A slower beat

- We expect the September MPS to imply the RBNZ will remain on hold until early 2015.
- RBNZ's interest rate outlook likely to be revised down around 30bp for mid-2017.
- More tough talk on the NZ dollar likely after July's "unjustified" and "potential for significant fall" comments.

The RBNZ's language and forecasts in its September Monetary Policy Statement should reinforce our and market views that the RBNZ is most likely to remain on hold until 2015. All up, developments have lessened the need for further interest rate increases. Dairy prices have continued to fall and the NZD, though in line with the RBNZ's June outlook, has still barely responded to the substantial year-to-date price falls. Confidence surveys reinforce that economic growth will inevitably moderate. House prices appear well contained, though net migration inflows have run ahead of RBNZ assumptions.

The RBNZ's tune has changed since the June Monetary Policy Statement when it give markets a metaphorical clip around the ears for driving term interest rates too low for its liking. Although we don't expect the RBNZ's growth and inflation forecasts to change much, we do expect the RBNZ will forecast lower interest rates than it did in June to get those outcomes.

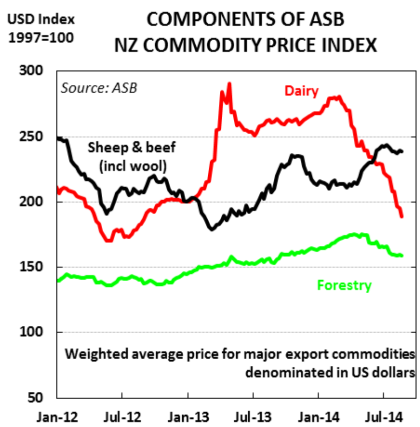
The extent to which the RBNZ revises down its 90-day bank bill forecast and length of any short-term pause will influence interest rates on the day. We expect a 30bp reduction to 5% for mid-2017 and a 3.8% rate for December 2014, outcomes that are likely to satiate markets. Market pricing is actually better aligned with drop of around 50bp in the RBNZ's forecasts, so a downward revision of 'only' 20bp or less could even see a modest lift in interest rates on the day. The RBNZ is also less tolerant of the NZD's stubborn strength, so be prepared for further pointed comments about the NZD's still-high level.

We expect the RBNZ to remain on hold until March 2015. The balance of risks is slightly towards an earlier start through scenarios such as a marked drop in the NZD or a very sharp rebound in dairy prices. The outcome of the looming election will be another factor to take into account, with recent political developments making the outcome appear finely balanced.

Commodity prices softer

Further falls in dairy auction prices are a downside risk to Fonterra's milk price forecast.

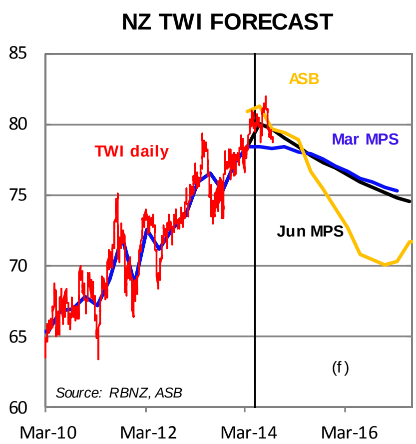
Further weakness in dairy prices since the July OCR increase is a fresh downside risk to the RBNZ's outlook. Since July 24 Fonterra has revised down its 2014/15 season milk price forecast to $6/kg milk solid from $7 and we have revised our forecast of Fonterra's milk price to $5.80. The GDT auction price has dropped a further 15%, signalling downside risk to those respective milk price forecasts. Forestry prices have fallen a further 3% in USD terms over the same period.



NZD – no need for upward revision

The RBNZ won't need to revise up its NZD view, for a change.

This MPS is likely to be the first since September 2013 in which the RBNZ hasn't had to revise up its forecast for the NZD Trade Weighted Index. It is even possible the RBNZ shaves the forecasts back a fraction but any changes should be modest.



NZD has softened recently, RBNZ may have been active.

The NZD has softened through a combination of RBNZ warnings, markets responding a little more to weakening dairy prices, and through the USD itself also looking a touch stronger. There are also strong rumours the RBNZ has been active in the FX market. Perhaps the RBNZ has taken the view that rather than revise up its NZD outlook again it will make the NZD come down to its outlook?! Light will be cast on that issue with the RBNZ's August FX reserves figures, for publication on September 29. Until then, the whodunit question

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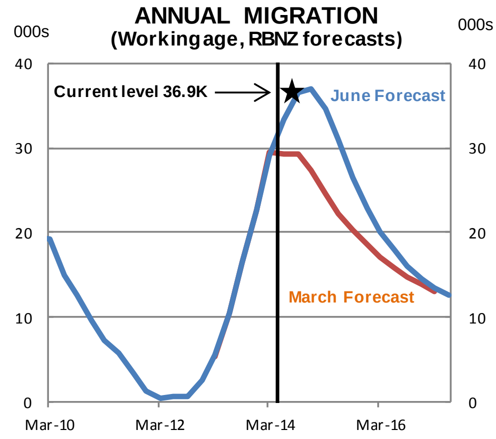
September 29. Until then, the whodunit question over some of the recent weakness in the NZD will remain a question of 'did it fall or was it pushed' (though the RBNZ's July comments that "there is potential for a significant fall" imply a degree of premeditation…).

RBNZ likely to make further comments about the high NZD.

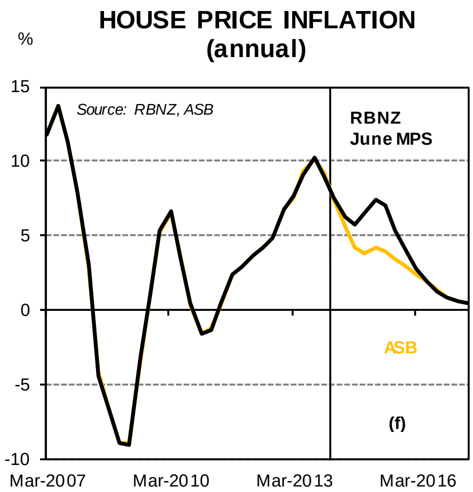
On the MPS day markets should be prepared for further comments about the undesirability of the still-high NZD, which is still only 2 big figures lower on the TWI than before the stern warnings given on July 24.



Migration still ahead of RBNZ expectations

Migration has been stronger than expected.

Once again the RBNZ is likely to revise up its working-age migration outlook, by around 4,000. Annual net migration in the year to July hit the annual total the RBNZ expected for the year to December, and if anything momentum has picked up recently. Though a stronger migration outlook would imply greater demand, there has been some evidence that the boost to labour supply has been quick in coming through.



Housing benign

House price growth appears mild.

House price growth continues to slow, and the nationwide REINZ stratified price index has actually edged down very slightly in the 3 months to July. In contrast, house sales have started to edge up recently after steady decline in the wake of the LVR restrictions. Despite that harbinger of stabilisation, we expect the RBNZ will be comfortable with housing developments from both inflation and macro-stability angles. There is scope for the RBNZ to revise down its house price outlook slightly, despite migration's strength.

Overall growth indicators

Growth solid in near term, early indicators point to future moderation.

Other broader indicators still point to solid growth over the near term, but early signs that growth will moderate are also appearing:

- Q2 retail spending was solid at 1% qoq;
- Q2 Building work up only slightly, though after an exceptional Q1;
- But Q2 employment growth was slightly more modest than expected, and
- Business confidence has softened from elevated levels and consumer confidence is edging down.

Inflation a touch lower in 2014

Inflation outlook likely to be lower for 2014.

Outcomes for the Q2 CPI and the July Food Price Index suggest the RBNZ may shave 0.1-0.2 percentage points off inflation for the second half of 2014. Other indicators of inflation pressure still point to a steady but slow rise in medium-term inflation pressures:

- Business surveys show steady cost pressure, though mixed evidence on intentions to raise prices;
- Overall wage growth ticked up slightly in Q2;
- Though construction wage growth continues to decelerate;
- And inflation expectations are still moderating.

Likely RBNZ forecast changes

Main forecast changes likely to be to 90-day bank bill forecasts.

We expect the RBNZ's forecasts to show:

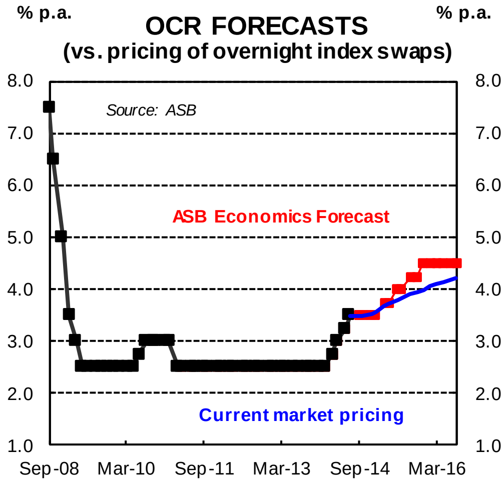
- A similar growth outlook to that of the June MPS (3.5% for March 2015, 2.3% for March 2016), though 2014Q2 revised down from 0.9% qoq.
- Lower near-term inflation, but the medium-term outlook remaining very near 2%.
- The NZD similar to (possibly fractionally lower) than the June MPS forecast track.
- The 90-day interest rate forecast around 30bp lower to 5% at mid-2017.

The quickest way to describe the likely forecast changes would be similar growth and medium-term inflation outlooks but taking softer monetary conditions to achieve that outcome. The downside risks for growth, inflation, the NZD and interest rates have all got a bit larger over the past couple of months.

Near-term 90-day track focus

Added interest in December 2014 90-day forecast

In addition to any drop in the longer-term 90-day forecast, an important detail will be how much lower the 90-day forecast for December 2014 will be compared to the 4.0% forecast in the June MPS. The forecasts should naturally show a rise from a September quarter actual/estimate of 3.7%. If the December forecast was also 3.7% that would strongly imply the Governor was busy with his pencil to explicitly carve a track consistent with the RBNZ being on hold until March. More likely is a forecast of 3.8%: some increase in the near future but leaving some wriggle room over when. A forecast of 3.9% is also plausible but would risk being interpreted as meaning a rate hike is baked in before year-end – well at odds with market pricing. And 4% would be unambiguous in conveying the RBNZ's pause won't extend to Christmas.



Implications

RBNZ to broadly endorse market view that OCR on hold into early 2015.

We expect the RBNZ to broadly endorse the market's and our view that the next OCR increase is likely to occur next year rather than this year. But market pricing is already substantially discounting how far the OCR will increase by the end of 2015: only 50bp compared to our forecast of 100bp (which in turn is broadly similar to where the RBNZ's last forecasts had reached by that point). Swap rates will be sensitive to how far the RBNZ revises down its interest rate outlook. A reduction of 30bp is likely to satiate markets. But, with market pricing better aligned with drop of around 50bp, a downward revision of only 20bp or less could even see a modest lift in interest rates on the day. The RBNZ is also less tolerant of the NZD's stubborn strength, so further pointed comments are likely.

Background to the data

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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