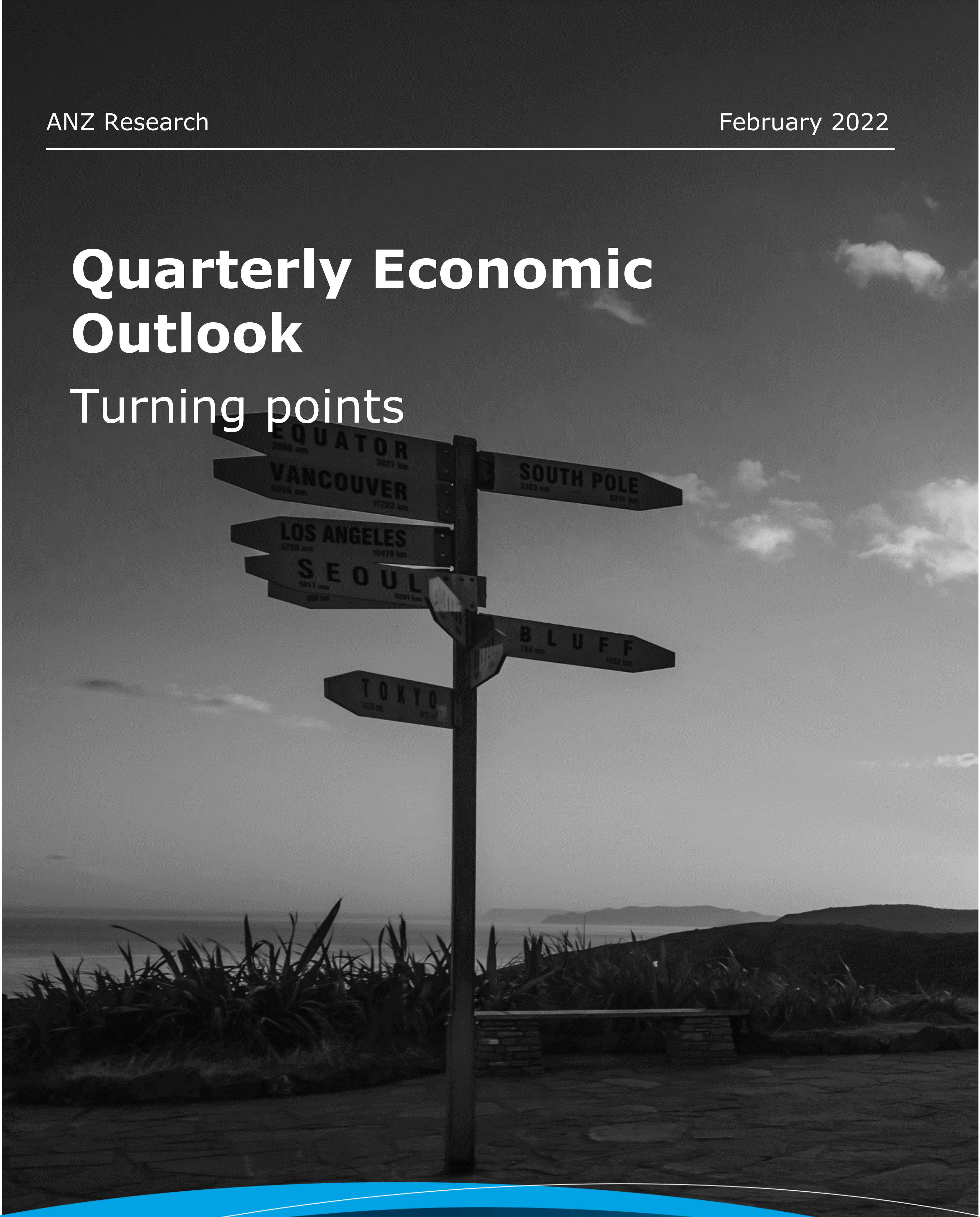
ANZ Research February 2022

Quarterly Economic Outlook

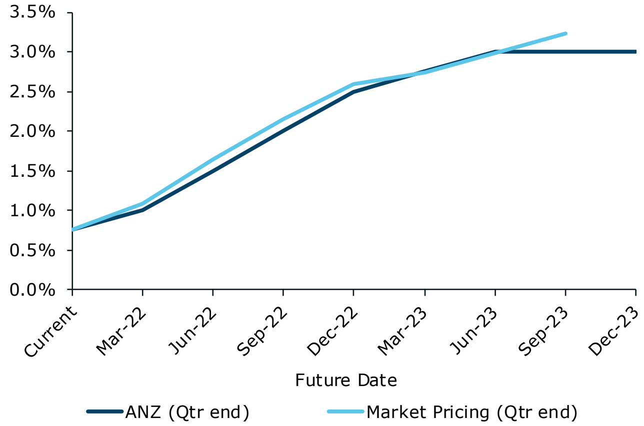
Turning points



Summary of forecasts

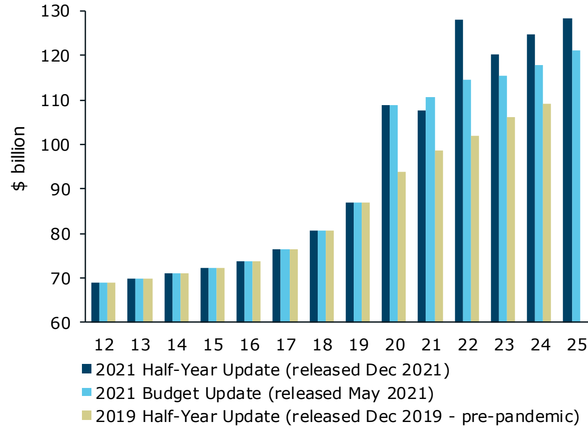
OCR expected to hit 3% by April 2023, providing the wheels don't fall off

OCR Forecast



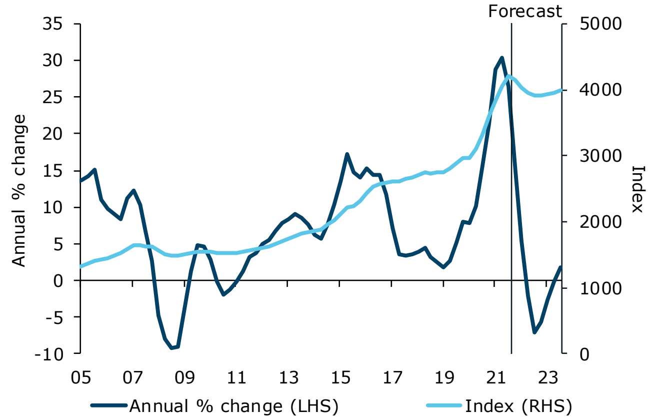
A higher-than-otherwise OCR may be needed to lean against even more fiscal stimulus come Budget 2022

Core Crown expenses (NZ Treasury forecast)



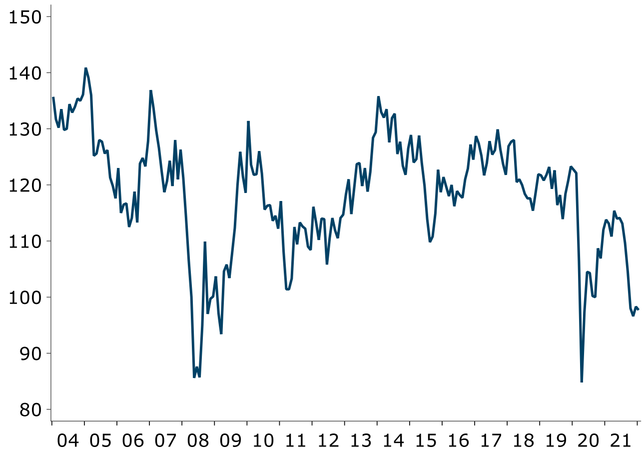
House prices expected to fall, but still a "soft landing"

REINZ House Price Index forecast



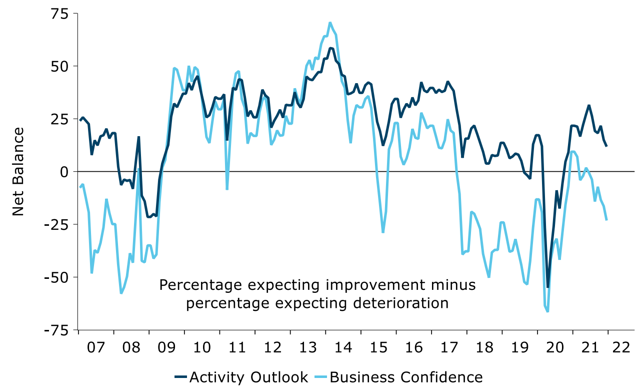
Consumer confidence is sub-par

ANZ-Roy Morgan Consumer Confidence



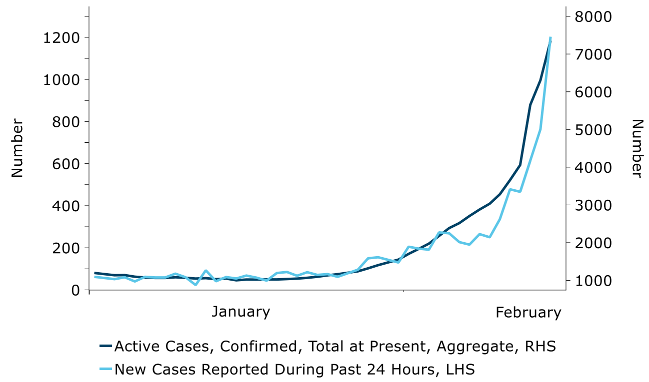
Business confidence has deteriorated

ANZ Business Outlook



Is the problem looming Omicron disruption or costs/inflation?

NZ active confirmed COIVD-19 case numbers



Source: REINZ, RBNZ, Bloomberg, ICAP, Roy Morgan, Ministry of Health, NZ Treasury, ANZ Research

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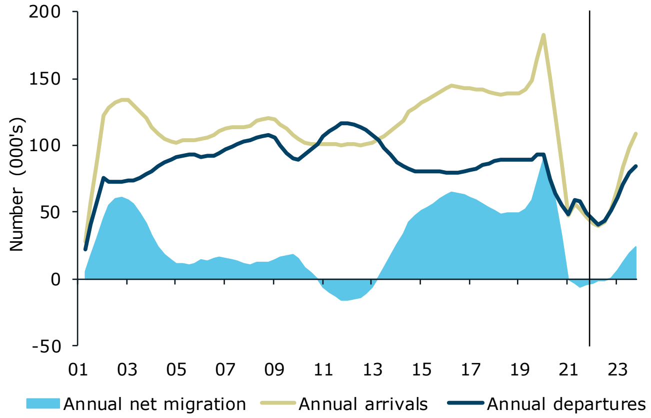
Summary of forecasts

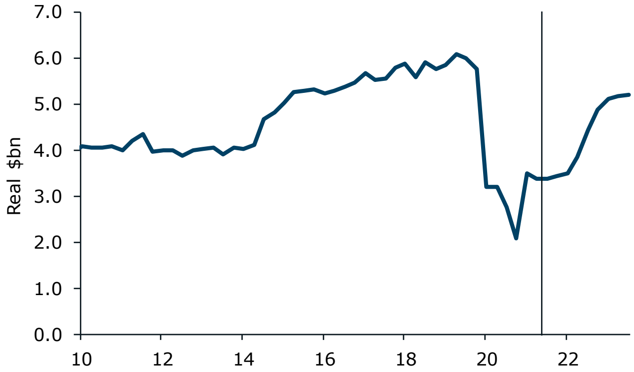
How the border reopening impacts net migration is a key uncertainty

Annual net migration forecast



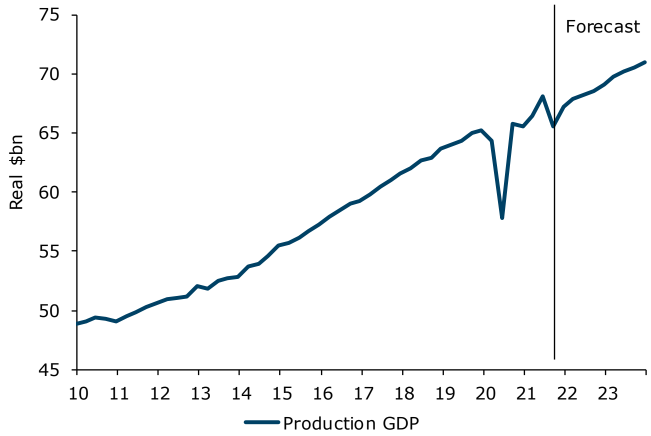
Services exports (education and tourism) expected to lift towards the end of the year

Total services exports forecast



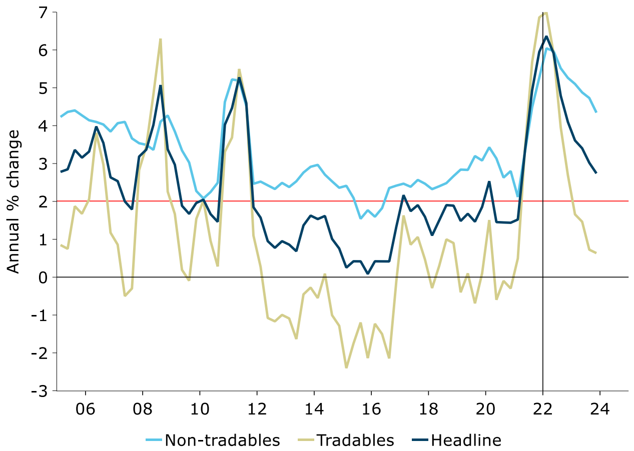
GDP to rebound from Delta lockdown over Q4 2021 and Q1 2022

Production GDP forecast



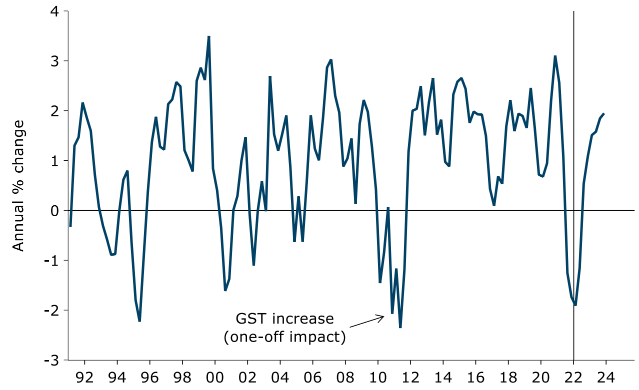
Very strong inflation in the near term, but expected to slow on higher interest rates

CPI inflation forecast



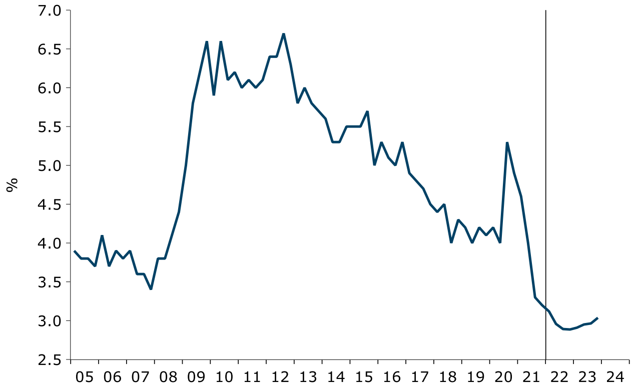
Real household wages expected to stop contracting by Q3 2022…

CPI inflation-adjusted average hourly earnings growth forecast



… as the exceptionally tight labour market supports a sustained expansion

Unemployment rate forecast



Source: Stats NZ, ANZ Research

Turning points

Summary

We're now about two years into the pandemic. While the economic implications are now better understood, and the worst of the data volatility is behind us (touch wood), there is still plenty of scope for surprises. Our focus has shifted from trying to gauge lockdown impacts, and the likely degree of economic scarring associated with them, to trying to gauge the likely evolution of the many drivers that influence both the supply and demand sides of the economy. This isn't anything new when it comes to the art of economic forecasting, but the abnormally long list of turning points for key drivers of economic activity certainly adds to the challenge.

Turning points

Turning points are tricky. Take the housing cycle as an example. There are many forces pulling and pushing on the housing market that make it very difficult to forecast the exact moment and level at which the housing cycle will peak, how much it might unwind, and when it might start turning upwards once again. Sure, we can build models that calibrate reasonably well with history, but no two housing cycles are the same, and not all drivers of the housing market (such as tax settings, CCCFA legislation, or LVR restrictions) are easily quantified or qualitatively accounted for. And the housing market is just one driver of economic outcomes.

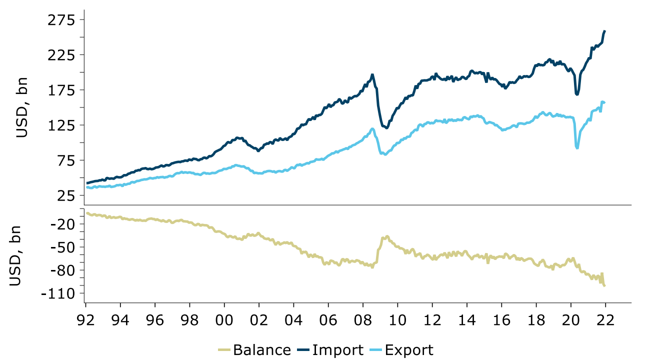
At the current juncture, practically all key economic drivers we pay attention to are either navigating a turning point, or are expected to transition through one or more turning points over the next few years. While it's true that many key drivers are related (eg the unwinding of monetary stimulus is contributing to housing market outcomes), there are also many turning points that are unrelated (eg COVID developments). As a general rule, the more turning points in the forecast, the more likely you'll get something wrong, whether it be direction, magnitude, or timing. Let's take stock.

- **COVID-19** is front of mind when we think about turning points in the outlook. The immediate challenge for NZ is navigating **Omicron**. If the NZ outbreak is anything like that experienced overseas, we need to expect a period of reduced demand for things like public transport and hospitality (as more people choose to work from home or are required to isolate). But worker absenteeism will also exacerbate already-acute labour shortages, adding to wage pressures and possibly creating scarcity for some goods and services. That's likely to negatively impact economic activity, but boost inflation pressures in the near term. But then there will be another turning point: case numbers will tail off and these impacts will unwind. When and from what level are important questions, but questions we can't answer. Then we need to ask, what comes **after Omicron**? What will further mutations look like, and how significant will they be as medical advancements in the treatment and inoculation space continue? We assume a gradual transition over 2022 towards more 'business as usual' economic conditions (eg reopening borders and a normalising household consumption basket), but COIVD will remain a wild card for a while yet.
- The pathway towards **reopening our border** is something we can at least base on announced policy. This will mark a turning point for the **migration cycle** and **net services exports** such as **international tourism and education**. Our assumption is that net migration will lift at a very gradual pace over 2022 as border settings allow. But near term there could be quite a bit of volatility. We don't know how many kiwis are waiting to come home versus waiting to depart NZ once they know the MIQ lottery is no longer a barrier to travel. History tells us that a strong Aussie labour market tends to attract a fair few kiwis, so it's entirely possible the first stages of NZ's reopening see a net migrant outflow. The next question is how many non-kiwis are waiting to migrate to NZ to fill labour shortages once border settings permit. There could be a lot, but it's also not clear what the Government's immigration "rebalance" (announcements expected in April) means for policy settings. And we don't know whether Immigration NZ have capacity to process migrant applications in a timely manner.
- **Labour supply** impacts from both border settings and omicron developments suggest the availability of labour could well deteriorate before it improves. But longer run, we think this shock will unwind (at least partially) as migrant workers help fill the gaps, and that should take some of the pressure off inflation.
- But it's not just labour – **goods and materials shortages** and **disrupted global supply chains** suggest the tradable inflation impulse will remain elevated for a time yet. While this seems to have some persistence to it, we don't think it can permanently intensify. That means the direct impacts on inflation will cease and then eventually drag on headline inflation. Another turning point for inflation.

Turning points

- Speaking of global inflation pressures, there must to be a turning point at some stage regarding the **composition of the global demand impulse**. Just look at the record-breaking goods trade deficit in the US, which shows that about one third of the global economy has been demanding a lot of goods in the face of reduced services spending. We expect that as the world continues to relax restrictions and people get accustomed to living with COVID, global household consumption baskets will diversify back into services like travel. The timing and magnitude is uncertain, but spreading out demand should help alleviate global inflation pressure by bringing unutilised capital and labour into the fold.

Figure 1. US goods trade



Source: U.S. Census Bureau, Macrobond, ANZ Research

- Turning back to the domestic economy, **housing** is a big one to keep front of mind. Data prove what we've long been expecting: the housing cycle is past its peak. But just how much prices may fall, over what time horizon, and then the path into the next eventual upturn is extremely uncertain. We've pencilled in a 7% fall over 2022, but Government policy changes - such as the Credit Contracts and Consumer Finance Act (**CCCFA**) - are adding significant distortion to any predictions based on fundamentals (ie supply vs demand; incomes vs serviceability). What we do know is that a turning point in the housing market also tends to mark a turning point in the construction cycle. Household spending momentum (particularly on durables) may turn a little as well, but with the labour market as tight as it is, and getting tighter, there will hopefully be limits to the associated softening in household demand.

- Indeed, households may not be feeling too flash (or too flush) right now, but they will hopefully perk up as their incomes start growing in real terms once again. Based on average hourly earnings (up 4.1% y/y) and CPI inflation (up 5.9% y/y), workers who have not increased their hours have gone backwards by around 1.7% over the past year. And for lower-income households (who spend a larger portion of their income on necessities, such as housing and food), the retreat in real terms has been much sharper and many times more painful. But as inflation pressures abate and the labour market tightness persists, we're hopeful that **inflation erosion** will eventually cease.

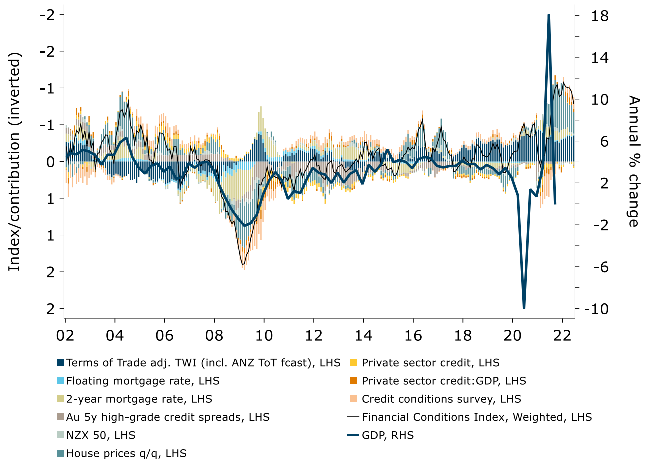
- Between housing and households sits a **record-high level of household debt**. It is clear that rising interest rates are going to hurt borrowers, particularly those pushing debt-to-income boundaries. But relative to incomes, we expect this to be broadly manageable. A little harder to quantify is the degree to which households will choose to deleverage in the face of rising rates and falling house prices. It may not be so much debt-servicing costs that dampen spending (particularly discretionary spending), but rather households choosing to pay their mortgage down a little faster now that interest rate risks feel a little higher. It'll be hard to disentangle, but there could easily be turning points not only relating to the direct effects of monetary tightening, but the indirect (behavioural) effects that are at least a function of the starting point: very high debt levels.

- **Businesses also aren't happy.** They can't get enough labour (which admittedly is a better problem than not having enough demand) and their costs are rising. But our business survey has provided a very good "sniff test" for our forecasts in the past – it was one of the first indicators to show broad economic robustness on the other side of the Great Lockdown of 2020. But now, it's heading south. That might be temporary (eg Omicron-related), but it will be worth keeping a close eye on. Firms' willingness to hire and invest, combined with household's willingness to spend, is fundamental in the sustained inflation narrative that's underpinning our (and the RBNZ's) medium-term inflation forecasts. If households pull back on spending, firms will pull back on hiring, and the virtuous cycle of labour market tightness and robust demand for goods and services could turn vicious.

- One key driver of demand that is still in the pipeline is **Government spending**. The Government has signalled that Budget 2022 will be another big one, with an operating allowance of $6bn marking yet another year of significant fiscal expansion. The details of this spending will matter a lot. If the Government directs it towards areas of the economy that are already up against significant capacity pressures, they will likely achieve little else than a crowding out of private sector activity, stronger-than-otherwise inflation (that will weigh on real household incomes), and higher-than-otherwise interest rates. At a macro level, fiscal settings are pro-cyclical (the output gap is positive and fiscal settings – tax and spending – are adding to demand). This is a hard fiscal position to justify from a macroeconomic perspective, but so too would be cutting taxes in this environment, as some are calling for. What we do know is that it is simply not sustainable for the Government to keep spending at the pace it has been. Climate change, the aging population, rising global interest rates, and the next inevitable economic downturn are all significant risks to the Government's balance sheet over the medium to long run. Our expectation is that after Budget 2022, the Government will return to more prudent fiscal settings, and that means the direct impact on the aggregate demand pulse from fiscal settings will turn contractionary (likely a 2023-2024 story). Yet another turning point. By then, however, the hope is that inflation is under control and real wage growth and the still-strong labour market are driving a sustainable economic expansion.

- While the turning point for monetary policy is now well behind us – the RBNZ was one of the first movers this global hiking cycle – it is important to note that **monetary policy tends to act with around a 12 to 18-month lag**. That means we are yet to see the full impacts of this tightening cycle, despite the fact that swap rates are already banking on a rising OCR, and that's pushed up mortgage rates by more than the cumulative lift in the OCR. Quantitative tightening is the next turning point in the unconventional monetary policy space, but we suspect it will be a gradual process (see Markets section).
- Looking at financial conditions more holistically, it's very clear the turning point has come and gone (Figure 2). Overall, contractionary financial conditions mean the RBNZ can afford to be patient and continue lifting the OCR in "considered steps".

Figure 2. ANZ Financial Conditions Index



Source: Stats NZ, RBNZ, S&P, REINZ, Bloomberg, Macrobond, ANZ Research

Putting it all together, both the supply and demand sides of the economy have either recently transitioned, are transitioning, or expected to transition through numerous and significant turning points. Making a forecast requires us (and the RBNZ for that matter) to make assumptions about all of them (timing, magnitude, and direction). It's all but impossible that we've nailed all of them, but the process of creating an internally consistent narrative is still a useful process for thinking in a disciplined manner about the drivers of the economy and what's really going to matter for the outlook over the next couple of years.

Policy makers are working hard to try to engineer a soft landing, but a misdiagnosis of the demand impulse relative to the economy's shifting supply capacity could result in cumulative forecast errors, significantly altering the appropriate path for policy settings.

We outlined a couple of scenarios a while ago that showed it might take more than a softening of economic activity to derail OCR hikes (ie if supply side inflation pressures prove stronger and/or more persistent). Conversely, a stronger supply-side recovery alongside a maturing demand impulse could easily see the output gap turn negative and inflation pressures evaporate (while activity holds up). Our central forecast view (see Summary of forecasts), which is very much an all-going-to-plan view, fits somewhere in between.

Markets outlook

Summary

The Reserve Bank is now in well into its rate hike cycle, having delivered two hikes before Christmas. We expect another hike in February, followed by a string of eight back-to-back 0.25bp hikes that will eventually take the OCR to 3%. As we outlined in the previous section, that forecast assumes everything goes to plan, but of course the list of potential surprises is unusually long at the moment. Our forecasts assume that very short-term rates, like the 90-day bill rate, rise along with the OCR. However, with markets already also expecting the OCR to rise, other short to medium-term rates like the 2 to 5-year have less scope to go up, having already risen a long way. They are expected to rise, just to a lesser extent. Global long-term interest rates have risen of late, led by the US. With US annual inflation at 7.5% and the Federal Reserve on the brink of starting its hiking cycle, we expect global long-term rates to continue to rise, taking local long-term rates with them. In currency markets, we expect the NZD to appreciate gradually, but there are risks in both directions.

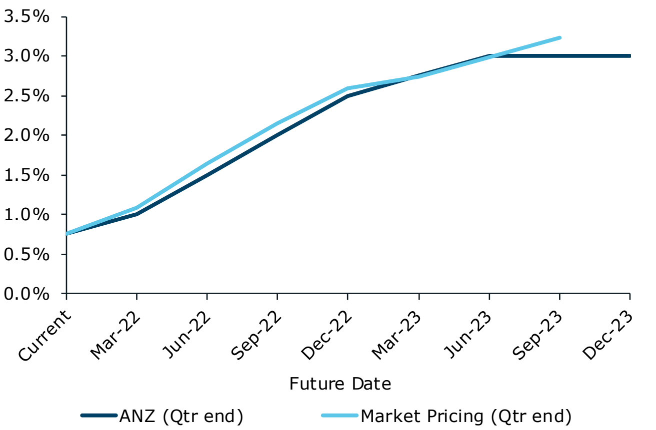
More rate hikes coming, but they're priced in

The monetary policy tightening cycle is already well underway, but given the extraordinarily low starting point for the OCR (0.25%), the rather sudden surge in inflation, and tightness in the labour market, it still has some way to go. Our forecasts assume that the OCR needs to get to around 3% in order to slow the economy and put the brakes on inflation. However, as we noted in the previous section, that is an 'all-going-to-plan' forecast, and a lot could go wrong. Even if rate hikes are derailed later on, there's not much that's likely to get in the way of near-term hikes, given the gap between the Reserve Bank's ("RBNZ") 2% inflation target and actual inflation that is running at close to 6%.

Additionally, unless (or until) some sort of surprise comes along, financial markets are likely to continue assuming that the OCR need to go a lot higher. What that means is that short-term interest rates are likely to remain under upward pressure for the time being. Although markets expect rate hikes to come (more on that later), very short-term interest rates like 90-day bank bills can only move slightly in advance of where the OCR goes.

However, market expectations of where the OCR is headed are closely aligned to our forecasts (figure 1), so there is less scope for rate hikes to drive other short to medium-term rates like 2 to 5-year rates higher. They are still expected to rise, but they have come a long way already, and our forecasts assume that we have seen the bulk of the increase already, with much of the remainder coming over the next two quarters. At this juncture, it is worth noting that unless the size or timing of OCR hikes that end up getting delivered are different to what's expected, the announcement of them shouldn't, all else equal, have much of an impact on these rates. Basically, what's coming is, in theory, already mostly in the price.

Figure 1. ANZ forecasts and market expectations for the OCR



Source: ICAP, Bloomberg, ANZ Research

Going global …

But whereas short-end rates are sensitive to where the OCR is headed, NZ long-term interest rates remain far more sensitive to moves in global long-term interest rates – especially the US. One reason for this is that New Zealand is a net borrower nation, and a high proportion of New Zealand bonds (issued by both the government and corporates) are held by foreigners. Offshore fund managers also actively trade the local swap market. So whatever happens offshore will be felt here.

On that score, the three main things to watch are:

1. the evolution of US Federal Reserve ("Fed") policy – which tends to set the scene for the US bond market;
2. inflation outcomes, especially in the US and here; and
3. the evolution of quantitative tightening, or "QT".

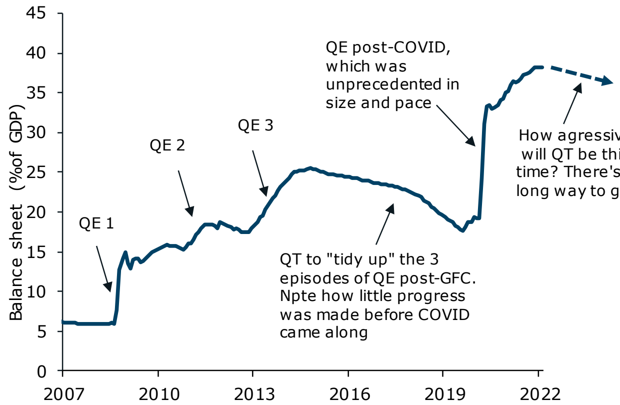
We expect the Fed to deliver their first hike of the cycle in March. US bond yields have been under upward pressure ahead of the first hike, and are likely to remain so as hikes continue throughout the year. Financial markets and forecasters are split about whether the Fed should kick off the tightening cycle with a 0.25bp or a 0.50bp hike. We think a 0.25bp hike will be more likely, but it is understandable that the market is hedging its bets ahead of February CPI and employment data. Once that data is released in early March, we'd expect markets to gravitate more firmly one way of the other. Looking further ahead, we are forecasting five Fed hikes in 2022, and expect the bellwether US 10-year Treasury bond yield to rise to 2.50% over the next year or so.

The second item on our list is inflation, and this is the main reason why central banks here and abroad are raising interest rates. There is good reason why the Fed has moved quickly from characterising inflation as "transitory" to getting itself ready to raise rates. Not only has US annual CPI been above 4% (ie twice the Fed's 2% target) since last April; data just in put it at a 40-year high of 7.5% in January. This bears watching because it will (alongside the US job market) drive Fed policy. But what happens to US inflation will arguably be even more important if investors start to tire of negative real yields (ie once inflation is subtracted). At the moment, US 10-year Treasury bond yields sit at around 2%. That's a long way below inflation at 7.5%. One reason why markets are happy to tolerate this is because there is confidence that the Fed will rein in inflation. But if they struggle to do so, or it takes longer than it has in the past, markets may become impatient, and bond yields could move higher – and the impact of that would likely be felt here in New Zealand.

The third item on our list is QT. This is the opposite of quantitative easing, or QE. Just as QE put downward pressure on long-term rates as the Fed bought bonds, QT has potential to put upward pressure on bond yields as the Fed stops buying, and as the bonds it had bought mature and that funding needs to be replaced by bonds bought by other investors, who will be more sensitive to inflation outcomes and expectations. The world has very little experience with QT, having really only experienced it in the US post-GFC/pre-COVID era. While it did proceed much more slowly than QE (figure 2), implying asymmetric impacts on rates too, it's still a consideration. Even if the Fed doesn't aggressively sell down its bonds into the market, the very fact that it will no longer be buying bonds after February means one less factor holding down US bond yields.

Incidentally, QT is also coming in New Zealand, but it too is likely to be a gradual process. And if the RBNZ sticks to its earlier commitment to either let its bonds roll off naturally as they mature, or only sell them to the Treasury (rather than into the open market), that is unlikely (on its own) to have much, if any, of an immediate impact on bond yields here.

Figure 2. The Fed's balance sheet through QE and QT



Source: Bloomberg, Federal Reserve, ANZ Research

A gradual NZD appreciation is expected, but there are risks …

Our forecasts assume that the NZD appreciates slightly over 2022, eventually topping out at 0.70. However, we expect volatility as global central banks shift to tightening mode, and as markets navigate some of the turning points discussed earlier in this document.

We are also mindful that there are a number of opposing cross-currents likely to be at play as the year progresses. For example, on the bright side, we have factors like:

- Interest rate differentials to other countries (or "carry", which has historically been important) suggest the NZD has scope to appreciate. Higher interest rates make it beneficial to be "long" the Kiwi and costly to be "short". With inflation this high and the labour market this strong, more OCR hikes are coming, so carry will become more intense, with the RBNZ at the front of the global policy tightening race.
- Commodity prices also tend to be influential, and these are rising right now (not just oil – so are milk prices).
- Growth is also looking robust – but that's not unique to New Zealand.

But there are also some reasons to be cautious:

- The housing market faces many headwinds.
- More broadly, there are growing concerns that NZ may experience a "hard landing".
- Business confidence has deteriorated, and the prospect of high rates of absenteeism associated with Omicron poses a risk to economic activity.
- Plans to open the border have been welcomed across the business community, but it may also lead to outward migration as Kiwis head offshore in search of higher wages. So it's complicated.

Markets outlook

- The Kiwi also tends to trade as a proxy for global risk of various kinds. Rising tensions in Eastern Europe weighed on sentiment in mid-February. If the situation were to deteriorate, we may see a "flight to safety", which would likely be to the detriment of the NZD.

Bringing it all together, we think that speaks to volatility more than it does directionality. Volatility is low now but it could rise as we inch closer to the first US Federal Reserve's first rate hike, expected next month. It also remains to be seen how currency markets respond to the cessation of QE in the US next month. As we also noted earlier, there is little history to draw on given the near-unprecedented situation we are in, but the risk is that bond markets don't take it well.

Table 1: Forecasts (end of quarter)

FX Rates	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23
NZD/USD	0.65	0.66	0.68	0.70	0.70	0.70	0.70
NZD/AUD	0.93	0.93	0.93	0.93	0.93	0.93	0.93
NZD/EUR	0.58	0.58	0.59	0.60	0.59	0.59	0.59
NZD/JPY	73.5	75.2	78.2	81.2	81.2	81.2	81.2
NZD/GBP	0.47	0.48	0.49	0.49	0.48	0.48	0.48
NZD/CNY	4.14	4.19	4.30	4.41	4.40	4.38	4.36
NZ$ TWI	69.8	70.5	72.1	73.5	73.3	73.1	73.0
Interest Rates	**Mar-22**	**Jun-22**	**Sep-22**	**Dec-22**	**Mar-23**	**Jun-23**	**Sep-23**
NZ OCR	1.00	1.50	2.00	2.50	2.75	3.00	3.00
NZ 90 day bill	1.52	2.02	2.52	2.77	3.10	3.10	3.10
NZ 2-yr swap	2.65	2.90	3.02	3.08	3.10	3.10	3.10
NZ 10-yr bond	2.70	2.90	3.10	3.40	3.50	3.50	3.50

Source: Bloomberg, ANZ Research

Key forecasts

Calendar Years	2017	2018	2019	2020	2021(f)	2022(f)	2023(f)
NZ Economy (annual average % change)							
Real GDP (production)	3.5	3.4	2.8	-2.0	5.5	2.4	2.8
Private Consumption	5.5	4.6	3.2	-1.2	6.9	2.7	2.9
Public Consumption	3.5	3.3	4.6	6.9	9.2	4.3	2.7
Residential investment	-1.1	-1.6	5.4	-3.3	11.3	5.0	2.9
Other investment	6.8	9.7	4.1	-8.2	6.9	3.4	5.7
Stockbuilding[1]	0.2	0.3	-0.5	-0.9	1.6	-0.8	0.0
Gross National Expenditure	5.2	5.2	3.1	-2.0	9.3	2.7	3.5
Total Exports	2.7	3.2	2.4	-12.9	-2.0	6.7	10.5
Total Imports	7.3	6.4	2.1	-15.9	15.0	10.2	6.5
Employment (annual %)	3.6	2.3	1.2	0.6	3.7	1.3	1.6
Unemployment Rate (sa; Dec qtr)	4.5	4.3	4.1	4.9	3.2	2.9	3.0
Labour Cost Index (annual %)	1.9	2.0	2.4	1.5	2.8	3.8	3.7
Terms of trade (OTI basis; annual %)	7.9	-4.8	7.1	-1.6	3.0	2.0	2.1
Prices (annual % change)							
CPI Inflation	1.6	1.9	1.9	1.4	5.9	4.1	2.7
Non-tradable Inflation	2.5	2.7	3.1	2.8	5.3	5.3	4.3
Tradable Inflation	0.5	0.9	0.1	-0.3	6.9	2.7	0.6
REINZ House Price Index	3.4	3.2	5.1	15.5	26.5	-7.0	1.8
NZ Financial Markets (end of December quarter)							
NZD/USD	0.71	0.67	0.67	0.72	0.68	0.70	0.70
NZD/AUD	0.91	0.95	0.96	0.94	0.94	0.93	0.93
NZD/EUR	0.59	0.59	0.60	0.59	0.60	0.60	0.59
NZD/JPY	79.9	73.8	73.1	74.6	78.6	81.2	81.2
NZD/GBP	0.53	0.53	0.51	0.53	0.51	0.49	0.48
NZD/CNY	4.62	4.62	4.69	4.74	4.35	4.41	4.34
NZ$ TWI	74.4	73.4	73.7	75.2	73.2	73.5	72.8
Official Cash Rate	1.75	1.75	1.00	0.25	0.75	2.50	3.00
90-day bank bill rate	1.88	1.97	1.29	0.27	0.97	2.77	3.10
2-year swap rate	2.21	1.97	1.26	0.28	2.17	3.08	3.10
10-year government bond rate	2.72	2.37	1.65	0.99	2.39	3.40	3.50

[1] Percentage point contribution to growth
Forecasts finalised 17 February 2022
Source: Statistics NZ, REINZ, Bloomberg, Treasury, ANZ Research

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