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OUR TAKE

TUESDAY 26 JANUARY, 2016

Holding one's nerve

January 2016 Official Cash Rate Preview

Key Points

- **We expect that the RBNZ will keep the OCR on hold at 2.50% at this week's review.**
- **While there is a growing chorus of commentators expecting the RBNZ will be forced to cut the OCR at some stage in 2016, we maintain our view that the Bank will keep the OCR on hold for some time.**
- **Despite a volatile global backdrop, recent data indicate NZ economic activity picked up heading into 2016, which is likely to satisfy the RBNZ that there is enough momentum in the economy to lift inflation back to well within its target band in the medium term.**
- **We expect the Bank is likely to tailor a more dovish toned statement compared to the December MPS, and maintain its stance that it is prepared to cut rates if circumstances warrant.**

Summary

We expect the RBNZ will hold the OCR at 2.50% at this week's OCR review. Since the start of the year developments have generally added to downside risks to NZ's growth and inflation outlook. Turmoil on global financial markets, due to concerns surrounding the strength of the Chinese economy, has led to sharp falls in the value of equity markets and commodity prices. Locally, December quarter inflation data fell short of the market and RBNZ's forecast, suggesting that the Bank may have a bigger job on its hands in getting inflation back to within its target band than expected late last year. Consequently, there is a growing chorus of commentators that believe that the RBNZ will need to cut the OCR further in 2016.

However, we maintain our view that the Bank will keep the OCR on hold at 2.50% for some time. September quarter GDP growth came in above the Bank's latest forecast and recent forward indicators of economic activity imply that growth picked-up heading into 2016. We believe there is enough momentum in the economy to convince the RBNZ that inflation will return to well within its target band in the medium term. In our view, the bank is likely to look through the current drop in oil prices, as they did at the beginning of last year, and take a wait-and-see approach before making changes to monetary policy settings. As the RBNZ pointed out in their December Monetary Policy Statement (MPS) "*…interest rates take 18 to 24 months to have their full effect on inflation, and cannot offset short-term inflation movements*". Nevertheless, we expect that the Bank will tailor a more dovish statement compared to their December MPS, showing that the Bank is prepared to cut rates if circumstances warrant.

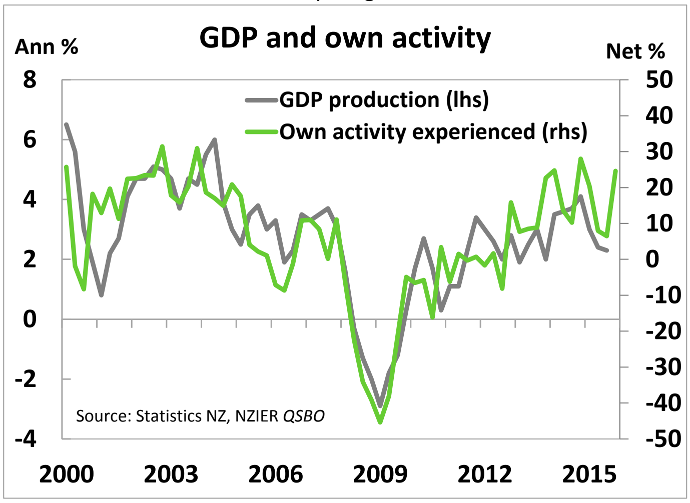
Key developments

Since the start of the year events have generally added to downside risks around NZ's growth and inflation outlook. Developments have prompted many to suggest that the RBNZ will have to cut the OCR further in 2016 in order to meet their inflation target. Offshore, concerns around the strength of the Chinese economy have seen the resumption of volatility on global financial markets. The value of equity markets fell rapidly, and in many cases have broken through lows seen in August 2015, the last bout of market malaise. Commodity prices have also fallen and oil prices hit 12-year lows trading around US$28/barrel – a 28% fall since Jan 1. Domestically, inflation data for the December 2015 quarter came in notably below the market consensus and the RBNZ's forecast, and barely grew over 2015 as shown by the 0.1%yoy increase. Tradables inflation declined 2.1%yoy in Q4 thanks in a large part to lower petrol prices. In addition, there was a lack of evidence to suggest that the depreciation in the exchange rate experienced earlier in the year had fed through to higher prices among importers.

However, we maintain our view that the RBNZ will hold the OCR at 2.50% for some time. Economic activity is likely to have surprised the RBNZ with a 0.9%qoq rate of growth in the September quarter of 2015, and recent confidence indicators (such as the QSBO) suggest that activity has held up heading into 2016. We believe there is enough momentum in the economy to convince the Bank that inflation will return to its target band in the medium term. We believe that similar to the start of 2015, the RBNZ will choose to look through the current sharp fall in petrol prices and prefer to take a wait-and-see approach before adjusting their policy stance. As the RBNZ pointed out in their December MPS "*…interest rates take 18 to 24 months to have their full effect on inflation, and cannot offset short-term inflation movements*".

The main drivers of our view are outlined below:

- **Economic Growth:** September quarter GDP growth at 0.9%qoq was notably stronger than the RBNZ had forecast at their December MPS. More importantly, in recent weeks forward indicators such as the December quarter QSBO indicate that activity held up heading into 2016. Firms' domestic trading activity (DTA), has a close correlation with GDP showed a net 25% of firms surveyed experienced an expansion in activity in Q4 – up from 6% in September and well above the survey average of 11%. Taking the DTA figure at face value suggests that the NZ economy grew 3%yoy in the final quarter of 2015 – from 2.3% recorded in Q3. While we do not expect growth in Q4 to have been that

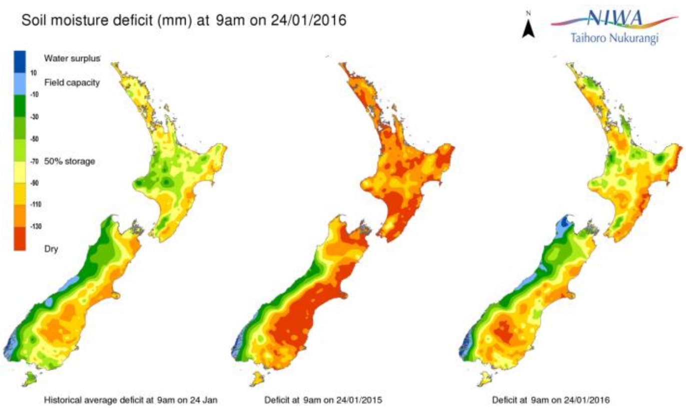


strong, own activity measure does provide an upside to our view that GDP growth was 2.1%yoy. In addition, there was an increase in the net share of firms expecting activity to pick up in the coming quarter. All else equal, the stronger outlook for economic growth suggests that there is less spare capacity in the economy than forecast, providing upside to the RBNZ's projection of non-tradables inflation.

- **Terms of trade (ToT):** The downward pressure on the ToT from lower prices of key export commodities is expected to be in part diminished by the current sharp fall in oil prices – of which NZ is a net importer. Dairy prices on the GlobalDairyTrade (GDT) auction have edged lower in both January auctions – in part due to better-than-expected rainfall. The headline GDT price index is 2.1% below the price recorded in the final auction of 2015. Dairy futures markets have also adjusted their outlook of prices since the current bout of financial market turmoil and suggest that dairy prices will recover at a more gradual pace than the RBNZ is forecasting. While Fonterra has maintained its forecast payout of $4.60/kgms for the current season, several market forecasters have recently lowered their forecasts closer to $4.00/kgms. The recent softness in dairy prices does imply a weaker ToT and farm incomes, a key focus of the RBNZ in 2015. However, sharp falls in global commodity prices have extended to oil. Given the size of the decline seen in oil prices – 28% lower than the start of the year – they are likely to mitigate the downward pressure on the ToT from dairy. For many consumers lower fuel prices are providing a boost to disposable income and subsequently spending.

- **Inflation:** We believe that the RBNZ will choose to look through the recent sharp fall in tradables inflation, which was in part driven by a 7%qoq fall in petrol prices. There are three reasons behind our thinking. First, non tradables inflation, the part of inflation that monetary policy has influence over, came in above the Banks expectation in the December quarter – up 1.8%yoy in Q4 from 1.5%yoy measured in Q3. The Non-tradables figure was driven in large part from rising housing-related prices, which in turn is being supported by the current record low mortgage rates. Second, core measure of inflation implies underlying inflation is stronger than the volatile headline measure indicates. The RBNZ's preferred measure of core inflation, the RBNZ sectorial factor model measure, edged higher through 2015 to 1.6%yoy in Q4 despite headline inflation weakening. Finally, pricing intentions data suggest firms are starting to put through, albeit modest, price rises. The December quarter QSBO revealed that a net 9% of firms expect to raise prices in the coming months.

- **El Niño:** A severe drought caused by the current El Niño weather pattern, while still a possibility, looks less likely than at the start of summer. Many regions have experienced dryer than average soil moisture conditions, but as the chart below shows, conditions are not as dry as the same time last year. Current weather conditions are likely to be satisfying the Bank's December MPS assumption that the El Niño weather pattern will not contributing to a significant decline in agricultural output.



As mentioned above, downside risks to the NZ economy and inflation, and ultimately our view, have intensified since the Banks December MPS. Consequently, the possibility that the RBNZ cuts the OCR below 2.50% in 2016 has increased. Global financial markets responded anxiously to concerns surrounding the strength of the Chinese economy. Equity market values have started the year down sharply, with the Shanghai composite index reaching lows seen last August. Commodity prices, such as oil, have weakened to multi-year lows. If recent global financial market volatility worsens and intensifies the slowdown in global economic growth the RBNZ would be forced to act. In addition, despite that risk surrounding an El Niño -related drought softening, NZ is not out of the woods yet. NIWA has noted that while it expects the current El Niño weather pattern to abate through to the remainder of summer and into autumn, there remains the potential for severe drought.

NZD concerns

Despite the 25bp cut to the OCR in December and the US Federal reserve lifting the Fed funds rate for the first time since 2006, the New Zealand dollar remained stubbornly high at around US$0.6900. Since the start of 2016 the dollar has depreciated as a result of current global financial market events, as investors seek a safe haven such as the US dollar denominated assets. Against the US dollar the kiwi had fallen to just under US$0.6400 (-7%). On a TWI basis the currency has edged closer toward the RBNZ's December MPS forecast for the March quarter, but remains a risk to the outlook for inflation through 2016. At the time of writing the dollar has crept up to around US$0.6500.

Policy Implications

Thursday's policy decision will be contained in a one page statement and therefore limits the amount of information that the Bank can publish. We believe that the Bank will refrain from including any explicit easing bias in the wording of the statement. The RBNZ is more likely to tailor a dovish statement showing that the Bank is prepared to cut rates if circumstances warrant. The move to a more dovish tone will partly be aimed at mitigating any unintended market response.

Market pricing

At the time of finalising this report, the OIS market was pricing in around a 6%-8% chance of a rate cut at this week's OCR review. The market is pricing in a 50/50 chance of a 25bp cut by the RBNZ's March MPS, and almost an entire 25bp cut is expected by September. All 15 economists polled by Bloomberg (including us), expect the OCR to remain on hold on 26 January, and 6/14 see at least a 25bps of cuts in place at the RBNZ's June statement.

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