17 August 2016

The Ironies of Our Delayed RBNZ Call

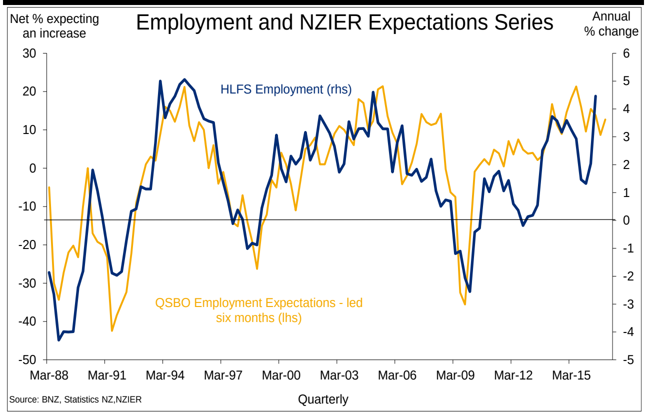
- We delay our expected OCR cut timings to Nov/Feb
- Essentially after recently explicit RBNZ guidance
- Real economy indicators strong
- Including today's HLFS (technicalities aside)
- Also: dairy prices rising, PPI shaking deflation, petrol higher
- But CPI inflation of 2% still far from assured
- Which should worry the RBNZ (but not so much us)

Today we formally delay the timing of the two further OCR reductions we forecast. We now see November and February as the likely strike points. This is rather than the September/November combination we thought the RBNZ would provide scope for in its August Monetary Policy Statement (MPS). We still see an OCR low of 1.50% just that it arrives a bit later. Importantly, this assumes the Bank will follow through with its strong easing signals – consistent with the CPI inflation (expectations) battle it has indicated is crucial to it, amid a strong currency.

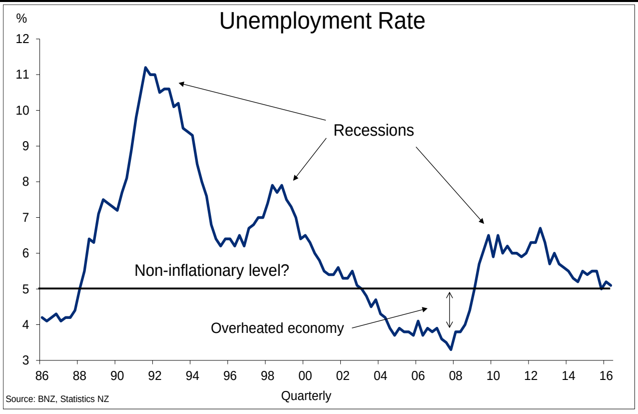
We have not delayed our OCR sequencing because of any change in our base view of the economy (or CPI inflation, for that matter). It's essentially because of recent rhetoric from RBNZ officials. In particular, Assistant Governor, John McDermott's interviews to various newswires, getting across the message that the Bank will defer any further rate reduction until the occasion of November's MPS, even though the Bank was still demonstrably dovish (more so than the market might have taken from the August MPS, initially).

Of course, we continue to stress that the Reserve Bank is, more generally, at risk of cutting the cash rate far too much – if, indeed, it hasn't done so already. Our amended OCR view is about what we think the NZ central bank will do as opposed to what we think it should do.

Q2 Job Growth Not All Technical



Back On An Even Keel



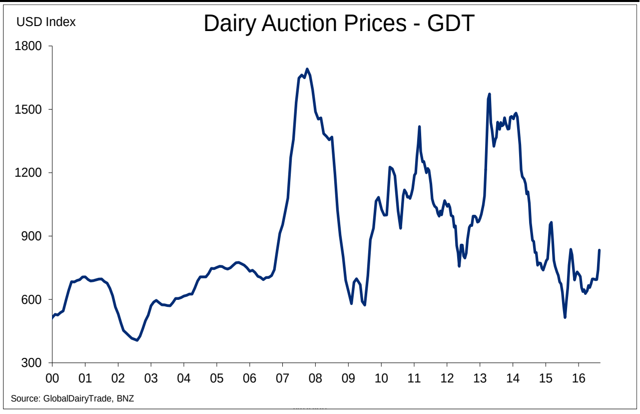
But if the RBNZ wanted any excuse to delay further OCR reduction until November – when the framework it's promoting argues for a more immediate and aggressive easing – then it could find it in recent domestic news.

For example, today's Household Labour Force Survey (HLFS). It was exceptionally robust. Sure, the 2.4% increase in its employment measure in the June quarter came with the newly designed questionnaire. This surely caused a step change in jobs (and participation). This was definitely so in respect to the inclusion of most defence force staff now – worth between 7,000 to 10,000 defence force staff who were previously not included in the Labour Force. But also by way of better capture of the self-employed, given the way the HFLS questions are now set out.

Nonetheless, the utter strength of the Q2 jobs gain, making for annual growth of 4.5%, suggests there's much more to it than measurement issues. A hefty expansion in employment certainly gels with the range of other labour market indicators we monitor, including from the various business surveys.

Through the bumpy bits in today's HLFS, the unemployment rate was arguably the most reliable indicator. It eased to 5.1%, from 5.2%. This tells of a labour market that has firmed up, hiring plenty enough to absorb all comers, including migrants. The RBNZ expected the Q2 jobless rate to be 5.2%, while the market, and, we, expected 5.3%.

Dairy Prices Jump

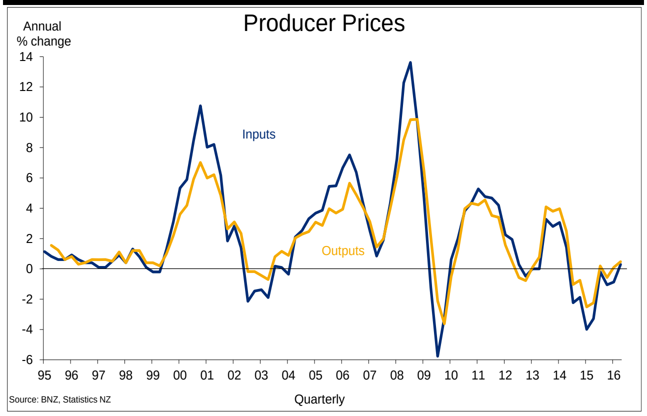


The other domestic news that questions the Reserve Bank's strong easing intent is the dairy sector. A big sore point for a good couple of years now, international (export) prices for the sector are beginning to post a recovery. At the GDT auction overnight the weighted price lifted a further 12.7%, building on the 6.6% gain at the previous event. This has caused us to revise up our milk price expectation for this season (2016/17) to $5.30, from $4.60 previously. This is a bit higher than most recent estimates of dairy industry production costs. For more on this see our note from today entitled "*The Cow Jumps*".

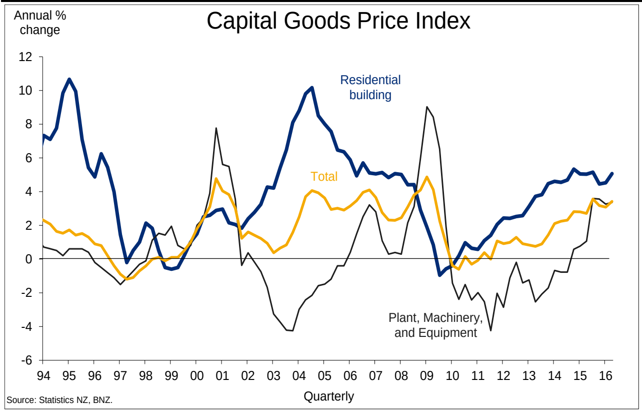
Fonterra's most recent forecast for the 2016/17 milk price was $4.25. So we might reasonably expect a decent upward revision to that, at its next announcement.

The RBNZ should also take some comfort from the fact that NZ producer prices (PPI) are showing signs of shaking their deflationary bent. In figures published this morning,

Deflation Passing



Inflation Undercurrents Firming



the outputs PPI edged up 0.2%, turning annual inflation into 0.5%, from 0.1% in Q1. This turnaround was being driven most of all by the commodity (export) sector. Input prices, meanwhile, lifted 0.9% in Q2, to be 0.3% higher than a year ago. It was only just over a year ago that it was deflating at an annual rate of 4.0%.

This morning's Q2 Capital Goods Price Index (CGPI) also gave a sense that deflationary elements are abating, to reveal a firm tone to underlying inflation trends. Overall, the CGPI increased 0.9% in the June quarter, to be 3.4% higher than a year ago. As part of this, residential building costs accelerated to 5.1% y/y, from 4.5%. While this phenomenon is also "aiding" CPI inflation, it continues to undermine the idea of so-called affordable housing.

Even petrol prices have rebounded a bit over the last week or so – albeit not enough to dent the likelihood of seeing a small dose of "deflation" in the Q3 CPI.

And, despite increased evidence of a robust real economy and firming inflation undercurrents, the RBNZ appears to be hinging an awful lot on its headline CPI forecasts and peoples' expectations thereof. Downplayed is the (PTA) flexibility that the RBNZ quite rightly emphasized earlier this year. It now seems a pitched battle about lifting headline CPI inflation, come what may. As for the stubbornly strong currency, as much as this might keep suppressing tradables inflation, it is concurrently reflecting New Zealand's relative economic health. Therein lays the irony.

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