23 March 2017

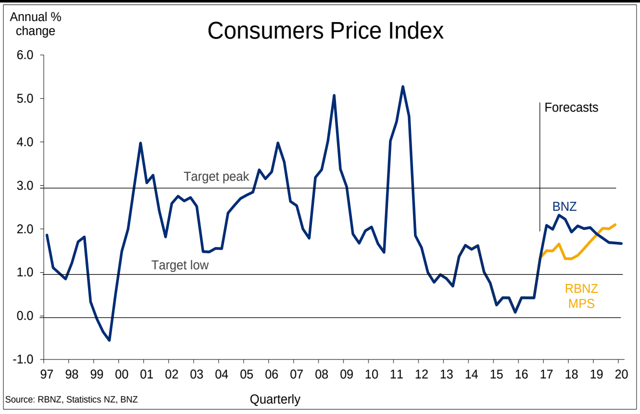
RBNZ Uncertainty Dominates Rate Stagnation

- OCR unchanged at 1.75%
- RBNZ's uncertainty shows no sign of diminution
- Bank back-handedly acknowledges likely Q1 CPI spike
- But sees it as an aberration
- Implied rate track sticks with end 2019/early 2020 tightening

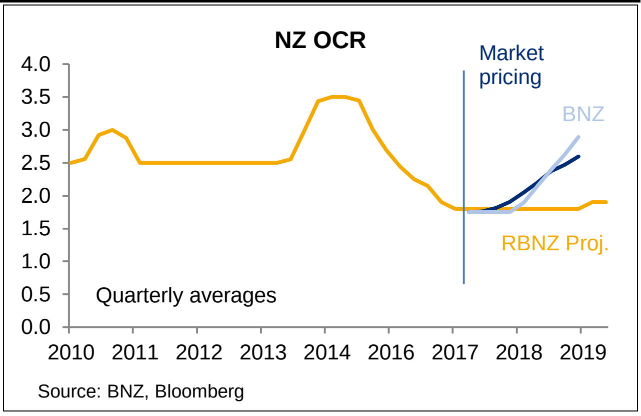
The RBNZ did its very best to produce an identical statement to its February Monetary Policy Statement (MPS) when releasing its OCR review today. However, as we had anticipated, it was forced to comment on the fact that GDP was surprisingly low in Q4 and that the upcoming CPI will likely surprise to the upside. It actually negotiated this minefield quite well (at least in a marketing sense) but we continue to believe the Bank is understating the extent and impact of likely inflation over the next few quarters and will, eventually, be bullied into raising interest rates earlier than projected in the MPS. Equally, however, we remain of the view that the market is a tad premature in its pricing of the first rate hike.

Uncertainty remains front of mind for the RBNZ. This uncertainty appears to have been exacerbated by recent GDP and CPI developments which are seen as aberrations and, hence, are simply adding to the confusion. To an extent, we concur with that view. We are on record as saying that the Q4 GDP outturn of 0.4% was a one-off and are forecasting a bounce to 0.7% (or higher) in Q1. Similarly, while we are forecasting a 0.9% Q1 CPI reading this does not mean we'd annualize this reading to conclude inflation was running at 4.0%. Quite the opposite, in fact, as we see annual CPI inflation sitting at or around 2.0% for the foreseeable future.

Inflation the Key



Market Overdone, RBNZ Underdone?



Actually, the RBNZ couldn't formally bring itself to concede how high the Q1 CPI reading might be. Possibly because it would prefer to explain the inflation story more fully in its May 11 MPS by which time it will have seen the April 20 CPI outturn. What the RBNZ did say was "Headline CPI will be variable over the next 12 months due to one-off effects from recent food and import price movements, but is expected to return to the midpoint of the target band over the medium term."

Where we appear to differ from the central bank's view is that we feel less uncertain that annual inflation will hit 2.0% and stay there. Accordingly, it will necessitate the cash rate moving to neutral faster than the RBNZ cares to believe. This process will be aided by the fact that:

- the currency is weaker than assumed;
- headline inflation printing at 2.0% will push inflation expectations higher;
- global growth is on the improve (and so too inflation);
- monetary conditions elsewhere are likely to tighten; and
- continuing tightness in the labour market will put upward pressure on wages.

But only time will tell whether we are right and the RBNZ will give itself that time. That's why we remain of the view that there is almost no chance of a rate hike this year and very little chance of a rate hike in the first quarter of next year. Financial markets are, at least, beginning to accede to this with the first hike not now fully priced until March 2018 and the probability of a hike in November having reduced from near 50% to just over 30%.

Full text of RBNZ statement next page.

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

Statement by Reserve Bank Governor Graeme Wheeler:

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent.

Macroeconomic indicators in advanced economies have been positive over the past two months. However, major challenges remain with on-going surplus capacity in the global economy and extensive geo-political uncertainty.

Global headline inflation has increased, partly due to a rise in commodity prices, although oil prices have fallen more recently. Core inflation has been low and stable. Monetary policy is expected to remain stimulatory, but less so going forward, particularly in the US.

The trade-weighted exchange rate has fallen 4 percent since February, partly in response to weaker dairy prices and reduced interest rate differentials. This is an encouraging move, but further depreciation is needed to achieve more balanced growth.

Quarterly GDP was weaker than expected in the December quarter, but some of this is considered to be due to temporary factors. The growth outlook remains positive, supported by on-going accommodative monetary policy, strong population growth, and high levels of household spending and construction activity. Dairy prices have been volatile in recent auctions and uncertainty remains around future outcomes.

House price inflation has moderated, and in part reflects loan-to-value ratio restrictions and tighter lending conditions. It is uncertain whether this moderation will be sustained given the continued imbalance between supply and demand.

Headline inflation has returned to the target band as past declines in oil prices dropped out of the annual calculation. Headline CPI will be variable over the next 12 months due to one-off effects from recent food and import price movements, but is expected to return to the midpoint of the target band over the medium term. Longer-term inflation expectations remain well-anchored at around 2 percent.

Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly.

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