WESTPAC WEEKLY ECONOMIC COMMENTARY

Spiralling.

14 November 2022

Kōwhai

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Data over the past week has highlighted that demand remains firm, while inflation pressures are showing few signs of abating. That reinforces our expectations for a jumbo sized 75 bp hike from the Reserve Bank of New Zealand at its upcoming 23 November policy meeting. However, there are big questions about just how far the RBNZ will have to go to cool demand and inflation.

Looking first at demand, the latest retail spending report delivered a sizeable upside surprise, with spending levels rising by 1.0% in October. That followed similarly sized gains over the past few months.

In part, the increase in spending levels has been due to the continued march higher in consumer prices, including the large increases in the prices of necessities like groceries. But despite those strong price rises, consumers have not been reining in their spending on discretionary items. In fact, October's lift in spending was predominantly due to a 2.8% rise in purchases of durable items, like household furnishings.

The resilience in durables spending is notable as purchases of such items tend to be quite sensitive to changes in borrowing costs. But despite the sharp rise in interest rates over the past year, spending is yet to show any real signs of slowing down.

And it's not just demand that has been holding firm. Inflation pressures are continuing to run red-hot in every corner of the economy. Consumer prices rose by 7.2% over the past year, and food price inflation hit a 14 year high of 10% in October. Similarly, business operating costs have increased by an average of 10%.

Crucially for the Reserve Bank, expectations for inflation over the coming years have also been pushing higher, as seen in the RBNZ's own survey of businesspeople and professionals. Notably, the closely watched gauge of expected inflation in two years' time has risen sharply, jumping from 3.1% in the September quarter to 3.6% now. That's the highest this measure has been since 1991 and well above the RBNZ's medium-term target of 2%.

The elevated level of inflation expectations is a big worry for the RBNZ. Expectations, especially over longer horizons, are a key influence on how businesses adjust prices and wages. Their recent rise signals that the current inflation cycle could be even more protracted.

Compounding the challenges for the RBNZ is that once inflation expectations do rise, it can be difficult to pull them down again. Doing so often requires a protracted fall in inflation, and that can mean a period of weak economic activity.

In response to those surging inflation pressures, the RBNZ has been hiking the Official Cash Rate at a rapid pace, with the cash rate rising by 325 bp since October last year. However, a year after the tightening cycle began, inflation is showing few signs of cooling.

At the same time, the drivers of inflation have changed. Initially, the upswing in prices was mainly due to Covid-related supply disruptions and a sharp rise in import costs. However, inflation pressures are now increasingly related to domestic factors, particularly the pressures in the labour market. With businesses across the country struggling to attract and retain workers in the face of firm demand, wage costs have been surging, with average hourly earnings in the private sector up a whopping 8.6% over the past year.

To head off those red-hot domestic inflation pressures, we're forecasting that the RBNZ will deliver a jumbo-size 75 bp hike at its 23 November policy meeting, and we expect that will be followed by continued rate increases in early 2023.

One of the major complications in the RBNZ's fight against inflation is the prevalence of mortgage rate fixing. Around 90% of New Zealand mortgages are on fixed rates, and many of those are still locked in at the very low interest rates that were on offer in the early stages of the pandemic. That's meant large numbers of households are yet to feel the impact of rate hikes to date, which has allowed them to maintain their spending patterns.

That picture will change dramatically over the coming months, with more than half of all mortgages coming up for repricing over the next 12 months. In many cases borrowers will face refixing at rates that are 3 percentage points higher than those they are currently on. And as that occurs, we're certain to see a slowing in domestic demand.

But while we wait for the full impact of interest rate hikes to date to ripple through the economy, we're still left with a picture of sizzling inflation pressures. And that leaves the RBNZ with a tough balancing act. Taking a more gradual approach and waiting to see the full impact of rate hikes could actually mean more pain in the longer term if inflation pressures do not ease off. In contrast, more aggressive rate hikes now could risk a sharper than necessary downturn in economic activity and employment.

Ultimately, we expect the RBNZ will maintain its 'stitch in time' approach. That means the central bank is likely to continue to front load its policy tightening. And on balance we think that is the right approach, especially given the clear upside risks for inflation expectations. Indeed, if the RBNZ doesn't get in front of those pressures soon, the New Zealand economy could realistically find itself mired in a wage-price spiral. That would impose serious harm on households and the economy more generally, with ongoing pressure on living costs and weakness in economic activity.

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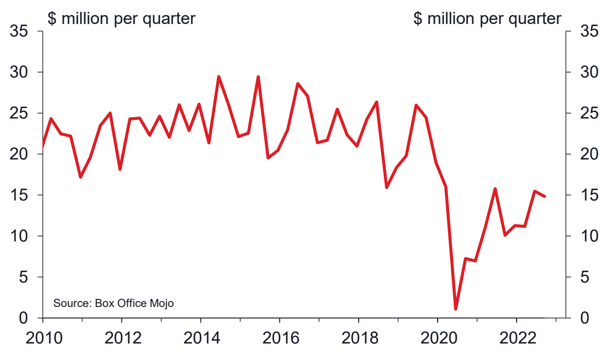
Chart of the week

Far fewer of us are actually going to watch movies at the cinema than before the pandemic. In fact, gross spending on movie tickets is only running at around two-thirds of the levels that we saw in the years prior to the outbreak. During the pandemic, restrictions on going out saw households around the globe signing up to streaming services. Now, despite the rolling back of in health restrictions, it seems many of us would still rather spend the night on the couch.

New Zealander's spending at the cinema

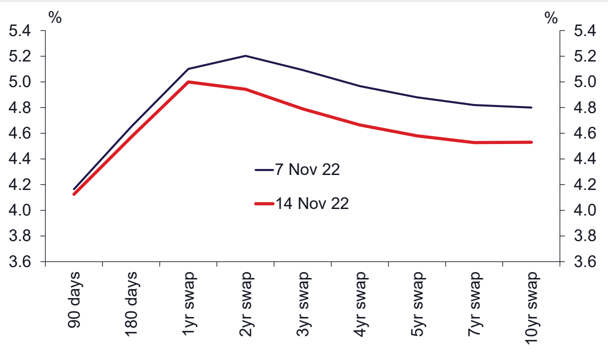


Fixed vs floating for mortgages

We expect the Reserve Bank to lift the Official Cash Rate to 5% and to hold it there for the next couple of years, before reducing it to a more sustainable level in the following years. Wholesale interest rate markets are pricing in a similar peak, but a higher level of the OCR over the longer term.

As a result, we believe that there is value in fixing for terms of up to two years. We would regard fixing for terms longer than this as expensive, but this option may suit those who want more certainty in their repayments.

NZ interest rates



The week ahead

NZ Oct REINZ house sales and prices

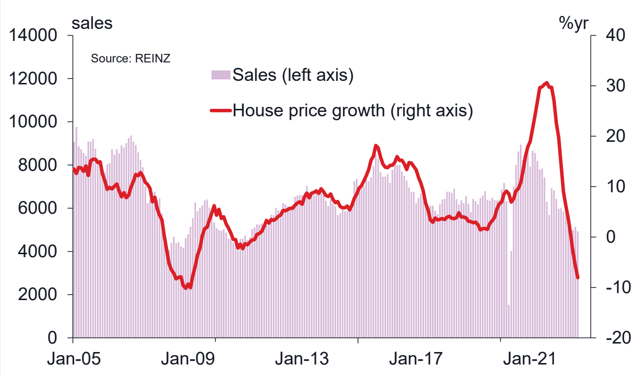
Nov 15, Sales last: -4.1% m/m, -10.9% y/y
Prices last: -1.6% m/m, -8.1% y/y

The correction in New Zealand's housing market continues at pace, with prices down by 11% since last November. That has only taken them back to where they were in April last year, highlighting the ferocity of the price rise over 2020 and 2021.

Higher interest rates have been the key driver of the correction, and they point to further price declines to come. Fixed-term mortgage rates eased slightly in August and September, but rebounded to reach new highs in October.

There are signs of house sales flattening out in recent months, albeit at very low levels. The supply of unsold homes on the market also looks to be stabilising, though this is largely due to a drop in new listings, as falling prices have kept potential sellers away from the market.

REINZ house prices and sales



NZ GlobalDairyTrade auction, whole milk powder prices

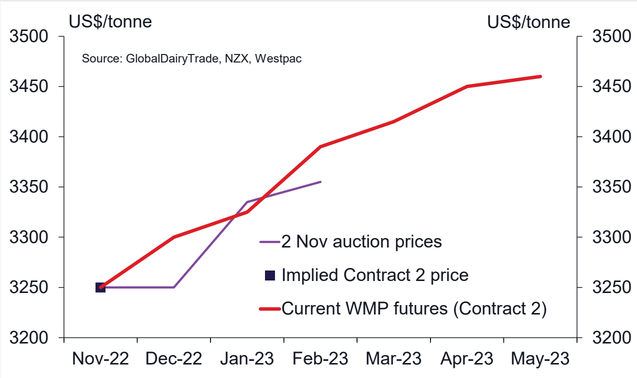
November 16, Last: -3.4%, Westpac: Flat

We expect whole milk powder prices to be unchanged at the upcoming auction. This follows a 3.4% price slide at the previous auction.

Our pick is roughly in line with futures market pricing (as at 10am Friday 11 November).

Fundamentally, very weak global dairy supply is underpinning the medium-term global dairy price outlook. However, weak demand on the back of a soft Chinese economy is providing offset to tight supply.

Whole milk powder prices



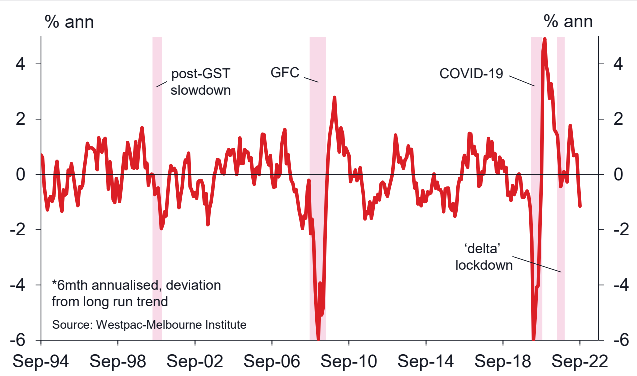
Aus Oct Westpac-MI Leading Index

Nov 16, Last: -1.15%

The six-month annualised growth rate fell to -1.15% in Sep, down from -0.33% in Aug, pointing to a material loss in momentum to a below-trend growth pace heading into 2023. The Sep read was the weakest since the pandemic first hit in 2020, and, prior to that, since early 2016.

October is likely to give a similar picture, with a further deterioration in the six month growth pace possible. It will include some weaker component updates for the Westpac-MI Consumer Expectations Index (down a further -8.6%); and the Westpac-MI Unemployment Expectations Index (deteriorating by a further 5.4%), with commodity prices continuing to slide in AUD terms (down a further -5.7%). Other components have been more mixed, the ASX posting a solid 6% rally through Oct, dwelling approvals falling back after a big rise in the previous month; and US industrial production and hours worked both flat rather than weak.

Aus Westpac-MI Leading Index



The week ahead

Aus Q3 Wage Price Index - excluding bonuses %qtr

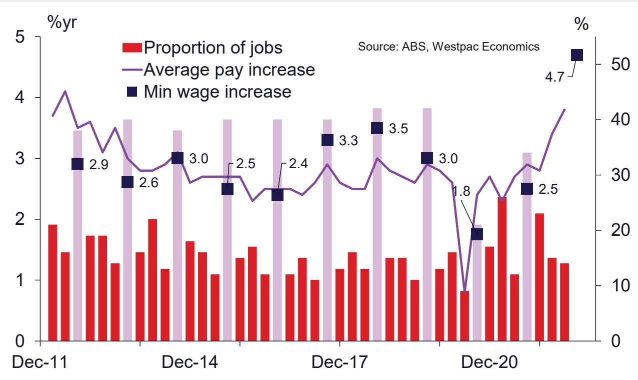
Nov 16, Last: 0.7%, WBC f/c: 1.1%
Mkt f/c: 0.9%, Range: 0.8% to 1.4%

The WPI lifted 0.7% in Q2, softer than Westpac's 0.9% forecast and the market's 0.8%. There has been a steady gradual rise in wage inflation but it is far from what you would describe as a wages breakout.

The annual pace lifted to 2.6%/yr from 2.4%/yr, well up on the H2 2020 low 1.4%/yr. It is now the fastest pace since March 2014. Back then wages also underperformed broader economic indicators. If there was ever a time for wages to regain some of their relationship to broader economic indicators, now must be the time.

The September quarter has historically been the quarter where the majority of workers received their pay rise as it is the start of the new financial year plus the quarter when the increase in awards/minimum wage is paid. This year the 4.7% increase in the award/minimum wage was much larger than previous year increases hence our 1.1% forecast, the largest quarterly rise since September 2010.

Aus private sector wage increase in quarter



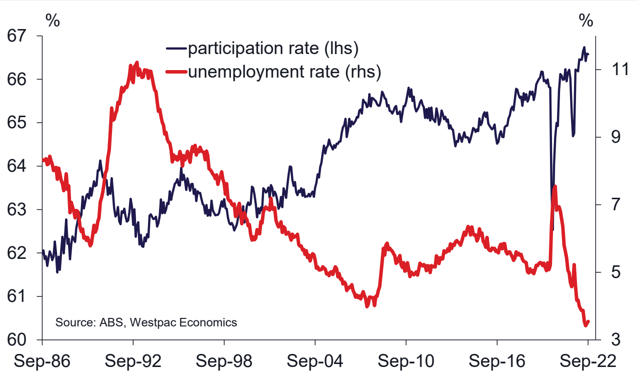
Aus October Labour Force - employment '000

Nov 17, Last: 0.9k, WBC f/c: 15k
Mkt f/c: 15k, Range: –3k to 45k

The 900 increase in employment in September was the third consecutive disappointing print from the Labour Force Survey. With a three month average increase in employment of just 200, compared to working age population growth average of 17.4k per month over the same period, it does appear that the Australian labour market stalled heading into the last quarter of the year.

Consumer unemployment expectations remain at historically sound levels but nonetheless, they are 17.8% higher in the last two months. Business surveys remain upbeat and vacancies at historical highs so the question is: are we at full employment resulting in a lack of suitable candidates? We can't be sure if that is the case but we do know that the lack of suitable labour is a critical constraint on activity.

Aus labour force participation and unemployment



Aus October Labour Force - unemployment %

Nov 17, Last: 3.5%, WBC f/c: 3.6%
Mkt f/c: 3.5%, Range: 3.5% to 3.6%

The 900 in employment in September was an increase of just 0.01%. Contrast that with a gain in the working age population of 0.08% and a 9.8k, or 0.07%, lift in the labour force. This left the participation rate flat at 66.6% and the unemployment rate flat at 3.5%. However, at two decimal points it lifted from 3.48% to 3.54% so very close to rounding up to 3.6% while the employment to population ratio eased back to 64.22% from 64.27%.

Holding participation flat in October, our forecast 15k gain in employment is not enough to prevent the unemployment rate rounding up to 3.6%. We see there is a risk of a softer gain in employment in October while participation can remain robust, hence we see upside risk to our unemployment rate.

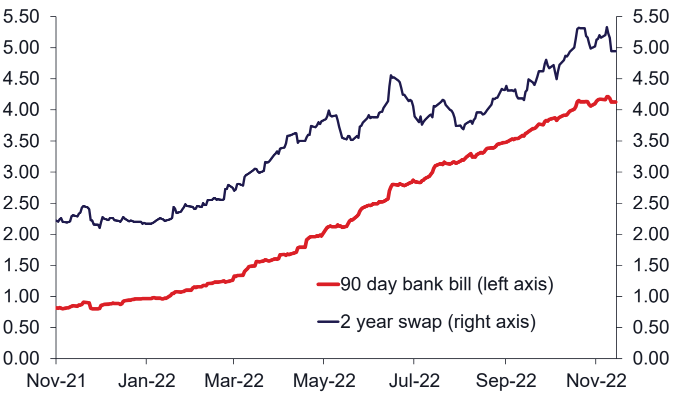
Aus unemployment expectations vs. employment ratio

New Zealand forecasts

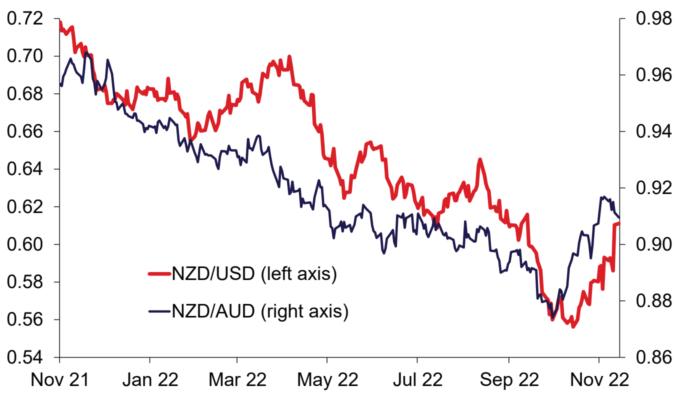
Economic forecasts	Quarterly				Annual			
	2022			2023				
% change	Jun (a)	Sep	Dec	Mar	2020	2021	2022f	2023f
GDP (Production)	1.7	0.4	0.6	0.6	-2.1	5.5	2.2	2.2
Employment	0.0	1.3	0.1	0.1	0.6	3.3	1.4	0.8
Unemployment Rate % s.a.	3.3	3.3	3.3	3.5	4.9	3.2	3.3	3.8
CPI	1.7	2.2	0.5	1.3	1.4	5.9	6.2	4.1
Current Account Balance % of GDP	-7.7	-7.7	-7.1	-6.0	-0.8	-6.0	-7.1	-4.4

Financial forecasts	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
Cash	4.25	4.75	5.00	5.00	5.00	5.00	5.00
90 Day bill	4.55	5.00	5.10	5.10	5.10	5.10	4.80
2 Year Swap	5.00	4.90	4.80	4.60	4.40	4.15	3.90
5 Year Swap	4.70	4.60	4.50	4.35	4.20	4.05	3.90
10 Year Bond	4.50	4.50	4.30	4.20	4.00	3.80	3.70
NZD/USD	0.58	0.59	0.60	0.62	0.65	0.66	0.66
NZD/AUD	0.89	0.89	0.90	0.90	0.90	0.90	0.89
NZD/JPY	85.3	85.6	85.8	86.8	88.4	87.1	85.8
NZD/EUR	0.58	0.58	0.59	0.60	0.61	0.60	0.60
NZD/GBP	0.51	0.52	0.52	0.53	0.54	0.54	0.53
TWI	68.3	68.5	68.4	69.2	71.1	70.8	70.8

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 14 November 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.95%	3.79%	3.54%
60 Days	4.04%	3.95%	3.78%
90 Days	4.13%	4.10%	4.01%
2 Year Swap	4.94%	5.02%	5.00%
5 Year Swap	4.58%	4.70%	4.79%

NZ foreign currency mid-rates as at 14 November 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6111	0.5802	0.5600
NZD/EUR	0.5896	0.5842	0.5744
NZD/GBP	0.5166	0.5027	0.4966
NZD/JPY	84.66	86.24	83.34
NZD/AUD	0.9095	0.9074	0.8960
TWI	71.08	69.81	67.59

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 14					
NZ	Oct BusinessNZ PSI	55.8	–	–	Demand for services has firmed in recent months.
Eur	Sep industrial production	1.5%	–	–	Support from easing supply issues but outlook is gloomy.
UK	Nov Rightmove house prices	0.9%	–	–	More declines to come as policy tightening continues.
US	Fedspeak	–	–	–	Waller, Brainard.
Tue 15					
NZ	Oct REINZ house sales %yr	-10.9%	–	–	Signs of sales flattening out, albeit at low levels.
	Oct REINZ house prices %yr	–8.1%	–	–	Rising interest rates point to further price declines to come.
	Sep net migration	47	–	–	Still low, but we're not seeing an outflow of people anymore.
Aus	RBA minutes	–	–	–	More colour on the Nov decision.
	Oct overseas arrivals, prelim '000s	1072.9	–	–	Net temporary visa arrivals starting to pick up.
Chn	Oct retail sales ytd %yr	0.7%	0.8%	–	Consumption is key for growth moving forward...
	Oct fixed asset investment ytd %yr	5.9%	5.9%	–	... but domestic virus risks, COVID-zero and a softening...
	Oct industrial production ytd %yr	3.9%	4.1%	–	... global economy are still clear headwinds for activity.
Eur	Nov ZEW survey of expectations	–59.7	–	–	A very challenging outlook ahead.
	Sep trade balance €bn	–47.3	–	–	Energy–related import values still elevated.
	Q3 GDP, second estimate	0.2%	0.2%	–	Growth outcome surprisingly resilient given headwinds.
UK	Sep ILO unemployment rate	3.5%	3.5%	–	Slack to become more visible into year–end.
US	Oct PPI	0.4%	0.5%	–	Producer inflation cooling as supply issues ease.
	Nov Fed Empire state index	–9.1	–5.0	–	Regional surveys showing weakness.
	Fedspeak	–	–	–	Williams, Harker, Cook, Barr.
Wed 16					
NZ	GlobalDairyTrade auction (WMP)	–3.4%	–	0.0%	Dairy prices to halt their recent slide.
Aus	Oct Westpac–MI Leading Index	–1.15%	–	–	Pointing to a material loss in momentum heading into 2023.
	Q3 wage price index	0.7%	0.9%	1.1%	The outsize increase in minimum wage seen this quarter.
UK	Oct CPI %yr	10.1%	–	–	Likely to crest by year's end.
US	Oct retail sales	0.0%	0.9%	–	Inflation and rates to weigh more heavily on consumption.
	Oct import price index	–1.2%	–0.5%	–	Import prices are declining from elevated levels.
	Oct industrial production	0.4%	0.2%	–	Weakness in domestic and global demand a key risk.
	Sep business inventories	0.8%	0.5%	–	Pace of inventory accrual beginning to slow.
	Nov NAHB housing market index	38	36	–	Housing market under significant and lasting pressure.
	Fedspeak	–	–	–	Williams, Barr, Waller.
Thu 17					
Aus	Oct employment, '000 chg	0.9k	15k	15k	Employment growth averaged just 200 per month for the last...
	Oct unemployment rate	3.5%	3.5%	3.6%	... 3 months & firm participation points to a rise in unemploy.
Eur	Oct CPI %yr	9.9%	10.7%	–	Final estimate to confirm expanding breadth of inflation.
US	Oct housing starts	–8.1%	–1.3%	–	Demand is being hit hard by rising interest rates...
	Oct building permits	1.4%	–3.0%	–	... while input availability limits construction.
	Nov Phily Fed index	–8.7	–6.0	–	Regional surveys showing weakness.
	Initial jobless claims	225k	–	–	Likely to remain at low levels, at least for time being.
	Nov Kansas City Fed index	–7	–	–	Regional surveys showing weakness.
	Fedspeak	–	–	–	Bullard, Bowman, Mester, Jefferson, Kashkari.
Fri 18					
UK	Nov GfK consumer sentiment	–47	–	–	Consumer confidence is historically weak...
	Oct retail sales	–1.4%	–	–	... leading many households to pull–back spending.
US	Oct existing home sales	–1.5%	–7.3%	–	Declines set to continue given further tightening from FOMC.
	Oct leading index	–0.4%	–0.4%	–	Growth outlook clearly deteriorating.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.1	4.9	4.2	1.9
CPI inflation %yr	1.8	1.8	0.9	3.5	7.9	4.1
Unemployment rate %	5.0	5.2	6.8	4.7	3.3	4.5
Current account % of GDP	-2.1	0.7	2.4	3.2	1.3	-0.9
United States						
Real GDP %yr	2.9	2.3	-3.4	5.7	1.9	0.4
CPI inflation %yr	2.4	1.9	1.2	5.1	7.1	2.5
Unemployment rate %	3.9	3.7	8.1	5.4	3.7	4.8
Current account % of GDP	-2.3	-2.6	-2.5	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	0.6	-0.4	-4.6	1.7	1.7	1.5
Euro zone						
Real GDP %yr	1.8	1.6	-6.1	5.2	3.2	0.4
United Kingdom						
Real GDP %yr	1.7	1.7	-9.3	7.4	3.6	-0.2
China						
Real GDP %yr	6.8	6.0	2.2	8.1	3.5	6.0
East Asia ex China						
Real GDP %yr	4.5	3.8	-2.3	4.2	4.5	4.4
World						
Real GDP %yr	3.6	2.8	-3.0	6.0	3.2	3.0

Forecasts finalised 4 November 2022

Interest rate forecasts	Latest	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
Australia								
Cash	2.85	3.10	3.60	3.85	3.85	3.85	3.60	3.35
90 Day BBSW	3.03	3.55	3.97	4.05	4.05	3.97	3.72	3.47
10 Year Bond	3.66	3.80	3.80	3.60	3.40	3.20	3.00	2.90
International								
Fed Funds	3.875	4.375	4.625	4.625	4.625	4.625	4.375	3.875
US 10 Year Bond	3.81	4.00	4.00	3.80	3.60	3.40	3.10	2.90

Exchange rate forecasts	Latest	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
AUD/USD	0.6616	0.65	0.66	0.67	0.69	0.72	0.73	0.74
USD/JPY	141.92	147	145	143	140	136	133	130
EUR/USD	1.0187	1.00	1.01	1.02	1.04	1.07	1.09	1.10
GBP/USD	1.1677	1.13	1.14	1.16	1.18	1.20	1.22	1.24
USD/CNY	7.1663	7.20	7.00	6.80	6.60	6.50	6.40	6.30
AUD/NZD	1.0999	1.12	1.12	1.12	1.11	1.11	1.11	1.12

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