WESTPAC WEEKLY ECONOMIC COMMENTARY

Early signs of slow thaw in inflation.

24 April 2023

Southern rātā

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Inflation was weaker than we and other analysts expected in the early part of this year. Crucially, it has fallen well short of the Reserve Bank of New Zealand's forecasts for a second quarter. This still leaves us with a picture of strong price pressures, including strong domestic inflation. However, inflation has now peaked and signs that rate hikes are weighing on demand are mounting. Against this backdrop, we expect only one more 25bp rate hike from the RBNZ, but interest rates will need to remain high for some time yet.

Consumer prices rose by 1.2% in the March quarter. That was lower than our forecast and saw the annual inflation rate dropping from 7.2% at the end of last year to 6.7% now. That's the lowest annual inflation has been since the end of 2021.

Importantly, inflation has now fallen well short of the RBNZ's forecasts for the past two quarters. Indeed, the RBNZ forecast that annual inflation would *rise* to 7.3%.

Inflation can be thrown around by big swings in a small number of items. And that certainly was the case in recent months (for instance, food prices were up 11% over the past year). But what's more important is the underlying trend in prices. And here's where things get interesting. Underlying inflation pressures are still running hot. After strong growth in recent years, capacity in the economy – especially in the labour market – has become increasingly stretched. That's seen businesses operating costs rising by around 8% over the past year, with wage costs up around 6% over the same period. The impact of those strong cost pressures has been seen most clearly in the domestically oriented components of inflation (sometimes referred to as non-tradables) which are continuing to rise at a rapid pace – up 1.7% in March and 6.8% over the past year.

Crucially, however, while those prices remain strong, they aren't accelerating. Measures of 'core' inflation, which smooth through the quarter-to-quarter swings in prices, continue to track around 6% and some measures are easing.

The past quarter also saw widespread falls in the prices of many imported durable items, like furnishings and appliances. That's consistent with the feedback were getting from many retailers, who are telling us that demand for durable items has been waning.

Similarly, increases in the cost of purchasing a newly built home (which drove much of the rise in overall inflation over the past year) have slowed sharply. That likely reflects weaker demand for new builds and falling house prices as interest rates have pushed higher.

This stabilisation in underlying inflation pressures is a key development for the RBNZ. Interest rates have been rising for over 18 months now. But as we've highlighted before, it takes time for those rate hikes to be reflected in household demand.

However, we are now firmly in the sweet spot where interest rate rises should be having an impact on inflation. While widespread mortgage rate fixing in the New Zealand market has delayed the impact of interest rate increases, a large number of mortgages have now rolled on to higher interest rates. In fact, accounting for the extent of mortgage rate fixing, the average 'effective' interest rate on residential mortgages has already increased by around 100 bps since early 2022. Looking ahead, the coming year will see around 50% of all mortgages repricing on to much higher interest rates. That will see the average mortgage rate rising by a further 160 bps over the year ahead, which will further dampen demand, the labour market and wage growth, and ultimately domestic inflation.

What does all this mean for the RBNZ?

Inflation is still uncomfortably high, and we don't expect that it will be back below 3% until the latter half of 2024. We continue to expect that the RBNZ will deliver another 25bp hike in the OCR at its May policy meeting. That would take the cash rate to 5.50%. Interest rates will need to remain high for some time yet, and the RBNZ is likely to maintain a hawkish stance in order to avoid an unwanted drop in borrowing rates.

However, with inflation falling well short of the RBNZ's forecasts, the chances of the central bank needing to take the OCR above 5.50% have fallen.

The RBNZ will still be keeping a close eye on some key factors that could boost inflation over the coming year. That includes the strength of the labour market, as well as potential increases in fiscal spending and spending on post-cyclone reconstruction (the next major updates on all of these issues will be released ahead of the RBNZ's May policy meeting). However, the large downside surprise in consumer price inflation will help to balance the RBNZ's concerns about the potential inflationary impacts of those other factors.

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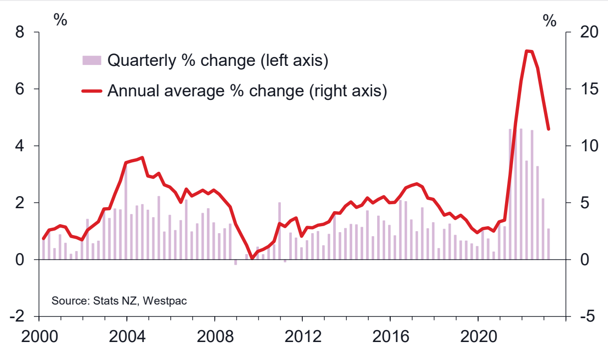
Chart of the week

The cost of purchasing a newly built dwelling rose by more than 18% over 2022, driving much of the rise in overall consumer prices. However, housing market conditions have now changed dramatically. Earlier supply disruptions have now eased. More importantly, the rise in interest rates has seen existing house prices falling sharply and has also dragged down the demand for new builds. Those conditions have put the brakes on how much building and construction firms can charge for new builds. We expect a further moderation over the year ahead.

Cost of purchasing a newly built dwelling

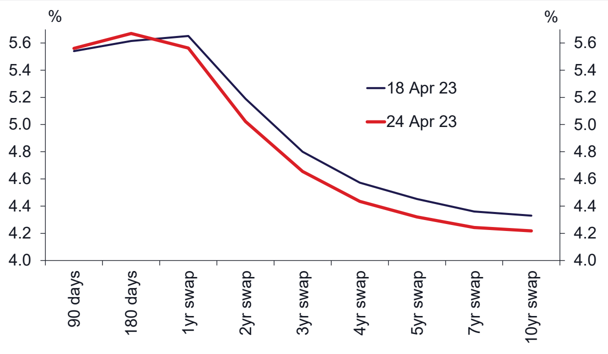


Fixed vs floating for mortgages

We expect the Official Cash Rate to reach a peak of 5.50% in May. As inflation pressures recede, we see scope for rate cuts in 2024 and 2025, although not as quickly as the market is pricing in.

As a result, we now see value in fixing for terms as long as three years. While there isn't a lot of difference between the expected cost of fixing for shorter vs longer periods, a longer period provides more certainty around the size of repayments. We would still regard fixing beyond three years as relatively expensive.

NZ interest rates



The week ahead

NZ Apr ANZBO business confidence

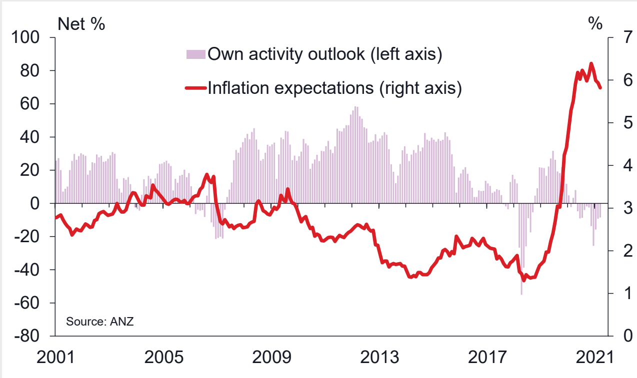
Apr 27, Last: -43.4

The results of the March business activity survey were "less bad" with confidence up and inflation gauges nudging down. However, that still left us with a pretty grim outlook, with the majority of businesses still expecting that trading conditions would deteriorate over the coming months.

We expect that the April confidence survey will continue to highlight weakness in business sentiment. However, it is a mixed picture across the economy – while retailers and those in the construction sector are reporting softer conditions, businesses in sectors like hospitality are reporting firmer activity (in part, supported by the ongoing recovery in international tourism).

The survey's cost and pricing gauges will be closely watched. While those gauges have softened in recent months, they continue to point to strong inflation pressures.

NZ business confidence



NZ Mar monthly employment indicator

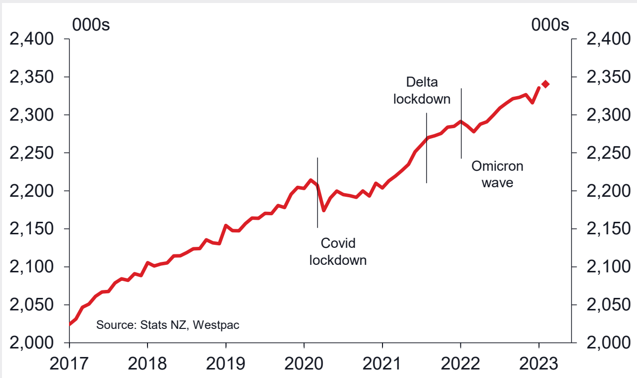
Apr 28, Last: 0.4%, Westpac f/c: 0.6%

The monthly employment indicator is drawn from income tax data. This makes it a fairly comprehensive record of the number of people in work, and helps to fill a gap in what is otherwise mostly quarterly data on the labour market.

Aside from a wobble at the end of last year, this indicator has shown consistent moderate growth in the number of filled jobs over the last year. The weekly snapshots provided by Stats NZ suggest that if anything the pace of growth has picked up in recent weeks. We've pencilled in a 0.6% rise for March, which would see annual growth accelerate to around 3.5%.

This pickup may well reflect the fact that there are more people around to hire – migrant inflows have surged to record levels in recent months, as the reopening of our border has unleashed a pent-up demand to travel here.

NZ monthly filled jobs



Aus Q1 Consumer Price Inflation

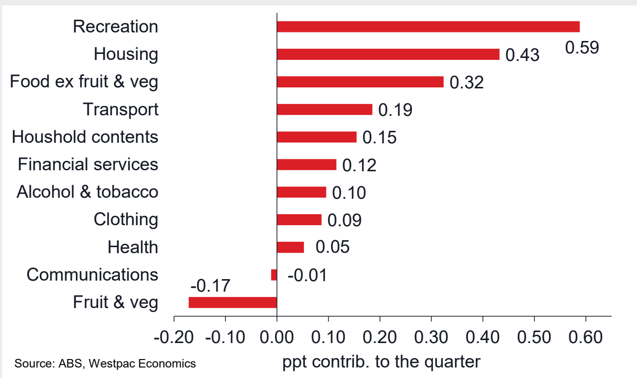
Apr 26, Last: 1.9%, WBC f/c: 1.4%
Mkt f/c: 1.3%, Range: 1.2% to 1.7%t

The December quarter CPI rose 1.9% with annual inflation lifting to 7.8%, the fastest since March 1990. The Trimmed Mean lifted 1.7% with the annual pace increasing to 6.9%, the fastest pace since December 1988 and above the RBA's forecast of 6.5%yr. The most significant contributions came from domestic holiday travel & accommodation, electricity, and international holiday travel.

The March quarter CPI is forecast at 1.4% taking the annual pace down 0.8ppt to 7.0%. The step down is due to an ongoing moderation in inflation for food, a seasonal decline in clothing & footwear, a further moderation in dwellings and household contents & services inflation, as well as falling prices for auto fuel and audio visual & computing equipment.

The Trimmed Mean is forecast to lift 1.4% in March with the annual pace set to moderate to 6.7%, down from 6.9% for December, which we see as the peak for the cycle.

Aus CPI



The week ahead

Aus Mar private sector credit

Apr 28, Last: 0.3%, WBC f/c: 0.3%
Mkt f/c: 0.3%, Range: 0.2% to 0.5%t

The appetite for credit has diminished significantly as sharply higher interest rates impact, reducing borrowing capacity.

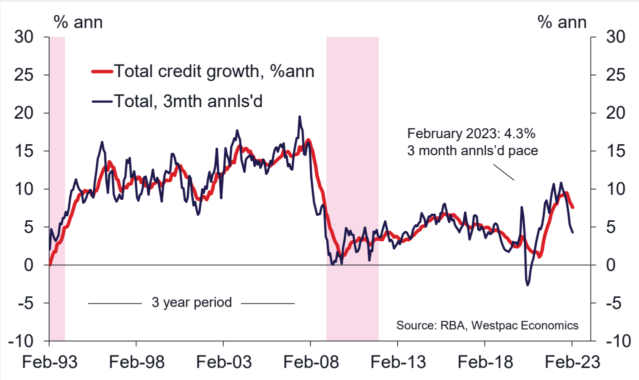
The monthly pace of credit growth has slowed progressively, from a high of 0.9% for April and May to be at 0.3% for February.

For March, we anticipate another reading of 0.3%, which would see annual growth slow from 7.6% to 7.3%%, while the 3 month annualised pace will be only 4.2%, down from 10.8% in mid-2022.

Housing credit grew by a modest 4.1% annualised in the three months to February, less than half the pace at the start of 2022. New lending for February was 33% lower than in January 2022.

Business credit grew by 5% annualised in the 3 months to February, down from over 19% last June, an unsustainable pace boosted by the reopening.

Aus private sector credit

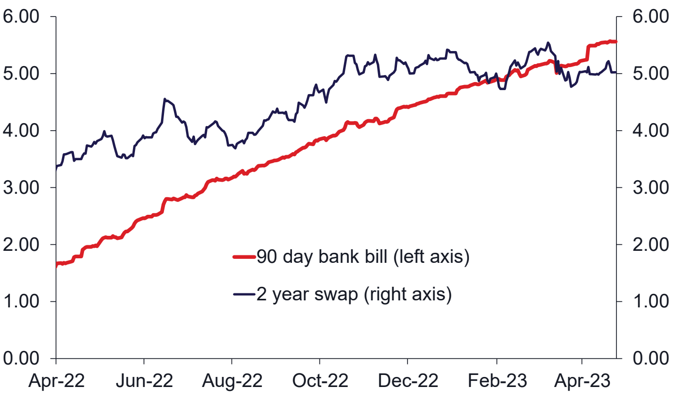


New Zealand forecasts

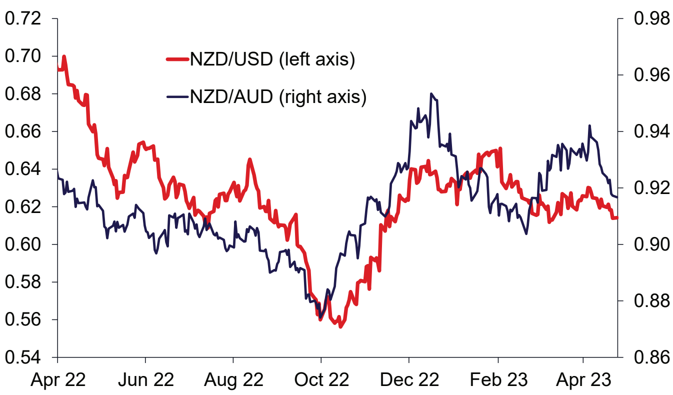
Economic forecasts	Quarterly				Annual			
	2022		2023					
% change	Sep	Dec	Mar	Jun	2021	2022	2023f	2024f
GDP (Production)	1.7	-0.6	0.2	0.2	6.0	2.4	1.1	-0.5
Employment	1.3	0.1	0.3	0.2	3.3	1.3	0.5	-0.3
Unemployment Rate % s.a.	3.3	3.4	3.5	3.6	3.2	3.4	4.0	5.1
CPI	2.2	1.4	1.2	1.0	5.9	7.2	4.5	2.7
Current Account Balance % of GDP	-8.5	-8.9	-8.5	-8.3	-6.0	-8.9	-6.7	-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	5.50	5.25	4.75	4.25
90 Day bill	5.60	5.60	5.60	5.50	5.05	4.55	4.25
2 Year Swap	5.10	4.80	4.50	4.20	3.90	3.70	3.50
5 Year Swap	4.40	4.25	4.10	4.00	3.90	3.80	3.70
10 Year Bond	4.20	4.10	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	83.2	85.1	85.8	85.7	85.1	84.4	84.3
NZD/EUR	0.58	0.59	0.60	0.60	0.59	0.59	0.59
NZD/GBP	0.52	0.53	0.54	0.54	0.53	0.53	0.53
TWI	71.4	72.5	72.7	72.5	71.7	71.1	71.0

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 24 April 2023

Interest rates	Current	Two weeks ago	One month ago
Cash	5.25%	5.25%	4.75%
30 Days	5.36%	5.33%	5.00%
60 Days	5.46%	5.41%	5.09%
90 Days	5.56%	5.49%	5.17%
2 Year Swap	5.02%	4.98%	4.82%
5 Year Swap	4.32%	4.24%	4.27%

NZ foreign currency mid-rates as at 24 April 2023

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6142	0.6244	0.6184
NZD/EUR	0.5587	0.5725	0.5743
NZD/GBP	0.4937	0.5024	0.5042
NZD/JPY	82.29	82.61	81.30
NZD/AUD	0.9167	0.9362	0.9317
TWI	69.95	70.96	70.57

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 24					
US	Mar Chicago Fed activity index	–0.19	–	–	Broadly reflecting a downbeat economic outlook.
	Apr Dallas Fed index	–15.7	–	–	Regional investment detail points to sustained weakness.
Tue 25					
NZ	ANZAC Day	–	–	–	Public holiday; markets closed.
US	Feb FHFA house prices	0.2%	–	–	Housing market will remain under lasting pressure...
	Feb S&P/CS home price index	–0.43%	–0.40%	–	... as house prices edge lower...
	Mar new home sales	1.1%	–1.6%	–	... and sales volumes hold at a subdued level.
	Apr consumer confidence index	104.2	104.1	–	Up-trend in confidence to depend on labour market outlook.
	Apr Richmond Fed index	–5	–	–	Regional investment detail points to sustained weakness.
Wed 26					
NZ	Mar trade balance $mn	–714	–	–850	Imports starting to lose steam on weaker domestic demand.
Aus	Q1 CPI	1.9%	1.3%	1.4%	Moderating food inflation, seasonal falls in clothing plus...
	Q1 CPI %yr	7.8%	6.9	7.0%	...a housing correction are offsetting rising utilities and rents...
	Q1 CPI trimmed mean	1.7%	1.4%	1.4%	...while childcare remains a significant risk. Nevertheless, ...
	Q1 CPI trimmed mean %yr	6.9%	6.7%	6.7%	...it appears that inflationary pressures peaked at end 2022.
US	Mar wholesale inventories	0.1%	–	–	Inventories at risk given uncertainty over activity outlook.
	Mar durable goods orders	–1.0%	0.7%	–	Weak headline and core orders pointing to subdued demand.
Thu 27					
NZ	Apr ANZ business confidence	–43.4	–	–	Overall conditions subdued, but mixed across the economy.
Aus	Q1 export price index	–0.9%	–2.6%	–2.6%	Lower global commodity prices.
	Q1 import price index	1.8%	0.5%	0.6%	Global goods inflation dissipating, lower energy prices.
Chn	Mar industrial profits %yr ytd	–22.9%	–	–	Profit growth will take time to pick-up.
Eur	Apr consumer confidence	–	–	–	Inflation and rates weighing on confidence recovery...
	Apr economic confidence	99.3	–	–	... across both consumers and businesses.
US	Initial jobless claims	–	–	–	Likely to remain low versus history.
	Q1 GDP, annualised	2.6%	2.0%	2.2%	A positive start to 2023 to reverse quickly.
	Mar pending home sales	0.8%	1.0%	–	Off recent lows but prolonged recovery not yet in sight.
	Apr Kansas City Fed index	0	–	–	Regional investment detail points to sustained weakness.
Fri 28					
NZ	Apr ANZ consumer confidence	77.7	–	–	Set to remain low due to ongoing financial pressures.
	Mar employment indicator	0.4%	–	0.6%	Hiring picking up as migrant worker inflows resume.
Aus	Mar private sector credit	0.3%	0.3%	0.3%	Slowed appreciably in face of sharply higher rates.
	Q1 PPI	0.7%	–	–	Falling goods & energy prices to drive a moderation.
Eur	Q1 GDP	0.0%	–	0.1%	Growth to remain weak in H1 2023.
UK	Apr Nationwide house prices	–0.8%	–	–	Price correction remains well entrenched.
US	Q1 employment cost index	1.0%	1.1%	1.0%	A crucial update on wage pressures.
	Mar personal income	0.3%	0.2%	–	Wage growth losing momentum...
	Mar personal spending	0.2%	–0.1%	–	... and being offset by above-target inflation.
	Mar PCE deflator	0.3%	0.1%	–	Attention remains focused on service inflation pulse.
	Apr Chicago PMI	43.8	43.5	–	Economic conditions clearly subdued.
	Apr Uni. of Michigan sentiment	63.5	–	–	Final estimate.
Sun 30					
Chn	Apr manufacturing PMI	51.9	51.5	–	Manufacturing in robust health...
	Apr non-manufacturing PMI	58.2	–	–	... and services strong post COVID-zero.

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	3.9	3.0
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	0.8	-0.1
United States						
Real GDP %yr	2.3	-3.4	5.7	2.1	0.9	0.7
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	1.3	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	4.1	4.4
World						
Real GDP %yr	2.8	-3.0	6.0	3.3	3.0	3.1

Forecasts finalised 6 April 2023

Interest rate forecasts	Latest	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Australia								
Cash	3.60	3.85	3.85	3.85	3.60	3.35	3.10	2.85
90 Day BBSW	3.69	3.95	3.95	3.97	3.72	3.47	3.22	2.97
10 Year Bond	3.49	3.40	3.30	3.20	3.00	2.80	2.70	2.50
International								
Fed Funds	4.875	4.875	4.875	4.875	4.375	3.875	3.375	2.875
US 10 Year Bond	3.54	3.50	3.40	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	0.6738	0.69	0.72	0.74	0.75	0.76	0.76	0.77
USD/JPY	134.13	130	129	128	127	126	125	124
EUR/USD	1.0964	1.10	1.11	1.12	1.13	1.14	1.15	1.16
GBP/USD	1.2433	1.23	1.24	1.25	1.26	1.27	1.28	1.29
USD/CNY	6.8742	6.70	6.60	6.50	6.40	6.30	6.20	6.10
AUD/NZD	1.0920	1.08	1.09	1.10	1.11	1.13	1.13	1.13

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(v) documented and well defined procedures for dealing with conflicts of interest;
(vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

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