WESTPAC WEEKLY ECONOMIC COMMENTARY

Cheese cutter.

12 June 2023

Southern rātā

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Global dairy consumers have fallen in love with cheese, with cheese prices sizzling at or near record highs since late 2021. While increasing global consumption of dairy products is normally a good thing for New Zealand, we are not well-placed to immediately benefit from higher cheese prices. With Chinese dairy demand also taking longer to rebound than anticipated, we have revised down our view of total dairy export and farm incomes and the 2023/24 farmgate milk price forecast.

Pinning down the exact genesis for the cheesy trend is a question for the marketing experts – however, we suspect it has something to do with Covid lockdowns, the ease of pizza deliveries during said lockdowns, and therefore a new-found love of cheese in large fast-growing markets, particularly in Asia.

New Zealand dairy companies have limited capacity to produce more cheese. Cheese production has expanded where possible, but generally companies are stuck producing other less profitable products like whole milk powder (WMP). As a result, New Zealand cannot optimise the average price of dairy exports given the current mix of global dairy product prices. Put differently, total dairy export values would be higher if New Zealand dairy companies could produce more higher value cheese products and less WMP. We note that in larger cheese producing regions such as the EU, average dairy prices are higher and thus total dairy incomes are faring better.

Cheese and WMP normally track each other, so there normally isn't a large trade-off between producing one over the other. However, over the last year or two, cheese prices have never been higher relative to WMP.

At the same time as cheese prices have boomed, WMP prices have continued to drift lower this year. Indeed, we had expected WMP prices to have turned up by now. We put this down to a slower than expected recovery of Chinese dairy demand and the Chinese economy more generally.

With the above in mind, we have lowered our 2023/24 milk price forecast to $8.90/kg, down from $10.00/kg previously. This puts our forecast slightly above the top end of Fonterra's forecast range of $7.25/kg to $8.75/kg.

At the same time, we expect high Fonterra dividends for farmers over the season just gone and also for 2023/24 (Fonterra's cheese profits are paid as dividends to farmers rather than reflected directly in the milk price). This is a new development given the low dividends Fonterra has paid over recent years.

Last month, Fonterra said that it expects normalised earnings per share of 65-80 cents for 2022/23. Assuming it pays 70% of its earnings as a dividend, this equates to a dividend of between 45.5 and 56 cents per share.

We anticipate that Fonterra will continue to pay a similar dividend over 2023/24. Adding this together to our milk price would equate to between $9.36/kg to $9.46/kg. In other words, the healthy dividend does not fully offset our lower milk price forecast (as Fonterra cannot fully capitalise on very high cheese prices).

Looking ahead, there are two key questions for dairy markets. Firstly, how soon can Fonterra and/or other dairy companies start to produce more cheese? And secondly, when will Chinese dairy demand come through more strongly?

For now, we assume that dairy companies cannot expand cheese production easily so the cheese price strength and relative WMP weakness persist over the year. However, if New Zealand companies can produce significantly more cheese in the next 12 months (and sooner than offshore rivals), then cheese prices will fall and WMP prices will rise, taking the milk price higher.

On the Chinese demand front, we expect the recovery will eventually pick up steam. For example, overall Chinese consumer demand remains firm, and we expect it to build broader momentum, including demand for dairy products, over the year. As a result, we expect that WMP prices will turn and lift gradually over the new season. All up, we expect these factors will lead to a gradual improvement in the milk price outlook and thus support our relatively positive milk price forecast.

GDP should show a less overheated economy but migration should remain strong.

Meanwhile, we expect a 0.4% drop in GDP for the March quarter, following on from the 0.6% fall in the December. We wouldn't describe this as a recession given the very strong labour market and general uncertainty on the quarterly drivers of GDP due to fluctuating seasonal factors and climatic events. Rather, we'd characterise the economy as 'less overheated' rather than 'weak'. Indeed, despite the expected fall in output the economy is still running well ahead of the potential growth rate where inflation remains stable and low. Thus, a substantial cooling-off period is needed to bring inflation fully under control.

Meanwhile, this week's migration and housing market data will be of key interest to assess to which strength in population growth is translating to broader economic strength. The current account deficit is likely to remain very elevated hinting at a still overheated economy.

Either way, monetary policy is starting to get traction in slowing the economy. But with annual inflation still closer to seven than six percent, it'll be a considerable period before the RBNZ can even hint at declaring victory.

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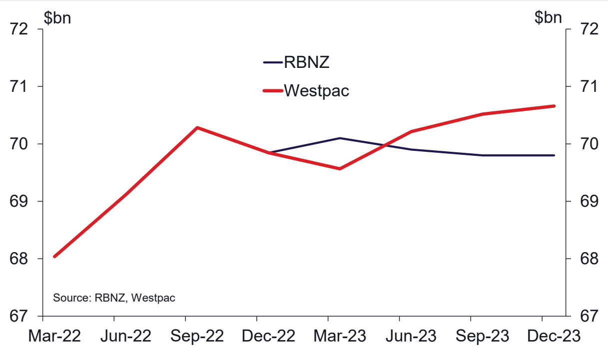
Chart of the week

We expect Thursday's GDP release to show a 0.4% decline for the March quarter, much softer than the Reserve Bank's estimate of a 0.4% rise. Beyond this point, though, our views diverge in the other direction. The RBNZ expects the economy to slip into a modest recession over the rest of 2023. In contrast, we're expecting some rebound from cyclone disruptions in the June quarter, and a migration-led boost to activity over the year. A negative GDP result this week might seem to support the RBNZ's 'on-hold' stance, but it's not yet certain that the economy is slowing enough to bring inflation under control.

Quarterly GDP forecasts

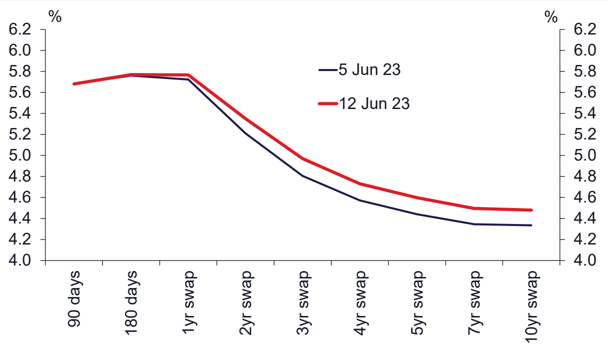


Fixed vs floating for mortgages

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 a much 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 three years. Rates for terms beyond three years are still relatively expensive, but would provide more certainty around the size of repayments.

NZ interest rates



The week ahead

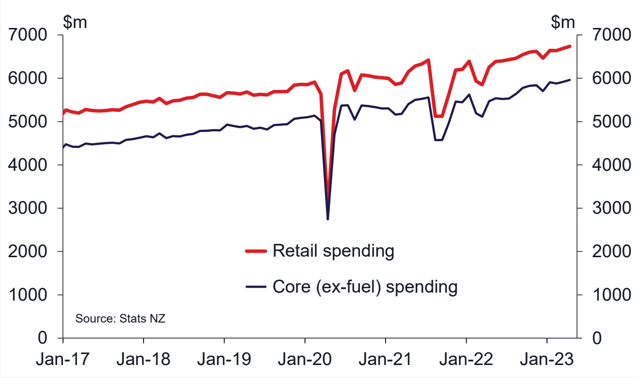
NZ Apr retail card spending

June 12, Last: +0.7%, Westpac f/c: +0.3%

Retail sales rose 0.7% in April, underpinned by increased spending on groceries and durable items like furnishings. While that rise points to resilience in spending appetites, retail prices are continuing to rise at a rapid pace, meaning consumers are getting less bang for their buck.

We're forecasting a 0.3% rise in retail spending in May, with falls in petrol prices restraining the rise in overall spending levels. Under the surface, we expect a firmer 0.5% rise in core (ex-fuel) categories, with spending levels being boosted by continued price rises and increases in the population.

NZ monthly retail card spending



NZ Apr net migration

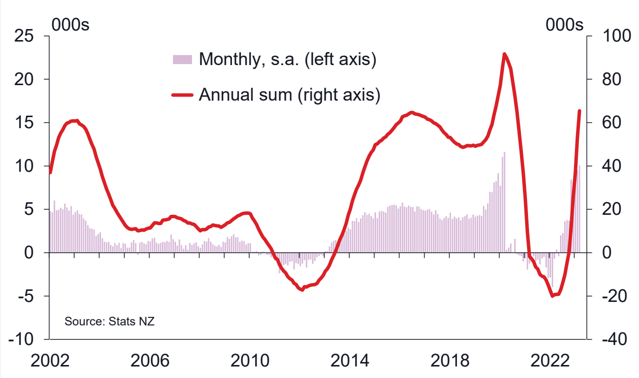
Jun 13, last: 12.1k mth, 65.4k annual

Net migration has turned sharply positive again, as the reopening of the border has unleashed a pent-up demand to live and work in New Zealand. Net inflows reached more than 65,000 people in the year to March, from a net outflow of 20,000 in the previous year.

While these inflows will eventually run their course, it's highly uncertain how high they will reach in the meantime. Our forecast is for a record net inflow of 100,000 people over 2023, but recent months have actually been running ahead of that pace.

The critical issue is not just the number of arrivals but the balance of their effects on the economy. Migrant workers will help to address labour shortages in some areas, but they also add to demand, most notably in the housing market.

NZ net migration



NZ May REINZ house sales and prices

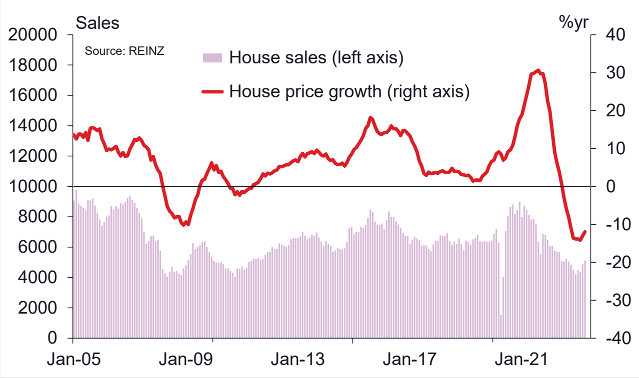
Jun 14, Sales last: +5.1% m/m, –15.3% y/y
Prices last: +0.2% m/m, –12.0% y/y

The New Zealand housing market has started to stabilise in recent months. House sales have risen by 20% since the end of last year, although they remain at a low level compared to history. The REINZ house price index recorded a slight increase in April, the first monthly gain since November 2021.

The forces that have been weighing against the housing market over the last couple of years are now turning. There's a growing belief that mortgage rates are at or near their peaks, and there have even been some cuts at the longer fixed terms.

On top of this, the flow of migrants has turned from a modest net outflow to a strong net inflow since New Zealand reopened its border. That will put renewed pressure on the housing stock, as the rate of homebuilding once again falls behind the pace of population growth.

REINZ house prices and sales



The week ahead

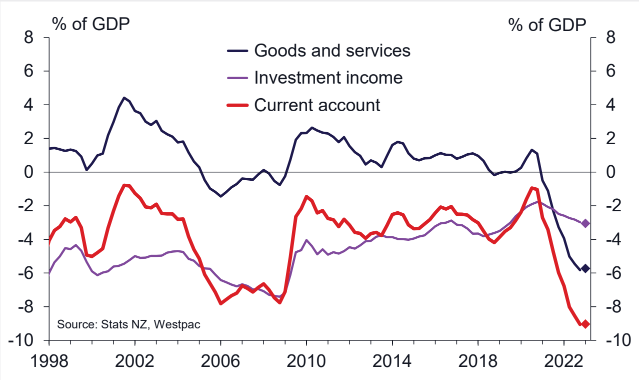
NZ Q1 current account balance, % of GDP

Jun 14, Last: –8.9%, Westpac f/c: –9.0%, Mkt f/c: –9.0%

New Zealand's current account deficit has blown out over the last two years. The loss of overseas tourist revenue (until recently) and the sharp rise in import prices and shipping costs have been a factor. But more broadly, the widening deficit is a symptom of an overheated economy – we are continuing to spend beyond our current means.

We expect the deficit to reach a fresh high of 9% of GDP for the year to March. The services balance is improving as overseas tourists return. However, the goods deficit worsened significantly in the March quarter as export prices fell sharply. A fall in import prices was offset by a rise in volumes.

Annual current account balance



NZ Q1 GDP

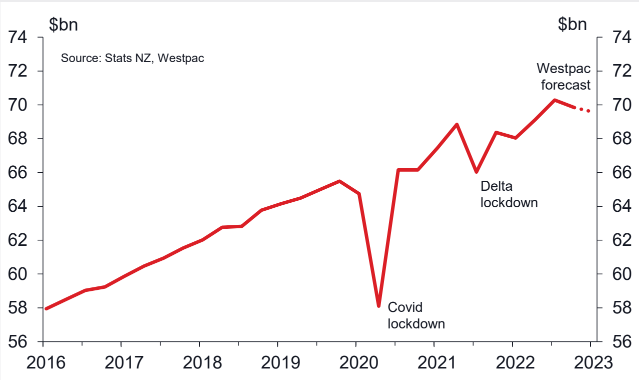
Jun 15, Last: –0.6%, Westpac f/c: –0.4%, Mkt f/c: 0.0%

We estimate that GDP fell by 0.4% in the December quarter. This would be the second straight quarterly decline, and would be weaker than market and Reserve Bank forecasts.

There's a high degree of uncertainty around the quarterly result, as Covid-19 has significantly disrupted the usual seasonal patterns in the data. However, the underlying picture is that the economy is losing momentum – as we'd expect to see after the accumulated monetary tightening over the last year and a half.

We would still characterise the economy as 'less overheated' rather than 'weak'. A substantial cooling-off period will be needed to bring inflation fully under control.

Production-based GDP



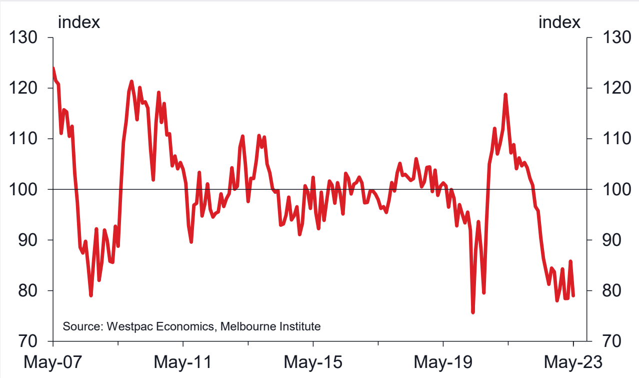
Aus Jun Westpac-MI Consumer Sentiment

Jun 14, Last: 79.0

Consumer sentiment dropped 7.9% to be back near historical lows in May – the RBA's decision to resume its hiking cycle after a brief pause in April dashing hopes of an extended pause and over-riding any positives around the Federal Budget.

The June update looks set to be more of the same, the RBA moving again and warning more increases may be required. Other factors that may influence sentiment include: the Fair Pay Commission's decision to increase the Federal minimum and award wages by 5.75%; more signs of a firming in housing markets, prices in particular; and a tepid update on economic growth from the Q1 national accounts.

Aus Consumer Sentiment Index



The week ahead

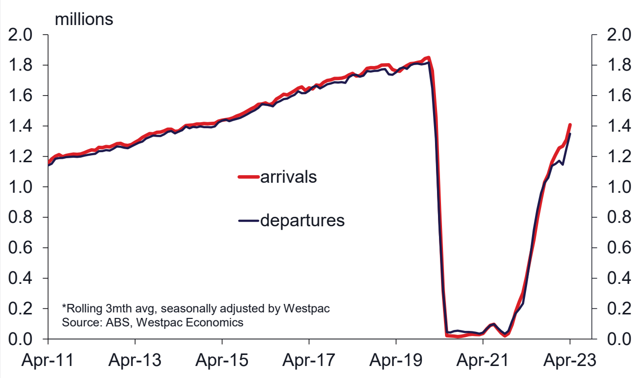
Aus May overseas arrivals and departures, preliminary

Jun 14, Arrivals, Last: 1372.4k
Jun 14, Departures, Last: 1433.0k

Following on from an unexpectedly strong pace of growth over the course of last year, the recovery in overseas arrivals and departures has begun to consolidate to a more manageable but still robust pace.

Permanent and long-term travel, which tends to be a better (albeit still limited) indicator of net migration flows, is continuing to exhibit strength, with net arrivals in this category tracking monthly gains of +37k/mth on a three-month average basis. The visa detail is also constructive, suggesting that the recovery in net overseas migration is continuing to track a strong pace.

Aus total overseas arrivals and departures



Aus May Labour Force - unemployment rate %

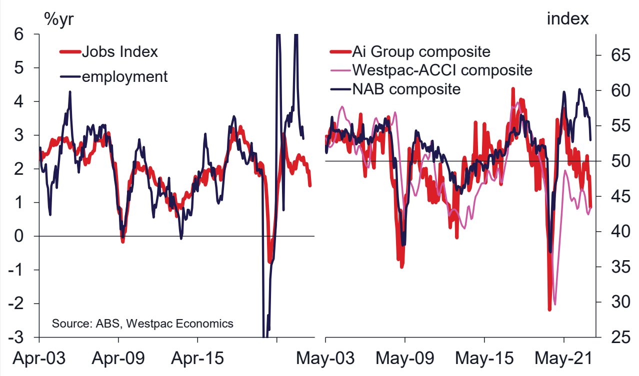
Jun 15, Last: 3.7%, WBC f/c: 3.7%
Mkt f/c: 3.7%, Range: 3.6% to 3.8%

The fall in the participation rate from 66.8% in March to 66.7% in April saw the labour force expand by only +18.4k, but this was enough to raise the unemployment rate from 3.5% to 3.7%. However, at two decimal points, the increase in the unemployment rate was a more modest 0.12ppt lift (3.54% to 3.66%).

Critical to the near-term evolution for unemployment is the strength of labour demand. Indicators suggest it remains robust for now, but the outlook is uncertain. On the one hand, job vacancies and advertisements are at historically elevated levels, and hours worked are rising strongly. On the other, emerging evidence from other business surveys points to an unfolding softening in labour demand.

For May, we have factored in a solid rise in participation back toward March's 66.8%, which would see the unemployment rate hold at 3.7%. Given the above, we would view the risks for unemployment as being tilted slightly to the downside.

Components of the Aus Jobs Index



US June FOMC meeting

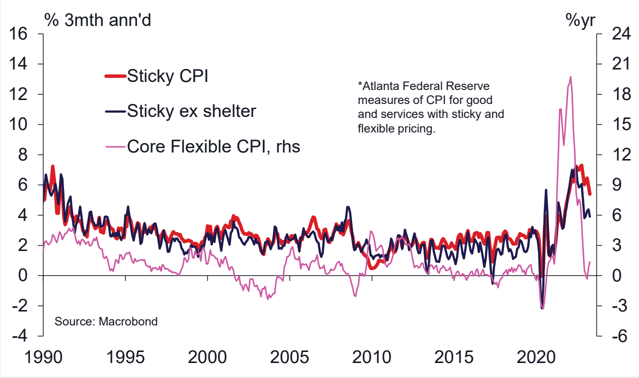
Jun 13-14: fed funds, Last: 5.125%, Mkt f/c: 5.125%, WBC: 5.125%

Commentary from the FOMC ahead of the pre-meeting blackout was decidedly mixed, with a number of participants initially highlighting inflation risks and a potential need to tighten further, but then senior members arguing for time to assess.

Together with the mixed data since, to us and the market it seems most appropriate for the FOMC to hold fire this month while retaining the option to tighten further in the second half of 2023, if conditions warrant it.

Albeit too late to inform their revised published forecasts, the May CPI report (due Tuesday, as the FOMC meet) will be closely scrutinised at the meeting. Most critical will be the impulse for services excluding shelter – a barometer of discretionary demand. Shelter itself requires more time to dis-inflate.

US disinflation trend broadening

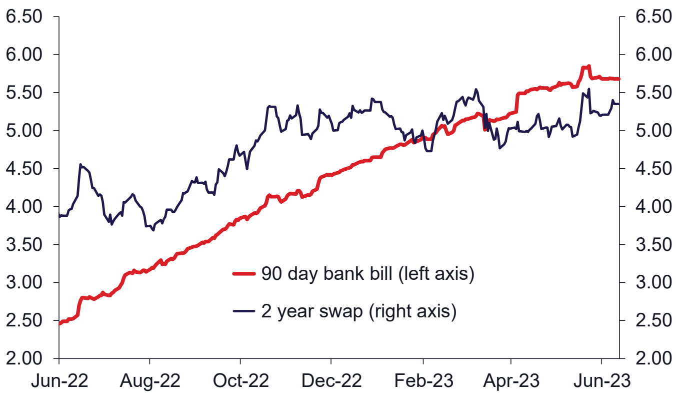


New Zealand forecasts

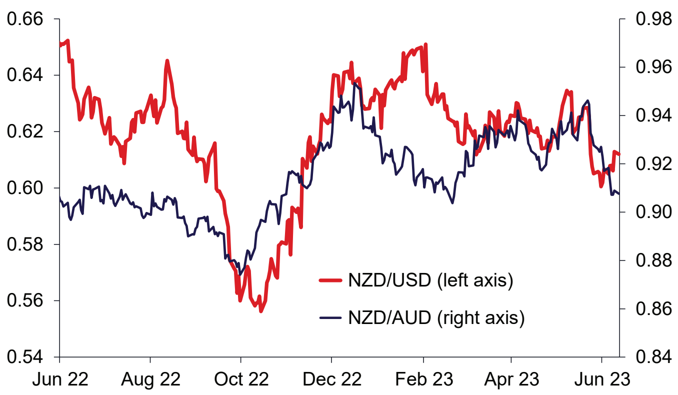
Economic forecasts	Quarterly				Annual			
	2022	2023						
% change	Dec	Mar	Jun	Sep	2021	2022	2023f	2024f
GDP (Production)	-0.6	-0.4	0.9	0.4	6.0	2.4	1.3	0.8
Employment	0.5	0.8	0.4	0.0	3.3	1.6	1.2	-0.4
Unemployment Rate % s.a.	3.4	3.4	3.5	3.7	3.2	3.4	3.9	4.9
CPI	1.4	1.2	1.0	1.8	5.9	7.2	4.6	2.9
Current Account Balance % of GDP	-8.9	-9.0	-9.0	-9.0	-6.0	-8.9	-8.2	-4.9

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	5.00	4.80	4.50	4.30	4.10	4.00	3.90
5 Year Swap	4.40	4.30	4.20	4.10	4.00	3.95	3.90
10 Year Bond	4.15	4.10	3.95	3.80	3.75	3.70	3.70
NZD/USD	0.66	0.67	0.68	0.68	0.68	0.68	0.68
NZD/AUD	0.92	0.91	0.90	0.89	0.89	0.88	0.89
NZD/JPY	85.8	85.8	85.7	85.1	84.4	84.3	83.6
NZD/EUR	0.59	0.60	0.60	0.59	0.59	0.59	0.58
NZD/GBP	0.53	0.53	0.54	0.53	0.53	0.53	0.53
TWI	72.5	72.7	72.5	71.7	71.2	71.0	71.0

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 12 June 2023

Interest rates	Current	Two weeks ago	One month ago
Cash	5.50%	5.50%	5.25%
30 Days	5.60%	5.61%	5.51%
60 Days	5.64%	5.66%	5.55%
90 Days	5.68%	5.70%	5.58%
2 Year Swap	5.35%	5.24%	4.95%
5 Year Swap	4.60%	4.55%	4.26%

NZ foreign currency mid-rates as at 12 June 2023

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6120	0.6058	0.6217
NZD/EUR	0.5695	0.5654	0.5715
NZD/GBP	0.4867	0.4907	0.4971
NZD/JPY	85.30	84.98	84.63
NZD/AUD	0.9076	0.9261	0.9297
TWI	70.57	70.33	71.14

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 12					
NZ	May retail card spending	0.7%	–	0.3%	Fuel prices down. Core spending continuing to rise.
Aus	King's Birthday public holiday	–	–	–	All states except Qld & WA. Markets closed.
Tue 13					
NZ	Apr net migration	12108	–	–	Arrivals have surged since the border was reopened.
Aus	Jun WBC–MI Consumer Sentiment	79.0	–	–	Bracing for another rate rise shock.
	May NAB business survey	14	–	–	Conditions cooling from Sep 2022 high, confidence fragile.
Eur	Jun ZEW survey of expectations	–9.4	–	–	Concerns shifting toward domestic outlook, rates and inflation.
UK	Apr ILO unemployment rate	3.9%	4.0%	–	Labour market gradually softening, but still tight for now.
US	May NFIB small business optimism	89.0	88.2	–	Outlook for small businesses increasingly tough.
	May CPI	0.4%	0.2%	0.3%	Goods inflation negligible; shelter holding up services.
Wed 14					
NZ	May REINZ house sales %yr	–15.3%	–	–	While still low, sales have been turning upwards...
	May REINZ house prices %yr	–12.0%	–	–	...while prices appear to be near or at their trough.
	May food price index	0.5%	–	0.7%	Prices rising rapidly, higher wage costs a key driver.
	Q1 current account % of GDP	–8.9%	–9.0%	–9.0%	Trade deficit remains unsustainably large.
Aus	May overseas arrivals, prelim '000s	1372.4	–	–	Permanent and long-term net arrivals exhibiting strength.
Eur	Apr industrial production	–4.1%	1.2%	–	Broad-based weakness highlights a challenging outlook.
UK	Apr trade balance £bn	–2.9	–	–	Deficit to narrow over this year upon consumer weakness.
	Apr monthly GDP	–0.3%	0.2%	–	Bounce-back from March's decline likely.
US	May PPI	0.2%	–0.1%	–	Decelerating quickly from a historic peak.
	FOMC policy decision, midpoint	5.125%	5.125%	5.125%	On hold this month, but hawkish bias to remain.
Thu 15					
NZ	Q1 GDP	–0.6%	0.0%	–0.4%	Economy is cooling as higher interest rates bite.
Aus	Jun MI inflation expectations	5.2%	–	–	Expectations broadly easing from an elevated level.
	May employment	–4.3k	+15k	+40k	Employment to bounce-back from April seasonal anomaly...
	May unemployment rate	3.7%	3.7%	3.7%	... a lift in participation to see unemployment rate unchanged.
	Q4 net migration	106.2k	–	–	To confirm a historic calendar year for net migration.
	RBA June Bulletin	–	–	–	Quarterly bulletin including RBA research articles.
Chn	May retail sales ytd %yr	8.5%	9.5%	–	Near-term volatility to be expected as economy adjusts...
	May industrial production ytd %yr	3.6%	3.9%	–	... to post-reopening normalisation, but the underlying...
	May fixed asset investment ytd %yr	4.7%	4.4%	–	... picture remains constructive for China this year.
Eur	Apr trade balance €bn	17.0	–	–	Stunning return to surplus as trade patterns normalise.
	ECB policy decision, deposit rate	3.25%	3.50%	3.50%	Another hike anticipated given lingering inflation risks.
US	May retail sales	0.4%	0.0%	–	Momentum likely to ebb further through 2023.
	Initial jobless claims	261k	–	–	Job shedding negligible as firms hold onto staff.
	May industrial production	0.5%	0.1%	–	Manufacturing under pressure.
	May import price index	0.4%	–0.6%	–	Consistent with limited imported inflationary pressure.
	Jun Fed Empire state index	–31.8	–15.6	–	Regional surveys highlight...
	Jun Phily Fed index	–10.4	–12.3	–	... downside risks for US.
	Apr business inventories	–0.1%	0.2%	–	Uncertain outlook points to inventory restraint.
Fri 16					
NZ	May manufacturing PMI	49.1	–	–	Production and orders remain subdued.
Eur	May CPI %yr	6.1%	6.1%	–	Final estimate to provide key detail around services.
US	Jun Uni. of Michigan sentiment	59.2	60.0	–	Inflation expectations the focus.

International forecasts

Economic Forecasts (Calendar Years)	2019	2020	2021	2022f	2023f	2024f
Australia						
Real GDP %yr	1.9	-1.8	5.2	3.7	1.6	1.0
CPI inflation %yr	1.8	0.9	3.5	7.8	4.0	3.1
Unemployment rate %	5.2	6.8	4.7	3.5	4.5	5.0
Current account % of GDP	0.7	2.4	3.1	1.2	1.2	0.3
United States						
Real GDP %yr	2.3	-2.8	5.9	2.1	1.1	0.6
CPI inflation %yr	1.9	1.2	7.2	6.4	2.5	2.0
Unemployment rate %	3.7	8.1	5.4	3.7	4.8	5.5
Current account % of GDP	-2.6	-2.5	-2.4	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	-0.4	-4.3	2.1	1.0	1.2	1.0
Euro zone						
Real GDP %yr	1.6	-6.1	5.4	3.5	0.6	1.4
United Kingdom						
Real GDP %yr	1.6	-11.0	7.6	4.3	-0.2	1.2
China						
Real GDP %yr	6.0	2.2	8.4	3.0	6.2	5.5
East Asia ex China						
Real GDP %yr	3.8	-2.3	4.3	4.5	4.1	4.4
World						
Real GDP %yr	2.8	-2.8	6.3	3.3	3.0	3.1

Forecasts finalised 5 May 2023

Interest rate forecasts	Latest	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Australia							
Cash	4.10	4.35	4.35	4.10	3.85	3.60	3.35
90 Day BBSW	4.21	4.45	4.47	4.22	3.97	3.72	3.47
10 Year Bond	3.95	3.50	3.40	3.20	3.00	2.90	2.70
International							
Fed Funds	5.125	5.125	4.875	4.375	3.875	3.375	2.875
US 10 Year Bond	3.74	3.40	3.30	3.10	2.90	2.80	2.60

Exchange rate forecasts	Latest	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
AUD/USD	0.6717	0.72	0.74	0.75	0.76	0.76	0.77
USD/JPY	139.42	130	128	127	126	125	124
EUR/USD	1.0780	1.11	1.12	1.13	1.14	1.15	1.16
GBP/USD	1.2563	1.25	1.26	1.26	1.27	1.28	1.29
USD/CNY	7.1215	6.60	6.50	6.40	6.30	6.20	6.10
AUD/NZD	1.1010	1.09	1.10	1.11	1.13	1.13	1.13

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