International Commentary — May 2, 2022

RBA & RBNZ Signal Faster Monetary Tightening Ahead

Summary

- In Australia, underlying inflation has accelerated and is now above the Reserve Bank of Australia's medium-term target. Given solid growth trends, we expect these underlying measures of inflation to remain persistently elevated in the coming quarters. As a result, we recently revised our 2022 Australian CPI forecast higher.
- We have also brought forward our expectations for Reserve Bank of Australia monetary tightening, and now expect an initial 15 bps rate hike to take place in June, after Q1 wage price index data is released mid-May. We then expect 25 bps hikes in July, August, November, and December, which would bring the policy rate to 1.25% at the end of 2022.
- Compared to Australia, inflation in New Zealand is even more elevated, and we recently revised our CPI forecast for 2022 higher to average 5.8% this year.
- In addition, we have adjusted our policy rate forecast for the Reserve Bank of New Zealand and now expect another 50 bps rate hike in May to 2.00%. We expect a steady series of 25 bps rate hikes in July, August, October, and November of this year, bringing the Official Cash Rate (OCR) to 3.00% at the end of 2022.

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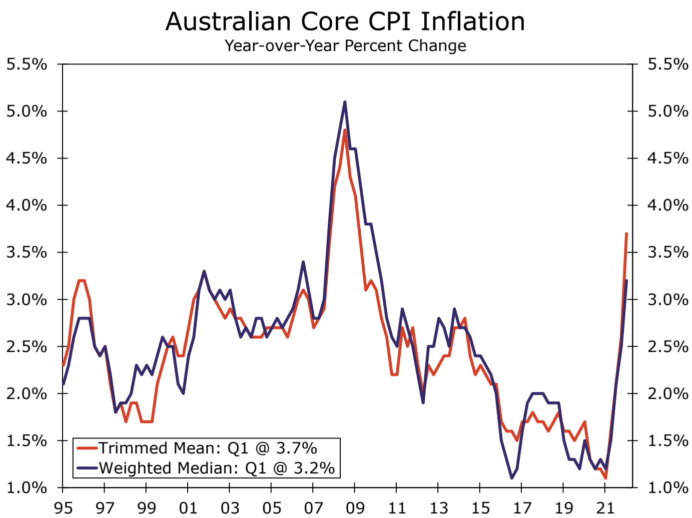
Australia: Resilient Growth & Quickening Inflation

After a steady rebound in growth in Q4-2021, recent activity data show that the momentum has continued into this year. So far in 2022, activity has been strong and trends in the labor market suggest the underlying fundamentals of Australia's economy are still improving, while inflationary pressures should be building across the country. Recent inflation data confirm those price pressures do indeed exist, as the Q1-2022 headline CPI surprised to the upside, quickening to a 5.1% year-over-year rate from 3.5% in Q4 of last year. Perhaps even more importantly, underlying inflation (also known as "core inflation" outside of Australia) is now elevated above the RBA's medium-term target of the midpoint between 2%-3%. Specifically, two measures of core inflation, the trimmed mean and weighted median CPI, accelerated to 3.7% and 3.2% year-over-year in Q1, up from 2.6% and 2.5% in Q4, respectively. Solid local activity trends and a global backdrop of high inflation suggest that these measures of underlying inflation will remain persistently elevated in the coming quarters. In that context, we also revised our Australian CPI forecast for 2022 higher in our April International Economic Outlook, and now expect annual inflation of 4.3% this year.



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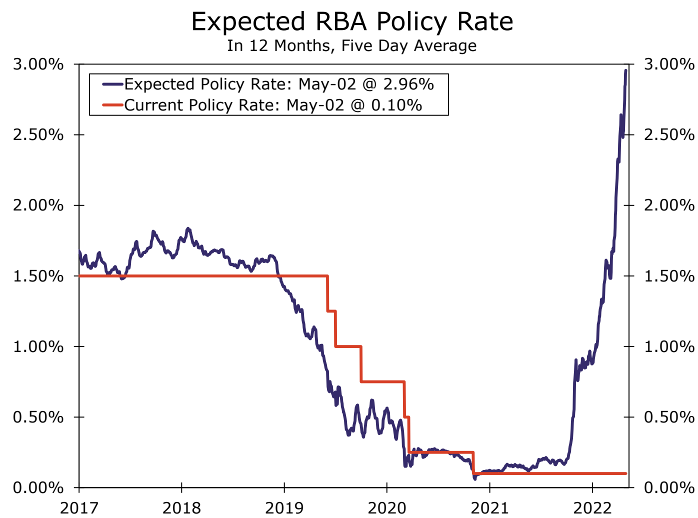

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Reserve Bank of Australia No Longer "Patient"

In an environment of positive economic momentum and above-target underlying inflation, the Reserve Bank of Australia (RBA) has turned more hawkish. In its April statement and minutes, the RBA said that faster inflation and a pickup in wage growth have moved up the likely timing of an initial rate hike. More specifically and arguably more notable, policymakers opted to drop the "patient" language from its official statement, further cementing the hawkish shift in tone. Overall, the RBA indicated that while these factors have brought forward the schedule of rate hikes, the timing of monetary tightening will still be data dependent with regard to underlying inflation and labor costs. We took this shift in language as an indication that the RBA may now be ready to initiate its tightening cycle as early as June. **Accordingly, we have brought forward our expectations for RBA policy rate increases, and now expect an initial 15 bps rate hike in June, followed by 25 bps hikes at each meeting in July, August, November, and December, which would bring the policy rate to 1.25% at the end of 2022. In 2023, we expect the tightening cycle to continue with 25 bps hikes in Q1, Q2, Q3, and Q4, taking the RBA policy rate to 2.25% by the end of next year.**

Even though we have brought forward our expectations for monetary tightening, we still believe RBA rate hikes should lag behind those of the Federal Reserve. We also believe RBA rate hikes are likely to fall short of the tightening currently priced by market participants. As a result, we expect the Australian dollar to soften against the U.S. dollar over the medium term with some potential stabilization later on. We forecast the AUD/USD exchange rate to reach 0.6700 by Q3-2023. However, we believe the risks are tilted to the upside. Should inflation prove to be more persistent, the currency could experience a more gradual pace of depreciation than our base case forecast suggests.

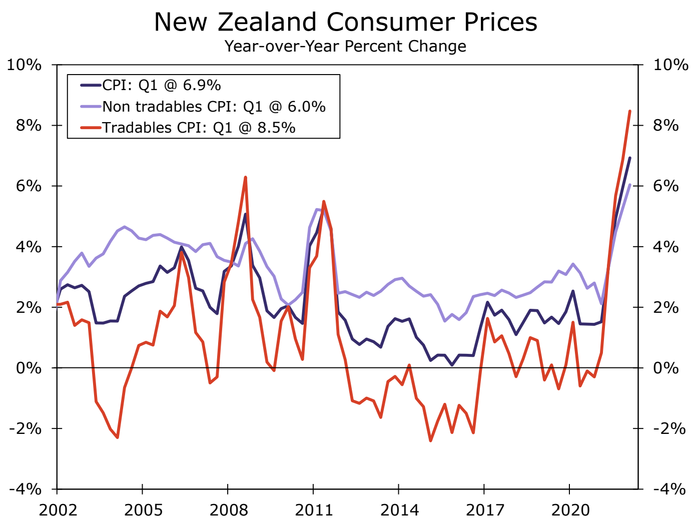
Reserve Bank of New Zealand on the "Path of Least Regret"

New Zealand's economy may be facing growing pains and temporary softness as it continues to reopen, but we believe the outlook for growth has the potential to improve in the coming months. Compared to Australia, inflation in New Zealand is even more elevated. Q1 CPI inflation surged to 6.9% year-over-year from 5.9% in Q4. Details of the CPI release show price gains were broad-based, especially given the 6.0% rise in non-tradables (domestically-oriented) inflation, as well as the 4.2% rise in sectoral factor model (core) inflation. In this context, we revised our CPI forecast for 2022 higher, and now expect inflation to average 5.8% this year. This quickening of inflation in Q1 reinforced the Reserve Bank of New Zealand's (RBNZ) decision to act more decisively and surprise markets with a 50 bps hike in April. In our view, high inflation and a hawkish RBNZ sets the stage for an accelerated rate hike schedule, including another 50 bps hike in May.

The RBNZ expects CPI to peak around 7% in the first half of this year and has indicated that the risk of persistent and high inflation expectations have increased. In its April statement, the RBNZ asserted that moving to a neutral policy rate sooner should reduce the risks of rising inflation expectations and provide more policy flexibility amid an uncertain global economic environment. The Committee noted that at its current level, the Official Cash Rate (OCR) is stimulatory, and a "stitch in time" approach (better to fix a problem when it is still small rather than waiting until it becomes a bigger problem) is consistent with near-term financial market pricing. In other words, increasing the Official Cash Rate more now than later is the policy “path of least regret”.

We interpret the RBNZ statement and latest actions as a move toward more consistent 50 bps rate hikes, at least in the short term. **We have adjusted our policy rate forecast for the RBNZ and now expect another 50 bps rate hike in May to 2.00%. We then expect a steady series of additional 25 bps rate hikes in July, August, October, and November of this year, which would bring the OCR to 3.00% at the end of 2022. In 2023, we expect 25 bps hikes in both Q1 and Q2, taking the OCR to 3.50%**, in line with the terminal rate from the RBNZ's most recent projections.

Similarly to the RBA, we expect the RBNZ will tighten monetary policy less aggressively than what is currently priced into financial markets and that RBNZ rate hikes will also be more gradual than the Federal Reserve's accelerated pace of tightening. As a result, we forecast the New Zealand dollar to soften against the U.S. dollar in the coming quarters. We expect the NZD/USD exchange rate to reach 0.6100 by Q3-2023. However, as inflation may prove to be more persistent than expected, we believe the risks are tilted towards a faster pace of rate increases than our base case forecast, which may support the NZ dollar.



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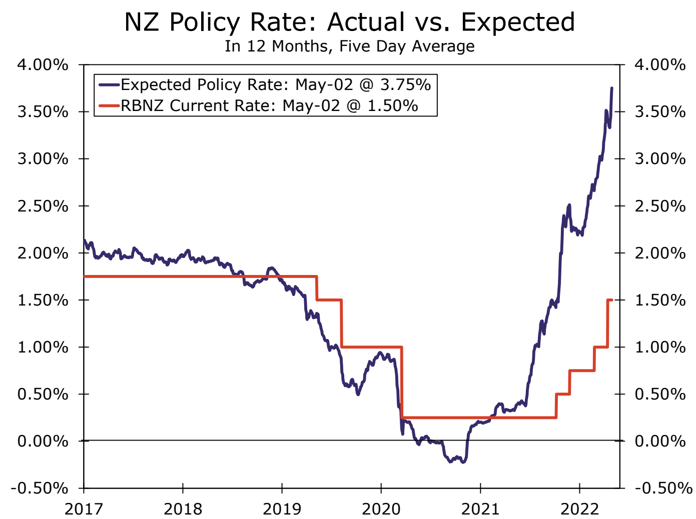

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