AUSTRALIA & NEW ZEALAND WEEKLY.

Week beginning 22 August 2022

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INFORMATION CONTAINED IN THIS REPORT CURRENT AS AT 19 AUGUST 2022.

WESTPAC INSTITUTIONAL BANK

RBA Board set for 50 basis points next month – wages report no headwind

The Reserve Bank Board Minutes of the August meeting provided some additional insights into the Board's intentions relative to the Governor's Statement which followed the August meeting.

The Minutes confirmed that "The Board expects to take further steps in the process of normalising monetary conditions over the months ahead, but it is not on a pre-set path. It is seeking to do this in a way that keeps the economy on an even keel. The path to achieve this balance is a narrow one and subject to considerable uncertainty."

Much has been made of the term "pre-set path" and we agree that it signals that at some point the Board will take a shift down in the pace of tightening from 50 basis points per meeting to 25 basis points.

However, we believe that shift will not occur in September because the current cash rate (1.85%) is still well short of the Governor's assessment of "neutral" which he has indicated in a previous speech is likely to be around 2.5%.

Once having reached 2.35% in September it seems likely the Board will lower the pace to 25 basis points as policy moves into the "contractionary zone". Note that unlike the Minutes to the July Board meeting there is no observation that "the level of interest rates was still very low", suggesting that the Board is nearing that period of lower monthly increases.

We also think that this sequence of 25 basis point movements will not include a pause and will need to extend into 2023 with the final move in February.

There is some evidence in the Minutes that the Board is becoming more concerned about the risks to inflation.

In previous Minutes, the Board has attributed much of the increase in inflation to global factors while recognising that domestic factors were also present. That sentiment is strengthened in these Minutes with reference to "domestic factors were increasingly playing a role" and observations of "widespread upward pressures on prices from strong demand, a tight labour market and capacity constraints." That is a stronger assessment of the domestic pressures than the July Minutes which referred to "domestic inflationary pressures continued to build." While the addition of "widespread" in the August Minutes is also significant.

The Board emphasises that strong demand conditions will hold in 2022, "The domestic economy had grown strongly over the first half of 2022 … Growth in consumption was expected to remain strong over the second half of the year reflecting strong labour income, still high savings rates and strengthened household balance sheets."

In contrast, the July Minutes described growth in the June quarter as "solid" while there was no specific guidance around the second half of the year.

These observations suggest the Board is prepared to continue its tightening cycle over the full course of 2022. Policy will be largely influenced by current economic conditions rather than pitching decisions around economic forecasts, where there was "considerable uncertainty."

But there is a clear reference to the Board's concern with household spending, "Members will be paying close attention to how the balance of these various factors affects the outlook for spending in their assessment of the appropriate setting of monetary policy".

While appropriately recognising this issue, it does not appear that the Board expects the evidence of a significant slowdown in spending to emerge before 2023.

The Minutes provide further evidence of the Board's most likely policy dilemma. By forecasting that growth will slow to a respectable 1.8% in 2023 and inflation will not reach even the top of the targeted 2-3% until 2024, it risks not delivering a decisive blow to inflationary expectations as businesses may continue to raise prices with demand slowing but not slowing sufficiently quickly.

In our view, a central bank should be stronger in its commitment to deflate inflationary expectations by announcing a commitment to bring inflation back into line with its objective over the next policy year.

In that regard the Board has a challenge because its forecasts are not based on its policy outlook but a mix of market pricing and analysts' forecasts. In forecasting that the policy action expected by the analysts and the market does not deliver the inflation target within a time-frame that will deflate inflationary expectations, the Board is taking an unnecessary risk.

The Board appropriately justifies the rate increase, "to bring inflation back to target by ensuring that inflation expectations remain anchored" but the term "anchored" seems somewhat optimistic especially when the Board itself is forecasting inflation to peak at 7.75% and only fall to 4.3% by the end of 2023.

The task of bringing inflation down from 7.75% in 2023 will be largely assisted by the easing of the supply side pressures but it will be necessary to flatten demand to reach the target levels as solid demand growth feeds the pricing expectations of businesses who have "finally" restored their confidence in being able to raise prices.

In turn, resilient inflationary expectations allow businesses to raise prices as their customers become conditioned to rising prices.

We do not think that the labour market related releases for the Wage Price Index or the July Employment Report will sway the Board from the 50 basis point move in September.

While the WPI printed 0.7% for the quarter, below our 0.9% estimate, we note that wages including bonuses were up by 0.9% (1.0% for the private sector) for an annual increase of 3.1%, up from 2.4% and the fastest annual increase since the December quarter in 2012.

Of those who received a pay rise in the quarter the average annual increase was 3.8%, up from 3.4% in the March quarter and the fastest annual pace since the June quarter 2012.

These prints from the Wage Price Index are consistent with firms being prepared to allocate substantial increases while emphasising total increase rather than the permanent increase.

Firms accept that wages must increase for now, given shortages, but are hopeful that by allocating some increases to bonuses they will start the negotiations for next year at a lower base.

Effectively, if demand slows significantly in 2023 and base increases are flat next year, firms will see an actual fall in wage costs. The concern will be if firms do not pitch increases towards a variable component indicating that the price increases they will need to adopt to finance higher wages are likely to be sustained for an extended period.

While there was some dovish reaction to the headline WPI report we do not think the Report will sway the Board from the expected 50 basis point increase on September 6.

Conclusion

We remain comfortable with our views on the outlook for the cash rate - 50 basis points in September; 25 basis points at the next four meetings culminating in a peak cash rate of 3.35% in February 2023.

We expect that profile will be sufficient to flatten demand with growth slowing to 1% in 2023 causing inflation psychology to be wrung out of the system as businesses are deterred by the soft demand conditions from further rounds of price increases.

However, we are nervous that the “patient” approach to reaching the target over a two and a half year period runs the risk of inflationary expectations becoming embedded in the system which would require a most undesirable second stage of rate hikes some time later in 2023.

Bill Evans, Chief Economist

THE WEEK THAT WAS

The strength of the Australian labour market was a key talking point this week as the unemployment and underemployment rates reached new multi-decade lows of 3.4% and 6.0% respectively.

Intriguingly, this occurred as the Australian economy lost 41k jobs and total hours worked declined 0.8%, offset by a 0.3ppt decline in participation. The ABS made clear that the loss of jobs in the month likely stemmed from the sample period coinciding with the winter school holidays; absences associated with COVID-19 and other illnesses; and flooding in NSW. Shifting seasonality also looks to have been a factor, with 35k jobs created on a non-seasonally-adjusted basis.

Not only is demand for labour strong, but the supply of labour remains heavily constrained (see below for a discussion of the latest migration data). Combined, these two trends look set to tighten Australia's labour market further in coming months, with the unemployment rate forecast to fall to 3.0% around the turn of the year. While the headline Wage Price Index is yet to respond to this historic degree of labour market tightness (0.7%; 2.6%yr), the detail of the Q2 report make clear momentum is building. Most significantly, the private sector respondents that received a wage increase in the quarter reported a 3.8% gain, the strongest result since June 2012. We expect these gains to broaden across the population and to strengthen further through 2023, with annual growth in the headline wage price index forecast to peak at 4.5% at end-2023.

The potential risk that (extremely) limited spare capacity poses to Australia's fight against inflation was evident in the RBA minutes for August, as discussed by Chief Economist Bill Evans. While global factors continue to be recognised for their role in the current inflationary episode, the August minutes gave "widespread upward pressures on prices from strong demand, a tight labour market and capacity constraints" greater attention. The Board also emphasised that strong demand conditions are expected to hold through 2022, potentially impacting inflation and expectations into 2023.

While cognisant of these risks, we continue to expect a peak cash rate of 3.35% at February 2023 will quell domestic inflation pressures as GDP growth abruptly slows to just 1.0%yr by December 2023. Before moving on from the RBA minutes, we also must highlight their discussion of climate change and the management of related risks. Specifically, climate change's growing prominence in investor decision making was emphasised, as was the potential for these considerations to impact the cost of funding. Disclosure standards as well as the risks to the economy and financial system from climate change were also front of mind.

As noted above, migration data for July was also released this week. The recovery in overseas travel was supported by a return to mid-year seasonal strength as Australian residents and visitors embarked on short-term holiday travel. Arrivals and departures have now risen to be at 60% and 55% of their respective pre-pandemic levels, with a full recovery in these headline figures by the end of summer becoming increasingly likely. However, the clear lack of evidence indicating positive net inflows of temporary workers presents some offsetting concerns. This is not due to a lack of foreign demand for Australian temporary work, but rather the presence of substantial visa processing delays creating a notable lag in the return of temporary workers, offering little support to alleviate labour supply constraints within Australia.

Across in New Zealand, the resolve of the RBNZ to suppress inflation and associated risks was again on display at their August meeting, with another 50bp hike delivered and more flagged for later this year. As detailed by our New Zealand economics team, the decision statement focused heavily on inflation pressures and capacity constraints, most notably in the labour market. The expected pace of rate increases was also accelerated and the projected peak for the cash rate lifted slightly to 4.1%. Our New Zealand team broadly concur with the RBNZ's thinking, having forecast two additional 50bp increases for the remainder of the year to a peak of 4.0%. However, they see more scope for interest rates to ease back in subsequent years given growing evidence that policy tightening is having the desired effect. Westpac's August Economic Overview is now available for a full view of New Zealand's economy.

Data received for the US this week was largely secondary in significance. July housing starts/ permits and existing home sales highlighted the shock to activity from tight financial conditions and declining real incomes, the latter materially impairing affordability. Retail sales meanwhile met expectations, but again showed a consumer challenged by the cost of living, with total sales flat in the month and core spending up modestly after a poor Q2.

The release of the week for the US was instead the FOMC's July meeting minutes. Perhaps because the July meeting is between participant forecast updates, or potentially as they expect recent weakness to be recovered quickly, the tone of the Committee's commentary was sanguine on activity and, in terms of the risks, still focused on inflation. That said, it seems as though expectations of risks are shifting. Inflation risks related to pandemic supply disruptions are seen as largely in the past, and "the apparent absence of a wage–price spiral" was noted – the latter minimising the risk of a third wave of inflation on strong consumer demand. Participants are also clearly of the view that "the bulk of the effects on real activity had yet to be felt" and so there is need to be cognisant of any change in activity momentum month to month. We remain of the view that September's 50bp hike will be followed by two 25bp hikes in November and December to a peak fed funds rate of 3.375%. However, a pause to late-2023 will then be seen with 125bps of cuts to follow from December quarter 2023. This easing should support growth back to trend by end-2024 and see the unemployment rate stabilise around 5.0%, up from 3.5% currently.

In Europe, inflation continues to spark concern. In short, the Russia-Ukraine conflict and the COVID-19 reopening represent a dual-front of inflationary pressures. Supply issues continue to drive record inflation prints in the Euro Area (8.9%yr), with energy (39.6%yr) and food (11.5%yr) making particularly strong contributions. Simultaneously, the rebound in consumer spending across recreation, furniture and restaurants has materially broadened this pulse. Indeed, annual core inflation is not only double the ECB's medium-term target at 4%yr, but a record 74% of the consumption basket is running at an annual inflation rate above 2.5%, well above the 10-20% range during the pre-pandemic era. Similarly in the UK, annual headline inflation has reached a double-digit pace of 10.1%, and a more concerning print for core inflation (6.2%yr) highlights the extent of the inflation challenge facing the region. Further monetary tightening is clearly warranted to fight this battle, even if a degree of weakness in activity materialises. Hence, we expect the ECB and the Bank of England to raise their respective key policy rates to 1.50% and 2.75% by year-end.

Coming back to China. The data received over the past week disappointed on every front. We are not anxious over the production environment, nor the outlook for infrastructure and business investment – even after the poor July credit outcome, year-to-date total social financing growth still sits at 15%, while comments by Premier Li this week made clear more support is coming. What is of concern though is the spread of COVID-19 in tourist areas such as Hainan. This outbreak has the potential to transmit the virus to multiple locations across the country, as holiday makers go home, and is also likely to deter other households from planning holidays and potentially increasing their discretionary services consumption closer to home. The limited progress in resolving the mortgage strike of recent months and with many developers remaining in a fragile state, it also seems likely that the recovery in housing investment will come later than we anticipated. As a result, we have revised down our 2022 growth forecast to 3.0% from 3.5%, but maintain a 7.0% projection for 2023. Authorities certainly have the capacity to deliver such an outcome, but co-ordinated action at both the central and local level will be required.

Week ahead & data wrap

Four of a kind

The RBNZ has delivered a fourth consecutive 50bp rate hike, and the accompanying policy statement fully endorsed Westpac's forecast for two additional 50bp hikes by the end of this year. Inflation pressures have been bubbling over and the RBNZ is set to continue with its 'go hard and early' approach over the course of this year. However, there are signs that demand is already starting to cool and a slowdown in growth is on the cards over the coming months. That will likely see the RBNZ shifting to an on-hold stance from the end of this year.

As expected, the Reserve Bank of New Zealand raised the Official Cash Rate by 50bps at its August policy meeting. That was the fourth consecutive 50bp rise and took the cash rate from 2.50% to 3.00%, its highest level in seven years.

An August rate hike had been well telegraphed. Consequently, the main focus was on what the RBNZ signalled going forward. On this front, the RBNZ's published projections and the accompanying commentary fully endorsed Westpac's forecast for two additional 50bp moves and a 4.00% peak in the cash rate by the end of this year.

The RBNZ's updated forecasts now show the cash rate peaking at 4.1% (up from 3.9% in their previous projection) with the cash rate also rising at a slightly faster pace than previously assumed. Underlying that higher projection for the cash rate was a hawkish assessment of recent economic developments, with the policy statement highlighting the tightness in the labour market and strength of domestic inflation pressures. Consistent with the hawkish assessment, the minutes from the August meeting noted that the Monetary Policy Committee agreed to bring forward the timing of OCR hikes. In addition, the Committee noted that "maintaining the recent pace of tightening remains the best means by which to meet their Remit." All of that is in line with our forecasts for continued large increases in the cash rate over the remainder of this year.

The RBNZ's updated projections did leave open the possibility that the size of rate increases could slow to 25bps by the end of this year, and that rate hikes could continue into next year. There certainly are some big question marks surrounding the longer-term outlook, including the strength of domestic demand and the state of the global economy. And a more measured pace of rate hikes would give the central bank time to take stock of whether the last few increases really will be required.

However, while the RBNZ has that flexibility if needed, we think they will continue with their current 'go hard and early' approach of 50bp moves. The strength of inflation has surprised the RBNZ and analysts alike, and it's set to remain above the RBNZ's target band for at least the next year. That is a big concern. Such a protracted period of strong price growth risks expectations of high inflation becoming embedded into households and businesses' behaviour. And that could result in serious long-term damage to the economy, including the risk of a wage-price spiral and the erosion of households' purchasing power. To offset those risks, the RBNZ is more likely to frontload rate increases to get the inflation genie back in its bottle.

Reinforcing the case for continued large rate moves is the uncertainty about where the 'neutral' level of the cash rate is. The neutral cash rate is the level of the OCR that is neither accommodative nor restrictive. When the OCR is above neutral, interest rates will tend to be a drag on demand. Conversely, when the OCR is below neutral (as it has been through much of the pandemic) the low level of interest rates will boost spending and activity. Right now, with domestic demand running hot and inflation bubbling over, the RBNZ is desperate to ensure that the cash rate has moved above neutral and into tight territory to cool the economy down.

Even in normal times, there are wide bounds of uncertainty around where exactly the neutral rate sits. And right now, we are a long way from normal. The neutral level of the cash rate in New Zealand is usually thought to be around 2%. However, the RBNZ has flagged the possibility that at the current time that level could be higher than usual (meaning that more policy tightening could be required). Given that uncertainty, the RBNZ are likely to continue with large and rapid rate hikes to ensure that the cash rate is having the intended dampening impact.

While we're forecasting rapid rate increases in the near term, there are signs that demand is already starting to cool and a slowdown in growth is on the cards over the coming months. As we've previously highlighted, the impact of rate increases to date has been blunted by mortgage rate fixing. However, a large number of mortgages will come up for repricing at substantially higher rates over the coming months. The related pressure on households' budgets will squeeze demand and help to bring inflation pressures to heel over the coming years. That will likely see the RBNZ shifting to an on-hold stance from the end of this year, capping the rise in the OCR at 4%.

Satish Ranchhod, Senior Economist

Round-up of local data released over the last week

Date	Release	Previous	Actual	Westpac f/c
Mon 15	Jul BusinessNZ PSI	54.7	51.2	–
Wed 17	GlobalDairyTrade auction – WMP	–6.1%	–3.5%	–1.0%
	RBNZ policy decision	2.50%	3.00%	3.00%
Fri 19	Jul trade balance $m	–1102	–1092	–1250

NZ Q2 retail spending (volumes)

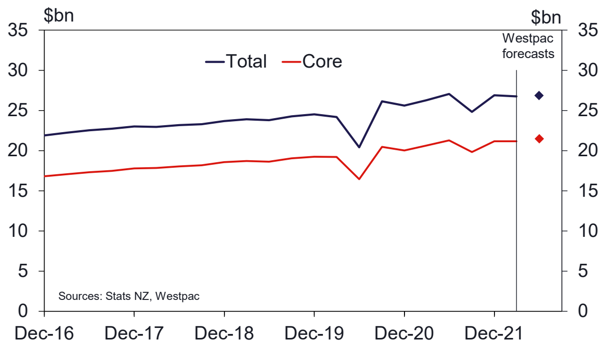
Aug 25, Last: -0.5%, Westpac f/c: +0.3%

The volume of goods sold fell 0.5% in the March quarter. However, that was a fairly small reversal following the solid 8% rise in the December quarter and left spending at firm levels.

We're forecasting a muted 0.3% rise in spending volumes in the June quarter. That's mainly related to a rise in hospitality spending following the relaxation of health restrictions earlier in the year. Spending in most other categories has remained steady.

The volume of goods sold has effectively been flat through 2022 to date. However, nominal spending has continued to trend higher due to the rise in consumer prices. We expect that the erosion of households' spending power (along with the rise in interest rates) will be an increasing drag on spending through the back half of the year.

NZ retail spending volumes



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 22					
US	Jul Chicago Fed activity index	–0.19	–	–	Regional surveys very volatile of late.
Tue 23					
Jpn	Aug Nikkei Japan PMI Services	50.3	–	–	Subdued near–term outlook for services…
	Aug Nikkei manufacturing PMI	52.1	–	–	… and manufacturing.
Eur	Aug S&P Global manufacturing PMI	49.8	49.3	–	Manufacturing tipping into contraction…
	Aug S&P Global services PMI	51.2	50.5	–	… services growth feeling pressure from cooling demand.
	Aug consumer confidence	–27	–28	–	Inflation pressuring capacity, spending and sentiment.
UK	Aug S&P Global manufacturing PMI	52.1	–	–	Manufacturing output has hit a 24–month low…
	Aug S&P Global services PMI	52.6	–	–	… services equally under pressure from rampant inflation.
US	Aug S&P Global manufacturing PMI	52.2	52.0	–	S&P PMIs point to much weaker conditions than ISMs…
	Aug S&P Global services PMI	47.3	50.2	–	… potentially implying larger effect on small/mid sized firms.
	Aug Richmond Fed index	0	–	–	Regional surveys very volatile of late.
	Jul new home sales	–8.1%	–1.7%	–	Housing sector under significant and lasting pressure.
Wed 24					
Aus	RBA Head of Domestic Markets	–	–	–	*Climate Change Risks in the Financial System*, Sydney, 9:05.
US	Jul durable goods orders	2.0%	0.6%	–	Investment partials point to material deterioration in spend.
	Jul pending home sales	–8.6%	–2.5%	–	Housing sector under significant and lasting pressure.
	Fedspeak	–	–	–	Kashkari.
Thu 25					
NZ	Q2 real retail sales	–0.5%	–	0.3%	Restrained volumes growth as prices charge higher.
Ger	Aug IFO business climate survey	88.6	86.6	–	Outlook highly uncertain; set to remain that way.
US	Q2 GDP	–0.9%	–0.9%	–	Q2's weak consumer a big risk for outlook.
	Initial jobless claims	250k	–	–	Likely to remain low versus history.
	Aug Kansas City Fed index	13	–	–	Regional surveys very volatile of late.
Fri 26					
NZ	Aug ANZ consumer confidence	81.9	–	–	Confidence low in the face of high inflation and rate rises.
US	Jul wholesale inventories	1.8%	–	–	Unwanted inventory accrual a risk given end demand.
	Jul personal income	0.6%	0.6%	–	Real income will remain under pressure until inflation…
	Jul personal spending	1.1%	0.3%	–	… comes back to more normal levels in 2023…
	Jul PCE deflator	1.0%	0.1%	–	… consumption will remain at risk until it does.
	Aug Uni. of Michigan sentiment	55.1	55.1	–	Consumption to remain weak into 2023.
	Jackson Hole Symposium	–	–	–	25–27 August. Chair Powell to speak on the 26th.

Forecasts

Interest rate forecasts

Australia	Latest (19 Aug)	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Cash	1.85	2.35	3.10	3.35	3.35	3.35	3.35	3.10
90 Day BBSW	2.33	3.05	3.55	3.55	3.55	3.55	3.38	3.13
3 Year Swap	3.47	3.30	3.25	3.20	3.10	2.90	2.80	2.75
3 Year Bond	3.09	2.95	3.00	3.00	2.90	2.70	2.60	2.55
10 Year Bond	3.40	3.20	3.40	3.30	3.10	2.90	2.65	2.50
10 Year Spread to US (bps)	50	40	40	40	40	40	35	30
US								
Fed Funds	2.375	2.875	3.375	3.375	3.375	3.375	3.125	2.875
US 10 Year Bond	2.90	2.80	3.00	2.90	2.70	2.50	2.30	2.20
New Zealand								
Cash	3.00	3.00	4.00	4.00	4.00	4.00	4.00	4.00
90 day bill	3.38	3.70	4.10	4.10	4.10	4.10	4.10	4.10
2 year swap	3.99	3.90	3.90	3.80	3.70	3.50	3.30	3.10
10 Year Bond	3.58	3.40	3.50	3.40	3.30	3.15	3.00	2.95
10 Year spread to US	68	60	50	50	60	65	70	75

Exchange rate forecasts

Australia	Latest (19 Aug)	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
AUD/USD	0.6912	0.71	0.73	0.75	0.76	0.77	0.78	0.78
NZD/USD	0.6236	0.64	0.66	0.68	0.69	0.70	0.71	0.71
USD/JPY	136.12	132	132	130	127	125	123	121
EUR/USD	1.0081	1.05	1.09	1.11	1.13	1.14	1.15	1.16
GBP/USD	1.1918	1.23	1.26	1.28	1.30	1.32	1.34	1.35
USD/CNY	6.8059	6.70	6.60	6.50	6.40	6.30	6.20	6.15
AUD/NZD	1.1081	1.11	1.11	1.10	1.10	1.10	1.10	1.10

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	2.0	1.0	0.6	0.4	0.2	–	–	–	–
%yr end	4.4	3.3	4.5	7.5	4.4	4.0	2.2	-0.7	4.4	4.4	1.0
Unemployment rate %	4.7	4.1	3.8	3.3	3.0	3.1	3.4	6.8	4.7	3.0	4.2
CPI % qtr	1.3	2.1	1.8	1.0	2.5	1.0	0.7	–	–	–	–
Annual change	3.5	5.1	6.1	6.3	7.6	6.4	5.2	0.9	3.5	7.6	3.1
CPI trimmed mean %qtr	1.0	1.5	1.5	1.5	1.2	0.8	0.7	–	–	–	–
%yr end	2.6	3.7	4.9	5.5	5.8	5.0	4.2	1.2	2.6	5.8	3.0

New Zealand economic growth forecasts

	2021	2022				2023		Calendar years			
% change	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	2020	2021	2022f	2023f
GDP % qtr	3.0	-0.2	1.0	0.4	0.6	0.6	0.5	–	–	–	–
Annual avg change	5.6	5.1	1.0	2.1	1.8	2.1	2.7	-2.1	5.6	1.8	2.0
Unemployment rate %	3.2	3.2	3.3	3.3	3.4	3.5	3.6	4.9	3.2	3.4	3.8
CPI % qtr	1.4	1.8	1.7	1.4	0.2	0.9	0.6	–	–	–	–
Annual change	5.9	6.9	7.3	6.4	5.1	4.2	3.1	1.4	5.9	5.1	3.2

DISCLAIMER

Things you should know.

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