29 January 2015

RBNZ Gambles on a Lower Currency

- OCR on hold at 3.5%.
- RBNZ completely removes its tightening bias.
- Door opened to a rate cut.
- Market expectations for a March reduction misguided.
- NZD slumps, housing market gets an even greater boost.

Today's OCR review was always going to be a test of the Reserve Bank's risk preferences. Specifically, was it more nervous about the possibility that the ongoing strength in the New Zealand dollar might undermine the economy, or was it more concerned that the housing market is again threatening to get out of control? We are erring on the latter view. The RBNZ today showed that it is leaning to the former.

The January OCR review was the RBNZ's most proactive attempt yet to get the currency down. In removing its tightening bias and opening the door to the possibility of a rate cut markets have, unsurprisingly, driven the NZD lower and started to fully price in a rate cut.

The focus on the currency was reinforced by an entire paragraph dedicated to highlighting the NZD's overvaluation and the RBNZ's statement that "We expect to see a further significant depreciation".

We misjudged the RBNZ's risk preferences. But we also think that they have taken a premature gamble with the housing market. There are clear signs that the housing market is again taking off with house sales up 8% in the December quarter 2014 when compared to year earlier levels. Traditionally, this would be expected to result in an acceleration in house price inflation. The Bank is bargaining on the recent pick up as being simply a transitory development as sales bounce back from a weak period pre-election. There may be some truth in this but, with excess demand clearly in evidence and very high migration inflows continuing unabated, it's hard to see much of a softening. Moreover, banks are already competing aggressively in the mortgage market with fixed rates, in particular, on a trend decline. The RBNZ today poured petrol on the fire and has almost guaranteed further, potentially significant, declines in mortgage interest rates. A precursor to this is today's rally in the swap curve which has seen the two to five year part of the curve rally between six and nine basis points.

It will be fascinating from here on in seeing how the RBNZ will confront an over-heating housing market when its own actions will have encouraged the very behaviour it doesn't want to see.

Fixed interest rate markets are now almost fully pricing in a rate cut as the RBNZ's next move. Moreover, the swaps curve intimates that we have now seen the peak in the rate cycle. We continue to beg to differ. While we don't rule out a rate cut as a possibility, we think the rationale for doing so, based on current economic evidence, is limited.

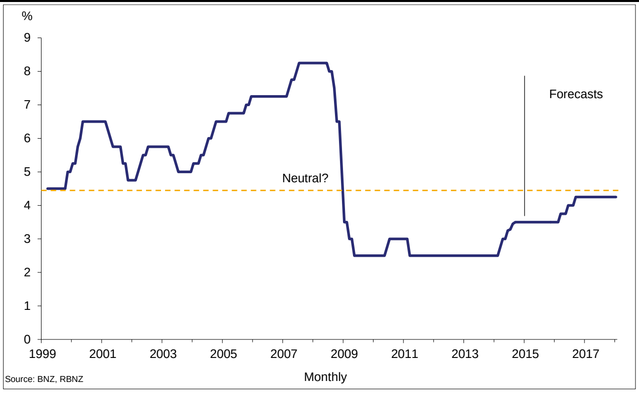
Interestingly, the market currently places a 30% probability on a rate cut at the RBNZ's next meeting in March. We think that, barring any near term disaster, this is way wrong. It also ignores the RBNZ's own conjecture that "we expect to keep the OCR on hold for some time". Even if the Bank does eventually ease, it is much more likely to be at the end of the year than any time soon.

The key data to be released between now and the March meeting include:

- Housing market figures which will show further strength in sales and prices;
- Labour market data which will reveal strong growth in employment and a modest overall tightening in conditions;
- Business and consumer confidence data which will remain consistent with above-trend economic growth;
- Q4 retail sales which should see annual growth in real spending sitting at just under 5.0%;
- A terms of trade outcome that will likely be better than the RBNZ's published views thanks to falling oil prices; and
- A victory in the final of the ICC World Cup for New Zealand over Australia, which will boost confidence across the nation (or maybe not!).

In addition, don't forget that the precipitous drop in the NZD witnessed today actually increases the probability of a tightening.

NZ Official Cash Rate



Given all this, the chances of a March easing look few and far between.

For the time being, we will maintain our call that the RBNZ's next interest rate move will be a hike and that the hike will be in March 2016. We do, however, concede that ongoing low inflation (even deflation) in New Zealand means that the balance of risk is that any hike is further delayed or simply doesn't happen at all. In this regard it is worth quoting from this morning's Federal Reserve statement where the Fed states that "economic conditions, may for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run". In New Zealand's case that longer-run normal is probably of the order of 4.25 to 4.50%. Where it now stands, at 3.50%, is already not far adrift of this level.

So what would it take to see the RBNZ ease?

- A sudden and unexpected drop in global activity;
- A sudden and unexpected drop in domestic activity;
- Further falls in dairy prices;
- A drought.

Of these, perhaps the most likely is the prospect that a widespread drought might knock the stuffing out of an already burdened dairy sector. Recent climatic developments are certainly worrying and we will be following soil moisture levels closely over the next few weeks.

In summary then, we reckon the RBNZ has taken a gamble that the benefits of hammering the NZD will ultimately outweigh the costs of providing more stimulus to the housing market. It's a brave bet and one we would not have advocated. We hope the Bank is eventually proven right!

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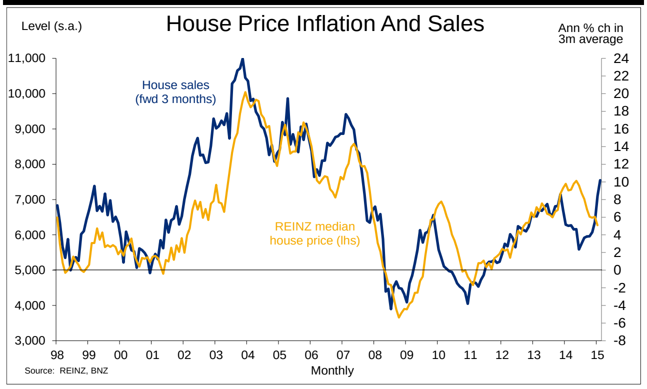
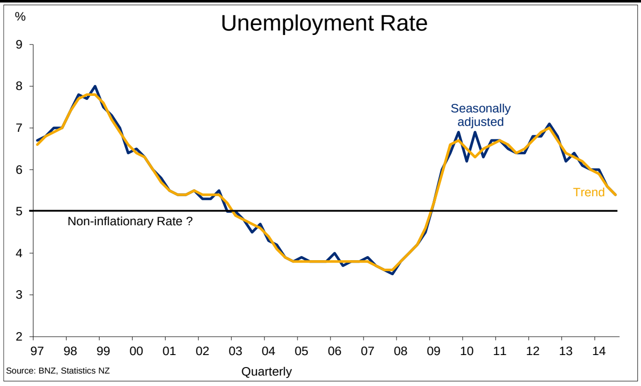
Time to Ease?

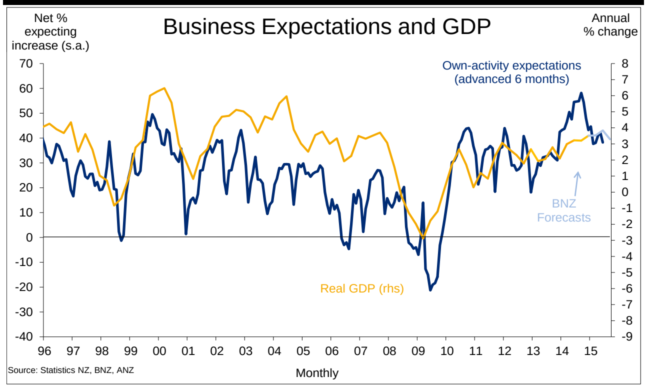
Housing Activity Soaring



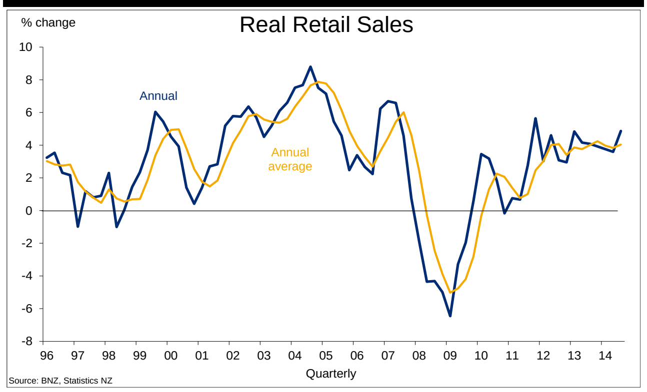
Labour Market Tightening



Confidence Robust



Retail Sales Aggressive



The full text of today's RBNZ OCR Review – OCR unchanged at 3.5 percent

The Reserve Bank today left the Official Cash Rate unchanged at 3.5 percent.

Trading partner growth in 2015 is expected to be similar to 2014, though the outlook is weaker than anticipated last year. Divergences continue among regions, with growth in China, Japan and the euro area easing in recent quarters, while growth in the US has remained robust.

World oil prices have fallen 60 percent since June last year, which will boost spending power in oil importing economies but reduce incomes for oil exporters. The oil price decline, together with uncertainties around the transition of US monetary policy, has led to an increase in financial market volatility.

The lower oil price will have a significant impact on prices and activity in New Zealand. The most direct and immediate effects are through fuel prices, with the price of regular petrol falling from a national average of $2.23 in mid-2014 to $1.73 currently. This will increase households' purchasing power and lower the cost of doing business.

Annual economic growth in New Zealand is above 3 percent, supported by rising construction activity and household incomes. The housing market is showing signs of picking up, particularly in Auckland. However, fiscal consolidation, the reduced dairy payout, the risk of drought, and the high exchange rate will weigh on growth.

While the New Zealand dollar has eased recently, we believe the exchange rate remains unjustified in terms of current economic conditions, particularly export prices, and unsustainable in terms of New Zealand's long-term economic fundamentals. We expect to see a further significant depreciation.

The high exchange rate, low global inflation, and falling oil prices are causing traded goods inflation to be very weak. Non-tradables inflation remains moderate, despite buoyant domestic demand and an improving labour market. Headline annual inflation is expected to be below the target band through 2015, and could become negative for a period before moving back towards 2 percent, albeit more gradually than previously anticipated.

In the current circumstances, we expect to keep the OCR on hold for some time. Future interest rate adjustments, either up or down, will depend on the emerging flow of economic data.

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