29 November 2018

bnz

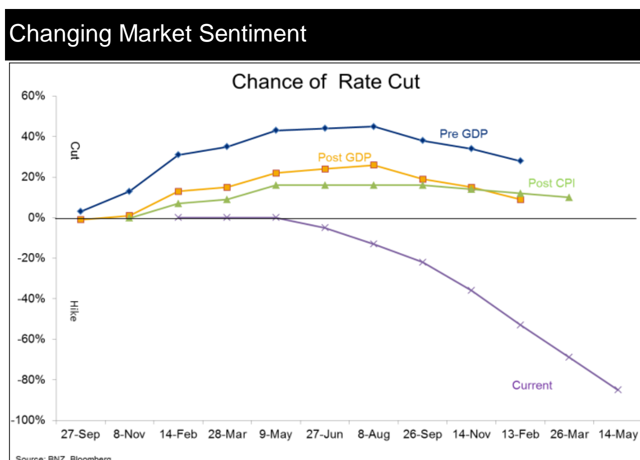
RBNZ in Summer Hibernation

- **We lower our interest rate profile**
- **But still have a strong tightening conviction**
- **Rate normalization the driving force**
- **But RBNZ flatlining**
- **Will take serious inflation to break the slumber**

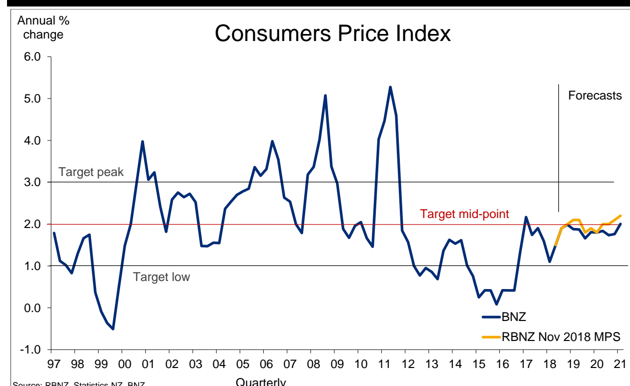
Different people have different ways. With this in mind, we have been taking our time observing closely the changing operating style of the RBNZ under the leadership of still-relatively-new-Governor Adrian Orr. Initially, financial markets decided the new regime would be far more dovish than its predecessor and, following a couple of soft data releases, started to price in a greater-than-even chance of a near term rate cut in New Zealand. We were staunchly opposed to that view as we found it difficult to believe a dual-target central bank could cut rates at a time when the economy was at full employment and hitting numerous capacity constraints. The data have, more recently, supported that view and, not surprisingly, the market has done an about-face and is now pricing in a greater chance of a tightening than an easing. We concur with that sentiment.

That said, the RBNZ decides where rates go and it's currently displaying a very real reluctance to even suggest interest rates might rise. Sure, in its November MPS it dropped the statement that there was an equal chance of a rate cut as a rate hike but it didn't change its interest rate track despite inflation and growth data surprising it to the upside. And, of course, the September quarter labour market report revealed much tighter conditions than expected too albeit that this report was released after the RBNZ's forecasts were finalized.

Changing Market Sentiment



2.0% Breached



Most importantly, the RBNZ broke ranks with recent-past practice in keeping its interest rate track unchanged despite its inflation forecasts lying above the magical 2.0% mark, for five consecutive quarters, at the end of the RBNZ's forecast horizon. We suspect the previous governor might have thrown in a 25 point hike, in the relatively near future, had this inflation forecast been delivered to him.

We are not passing comment on the efficacy of the policy stance but simply note that there is clearly a relatively high hurdle in existence before the cash rate might be pushed any higher. Accordingly, we can't help but conclude that recent economic developments will not be sufficient to convince the Bank that any change in rates should occur any time soon. In fact, they could even cause it to adopt a more dovish disposition.

In particular, we think the Bank will defer to the fact that:

- The global growth outlook is deteriorating. Trading partner growth expectations are falling and financial market volatility is rising.
- The Federal Reserve is looking a little less aggressive.
- Q3 retail sales were surprisingly soft.
- Dairy prices have fallen and the expected dairy payout is being revised lower.
- Falling commodity prices, especially petrol, are lowering CPI projections. While the headline impact is irrelevant, because the RBNZ looks through fuel price impacts, falling prices may well help keep a cap on inflation expectations.

- The NZD TWI is sitting over 4.0% above the RBNZ assumed level for Q4 implying that the Bank's annual inflation forecasts for the year or so ahead could be lowered by around 0.4%.

Given the Reserve Bank's predilections, we have decided to delay, and reduce the extent of, the tightening we had built into our forecasts. We still think there is a strong argument for higher interest rates but we also acknowledge, and can see the rationale, behind the RBNZ's approach.

Nonetheless, our view remains that if interest rates are to move within the next twelve months then there is more likelihood of a rate hike than a rate cut. And, if we were running monetary policy, this is probably what we would be doing. Our stance is not based so much on the fact that we need higher interest rates to curb inflation but more because we believe there is a strong argument for rate normalization in the current environment. Be that as it may, we also note that, the longer the cash rate stays where it is, the greater the chance becomes that the next move will be a cut.

In short, we think that in order to minimize future potential financial market and real economy volatility it would be appropriate to start, gently, the process of interest rate normalization sooner rather than later. As we see it:

- We already have maximum sustainable employment and, probably, an excess demand for labour.
- The economy is operating at potential in a levels sense.
- The economy is forecast to remain growing near potential for some time.
- Consumer price inflation is basically at target.

On this basis, there is little need for interest rate settings to be as stimulatory as they are. We would not argue for contractionary policy just interest rates that imply a little less pressure on the accelerator.

Given our starting position, we are also not sure how much more the economy can take before CPI inflation becomes problematic, especially given the margin pressure that corporate New Zealand currently appears to be facing. We concede, nonetheless, that inflation has remained restrained for a long time already and could well remain so for the foreseeable future. And given the RBNZ's current stance, it looks, increasingly, like the Bank would have to expect inflation to head sustainably into the top end of the RBNZ's target range before it might react. While we feel comfortable ruling out a near term rate cut, we no longer have sufficient evidence to argue for a nearish term rate hike.

And, if what we are experiencing now is not enough to generate a response then it may well be that nothing will.

Moreover, as we head into late 2019/early 2020 it is plausible that the global economic cycle will have come to an end, asset prices will be correcting relatively aggressively, domestic conditions will be deteriorating, the unemployment rate will be rising and inflationary pressures, generally, will be diminished. All of which would lean more to a cut than a hike. So, we reiterate, the longer there is no rate hike, the greater the chance of a rate reduction.

Now that the market has priced out the chance of a rate cut, we see no reason to bet against market positioning. In terms of upcoming data we would note the following:

Arguing for tighter policy

- The Q4 labour market data are due for release February 7. The Q4 data will probably be too late for inclusion in the RBNZ's next forecast but, in many ways, that doesn't matter because the Q3 data (released just before the November MPS) was already sufficiently different to RBNZ expectations that a changed labour market track will be demanded. We forecast a Q4 unemployment rate of 4.2% compared with a current RBNZ projection of 4.4%.
- Non-tradables CPI, released January 23, could well surprise the RBNZ to the upside. The Bank is forecasting an annual 2.5% increase, we are picking 2.6% with upside risk.
- Deteriorating external accounts suggest excess domestic demand.
- We think the housing market will be more resilient than the RBNZ expects.

Arguing for easier policy

- Dairy price weakness.
- Weakening dairy land prices.
- Moribund business confidence.
- A softening global outlook.
- A stronger than anticipated NZD.

Arguing for no change

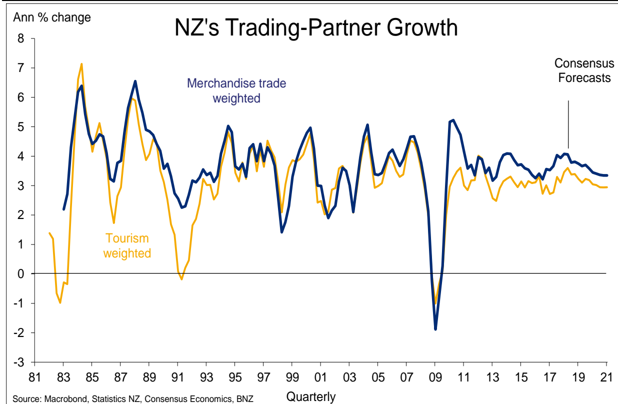
- Q3 GDP released December 20 is unlikely to be significantly different to the RBNZ's 0.7% projection.
- Q4 CPI released January 23 is unlikely to produce a headline reading significantly different to the RBNZ's current estimate.

The balance of these factors thus argues for the market to continue, for now at least, pricing more of a chance of a rate hike than a rate cut but the intransigence of the central bank argues against pushing this bet too hard

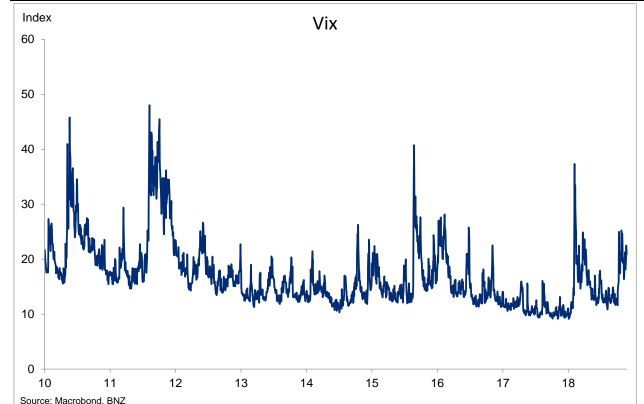
(*text continues on page 5*)

Reasons Not To Tighten Now

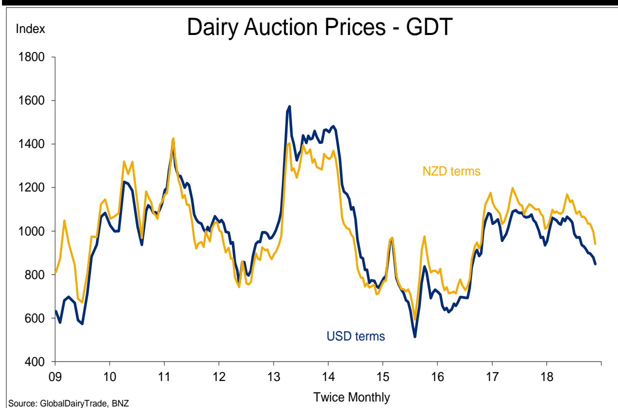
Trading Partner Growth Deteriorates



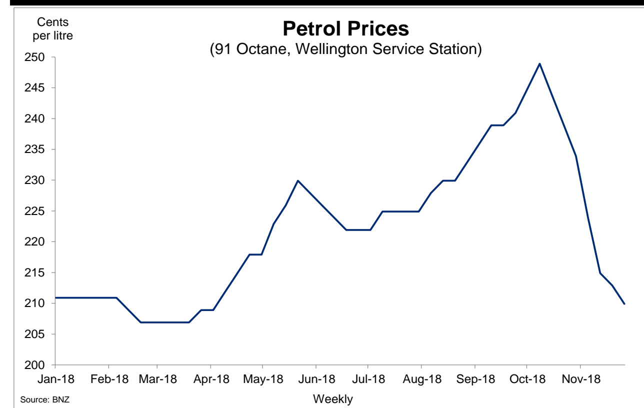
Market Volatility Spiking



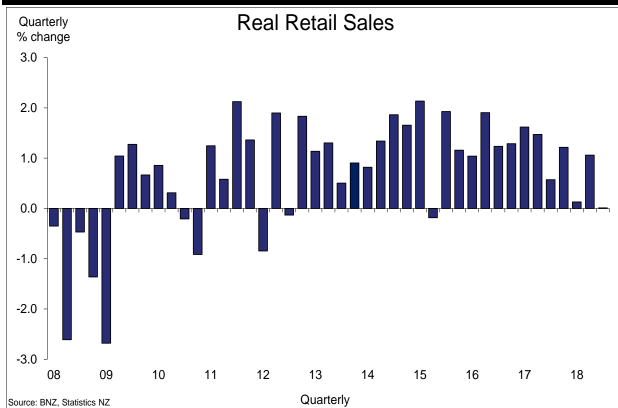
Dairy Prices Have Fallen



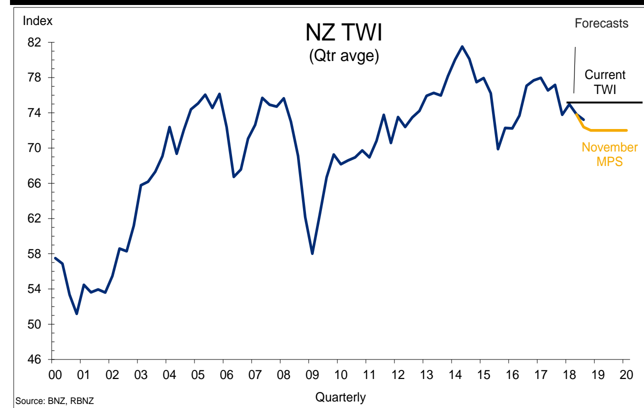
Petrol Prices Correct



Consumer Spending Softens

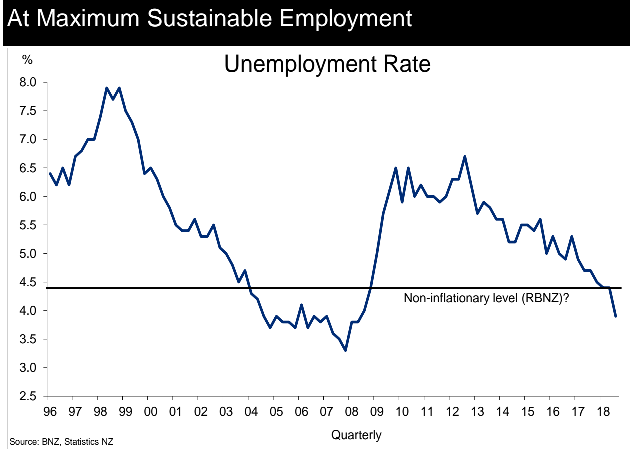


A Stronger NZD

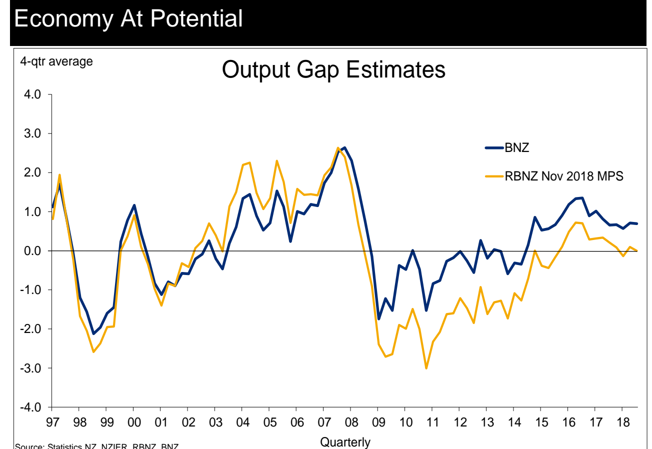


Reasons To Tighten Now

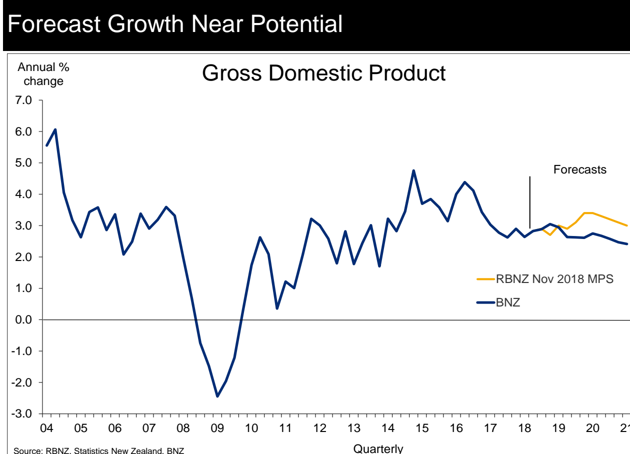
At Maximum Sustainable Employment



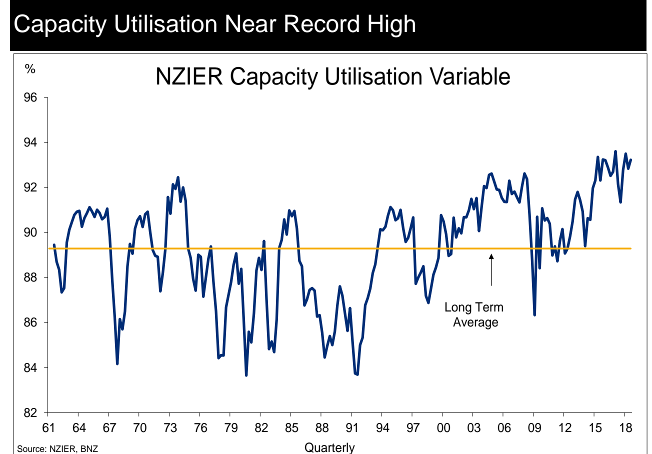
Economy At Potential



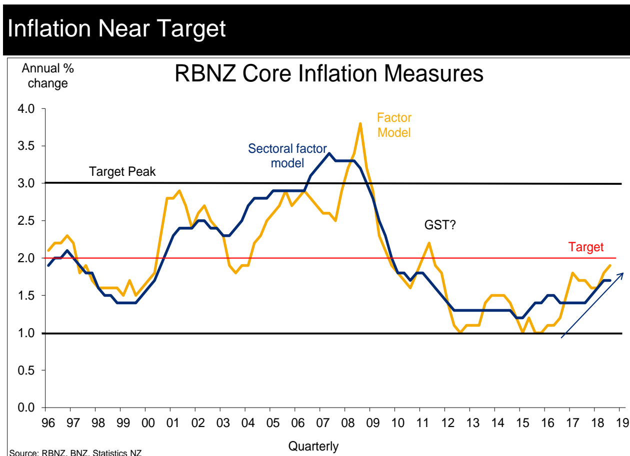
Forecast Growth Near Potential



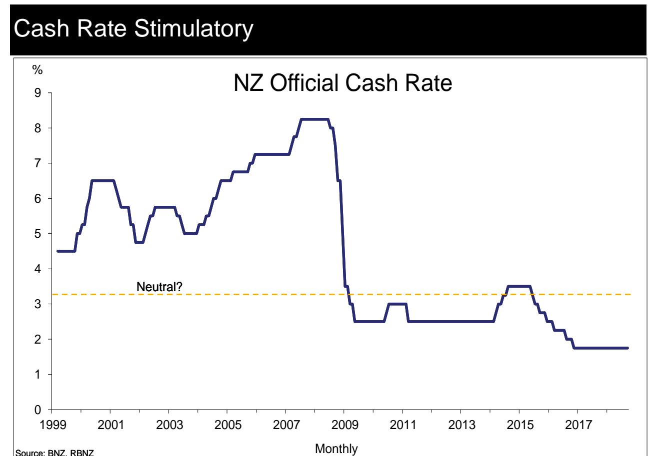
Capacity Utilisation Near Record High



Inflation Near Target



Cash Rate Stimulatory

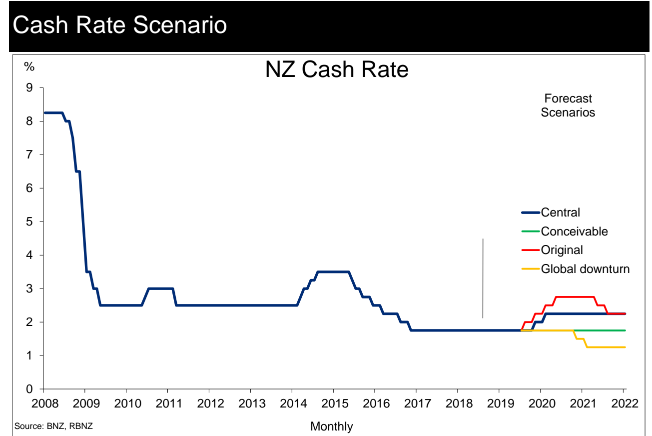


unless clear signs of upside inflation surprise are observed.

Putting all this together, our central scenario now sees the first rate increase delayed until November 2019 from August 2019 with the cash rate peaking and stalled at 2.25% (previously 2.75%). The accompanying chart shows a range of scenarios.

The central scenario is as described though we are quick to note that we see this rate track as indicative rather than something we would thump the table on. It is heavily reliant on inflation (particularly non-tradables inflation) rising sufficiently to force the RBNZ to pull the trigger. Clearly the interest rate track is heavily data dependent and if inflationary pressures do come quicker and stronger than anticipated our original interest rate track will come back into focus. Alternatively, given the current stance of the RBNZ it is conceivable that interest rates remain unchanged for a very long time. We now think the risk of a flatline track is greater than the upside alternative.

And lastly, if no inflation is generated during the current period and the NZ economy gets sideswiped by falling global activity there remains an outside chance that the next move in rates is down, albeit some distance into the future.



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