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NEW ZEALAND ECONOMICS
PREVIEW OF RBNZ JANUARY OCR REVIEW

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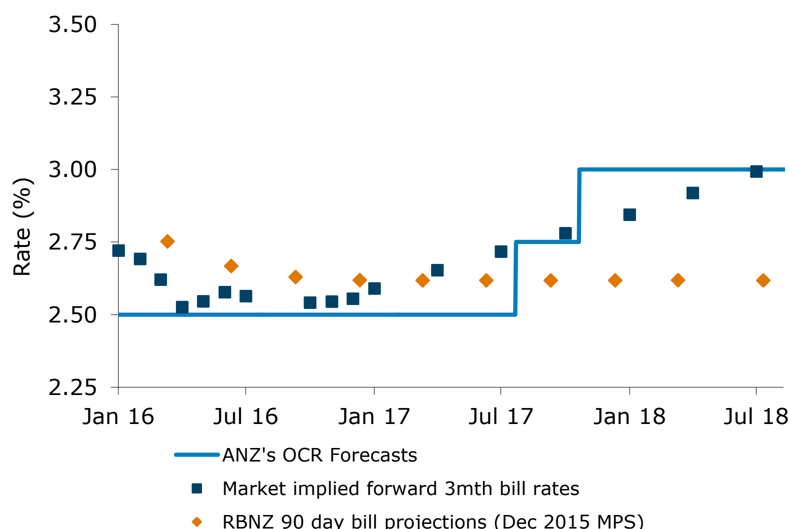
WATCHFUL RATHER THAN ACTIVE

KEY POINTS

- We expect the RBNZ to maintain the OCR at 2.5% next Thursday (9:00am NZT). This view is in line with the unanimous analyst community and market pricing.
- Certainly, low headline inflation, the fragile global backdrop and falling oil (commodity) prices are providing plenty of food for thought, and keep the risks skewed towards future OCR cuts.
- But a very solid domestic economy and upward tilt in the RBNZ's preferred measure of core inflation to a four-year high should keep it watchful rather than active. If headline inflation were low *and* growth decelerating it would be a completely different story; that's when you cut or at least set the stage. We have low headline inflation amidst accelerating growth.
- That said, given the heightened negative risk profile globally, we expect a slight tilt in language and tone towards the dovish side, but not a lurch. The RBNZ noted last time that it would "reduce rates if circumstance warranted" and, whilst this states the obvious, it still applies.
- The market currently has close to a full 25bp cut priced in by August and is broadly 50% priced for a cut in March. While developments offshore could quickly turn that into a reality, as it stands we struggle to see a March cut eventuating, given the current state of the domestic economy. The RBNZ will certainly not shut the door on the possibility of a March cut, but we suspect those looking for an explicit signal will be disappointed and hence we see a risk of a mild back-up in short-end yields and NZD strength on the day.

ANZ OCR FORECAST VS MARKET IMPLIED 90-DAY RATES AND RBNZ PROJECTIONS



Source: ANZ, RBNZ, Bloomberg

OCR PREVIEW

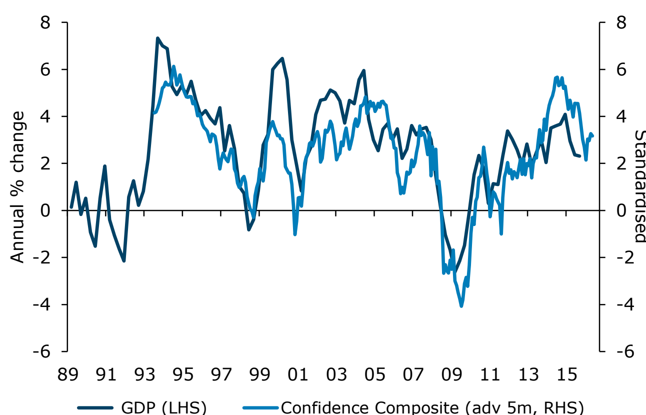
WATCHFUL RATHER THAN ACTIVE

Following the return of the OCR to its post-GFC low of 2.5% in December, we expect the RBNZ to leave policy unchanged next Thursday. This is a view unanimously shared by the analyst community and at the time of writing the market was pricing in only an 8% chance of a 25bp cut.

At its December *Monetary Policy Statement*, the RBNZ delivered a far more balanced assessment of the outlook than in previous communications. The 90-day bank bill projection was flat-lined and economic projections showed an improving outlook for growth and an eventual lift in non-tradable inflation. While a soft easing bias was retained, with the Bank stating that it "will reduce rates if conditions warrant", it presented both upside and downside scenarios for the monetary policy outlook. Specifically, the RBNZ noted that it was watching four factors closely: migration and consumer behaviour on the upside, and El Nino and the global backdrop on the downside.

Since that time, evidence has grown that the domestic economy has rebounded strongly and is performing well. Sentiment has lifted, our Truckometer has surged and the labour market is stabilising. Annualised quarterly GDP growth has risen above 3%; that's above trend. Though recoil is partly at play, underlying growth is not far from 3%. There has even been the odd hint (albeit tentative) of some pricing tension emerging in some pockets, with the RBNZ's preferred measure of core inflation (Sectoral Factor Model) actually rising to a four-year high of 1.6% (although that is still below the target mid-point of course). House prices outside of Auckland have firmed considerably and we're seeing re-leveraging household behaviour. Additionally, given recent rains, downside risks stemming from El Nino look to have reduced.

FIGURE 2. GDP AND CONFIDENCE COMPOSITE



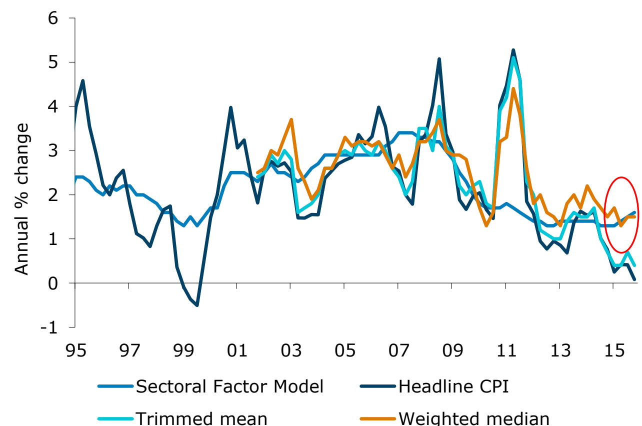
Source: ANZ, Statistics NZ, Roy Morgan

The main downside surprises since December have stemmed from two clear facets:

1. **Oil price weakness.** Since the *MPS*, USD Dubai oil prices have tumbled by about 35%. Together with the NZD TWI holding at a still-elevated level, the lift in tradables inflation that the RBNZ was looking to help drive headline inflation back into the target band is not going to occur to the degree expected. Additionally, the Q4 CPI data showed competitive pressures are containing the inflationary impulse from the lower NZD. A return of headline inflation to the target band won't occur until late 2016 at the earliest, and back to the target midpoint beyond that!
2. **The global backdrop.** Financial markets have started the year horribly. Equities are weak, credit is deteriorating, funding costs are on the increase, commodities are falling and volatility is rising. Chinese economic concerns are front and centre. Asian currencies are under pressure.

We don't think there is enough in these yet to shift the RBNZ back to a more explicit easing bias much beyond what was laid out in December. It's hard to ignore better growth prospects (outside of dairy anyway) and rising inflation from the RBNZ's preferred measure. This measure of core inflation has been remarkably stable, so it's notable when it starts to shift. **If growth were decelerating at the same time inflation were low it would be a completely different story; that's when you cut or at least set the stage. We have low inflation amidst accelerating growth.** While we can question how sustainable domestic prospects will prove to be amidst global turbulence, rising funding costs and commodity price trends, that's a question the RBNZ (like us) can't answer with any conviction.

FIGURE 3. CPI AND CORE INFLATION MEASURES



Source: ANZ, RBNZ, Statistics NZ

OCR PREVIEW

However, the risks are blatantly obvious with global developments fluid, to say the least. This probably tilts the balance in language towards something slightly more dovish than expressed in December, but a tweak, not a lurch. The RBNZ noted last time that it would "reduce rates if circumstance warranted" and, whilst this merely states the obvious, it still applies. The same nuances in some shape or form will no doubt appear again.

While we are closely watching funding costs, China, the currency, confidence, core inflation, credit growth, and contagion risks (all the C's), to name but a few, the reality is that given low inflation, any signs of a turn, or questions over local real activity prospects, would necessitate a policy response. We are not at that point yet.

FINANCIAL MARKET IMPLICATIONS

The market currently has close to a full 25bp cut priced in by August and is broadly 50% priced for a cut in March. While developments offshore could quickly turn that into a reality, as it stands we struggle to see a March cut eventuating given the current state of the domestic economy. The RBNZ will certainly not shut the door on the possibility of a March cut, but we suspect those looking for an explicit signal will be disappointed and hence we see a risk of a mild back-up in short-end yields and NZD strength on the day.

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