WESTPAC WEEKLY ECONOMIC COMMENTARY

Scratching below the surface.

13 March 2023

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At first glance, the economy appears resilient in the face of high interest rates and red-hot inflation. However, scratching below the surface reveals clears signs of weakness. And it's on this basis, that we expect the economy to continue to slow, with a recession kicking in from late 2023.

In some ways, business conditions have remained surprisingly resilient. Notably, domestic spending levels have remained firm. That's despite the deterioration in financial conditions over the past year as interest rates have jumped progressively higher and inflation has run red hot.

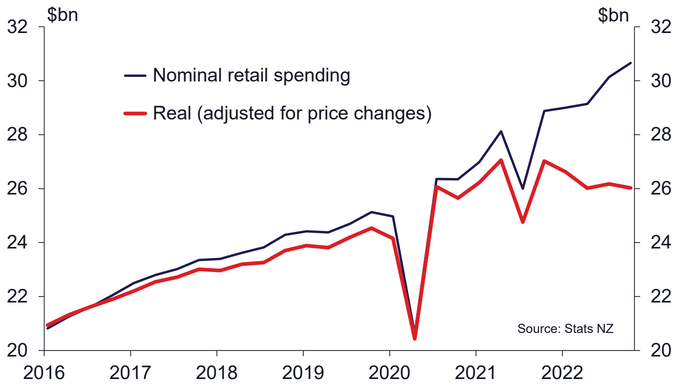
The retail sector is case in point. The December quarter data showed nominal retail sales climbing a decent 1.7% over the quarter and a solid 5.4% over the year. At first glance, these numbers don't hint at any particular weakness.

Similarly, manufacturing survey data out last week pointed to a sector that, whilst not exactly shooting the lights out, is still in expansion. Over February, the PMI was up 0.8 percentage points to 52.0, with the reading pointing to expansion for the second consecutive month.

Meanwhile, the last PSI survey from January ticked up higher and pointed to healthy service sector activity levels on the back of the rebound in tourism sector activity – tourism arrivals have rebounded back to two thirds of their pre-Covid levels. The combination of those two surveys also points to relatively resilient activity.

But buried below the surface of these relatively positive headlines are signs of clear weakness. For example, looking underneath the firm nominal retail spending figures, the volume of goods sold (i.e. spending adjusted for price changes) has fallen by around 4% over the past year. In other words, households are feeling the squeeze - red hot inflation is gobbling up consumers' spending power meaning that they are getting less and less bang for their buck.

Retail spending



Firms are also coming under pressure. In our discussions with businesses, a clear theme has emerged. That is, while sales and revenue remain resilient, firms' costs continue to rise at pace, and this is putting a squeeze on firms' profits. Indeed, average operating costs have risen by around 8% over the past year. In a few sectors such as the construction, manufacturing and agriculture sectors the jump has been even higher at 12% or more over the same period.

Firms are also telling us that they are beginning to act on these trends. First up, they are dialling back their hiring plans. And these anecdotes gel with the trend in job ads data: these have fallen by over 20% since their peak back in August 2022. Secondly, firms are becoming increasingly cautious about capital expenditure, with recent surveys showing that plans for investment spending have been wound back.

From here, we expect economic activity to continue to slow. As we have noted in recent publications, many households and particularly those with mortgages are likely to tighten their belts over the year ahead, with a decline in retail spending levels likely to flow from there. In fact, many households are now facing an increase in their mortgage interest rate payments as they roll off fixed terms considerably lower than prevailing rates. Recall that we have estimated that the average mortgage rate was 3.8% in December 2022 and that it will rise to circa 5.3% by December 2023.

Similarly, we expect building activity to slow. Financial conditions in the housing construction sector have become a lot tougher. Operating and financing costs have risen sharply over the past year. And at the same time, house prices are tumbling in many parts of the country. That's meant prospective buyers are increasingly nervous, and developers are cautious about bringing new projects to market. Builders, as well as those supplying into the industry, have told us that those conditions are weighing on demand, with forward orders dropping off. Data out this week were consistent with this trend. The amount of residential building work put in place fell by 2.6% over the December quarter.

Household spending and residential investment account for the largest chunk of the economy. Household spending alone represents over 60%. As a result, declining activity in these two areas will be enough to tip the economy into recession from the end of the year and into early 2024. Although, the ongoing rebound in tourism arrivals and the boost to activity from reconstruction after the recent storms will help to support activity through 2023 and 2024.

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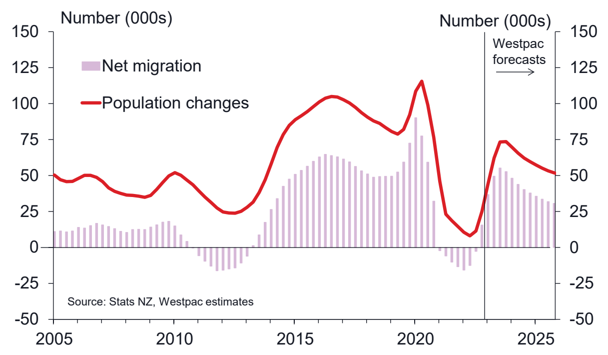
Chart of the week

Last week's census will be a treasure mine of demographic data once the results become available. Looking at population data currently to hand, Covid has induced large swings in our population movements. Between 2014 and 2019, our population grew annually by an average of 94,000 or 2%. The closure of the border saw this slump as low as 13,000 or 0.3% in 2021. From here, we expect population growth to lift once again. However, we don't expect to reach the pre-Covid heights. This year we expect annual population to bounce to around 74,000, before settling back around 50,000 over the coming years.

Population growth (annual)

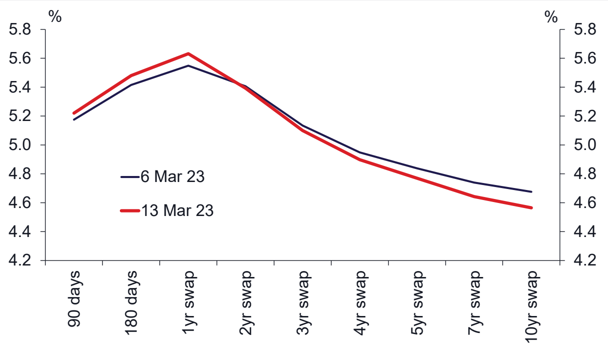


Fixed vs floating for mortgages

We expect the Reserve Bank to lift the Official Cash Rate to 5.50% in the first half of this year, a move that has also been factored into wholesale interest rates. However, we see more scope for reducing the OCR over the longer term as inflation pressures recede.

As a result, we believe that there is value in fixing for terms of up to two years. We would still 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 Feb REINZ house sales and prices

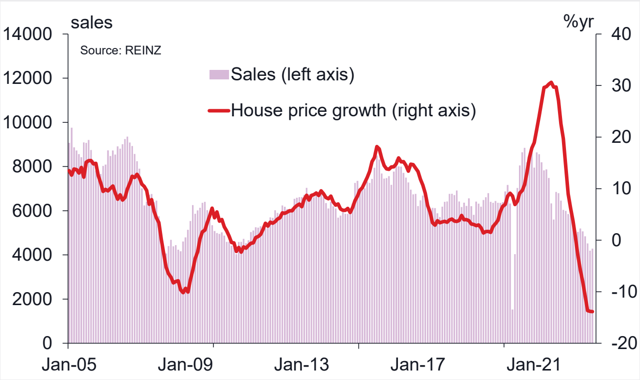
Mar 14 (tbc), Sales last: +2.2% m/m, -27% y/y
Prices last: -0.7% m/m, -13.9% y/y

The housing market continued its decline in the early part of this year. Nationwide house prices have now fallen by 15% from their peak, taking them back to where they were in early 2021.

We expect house prices to continue to fall in the coming months. Fixed-term mortgage rates may have reached their peaks and are even coming down in some instances. However, the market is still adjusting to the higher level of interest rates, with low listings and turnover slowing the price discovery process.

Flooding and cyclones are likely to have disrupted house sales in February, though with no obvious implication for prices.

REINZ house prices and sales



NZ Q4 current account balance, % of GDP

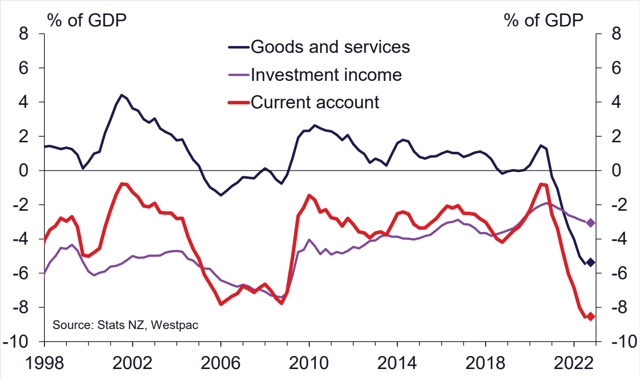
Mar 15, Last: -8.6%, Westpac: -8.5%, Mkt: -8.3%

New Zealand's current account deficit has blown out in the last year. The loss of overseas tourist revenue (until recently) and the sharp rise in imported goods 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.

The deficit for the year to September was initially reported at 7.9% of GDP. However, Stats NZ has noted some significant upward revisions to overseas travel by New Zealanders, which will further add to the deficit. We expect the September result to be revised to 8.6% of GDP, which would make it the largest deficit since the 1970s.

For the year to December, we expect the deficit to narrow slightly to 8.5% of GDP. With the border now open, (net) tourism spending is picking up again. This will flow through to the annual balance over several quarters.

Annual current account balance



NZ Q4 GDP

Mar 16, Last: 2.0%, WBC f/c: -0.2%, Mkt: -0.2%

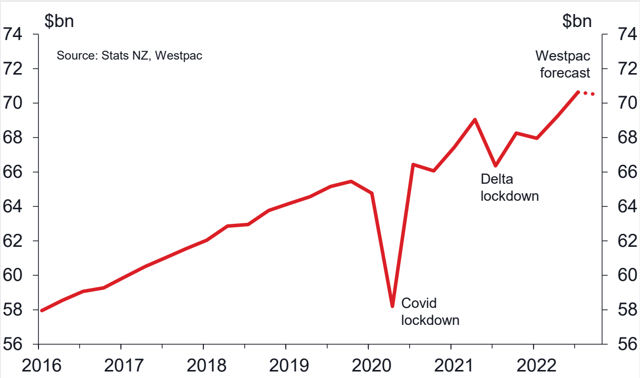
We estimate that GDP fell by 0.2% in the December quarter. That follows a surge of almost 4% over the two previous quarters, as the reopening of the border and the return of overseas tourists boosted activity to a surprising degree.

The GDP data has been choppy since the Covid pandemic, with alternate data sources having to be used, and with the border closure throwing out the normal seasonal patterns. This would be the third time in two years that we see a drop in quarterly GDP that wasn't caused by a lockdown.

The drivers of growth are becoming patchier. Retail, wholesale, manufacturing and construction all saw declines in the December quarter, while both personal services (including tourism) and businesses services look to have strengthened.

Like us, market forecasts appear to be converging on a negative number. This would be markedly softer than the 0.7% growth that the Reserve Bank expected in its February policy statement.

Production-based GDP



The week ahead

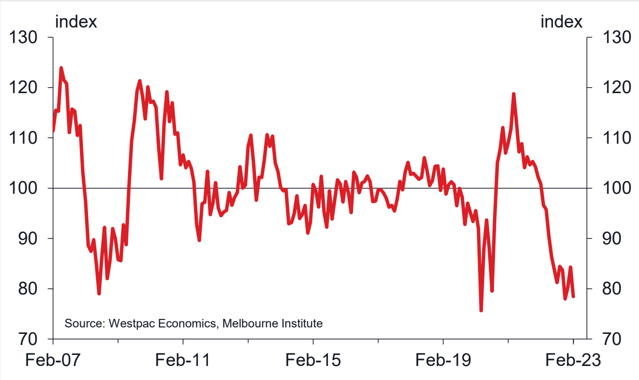
Aus Mar Westpac-MI Consumer Sentiment

Mar 14, Last: 78.5

Consumer sentiment fell 6.9% in February to 78.5, moving back into deeply pessimistic territory. Hopes of some easing in cost of living and interest rate pressures were dashed by a strong December quarter CPI and the RBA's resumption of its interest rate tightening cycle.

March looks likely to be much the same. The RBA raising rates by another 25bps and signalling further tightening ahead, albeit with the Governor's decision statement and comments indicating the path is now more data-dependent, with the Board open to pausing. On the economy, the Q4 GDP came in softer than expected, perhaps raising concerns about near term prospects. Notably, housing markets have shown some tentative signs of stabilising at the start of the year, which may have eased home-owner concerns about the impact of further price declines on balance sheets.

Aus Consumer Sentiment Index



Aus Feb overseas arrivals and departures, preliminary

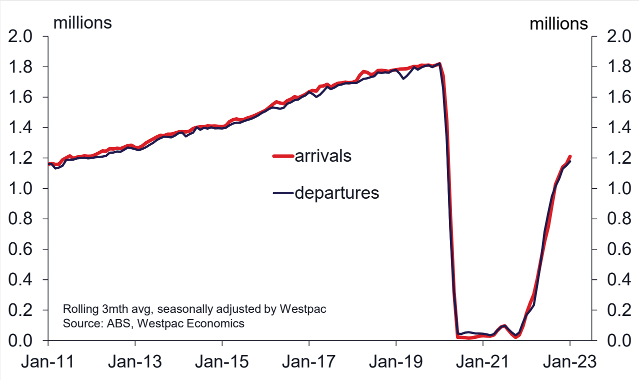
Mar 15, Arrivals, Last: 1608.2k
Mar 15, Departures, Last: 1384.6k

Over the course of last year, the recovery in overseas travel has forged ahead at an unexpectedly strong pace. For the month of January, both arrival and departure flows are sitting at 80% of their respective pre-pandemic levels for that month.

Net visitor arrivals rose considerably from H1 2022 (+420k) to H2 2022 (+675k); net visa arrivals for students and temporary workers remained elevated into year-end; and short-term visitor arrivals from China are set to bounce in 2023 given recent removal of COVID-zero restrictions. All of this points to a substantial increase in net migration in the years to come, which we estimate to be +400k, +350k and +275 in 2022, 2023 and 2024 respectively.

The February provisional estimate will provide a timely look into the patterns of student travel. Given the Chinese Government's mandate for a return to in-person learning, a burst in student arrivals is likely.

Aus total overseas arrivals and departures



Aus Feb Labour Force - employment chg, '000

Mar 16, Last: –11.5k, WBC f/c: +50k
Mkt f/c: +50k, Range: +4k to +100k

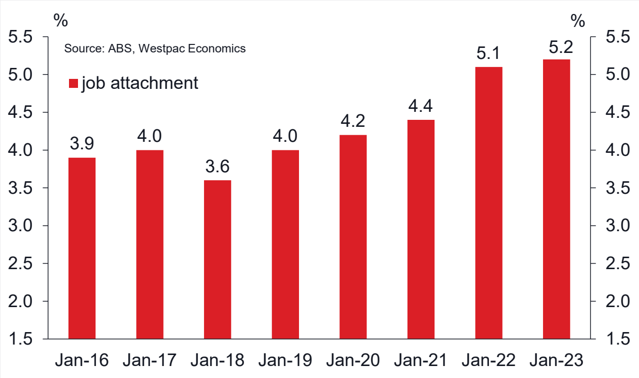
The 11.5k decline in employment in January marked the second consecutive fall in jobs growth from the Labour Force Survey. With a three-month average increase in employment of just 1k and annual growth in employment moderating to 3.0%yr in January from 6.8%yr in October, it raises the question - whether the Australian labour market stalled into early 2023.

The positive is that the January survey reported a larger-than-usual number of people indicating that they have a job to go to in the future. This, coupled with the recent run of soft prints, suggests that employment growth should bounce in the February survey.

We are cautious about forecasting a particularly large rise in employment given the uncertainty around holiday and illness dynamics.

We have pencilled in a 50k rise in employment for February, but risks are clearly to the upside.

Aus proportion not employed with job to go to



The week ahead

Aus Feb Labour Force - unemployment rate %

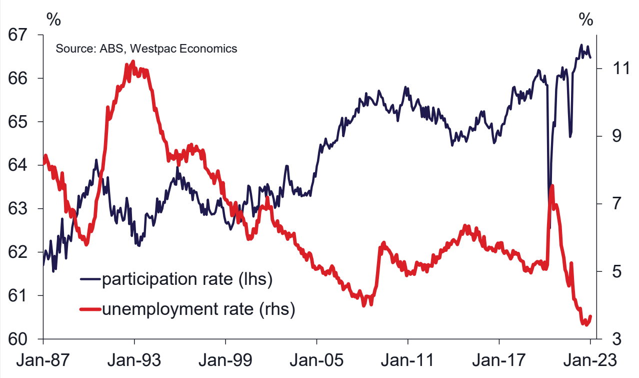
Mar 16, Last: 3.7%, WBC f/c: 3.6%
Mkt f/c: 3.6%, Range: 3.5% to 3.8%

In January the labour force increased by 10.4k. Contrast that with the 11.5k decline in employment, and the participation rate nudged down from 66.6% to 66.5% (or 66.56% to 66.48%). This saw the unemployment rate lift from 3.5% to 3.7%, which is the highest read since May 2022.

On our forecast of employment +50k, and an expectation that the participation will hold flat at 66.5%, the unemployment rate edges lower, from 3.7% to 3.6%.

If, alternatively, the jump in employment is much larger than our 50k forecast, a sharp move lower in the unemployment rate will not necessarily occur. This is because, a significant proportion of those not employed in January but with a job to go may have been out of the labour force. So, upon return, they will not only boost employment but also participation.

Aus unemployment rate



US Feb CPI report

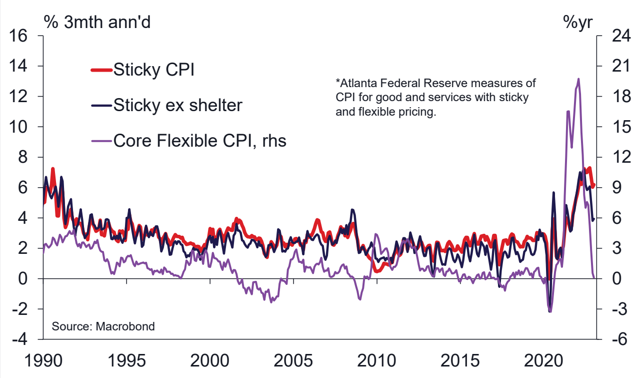
Mar 10: headline, Last: 0.5%, Mkt f/c: 0.4%, WBC: 0.4%

US inflation data continues to justify policy makers taking a skewed risk view, particularly after the upward revisions to December 2022 and the momentum shown in January.

Come February or March, the pulse should downshift. Goods inflation has already disinflated, and the partial indicators for shelter point to a near and abrupt turn in the sub-sector's trend. This is key given the weight it has in the basket.

Still, with the labour market holding in, it is likely that the FOMC also wants to see a material deceleration in the core services, ex-shelter component – a barometer of both discretionary demand and the passthrough of wage gains. A delayed softening of this component risks the FOMC pushing on with rate hikes past our current forecast peak of June.

US inflation

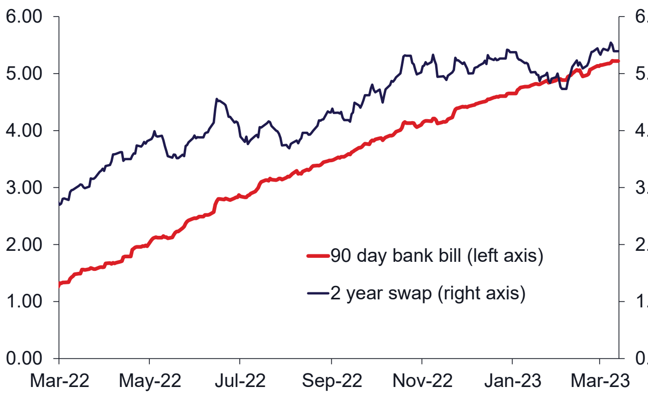


New Zealand forecasts

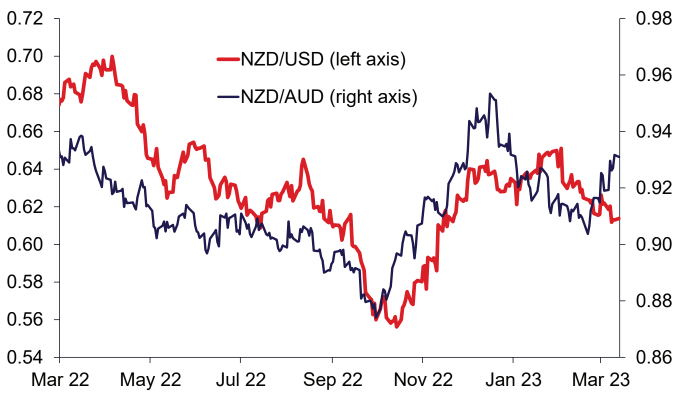
Economic forecasts	Quarterly				Annual			
	2022		2023					
% change	Sep	Dec	Mar	Jun	2021	2022f	2023f	2024f
GDP (Production)	2.0	-0.2	-0.2	0.2	6.1	2.7	1.3	-0.5
Employment	1.3	0.1	0.3	0.2	3.3	1.3	0.5	-0.3
Unemployment Rate % s.a.	3.3	3.4	3.5	3.6	3.2	3.4	4.0	5.1
CPI	2.2	1.4	1.3	1.3	5.9	7.2	5.1	2.9
Current Account Balance % of GDP	-8.6	-8.5	-6.8	-6.5	-6.0	-8.5	-5.8	-4.5

Financial forecasts	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Cash	5.50	5.50	5.50	5.25	4.75	4.25	3.75
90 Day bill	5.60	5.60	5.50	5.05	4.55	4.05	3.75
2 Year Swap	5.10	4.80	4.40	4.10	3.80	3.60	3.40
5 Year Swap	4.60	4.40	4.20	4.00	3.80	3.70	3.65
10 Year Bond	4.50	4.20	4.00	3.85	3.70	3.60	3.50
NZD/USD	0.64	0.66	0.67	0.68	0.68	0.68	0.68
NZD/AUD	0.93	0.92	0.91	0.90	0.89	0.89	0.88
NZD/JPY	83.8	85.8	86.4	86.4	85.7	85.1	84.3
NZD/EUR	0.59	0.60	0.60	0.60	0.60	0.59	0.59
NZD/GBP	0.52	0.54	0.54	0.54	0.54	0.53	0.53
TWI	71.5	72.6	72.8	72.6	71.8	71.3	71.1

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 13 March 2023

Interest rates	Current	Two weeks ago	One month ago
Cash	4.75%	4.75%	4.25%
30 Days	4.95%	4.82%	4.75%
60 Days	5.09%	5.01%	4.93%
90 Days	5.22%	5.14%	5.07%
2 Year Swap	5.39%	5.44%	5.23%
5 Year Swap	4.77%	4.89%	4.56%

NZ foreign currency mid-rates as at 13 March 2023

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6138	0.6155	0.6333
NZD/EUR	0.5761	0.5825	0.5930
NZD/GBP	0.5102	0.5139	0.5260
NZD/JPY	82.71	83.89	83.96
NZD/AUD	0.9310	0.9164	0.9144
TWI	70.70	70.82	71.62

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 13					
NZ	Feb BusinessNZ PSI	54.5	–	–	Has remained at moderated levels despite headwinds.
	Feb food price index	1.7%	–	0.6%	Price rises widespread, boosted by poor weather.
Tue 14					
NZ	Feb REINZ house sales %yr	–27.0%	–	–	The rise in borrowing costs...
	Feb REINZ house prices %yr	–13.9%	–	–	...is continuing to weigh on prices and sales.
	Jan net migration	4581	–	–	With a firm jobs market, net inflows have risen sharply.
Aus	Mar WBC–MI Consumer Sentiment	78.5	–	–	Rate hikes and cost of living pressures still weighing heavily.
	Feb NAB business survey	18	–	–	Conditions index peaked last September – as economy slows.
UK	Jan ILO unemployment rate	3.7%	–	–	Firm for now, but slack to emerge over coming months.
US	Feb NFIB small business optimism	90.3	–	–	Inflation remains the key concern for small businesses.
	Feb CPI	0.5%	0.4%	0.4%	Waiting for shelter inflation to begin downtrend.
Wed 15					
NZ	Q4 current account, % of GDP	–8.6%	–8.3%	–8.5%	Slight improvement from record deficit as tourists return.
Aus	Feb overseas arrivals, prelim '000s	1608.2k	–	–	Focus centred on rebound in Chinese visitors and students.
Chn	Feb retail sales ytd %yr	–0.2%	3.5%	–	Conditions have drastically improved since the removal...
	Feb fixed asset investment ytd %yr	5.1%	4.5%	–	... of COVID-zero; risks around global demand remain, but...
	Feb industrial production ytd %yr	3.6%	2.6%	–	... burgeoning support will provide a longer–term offset.
Eur	Jan industrial production	–1.1%	–	–	Lasting issues with energy-intensive sectors; otherwise positive.
US	Feb PPI	0.7%	0.3%	–	Decelerating quickly from historic peak.
	Mar Fed Empire state index	–5.8	–7.7	–	Consolidating at a broadly weak level.
	Feb retail sales	3.0%	0.2%	–	Soft outcome expected after stellar bounce in January.
	Jan business inventories	0.3%	0.0%	–	Inventory accrual near stalling speed as economy slows.
	Mar NAHB housing market index	42	41	–	Past the worst, but housing market still under major pressure.
	Fedspeak	–	–	–	Bowman.
Thu 16					
NZ	Q4 GDP	2.0%	–0.2%	–0.2%	Growth is becoming patchier outside of the tourism rebound.
Aus	Mar MI inflation expectations	5.1%	–	–	Expectations becoming increasingly important for RBA.
	Feb employment	–11.5k	+50k	+50k	Some catch–up with many people expecting a job in Feb...
	Feb unemployment rate	3.7%	3.6%	3.6%	... flat participation should see unemployment tick downwards.
	RBA March Bulletin	–	–	–	Quarterly Bulletin includes RBA research articles.
Eur	ECB policy decision, refi rate	3.00%	3.50%	3.50%	To deliver well-telegraphed 50bp rate hike with hawkish tone.
US	Feb import price index	–0.2%	–0.2%	–	Falling energy costs driving a sharp deceleration.
	Feb housing starts	–4.5%	0.1%	–	Flattening near pre-pandemic levels...
	Feb building permits	0.1%	0.8%	–	... sustained recovery not yet in sight.
	Initial jobless claims	211k	–	–	To remain at a relatively low level for now.
	Mar Phily Fed index	–24.3	–14.8	–	Consolidating at a broadly weak level.
Fri 17					
Eur	Feb CPI %yr	8.6%	–	–	Final estimate; critical insight into services inflation.
US	Feb industrial production	0.0%	0.5%	–	Performance in line with evidence from regional surveys.
	Feb leading index	–0.3%	–0.2%	–	Pointing to materially weak conditions over the period ahead.
	Mar Uni. of Michigan sentiment	67.0	67.0	–	Renewed hawkishness from FOMC a risk for confidence.

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	3.0
Unemployment rate %	5.2	6.8	4.7	3.5	4.6	5.1
Current account % of GDP	0.7	2.4	3.1	1.2	0.8	-0.1
United States						
Real GDP %yr	2.3	-3.4	5.7	2.1	0.9	1.0
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	-4.6	1.7	1.6	1.5	1.0
Euro zone						
Real GDP %yr	1.6	-6.1	5.2	3.5	0.6	1.4
United Kingdom						
Real GDP %yr	1.7	-9.3	7.4	4.0	-0.5	1.5
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	4.2	4.6	4.2	4.3
World						
Real GDP %yr	2.8	-3.0	6.0	3.3	3.0	3.1

Forecasts finalised 10 March 2023

Interest rate forecasts	Latest	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Australia								
Cash	3.60	4.10	4.10	4.10	3.85	3.60	3.35	3.10
90 Day BBSW	3.64	4.30	4.30	4.22	3.97	3.72	3.47	3.22
10 Year Bond	3.63	3.70	3.40	3.20	3.00	2.80	2.70	2.50
International								
Fed Funds	4.625	5.375	5.375	5.375	4.875	4.375	3.875	3.375
US 10 Year Bond	3.87	3.80	3.50	3.30	3.10	2.90	2.80	2.60

Exchange rate forecasts	Latest	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
AUD/USD	0.6584	0.69	0.72	0.74	0.75	0.76	0.76	0.77
USD/JPY	136.02	131	130	129	128	127	126	124
EUR/USD	1.0591	1.09	1.10	1.11	1.12	1.13	1.14	1.15
GBP/USD	1.1919	1.22	1.23	1.24	1.25	1.26	1.27	1.28
USD/CNY	6.9652	6.70	6.60	6.50	6.40	6.30	6.20	6.10
AUD/NZD	1.0779	1.08	1.09	1.10	1.11	1.13	1.13	1.13

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