International Commentary — June 18, 2024

Australia & New Zealand: Mid-Year Macro Update

Summary

- The Reserve Bank of Australia (RBA) held its policy rate steady at 4.35% this week, while its accompanying statement was generally hawkish in tone. The RBA said inflation remains above target and is proving persistent. At the post-meeting conference, RBA Governor Bullock said policymakers discussed the case for a rate hike, but did not consider a rate cut.
- We think a mix of weak growth but elevated inflation data will be firm enough to keep the RBA wary of lowering interest rates prematurely. **As a result, we now expect the RBA to hold interest rates steady for all of 2024.** As inflation eventually slows we expect the central bank to proceed with a careful and steady monetary easing cycle from early next year. **We expect 25 bps rate cuts in February, May, August and November 2025, which would see the policy rate end next year at 3.35%.**
- In New Zealand, sentiment surveys and activity data have remained weak in early 2024, and we forecast GDP growth of just 0.8% this year. At the same time inflation, and especially domestically oriented inflation, has remained elevated above the central bank's target. Against this backdrop, the Reserve Bank of New Zealand (RBNZ) has maintained a hawkish stance, saying interest rates may need to remain at a restrictive level for longer than previously anticipated.
- **With inflation trends seemingly dominating the RBNZ's policy outlook, we now expect the central bank to begin lowering interest rates later than previously envisaged. We forecast an initial 25 bps rate cut to 5.25% at the RBNZ's November meeting**, although we acknowledge an initial rate cut could come later still. **In 2025, we expect the RBNZ to cut rates at a steady 25 bps per quarter pace, and anticipate rate cuts at the February, May, August and November announcements.**

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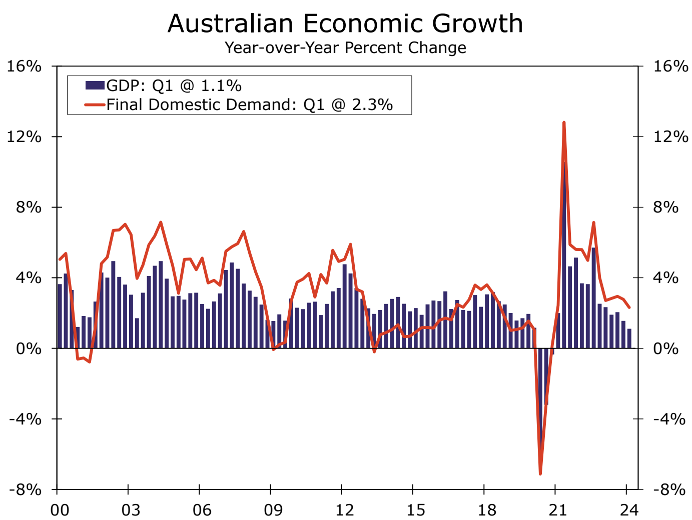
Reserve Bank of Australia Holds Steady, Repeats Inflation Worries

The Reserve Bank of Australia (RBA) held its policy interest rate at 4.35% at this week's meeting, and its accompanying statement was generally hawkish in tone as it took the opportunity to reiterate its ongoing inflation concerns. The RBA said:

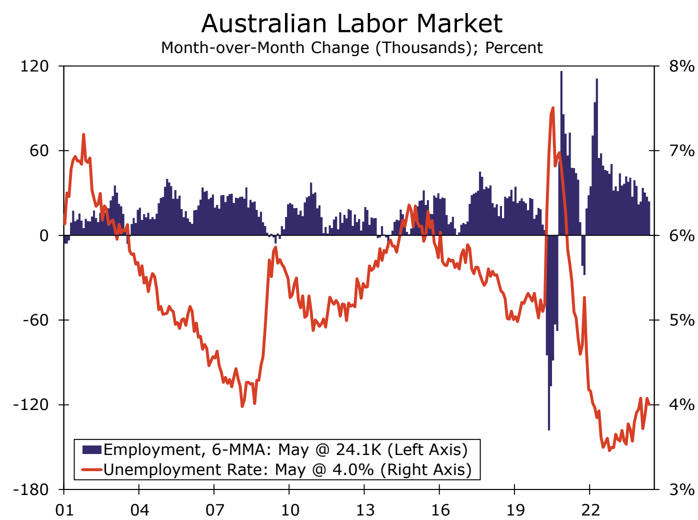
- Inflation remains above target and is proving persistent. While inflation is easing, it has been doing so more slowly than previously expected. It will be some time yet before inflation is sustainably in the target range.
- While recent data have been mixed, they have reinforced the need to remain vigilant to upside risks to inflation. The persistence of services inflation remains a key uncertainty.
- Broader data indicate continuing excess demand in the economy, coupled with elevated domestic cost pressures.
- Although the labor market is easing, it remains tighter than is consistent with sustained full employment and inflation at target.
- Policymakers are not ruling anything in or anything out regarding the path of interest rates.

The RBA also offered mixed comments on recent economic trends. The central bank said that momentum in economic activity is weak, including a slowing in GDP growth. However, it also noted that real disposable incomes have now stabilized and should grow later this year, assisted by lower inflation and tax cuts, which should also support consumer spending. And finally, the RBA said budget outcomes could impact demand, but that energy rebates could also temporarily reduce headline inflation.

In the post-meeting press conference, RBA Governor Bullock reinforced a hawkish leaning tone, saying that policymakers had discussed the case for a rate hike at this meeting, but that the case for a rate cut wasn't considered. At the same time, Bullock said the use of 'vigilant' in the central bank's language is not a signal for a rate rise, and in her view, wouldn't say that the case for a rate hike is increasing. Overall, while in our view a Reserve Bank of Australia rate hike is not a serious threat just yet, the central bank is also clearly not contemplating interest rate cuts in the immediate future.



Source: Datastream and Wells Fargo Economics



Source: Datastream and Wells Fargo Economics

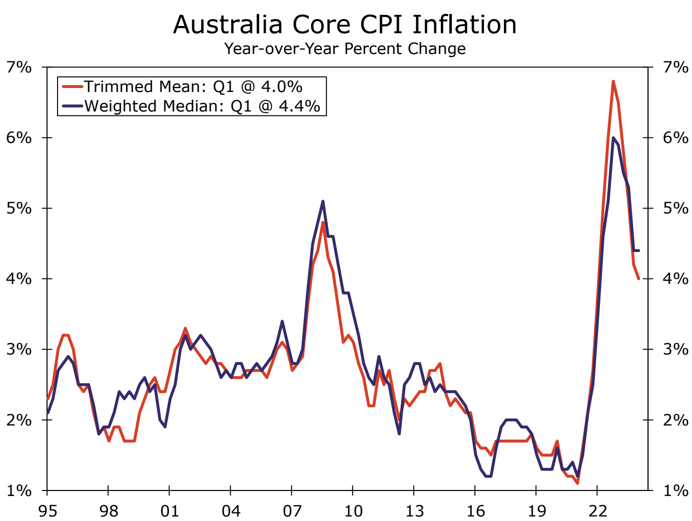
Mix of Weak Growth, High Inflation To Keep Rates Steady For Some Time

Our own assessment is that the incoming flow of Australian data, while mixed, is still firm enough to keep RBA policymakers wary of lowering interest rates prematurely, and thus consistent with interest rates remaining at current levels for some time. Q1 GDP surprised to the downside, with growth of just 0.1% quarter-over-quarter and 1.1% year-over-year. Household consumption was modestly stronger, rising 0.4% quarter-over-quarter, but private investment fell 0.8%, driven in particular by a decline in construction expenditures. With the household saving rate at just 0.9% of income, any upswing in spending may be modest, even with approaching tax cuts. Indeed, we forecast Australian GDP growth of just 1.2% in 2024, down from 2.0% in 2023.

Despite the underwhelming performance of the overall economy, there are some areas where activity remains more solid, most notably the labor market. The May labor market report saw employment rise by 39,700, above the consensus forecast and also larger than the increase seen in April. Other details of the May labor market report were also firm, with the employment increase driven by a 41,700 increase in full-time jobs, and the unemployment rate dropping to 4.0%. Over the past six months the average increase in Australian employment has been a very respectable 24,100 per month. To put that in context and for comparison, that pace of increase is broadly equivalent to U.S. nonfarm payrolls rising at average pace of 260,000 per month over the same period. Australia's still reasonably solid labor market trends, combined with a minimum wage increase and tax cuts that are set to take place from July, should in our view protect against the risk of unexpected economic contraction.

Meanwhile, recent price data are consistent with the RBA's view that underlying inflation is decelerating only slowly. Of note, Q1 inflation surprised to the upside as the headline CPI slowed less than expected to 3.6% year-over-year, the trimmed mean CPI eased to 4.0%, and the weighted median CPI was steady at 4.4%. The core inflation measures in particular remain some way above the RBA's medium-term inflation target range of 2%-3%. Another measure of domestically oriented price pressures, non-tradeables inflation, also remains elevated at 5.0%. More recent figures suggest inflationary pressures likely persisted into the second quarter. The monthly CPI for April saw headline inflation unexpectedly tick higher to 3.6% year-over-year, while the monthly indicator for trimmed mean inflation also ticked higher to 4.1%. Separately, wage pressure are easing but only gradually, while the minimum wage increase scheduled for July could see at least a temporary interruption to any slowdown in wage growth later this year.

With the recent trend of inflation and wages still elevated and given the limited risk (in our view) of economic contraction, we doubt the RBA will be in any rush to lower interest rates. In fact, whereas we had previously forecast an initial policy rate cut in November, **we now expect the RBA to hold its policy rate steady at 4.35% for all of 2024.** As wage growth and underlying inflation slow from their current pace, we expect the central bank to proceed with a careful and steady monetary easing cycle from early next year. **We expect 25 bps rate cuts in February, May, August and November 2025, which would see the policy rate end next year at 3.35%.** Considering our base case for later easing from the Reserve Bank of Australia than the Federal Reserve, and so long as Australia's economy avoids an unexpected downturn, we expect the Australian dollar to strengthen against the greenback over the medium-term.



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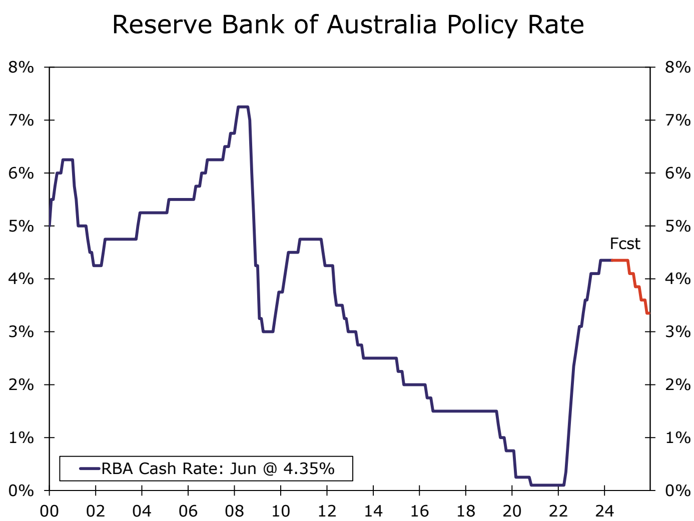

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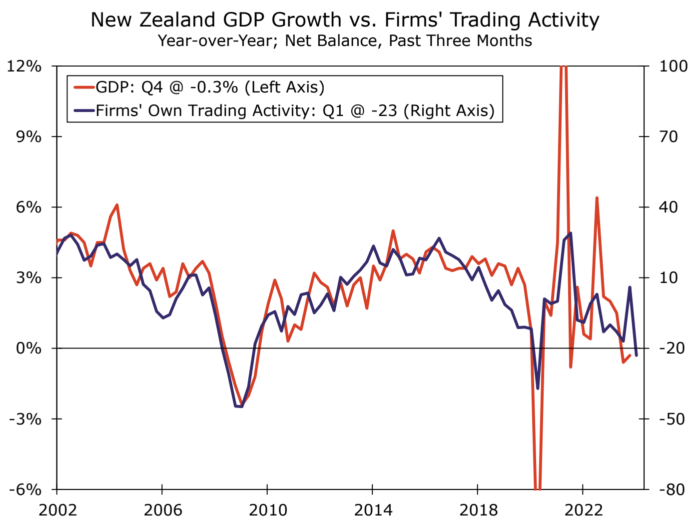
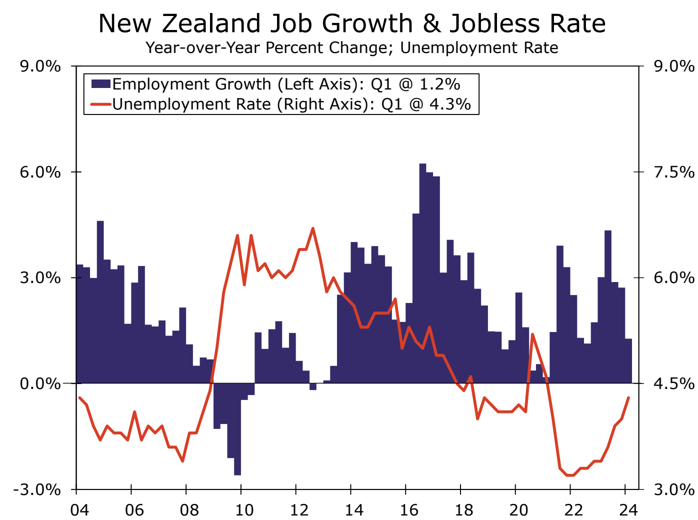
New Zealand's Unpleasant Growth and Inflation Dichomoty Continues

In New Zealand, the central bank has maintained a generally hawkish stance as a mix of very weak activity data and elevated inflation has continued. The economy ended 2023 on a soft note as Q4 GDP fell 0.1% quarter-over-quarter (the fourth decline in the past five quarters) and 0.3% year-over-year. Hopes for a stronger start for activity this year have been dashed by soft data for early 2024. Quarterly business confidence deteriorated in Q1, as a net 25% of firms expected the economy to get worse. Firms' assessment of their own activity also softened in Q1, with a net 23% of businesses reporting a decline in their own trading activity during the quarter, more than offsetting the uptick seen during Q4.

It was not only survey data that pointed to economic weakness in early 2024, with the Q1 labor market report also consistent with a subpar economy. Q1 employment unexpectedly fell 0.2% quarter-over-quarter and slowed to 1.2% year-over-year, while the unemployment rate rose more than forecast to 4.3%. Perhaps the main “bright spot” was a 0.5% quarter-over-quarter gain in Q1 retail sales, although that came after a 1.8% slump in Q4. Overall, our view remains for underwhelming performance from the New Zealand economy, with GDP seen rising 0.8% in 2024 after a 0.6% gain in 2023.



Source: Bloomberg Finance L.P. and Wells Fargo Economics



Source: Datastream and Wells Fargo Economics

Despite the subpar growth performance of the New Zealand economy, inflation has remained elevated and domestic inflation pressures stubbornly persistent. The Q1 headline CPI slowed to 4.0% year-over-year, matching the consensus forecast, although that is still some way above the central bank's 2% inflation target. Moreover, it was once again non-tradeables inflation that showed the most persistence, easing only slightly to 5.8%, in contrast to tradeables inflation which slowed sharply to 1.6%. In addition, even as economic growth remains soft and unemployment rises, wage growth is decelerating only gradually. The Q1 private sector labor cost index (excluding overtime) moderated to 3.8% year-over-year. That is down from the cycle peak of 4.5%, but still much higher than the 1.5% to 2.5% range that prevailed prior to the pandemic.

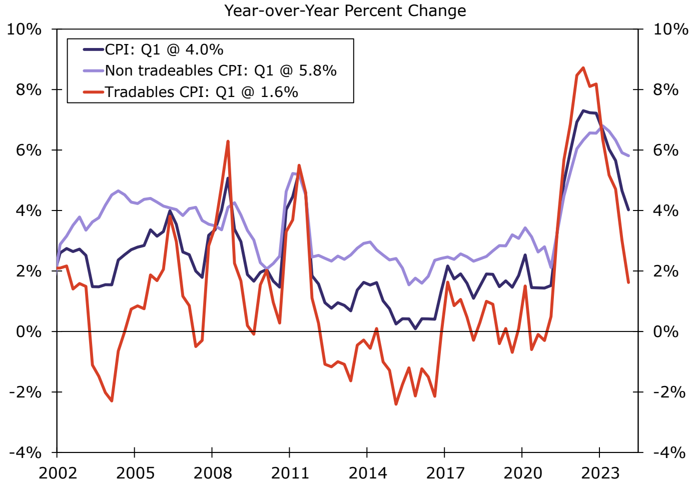
Given these stubborn inflationary pressures and despite the weak growth environment, the Reserve Bank of New Zealand (RBNZ) has maintained a hawkish monetary policy stance. In fact, at its most recent monetary policy announcement in May, RBNZ policymakers said they discussed the possibility of increasing the policy rate from its current 5.50%, and agreed that interest rates may need to remain at a restrictive level for longer than previously anticipated. The RBNZ said the persistence of domestic inflation remains a significant upside risk. With respect to its updated economic projections, the RBNZ revised its forecast policy rate peak higher to 5.65%, while those projections also showed the policy rate not falling back to 5.40% until the third quarter of next year.

With inflation trends seemingly dominating the RBNZ's monetary policy outlook and despite the weak economy, we now expect the central bank to begin lowering interest rates later than previously envisaged. We forecast an initial 25 bps rate cut to 5.25% at the RBNZ's November

meeting, although we acknowledge an initial rate cut could come later still. In 2025, we expect the RBNZ to cut rates at a steady 25 bps per quarter pace, and anticipate rate cuts at the February, May, August and November announcements. That outlook would see the RBNZ's policy rate end 2024 at 5.25%, and end 2025 at 4.25%. While we think the risks are tilted toward more gradual easing during 2024, given the weak economy and if inflation trends improve more quickly than expected over the medium-term, we view the risks as tilted toward a faster pace of easing than our base case in 2025.

New Zealand Consumer Prices

Year-over-Year Percent Change



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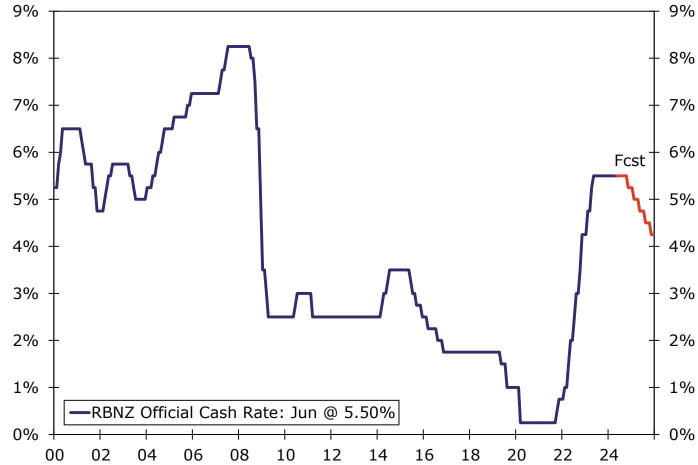
Reserve Bank of New Zealand Policy Rate



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