Rock and a hard place

- RBNZ faces choice between dragging the NZD up with the OCR or pausing and triggering an unwanted drop in term rates.
- We expect the RBNZ to lift the OCR 25bp on July 24 and then pause until December.
- But communicating a pause may be a challenge for the RBNZ.

July's OCR decision has evolved to be less a case of what would prompt the RBNZ to lift the OCR to more what would make it pause. By and large the RBNZ's outlook is on track enough for the RBNZ to follow through. While we expect the RBNZ will raise the OCR by 25bp next Thursday we acknowledge the central bank is stuck a bit between a rock (risk of the NZD lifting further) if it hikes and a hard place (risk of term rates falling and undermining RBNZ's actions) if it stays on hold.

The growth outlook is largely on track. Q1's 1.0% GDP lift was just under the RBNZ's forecast. The details were not alarming from an inflation standpoint with consumption surprisingly flat. Q2 CPI also points to a benign inflation environment. Migration is still on the high side, and an important point given RBNZ's focus on demand side impacts on inflation.

At the time of writing, escalating geopolitical tensions in Ukraine as well as Gaza are unsettling global developments. For now, it is too early to tell whether the situation will have a lasting impact on financial markets. Other recent events that will be key concerns for the RBNZ to keep an eye on include the continued drop in global dairy prices, mortgage rate movements and the high NZD. The recent global dairy price declines point to a downward revision to Fonterra's current milk price forecast. Meanwhile, fixed mortgage rates have lifted and the NZD TWI remains higher than the RBNZ's assumption despite the recent pull-back from record highs The higher than expected NZD puts the RBNZ between the rock and a hard place. Interest rate differentials are still supporting the NZD at a high level. The RBNZ has a tough choice between going 'soft' on the OCR to reduce pressure on the NZD against keeping up some transmission of a higher OCR to term rates. In the current environment it can only choose one, and we expect the RBNZ to choose maintaining a floor under mortgage rates.

Along with the softer tone of recent data, this dilemma reinforce to us that the RBNZ will pause after July. With 100bp of tightening done by the end of this month, and looming uncertainties from the upcoming election, it is an opportune time to sit back and assess how the economy is responding. It is possible the RBNZ gives a bit of a hint it will pause. But giving such a hint risks having the market push wholesale rates back down and undermining the RBNZ's intent of tightening policy.

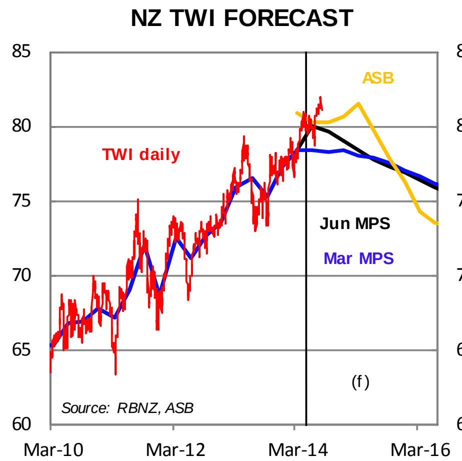
RBNZ outlook on track

June MPS signalled clear intention to raise the OCR in July.

The key take-out from the RBNZ's June Monetary Policy Statement (MPS) was the Bank remained on track to lift the OCR again in July. Whether a hike will actually occur has been more about what might hold the RBNZ back. As the decision date has drawn closer, the outlook has been tracking close enough that a further hike is likely.

Continued momentum in the NZ economy.

The RBNZ will remain comfortable that the economic momentum is continuing. The NZD's ongoing strength and further weakness in dairy prices will be of concern but unlikely to sideline the RBNZ this month. The broader picture of robust growth this year will reinforce to the RBNZ that interest rates need to keep rising.



Dairy prices – still weakening

Drop in global dairy prices indicates downward revision to 2014/15 season milk price payout.

Dairy prices have weakened further in recent GDT auctions, suggesting Fonterra's milk price payout for the 2014/15 season will be closer to $6 per kg of milk solids than its current forecast of $7.

The RBNZ will also be aware of the mixed outlook for other key exports. The outlook for forestry, in particular, has softened in recent months.

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NZD – still high despite recent depreciation

The NZD remains above the RBNZ's assumption.

Despite the depreciation over the past week the NZD remains above the RBNZ's assumption, and is higher than what the lower dairy prices would suggest. The RBNZ has over the past year more directly linked the NZD's path to the Terms of Trade, of which export commodity prices are a key driver. And over a long period of time this relationship is strong. But, like many other currency drivers, periods of disconnect occur.

Stronger migration largely offsetting effects of high NZD.

Over time, the NZD has continued to exceed the RBNZ's assumptions, even as they have been progressively revised higher. However, to date there have often been other counterbalancing factors, such as stronger than expected migration, that have kept the RBNZ firmly on the path to higher interest rates.

Yield demand for NZD remains strong.

At present, the RBNZ's solo path to higher interest rates remains a very strong driver of the NZD. We believe that the RBNZ will simply have to resign itself to the NZD remaining high into 2015 if it continues to lift the OCR as it had signalled.

Term rates have lifted

Effects of higher term rates should bite over the coming year.

One development the RBNZ will have been pleased with after the June MPS is the rebound in wholesale interest rates in response to the RBNZ showing no sign it was about to pause. The RBNZ had faced a situation of lower global rates and strong banking competition delivering lower fixed mortgage rates than were available at the start of the tightening cycle – blunting the RBNZ's efforts. The 2- and 3-year swap rates have now risen over 30bp from their late-May lows, giving some belated 'bite', and higher 2-3 year fixed mortgage rates.

Migration – keeping the RBNZ wary

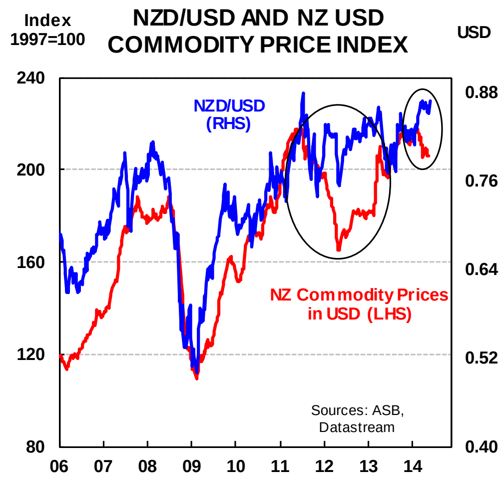
Stronger than expected migration would mean interest rates would have to go up even higher.

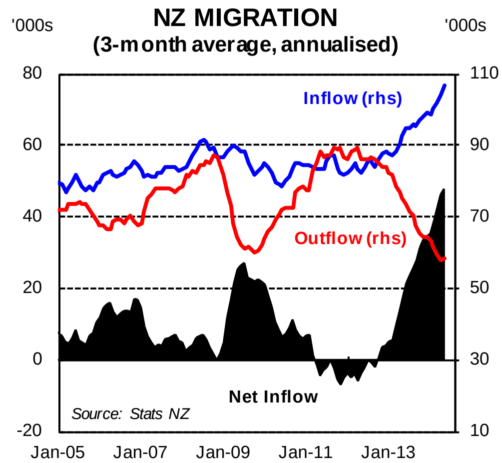
Net migration continues to come in on the high side of RBNZ expectations. The RBNZ remains firmly of the view that the demand side impacts come first, so wariness about upside inflation risk will remain. We estimate the RBNZ's outlook for peak annual working age migration of 37,000 at the end of this year is on the low side. The RBNZ's migration scenario in the June MPS implied an additional 4,300 migrants over the next 3 years was worth around 50bp in higher interest rates.

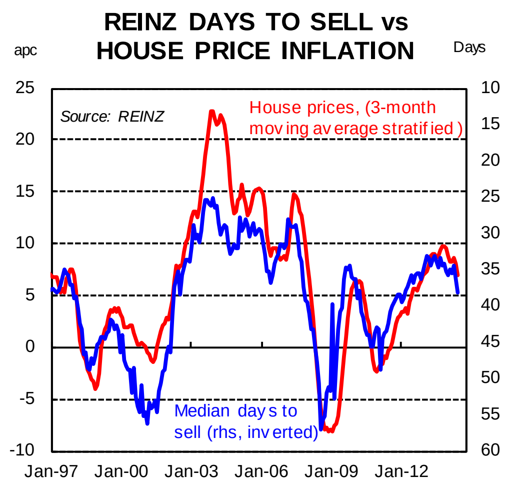
Housing – moderation in line with expectations

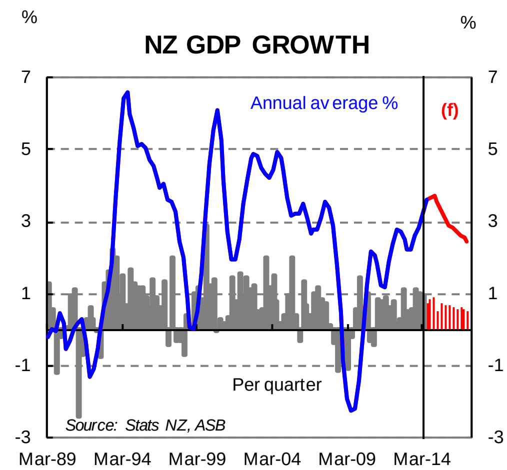
RBNZ likely to be comfortable with current housing market trends.

The housing market continues to gradually lose momentum. The various house price measures still suggest some price growth in Auckland – the market in the RBNZ's sights. We are of the view that house price growth will prove to be slightly weaker than the RBNZ's outlook through to the end of 2015, though in the here and now the RBNZ will be comfortable with market trends. What is telling is that the RBNZ has barely needed to revise its house price forecast even though migration has been stronger than it expected.





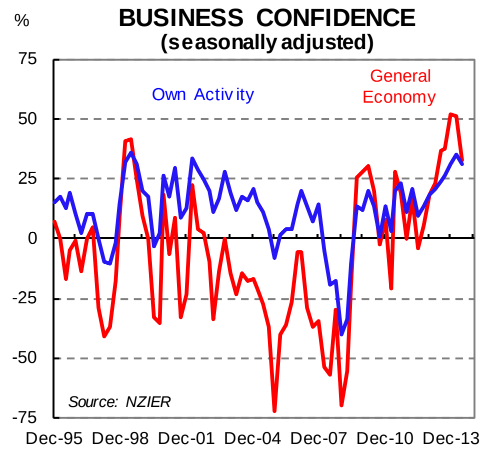




NZ economy starts 2014 on a solid note.

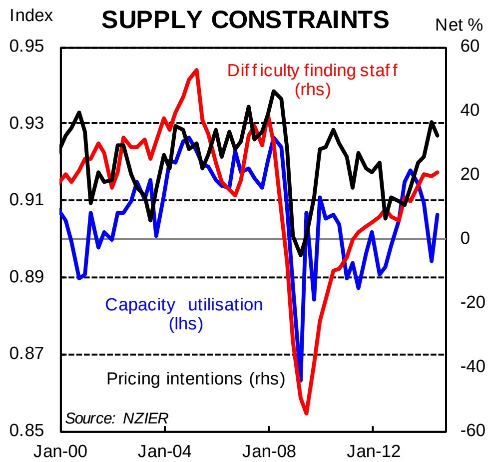
Growth momentum continuing

Q1 GDP showing growth of 1% over the quarter was close enough to the RBNZ's forecast to keep it confident enough about the outlook. The release confirmed that the ramp-up in construction activity is leading growth in the NZ economy. But the details, including flat consumption, won't have caused alarm: household demand is not likely to be an added threat to the inflation outlook.



Business confidence easing but remains high.

Business confidence is starting to ease, suggesting some slowing of economic momentum ahead. But some easing is to be anticipated with interest rates going up, dairy prices falling and an election approaching. Even with recent falls, confidence is at levels that are consistent with solid economic momentum.



Headline inflation as expected, but non-tradable inflation weaker.

Inflation benign

Q2 CPI came in bang on the RBNZ's June MPS forecast, but the weaker than expected non-tradable inflation suggested a benign inflation environment. Although housing-related prices continue to pick up steadily, prices across many of the services groups were subdued.

Net migration inflows will boost labour supply and keep a lid on wage growth.

Inflation gauges remain moderate, though firms' pricing intentions are creeping up. We remain of the view that the strength of migration flows will substantially boost the supply of labour, meaning an only gradual fall in the unemployment rate and muted wage pressures in meantime.

Recent softening in data and continued high NZD reasons for RBNZ to pause after July.

Weighing up: hike this month but plenty of reasons to pause beyond that

The momentum in the NZ economy support our expectations of a July OCR increase. But the softening tone of recent data, and in particular the continued divergence of the NZD and dairy prices are valid reasons to then pause. The inflation outlook is not setting off any alarm bells, either, and the housing market is in line with expectations despite migration's strength.

The big picture also suggests the RBNZ has plenty of scope to wait after July. The RBNZ will have delivered half the 200bp of tightening its June MPS forecasts suggested were needed over 2014 and 2015. A pause gives time to assess the impact of the rapid-fire hikes made to date, particularly as the initial impact was masked by low term rates. And, the RBNZ has leeway to sit out any pre-election and post-election uncertainties and assess how the dust settles.

We expect the RBNZ to hike in July, before pausing until December.

Implications

We expect the RBNZ to hike in July and then pause until December, before gradually lifting the OCR to 4.5% by the second half of 2015. Market pricing is closely in line with our view over 2014, but for 2015 is a touch behind our view. The market continues to discount the RBNZ's implied 5+% peak.

Challenge for RBNZ in communicating that pause.

The challenge for the RBNZ in pausing after July is minimising the propensity of financial markets to interpret a pause as the first step towards ending the whole tightening cycle. For this reason the RBNZ is likely to be cautious about signalling too strongly that a pause in September is probable, and that caution is likely to shape the statement's wording. The RBNZ will be keen to avoid unwittingly reversing the effective tightening it has enacted since March.

Background to the data

OCR formally reconsidered every 6-7 weeks.

The Reserve Bank of New Zealand (RBNZ) releases a Monetary Policy Statement (MPS) each quarter outlining its thinking about the economy, especially future growth and inflation rates. At the Statements and at mid quarter Reviews the RBNZ take the opportunity to review the setting of the Official Cash Rate (OCR) target.

The OCR target effectively locks the level of wholesale overnight rates. Other wholesale short-term interest rates change to reflect anticipations of where the OCR might be in the ensuing weeks. In turn, the retail rates set by the banks will adjust to the level of wholesale rates.

Wholesale and retail rates need not adjust in the same direction and magnitude of any OCR change. The reaction will depend on the extent to which the RBNZ action has already been anticipated and built into rates.

While interest rates are a key factor in exchange rate determination, the exchange rate may or may not also respond to changes in the level of short-term rates. Other factors may also come into play at the time.

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