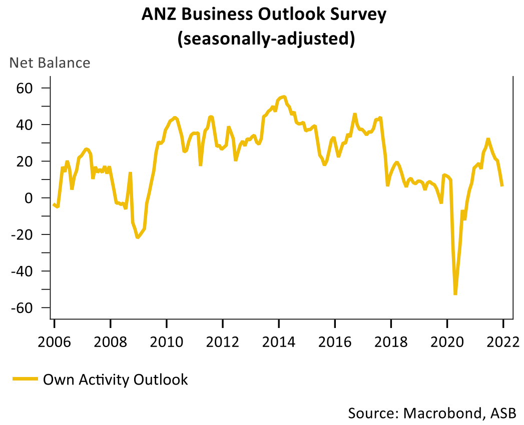
Medium-term outlook

We expect a steady sequence of 25bp hikes at each decision, with the OCR peaking at 2.75% in early 2023. Risks to the OCR outlook are to the upside with the risk of a faster pace of hikes and a higher OCR endpoint. The RBNZ will also start quantitative tightening from July and this could provide upward pressure to longer-term yields. Our CBA colleagues expect RBA rate hikes from June (1.25% endpoint). The US FOMC is expected to have finished its QE tapering and to hike rates by 50bps in March 2022 (2.25-2.5% by early 2024), running down its balance sheet in June. Longer-term local and global yields are expected to drift up, keeping the yield curve flat. mark.smith4@asb.co.nz

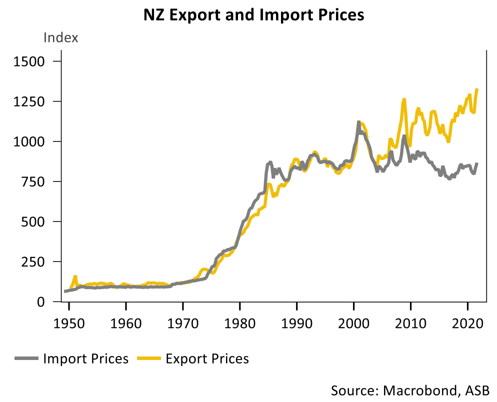
Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market Expects	ASB Expects
ANZ Business Outlook, Feb, Own Activity	28/2	1.00 pm	11.8	-	-
Terms of Trade, Q4, %qoq	2/3	10.45 am	0.7	-	-1.3
ANZ Consumer Confidence, Headline, February	4/3	10.45 am	97.7	-	-

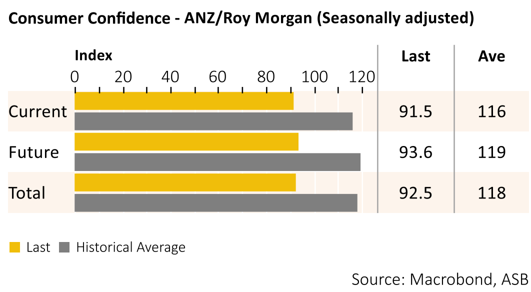
The February iteration of the ANZ Business Outlook will be the first since the community Omicron outbreak, which has added to stresses facing a number of businesses. Sector details may highlight increasing difficulties facing retail and some services sector firms. Activity and investment metrics from the survey could wobble, but widespread labour shortages should hold up employment intentions. Continued cost increases are likely to keep margins under pressure with firms signalling more price increases are coming. We expect the Omicrom hit to be brief, with business sentiment to subsequently recover. With the household sector set to have a breather this year, it is up to businesses to drive the domestic expansion, with an increase in business investment a pre-requisite to increasing the duration of the pending expansion.



We expect NZ's terms of trade fell 1.3% over Q4, paring back off the record high it reached in Q3 of 2021. Both export and import prices appear to have advanced over the quarter in line with rising commodity prices, stock shortages and cost pressures around the world. However, we anticipate that import price gains outpaced those for exports, +3% vs 1.6%. Despite this quarter's forecast, we still expect NZ's terms of trade to lift over the course of 2022, providing a key support for the recovery as household spending falters.



NZ February consumer confidence is expected to remain subpar given the current Omicrion outbreak, pressures on household budgets and growing housing market headwinds. Consumer assessments of their current conditions should remain well under 100 as stock shortages, higher inflation and rising interest rates weigh on assessments of it being a good time to purchase a major item. Households are also unlikely to feel much better than a year ago and may likely further scale back assessments of their future outlook given COVID-19 jitters, with views of the general economic outlook likely to be reasonably downbeat. Inflation expectations from the survey are biased higher and the cooling housing market should see a trimming of house price expectations.



Major International Events for the week ahead

Data	Date	Time (NZT)	ASB
AU Business Indicators	28/02	1:30 pm	
Company Profits (%)			2.0%
Inventories Contribution to GDP			+0.5pts
AU Retail Trade, Jan (%)	28/02	1:30 pm	+2%
AU Private Sector Credit, Jan (%)	28/02	1.30 pm	+0.7%
AU CoreLogic Dwelling Prices, Feb	01/03	12.00 pm	0.3%
AU Balance of Payments, Q4 21	01/03	1:30 pm	
Net Exports Contribution to GDP			-0.5%pts
Current Account Balance			$A13.4BN
AU Lending Indicators, Jan (%)	01/03	1:30 pm	-2%
AU RBA Board Meeting, March	01/03	4.30 pm	-
AU GDP, Q4 21 (%)	02/03	1.30 pm	3.0%
EZ Headline CPI, Feb / Core CPI	02/03	11.00 pm	5.3%/yr / 2.5%/yr~
CA GDP, December (%)	02/03	2:30 am	0.0%
AU Building Approvals, Jan (%)	03/03	1:30 pm	-3%
AU Trade Balance, Jan	03/03	1.30 pm	$A8.5bn
US ISM Manufacturing Index, Feb	03/03	4.00 am	57pts
CA Bank of Canada Meeting, Overnight Policy Rate	03/03	4:00 am	0.50%
US Non-Farm Payrolls Feb / Unemployment Rate (%)	05/03	2.30 am	400,000 / 3.9%

** Forecasts and commentary originally published by CBA Global Markets Research Friday 25th February*

We expect a lift in **Aussie company profits** of 2% in Q4 21. There is a higher degree of uncertainty though this quarter given various government support programs were wound back as COVID restrictions eased. We also expect inventories to 0.5ppts to Q4 21 GDP.

Based on our internal data we expect a 2% lift in **Aussie retail trade** in January. This follows a fall of 4.4% in December. According to CBA's high frequency card spending data there was a period of weakness in spending, particularly in services in early January before recovering in the second half of the month as case numbers peaked.

We expect a lift in **Aussie private sector** growth of 0.7% in January. This would be a slight slowdown from the 0.8% lift in December. Housing credit growth should remain solid, reflecting the lift in new lending in late 2021. Business credit growth has also been strong reflecting the lift in business investment.

The monthly gains in **Aussie dwelling prices** appears to have moderated further in February based on daily data. Prices have slowed across the board, with a further slowdown in Sydney and Melbourne as well as slower gains in Brisbane and Adelaide, both of which had been rising at a brisk pace.

We expect **Aussie net exports** to detract 0.5% from Q4 21 GDP growth. This assumes a flat move in commodity prices over the quarter (there were mixed results between the trade price index and the RBA data). We also expect the current account surplus to print at $A13.4bn, or 2.4% of GDP, down from $A23.9bn, or 4.4% of GDP. The trade balance is expected to shrink and the net income deficit is expected to widen.

We do not expect any change to policy at the **RBA Board meeting** in March. There has been some slight change in language by the RBA since the February meeting, noting rate hikes are plausible in 2022 and they would like to see a couple more CPI prints. Of most interest will be the RBA's reaction to the Q4 21 WPI print of 0.7%.

Our preliminary estimate for Q4 21 **Aussie GDP** is 3.0%/qtr. We will firm up our final estimate after the rest of the partial data early next week. We expect consumer spending, business investment and inventories to add to growth while public and net exports to detract.

We expect a further acceleration in both headline and core **Eurozone CPI** in February. Still elevated energy prices are spilling over into other sectors, including transport. The Eurozone PMIs showed output prices reached a record high in February.

We expect **Canadian GDP** growth was flat in December following strong gains in the previous two months. Renewed lockdowns amid a surge in Omicron cases likely weighed heavily on spending, particularly in the services sector. However, easing supply chain bottlenecks (before the Ottawa trucker protests) might have partly offset some of the weakness in activity.

We expect **Aussie building approvals** to fall by 3% in January, driven by lower multi-unit approvals and roughly unchanged detached dwellings.

We expect the **Aussie trade balance** to print at $A8.5bn in January, just up from the $A8.4bn surplus in December. In January we expect exports to have risen faster than imports, mainly due to a lift in commodity prices

Already-released regional manufacturing surveys point to another slight moderation in the **US ISM Manufacturing** index to 57pts in February. However, at this level, US manufacturing remains in a strong condition. Once again, analysts will watch closely for any signs of easing demand and supply imbalances.

We expect the **Bank of Canada** will look past the potential adverse impacts on the Canadian economy from Omicron and the Ottawa trucker protests. We do not expect the Russia-Ukraine war will throw the imminent BoC tightening off course. In our view, persistent high inflation will lead the BoC to raise the policy rate by 25bp to 0.50%. Markets will also watch if the BoC provides any hints on its plans for balance sheet reduction.

We expect a solid 400,000 lift in **US employment** in February. At the same time, we expect the unemployment rate to fall further to 3.9%. The data will reinforce that the US labour market is very tight. The tightness should continue to underpin solid US wages growth.

Key Forecasts

ASB NZ economic forecasts	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Mar-24
	<< actual	forecast >>						
GDP real - Q%	-3.7	3.3	0.7	0.3	0.4	1.3	0.8	0.6
GDP real - A%	-0.3	3.4	2.6	0.5	4.7	2.7	2.8	2.5
GDP real - AA%	5.0	5.7	5.5	1.6	2.8	2.6	2.6	2.9
NZ House Prices (QV Index) - A%	25.5	24.7	11.3	4.7	-0.1	-6.0	-2.2	6.8
CPI - Q%	2.2	1.4	1.5	0.7	1.3	0.8	0.7	0.5
CPI - A%	4.9	5.9	6.6	6.0	5.0	4.4	3.6	2.9
HLFS employment growth - Q%	1.9	0.1	0.0	-0.3	0.8	0.4	0.3	0.3
HLFS employment growth - A%	4.2	3.7	3.0	1.6	0.5	0.8	1.2	1.2
Unemployment rate - %sa	3.3	3.2	3.0	2.9	2.8	3.0	3.1	3.4

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	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Mar-24
(end of quarter)		<< actual	forecast >>					
NZ OCR	0.25	0.75	1.00	1.50	2.00	2.50	2.75	2.75
NZ 90-day bank bill	0.65	0.97	1.25	1.75	2.25	2.75	2.87	2.90
NZ 2-year swap rate	1.42	2.17	2.60	2.65	2.70	2.75	2.80	3.00
NZ 5-year swap rate	1.87	2.55	2.95	3.00	3.05	3.10	3.15	3.20
NZ 10-year swap rate	2.24	2.64	3.05	3.10	3.15	3.20	3.25	3.40
NZ 10-year Bond	1.97	2.37	2.85	2.88	2.90	2.95	3.00	3.15

ASB foreign exchange forecasts	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Mar-24
(end of quarter)		<< actual	forecast >>					
NZD/USD	0.69	0.68	0.71	0.73	0.74	0.75	0.73	0.73
NZD/AUD	0.96	0.94	0.96	0.96	0.95	0.94	0.94	0.94
NZD/JPY	77	79	82	86	88	90	88	88
NZD/EUR	0.59	0.60	0.62	0.63	0.63	0.63	0.60	0.56
NZD/GBP	0.51	0.51	0.53	0.54	0.54	0.54	0.51	0.50
NZD/CNY	4.4	4.4	4.5	4.6	4.6	4.7	4.5	4.5
NZD TWI	73.7	73.2	75.6	77.0	77.2	77.6	75.6	75.0

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