SALT INSIGHT

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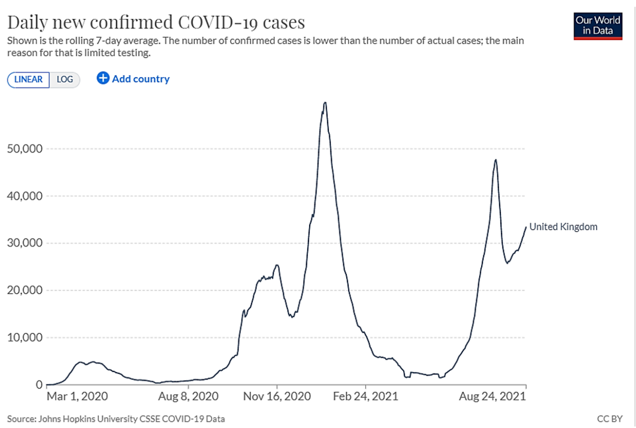
Delta, the NZ economy and the RBNZ

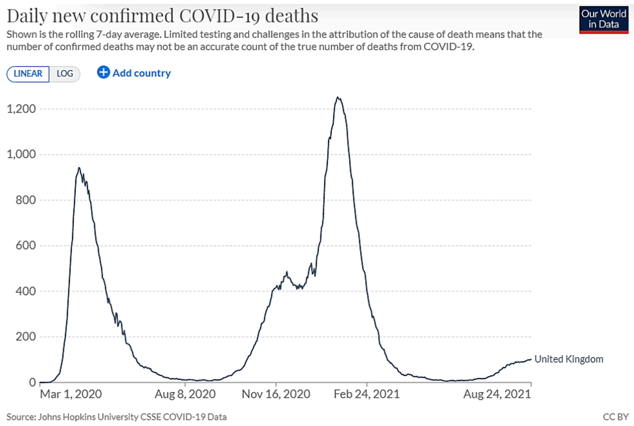
Ten days into level 4 lockdown and we're all back to watching 1pm Covid briefings, looking for the signs the numbers are peaking, and that life will soon return to normal – or as close to it as possible.

It feels different this time, largely because events have gone against the runsheet we had in our minds: eliminate the virus, get vaccinated, return to normal. The delta variant, with its more infectious characteristics, has altered that runsheet.

We have long highlighted the key risk to the economic outlook was that the virus would mutate into a form that the current range of vaccines were less effective or, worst case, ineffective against. The good news is that while the vaccine doesn't stop you from contracting the virus, it certainly appears effective in reducing the severity of the illness, hospitalisations and mortality rates.

The recent experience of the United Kingdom is illustrative. As vaccination rates rose the economy reopened, but as the economy opened, the daily case numbers rose. However, hospitalisation and mortality rates have remained low. Analysis carried out by the UK government shows two doses of the Pfizer/BioNTech or Oxford/AstraZeneca vaccine are estimated to be 96% and 92% effective against hospitalisation with the Delta variant, respectively.





This experience has not been universal, however. In the United States, hospitalisation and mortality rates have risen is line with new case numbers. That is explained by the uneven vaccination rate from state to state and that the increase in hospitalisation and mortality is centered in states with relatively low vaccinations rates.

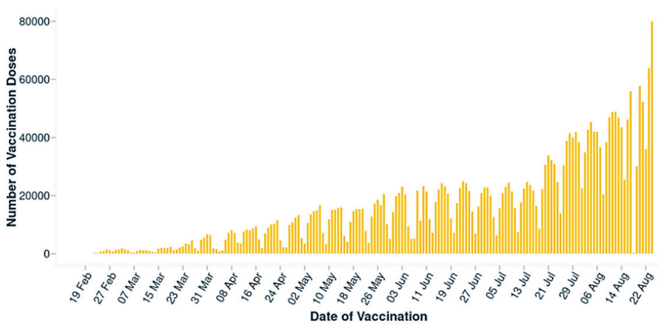
In Israel, the country that led the charge on vaccinations, there has been a similar increase in hospitalisation and mortality rates. The roll-out of a third "booster" shot seems to be having a positive impact, though the position of the World Health Organisation remains that a third vaccination is not required. Time will tell.

As the Delta variant has emerged in other countries, those with low vaccination rates have had to resort to renewed lockdowns. This includes Australia and, of course, here in New Zealand. The pathway out of lockdown, especially on a more sustained basis, is vaccination rates.

So, the race is on to get vaccinated. The good news on this front is that the vaccination rollout has been significantly ramped up in New Zealand.

While good progress is being made, the pace needs to be maintained or, even better, accelerated further. With around a quarter of the eligible population fully vaccinated, we are well behind other countries we tend to compare ourselves to. Latest data shows the United Kingdom has full vaccinated 61.8% of its population with Canada on 66.1% and the United States 51.2%. Australia currently stands at 25.1%.

Vaccinations by day



Cumulative vaccinations by age

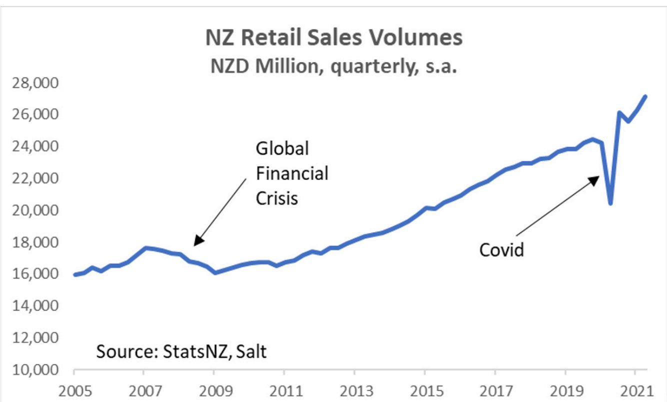
Age	First dose administered	First doses per 1000 people	Fully vaccinated	Fully vaccinated per 1000 people
12 - 29 years	228,204	193	98,614	83
30 - 49 years	449,503	341	210,851	160
50 - 64 years	551,101	594	261,674	282
65 and over	653,298	828	479,209	607
Total	**1,882,106**	**447**	**1,050,348**	**249**

The Economy

The economy was in good shape prior to the new lockdown. GDP growth was strong with activity already back to above pre-Covid levels by the end of the March quarter. The labour market was performing well with strong employment growth driving a decline in the unemployment rate to 4.0%, its lowest level since before the Global Financial Crisis, and below all measures of its sustainable level.

Data released more recently has continued that strong theme. June quarter retail spending exceeded already upbeat expectations by a considerable margin. Following an upwardly revised increase of 2.8% growth in the March quarter, June quarter retail sales volumes rose a further 3.3% over the 3-month period.

Annual percent changes are meaningless now given the base effects that are still washing through the numbers, but it's notable that June quarter sales were 11.0% higher than the last pre-Covid reading in the June 2019 quarter.



That story all changed at 11.59pm on Tuesday August 17th as the whole country entered Level 4 lockdown. We expect the same patterns we saw during the last lockdown to show through in the numbers this time. We will see a sharp drop in spending across most retail sectors but with some areas such as supermarkets holding up well, though that is more complicated this time given the closure of several supermarkets. Online shopping will get another boost.

The same government support measures have kicked in this time, primarily via the Wage Subsidy Scheme and the Resurgence Support Payment. This will help businesses get through and assist the retention of labour, just as it has done on previous occasions. This supports our expectations of a similarly sharp rebound in activity as alert levels are progressively lowered.

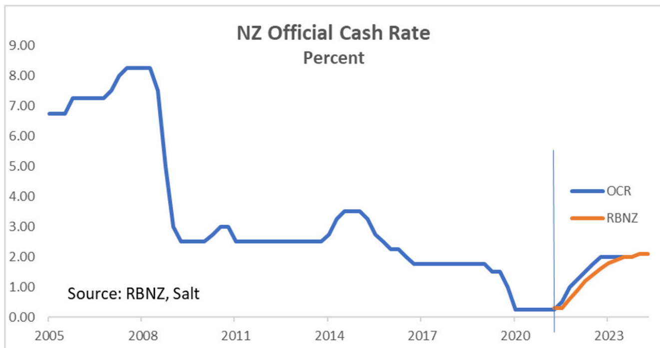
Inflation and the Reserve Bank of New Zealand

As regular readers are aware we have long argued that while much of the recent inflation will prove transitory in time as supply constraints ease, more durable inflationary pressures were bubbling under the surface in the form of the tightening of the labour market and strong wage inflation.

The RBNZ had clearly come to that view in the lead up to the August 18th Monetary Policy Statement and were only stymied from moving rates higher by the "optics" of tightening monetary conditions less than 24 hours after going into a nationwide lockdown.

In fact, their interest rate projection track only differed from our forecasts by the fact that we had an extra 25bp hike in this year and while we see the peak at 2.0%, their track peaked at 2.1%.

We see the decision by the RBNZ not to raise interest rates last week as a temporary delay. We expect they



will pull the trigger at the Monetary Policy Review scheduled for October 6th, regardless of lockdown conditions, and continue tightening until the OCR is around the assumed neutral level of 2.0%.

There are a number of assumptions behind that:

- The only way out of lockdown permanently is vaccinations and vaccinations are ramping up;
- The pathway to re-opening of borders is now more complicated and likely slower, delaying the arrival of migrant labour to assist an already stretched labour market;
- Monetary policy is relatively ineffective in supporting the economy through lockdown. That is a job for fiscal policy and fiscal policy is doing its job. That bodes well for the post-lockdown recovery;
- Lockdowns contribute to worsening supply bottlenecks and are thus inherently inflationary. Its also the fact that global supply chains remain congested and, according to some anecdotal reports, delays are worsening;
- Lockdowns and the ongoing risk of their return may delay investment decisions by firms at a time when labour markets are tight and higher investment is required to boost productivity and help keep inflation in check; and
- The bank has "softened " us up for a tightening and will have time before October 5th to get its communications plan in place.

Markets have reacted largely as expected given the developments of the past last week. New Zealand shares have largely shrugged off lockdown, instead benefiting from the delay to the interest rate increase. Earnings season has been mixed and on balance has failed to exceed what were already lofty expectations. The New Zealand market has also benefitted from the general "risk on" tone in global markets.

The NZD fell sharply as the country went into lockdown and the expected rate hike from the RBNZ was delayed. From over US70 cents the NZD fell to a low of US68.15. It has since recovered reflecting a more "risk on" tone in markets, a sharp rise in commodity prices and "hawkish" media comments from members of the RBNZ Monetary Policy Committee. The NZD is currently trading at US69.6 cents. We expect further appreaciation as the rate hike cycle gets underway and New Zealand leads the world on the pathway to less accomodative monetary conditions.

Interest rate markets have been slow to come to the realisation that the RBNZ means business. Big moves yesterday following reported comments from Assistant Governor Hawkesby has the OIS market now only a handful of basis points short of pricing in two full 25bp hikes by the end of the year.

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