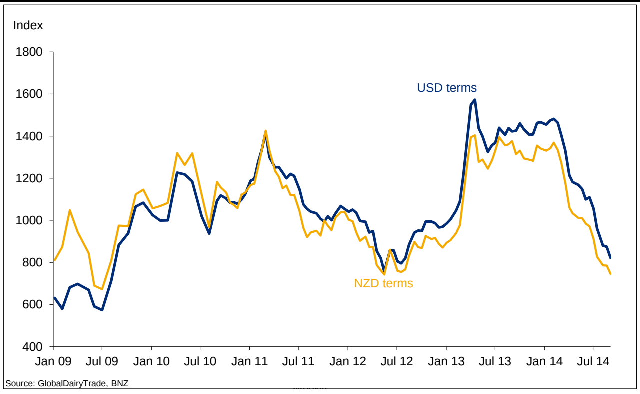
Economy Watch

5 September 2014

Dairy Curdles Prospective Rate Hikes

- RBNZ on hold for some time
- As downside risks to growth and inflation dominate
- Dairy prices and the currency of prime importance
- Nonetheless, interest rate neutrality remains the goal
- Markets may be underpricing this intent

Dairy Auction Prices - GDT



The RBNZ is in an awful position as it tries to disseminate two key messages which might appear, at face value, contradictory. Given recent economic developments, the RBNZ will need to signal that it is on hold for the foreseeable future until there are clear signs of building inflationary pressure. Yet, at the same time, it will want to maintain its view that the cash rate needs to move, eventually, back to neutral, which must be at least 100 basis points higher than where it is now.

Deliver a statement that is too dovish and it risks a rally in money market rates which might lead to much lower mortgage rates and excess stimulus for an already overvalued housing market that is far from its death throes. Come across too hawkish and you end up with a credibility issue, given the negative news that abounds, and a NZD reaction that exacerbates that negativity.

We thus believe the RBNZ will try to take the middle line in delaying its next rate hike into 2015 (or at least talk about the risk of such) while still publishing an interest rate track that shows the cash rate headed back to at least neutral (4.5%) by the end of the forecast period.

This moderated stance has its roots in the June Monetary Policy Statement in which the Bank produced the following statement "The projection for inflationary pressures, and so how far and how quickly interest rates will need to move, depends on developments in several key economic drivers – in particular export prices, the exchange rate, net immigration, the housing market and construction. How households and businesses react to these drivers and to increases in interest rates, will also be important".

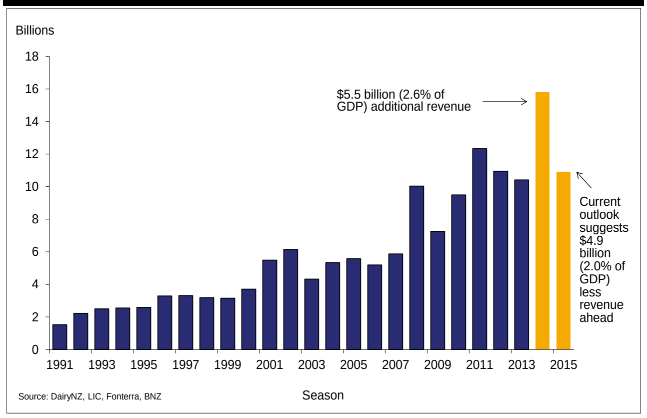
While there has been movement in each of these factors, and sometimes in opposing directions (in terms of the monetary policy response), we believe that the dominating force is the drop in dairy prices that has occurred without an appropriate offsetting slump in the NZD. Sure the NZD has fallen – but not enough.

We all knew dairy prices were going to fall and fall a lot. Given past cycles we probably shouldn't have been surprised by the fall that has occurred, but we have been. And we suspect that the RBNZ has been too. The GDT price index is now down a cumulative 45% since February and 25% since the forecasts for the June MPS were put to bed. Unless things improve, which seems increasingly unlikely, the boom in dairy revenues that occurred in the year ending September 2014 will be almost entirely obliterated in the upcoming season.

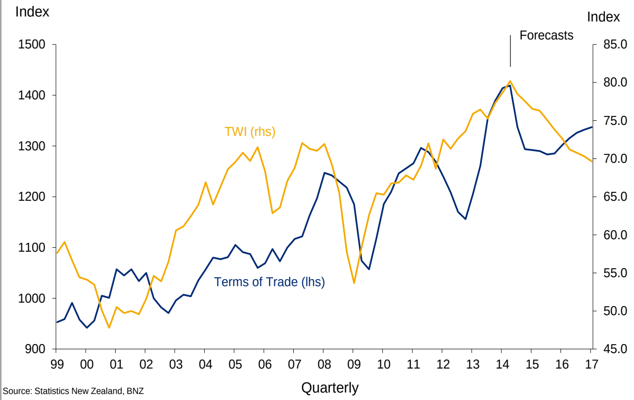
And yet the NZD is barely reacting. It has fallen. Indeed, at current levels it is where the Reserve Bank assumed it would be through the December quarter of this year. But that assumed level would not have been the level anticipated had the Bank projected the extent of the dairy price slump that has eventuated. To put this in perspective, the RBNZ was looking for a 27% fall in dairy prices over 2014. This is miles short of reality.

Ironically, while we are convinced that the slump in dairy prices will eventually show up in the terms of trade, that

Dairy Revenue Proxy



Terms of Trade and TWI



Source: Statistics New Zealand, BNZ

measure is currently well above the RBNZ's published expectations. In the June MPS the Bank stated that "the projection assumes aggregate export prices will fall by 11 percent over 2014, leading to a 10 percent fall in the terms of trade." The Bank may be using a slightly different measure than are we but, given the surprisingly strong Q2 Terms of Trade outturn, we are forecasting a 7.9% drop in export prices for the year and a 6.9% drop in the terms of trade.

Nonetheless, the Bank clearly made the point that "If the exchange rate were to remain elevated while commodity prices fell, the 90-day track would need to be even lower than depicted here (the June MPS track) for inflation to settle at 2 percent".

Not only is the export price/currency combination putting downside pressure on the RBNZ's rate track but the housing market also appears to be on the softer side of expectations. The RBNZ was quick to conclude that house sales were impacted more adversely by the LVR restrictions than it had anticipated but was not so convinced of the pricing impact. However, more recent data suggest that price pressures may also be more moderate than at first believed.

According to the PropertyIQ data that the RBNZ uses, annual house price inflation for the year ended March 2014 was 7.2% compared to its forecast of 7.6%. More importantly, even if prices grow 1.0% per quarter from here on in, annual house price inflation drops to 3.0%, much lower than the RBNZ's 6.5% projection.

It's not clear to us why house price inflation, on this measure, is as low as it is. Perhaps it's because:

- the increase in supply is taking pressure off the market;
- houses are simply unaffordable so demand is dropping;
- the LVR restrictions really are biting;
- the upcoming election is having an adverse impact on housing market activity;
- Interest rate hikes are hurting.

Whatever the case, house price inflation is moderating for the time being. That said, be aware that the measure of house price inflation that the RBNZ uses seems, at this stage, to be showing more moderate house price inflation than other measures such as QVNZ which continues to suggest inflation of around 7.0%.

The inter-relationship between the housing market and migration is also a key point of interest. Net migration inflows are clearly threatening to exceed the Reserve Bank's expectations by a significant amount. The possibility of such was highlighted by the Reserve Bank, in June, as the single biggest risk to its forecast interest rate track – on the upside! Given where the migration flows appear to be headed, RBNZ scenario analysis would suggest that interest rates should be some 50 basis points higher, as a consequence.

The RBNZ's "projection assumes annual net inflows peak in mid-2014 at 37,000 working age persons". We reckon the peak will be closer to 50,000 but are quick to point out that, right here and now, the annual reading is only a tad above the RBNZ's expectations. But net migration inflows would have to drop sharply, relatively soon, if the Bank's forecasts are to be proven accurate.

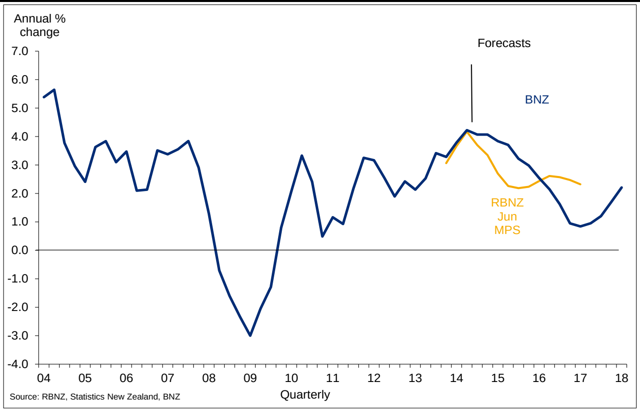
The really interesting aspect of the Bank's alternative scenario, however, is the manner in which higher net migration is transmitted to the broader economy. In short, the Bank's models show higher migration leads to higher house prices, which in turn feed into private consumption, stronger GDP growth and heightened capacity problems leading to more generalised inflationary pressure. So under the Reserve Bank's alternative scenario, house price inflation rises to 8.5%. But, as already noted above, the housing market is not displaying these characteristics so, all other things being equal, the inflationary impact is mitigated.

Moreover, the RBNZ seems to be suggesting that the supply side impact of migration on the labour market is proving to be more disinflationary than first thought.

Putting all this together, it would appear that the upward pressure on interest rates from the stronger than expected migration inflows will not be sufficient to fully offset the downside impact from the other factors already discussed.

There has also been some talk that growth is falling behind expectations and that this will further moderate the Reserve Bank's stance. This has been further supported by declines in business and consumer confidence. We think this analysis is misguided.

Gross Domestic Product



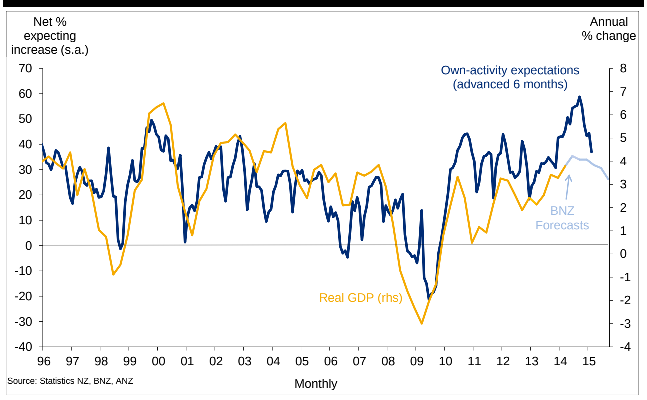
To start with, the RBNZ forecast 1.1% growth in Q1 GDP. The published outcome was 1.0%. Not only is this insignificantly different to the Bank's forecasts but there were upward revisions to back data. Moreover, while activity indicators are tending to surprise us on the downside, such surprises are not great enough to have us revising our GDP track as low as the RBNZ's profile of Q2 2014 0.9%, Q3 0.7%, Q4 0.6%, and Q1, 2015 0.5%. Bear in mind we are getting around 0.4% GDP growth per quarter from population growth alone.

And, yes, the confidence indicators are turning down but, at this stage, they are still consistent with a robust pace of growth. It's also worth remembering that if annual growth remains at any level above 2.75% it is further generating inflationary pressure.

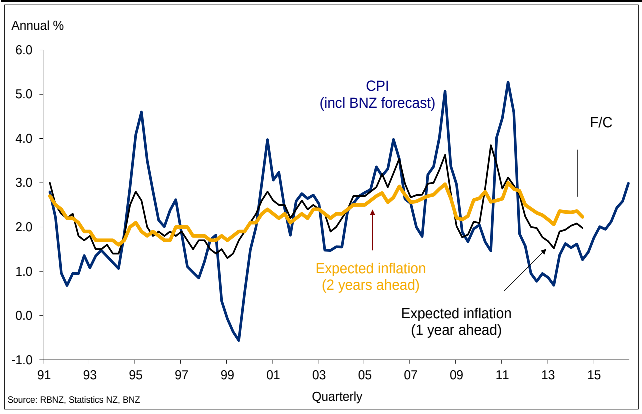
Of course, let us not forget that this is all about inflation – nothing more, nothing less. In this regard the RBNZ will be overjoyed that inflation expectations appear to be in decline whether measured via such things as the business surveys or the RBNZ's own survey of expectations.

For example, both the one and two-year ahead expectations of annual CPI inflation fell in the latest RBNZ survey. In the last quarter the one-year expectation has gone from 2.08% to 1.96%. The two year from 2.36% to 2.23%. In its July OCR review the RBNZ said that "it is important that inflation expectations remain contained". They will thus be happy on this front.

Business Expectations and GDP



Inflation and Inflation Expectations



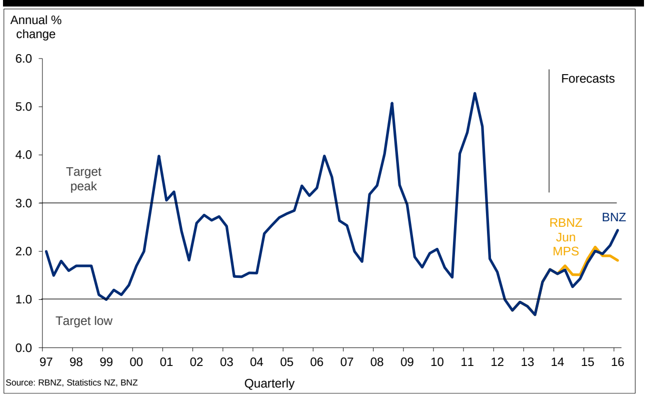
There is a view that the Q2 CPI had surprised the RBNZ to the downside. It may have at the margin, and in composition, but the published outturn was actually bang on expectations at 0.3%. Non-tradables inflation was lower than expected but this was offset by higher tradables prices. The later might have been effected by increased demand allowing businesses to increase margins.

That said, everything we see suggests softer immediate inflation outcomes than we had once believed. We are now looking for the CPI to increase just 0.5% in Q3. The June MPS forecast by the RBNZ is 0.8% but we suspect that it will be dropping its forecasts too. We now see inflation at 2.0% or less through until Q3 next year. It's hard to raise rates in such an environment.

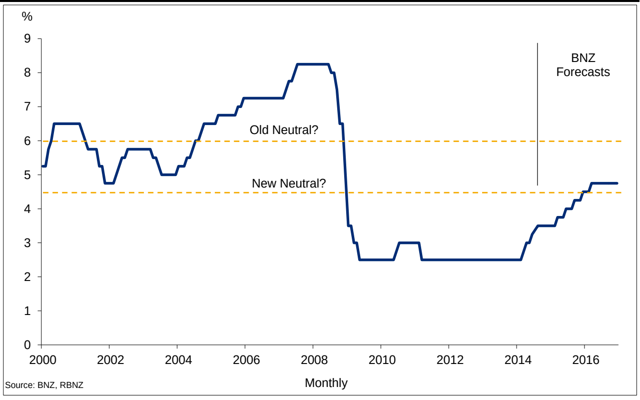
Importantly, continued low inflation feeds upon itself by lowering expectations and keeping a cap on wage growth. While we are expecting wage growth to accelerate, given the declining unemployment rate, there is little sign of such (with the exception of the construction sector) yet. Again, from the June MPS, "Continued weakness in wages could have implications for our assessment of the pricing environment and outlook, and so for the pace of interest rate increases required".

Putting all this together, we see no option but for the RBNZ to take a less hawkish stance when it releases its September Monetary Policy Statement. The Bank was

Consumer Price Index



NZ Cash Rate



never going to raise rates in September, nor October for that matter, so this should be confirmed. The real point of interest is when the Bank resumes its tightening cycle, how far it goes and the general tenor of the statement in terms of risk.

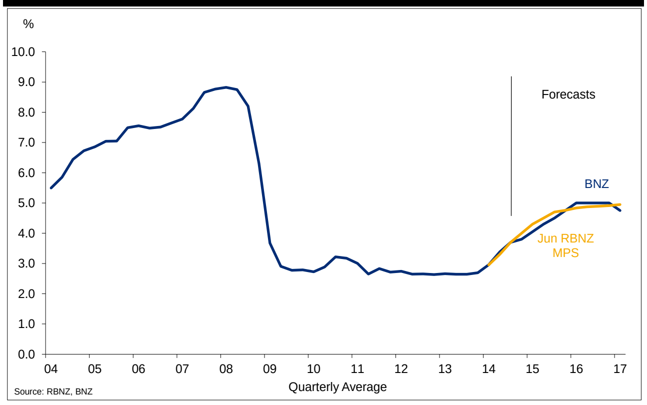
In reality, we believe the Bank is now on hold indefinitely until it finds the excuse to resume the tightening cycle. We believe that excuse will be provided in its published forecasts by further depreciation in the exchange rate and the eventual push in the economy towards substantial excess demand.

We think the Bank will signal as much with a penciled in rate hike around the end of Q1 next year. This will represent a delay of a quarter relative to its June missive.

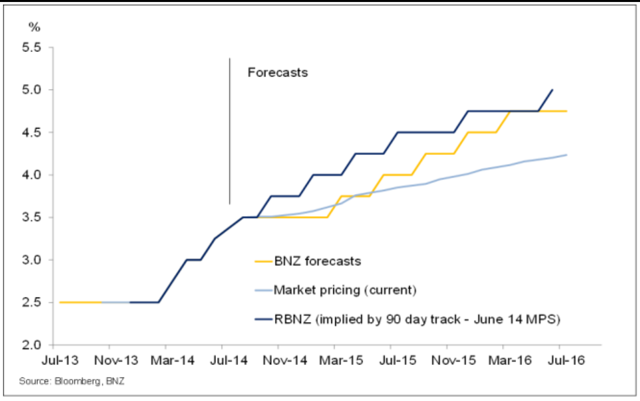
The Bank won't really have a strong view on the track of interest rates as it will be highly conditional on a multitude of potential economic developments. Be that as it may, we think it will want to stick to the story that the cash rate will need to eventually move to neutral so will maintain a cash rate peak at around 5.0%.

Given this, we are formally removing our December rate hike call but are leaving the remaining moves as previously published. Namely, four rate hikes through calendar 2015 (starting in March) with a further move in March 2016. This takes the peak in the cash rate to 4.75%

90 Day Bank Bills



OCR Expectations



compared with our previous forecast of 5.0%. The rate track remains highly dependent on our view that the NZD falls consistently from here on in.

Our actual track has quarterly increases in the cash rate. Of course, this won't be the case. The track should be seen as indicative only. In reality, the Bank will, when it meets its hurdle for action, push through with a series of hikes in short shrift and then pause again – in the manner of this year. It's just that there is significant doubt at this juncture as to when such a process might begin.

Similarly, market pricing is almost certainly wrong. The market is pricing 35 basis points of hikes in the next twelve months and 50 by the end of next year. We, and we believe the Bank, will be looking for more than that to get the cash rate nearer to neutral. But the real point here is either the RBNZ doesn't go at all, because the wheels fall off the economy (potentially true but not our forecast) or the Bank embarks on a series of rate hikes such that 35 points is clearly not enough. So one way or t 'other there's room for a significant move, eventually.

How the market responds on the day to "the lower for longer but higher eventually" message is anyone's guess.

We would be gobsmacked if the Bank didn't mention the currency's overvaluation yet again. We also think that in the event that the NZD shows weakening tendencies on the day it may provide the RBNZ the opportunity for a bit more passive intervention. There is a risk, however, that the "eventually higher" part of the message ends up holding the currency aloft. In which case the opportunity to meddle would be reduced.

This is an extraordinarily difficult environment for the central bank to operate in. So far it has managed the process with aplomb. We reckon it will broadly stick to the same song but simply won't be able to ignore the downside risks to both growth and inflation that have been building. Consequently, the rate track may well be moderated and there can be no doubt that the Bank will spend more time highlighting the downside risks to its June projections than the converse.

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