10 May 2018

Clarity Defines Orr Debut

- Cash rate unchanged at 1.75%
- OCR track unchanged
- But overall tenor of statement more dovish than market anticipated
- We push back our rate hike track
- But our core themes remain intact

The defining feature of Adrian Orr's first Monetary Policy Statement (MPS) is the clarity of the message. Instead of having to flounder through screeds of mumblings to find out what the Bank really thinks, the message is up front. Symptomatic of this is the very first paragraph in the policy assessment which states: "The Official Cash Rate (OCR) will remain at 1.75 percent for some time to come. The direction of our next move is equally balanced, up or down".

So up front was it that we missed the message on first read as the initial paragraph of the MPS has usually tended to be a narrative on the state of the global economy.

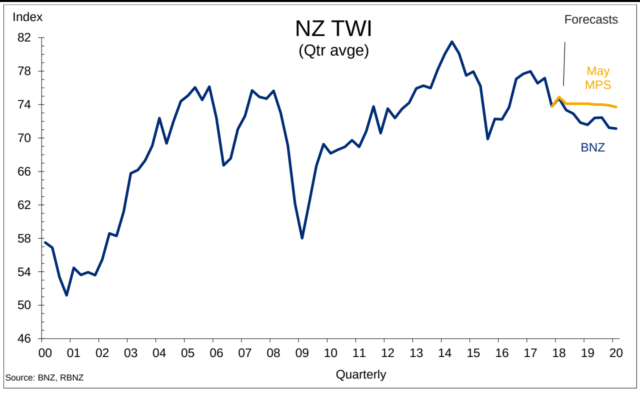
Do we believe that there is equal likelihood of an easing as a tightening at the moment? No. And we are not even convinced that the RBNZ thinks that because it still has a rising interest rate track as its central scenario. But, at least the Bank's thinking is clear for all to see.

And to be fair, the details of the Bank's writings actually imply there is almost no chance of a rate cut or a rate hike any time soon. So the equal chance is, in both cases, near zero.

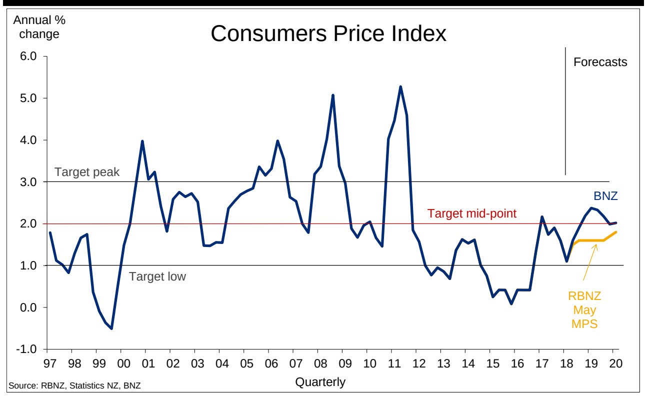
Be that as it may, this view of equality of chance is the thing that the market has, unsurprisingly, focused on (as was clearly the Bank's intent). Accordingly, those looking for a rate increase this side of Christmas have softened that view and the first rate hike is now not fully priced until September 2019. We too have taken the opportunity to formally push back our forecast first rate hike to May 2019 from February. We had signaled that we were moving in this direction, anyway, and were looking for a catalyst to move. Today's statement is such a catalyst. And we again caution that May is only indicative. The only thing we can say with some conviction is that the first hike is some time away.

Consistent with the interest rate response, the New Zealand currency also came under pressure falling around

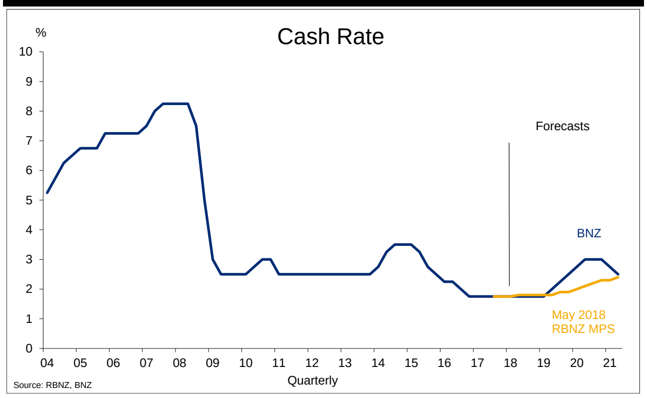
We're Assumig A Lower TWI



So A Higher CPI



And A Higher Cash Rate



50 basis points against the NZD and on a TWI basis. Of course, the irony of this is that it pushes up likely future inflation. Currently the TWI is sitting at 73.02. This compares with the RBNZ's assumed TWI level of 74.1 for this quarter. Was the current level of the currency to be sustained it would add around 0.2% to the Bank's year ahead CPI forecasts.

Interestingly, and coming as a surprise to us, the RBNZ lowered its year ahead CPI forecasts by 0.2% in this MPS. We had seen upside risk given what we perceived were tighter capacity constraints, elevated commodity prices (especially oil) and a weaker NZD. But the Bank didn't see it that way.

In terms of the Bank's broader forecast framework, we note that the Bank lowered its GDP growth expectations for the March years 2019 and 2020 by 0.2% per annum to

3.1% and 3.3% respectively. This is now closer to, but still above, our own expectations of 3.1% and 2.8%.

In lowering these GDP forecasts, and keeping potential output expectations unchanged, it has reduced the Bank's view on the output gap. The Bank still believes the economy is operating above full capacity, but only marginally so, and the lesser gap that the Bank now forecasts will reduce its perceived upward pressure on inflation.

There was, understandably, considerable attention on how the RBNZ would incorporate the new Policy Targets Agreement into its forecast commentary and, in particular, its interpretation of maximum sustainable employment (MSE). The Bank did not disappoint in spending considerable effort in explaining its stance on this. We will go into this in further detail in a future note but, suffice it to say, that the Bank said that currently the labour market is "there or thereabouts" in terms of its proximity to maximum sustainable employment.

There was also a lot of interest in what the Governor would say about the currency. As it turned out, Orr said absolutely nothing. In our opinion this is an appropriate position to take. We have oft criticized his predecessor for trying to talk down the currency – especially when we could find no reason to substantiate why the NZD should be any lower. Orr's only nod to the currency was in his post-match press interview when he noted that the strength of the NZD could be justified by the strength in New Zealand's terms of trade.

So, in terms of our overall view of the world:

- We have shifted our first rate hike call to May 2019 from February 2019;

- This supports our view that there is (and will be) no interest rate support for the New Zealand Dollar so we expect it to weaken further on a TWI basis;

- It is consistent with our view that the New Zealand yield curve steepens (no rate hike any time soon but rising medium term inflationary pressure); and

- It reinforces our positive view on inflation-linked bonds.

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The full text of today's RBNZ OCR Review – Official Cash Rate unchanged at 1.75 percent

The Official Cash Rate (OCR) will remain at 1.75 percent for some time to come. The direction of our next move is equally balanced, up or down. Only time and events will tell.

Economic growth and employment in New Zealand remain robust, near their sustainable levels. However, consumer price inflation remains below the 2 percent mid-point of our target due, in part, to recent low food and import price inflation, and subdued wage pressures.

The recent growth in demand has been delivered by an unprecedented increase in employment. The number of willing workers continues to rise, especially with more female and older workers choosing to participate. Likewise net immigration has added to the supply of labour, and the demand for goods, services, and accommodation.

Ahead, global economic growth is forecast to continue supporting demand for New Zealand's products and services. Global inflation pressures are expected to rise but remain contained.

At home, ongoing spending and investment, by both households and government, is expected to support economic growth and employment demand. Business investment should also increase due to emerging capacity constraints.

The emerging capacity constraints are projected to see New Zealand's consumer price inflation gradually rise to our 2 percent annual target.

To best ensure this outcome, we expect to keep the OCR at this expansionary level for a considerable period of time. This is the best contribution we can make, at this moment, to maximising sustainable employment and maintaining low and stable inflation.

Our economic projections, assumptions, and key risks and uncertainties, are elaborated on fully in our Monetary Policy Statement.

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