RESEARCH
ECONOMY WATCH

8 November 2019

MPS Preview: Nervous Nellie Edges Steady Eddie

- **The RBNZ shouldn't cut next week but probably will**
- **As it frets about GDP and inflation expectations**
- **Alternatively the Bank could shape a dovish pause**
- **Limiting any "adverse" market reaction**
- **Up to inflation to stop broader OCR capitulation**

Pity the financial markets. After a long feast, they are practically close to running out of cash rate cuts to trade. And they will be sweating on next Wednesday's RBNZ decision. It is shaping up as a close call. Market pricing has come to reflect this. Just a few weeks ago it was 100% for a 25 point cut in the Official Cash Rate (OCR), to 0.75%. As we speak, the odds are 60% or so.

While the seven committee members will no doubt have their priors going into the meeting, we can imagine there will be a vigorous debate before a collective decision is arrived at. There is a lot that the committee will feel it has to weigh up.

To our mind, there is not a strong case for the Bank cutting its cash rate even further next week. The extremes to which monetary policy have already plumbed are starting to create medium-term risks of volatility, even instability. This is outweighing short-term impacts on activity and inflation which are arguable at best.

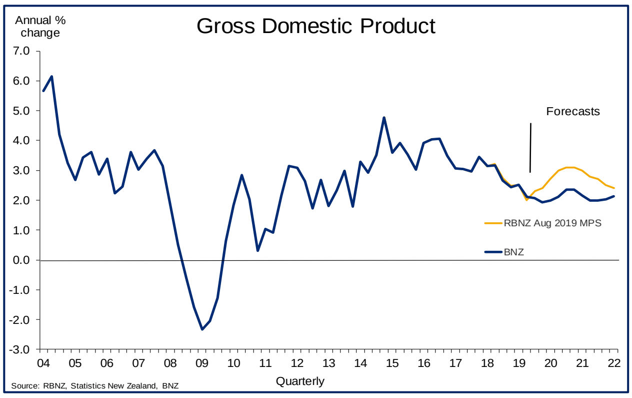
While interest rate cuts are supposed to stimulate the economy, what we're actually hearing from businesses and households is that they are feeling very uneasy about it. Far from instilling confidence, the interest rate sinkage is piquing concerns. Unless you're in real estate, or the financial markets, that is.

As for what the RBNZ officials (and committee members) will be weighing up for next week's MPS and OCR decision, we'd venture two main trains of thought.

The first is to ease the OCR a further quarter-point, to 0.75%, with a mild easing bias attached. This is predicated on the Bank starting to come around to the view that the GDP growth forecasts it had in the August MPS were just too optimistic.

To be sure, Q2 GDP, in expanding 0.5%, was in line with the Bank's expectation (and annual growth of 2.1% a notch higher). Its 0.6%/0.7% forecasts for Q3/Q4 are higher than ours (0.3%/0.5%). But it's also the Bank's view that quarterly GDP growth chugs along at 0.8% through most of 2020, driving annual growth to 3.1%, which looks prone.

A big Ask



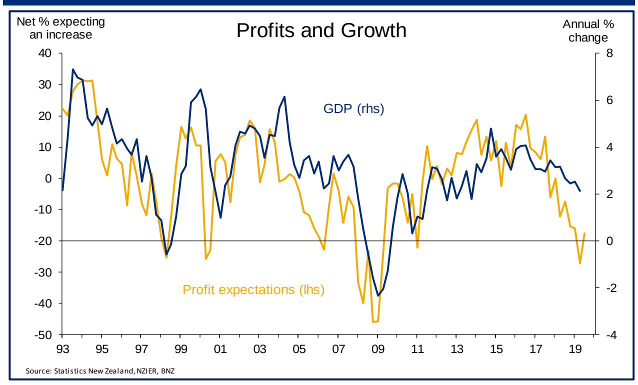
This is especially when a range of leading indicators suggest New Zealand's annual GDP growth will subside to the vicinity of 1.0% before too much longer, rather than accelerate to around 3.0%.

We are somewhere in between, in forecasting annual GDP growth of around 2% for the coming year and following. To our way of thinking, this would be enough to sustain inflation near the mid-point of the Reserve Bank's 1.0 to 3.0% target band.

However, run GDP growth of 2% per annum through the RBNZ models and we're pretty sure the Bank would be filled with disinflationary discomfort. Thus, it would feel the need to send greater OCR stimulus into battle, forthwith.

Indeed, looking at the August MPS forecasts it was clear the Bank considered it necessary to get a period of not just resilient GDP growth ahead but above-trend expansion, in order to achieve its inflation (and employment) mandates.

Not a good Look



Imagine if it thought it was facing, or felt at risk of, a period of sub-trend growth instead?

With this, the RBNZ would also feel vulnerable with respect to CPI inflation achieving the perceived 2.0% ideal over the medium term. This is at a time when inflation expectations measures have already drifted below that mark, over recent months. And while a range of core CPI inflation measures are sending a middling message at the moment, the one that the Bank appears to favour – its own sectoral factor model – was stuck at 1.7% y/y in Q3.

The Bank would also feel challenged by a less-bullish GDP prognosis in the sense it would undermine its maximum sustainable employment objective, over time.

Add in the Reserve Bank's revealed openness to front-loading policy changes, and the likelihood of seeing another OCR cut next week would appear to be compelling. Integral to this, the Bank might also fear that failing to cut would have it lose the initiative it thought it was securing, in getting interest rates, and the exchange rate, down.

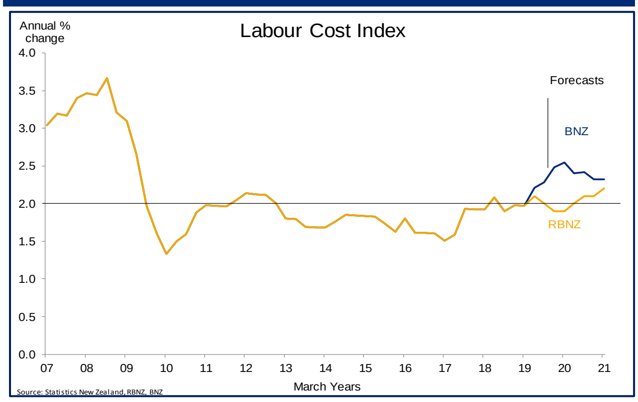
However, as compelling as this seems, it's not as straightforward as all that.

Indeed, there is a decent case to be made for the Bank electing to push pause on the OCR at next week's MPS (while maintaining a clear easing bias to guard against "adverse" market reactions).

Clouded as the economic forecasts are, there is little evidence that things are falling behind the Reserve Bank's August expectations just yet. Yesterday's Household Labour Force Survey was the latest example of this. And the accompanying Labour Cost Index inflation was running further north of what the Bank anticipated.

And while we can't ignore the leading growth indicators, there are also a lot of macro tailwinds to the economy that shouldn't be overlooked. Strong population growth is one, buoyant terms of trade another. And, yes, there is some fiscal stimulus coming through too.

Upside Surprise



Meanwhile, the trade-weighted exchange rate, at around 70.3, is about 4% below the level the August MPS assumed for Q4 2019. This is in spite of the nation's buoyant terms of trade. As part of this, forecasts of Fonterra's milk price for 2019/20 have been revised up over the last month or two, to a solid level.

Of course, annual CPI inflation has been running in the bottom half of the Bank's target band. Still, it looks as though it will beat August MPS projections by a comfortable margin over coming quarters.

It already did so in the September quarter, with annual inflation of 1.5%, versus the 1.3% that the Reserve Bank expected. We believe the gap will open further in Q4 with our 1.8% versus the Bank's 1.4%, while we forecast annual CPI inflation to get to 2.2% in Q1 2020, a half-percent higher than the 1.7% the August MPS foresaw.

This, in turn, infers more support for inflation expectations than the Bank figured on in August.

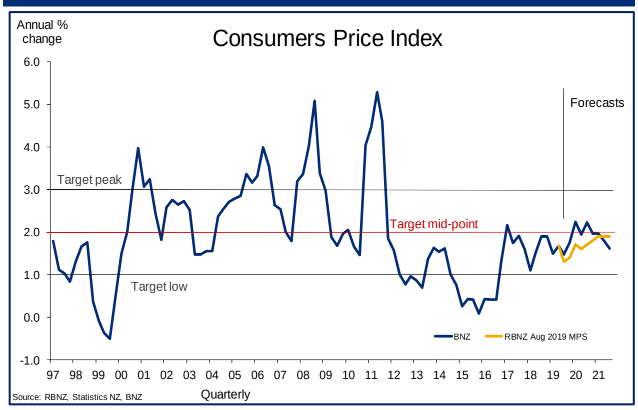
It's also worth repeating that annual non-tradables CPI inflation in Q3 2019 beat August MPS expectations but quite some margin – 3.2% versus 2.7%. To be fair, a part of this was once-off in nature. But a good part of it wasn't.

Another affront to the Bank easing policy further is the housing market. It's exhibiting signs of sparking up again. Of course, we know the Reserve Bank has tended to treat the housing market as distinct from the wider economy; only significant to the extent it influences CPI inflation. In this sense, the Bank will probably welcome the recent signs of a housing market pick-up, as evidence monetary policy is "working".

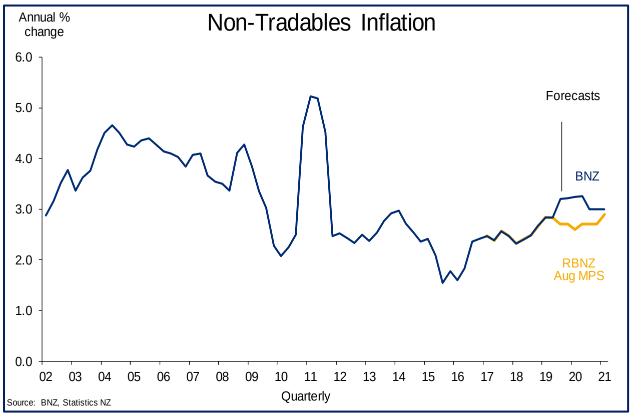
Having said this, with financial stability still implicit in the RBNZ mandates, there might come a point where questions are asked about the sustainability of house price inflation, even the levels that house prices are already approaching.

With all of this, there is a strong sense that the marginal news since the August MPS, and running through the late-September (on-hold) OCR Review, has held its shape, even strengthened in key respects.

Upside



Upside



So there is a hurdle for an immediate easing in the cash rate, which concern over the economy's medium-term prognosis would need to vault.

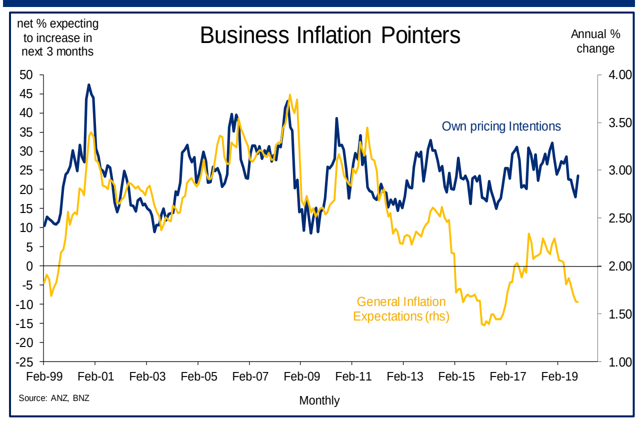
If the Reserve Bank does opt to push the pause button on the OCR next week, no one should have cause for great surprise. Unlike in August, when the Bank's 50-point cut came from left field, a pause next Wednesday would be in the realm of what RBNZ officials have been musing about over recent weeks.

To be sure, the Deputy Governor, Geoff Bascand was reported to have said in mid-October that there was a "reasonable prospect" of another cut. However, that is no lock-in, especially for the very next meeting.

Subsequently to that, Assistant Governor, Christian Hawkesby, has come out with more open-ended comments, casting some doubt on how committed the Bank is to another near-term policy ease. If this was to give the OCR committee some breathing space, it has been well reflected in recent market pricing.

In doing so, Hawkesby was quite explicit in reminding that the August MPS forecasting round was signalling the need for 60 points of OCR easing (evident in the Bank's published OCR forecasts).

Divergent



So to front-load 50 basis points of it on the day, effectively left 10 points for down the road. That's marginal stuff, albeit important in a directional sense.

With this in mind, the Bank also needs to be a bit careful about the market (over)reacting to any further OCR easing that it chooses to effect next Wednesday. It might have underappreciated this aspect in August. While the Bank thought it was simply front-loading the two 25bp cuts being priced at the time, the market clearly had other ideas. The 1-year swap rate fell the best part of 20 basis points in response to the August MPS.

The global backdrop is harder to read a bias into, with respect to next week's MPS. In many ways, the global economy is doing the reverse of New Zealand's, in showing clearer signs of suffering at present but with emerging hopes of a pick-up over time. News around international trade policy has reinforced this.

As for global monetary policy, while it's true that there's now a sense of pause, the fact is that many central banks have eased policy over the last month or so, including the Fed and the RBA.

Pulling everything together then, the OCR committee will probably feel the case for another rate cut is finely balanced – in the least not obvious. After much toing and froing, however, it will probably err on the side of a 25 basis point cut, we believe. This is even though we think there is no overwhelming basis for it, at this juncture.

But we can't leave our discussion at that. We need also think about where NZ monetary policy might be going over the broader sweep. Pause or no pause next week, the RBNZ will still feel its policy is keyed off its GDP growth forecasts. With this, and its inherent vulnerabilities, we might wonder…what will stop the OCR ultimately going to zero (even negative)?

We can't help but think it will have to be signs that inflation (pressure) is more robust than the Bank judges. This is unlikely to be obvious via headline GDP growth, which looks set to appear a bit underwhelming. So it will likely have to involve more direct signs that inflation is simmering, even heating up, in turn causing reassessments of output gaps, the NAIRU, and the like.

We would argue that such indications are already appearing, in the likes of; the latest labour market data; non-tradables inflation; the strong cost inflation that is pressuring the business sector, even the renewed broadening in house price inflation. But it will probably take more time for this to become obvious, especially in the eyes of the RBNZ. And, of course, if the economy genuinely loses a lot of steam, complete capitulation in the OCR would seem the likely end-game, in that scenario.

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