AUSTRALIA & NEW ZEALAND WEEKLY.

Week beginning 18 July 2022

Editorial: RBA: 50bp hike confirmed for August with no scope for September pause

RBA: Minutes July Board meeting, Governor Lowe speaking.

Australia: Westpac–MI Leading Index.

NZ: Q2 CPI, trade balance.

Europe: ECB policy decision, CPI.

UK: unemployment rate, CPI, retail sales.

US: housing starts, building permits, existing home sales, leading index.

Global: S&P Global PMIs.

Key economic & financial forecasts.

INFORMATION CONTAINED IN THIS REPORT CURRENT AS AT 15 JULY 2022.

WESTPAC INSTITUTIONAL BANK

RBA: 50bp hike confirmed for August with no scope for September pause

We have reconfigured our RBA cash rate profile following the July employment report and some revisions to our inflation forecasts.

However, we have not lifted the forecast terminal rate of 2.6% by the February 2023 Board meeting.

We continue to expect a 50bp increase in the cash rate at the August 2 Board meeting.

But a pause in the cycle in September now seems unlikely.

We expect a 25bp increase in the cash rate at the September 6 Board meeting.

With our estimate of the neutral range of policy being 1.5-2.0% the September move of 25bps would shift the cash rate to 2.1%, into contractionary territory.

As we move further towards the end of 2022, we expect that the evidence that the RBA's 200bp increase in just five months will start to impact the spending momentum.

Factors that we assess as important to maintaining spending momentum through the June and September quarters will have eased by October. These will include the 'reopening' effect in NSW and Victoria and the boost to spending capacity from the fall in the savings rate over the course of 2020.

To date our Westpac Card Tracker Index, based on consumption-related card transaction activity, has held up quite strongly but we expect that by late September spending momentum will have eased significantly.

Along with what are likely to be more very weak reads on Consumer Sentiment and Business Confidence; a sharp deterioration in housing markets; and evidence that the US economy is faltering under the weight of the high inflation and aggressive tightening from the FOMC, the case for a pause in October will be convincing.

We have slightly lifted our forecast for the June quarter inflation report.

Our forecast for underlying inflation (trimmed mean measure) has been lifted from 1.3%qtr to 1.4%qtr – largely reflecting a stronger increase in the cost of new dwelling construction, marked up from 4.6% to 5.5% in the quarter.

Our forecast for headline inflation in the quarter has also been lifted from 1.5% to 1.7%.

Overall, annual underlying inflation is expected to print 4.6%yr, up from 3.7%yr in March, and headline inflation is expected to lift from 5.1%yr to 6.1%yr (compared to our earlier forecast of 5.8%yr).

This slightly higher inflation is not sufficient to cause the RBA Board to lift the hike at the August meeting to 75bps but does increase the headwind for a pause in September, when the cash rate would be within the neutral zone.

The sharp fall in the June unemployment rate from 3.9% to 3.5% is more rapid but broadly consistent with our long-held forecast that the unemployment rate would reach 3.2% in the second half of 2022.

There is no need to lift the pace of the rate hike in August from 50bps to 75bps but the rapid improvement does weaken the case for a pause in September.

We did note that despite now factoring in a hike in September rather than a pause we still expect the peak in the cash rate to be 2.6%.

The rate hike we had previously expected in December has been moved ahead to September. That is consistent with our view that by December the evidence will be convincing that the Australian economy is slowing under the weight of a cash rate of 2.35% (following the expected 25 basis point move in November), which is firmly in contractionary territory.

We have also not changed the timing of the final rate hike in the cycle – a 25bp increase at the February 2 Board meeting.

We expect that the final move in the cycle will be in response to the March quarter inflation report that will show underlying inflation printing 1.0% for the quarter and a peak 5% annual rate, with headline inflation also expected to peak at 7.2%.

However, the key track of the underlying quarterly prints is expected to be: 1.4% (March); 1.4% (June); 1.2% (September); and 1.0% (December). That is a clear slowing in the quarterly pace but the annual rate is still too high for the RBA to pause. The mood of central banks to err in favour of containing inflation and expectations rather than fine tuning activity will be apparent in that decision.

That quarterly pause is expected to come at the May Board meeting when the quarterly pace in underlying inflation slows to 0.8% for 4.4%yr; down from 5%yr in the December quarter.

By May, the slowing Australian and US economies and the encouraging slowing in the quarterly inflation pace will be sufficient for the RBA to remain on hold, pending inflation and growth developments that could allow an eventual easing in policy.

By the second half of 2023 there will be some upward drift in the unemployment rate while underlying inflation will be converging on the top of the target band, although there will be caution around easing policy while inflation remains above the top of the 2-3% range.

Bill Evans, Chief Economist

This week's Australian data highlighted the growing disparity between current activity and confidence.

According to NAB's latest business survey, while business conditions continue to show strength across the economy, confidence has fallen below its long-run average. Arguably this deterioration stems from the availability and price of labour and other inputs as well as growing uncertainty over the global outlook. The rapid turn in monetary policy is also cause for concern for business, though at the moment the impact on activity is limited given support from the labour market and the full re-opening of the services sector. In the second half of 2022 and into 2023, business conditions are likely to come under greater pressure.

While the Westpac-MI consumer sentiment survey continues to signal confidence in the labour market and the longer-term economic outlook, households' near-term personal financial outlook is of great concern given historic inflation and rapidly rising interest rates. Highlighting this, underlying the seventh consecutive fall in the headline index to a level only seen during times of significant economic disruption are views on family finances 20ppts below average and an economic view for the year ahead 12pts below average.

Unsurprisingly, the 'time to buy a dwelling' index is now 32ppts below average and house price expectations continue to deteriorate. Also of concern for the growth outlook, 'time to buy a major household item' is now 30ppts down on its average level – note though this indicator is also picking up the rotation from goods to services as the economy re-opens. After its release, Chief Economist Bill Evans provided a video update on the implications for the economy and RBA of these trends.

At least the labour market outlook should remain an enduring positive, with June's employment print coming in materially higher than expectations at a strong 88k. The employment outcome also saw the unemployment rate fall 0.4ppts to a 48-year low of 3.5% despite a 0.1ppt rise in participation. Australia's labour market is clearly in unprecedented territory, with there now being one unemployed person per job vacancy and a record-high employment-to-population ratio. Gains over the remainder of 2022 will depend on how much further participation can rise as well as the outlook for immigration.

Australia's arrivals and departures data suggests material changes in labour supply through immigration will take time, with a robust increase in arrivals to 737k in June offset by a very strong lift in departures to 885k, reflecting the normalisation of visitor flows as recent short-term visitor arrivals cycle out as departures. This lack of positive net arrivals is also evident in the underlying detail. Travel on a permanent/long-term basis and visa-related travel over recent months has shown as many arrivals as departures.

Turning then to New Zealand: as expected, the RBNZ delivered another 50bp hike at their July meeting, taking the cash rate to 2.50%. Our New Zealand economics team provided a full update on the decision and outlook after the announcement, highlighting in particular that the "RBNZ's focus remains on the risk of homegrown inflation pressures becoming persistent, with strong demand running up against capacity constraints" and that the team continues to expect another 50bp increase in August, taking the cash rate near the level likely to prove the peak for this cycle.

Moving further afield, inflation and the required response of monetary policy remained front of mind for the US. In June, the headline CPI surprised to the upside again, prices rising 1.3%/9.1%yr. Core inflation was also stronger than expected, 0.7%/5.9%yr. Price pressures are certainly strong and broad based. But, in the detail of the report, there were no new breakout price moves. As supply constraints are worked through and demand remains under pressure from declining real incomes and tighter policy, we expect inflation will moderate back near the FOMC's target.

In terms of the timing and implications for monetary policy, while July has so far seen a significant decline in the price of oil and food commodities, we expect the FOMC will feel compelled to continue tightening at a rapid rate in July and September – we forecast hikes of 75bps and 50bps. However, by the November and December meetings, when we expect two 25bp hikes to conclude the tightening cycle, declining commodity prices and the (already evident) reduction in price growth for goods ex energy and food should combine to give the FOMC comfort that the inflation threat is passing, allowing an on-hold stance to be adopted at a contractionary level of 3.375% from December.

In our view, the implications for activity of the above outturn for policy are concerning, with economic stagnation or recession to remain a material risk through 2022 and 2023. As we outlined this week, the Atlanta Fed's nowcast for Q2 GDP currently suggests GDP contracted through the six months to June as the headwinds from declining real incomes, the rapid tightening of financial conditions, and historically-low confidence began to take effect.

In addition to the full impact of these forces being felt in coming quarters, it is also now clear that employment growth is slowing abruptly and nominal wages growth decelerating ahead of inflation. These trends bode ill for the business investment outlook as does the 20-year high for the US dollar. If the FOMC does not progressively shift its view on the risks from inflation to activity, not only is stagnation likely during 2022 and 2023, but potentially also into the medium-term. To combat this risk, we anticipate 125bps of easing from December quarter 2023 to December 2024, leaving the fed funds rate at 2.125%.

Finally then to China. Q2 GDP came in below the market's bearish expectation, annual growth slowing to 0.4% from 4.8%yr at March. Year-to-date, growth therefore sits at 2.5% against authorities' goal of 5.5%. To achieve that goal from here would require growth through the second half of 2022 of around 20% annualised. While possible, this seems unlikely. If instead growth circa 13% annualised is seen, year-average growth will land around 3.5%. Note though, such an outturn would still leave through the year growth to December 2022 near 5.5% – so, albeit on a non-standard benchmark, authorities could still hold that their ambition had been achieved. Through the year growth around that level in 2023 would then see year-average growth strengthen to 7.0% in 2023.

Arguing in favour of a strong rebound in activity from the second half of 2022 is the resilience shown by fixed asset investment over the six months to June as well as the recent momentum in credit. Also of significance is the material beat for retail sales in June, now tracking 3.1%yr. We had expected consumption to rebound with a delay, but this outcome suggests recovery could come quickly, assuming further outbreaks are limited in scale.

Week ahead & data wrap

The monetary policy hat-trick

At their July policy review this week, the RBNZ delivered a third consecutive 50bp hike, bringing the Official Cash Rate to a level of 2.50%. The RBNZ also reaffirmed that it is planning to continue raising the cash rate to a level where they are confident that inflation will settle within the 1% to 3% target range. That said, with inflation pressures still running red hot, we are forecasting another 50bp hike in August. Further ahead, additional rate hikes are on the cards, but those are likely to occur at a more measured pace. We continue to expect that the cash rate will peak at 3.50%, lower than assumed in the RBNZ's last published forecasts.

While the statement that accompanied this week's rate hike was largely a 'copy and paste' from May, developments in recent weeks have actually been quite mixed. Globally, there are mounting concerns that policy tightening by major central banks aimed at reining in inflation could push many economies into recession. Similarly, here in New Zealand confidence among both households and businesses has plummeted.

While the RBNZ did acknowledge growing downside risks for growth, these concerns come against a backdrop of red-hot inflation pressures. In fact, we expect that next week's CPI report will show that annual inflation has now risen to 7% (up from 6.9% earlier in the year). That would be the highest level in more than three decades.

It's true that much of the rise in inflation has been due to factors beyond the RBNZ's control. That includes the high level of petrol prices, as well as ongoing disruptions to global supply chains that have resulted in shortages of both raw materials and finished goods.

But what's really lit a fire under consumer prices has been the strength of domestic demand. As we have noted before, demand has been running hot ever since New Zealand first moved out of lockdown, and the economy's productive capacity has not been able to keep up. Indeed, if we look at the areas where businesses are reporting significant shortages of supplies, they're predominantly in areas where demand has been strong, like the construction sector.

That strength in demand is a big concern for the RBNZ, because if demand is running hot, inflation is likely to remain elevated even when the current pressure on operating costs (eventually) eases off. And a key factor underpinning the strength of household demand has been stimulus from low interest rates.

Given the continuing strength in inflation pressures, we are forecasting the RBNZ to deliver a fourth 50bp hike at the time of the August policy review. That would bring the OCR up to a level of 3.00%.

However, it's at that point that we might see a change of tone from the RBNZ. Specifically, in August the Monetary Policy Committee could signal that while further OCR increases are still likely, the pace and extent of any additional hikes will be dependent on how the economy is tracking. By that time, the OCR will have moved into 'tight' territory and will be much closer to the 3.9% peak that the RBNZ assumed in their last published projections from May (and which the Monetary Policy Committee confirmed they remain broadly comfortable with this week). That means there will be less urgency to lift the cash rate than in recent months when the RBNZ has been racing to stifle the build-up of inflation pressures.

By August, the RBNZ will also have had time to fully account for the cooling in the global economy, as well as any signs that domestic activity is starting to lose traction. With regards to the latter, the past week saw two notable developments which came a little late for the RBNZ to factor into its July policy review. First, the June housing market update revealed a continued cooling, with house prices now down 6.7% since their peak in November and sales at their lowest level in more than a decade (barring the Covid lockdown period in 2020). Second has been the effective stalling in retail sales: despite continued rapid price increases, nominal spending was up just 0.1% in June, while spending in categories other than fuel was down 0.3%. In other words, while our nominal spending levels may be holding broadly steady, the amount of goods we are actually buying is going backwards. Looking ahead, we expect a further cooling on both of those fronts, and that signals a broader softening in economic activity as we approach year end.

Reflecting the above considerations, we expect that the pace of rate hikes is likely to become more measured in the latter part of the year. We're forecasting 25bp increases in both October and November, which would take the OCR to a peak of 3.50%.

There is one final aspect of the RBNZ's forecast (and ours) that has not garnered much attention yet: once the OCR does peak, it's likely to fall again in the years to come as inflation pressures ease back. That idea has not really been reflected in longer-term market interest rates, which are more consistent with the OCR rising and staying there. If the economic outlook does turn gloomier from here, there's plenty of scope for a fall in longer-term interest rates – and a de facto easing in monetary conditions – without the RBNZ having to do anything differently. So for now the RBNZ can afford to keep up its inflation-fighting message, without making concessions to the market's worries.

Satish Ranchhod, Senior Economist

Round-up of local data released over the last week

Date	Release	Previous	Actual	Westpac f/c
Mon 11	Jun card spending	1.4%	0.1%	-0.5%
Tue 12	May net migration	64	-828	–
Wed 13	RBNZ policy decision	2.00%	2.50%	2.50%
	Jun food price index	0.7%	1.2%	1.0%
Thu 14	Jun REINZ house sales	-3.5%	-12.6%	–
	Jun REINZ house prices %yr	3.7%	0.7%	–
Fri 15	Jun manufacturing PMI	52.6	49.7	–

DATA PREVIEWS

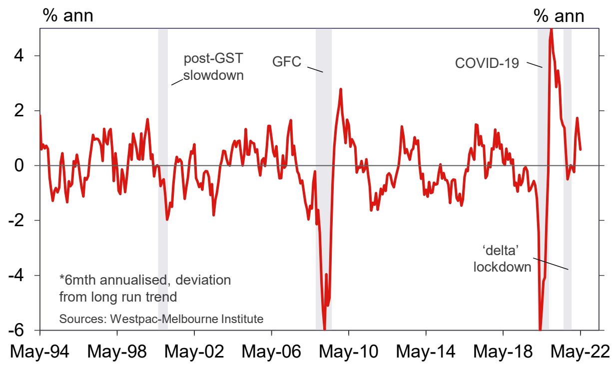
Aus Jun Westpac–MI Leading Index

Jul 20, Last: 0.58%

The six-month annualised growth rate slowed further to 0.58% in May but remained consistent with above trend growth momentum sustaining into the second half of 2022 and early 2023.

The June update is likely to see a further moderation. Most monthly component updates will again be on the soft side, the ASX200 down -8.9%; the Westpac-MI Consumer Expectations Index down another -3.7%, commodity prices edging down -1.5% in AUD terms and hours worked holding flat. Dwelling approvals bucked the wider trend with a surprise 9.9% gain in May.

Westpac-MI Leading Index



NZ Q2 Consumer price inflation

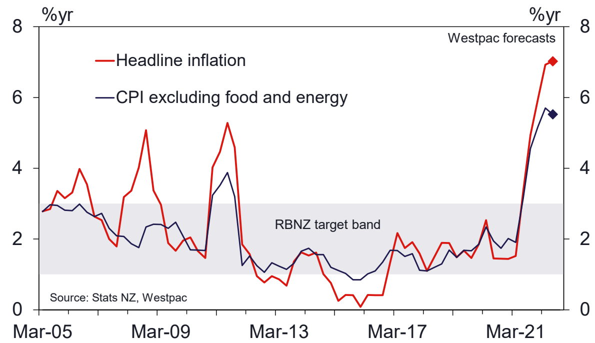
Jul 18, Last: +1.8%, Westpac: +1.4%, Market f/c: +1.5%

We expect a 1.4% increase in consumer prices in the June quarter. That would take annual inflation to 7.0%, up from 6.9% last quarter and marking the highest annual inflation rate in more than three decades. Our forecast is in line with the RBNZ's last set of published forecasts.

There have been particularly large increases in the prices of food, fuel and housing related costs. However, price pressures are bubbling over in every corner of the economy. Both tradables (imported prices) and non–tradables (domestic prices) are running hot.

Businesses are continuing to grapple with shortages of staff and supplies. But what has really lit a fire under consumer prices has been the strength of demand.

NZ Consumer Price Inflation



NZ GlobalDairyTrade auction, whole milk powder prices

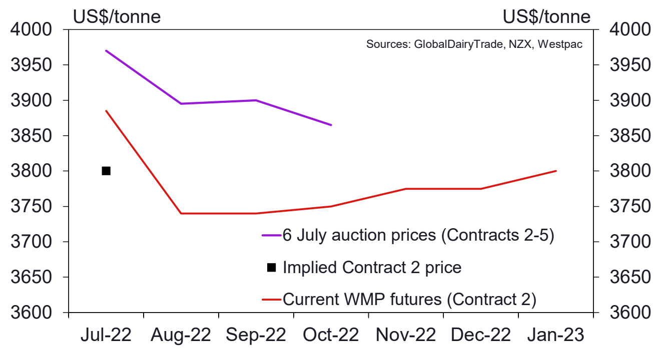
Jul 20, Last: –3.3%, Westpac: –4%

We expect whole milk powder prices (WMP) to drop by around 4% at the upcoming auction. This follows a 3.3% price dip at the previous auction.

In the short term, commodity prices are under pressure and we expect global dairy prices to be similarly impacted. In addition, Fonterra is offering more WMP on the auction platform. This move will increase the downward pressure on prices at least temporarily.

However, further out, we anticipate that very weak global supply combined with rebounding Chinese demand will support global dairy prices.

Whole milk powder prices



Past performance is not a reliable indicator of future performance. The forecasts given above are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The results ultimately achieved may differ substantially from these forecasts.

For the week ahead

		Last	Market median	Westpac forecast	Risk/Comment
Mon 18					
NZ	Jun BusinessNZ PSI	55.2	–	–	Business conditions have started to soften.
	Q2 CPI	1.8%	1.5%	1.4%	Domestic and imported price pressures running hot.
UK	Jul Rightmove house prices	0.3%	–	–	Demand to soften as rate hikes take effect.
US	Jul NAHB housing market index	67	66	–	Outlook for builders to deteriorate given rates & uncertainty.
Tue 19					
Aus	RBA minutes	–	–	–	Colour around July 50bp hike, and risks to outlook.
	RBA Deputy Governor Bullock	–	–	–	Speaking at ESA Business Lunch, Brisbane, at 12pm.
Eur	Jun CPI	0.8%	0.8%	–	Final; driven by soaring food and energy prices.
UK	May ILO unemployment rate	3.8%	3.9%	–	Holding near pre-pandemic level.
US	Jun housing starts	-14.4%	2.7%	–	Input supply the primary constraint for current construction…
	Jun building permits	-7.0%	-1.7%	–	… tighter financial conditions to weigh on pipeline.
Wed 20					
Aus	RBA Governor Lowe speaking	–	–	–	Australian Strategic Business Forum, Melbourne, at 9:10am.
	Jun Westpac-MI Leading Index	0.58%	–	–	Losing altitude but still tracking above trend.
NZ	GlobalDairyTrade auction prices (WMP)	-3.3%	–	-4.0%	We anticipate a second successive global dairy price fall.
Eur	Jul consumer confidence	-23.6	-25.0	–	Energy security and inflation weighing heavily on confidence.
UK	Jun CPI	0.7%	0.5%	–	Energy remains key driver.
US	Jun existing home sales	-3.4%	-0.2%	–	Affordability locking many out of market.
Thu 21					
NZ	Jun trade balance $mn	263	–	-100	Agri exports slowing down seasonally; oil prices still high.
Eur	ECB policy decision, refi rate	0.00%	0.25%	–	Clear guidance for the first 25bp rate hike in July.
US	Jul Phily Fed index	-3.3	1.7	–	Regional surveys have deteriorated materially of late.
	Initial jobless claims	244k	–	–	Remain near historic lows.
	Jun leading index	-0.4%	-0.5%	–	Growth outlook deteriorating.
Fri 22					
Jpn	Jun CPI %yr	2.5%	2.4%	–	Weak underlying price pressures supporting BoJ's stimulus.
	Jul Nikkei services PMI	54.0	–	–	Easing of health restrictions supporting services…
	Jul Nikkei manufacturing PMI	52.7	–	–	… but supply issues pose near-term risks to mfg.
Eur	Jul S&P Global manufacturing PMI	52.1	51.0	–	Supply and cost pressures weighing on mfg activity…
	Jul S&P Global services PMI	53.0	52.0	–	… as services lose momentum from inflation pressures.
UK	Jul GfK consumer sentiment	-41	–	–	Confidence collapsed amid inflation pressures…
	Jun retail sales	-0.5%	0.1%	–	… restricting consumer's spending capacity.
	Jul S&P Global manufacturing PMI	52.8	52.0	–	UK manufacturing and services…
	Jul S&P Global services PMI	54.3	54.0	–	… to face a sharp slowdown over 2022.
US	Jul S&P Global manufacturing PMI	52.7	51.0	–	Broad-based deterioration in activity across industry…
	Jul S&P Global services PMI	52.7	52.0	–	… coming to US economy.

Forecasts

Interest rate forecasts

Australia	Latest (15 Jul)	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Cash	1.35	2.10	2.35	2.60	2.60	2.60	2.60	2.60
90 Day BBSW	2.15	2.55	2.72	2.80	2.80	2.80	2.80	2.80
3 Year Swap	3.47	3.55	3.50	3.30	3.10	2.90	2.80	2.75
3 Year Bond	2.98	3.10	3.10	2.95	2.80	2.65	2.60	2.55
10 Year Bond	3.42	3.60	3.50	3.35	3.15	2.90	2.65	2.50
10 Year Spread to US (bps)	48	50	50	45	45	40	35	30
US								
Fed Funds	1.625	2.875	3.375	3.375	3.375	3.375	3.125	2.875
US 10 Year Bond	2.94	3.10	3.00	2.90	2.70	2.50	2.30	2.20
New Zealand								
Cash	2.50	3.00	3.50	3.50	3.50	3.50	3.50	3.50
90 day bill	3.06	3.40	3.60	3.60	3.60	3.60	3.60	3.60
2 year swap	4.08	4.30	4.10	4.00	3.80	3.50	3.20	2.90
10 Year Bond	3.70	4.00	3.80	3.60	3.40	3.20	3.00	2.90
10 Year spread to US	74	70	70	70	70	70	70	70

Exchange rate forecasts

Australia	Latest (15 Jul)	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
AUD/USD	0.6749	0.72	0.75	0.77	0.78	0.79	0.80	0.80
NZD/USD	0.6126	0.65	0.68	0.70	0.71	0.72	0.72	0.72
USD/JPY	139.02	134	132	130	127	125	123	121
EUR/USD	1.0021	1.05	1.09	1.11	1.13	1.14	1.15	1.16
GBP/USD	1.1826	1.23	1.26	1.28	1.30	1.32	1.34	1.35
USD/CNY	6.7563	6.55	6.35	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.1018	1.11	1.10	1.10	1.10	1.10	1.11	1.11

Australian economic growth forecasts

	2021	2022				2023		Calendar years			
% change	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	2020	2021	2022f	2023f
GDP % qtr	3.6	0.8	1.3	1.1	0.8	0.4	0.5	–	–	–	–
%yr end	4.4	3.3	3.9	6.9	4.0	3.6	2.8	-0.7	4.4	4.0	2.0
Unemployment rate %	4.7	4.1	3.8	3.4	3.2	3.2	3.3	6.8	4.7	3.2	3.5
CPI % qtr	1.3	2.1	1.7	0.8	2.4	1.1	0.6	–	–	–	–
Annual change	3.5	5.1	6.1	6.1	7.2	6.1	4.9	0.9	3.5	7.2	2.9
CPI trimmed mean %qtr	1.0	1.4	1.4	1.2	1.0	0.8	0.8	–	–	–	–
%yr end	2.6	3.7	4.6	5.0	5.0	4.5	3.9	1.2	2.6	5.0	3.2

New Zealand economic growth forecasts

	2021	2022				2023		Calendar years			
% change	Q4	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	2020	2021	2022f	2023f
GDP % qtr	3.0	-0.2	1.0	0.7	1.2	0.8	0.6	–	–	–	–
Annual avg change	5.6	5.1	1.0	2.2	2.1	2.7	3.6	-2.1	5.6	2.1	3.3
Unemployment rate %	3.2	3.2	3.1	3.0	3.0	3.0	3.1	4.9	3.2	3.0	3.3
CPI % qtr	1.4	1.8	1.4	2.0	0.1	0.6	0.7	–	–	–	–
Annual change	5.9	6.9	7.0	6.8	5.3	4.1	3.4	1.4	5.9	5.3	2.8

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