

WESTPAC WEEKLY ECONOMIC COMMENTARY

Inflation likely to be down, but not out.

17 July 2023



Southern rātā

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The key domestic event over the past week was the Reserve Bank's review of monetary policy. As expected by Westpac and the market, the RBNZ maintained the OCR at 5.5%. The statement accompanying the decision provided no surprises either, with the Bank repeating much of the language used in its previous post-meeting statement.

The RBNZ's comfort with recent developments was front and centre, with the statement opening with the observation that "The level of interest rates are constraining spending and inflation pressure as anticipated and required." So unsurprisingly, the Bank also restated that it is confident that maintaining interest rates at restrictive levels for some time will allow CPI inflation to move back within the target range. In the minutes of the meeting, it was stated that MPC members consider the risks around the inflation projection to be "broadly balanced".

Westpac remains of the view that the OCR will be increased by 25bps to 5.75% at the August Monetary Policy Statement. As we have written previously, since the May Statement there wasn't enough data to significantly shift the RBNZ's strong view for a protracted period of unchanged rates. However, the month ahead will see some key information in the form of the June quarter CPI and labour market report. These will provide more information on the persistence of core inflation pressures and the strength of the labour market, and hence prospects for a fall in GDP during the second half of this year. Partial indicators

suggest the labour market has not cracked yet, which raises the likelihood that the RBNZ will need to upgrade its growth forecasts for this year. This would add some upside risk to the inflation outlook and lengthen the already protracted period over which inflation remains above the target range. As a result, we aren't yet convinced that the door to an August tightening has been closed, although the hurdle to moving through that door remains high.

With the July policy meeting now out of the way, attention has returned to local economic data. The news from the household sector has been a little more upbeat. Consumer spending in the retail sector rebounded 1.0% in June, albeit owing much to a lift in spending on fuel. However, led by further weakness in hospitality – perhaps pointing to a clampdown on discretionary spending – core spending was flat in June after a 1.4% decline in May. Meanwhile, the housing market continued to establish a base in June. After adjusting for seasonal factors, sales rose 2.2% – the fourth consecutive increase – and were almost 15% higher than a year earlier. While the median days to sell remains elevated, the house price index increased 1.2%, reducing

the annual decline in prices to 9.0%. While the RBNZ seems comfortable with recent trends, going forward the housing market will be an important area to monitor.

The lift in housing activity likely owes in part to the strength of migrant inflows earlier this year. On that score, a net inflow of almost 5000 permanent and long-term migrants arrived in New Zealand in May. While recent outturns are prone to revision, this is well down from the pace seen earlier this year. This month, a notable feature was a further lift in non-resident departures to above pre-Covid levels. The annual inflow appears on track to peak at around 85,000 to 90,000. Although this is a little less than had seemed likely a few months ago, picking the exact peak is a second-order issue; going forward, what will be far more important is understanding the impact on the labour and housing markets, and ultimately the required level of interest rates.

The news from the corporate sector was mixed. The BusinessNZ manufacturing PMI fell 1.2pts to 47.5 in June, led by a 6.4pt decline in the new orders index to 43.8 – in both cases the lowest readings this year and indicating ongoing malaise in the manufacturing sector. But in some good news for the hospitality industry, short-term visitor arrivals appear to have recovered further in May. That said, while visitor arrivals were more than double last year’s level, they remain down by more than a quarter compared with the equivalent pre-Covid level.

Looking ahead to the coming week, the local economic diary is dominated by the Wednesday’s June quarter CPI release. Following news of a large increase in food prices in June, Westpac has finalised its forecast of quarterly headline inflation at 0.9%, a result which would be 0.2ppts below the forecast the RBNZ made back in May. That would see annual inflation slipping to 5.9%, down from 6.7% previously. A sharp 2.5% increase in food prices will make the largest upward contribution to quarterly inflation, while the decline in annual inflation owes almost entirely to lower fuel prices. Non-tradables inflation – of greatest importance to the RBNZ – also seems likely to print at 0.9%. Thanks to a slower pace of increase in the construction sector, this will lower annual inflation slightly to 6.2%. While down from last quarter’s peak of 6.8%, domestic inflation remains elevated and will need to decline much further if the Reserve Bank is to meet its inflation target.

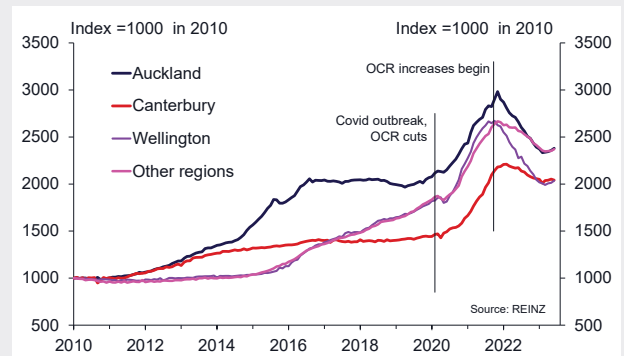
Other news to look out for over the coming week include the services PMI and the latest GDT dairy auction. The services PMI has only a loose correlation with measured activity in the sector, but will likely trend lower over time as monetary policy tightening gains traction. Meanwhile, futures contracts indicate that the whole milk powder price may move lower at the auction, as they did a fortnight earlier – perhaps reflecting ongoing weak sentiment coming out of China.

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Chart of the week

The June update from the REINZ reinforced signs that the New Zealand housing market has found a base. House sales have risen in each of the past four months and are 15% higher than this time last year. Similarly, house prices in Auckland, Wellington and Canterbury have all risen 2% from the lows they reached earlier this year. While we’re forecasting modest house price rises over the next few months, the firm June housing report hints that the market may be heating up sooner than anticipated.

House prices by region

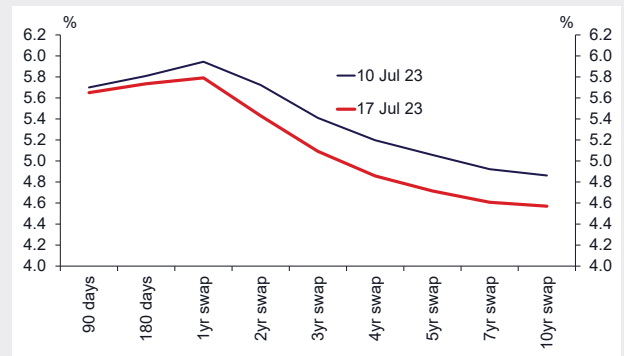


Fixed vs floating for mortgages

The RBNZ has signalled that it expects to hold the cash rate at its current level of 5.50% for an extended period. In contrast, financial markets are pricing in an earlier start to interest rate cuts, from early next year. We see a risk that the OCR could go higher in the coming months, and that interest rate cuts could be some time away.

As a result, we see value in fixing for terms as long as two years. Rates for terms beyond two years are still relatively expensive, but would provide more certainty around the size of repayments.

NZ interest rates



The week ahead

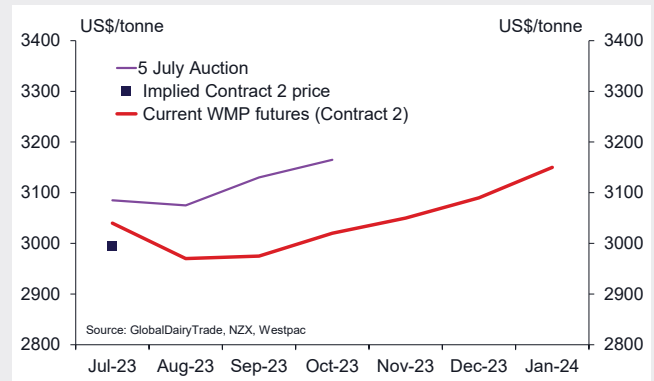
NZ GlobalDairyTrade auction, whole milk powder prices

Jul 19, Last: -0.7%, Westpac: -3.0%

We expect whole milk powder prices (WMP) to fall by 3% at the upcoming auction. If prices fall as expected, then this would continue the downward trend seen over recent months. Our pick is similar to the 3.4% drop that the futures market is pointing to as at Thursday 13 July.

We continue to expect that underwhelming Chinese dairy demand will put downward pressure on prices in the short term. Soft underlying global dairy production coupled with and an expected improvement in Chinese dairy demand should support dairy prices in the medium term.

Whole milk powder prices



NZ Q2 CPI

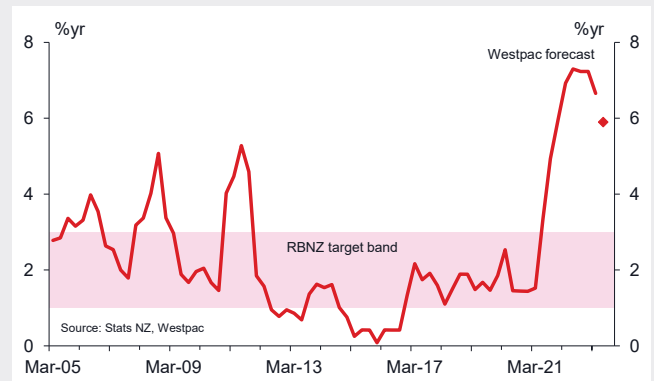
Jul 19, Qty. – Last: +1.2%, Westpac: +0.9%, Mkt f/c: +0.9%
Annual – Last: +6.7%, Westpac: +5.9%, Mkt f/c: +5.9%

We estimate that New Zealand consumer prices rose by 0.9% in the June quarter. That would see annual inflation slipping to 5.9%, down from 6.7% in the year to March. But while headline inflation is dropping back, underlying price pressures remain strong. Measures of core inflation are set to linger at levels of around 5% to 6%.

The June quarter saw a further large increase in food prices. Those increases have been partially offset by falls in fuel prices.

Our forecast is lower than the RBNZ's last published projection reflecting a lower forecast for tradable prices.

Consumers Price Index



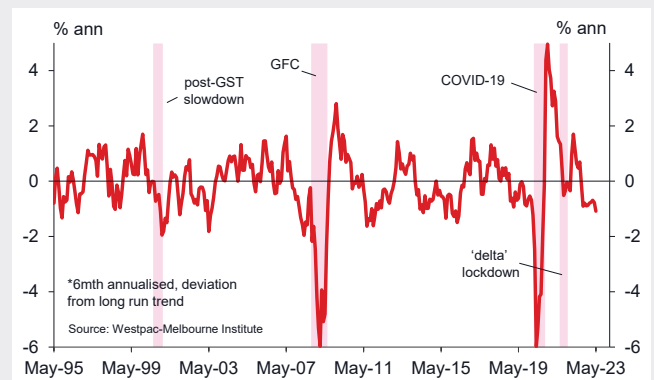
Aus Jun Westpac-MI Leading Index

Jul 19, Last: -1.09%

The Leading Index continued to send a weak signal in May, the six-month annualised growth rate declining to -1.09%, the lowest read since the pandemic and continuing the run of negative growth rates that began back in August last year. The picture remains consistent with weak growth running well below trend.

The June read will include a mixed bag of updates with a big, but likely temporary, bounce in dwelling approvals (+20%) and slightly better reads on equity markets (the ASX200 up 1.6% in June) and the Westpac-MI Consumer Expectations Index (up 4.5%) but another big decline in commodity prices (down -12.8% in AUD terms). The net result may see a slight lift in the overall index growth rate but another negative read looks likely.

Aus Westpac-MI Leading Index



The week ahead

Aus Jun Labour Force - employment chg, '000

Jul 20, Last: 75.9k, WBC f/c: +25k
Mkt f/c: 14k, Range: -10k to +36k

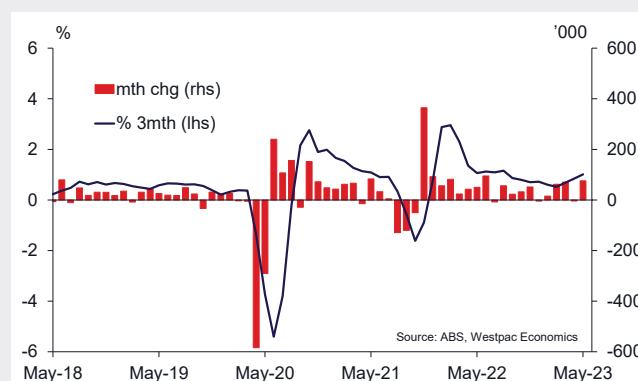
April's modest decline in employment (-4.0k), associated with a seasonal anomaly, was followed by a sizeable gain in May (+75.9k), exceeding even Westpac's near top-of-the-range forecast.

By way of context, jobs growth has lifted by 220k year-to-date in 2023. This is only moderately below the 254k that was observed in 2022, back when Australia finally emerged from lockdowns and the reopening 'burst' of activity was well and truly in full swing.

The historically elevated level of vacancies has proven immensely supportive to employment growth, reflective of lasting strength in labour demand amid a robust recovery in population growth.

For June, we have pencilled in an around-trend lift in employment of +25k. That said, momentum in jobs growth should slow to a stalling-pace into year-end as economic conditions falter under the weight of rapidly rising interest rates and cost-of-living pressures.

Aus employment growth



Aus Jun Labour Force - unemployment rate %

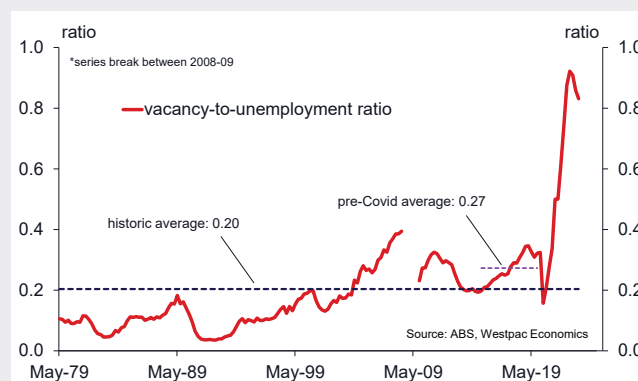
Jul 20, Last: 3.6%, WBC f/c: 3.6%
Mkt f/c: 3.6%, Range: 3.5% to 3.7%

In May, the participation rate rose to a historic high of 66.9%. This saw the labour force expand by a sizeable 59.4k, but with jobs growth also lifting strongly, the unemployment rate managed to fall from 3.7% to 3.6% (or 3.55% to two decimal places).

Critical to the near-term evolution for unemployment is the strength of labour demand. Vacancies have barely moderated from its peak in May 2022 and business surveys are only now beginning to more convincingly reflect an unfolding softening in labour demand. On balance, this points to downside risk for the unemployment rate this year, which we have now revised down from 4.2% to 4.0%.

For the June survey, we expect the participation rate will be unchanged, at 66.9%, which would result in the unemployment rate holding flat at 3.6%.

Aus vacancy-to-unemployment ratio



China Q2 GDP

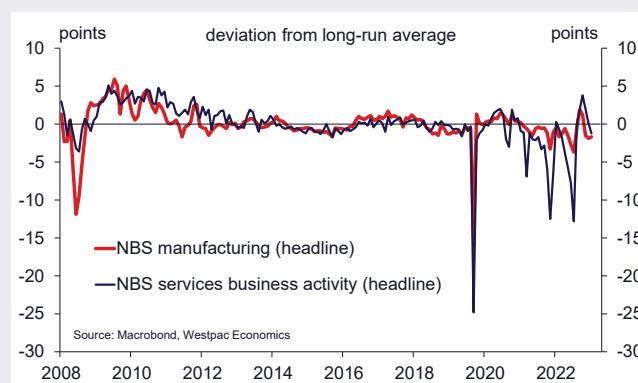
Jul 17: Last: 4.5%yr ytd, WBC f/c: 6.1%yr ytd
Mkt f/c: 6.1%yr ytd

Through Q2, uncertainty over China's near-term outlook continued to grow as confidence amongst consumers waned while local government authorities and property developers remained cash constrained.

Growth in Q2 is therefore likely to be modest, a little short of 4% on an annualised basis. Still, with Q1 growth near 9% annualised, a sub-par outcome in Q2 still leaves the economy on track to register growth circa 5.7% for the full year – assuming authorities work to remedy consumers' concerns and make liquidity available to businesses and government entities that need it.

The June activity data released with GDP will also be critical, making clear the pulse of key sectors of the economy ahead of Q3.

Chinese PMI and PSI

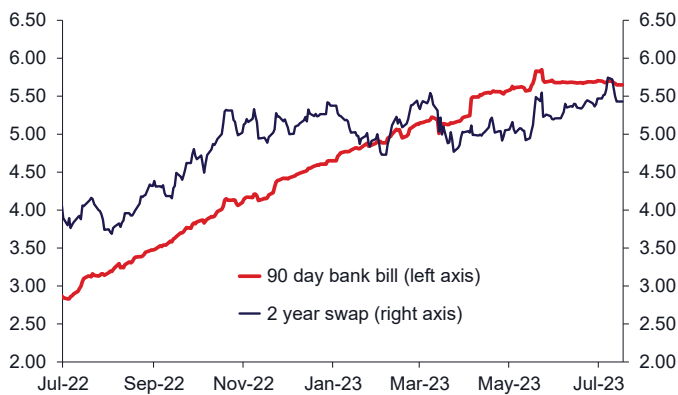


New Zealand forecasts

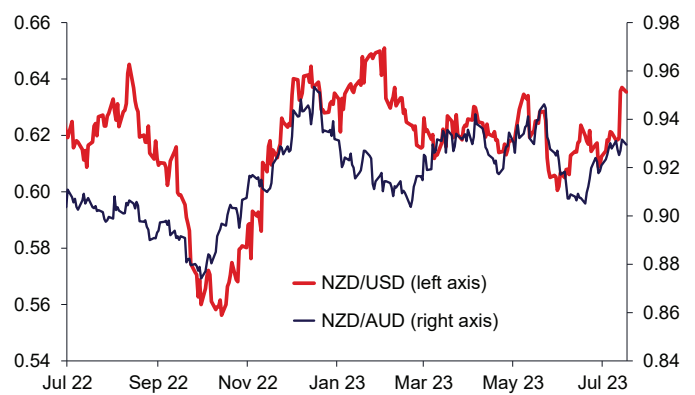
Economic forecasts	Quarterly				Annual			
	2022	2023						
% change	Dec	Mar	Jun	Sep	2021	2022	2023f	2024f
GDP (Production)	-0.7	-0.1	0.5	0.5	6.0	2.7	1.2	0.5
Employment	0.5	0.8	0.4	0.0	3.3	1.6	1.2	-0.4
Unemployment Rate % s.a.	3.4	3.4	3.5	3.7	3.2	3.4	3.9	4.9
CPI	1.4	1.2	0.9	2.0	5.9	7.2	4.7	2.9
Current Account Balance % of GDP	-9.0	-8.5	-8.2	-7.9	-6.0	-9.0	-6.8	-4.0

Financial forecasts	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
Cash	5.75	5.75	5.75	5.75	5.25	4.75	4.50
90 Day bill	5.85	5.85	5.85	5.55	5.05	4.75	4.30
2 Year Swap	5.30	5.00	4.70	4.40	4.20	4.00	3.90
5 Year Swap	4.80	4.60	4.45	4.30	4.15	4.05	3.95
10 Year Bond	4.60	4.40	4.20	4.00	3.90	3.80	3.70
NZD/USD	0.62	0.62	0.63	0.64	0.65	0.66	0.66
NZD/AUD	0.90	0.90	0.89	0.89	0.89	0.89	0.89
NZD/JPY	86.8	85.6	85.7	85.1	84.5	84.5	83.5
NZD/EUR	0.56	0.56	0.56	0.57	0.57	0.57	0.57
NZD/GBP	0.49	0.49	0.49	0.50	0.50	0.51	0.51
TWI	70.9	70.3	70.1	70.4	70.7	71.0	70.8

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 17 July 2023

Interest rates	Current	Two weeks ago	One month ago
Cash	5.50%	5.50%	5.50%
30 Days	5.60%	5.61%	5.60%
60 Days	5.63%	5.66%	5.64%
90 Days	5.65%	5.70%	5.68%
2 Year Swap	5.43%	5.47%	5.34%
5 Year Swap	4.72%	4.66%	4.59%

NZ foreign currency mid-rates as at 17 July 2023

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6354	0.6145	0.6199
NZD/EUR	0.5663	0.5642	0.5677
NZD/GBP	0.4853	0.4849	0.4840
NZD/JPY	88.23	88.94	87.93
NZD/AUD	0.9295	0.9234	0.9051
TWI	72.62	71.42	71.23

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 17					
NZ	Jun BusinessNZ PSI	53.3	-	-	Financial headwinds weighing on demand.
Chn	Q2 GDP ytd %yr	4.5%	6.1%	6.1%	Post-Covid reopening has been difficult to navigate...
	Jun retail sales ytd %yr	9.3%	8.0%	-	... but the outlook is constructive, as investment responds...
	Jun industrial production ytd %yr	3.6%	3.5%	-	... to Asia's development and the global green transition...
	Jun fixed asset investment ytd %yr	4.0%	3.4%	-	... trends that will facilitate high quality, sustainable growth.
US	Jul Fed Empire state index	6.6	0.0	-	More volatile than usual, reflective of uncertain conditions.
Tue 18					
Aus	RBA Minutes	-	-	-	More colour around July's pause.
US	Jun retail sales	0.3%	0.5%	-	Car sales a positive; core spending remains fragile.
	Jun industrial production	-0.2%	0.0%	-	PMIs indicative of further downside over near-term.
	May business inventories	0.2%	0.2%	-	Accrual nearing stall speed as economy slows.
	Jul NAHB housing market index	55	-	-	Lack of supply aiding confidence boost.
Wed 19					
NZ	GlobalDairyTrade auction (WMP)	-0.7%	-	-3.0%	Weaker prices to reflect still sluggish Chinese demand.
	Q2 CPI %qtr	1.2%	0.9%	0.9%	Higher food prices offsetting fuel price declines...
	Q2 CPI %yr	6.7%	5.9%	5.9%	... inflation trending down, still elevated.
Aus	Jun Westpac-MI Leading Index	-1.09%	-	-	Significantly below trend for nine consecutive months now.
Eur	Jun CPI %yr	6.1%	5.5%	-	Final estimate to provide key detail around services.
UK	Jun CPI %yr	8.7%	8.3%	-	Base effects support deceleration, but core pressures remain.
US	Jun housing starts	21.7%	-10.2%	-	Partial reversal following May's surge likely...
	Jun building permits	5.6%	-0.9%	-	... risks around pipeline to linger.
Thu 20					
Aus	Jun employment	75.9k	14k	25k	Vacancies have greatly support jobs growth year-to-date...
	Jun unemployment rate	3.6%	3.6%	3.6%	... allowing U/E to remain lower, for longer.
Eur	Jul consumer confidence	-16.1	-	-	Uptrend limited by persistent inflation and rates pressures.
US	Initial jobless claims	237k	-	-	Showing few signs of significant slack emerging.
	Jul Philly Fed index	-13.7	-10	-	Sustained downtrend highlights risks for manufacturing.
	Jun existing home sales	0.2%	-1.2%	-	Historically low rate of turnover given supply and affordability.
	Jun leading index	-0.7%	-0.6%	-	Clearly signalling downside growth risks.
Fri 21					
UK	Jul GfK consumer sentiment	-24	-	-	Uptrend surprisingly resilient given inflation and rates...
	Jun retail sales	0.3%	-	-	... seeing discretionary spending hold up year-to-date.

International forecasts

Economic Forecasts (Calendar Years)	2019	2020	2021	2022	2023f	2024f
Australia						
Real GDP %oyr	1.9	-1.8	5.2	3.7	1.4	0.5
CPI inflation %oyr	1.8	0.9	3.5	7.8	4.2	3.2
Unemployment rate %	5.2	6.8	4.7	3.5	4.2	5.3
Current account % of GDP	0.7	2.4	3.1	1.2	0.8	0.4
United States						
Real GDP %oyr	2.3	-2.8	5.9	2.1	1.6	0.3
CPI inflation %oyr	1.9	1.2	7.2	6.4	2.5	2.0
Unemployment rate %	3.7	8.1	5.4	3.6	3.6	4.5
Current account % of GDP	-2.6	-2.5	-2.4	-2.4	-2.4	-2.4
Japan						
Real GDP %oyr	-0.4	-4.3	2.1	1.1	1.2	1.0
Euro zone						
Real GDP %oyr	1.6	-6.1	5.4	3.5	0.6	1.2
United Kingdom						
Real GDP %oyr	1.6	-11.0	7.6	4.0	0.3	0.8
China						
Real GDP %oyr	6.0	2.2	8.4	3.0	5.7	5.5
East Asia ex China						
Real GDP %oyr	3.8	-2.3	4.3	4.5	3.7	4.3
World						
Real GDP %oyr	2.8	-2.8	6.3	3.4	3.0	3.0

Forecasts finalised 7 July 2023

Interest rate forecasts	Latest	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Australia							
Cash	4.10	4.60	4.60	4.60	4.35	4.10	3.85
90 Day BBSW	4.29	4.80	4.80	4.63	4.38	4.13	3.88
10 Year Bond	3.95	3.90	3.70	3.50	3.30	3.20	3.10
International							
Fed Funds	5.125	5.375	5.375	5.125	4.625	4.125	3.625
US 10 Year Bond	3.76	3.70	3.50	3.30	3.10	3.00	2.90

Exchange rate forecasts	Latest	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
AUD/USD	0.6893	0.69	0.69	0.71	0.72	0.73	0.74
USD/JPY	137.48	138	136	134	132	130	128
EUR/USD	1.1239	1.11	1.12	1.12	1.13	1.14	1.15
GBP/USD	1.3137	1.28	1.28	1.29	1.29	1.30	1.30
USD/CNY	7.1363	7.10	7.00	6.80	6.70	6.60	6.50
AUD/NZD	1.0755	1.11	1.11	1.13	1.13	1.12	1.12

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- (ii) physical separation of various Business/Support Units;
- (iii) and well defined wall/cell crossing procedures;
- (iv) a "need to know" policy;
- (v) documented and well defined procedures for dealing with conflicts of interest;
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