30 June 2017

Central Banks Stir as RBNZ Hibernates

- RBNZ on hold for "considerable period"
- As BOC, BOE and Fed show signs of aggression
- We formally relinquish our Feb rate hike view
- As short term inflation indicators weaken
- Nonetheless, we remain mindful that capacity pressures continue to build

With some trepidation, we are now formally pushing back our expectation of a first RBNZ rate hike to mid-2018 from Q1 2018. There remains huge uncertainty around the timing of the move and we are certainly not ruling out a February rate hike. However, we now think looking for a May (or August) move is a better reflection of our central view of the RBNZ's reaction function with equivalent risks of an earlier or later move. Our view remains significantly more aggressive than the central bank's and modestly more so than market.

We have long held the belief that the process to a tightening would be a three stage one. Given that the Bank's current forecasts have no increase in rates until late 2019/early 2020, it would be difficult to justify a hike in rates any time soon without first acknowledging that the time for doing so was no longer so distant. As such, we think the first action of the central bank would be to go to a tightening bias, the second to formally bring forward any prospective tightening and then, finally, actually pull the trigger. Given that the Reserve Bank doesn't seem to like shifting its stance at OCR reviews, this process would need to evolve over three consecutive Monetary Policy Statements. If we are right, this would mean, at the earliest, an August, 2017 move to a tightening bias, November bring forward the projected tightening and then February, 2018 raise rates.

We had thought the RBNZ would accede to the strength in the domestic economy and move to a tightening bias by August at the latest. However, the May Monetary Policy Statement revealed no intent whatsoever to do this with the Bank restating its view that it saw an equal chance of a rate cut as a rate hike. As hard to believe as this may be, it is the Bank's stated view so can't be ignored.

The stance was, implicitly, restated in the June OCR review and, perhaps, more importantly, developments since the May MPS are more likely to convince the RBNZ that it is doing the right thing than not.

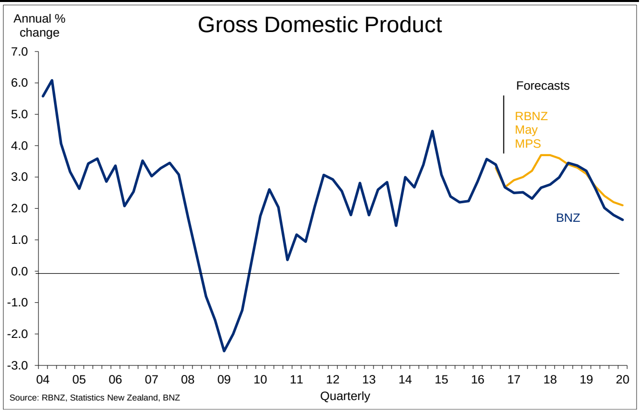
To start with, Q1 GDP came in well shy of the RBNZ's expectations. The Bank was forecasting 0.9% for the quarter; the actual outturn was 0.5%. Importantly, while we think that GDP growth will pick up, on a quarterly basis, from here, we do not think that it will rise sufficiently to offset the Q1 "shortfall".

Of greatest significance is the fact that inflation indicators have taken a turn to the low-side. Oil and, in turn, petrol prices have plummeted. So much so that we have lowered our Q2 CPI forecast to 0.1% and slashed our Q3 number to 0.2%. This now leaves our year to March 2018 annual CPI forecast sitting at just 1.2%.

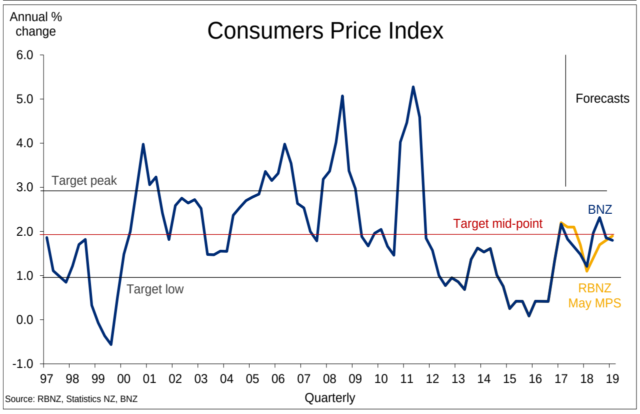
Moreover, it is quite likely that the RBNZ's August MPS forecasts for the year ahead will be even lower than ours as their already low forecasts would not have had the petrol price plummet in them and definitely did not have the currency as strong as it is. The RBNZ had assumed the TWI would average 75.0 through the September quarter. If it stays where it is (78.6) then this, by itself, could take 0.5% off the Bank's year-ahead CPI forecasts and, in turn, demand an even lower interest rate profile than the RBNZ currently assumes. Indeed, at face value, it would demand rate cuts.

If all this wasn't enough, bank lending rates have been drifting higher even as the cash rate has stayed the same.

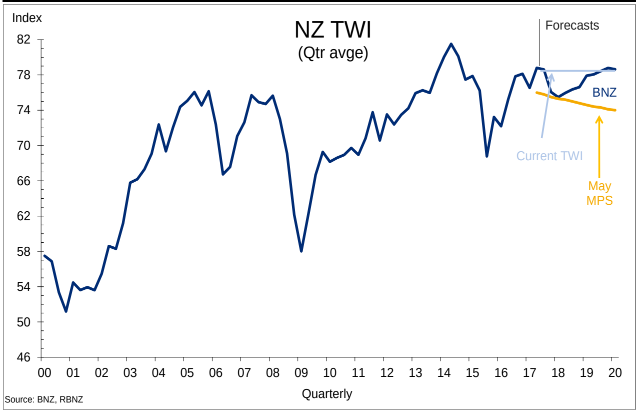
GDP Surprises to the Low Side



Inflation to Fall



NZD Stronger for Longer



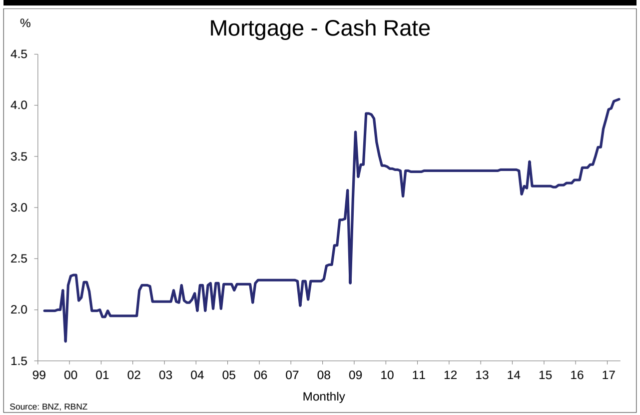
For example, the variable 1st mortgage housing rate is up over 20 basis points since late last year and the average two year fixed rate has risen 50 bias points from its low. Of course, this is, in part, due to financial markets having priced in rate hikes earlier than the RBNZ has suggested.

With bank lending rates rising, macro-prudential policy biting and the banking sector suffering funding constraints, inflation in the housing market has also softened playing further into the RBNZ's dovish inclinations.

One might reasonably ask why, under these conditions, we are even talking about rate increases at all. To start with there are some statistical offsets:

- Food prices are remaining stubbornly high and will put upward pressure on headline inflation;
- Core inflation looks like it will soon sit above headline inflation;
- We expect inflation expectations to remain consistent with CPI inflation sitting at or above the mid-point of the RBNZ's target band;
- Fiscal policy will prove to be quite stimulatory and this will not yet have been built into the RBNZ's forecasts;
- Commodity prices have risen and the terms of trade is headed for record highs;
- Capacity utilisation is approaching a record high; and
- The labour market continues to tighten.

Retail Rates Rise as OCR Doesn't



Additionally, it would appear that central banks around the world are starting to shift their positions:

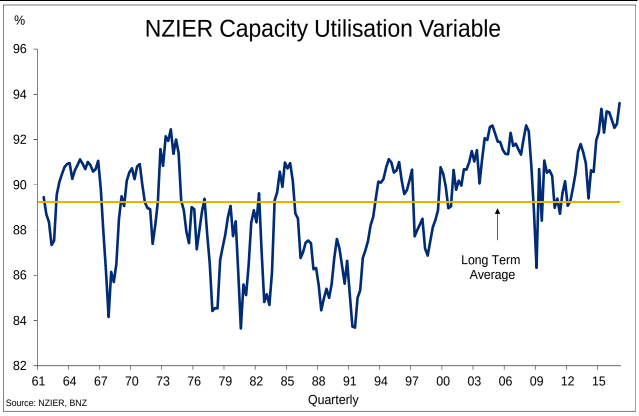
- The Federal Reserve has already tightened, will tighten more and will soon start reducing its balance sheet;
- The Bank of England's vote to keep rates unchanged narrowed to a slim 5-3 margin and Governor Carney suggested there is now less need for stimulus - so markets now believe there is a 55% chance of a hike by November;
- The ECB seems to be shifting, albeit glacially, towards a tightening bias;
- And the Bank of Canada surprised in indicating that its first tightening might be sooner than thought. Indeed, we were particularly attracted to Governor Poloz's comment that rate cuts "have done their job. We're just approaching a new interest rate decision . . . . Certainly we need to be at least considering that whole situation now that capacity – excess capacity – is being used up steadily". Markets have correspondingly shifted to pricing a 70% chance of a rate hike in July.

If these respective central banks do start moving in the manner implied it will make it easier for the RBNZ to do likewise. Importantly, Governor Wheeler seems to have been heavily influenced by the actions and rhetoric of the key central banks in the past. Indeed, it is this, more than anything that has created our trepidation in pushing back our expectations of the RBNZ's expected rate track, particularly given that we believe both inflation and capacity pressures are greater in New Zealand than in Canada. Sure the NZD has been stronger than the currencies of Canada and the UK but it is domestic demand that is at the centre of the tightening discussion and here New Zealand is a leader.

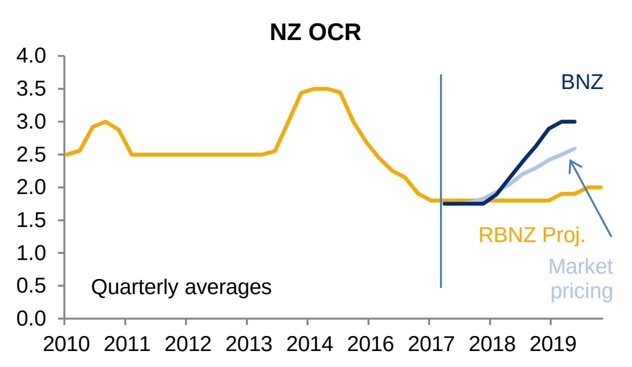
Furthermore, we maintain our view that, whatever happens to headline inflation, interest rate settings in New Zealand are currently more consistent with an economy that is under significant duress than one which is growing steadily tightening designed to slow down the economy but more the removal of "emergency" stimulus measures as the fear (founded or not) of deflation gripped the Bank.

We should, of course, note that forecasting the actions of the RBNZ over the next twelve months is even more fraught with danger than normal. In September, Graeme Wheeler departs. In March, Deputy Grant Spencer does

Capacity Utilisation at Record High



RBNZ Rate View Not Shared



Source: BNZ, Bloomberg

likewise and the new Governor is appointed. Even if the Bank's mandate remains unchanged, we know from both past New Zealand experience and what's happened offshore that the culture of the central bank can change and even its interpretation of the "rules" can do likewise.

At the extreme, a new Governor may even choose, with the support of the Finance Minister to adjust the Policy Targets Agreement. There is certainly significant precedence for this. And, last but not least, we do have a General Election which could conceivably deliver a new Minister of Finance with a very different view of how the RBNZ should operate.

Our view on where the rate hike cycle begins is not that different to the market's with June 2018 currently priced in for the first move. June, of course, is unlikely as it's an OCR review date not an MPS. The market then has a second rate hike by November 2018 with the potential for a couple more the following year.

We still think that, ultimately, the cash rate will need to push up to and through neutral and that when the process begins it will tend to be quicker than the market will price. We do not know exactly where neutral is these days but we do think it is substantially higher than where rates currently are. We have, for now, lopped the top off the peak in our OCR track to 3.0% from 3.75% to acknowledge the widening spread between the cash rate and lending rates but acknowledge that this spread has changed significantly in the past and can do so again.

stephen_toplis@bnz.co.nz

Contact Details

BNZ Research

Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Senior Economist
+(64 4) 474 6923

Jason Wong
Senior Market Strategist
+(64 4) 924 7652

Main Offices

Wellington
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 473 3791
FI: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Ray Attrill
Global Co-Head of FX Strategy
+(61 2) 9237 1848

Skye Masters
Head of Interest Rate Strategy
+(61 2) 9295 1196

Wellington
Foreign Exchange +800 642 222
Fixed Income/Derivatives +800 283 269

Sydney
Foreign Exchange +(61 2) 9295 1100
Fixed Income/Derivatives +(61 2) 9295 1166

London
Foreign Exchange +(44 20) 7796 3091
Fixed Income/Derivatives +(44 20) 7796 4761

New York
Foreign Exchange +1 212 916 9631
Fixed Income/Derivatives +1 212 916 9677

Hong Kong
Foreign Exchange +(85 2) 2526 5891
Fixed Income/Derivatives +(85 2) 2526 5891