ANZ Research

November 2022

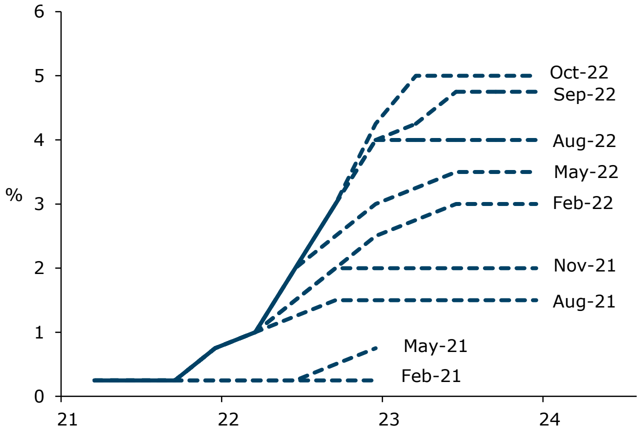
Quarterly Economic Outlook

Coming in to land

Summary of forecasts

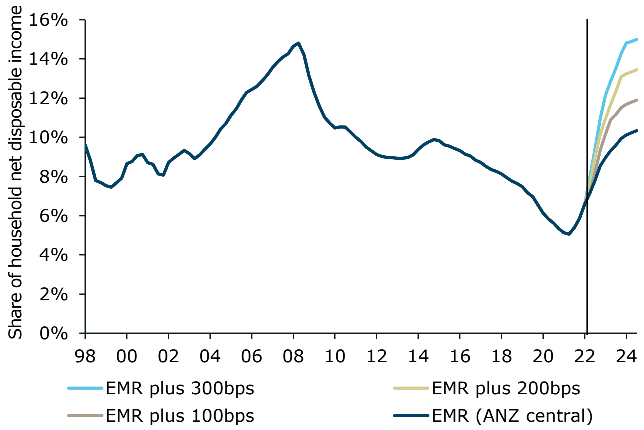
The wage-price spiral keeps surprising, necessitating a higher OCR outlook

Our OCR forecast peaks at 5%, but current wage growth momentum means it may need to go higher



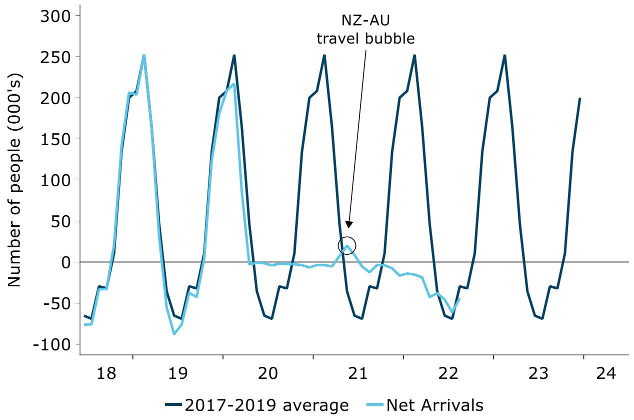
Household debt-servicing burdens will rise, and sharply

But it would take another 300bps on top of our forecast to reach previous highs



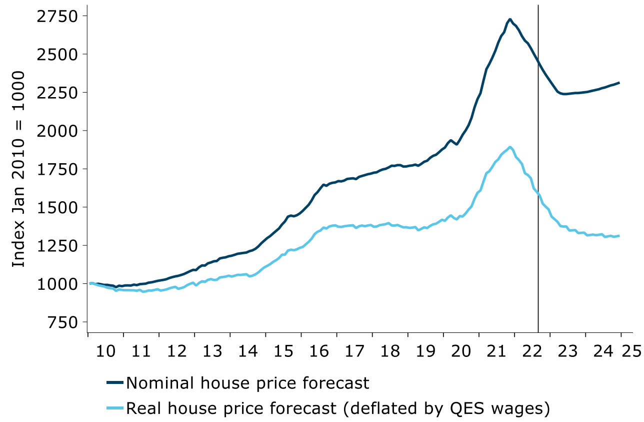
Net visitor arrivals are poised to recover

But it's a steep mountain to climb to normality



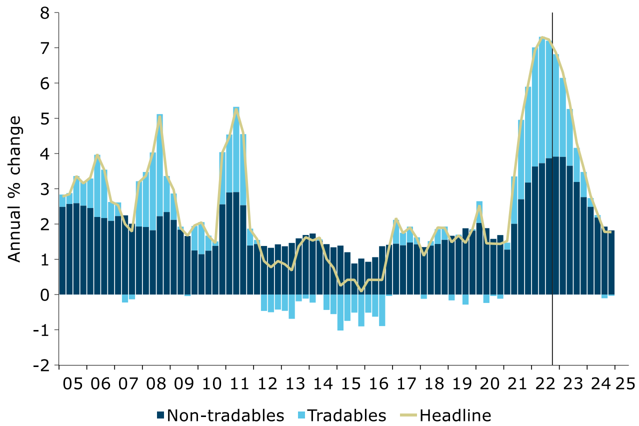
House prices have further to fall

We expect a full unwinding when adjusted for incomes



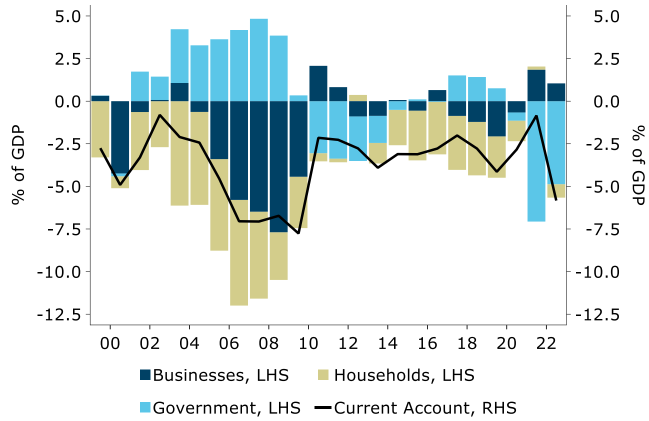
Inflation will slow

But it will take slack opening up in the labour market to take care of 'sticky' domestic inflation



Fiscal restraint will help cool inflation and narrow the current account deficit

But the annual current account deficit is expected to widen a little more in the very near term



Source: Stats NZ, RBNZ, REINZ, Macrobond, ANZ Research

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Coming in to land

Summary

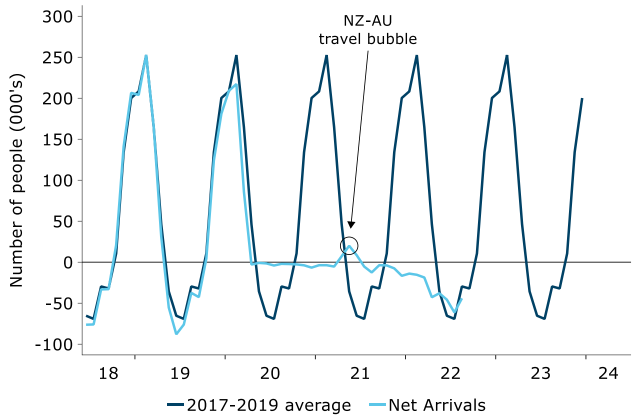
Economic growth is poised to slow as monetary tightening weighs on domestic demand. But the return of international tourism and weaker demand for imports should provide a decent offset in GDP terms. Whether or not New Zealand avoids recession remains a line ball call. But it's important to note that not all recessions are created equal. A recession that brings about a transition from the currently over-stretched economy towards sustainable expansion, while also avoiding a significant household income shock, may not be as bad as the R-word sounds, particularly from a long-run economic stability perspective. And if it means squashing the current wage-price spiral before it necessitates even more aggressive action by the RBNZ, then it may be a cost worth paying. One way or another, the economy needs to find its way to a sustainable path. Price (and economic) stability is at stake, and so too is very hard-won central bank credibility. Hopefully a 5% OCR is enough to get the job done.

Coming in to land

Broadly, our economic outlook hasn't changed. We continue to expect growth to soften meaningfully in 2023 as the impacts of monetary tightening weigh. We've pencilled in a small contraction in business investment and around a 10% contraction in residential investment. Private consumption is expected to slow to a snail's pace as the high cost of living, falling house prices, and rising interest rates outweigh a still-tight (but loosening) labour market and continued robust income growth. Come Budget 2023, we're also expecting fiscal settings to continue to become less expansionary.

Offsetting this is net exports (exports less imports) flipping from a growth 'drag' to a 'driver'. Part of that is simply owing to the fact that softer domestic demand (plus the weak NZD) means fewer imports, and part of it reflects the recovery of our largest export earner: international tourism. But as figure 1 shows, from a net perspective (kiwi departures less international visitor arrivals) there is a big mountain yet to climb as we move into the warmer months. And with airline capacity not yet back to 100%, the high cost of airfares, and general labour scarcity, it's hard to foresee a full recovery in net travel-related exports over the coming season.

Figure 1. Net visitor arrivals



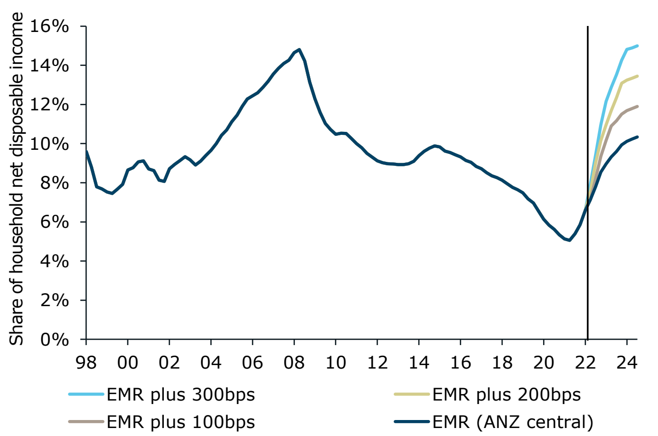
Source: Stats NZ, Macrobond, ANZ Research

It's still touch and go whether the net exports recovery and robust labour market will be enough to prevent the economy from entering recession. But what we would say about the R-word is this: a technical recession (two consecutive quarters of negative growth) with a still-robust labour market (ie with unemployment still historically low) is a very different scenario to a sharp negative employment shock. Indeed, a small contraction in activity that reflects a transition from extremely stretched economic resource (labour and capital) to something a little more sustainable may, from a longer-run perspective, not be as bad as it sounds. But at the same time, a mild technical recession of this nature may not be all that disinflationary, meaning it may not be the green light one might assume for the RBNZ to suddenly switch into monetary policy loosening mode. For that, the RBNZ will need to be convinced that meaningful spare capacity in the economy has opened up, and that would likely entail a significant rise in unemployment.

One key thing has changed since our last Quarterly Economic Outlook. We now think the OCR will need to go higher to bring about this weaker domestic demand pulse. In August, we had the OCR peaking at 4% in our forecast; now we have it at 5%. In technical terms, the bulk of our OCR call change reflects an expectation that the neutral OCR is higher (that's the level of the OCR that is neither adding to nor subtracting from inflation over the medium term). When neutral is higher, the OCR must follow 1:1 to achieve the same monetary policy tightening traction. And while the neutral OCR is unobservable and uncertain, it's inevitable that the faster household incomes are growing, the higher the neutral OCR sits, in a short-term sense at least. Indeed, the Q3 labour market data showed QES private sector average hourly earnings running at an annual pace of 8.6% – convincingly outpacing inflation of 7.2%. That's great news from the perspective of inflation-squeezed households, but all else equal, improving CPI-adjusted household incomes likely mean more work to do than otherwise for the RBNZ (which is trying to soften the demand pulse). In fact, the wage-price spiral is now looking so developed that we think it necessitates back-to-back 75bp hikes in November and February.

While CPI-adjusted income is now back in positive growth territory, many households out there will be finding the rising interest rate environment a significant challenge. Indeed, any household with a high debt-to-income ratio will find it relatively hard to hide from the impact of rising rates, with strong income growth providing only a partial offset. And given typical re-fixing lags, the peak impact for these households is yet to come. That said, the aggregated debt and income data shows we've been here before in terms of the looming economy-wide increase in household debt-servicing burdens. In fact, to get to the levels preceding the Global Financial Crisis, we'd have to add about 300bp to our mortgage rate assumption (figure 2).

Figure 2. Household debt-servicing share[1]

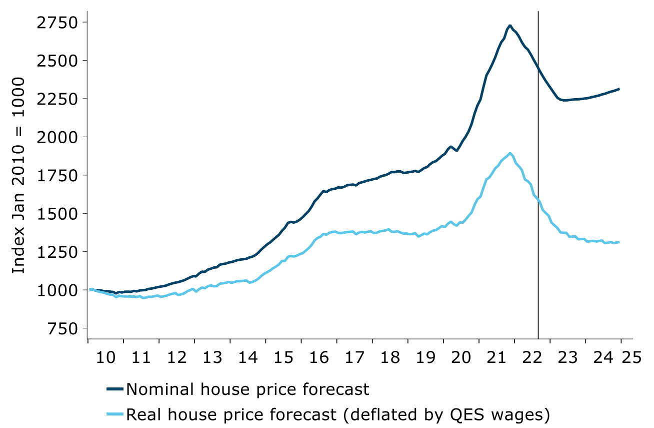


Source: Stats NZ, RBNZ, ANZ Research

But while the level of debt servicing implied by our current forecasts in the above chart isn't unprecedented nor even particularly high, the pace of change is very sharp. It will therefore carry some shock value – particularly for recent first home buyers (or anyone with a high debt-to-income ratio) who wasn't expecting this and may also now find themselves in a negative equity situation. But so far, there is little evidence to suggest that a meaningful lift in forced house sales is underway. In fact, new listings data for October were unseasonably weak, suggesting potential sellers are choosing to wait it out. All else equal, this will be keeping growth in inventories contained (as house sales slow), keeping the market tighter than otherwise and preventing prices from falling as much or as fast as they would if listings were higher. It's all been a very orderly adjustment so far, with very little blood on the floor. While around 2% of households are currently in negative equity, these remain, on the whole, paper losses.

But for house prices, there's still no escaping the fundamentals: new housing supply is much higher than new demand, housing inventories are at a six-year high, affordability (as measured by house prices relative to incomes) still has a long way to go to get to half-respectable levels, and debt-servicing costs are still lifting. We see this culminating in around a 18% peak-to-trough decline in house prices, or 27% when deflated by QES wage growth (figure 3). In income adjusted terms, that's a full unwinding of the pandemic stimulus / FOMO driven bump.

Figure 3. House price forecast



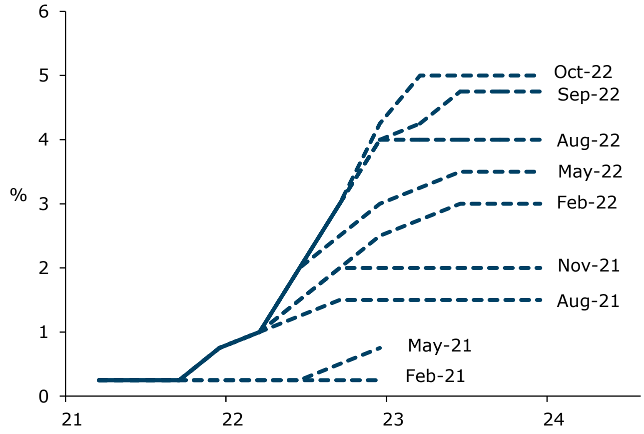
Source: Stats NZ, REINZ, Macrobond, ANZ Research

For the RBNZ to unlock 'inflation target achieved' status, they need softer domestic demand to translate into softer demand for labour. Without that, the wage-price spiral continues, core and domestic inflation pressures remain too high, and the OCR will need to be lifted even higher. And that's exactly how the data have evolved over the past 18 months or so, with figure 4 showing how persistent positive inflation and capacity stretch (pipeline inflation) surprises have affected the evolution of our OCR call. You

[1] The EMR (effective mortgage rate) takes into consideration the fixing pattern of home loans. The 'ANZ central' reflects our OCR call (5% peak). We also assume 7% household income growth in the forecast, and relatively stagnant household credit growth (reflecting the slowing housing market).

probably wouldn't guess by looking at the chart below, but on the whole we've tended to lead the market with our OCR call through this hiking cycle. And we're not yet convinced domestic and core CPI inflation has stopped surprising on the upside.

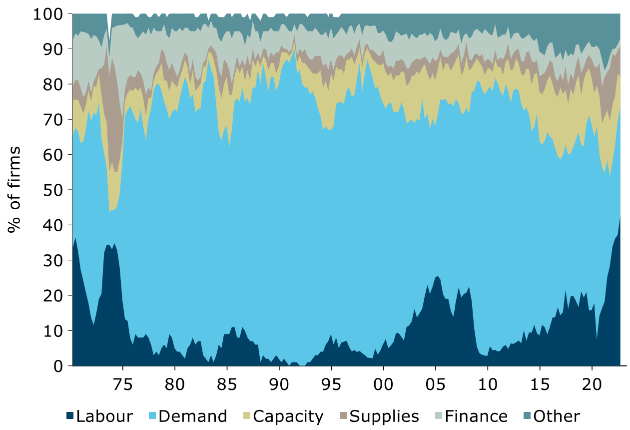
Figure 4. Revisions to our OCR forecast



Source: RBNZ, ANZ Research

So while our forecast is that a 5% OCR will get the job done, the potential for ongoing positive inflation surprises (particularly via labour costs) shouldn't be discounted. Indeed, the Q3 read on the labour market was worryingly tight, with records broken all around and recent business survey data from the NZIER's Quarterly Survey of Business Opinion showing labour as a limiting factor ratcheting up to record levels in Q3. That's in data that goes back to the 1970s, and we all know what inflation dynamics were like then – not groovy!

Figure 5. Firms' limiting factors of production



Source: NZIER, Macrobond, ANZ Research

Wage growth is where the rubber meets the road for the sticky domestic inflation pulse, and with average hourly earnings surprising all forecasts in Q3 at a record high of 8.6% y/y the RBNZ should be worried about just how developed the wage price spiral has become. Some large retail-sector wage settlements of late have been well into double digits, and have the potential to be the new benchmark for upcoming negotiations.

Indeed, while we do expect CPI inflation to slow from here, we still see significant upside risk to the domestic inflation outlook. If the labour market doesn't show signs of loosening soon, the OCR will very likely need to go higher than the 5% peak we've pencilled in.

It's important to note that not all wage growth is created equal.

At one end of the spectrum you have wages chasing their tail: that's when higher wages lead to higher prices, which then get factored into wage negotiations. This is the end of the spectrum you don't want to be in, as while wage growth in this scenario is good insofar that it prevents inflation from eroding *real* household incomes, the improvement in real incomes is likely to prove fleeting as inflation persists at high rates. But that is unfortunately a fair description of the current wage-price spiral dynamics we are seeing.

At the other end of the spectrum, you have wage growth driven by improving labour productivity. In this case, a given amount of labour input yields higher output for businesses, who can then afford to pay a higher wage, while not having to increase their prices. Households get the benefit of higher wage growth without the self-defeating flow-on effect on inflation eating that up. But while improved labour productivity would be a wonderful thing right now, it's not an easy thing to generate. In fact, productivity has taken something of a hit in the wake of the pandemic, and that's just made the inflation problem worse.

When it comes to inflation, there's a lot to unpack. To understand the outlook, and the threat current economic conditions pose to medium term inflation, and therefore the monetary policy outlook, it helps to understand the evolution of inflation to this point.

- NZ's inflation acceleration first kicked off as a global phenomenon, with global supply chains caught out by the post-pandemic, fiscally stimulated, nothing-else-to-do-but-buy-widgets surge in household demand. Imports of goods into the US and other advanced economies went ballistic, supply chains came under immense pressure, and shipping costs and commodity prices skyrocketed. Broadly, demand for goods became more concentrated as many services (eg international travel) were not an option. As a result, tradable inflation surged, but policy makers, expecting supply chain bottlenecks to eventually get worked out, diagnosed this inflation as 'transitory'. They weren't necessarily wrong about that, but it's certainly taking much longer to dissipate than expected.

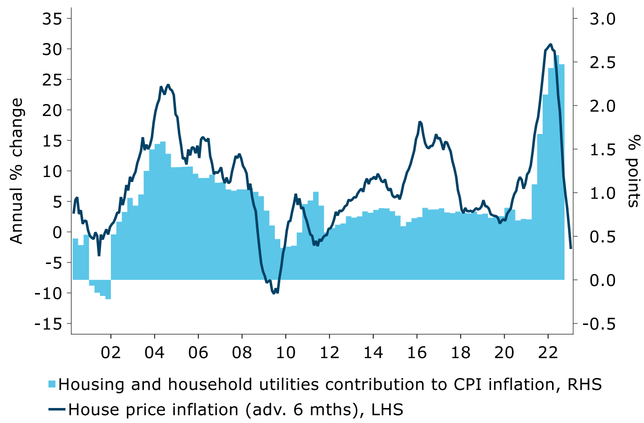
- But then Russia's invasion of Ukraine made the tradable component of inflation less transitory by restricting global energy and food supplies. New Zealand, however, has been more insulated from these effects than many other countries, particularly those in Europe. But the higher-than-otherwise global inflation pulse still makes its way to NZ shelves, at least indirectly.

- Meanwhile, the ability for the labour market to respond to demand underwent a significant shock – and one that lingers to this day. Labour mobility first took a hit on the back of closed borders, with New Zealand slower than most countries to ease border settings and allow imported labour to meet current insatiable demand for it. But the Government also took the opportunity to adopt an 'immigration reset', ultimately leaving post-pandemic migration settings at a more restrictive level than the pre-pandemic era. That may not be a bad thing over the longer run, but the immediate impact has been a more severe mismatch between labour supply and labour demand than otherwise, ultimately pushing the labour market further beyond sustainable levels (more on this later) and adding fuel to the wage-price spiral that's currently unfolding. It's important to note that low unemployment is a good thing for households, but at unsustainably tight levels, boom-bust risks are growing, and that puts medium-term economic stability at risk. There is a sweet spot (equilibrium) for the labour market, and we think this is currently closer to an unemployment rate of 4.5%.

- On top of reduced job-matching efficiency (described above), the other significant pandemic-related labour productivity shock is the ongoing resource required to mitigate COVID transmission risks and cover increased worker absenteeism. For businesses, that's less output of their goods and services for a given level of input. That's a productivity shock that businesses can deal with by either lifting their prices and/or taking a profit haircut. The latter can't continue for too long without firms going under.

- The next inflation driver worth a mention is the nutty housing market that peaked in late 2021. Housing went gangbusters after considerable monetary (and macro-prudential) loosening met a much healthier household sector (financially and physically) than the RBNZ's early pandemic forecasts assumed (partly due to the success of the wage subsidy in keeping people connected to the labour market). Add a hefty portion of FOMO to the mix and the 45% lift in prices was like nothing we've seen before. The contribution to CPI inflation from the housing and household utilities group (which includes the cost to build a new house excluding the land, and rent) added considerable heat to non-tradable inflation (figure 6).

Figure 6. House price inflation and housing related contribution to CPI inflation



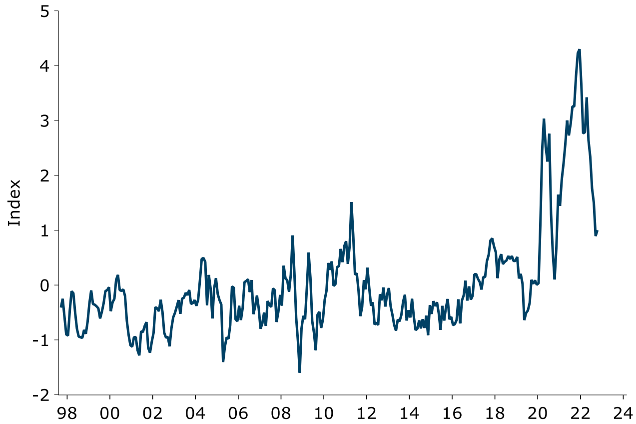
Source: Stats NZ, REINZ, Macrobond, ANZ Research

- Lastly, and as we are all very aware, the labour market has held it together very well through this, ending up tighter now than before the pandemic, and well beyond the RBNZ's assessment of maximum sustainable employment. Ultimately, that suggests (with the benefit of hindsight) that the Government and RBNZ delivered too much stimulus for the conditions. That stimulus pushed demand well beyond the economy's ability to supply (ie we've largely run out of workers, as well as building materials for a time), with high domestic inflation dropping out the other end. Labour costs are now at a record high, setting up a worrying domestic inflation pipeline that's now at the root of the RBNZ's inflation problem.

All up, it's really been a perfect storm for inflation. And one where about half of the impulse reflects global factors (tradable, aka imported inflation) and half reflects domestic factors (non-tradable inflation). Looking forward, the global vs domestic inflation mix is expected to evolve, with high domestic inflation expected to be public enemy #1 for the RBNZ.

- First, and perhaps most obviously, many of the tradable inflation pressures described above have already diminished quite significantly. Global supply chain pressures are easing (figure 7), shipping costs are falling, and commodity prices are off their peaks. On the other side of that coin, global demand is slowing on the back of monetary tightening, and household spending is less concentrated in goods. For New Zealand, however, some of these benefits may take a while to be felt. That's because the weak NZD is keeping the price of our imports high (though the NZD has appreciated somewhat in recent weeks), and falling global shipping costs are being offset by the fact that there are still fewer ships visiting New Zealand – and the ones that are coming here are frequenting fewer ports.

Figure 7. Global supply chain pressure index



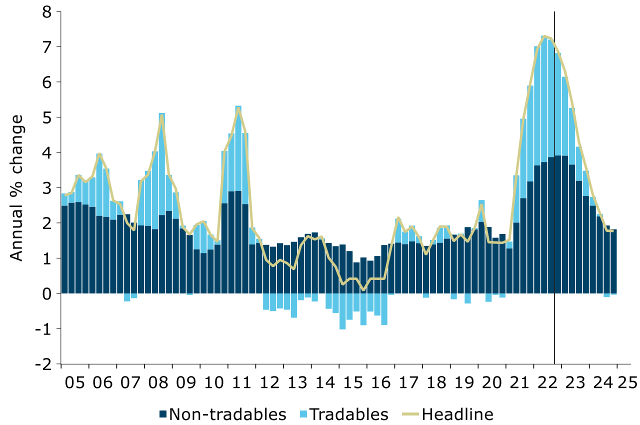
Source: FRBNY, Macrobond, ANZ Research

- On the non-tradable side, ongoing slowing in the housing market is expected to see the heat come out of housing-related CPI inflation. However, there remains a very lengthy pipeline of consented work, meaning cost pressures could remain higher for longer. It's also important to note that while the housing and household utilities group has been a big driver of domestic inflation of late, a weak impulse (even a negative one), while necessary to tame inflation, will not be sufficient on its own to bring domestic inflation down to appropriate levels. That's because the broader labour market looks set to remain a key source of domestic inflation for a while yet. Labour shortages started in construction but now affect every sector.

- Indeed, either supply of labour needs to drastically increase and/or demand for labour needs to soften significantly, before core and domestic inflation pulls its head in. And that's no easy feat for the RBNZ given the starting point is one where record-high wage growth is eroding the impact of monetary tightening delivered to date. But there's no limit to how high the OCR can be raised, so it's a question of "what'll it take?" rather than "will it happen?"

All up, the baton of high inflation drivers has passed from global and pandemic-related factors to housing-related drivers, to the current wage-price spiral. Two out of three of these things now appear past their peak, but one (the too-tight labour market) may yet produce a few more positive inflation surprises before it turns.

Figure 8. Contributions to inflation



Source: Stats NZ, Macrobond, ANZ Research

NZ's external imbalance needs friends too

The interaction between fiscal and monetary policy is an extremely important part of macro-stabilisation, and therefore the long-run success of the economy. Fiscal expansion at a time when there is no economic capacity (eg labour) to accommodate it is likely to crowd out private sector activity, boost inflation pressure, and result in a higher OCR than otherwise (as the RBNZ responds to the extra inflation). That means tax payers not only foot the bill for increased government borrowing (via higher future taxes and/or lower government services than otherwise), but the cost of servicing debt in the economy will also be higher for both the public and private sector. That is, households and business will be indirectly paying for this 'crowding out' with higher-than-otherwise loan payments. This will be partially offset by higher-than-otherwise income growth, but as already mentioned, without productivity growth, the benefit to households may not be large.

New Zealand's $75bn COVID Response and Recovery Fund was huge (representing around 23.5% of 2019 annual GDP), and Budget 2022 (covering the fiscal year to June 2023) was expansionary. With the output gap (a measure of capacity stretch) estimated to be strongly positive thorough this period, this meets the definition of pro-cyclical (inflationary) fiscal policy.

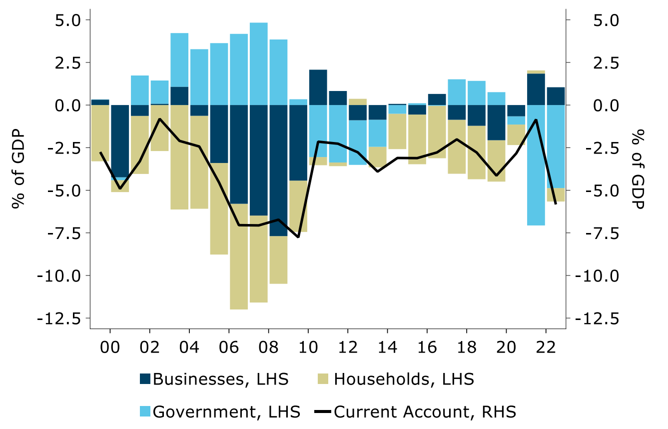
With economic resource all but tapped out, economic conditions are ripe for fiscal consolidation. Indeed, if now isn't a good time for fiscal consolidation, with unemployment near a record low, when is? Tax cuts, higher spending, or even spending positive tax revenue surprises (rather than banking them) will only make the RBNZ's job harder and add pressure to the growing debt-servicing burden households are currently facing.

The recent situation in the UK is a somewhat extreme, but relevant example. The Truss Government planned to stimulate its way out of an inflation pickle, without a plan to raise Government revenue (ie taxes) to pay for it. The implications of such a policy stance would have been higher and more persistent inflation, higher interest rates, and given already very high levels of public sector debt, an increased risk that the Government's interest cost would one day explode, driving either a future solvency event and/or the need for a very sharp and economically painful pivot to austerity. In other words, such a policy put financial stability at risk.

While the very high starting point for UK government debt was a key constraint, another key reason why the UK example was considered so unsustainable is the fact that the UK has also seen its current account deficit widen sharply. That means the UK economy has become more dependent on foreign capital to fund domestic activity. That's not a bad thing on its own (direct foreign capital can fund good investments that make everyone better off), but the more dependent an economy is, the higher the risk of a misallocation of capital, and the higher the risk that foreign creditors pull the plug, again necessitating the need for a painfully sharp adjustment in domestic activity.

While New Zealand's government debt as a share of GDP is still much lower than the UK's (55% versus 146%, according to this OECD measure of general government debt), New Zealand's current account deficit is slightly wider. And when considered through a savings-less-investment lens, a big part of the recent blowout in the deficit has been facilitated by the mismatch between Government savings and investment (figure 9). That's what you'd expect to happen when the Government uses its balance sheet to support households and businesses through an income shock. But that shock is largely over (touch wood). Provided the Government enters a fiscal consolidation phase, as our forecasts assume, we can have confidence that New Zealand's current account deficit will narrow in time.

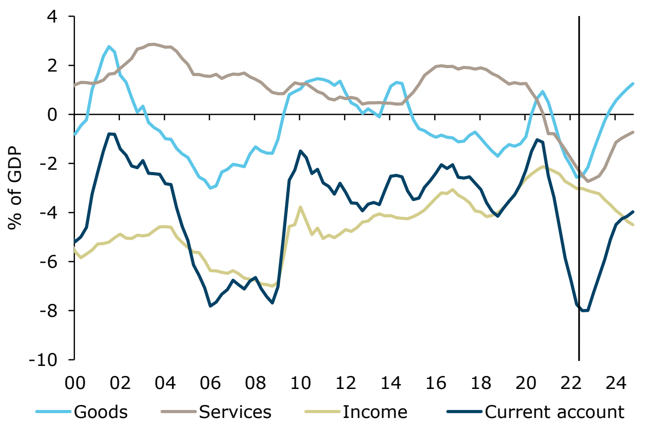
Figure 9. Contributions to current account by sector[2]



Source: Stats NZ, Macrobond, ANZ Research

Cut another way, our current account forecast sees the annual deficit as a share of GDP picking up an 8 handle from Q3 this year, before improving over 2023 and returning to 4% in 2024 as demand for imports declines as the domestic economy cools, and as travel services exports (education and tourism) recover. But as a net borrower from the rest of the world, we do expect New Zealand's income deficit to widen as higher debt-servicing costs bite (figure 10).

Figure 10. Current account forecast



Source: Stats NZ, ANZ Research

[2] See this note from the NZ Treasury for more on recent current account dynamics. Estimates for the year to March 2022 and March 2021 are provisional and based on experimental quarterly income GDP.

Coming in to land

Could we miss the runway?

Central banks the world over are working hard to get policy settings just tight enough to rein in inflation while not causing unnecessary economic pain in the process. But no one has perfect economic foresight, and that means that while policy makers are doing their best to pull off a soft landing, no one can really say for certain how bumpy things are going to get.

It's fair to say that since our last Quarterly Economic Outlook was published, upside inflation risks have materialised to some extent, while downside economic activity risks have not. Adjusting for the new starting point, we don't see the general risk profile to the outlooks as having changed much.

At the more likely end of the spectrum, we continue to see upside risks to the domestic inflation outlook, with a labour market that takes a little longer than expected to transition to sustainable (and less inflationary) levels. This has certainly been the case recently. If such risks continue to materialise, there's no reason to think the RBNZ won't take the OCR higher than the 5% peak we currently expect.

Conversely, it's also important to acknowledge the long and variable lags between monetary policy settings and inflation. It's entirely possible that the RBNZ has already done enough to get inflation down, and all that's required from here is a little patience. If this does prove to be the case, then ultimately our forecast has the RBNZ oversteering, potentially causing (with the benefit of hindsight) a harder landing than needed. But that's not the most severe downside risk to economic activity out there.

Indeed, when New Zealand business cycles come to an end there's typically a nasty global financial shock in the mix. And the global rising rates environment will be a key test for the many global financial market vulnerabilities that have only intensified with pandemic-related borrowing. A 'tail-end' (low probability) risk of this nature, if it were to materialise, could have very significant impacts on economic activity and incomes. And there is no inverse upside, low-probability high impact risk offsetting this one.

But what's important for policy makers is that they don't let this risk distribution bias their judgement. Putting weight on tail-end downside risks when setting the OCR will almost guarantee the RBNZ to overshoot their inflation target in normal times (when such risks fail to materialise). The OCR must be set for the single most likely outcome, but with policy makers ready to act promptly should things drastically change.

If policy makers do manage to pull off a soft economic landing while reining in inflation, the broad economic vibe is still very likely to feel a little soggy to most. Once in the air, the pilot can't exactly avoid the weather at the landing strip, merely adjust speed and trajectory for the conditions. And that's exactly what the RBNZ is expected to do. If they discover more inflation in the system than expected, they'll hike more. If things turn the other way faster than expected, they may even be able to loosen.

Markets outlook

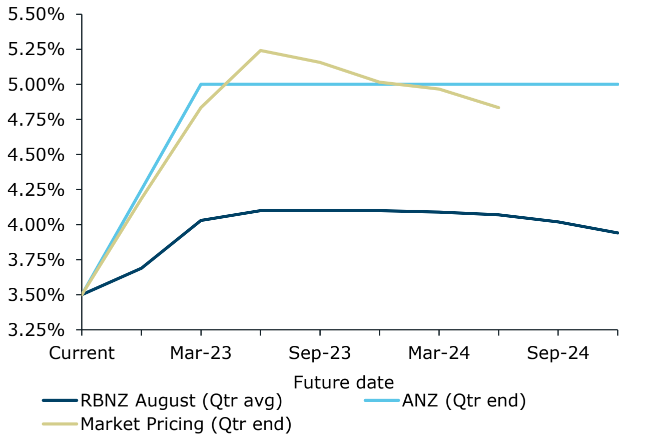
Summary

New Zealand and US long-term bond yields continue to drift higher, fuelled by higher-than-expected inflation and continued hawkish rhetoric (and action) by their respective central banks. While the rapid pace of hikes is going some way to lean into inflation, there is much work to be done, and we expect the entire term structure of interest rates here and in the US to continue edging higher over H1 2023. Although both markets are now pricing in peak policy rates that are higher than our forecasts, leaving less room for further upside at the short end, with the risks around inflation and the labour market still tilted to the upside, there is equally little scope for any significant reprieve. NZ long-end rates remain sensitive to US rates and how long policy rates there will hold up for, and to inflation itself. This is where we see the biggest scope for higher rates as markets price in a longer period of tighter policy. In the FX space, USD strength continues to dominate, but we do think the NZD will do better in 2023 as US and NZ policy rates converge on 5%.

Short-end rates now pricing in a lot …

Policy rates have continued grinding higher across the globe over the past three months, as have market expectations for future policy rate hikes. These moves – which have largely been fuelled by higher inflation outturns – have seen market expectations for the peak in the US federal funds rate and the peak RBNZ OCR rise to around 5.15% and 5.25% respectively. In both cases, those expectations exceed the 5% mark, the level we are currently pencilling in as the likely peak in policy rates in both countries (figure 1 shows where things sit for New Zealand). In principle, that makes us more guarded about the prospect of short-end rates rising much further from here. But equally, with easing miles off, short rates are unlikely to fall any time soon.

Figure 1. ANZ OCR forecasts vs the market and RBNZ



Source: Bloomberg, ANZ Research

Although we expect the RBNZ to ratchet up the pace of tightening to 75bps at the November and February decisions, this is now almost fully priced in. Technically markets haven't priced in a 5% OCR by February, but they are pricing in a peak above 5%, and in the spirit of give and take, we think that's pretty similar to what we expect and don't see this as a significant source of friction between our view and the market's.

… but with little tangible evidence of inflation slowing, don't expect any let-up …

As the rate hike cycle advances and matures, at some point hikes will potentially slow, definitely cease, and eventually give way to cuts. That has obviously been the experience of past cycles and it is natural that markets will look to learn from that experience. The only trouble is; without any tangible evidence that inflation is slowing or the jobs market easing (and in New Zealand's case, if anything the signs are pointing in the other direction), we think the risks remain skewed towards the OCR needing to go beyond 5%. And even if something around 5% will do the trick, it is likely to be some time before the OCR can actually come down. At best then, we might be at or close to the peak in short-term rates, but we think it is way too premature to assume that an easing cycle is just around the corner (assuming global financial markets keep it together as monetary conditions tighten).

So far this cycle inflation and labour market outcomes have repeatedly surprised to the upside, necessitating a long string of upward revisions to our (and the market's) expectations of where the OCR might peak. While by definition the "end" is nearer as each hike is delivered, against the backdrop of 7.2% inflation, 8.6% private sector wage growth and a labour market setting a string of records, upside risks to our OCR call feel very real.

The outlook for growth is almost certainly slowing, and for some parts of the economy, it is likely to feel like recession is nigh. But the RBNZ (and we) already have a marked slowdown and sharply rising unemployment in our forecasts – forecasts that imply small to no cuts in the foreseeable future. It has to be worse than that to imply the RBNZ will decide cuts are appropriate.

So, what does all this mean for our short-end interest rate forecasts? We assume that 3mth bill rates will continue rising gradually with the OCR (their short term means that they can't pre-empt hikes as well as longer-term rates can). However, presuming the OCR does peak at 5%, we are likely near the peak in the bellwether 2yr swap rate, which we ultimately see peaking around 30bps above the OCR.

Markets outlook

Watching US interest rates closely

US interest rates are expected to be the main driver of New Zealand long-term interest rates, and we continue to watch them closely. Readers may well ask why. It is because history clearly shows that local long-end interest rates tend to, by and large, move in the same direction as US long-end interest rates. Among other things, this is because the majority of NZ government bonds are offshore owned, and many investors view them as close substitutes to bonds issued by other governments. Figuring out where US bond yields are headed is thus just as important as figuring out what the RBNZ will do next, and it's the combination of the two that generally dictates the term structure of New Zealand interest rates.

We are forecasting US 10-year bonds to peak around 4.5%, with upside risk on both technical and economic factors. NZ 10yr bond yields are, in turn, expected to peak at around 5%. Longer-term bond yields are sensitive to assumptions about how long policy rates will remain elevated for, and if markets do expect an extended period of on-hold policy. And on that score, the US Federal Reserve has warned markets not to expect policy rates to come down any time soon. While it has said that the pace of tightening will inevitably slow soon, this should not be confused with the idea that cuts are coming.

We do see scope for NZ/US spreads to narrow as NZ and US policy rates converge on 5%, and as investors seek out higher-yielding alternatives to US Treasury bonds, especially now that New Zealand bonds are included in the prestigious FTSE/Russell World Government Bond Index, extending their appeal. But that is more likely to cap any upside, and is unlikely to drive long bond yields (and long-term swap rates) lower here.

NZD turn coming soon

2022 has been a frustrating year for FX forecasters, and the NZD in general. The USD has dominated as the Fed has embarked on a series of outsized rate hikes, and markets have embraced the safe-haven appeal of the USD amid heightened geopolitical risks, and generalised risk aversion as asset prices have tumbled. Looking ahead, while it is impossible to forecast when we might see geopolitical risks lessen, we do expect USD domination will slowly subside as the US economic cycle itself matures.

The last six months have also been characterised by the Fed's policy rate catching up quickly to the RBNZ's OCR. While the RBNZ got underway with hikes sooner, and has been hiking in 50bp increments since April, the Fed has been hiking in 75bp increments since June. This has allowed the Fed to close the gap on the RBNZ to the detriment of the NZD. Indeed, as we go to print, the US fed funds rate is 50bps above the OCR. However, with the RBNZ expected to hike by 75bps at the next two meetings, and the Fed expected to slow the pace of hikes, the NZD has scope to regain some lost ground.

New Zealand's external imbalances are large (the current account deficit is back at levels not seen since before the GFC). This is generally viewed by markets as more of a risk factor rather than as a reason to aggressively sell the NZD, but the fact that the deficit is set to narrow over 2023 as international tourism recovers (off a near-zero base) does reduce a negative in the equation for the NZD.

As in last quarter, one other string in the NZD's bow is the gap between its current level and fair value, which we see at around 0.65. Our forecasts have this gap slowly closing over coming quarters, taking the NZD to fair value by the end of 2024.

Table 1: Forecasts (end of quarter)

FX Rates	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24
NZD/USD	0.59	0.57	0.58	0.59	0.60	0.62	0.63
NZD/AUD	0.91	0.89	0.89	0.89	0.88	0.89	0.88
NZD/EUR	0.61	0.60	0.60	0.59	0.58	0.59	0.59
NZD/JPY	86.7	85.5	85.8	85.6	85.2	86.8	86.9
NZD/GBP	0.53	0.52	0.51	0.50	0.50	0.52	0.51
NZD/CNY	4.34	4.19	4.21	4.22	4.23	4.34	4.38
NZ$ TWI	71.1	69.2	69.5	69.6	69.6	71.0	71.2
Interest Rates	**Dec-22**	**Mar-23**	**Jun-23**	**Sep-23**	**Dec-23**	**Mar-24**	**Jun-24**
NZ OCR	4.25	5.00	5.00	5.00	5.00	5.00	5.00
NZ 90 day bill	4.85	5.10	5.10	5.10	5.10	5.10	5.10
NZ 2-yr swap	5.30	5.30	5.30	5.20	5.20	5.10	5.00
NZ 10-yr bond	5.00	5.00	4.75	4.75	4.75	4.50	4.50

Source: Bloomberg, ANZ Research

Key forecasts

Calendar Years	2018	2019	2020	2021	2022(f)	2023(f)	2024(f)
NZ Economy (annual average % change)							
Real GDP (production)	3.4	2.9	-2.1	5.6	2.1	1.8	1.4
Private Consumption	4.6	3.2	-1.3	6.6	2.5	-0.9	1.0
Public Consumption	3.3	5.1	6.9	9.9	7.8	2.6	1.1
Residential investment	-1.6	5.4	-3.3	8.1	-0.3	-9.6	-2.8
Other investment	9.7	4.1	-8.2	9.4	3.4	-2.2	-0.8
Stockbuilding[1]	0.3	-0.5	-0.8	1.5	-0.8	0.0	0.0
Gross National Expenditure	5.2	3.2	-2.0	9.3	3.2	-0.6	0.5
Total Exports	3.1	2.6	-12.9	-3.2	-1.8	13.6	6.2
Total Imports	6.4	2.1	-15.8	14.6	2.5	0.5	1.2
Employment (annual %)	2.2	1.2	0.6	3.3	1.5	-0.7	0.1
Unemployment Rate (sa; Dec qtr)	4.4	4.1	4.9	3.2	3.3	4.5	4.9
Labour Cost Index (annual %)	2.0	2.4	1.5	2.8	4.2	4.0	2.9
Terms of trade (OTI basis; annual %)	-4.8	7.1	-1.6	2.8	-0.5	1.9	1.6
Prices (annual % change)							
CPI Inflation	1.9	1.9	1.4	5.9	6.9	3.6	1.8
Non-tradable Inflation	2.7	3.1	2.8	5.3	6.6	4.7	3.1
Tradable Inflation	0.9	0.1	-0.3	6.9	7.1	1.7	-0.1
REINZ House Price Index	3.1	5.1	15.5	26.2	-12.7	-5.0	2.6
NZ Financial Markets (end of December quarter)							
NZD/USD	0.67	0.67	0.72	0.68	0.59	0.60	0.65
NZD/AUD	0.95	0.96	0.94	0.94	0.91	0.88	0.87
NZD/EUR	0.59	0.60	0.59	0.60	0.61	0.58	0.59
NZD/JPY	73.8	73.1	74.6	78.6	86.7	85.2	87.8
NZD/GBP	0.53	0.51	0.53	0.51	0.53	0.50	0.52
NZD/CNY	4.62	4.69	4.74	4.35	4.34	4.23	4.45
NZ$ TWI	73.4	73.7	75.2	73.2	71.1	69.6	72.0
Official Cash Rate	1.75	1.00	0.25	0.75	4.25	5.00	5.00
90-day bank bill rate	1.97	1.29	0.27	0.97	4.85	5.10	5.10
2-year swap rate	1.97	1.26	0.28	2.17	5.30	5.20	5.00
10-year government bond rate	2.37	1.65	0.99	2.39	5.00	4.75	4.25

[1] Percentage point contribution to growth

Forecasts finalised 8 November 2022

Source: Statistics NZ, REINZ, Bloomberg, Treasury, ANZ Research

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