First View
Kiwibank economics.

Interest rates may have peaked. And the outlook for housing is better balanced.

- Central bankers were a unified voice at Jackson Hole. Inflation is public enemy no.1, and returning the rate to target is the top task. A material slowdown in economic growth is necessary.
- We believe we may have seen the peak in fixed mortgage and business lending rates. With falling inflation and weaker growth, the market is perfectly priced, for now.
- We updated our analysis on the supply and demand dynamics of the Kiwi housing market. The housing market is becoming better balanced. And we may see a surplus of dwellings in time.

"Keep at it until the job is done". That was the main message from US Fed Chair Jerome Powell at the annual get-together of central bankers and the like at Jackson Hole. Powell's speech, titled "Monetary Policy and Price Stability", was short, sharp, and straight to the point. Powell doubled down on the Fed's commitment to ease 40-year high inflation with ongoing rate hikes, pushing back against the growing expectation that they would soon reverse course. Returning inflation to target is the *"overarching focus"* at the Fed, and will require monetary policy to remain restrictive until demand and supply are better balanced. Inflation is broad-based and increasingly demand-driven. The drop in the inflation rate is an encouraging development. But one data point does not make a trend. And the Fed wants to see a sustained reduction in inflation before they loosen the reins on monetary policy.

"We are taking forceful and rapid steps to moderate demand so that it comes into better alignment with supply, and to keep inflation expectations anchored. We will keep at it until we are confident the job is done" Powell

The path for US interest rates is unambiguously higher. Interest rates must be kept at elevated levels to dampen demand and restrain growth. Powell cautioned that restoring price stability will require a *"sustained period of below-trend growth"* and a weaker labour market. But the firm tone from the Fed Chair signals that they're willing to raise rates into a slowing economy to tackle inflation.

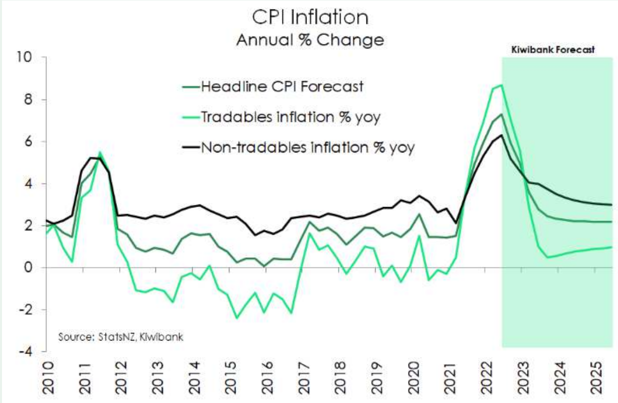
RBNZ Governor Adrion Orr made similar comments in an interview at Jackson Hole. Orr made clear that returning inflation to target is the top task. Orr laid out the struggles plaguing the Kiwi economy; the labour shortage being at the forefront. And in an economy starved of supply, unable to *"print people"*, the RBNZ's focus is on slowing demand. Verbalising the RBNZ's latest forecasts, Orr warned that economic activity *"slower than the potential growth of the economy"* is needed to tame inflation – though stopped short of calling a recession. *"Slower growth is a necessary position that we have to see"*.

Equity markets suffered the biggest blow from Powell's hawkish display. The Dow closed the day down 3%, while the 3.4% and almost 4% drop in the S&P 500 and Nasdaq, respectively, were the biggest one-day declines for both indices since mid-June. The reaction in rates market was relatively more muted, as the message of higher rates for longer was in line with expectation. Ongoing rate hikes continues to prop up the short-end of the yield curve, while mounting growth concerns is weighing on the long-end. The US dollar strengthened following Powell's comments, which sent the Kiwi flyer tumbling to a low of 0.6140.

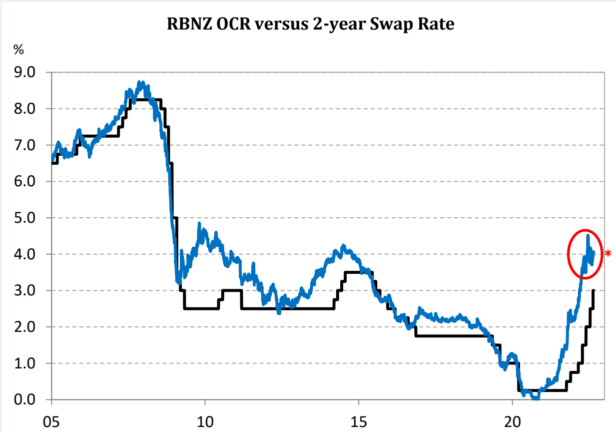
In other news, the volume of retail sales declined in the June quarter. It was the second consecutive decline. And 10 of the 15 retail industries experienced lower sales volumes. Car sales were hit the hardest, partly due to delayed shipments. Spending around the home has also been weak, after a few years of strong Covid lockdown induced spending. It also comes as no surprise that the volume of spending on petrol has declined, with the ramp up in prices. These themes were all covered in our last spending tracker, see here.

Have we seen the peak in interest rates? We may have...

We expect commodity prices and shipping costs to continue to decline into 2023. Our first chart illustrates the likely decline in Kiwi inflation into 2023. Our imported (tradables) inflation is likely to fall the fastest, and provide the most relief. Economic growth is also slowing. If our forecasts are realised, the RBNZ may be in the position to start lowering interest rates in the second half of 2023.

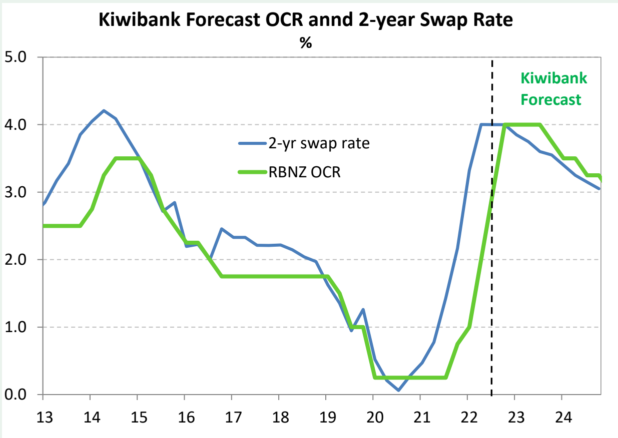


Financial markets have been volatile, to put it politely. Interest rates have risen swiftly, and looked to have peaked in June. Expectations for the peak in the RBNZ's cash rate were ratcheted higher to 4.5% in June, with the pivotal 2-year swap rate hitting a peak of 4.55%. Since then, expectations have come back, with a terminal rate of a little over 4% priced into the Kiwi short-end. The 2-year swap rate is trading just over 4% (at time of writing).



The spike in June saw mortgage rates push higher. The retracement lower in July has enabled banks to lower mortgage and business lending rates.

We believe the market is perfectly priced, for now. We expect the 2-year swap rate to trade in a relatively narrow range around 4% for the rest of the year and into 2023. We believe the OCR will eventually be lowered back towards a more neutral setting, with rate cuts in the second half of 2023.



The timing of the unwind will depend on the global backdrop. A global recession would cause a sharp drop in interest rates. Whereas a soft landing would see interest rates ease at a much more modest rate. We're forecasting a soft landing for the Kiwi economy. But the risks are certainly tilted towards a deeper correction.

For more detail, check out: "Human behaviour: interest rates invert as inflation peaks and growth slows."

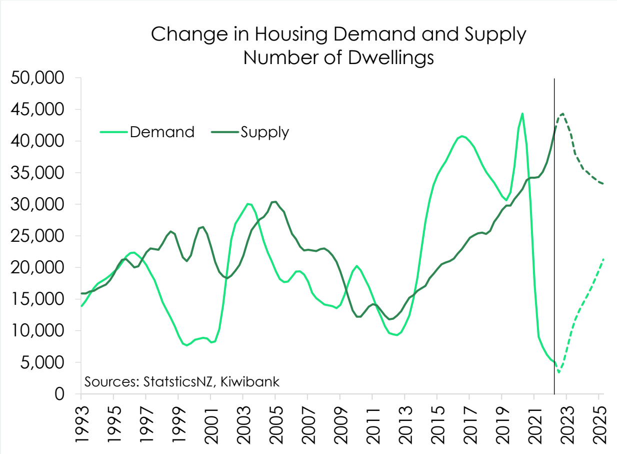
Charts of the week: A better balanced housing market.

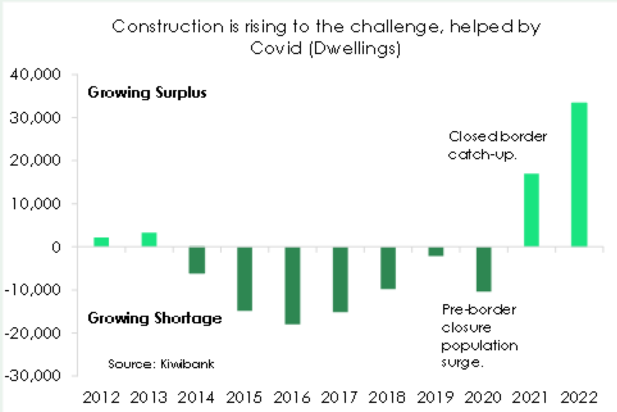
In the current covid era of continuous disruption, it's easy to overlook just how busy some parts of the economy have been. Take construction for instance. StatsNZ estimates a total of over 41,000 homes were added to NZ's housing stock in the year to June 2022. That is by far the largest addition to our housing stock in the data going back to 1991. Equivalent to all the dwellings in the whole Southland region according to the 2018 census.

The current building boom has coincided with artificially low growth in demand. The closed border has slowed population growth to a trickle. In fact, Aotearoa experienced a net outflow of 11,500 migrants in the year to June, sending population growth to the lowest rate since the mid-1980s. The seismic shifts we've seen in housing supply and demand drove down New Zealand's housing shortage to an estimated 23,000 homes, still large but massively down from a revised 57,000 shortage estimated last year.

The current yawning gap between supply and demand points to New Zealand's cumulative housing shortage disappearing over the next 12 months. However, forward indicators suggest that the covid-era trends in housing supply and demand are about to change. The outlook for house building has dimmed. And with our border fully reopened, positive net-migration next year should see demand lift off lows. The good news is that the housing market should be better balanced in the coming years.

For more detail, check out: "Housing supply and demand: from famine to feast."





Financial Markets

The comments below were provided by Kiwibank traders. Trader comments may not reflect the view of the research team.

In rates, growth concerns dominate:

"Last week was dominated by Fed heads Powell's key speech at Jackson Hole which didn't disappoint the hawks, that being only slightly offset by a the clearly weakening domestic growth story. NZ rates have been dragged higher by the global themes, the European gas crisis comes to mind coupled with global central bank refocus on breaking the back of inflation. The NZ market is now pricing slightly more rate tightening than the RBNZ August MPS forecasts, with +93bp of hikes priced by year end and a peak OCR of 4.16% priced by April 2023. In conjunction with that the RBNZ speeches have all reinforced the hawkish message, Orr's MPS Q&A "4.00% is a long way from neutral" comment now faded into history. Orr spoke from Jackson Hole on Friday sending yields lower, hinting another "couple of hikes", wanting weaker by not necessarily negative growth, and slightly higher inflation at the end of the hiking cycle is better than deflation. Regardless, from here yield direction is very global rates driven which given the Fed/ECB direction is higher and higher for longer. The oddity here is the NZ curve shape has steepened on the global hike story, when in fact it should be flattening on the domestic rate outlook. This is testament to the biggest force for long end rate continuing to be offshore driven, or more aptly relative value/spread driven. However, eventually domestic forces will bubble to the surface again, NZ GDP on 15 September the next big release with the poor Retail Sales last week not boding well." **Ross Weston, Senior Portfolio Manager.**

In currencies, US inflation data is the focus:

"Akin to a battered boxer on the ropes, the Kiwi dollar continued to take the hits last week - but importantly, for now at least, continues to be in the fight by still holding its head above the 2022 lows. Last week's 'round-hook' in the form of hawkish central bank commentary stemming from the annual Jackson Hole symposium gathering of economic minds, curtailed some developing hope of a late

round comeback for the NZ Dollar. Having traded to an intra-week high of 0.6251, a flow of united central banker language, including Fed Chair Jerome Powell, of a steadfast commitment to drive down inflation and not blinking should economic conditions soften, saw a renewed bout of risk aversion as front-end rates drove higher on expectations higher for longer monetary settings, NZDUSD opens the week under pressure around the 0.6130 mark. As attention turns to this Fridays US employment print for August, followed by the mid-September monthly US CPI release, flying under the radar somewhat over the weekend was a below expectation reading of the Federal Reserves preferred inflation measure - the PCE Deflator. Printing at -0.1% for the month of Aug, and with it dragging the annualised core reading down to a 4.6% level – its lowest level since Nov 21 back when the Fed started to pivot from its ultra-loose monetary settings and forward guidance approach, hope still exists of a further deceleration in headline US inflation and helps to explain why the market is still split down the middle as to the need of 50bp or 75bp at the next FOMC gathering on the 21st of Sept. So it's a case of back to the data watching as plucky little Kiwi continues to duck and weave the hits stemming from a currently reinvigorated US Dollar title holder. For the week ahead, we stick to last week's 0.6050 – 0.6250 script albeit with price action likely to be muted given a relatively quiet data calendar into the month end. Against the Aussie Dollar, the Kiwi continues to underperform as investors position both currencies against recent relative commodity price (Milk vs Iron Ore) performance. Touching a new 5-year low of 0.8885 on Saturday morning, NZDAUD kicks off the week holding above the 89 cent mark – acting as an important downtrend support level with the next key downside support zone being the 2017 low at 0.8855."
Hamish Wilkinson, Senior Dealer – Financial Markets.

Weekly Calendar

Date		Economic Indicator	Last	Consenus	Comment
Mon, Aug 29	**EZ**	ECB Speaker - Lane	-	-	We'll let central bank officials speak for themselves.
Tue, Aug 30	**EZ**	ECB Speakers - Holzmann, Stournaras, Wunsch, Muller	-	-	We'll let central bank officials speak for themselves.
	US	Fed Speakers - Brainard, Barkin, Williams	-	-	
		Aug Conference Board Consumer Confidence Index	95.7	97.7	A fall in fuel prices seems to have done wonders for US consumer confidence. Moreover, the US labour market is supporting households. Nevertheless, high inflation is likely to keep consumer sentiment at below average levels.
Wed, Aug 31	**NZ**	Jul Building Permits (% mom)	-2.3	-	Recent business confidence surveys suggest future residential investment is weakening. Not a surprise given rapidly rising construction costs and the current slump in the housing market. Residential building consents should continue to trend lower.
		Aug ANZ Activity Outlook (Net % of Firms)	-8.7	-	Business confidence and firms' outlook for their own activity remains weak. Inflation expectations and pricing intentions remain high, but look to have stopped intensifying. The outlook for the economy isn't great.
	CH	Aug Manufacturing PMI	49.0	49.3	China's official manufacturing PMI is expected to remain below 50 in August. The Chinese economy is facing myriad challenges. Including a housing market slump, covid flare-ups and major droughts. The non-manufacturing PMI is expected to fair better.
		Aug Non-manufacturing PMI	53.8	52.2	
	JN	Jul Industrial Production (% mom)	9.2	-0.5	The market is picking some payback from June's 9.2% surge - driven by the relaxation of covid restrictions in Shanghai (a major bottleneck of inputs for Japanese production).
		Jul Industrial Production (% yoy, prelim)	-2.8	-2.4	
	EZ	Aug CPI Estimate (% yoy)	8.9	9.0	Despite fuel prices easing over August, CPI inflation in the Eurozone is expected to edge higher to 9% - a new record high.
		Aug CPI (% mom)	0.1	0.4	
	US	Fed Speaker - Mester	-	-	We'll let central bank officials speak for themselves.
Thu, Sep 01	**CH**	Aug Caixin Manufacturing PMI	50.4	50.1	The Caixin manufacturing PMI, which focuses on smaller private and export orientated firms, is picked to slide. Weakening offshore demand and covid disruption at home are likely to weigh on the index. There is a risk the Caixin measure will fall below 50 - a reading below 50 is indicative of contracting activity.
	EZ	ECB Speaker - Centeno	-	-	We'll let central bank officials speak for themselves.
	US	Fed Speaker - Bostic	-	-	
Fri, Sep 02	**NZ**	Jun Qtr Overseas Trade Index (Terms-of-Trade, % qoq)	0.5	-	NZ's terms of trade, or our purchasing power with the rest of the world, is likely to come under some downward pressure ahead. Commodity prices, such as our key commodity export prices, have eased in recent months.
	US	Aug Change in Nonfarm Payrolls (000)	528	300	The pace of hiring in the US is picked to have slowed in August. Nevertheless, the unemployment rate is expected to remain unchanged at a very low 3.5%. If the market consensus is correct, and the labour market remains solid, then the US federal reserve will likely follow through with another 75bp hike in Sept.
		Aug Unemployment Rate (%)	3.5	3.5	
		Fed Speaker - Bostic	-	-	We'll let central bank officials speak for themselves.

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