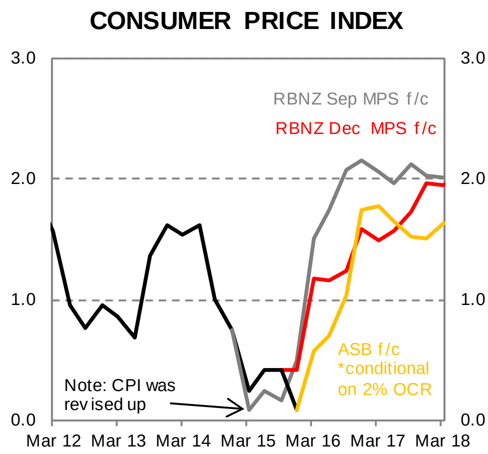
Circumstances warrant

- **Inflation is very low and will continue to track below the RBNZ's recent expectations.**
- **We continue to expect the RBNZ to cut the OCR in June and August – but risks are skewed to an earlier move.**
- **We expect a clearer easing bias, though a strong signal for a March OCR cut is unlikely.**

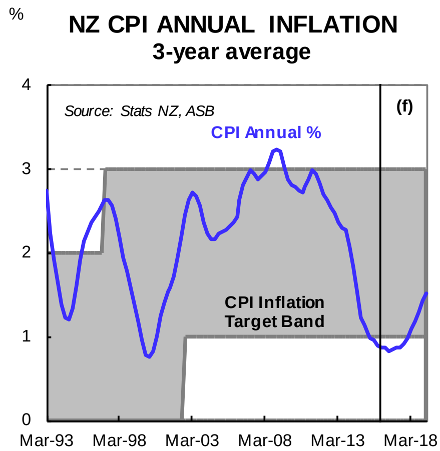
Summary
The risks have grown that inflation will remain weaker than the RBNZ's most recent inflation forecasts. The weak Q4 CPI showed little of the NZD impact the RBNZ is banking on. Added weakness in oil prices will hold inflation lower for longer, further increasing the risk that inflation expectations remain low. Question marks over China's economy have renewed, along with another bout of equity market weakness. The NZD still risks remaining slightly firmer than the RBNZ has bargained on. We continue to expect 50bp of OCR cuts from June, but the risks are skewed to an earlier start.

Developments, particularly the weak Q4 CPI outcome, should be prompting a rethink within the RBNZ. The extent to which any sea change is evident in the January OCR Review is critical: markets are pricing in a high chance of a March cut and fully pricing a 25bp cut by June. We think the January OCR review is a little too soon to get a clear signal the RBNZ will cut as early as March, but even so both the March and April OCR windows are now 'live'.

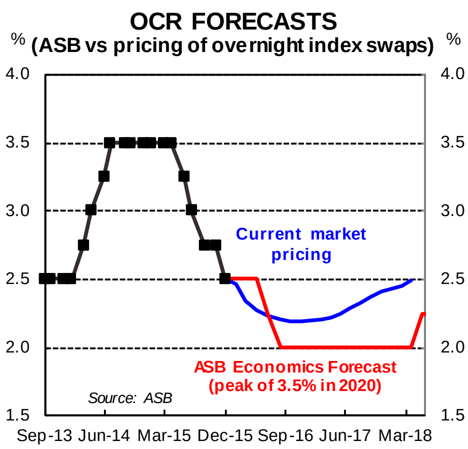


Comment
All up the risks have grown that inflation remains lower than the RBNZ has assumed. To use the RBNZ's turn of phrase, OCR cuts are now more a matter of when rather than "if" circumstances warrant.

We are not convinced the RBNZ will strongly signal – yet – that it is seriously contemplating an imminent OCR cut. A strong signal could be along the lines of "it is increasingly unlikely that inflation will return near the target mid-point without further policy easing" and that the RBNZ "will reassess in March whether further easing is appropriate". Such a signal would have markets and forecasters zeroing in on the March or April OCR windows as likely timing for policy action.



We expect it will take a little longer for the RBNZ's stance to change significantly. At the least we expect the RBNZ to now show more of an easing bias than was clear in its staunch-sounding December MPS. The RBNZ may express more uncertainty about the (lack of) inflationary impact of the lower NZD, will note that oil prices will restrain headline inflation over the next year, and should note that global risks have increased. The March OCR window and onwards now are all realistic possibilities for OCR cuts.



We see two looming consequences of an even more subdued inflation environment. First, **inflation expectations may remain subdued for longer.** With that comes the added risk that monetary policy is less effective in pushing inflation back up.

Second, inflation has been extremely low for a considerable time. **By our estimates annual inflation will spend 7 quarters (nearly 2 years) below the 1% floor of the target band**. A 3-year moving average of inflation will persist below 1%. Although the policy target emphasises the medium term, the RBNZ doesn't have wriggle room to absorb any further disinflationary surprises.

February's labour market data, the Q1 CPI, housing market developments, the NZD, global growth and global inflation developments will play key roles in determining just when the RBNZ next cuts the OCR.

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Summary of key developments:

- **The Q4 CPI significantly undershot the RBNZ's forecasts** at 0.1% yoy vs. the RBNZ's forecast of 0.4% yoy. Discounting and competition appeared to limit the inflationary impact of the weaker NZD, for that quarter at least, undermining the key driver of the lift in inflation the RBNZ expects. Our full CPI review is here.

- **Oil prices have fallen further still,** pulling down NZ fuel prices. Fuel price falls knocked 0.36 percentage points off the Q4 CPI (just released) and we estimate they will knock a further 0.1 ppts off the Q1 CPI.

- **Net migration inflows** kept setting fresh month-to-month records in the second half of 2015, stronger than both we and the RBNZ had expected. The annual net inflow has hit 63.7k. Continued strong growth in the supply of working-age people, at a time when employment growth is slowing, will keep wage-related inflation pressures subdued.

- The **NZ TWI has again persisted above the RBNZ's assumptions.** The RBNZ is likely to be disappointed by how little the US Federal Reserve's interest rate increase has weakened the NZD. The NZD weakness in the New Year has been triggered by global risk aversion and heightened expectations the RBNZ will eventually cut the OCR further. But the NZD could regather if the risk environment improves or market anticipation of future RBNZ easing gets dashed.

- **Global economic risks have increased.** Much of the focus is on China in the wake of a weak manufacturing survey and plunging equity markets. Commodity prices have fallen, which will further constrain global inflation and NZ import costs.

- **Chinese economic growth has continued to decelerate**, to 6.8% yoy in Q4. More broadly, over the past 6 months the Consensus forecast outlook for NZ's main trading partners has eased by 0.4 percentage points to 3.5%.

- **Dairy risks are mixed relative to the December MPS.** We have revised down our expectation for this season's Fonterra milk price to $4.10. But drought risks have receded with recent rain.

- **Q3 GDP grew 0.**9% qoq, stronger than the RBNZ's 0.6% expectation (review here).

- The RBNZ won't be counting its chickens before they hatch, but **the various property investor restrictions are slowing the Auckland market**, albeit we judge the October-November sales weakness overstated the true impact. More time will give the RBNZ comfort, but continued deceleration of Auckland house price growth will reduce one of the roadblocks for not responding more aggressively to the weak inflation environment.

- For background, our **December MPS review is here**.

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