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OUR TAKE

THURSDAY 26 MAY, 2016

Waiting patiently

Preview of the RBNZ's June 2016 Monetary Policy Statement

Key Points

- **We have pushed back our call for the timing of the next rate cut from the RBNZ and now expect the Bank will leave the OCR unchanged at the June MPS.**
- **We still believe there is a case for an additional 25bps of easing, but we now see the most likely timing as the August MPS.**
- **Data since the March MPS has been mixed, with growth indicators slightly better while inflation pressures remain subdued.**
- **The OIS market has significantly scaled back the pricing for a rate cut in June, with just over a 20% chance of a cut priced. However, the RBNZ is expected to leave the door open for further policy easing if required.**

Summary

Heading into the next RBNZ announcement on June 9 we remain convinced that the RBNZ will end up delivering on the interest rate track presented in the March Monetary Policy Statement (MPS) - cutting the OCR by another 25bps to 2%. The main question however, is one of timing. Since the RBNZ's March MPS, the economic environment has improved marginally while future inflation pressures remain relatively subdued. The two key reasons that the RBNZ cited that support the March rate cut – namely a weaker global growth outlook and a decline in inflation expectations – have not fundamentally changed in recent months. However, other data since March has been slightly more positive from an economic growth viewpoint, and higher oil prices will boost near-term inflation.

Weighing up the combination of data we have seen since the March MPS there doesn't appear to be an urgent need for additional policy stimulus. Moreover, the RBNZ is in the unique position of having back-to-back Monetary Policy Statements in June and August – complemented by the fact that the RBNZ has shown a slight preference to begin or end cutting/hiking cycles on MPS releases. The Bank will have a much clearer picture on both the domestic and international economic outlook if they choose to leave the OCR unchanged and defer any rate change decision to August. By the August 11 MPS, the RBNZ will have had several useful pieces of information, including:

- GDP, CPI and employment data for Q2,
- updated housing market data,
- the Brexit vote will have passed,
- the Fed's June and July meetings will have gone – which may well deliver another rate hike (and hence help the NZD/USD lower), and
- RBA's June and July meetings and a clearer picture on if/when further rate cuts in Australia may happen.

Ultimately, the RBNZ's decision about whether or not to cut the OCR in June will be a close call, and one that the Bank has probably not decided on yet. Our view anticipates that the Bank will choose to again 'keep its powder dry' and wait until it has a clearer picture on the global and domestic landscape before deciding on its next move. Market pricing suggests just over a 20% chance of a rate cut in June with a full 25bp rate cut not priced until early 2017.

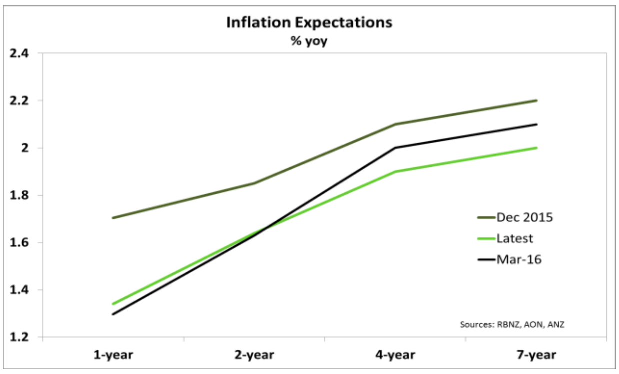
We expect the MPS commentary to keep the door open for one further 25bps rate cut via both its 90-day interest rate track forecasts and the wording in the Statement. They could repeat the last phrases from the April OCR review, stating "*Monetary policy will continue to be accommodative. Further policy easing may be required to ensure that future average inflation settles near the middle of the target range. We will continue to watch closely the emerging flow of economic data*".

Recent developments

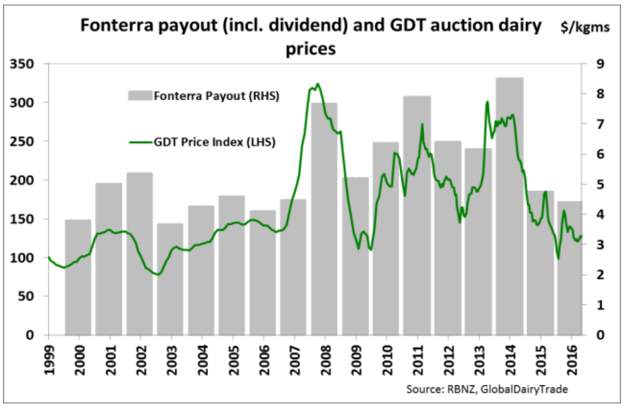
Since the March MPS, data has on the whole been slightly on the more positive side for the economic outlook. However, with inflation expectations remaining low and the NZ TWI still elevated, we think an additional 25bps of easing (as forecast in the RBNZ's March MPS) remains warranted. We discuss some of the key developments since the March MPS below:

- **International outlook:** Both equity and commodity prices are close to year-to-date highs, after declining sharply at the start of 2016. However, the underlying reason behind the sell-off earlier this year – namely weaker global growth concerns – have not substantially changed. Chinese authorities have committed to a GDP growth target of 6.5% yoy over the next five years, but to do this they are having to ramp up public investment spending and credit growth. Bad debts in the Chinese banking system are already rising rapidly and total debt to GDP is now up at 246%, while shadow lending is estimated to be close to 60% of GDP. In addition, there remain several international factors that could spark another bout of market volatility before the end of the year, including; Brexit vote (23rd June), Europe and Greece, and the US election (November 8).
- **International monetary policy:** Markets are now pricing about a 30% chance of a rate hike at the Fed's June 16 meeting following more upbeat minutes from the last FOMC meeting and several comments from Fed speakers suggesting either a June or July cut is likely if data continues to improve. This has already placed downward pressure on the NZD/USD exchange rate. The Reserve Bank of Australia delivered a surprise rate cut at its May meeting, taking the cash rate down to a new low of 1.75%. Markets are priced for at least one more rate cut over the coming year; the majority of analysts are expecting this to be delivered until around November.

- **NZD:** The prospect of a Fed rate hike in coming months has seen the NZD/USD drop around 2 cents in recent weeks – back to levels seen around the time of the March MPS. On the other hand, the recent rate cut from the RBA has seen the NZD/AUD appreciate over three cents. This has kept the upward pressure on the NZ TWI, which has averaged just over 73 over the June quarter to date – compared with 70.9 forecast by the RBNZ. With a currency about 3% higher than predicted in the March MPS, this will place downward pressure on tradables inflation over the next 6-12 months.
- **Inflation:** March quarter CPI increased by 0.2% qoq, taking annual inflation to 0.4% yoy – in line with the RBNZ's forecasts. With regards to the outlook for tradables inflation, there are several moving parts at present. A higher NZ TWI (if sustained) will dampen tradables inflation and mean less relief for struggling dairy farmers. The recent rebound in oil prices has seen prices at the petrol pump pushed up – which will add to inflation in the June quarter. In addition, inflation in Australia (one of our major trading partners) is now lower than anticipated, adding downward pressure on imported inflation. Looking at domestic (non-tradable) inflation, firms reported increasing cost pressures in the NZIER Quarterly Survey of Business Opinion (QSBO) but these have not yet translated into higher prices at the till. Looking at the March producer price index (PPI), input costs have actually declined by 1% over the past year – which may explain why firms have avoided lifting selling prices thus far.
- **Inflation expectations:** The two key reasons the RBNZ cited for its rate cut in March were the deterioration in the global growth outlook and a "*material decline in a range of inflation expectations*". The latest set of inflation expectations surveys show a pickup in 1-2 year ahead inflation expectations (which is unsurprising given the rebound in commodity prices in recent months). However, we have seen inflation expectations out beyond 2-years decline slightly in the latest AON survey (see chart below). Inflation expectations remaining subdued is one reason we expect to see another 25bps rate cut in coming months. If the RBNZ is really concerned about getting inflation expectations higher than they might choose to cut in June, but we expect they will take a more holistic view on the economy and wait for the next round of economic data.



- **Dairy outlook:** Dairy prices have gradually increased since the March MPS; with whole milk powder now trading back at around $2250 – a price that was last seen at the end of 2015. Since the March MPS forecasts were finalised, whole milk powder (WMP) prices are about 14% higher with the overall GlobalDairyTrade Index rising by a more modest 4.3%. Despite the recent gains in dairy prices, Fonterra's opening payout for the 2016/17 season is $4.25/kgms. This is lower than most analysts' forecasts - which were suggesting something between $4.50-$5.00/kgms. Fonterra cited an elevated NZD and high global supply as the reasons behind the relatively low forecast.



- **Unemployment:** The unemployment rate rebounded from 5.3% at the end of 2015, back up to 5.7% at the end of March. A bounce back in the participation rate from 68.5% to 69.0% drove the unemployment rate higher, despite employment growth rising by 1.2% qoq, taking employment to 2% yoy. Overall the implications from rising unemployment have been muddied by the RBNZ's new Labour Utilisation Composite Index (LUCI) measure of the labour market. This encompasses a wide range of measures which is likely to suggest the labour market has less capacity than suggested by the outright unemployment rate.
- **Wage growth:** Wage growth in the economy remained steady at 1.6% yoy in March, although private sector wage growth picked up slightly, with annual growth running at 1.8% yoy. Despite labour force participation increasing and inflation pressure remaining low, it appears that pockets of the economy with high demand for labour (in particular construction workers), are experiencing stronger wage growth. Outside of hot pockets of demand for skilled labour, we aren't seeing much wage pressure coming through – particularly as headline inflation remains low.
- **House prices:** Aside from the commentary on the housing market from a financial stability viewpoint in the FSR, the RBNZ also noted that property prices in Auckland have picked up strongly in the last couple of months and a lack of housing supply and low mortgage rates, combined with on-going net migration are adding to price pressure. Prices are

now rising in almost all other regions and house price inflation across the country is currently running at 14.5% yoy. If prices continue to appreciate strongly, then we could be looking at the housing market being closer to the RBNZ's upside scenario presented in the March MPS. We haven't seen widespread evidence of a wealth effect from rising property prices boosting household consumption as yet, but if that occurred then the Bank may not need to cut the OCR by the final 25bps it has in its current forecasts. A couple more months of housing data should provide a clearer picture.

Pulling all of these moving parts together we still expect the RBNZ to reduce the OCR by another 25bps in coming months. We can make a case either way in favour of cutting the OCR in June or leaving rates on hold for now, but we favour the on-hold approach given the significant amount of data that we will get between the June and August monetary policy statements.

Market pricing and reaction

In recent weeks, market pricing for a rate cut in June has pulled back significantly from being almost 70% priced for a rate cut to now only 20% priced. In addition, the OIS market has reduced its expectation for rate hikes further down the line as well, with a terminal OCR of 2% priced in compared with 1.85% a few weeks ago. In part this has been driven by international markets significantly repricing the risk of an interest rate hike from the US Federal reserve in coming months. Minutes from the FOMC's April meeting showed that officials were open to lifting interest rates in June if data continues to improve. In addition, several comments from Fed officials in recent weeks have signalled that a June or July rate hike is a distinct possibility. The market has moved to around a 35% chance of a June Fed rate hike, up from about a 5% chance a few weeks ago, with a total of over 30bps of hikes priced in by the end of 2016. This has seen local swap rates push higher on the back of international moves. NZ's 2-year swap rate has appreciated from a recent low of 2.13%, up to around 2.30%.

While we expect to see the Bank leave the OCR unchanged in June, we think the market is under-pricing the risk that they could move; in our opinion the weighting should be closer to 40% priced for a rate cut in June (60% chance of a hold). If the RBNZ does end up delivering a rate cut in June, then the market reaction will be reasonably sharp given current pricing. If the Bank delivers an 'on-hold' decision with an accompanying Statement still implying another cut to come then that should generate the least market reaction.

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