WESTPAC WEEKLY ECONOMIC COMMENTARY

Steady as she goes.

21 February 2022

Kākābeak/ngutukākā

Westpac Economics Team
economics@westpac.co.nz
westpac.co.nz/economics

This week's *Monetary Policy Statement* will be much anticipated, not least because of the unusual three-month gap between reviews. But it's not just due to the long wait; a lot of economic action has been crammed into the last few months as well.

At the forefront of the discussion has been inflation – it reached a 30-year high of 5.9% at the end of last year. Similarly, inflation is coming back on to global radars. The US annual inflation rate hit 7.5% in January, the highest level there in 40 years.

With the inflation genie out of the bottle, that suggests the Reserve Bank has a lot of work to do. But housing market developments have also been significant.

The RBNZ doesn't target housing directly, but it is an important channel for monetary policy. Property values affect people's willingness to spend, and that flows through to the wider economy. So the fact that the housing market has really hit the brakes recently is an important development for the policy outlook.

We think that's mostly about rising interest rates. Fixed-term mortgage rates have risen sharply since last September, as the market has baked in the idea of a series of cash rate hikes over the next couple of years. And those higher mortgage rates are now having an effect – nationwide house prices actually fell a little in December and January (down 1.6% combined).

That doesn't mean the RBNZ's job on the housing market front is done. To keep the pressure on the housing market, they'll still need to deliver those cash rate hikes that the market has already baked in over this year and next.

With that in mind, we expect the OCR to reach a peak of 3% by the second half of next year. And to get there, we think that the RBNZ can do so in steady steps of 25 basis points at each review. In other words, while there is a small chance of a larger 50 basis point move, we think that it is unlikely at this stage.

Omicron is upon us.

Meanwhile, Omicron is now well-established in the community. Over 2,500 cases were reported yesterday, more than triple the number from a week earlier. As we've seen overseas, the incidence of severe illness has been much lower with this variant. That said, there could still be a tough period ahead, even if it proves to be a relatively brief one. In the UK and Australia, the worst of the Omicron wave took around two months to pass.

In terms of the economic impact, the reality is that for the next few months the economic data is going to be messy. And importantly, it won't tell us much about how things will look on the other side of the wave. On that front, eventually, we expect that the underlying strength in the economy as well as capacity pressures will return.

Global dairy prices strong for longer.

Last week, on the back of the continued strength in global dairy prices, we upgraded our 2022/23 farmgate milk price forecast by $1.00 to $8.50/kg. A weaker NZD/USD is also supporting a higher forecast. Meanwhile for now, we are sticking with our record-high 2021/22 forecast of $9.50/kg.

This revision to next season's forecast comes as global dairy prices continue to surge. Already, overall prices have lifted nearly 14% so far over 2022, while key whole milk powder prices have lifted over 16%.

On the global dairy supply side, essentially everything that could go wrong has gone wrong. Over the year to date, bad New Zealand weather has slammed the brakes on dairy production. Indeed, we now expect New Zealand production to fall by 3.0% compared to last season. Previously, we expected production to fall by a more modest 1.5%.

Meanwhile, dairy production elsewhere is also soft. Indeed, a similar combination of bad weather and high feed and other costs has hit production in other key exporters such as the EU and US. We can now also add Ukraine-Russia tensions to the supply mix. Both countries are major grain producers, while Russia is a major oil and gas producer. As a result, the tensions are putting further upward pressure on already sky-high global grain and fertiliser prices. In turn, this is adding even more upward pressure on global dairy prices.

With the above in mind, we now expect global dairy prices to start the 2022/23 season from a higher starting point. We still expect prices to moderate over the season as global dairy supply eventually rebounds. Nonetheless, prices for the season as a whole are likely to average higher than we previously expected.

With the milk price at record highs, cash is rolling into the dairy sector. However, it's being used differently compared to previous dairy price booms. Many farmers and growers have chosen to repay debt instead of re-investing the cash back into their businesses. Indeed, agriculture debt has fallen from its peak in July 2019 by over $2bn and now stands at $61.8 billion. We expect this trend to continue over 2022.

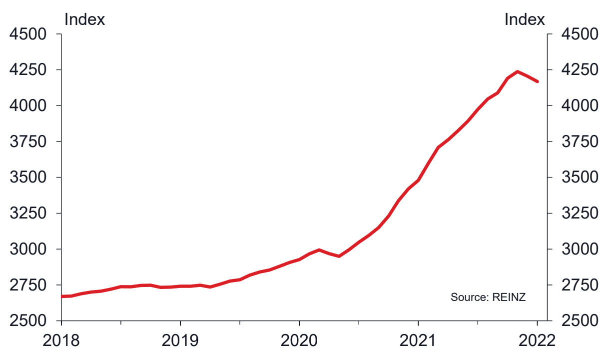
With more debt repayment and less on-farm investment, the rebound in dairy production over coming seasons is going to be quite muted. Also underlying these moves are tighter environmental regulations, restricting production growth. As a result, our long-run view of the milk price has shifted structurally higher. Indeed, we now expect the milk price to average between $7.50/kg and $8.50/kg in the long term.

Nathan Penny, Senior Agri Economist
+64 9 348 9114
nathan.penny@westpac.co.nz

Chart of the week

House prices were already starting to lift in 2019, on the back of lower mortgage rates. But the sharp drop in interest rates in response to Covid sent the property market into overdrive, with prices rising 44% since the country emerged from the initial Covid lockdown in 2020. That stimulus has now gone into reverse; the most popular fixed-term mortgage rates are back to around where they were at the start of 2019.

House prices

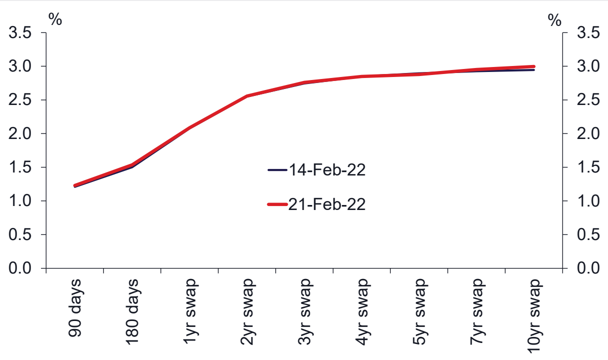


Fixed vs floating for mortgages

Wholesale interest rates are now largely in line with our forecast of a 3% cash rate by mid-2023. That suggests there is no longer an advantage to fixing for longer terms.

While the one-year mortgage rate is likely to rise further in the next couple of years, fixing and rolling for this term is likely to produce a lower borrowing cost on average over the next few years. Longer fixed terms are more suited to those who want certainty in their repayments.

NZ interest rates



The week ahead

RBNZ Monetary Policy Statement

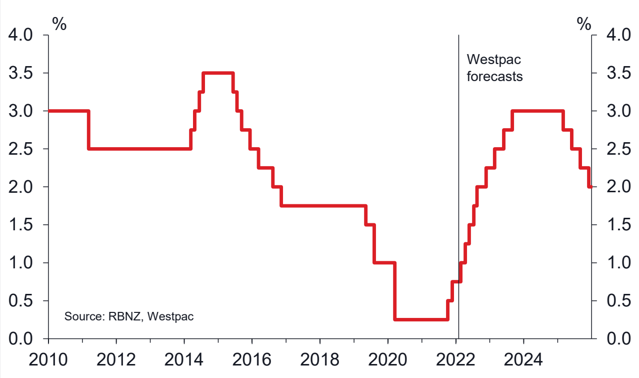
Feb 23, last: 0.75%, Westpac f/c: 1.00%, Market f/c: 1.00%

We expect the Reserve Bank to lift the Official Cash Rate by 25 basis points to 1.00% at its February policy meeting.

In November the RBNZ's cash rate projection reached a peak of around 2.6%. We expect that the track this time will be lifted to something closer to our view of a 3% peak, but not beyond that. Developments over the last three months have been positive for the interest rate outlook on balance. However, there are also some negatives including the faster than expected cooling in the housing market and the recent Omicron outbreak.

Financial markets are also expecting a 25bp hike, but have priced in some chance of 50bp rise. We think that is unlikely given some of the near-term risks.

RBNZ Official Cash Rate



NZ Q4 retail spending (volumes)

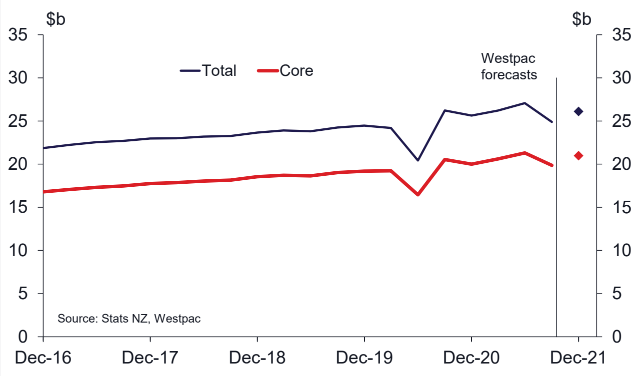
Feb 25, Last: -8.1%, Westpac f/c: +5.0%

Retail spending fell sharply in the September quarter, dropping by 8%. That softness was a result of New Zealand's Delta outbreak in August, which saw strict activity restrictions imposed for several weeks.

We expect a 5% rise in spending over the December quarter, which would leave spending a little below pre-Delta levels. Activity restrictions remained in place for much of the quarter (though they were gradually relaxed over time). As a result, spending in the hospitality sector remain subdued. That was partially offset by increased spending on groceries and durables.

We're also expecting to see another strong rise in retail prices, with continued increases in transport costs and ongoing disruptions to global supply chains.

NZ retail spending volumes



Aus Q4 Wage Price Index

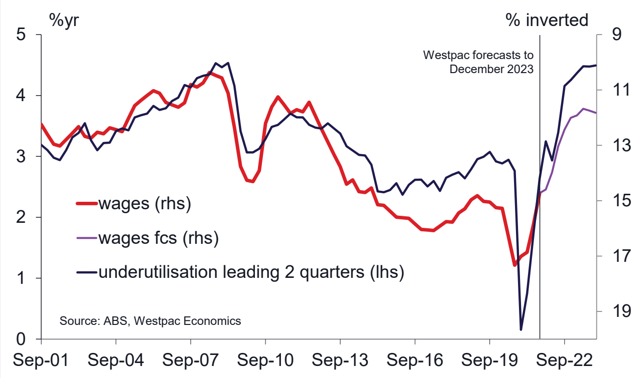
Feb 23, Last: 0.6%, WBC f/c: 0.7%
Mkt f/c: 0.7%, Range: 0.6% to 1.0%

The September WPI lifted 0.6% returning wage inflation to pre-Covid rates. And back then wages were underperforming their longer-term relationship with economic activity. The annual pace lifted to 2.2%y from 1.7%yr.

Private sector wages lifted 0.6%. With base effects the annual pace lifted 0.5ppt to 2.4%yr, the fastest since Q1 2019. The gains was due to an increase in salary reviews with small, isolated pockets of strong labour demand. Of the Q3 0.9% rise in wages in original terms (not seasonally adjusted), the ABS reports that 0.44ppt came from individual arrangements, 0.34ppt via enterprise agreements and just 0.10ppt from awards.

We are looking for the gains to again come via a lift in individual arrangement wages which when seasonally adjusted (Q4 tends to be a softer quarter) will underpin our 0.7%qtr forecast.

Aus labour market



The week ahead

Aus Q4 construction work

Feb 23, Last: -0.3%, WBC f/c: 2.5%
Mkt f/c: 2.1%, Range: 1.0% to 3.0%

Construction sector activity advanced throughout much of 2021, supported by substantial policy stimulus, notably: record low interest rates; the HomeBuilder program; and additional public works.

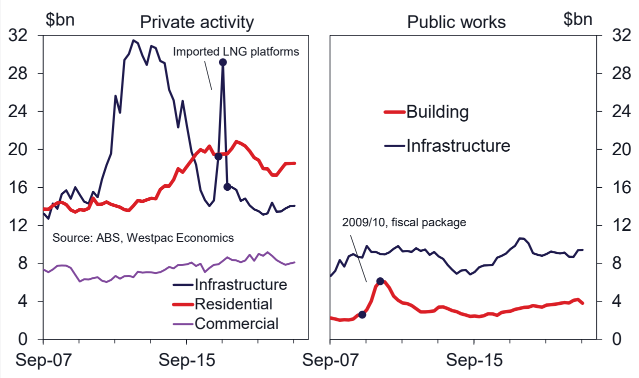
The delta lockdowns of Q3 briefly punctuated the construction sector upswing. With the reopening of the economy from those lockdowns the uptrend in work likely resumed in Q4.

For Q4, we anticipate a 2.5% lift in construction work. That follows a modest fall in Q3, of -0.3%, and gains of 1.8% and 2.2% in Q1 and Q2.

The lift in private construction work in the December quarter is likely to be broadly based, evident across: new home building, home renovations, commercial building, and infrastructure.

Public works, which at times is volatile, is expected to bounce back from the 2.7% drop in the September quarter.

Aus construction work by segment



Aus Q4 private business capex

Feb 24, Last: -2.2%, WBC f/c: 3.0%
Mkt f/c: 2.5%, Range: 0.5% to 4.0%

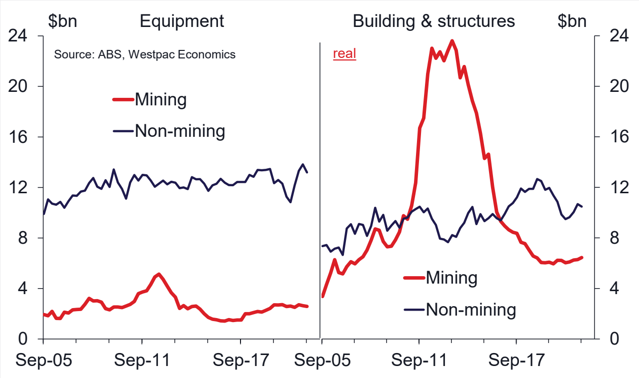
The business mood was generally upbeat throughout 2021, albeit with brief setbacks when virus case numbers spiked.

Firms have been increasing investment spending, particularly on equipment. This is in response to underlying strength in demand, limited spare capacity (mainly in the goods sectors) and generous government tax incentives.

We anticipate a 3% lift in private business capex in Q4, more than reversing a delta lockdown associated dip in Q3 of -2.2%. That would see annual growth at around 11%.

Equipment spending understandably took a hit during the Q3 delta lockdowns, contracting by -4.1% (centred on NSW, -14.8%). For Q4, we anticipate a 4.5% rebound. For building & structures expenditure, we've factored in a 1.7% gain, coming off a fall of -0.2%.

Aus CAPEX by industry



Aus 2021/22 capex plans

Feb 24, Last: Est 4 $138.6bn

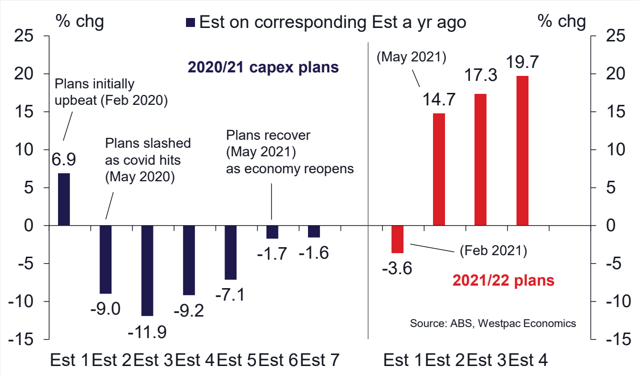
Capex plans confirm a strong rise is in prospect for 2021/22. Recall, for a given financial year, their are 7 estimates of capex plans, with the figure revised each 3 months, until the outcome. The tone of this update, conducted in January and February, will likely be positive.

Est 4 for 2021/22 printed $138.6bn, some 19.7% above Est 4 a year ago. We calculate (using average realisation ratios) that Est 4 implies capex spend for 2021/22 will be 14% above that in 2020/21.

Est 5, we speculate, potentially will print around $140bn, 15% above Est 5 a year ago - and on our calculations (subject to the detail) implies a 13% lift for 2021/21. Slippage due to covid disruptions poses a downside risk. Our business investment forecast is +11%.

Est 1 for 2022/23, could be in the order of $122bn, +16% on Est 1 a year ago and implying +9% (based on avg RRs) - broadly comparable to our forecast, +10%. But we caution, Est 1 (and Est 2) are at times, a (very) unreliable guide to actual capex spending.

Aus Capex plans

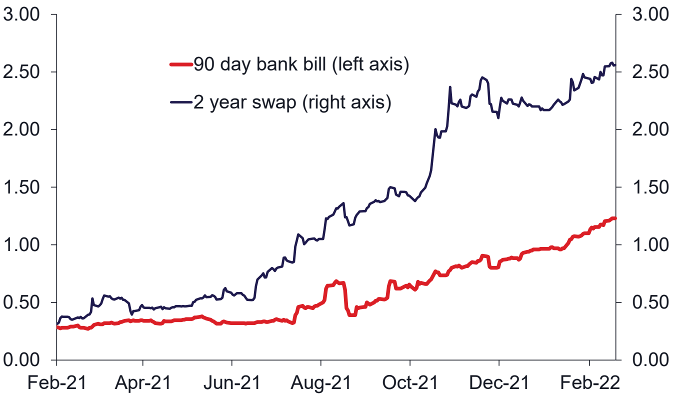


New Zealand forecasts

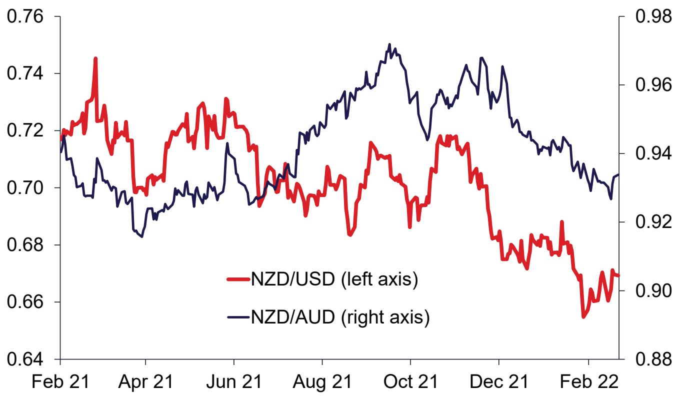
Economic forecasts	Quarterly				Annual			
	2021		2022					
% change	Sep (a)	Dec	Mar	Jun	2020	2021f	2022f	2023f
GDP (Production)	-3.7	1.1	1.6	2.4	-1.9	5.1	4.4	4.7
Employment	1.9	0.1	0.5	0.1	0.6	3.7	0.9	1.0
Unemployment Rate % s.a.	3.3	3.2	3.1	3.0	4.9	3.2	3.0	3.3
CPI	2.2	1.4	1.1	0.7	1.4	5.9	3.1	2.7
Current Account Balance % of GDP	-4.5	-5.3	-5.4	-6.1	-0.8	-5.3	-5.7	-3.9

Financial forecasts	Mar–22	Jun–22	Sep–22	Dec–22	Mar–23	Jun–23	Sep–23	Dec–23
Cash	1.00	1.50	2.00	2.25	2.50	2.75	3.00	3.00
90 Day bill	1.40	1.90	2.20	2.45	2.70	2.95	3.10	3.10
2 Year Swap	2.55	2.75	2.90	2.95	3.00	3.00	2.95	2.90
5 Year Swap	2.80	2.95	3.05	3.10	3.15	3.15	3.15	3.10
10 Year Bond	2.80	2.85	2.90	3.00	3.00	3.00	3.00	2.95
NZD/USD	0.65	0.65	0.66	0.68	0.69	0.70	0.71	0.71
NZD/AUD	0.93	0.93	0.93	0.93	0.92	0.92	0.92	0.91
NZD/JPY	75.4	75.4	77.2	79.3	81.4	82.6	83.9	84.5
NZD/EUR	0.59	0.60	0.61	0.62	0.62	0.63	0.62	0.62
NZD/GBP	0.48	0.47	0.48	0.49	0.50	0.51	0.52	0.53
TWI	70.1	70.1	70.7	71.9	72.5	73.1	73.4	73.6

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 21 February 2022

Interest rates	Current	Two weeks ago	One month ago
Cash	0.75%	0.75%	0.75%
30 Days	1.05%	0.94%	0.83%
60 Days	1.15%	1.05%	0.95%
90 Days	1.23%	1.16%	1.07%
2 Year Swap	2.55%	2.44%	2.36%
5 Year Swap	2.88%	2.75%	2.74%

NZ foreign currency mid-rates as at 21 February 2022

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6694	0.6606	0.6692
NZD/EUR	0.5916	0.5784	0.5912
NZD/GBP	0.4926	0.4895	0.4957
NZD/JPY	76.96	75.98	76.10
NZD/AUD	0.9338	0.9318	0.9376
TWI	71.70	71.01	71.72

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
Eur	Feb Markit manufacturing PMI	58.7	58.6	–	Strength in manufacturing clearly apparent...
	Feb Markit services PMI	51.1	51.7	–	... services growth remains muted given omicron.
UK	Feb Rightmove house prices	0.3%	–	–	Housing demand set to cool over the course of 2022.
	Feb Markit services PMI	54.1	55.0	–	Services demand is starting to recover from omicron...
	Feb Markit manufacturing PMI	57.3	57.0	–	... manufacturing remained resilient throughout.
Tue 22					
Aus	RBA Assist' Governor Financial Mkts	–	–	–	Kent, speaking to Australian Financial Markets Association.
US	Dec FHFA house prices	1.1%	1.0%	–	Robust underlying demand for housing...
	Dec S&P/CS home price index	1.18%	1.00%	–	... set to continue buoying house prices.
	Feb Markit manufacturing PMI	55.5	56.0	–	Omicron has slowed the stunning pace of growth...
	Feb Markit service PMI	51.2	53.0	–	... in both manufacturing and services.
	Feb consumer confidence index	113.8	110.0	–	Uni of Mich surprised materially to downside this month.
	Feb Richmond Fed index	8	9	–	Difficulties in sourcing labour a challenge for manufacturing.
	Fedspeak	–	–	–	Bostic.
Wed 23					
NZ	RBNZ policy decision	0.75%	1.00%	1.00%	RBNZ likely to revise up the forecast peak in the cash rate.
Aus	Q4 wage price index	0.6%	0.7%	0.7%	Individual arrangements to drive a lift in wages.
	Q4 construction work	–0.3%	2.1%	2.5%	Uptrend resumes, supported by considerable stimulus.
Eur	Jan CPI	5.0%	5.2%	–	Final estimate; robust energy inflation remains a key driver.
Thu 24					
Aus	Q4 private new capital expenditure	–2.2%	2.5%	3.0%	Bounce back from delta, led by equipment investment.
	2021/22 capex plans, $bn	138.6	–	–	Est 4 on Est 4 a yr ago, +19.7%. Another positive reading likely.
US	Jan Chicago Fed activity index	–0.15	–	–	To provide a timely update on activity in the region.
	Initial jobless claims	248k	–	–	Set to remain at a very low level.
	Q4 GDP, annualised	6.9%	7.0%	–	A very small revision expected in second estimate for Q4.
	Jan new home sales	811k	810k	–	To remain strong as supply constraints slowly alleviate.
	Feb Kansas City Fed index	24	–	–	Manufacturing outlook remains very strong for the region.
	Fedspeak	–	–	–	Barkin, Bostic and Mester.
Fri 25					
NZ	Jan trade balance $mn	–477	–	–1250	Run of deficits to continue as import strength is ongoing.
	Q4 real retail sales	–8.1%	6.0%	5.0%	Continued activity restriction limited the recovery in spending.
Eur	Feb consumer confidence	–	–	–	High inflation and omicron concerns...
UK	Feb GfK consumer sentiment	–19	–	–	... continue to weigh on consumer confidence.
US	Jan personal income	0.3%	–0.3%	–	Weakening purchasing power is becoming a concern...
	Jan personal spending	–0.6%	1.2%	–	... strength in services is necessary for GDP growth above trend.
	Jan PCE deflator	0.4%	0.6%	–	PCE inflation has reached a 40-year high...
	Jan core PCE deflator	0.5%	0.5%	–	... price pressures will only slowly abate through 2022.
	Jan durable goods orders	–0.7%	0.6%	–	Expected to advance; centred on ex transportation segment.
	Jan pending home sales	–3.8%	–	–	Tight housing supply is hampering sales activity.
	Feb Uni. of Michigan sentiment	61.7	61.7	–	Final estimate; high inflation and omicron taking a toll.

International forecasts

Economic Forecasts (Calendar Years)	2018	2019	2020	2021f	2022f	2023f
Australia						
Real GDP %yr	2.8	2.0	-2.2	4.4	4.4	4.0
CPI inflation %yr	1.8	1.8	0.9	3.5	3.3	3.5
Unemployment rate %	5.0	5.2	6.8	4.7	3.8	3.9
Current account % of GDP	-2.1	0.7	2.6	3.7	1.3	-3.1
United States						
Real GDP %yr	3.0	2.2	-3.5	5.7	3.4	2.5
CPI inflation %yr	2.4	1.9	1.2	5.1	5.2	2.5
Unemployment rate %	3.9	3.7	8.1	5.4	3.9	3.6
Current account % of GDP	-2.3	-2.6	-2.5	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	0.6	0.3	-4.8	2.3	2.7	1.5
Euro zone						
Real GDP %yr	1.9	1.3	-6.6	4.9	4.1	2.5
United Kingdom						
Real GDP %yr	1.3	1.4	-9.9	7.0	4.5	2.0
China						
Real GDP %yr	6.7	5.8	2.3	8.1	5.7	5.6
East Asia ex China						
Real GDP %yr	4.4	3.7	-2.4	3.9	4.7	4.7
World						
Real GDP %yr	3.6	2.8	-3.3	5.4	4.4	3.6

Forecasts finalised 4 February 2022

Interest rate forecasts	Latest	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Australia									
Cash	0.10	0.10	0.10	0.25	0.50	0.75	1.00	1.25	1.50
90 Day BBSW	0.08	0.10	0.10	0.35	0.60	0.95	1.20	1.45	1.70
10 Year Bond	2.23	2.15	2.40	2.40	2.50	2.50	2.40	2.30	2.20
International									
Fed Funds	0.125	0.375	0.625	0.875	1.125	1.375	1.625	1.875	1.875
US 10 Year Bond	2.02	2.00	2.30	2.40	2.50	2.50	2.40	2.30	2.20

Exchange rate forecasts	Latest	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
AUD/USD	0.7195	0.70	0.70	0.71	0.73	0.75	0.76	0.77	0.78
USD/JPY	115.19	116	117	117	118	118	119	119	119
EUR/USD	1.1368	1.13	1.11	1.12	1.13	1.14	1.15	1.15	1.16
GBP/USD	1.3604	1.36	1.37	1.38	1.38	1.38	1.37	1.37	1.36
USD/CNY	6.3355	6.35	6.35	6.30	6.25	6.20	6.15	6.15	6.10
AUD/NZD	1.0729	1.08	1.08	1.08	1.08	1.09	1.09	1.09	1.10

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Nathan Penny, Senior Agri Economist
+64 9 348 9114

Paul Clark, Industry Economist
+64 9 336 5656

Gregorius Steven, Economist
+64 9 367 3978

Any questions email:
economics@westpac.co.nz

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