TD Securities

New Zealand Market Musing

Rates, FX and Commodities Research

30 April 2015 | TD Securities | Singapore

RBNZ PREPARING TO EASE?

Central bank drops reference to "up" and "period of stability"

The RBNZ left the cash rate at 3.5% as expected by unanimous consensus, but today was all about the statement. As the RBNZ Assistant Governor's speech on inflation last week spelled out the hurdles to lower cash rates, it was increasingly expected that the reference to "the next move could be up or down" would be dropped today. While we were skeptical, we were wrong.

Is the RBNZ preparing for a rate cut? Possibly. However, the contingencies are (1) slowing domestic demand (2) how inflationary pressures evolve, and more specifically (3) wage and price setting outcomes being consistent with missing the 2% inflation target to the downside.

The NZD was firmer overnight via a very weak U.S. GDP report (ex-inventories –0.5%) reaching $US0.7744 (a near three-month high), weakening in early trade, then crashed to $US0.76 on the dovish bias. We see $US0.755 being tested as other markets open. Swap rates are 2-5bp lower, steepening the curve by +3bp. However, while the RBNZ may not cut, we expect swap rates to rally further from here towards a flatter 3.5% curve as duration looks attractive.

While regular readers know we called for a cash rate reduction (-25bp to 3.25%) at the March 12 *Monetary Policy Statement,* we were subsequently roundly chastised for not appreciating the strength of the economy, the substantial positive output gap, and the impact of record high net migration on inflation. The RBNZ were convinced that inflation would reach its 2% target over the medium term. **Since then, net migration continues to post fresh highs, house prices jumped in March and domestic inflation remained at 2¼%/yr** (charts page 2).

The next key hurdle is Q1 employment, on May 6. TD forecasts a solid report, with employment at +1%/qtr and the unemployment rate falling from 5.7% to 5.5%, even with a record high participation rate. Wages (LCI) are also released for Q1 and TD forecasts +0.4%/yr and +2.0%/yr, impressive real wages growth with inflation at zero.

Bottom line: our base case is for a pause at 3.5% for some time, as we (and the RBNZ) need data to disappoint to trigger a cut. **Perhaps today's dovish bias is merely another way of jawboning the currency lower as the USD remains stubbornly and unexpectedly weak.** We expect the markets to shift towards a rate cut in June, keeping the NZD and rates under pressure, and today's market reaction will be welcomed by the RBNZ (if not by us). Our AUDNZD target of 1.01 by mid-year now wholly relies on a "surprise" rate cut by the RBA on May 5.

Policy Assessment [TD comments].

The Reserve Bank today left the OCR unchanged at 3.50 per cent. **[as expected]**

Trading partner growth continues at around its long-term average, but remains dependent on highly accommodative monetary settings. Policy interest rates are at record lows and many European government bonds are trading at negative yields. Looking ahead, **considerable uncertainties exist in Europe, China and Australia, and on the timing of US monetary policy adjustment**, although global growth should be boosted by the decline in world oil prices. Crude oil prices are almost 50 percent below their July 2014 level, with increasing supply mostly contributing to this fall. **[cautious global outlook, which is fair]**

The New Zealand economy continues to grow at an annual rate of around 3 percent, supported by low interest rates, high net immigration and construction activity, and the fall in fuel prices. **House price inflation is elevated in Auckland**. However, lower dairy incomes, lingering effects of drought, fiscal consolidation, and the high exchange rate are weighing on the outlook for growth. [**dismissing house price strength (?) the other downsides are well worn now**]

Lower fuel prices, coming on top of the high exchange rate and low global inflation, lowered annual CPI inflation to 0.1 percent in the March quarter. Underlying inflation remains low and is expected to pick up gradually. Monetary policy will focus on the medium-term trend in inflation. The Bank expects to keep monetary policy stimulatory, **and is not currently considering any increase in interest rates [this is not really new but leaves the bias one-sided now].**

We are watching closely the ongoing impact on tradables inflation from global forces and the high New Zealand dollar. On a trade-weighted basis, **the New Zealand dollar continues to be unjustifiably high and unsustainable in terms of New Zealand's long-term economic fundamentals**. The appreciation in the exchange rate, while our key export prices have been falling, is unwelcome.**[not new either].**

The timing of future adjustments in the OCR will depend on how inflationary pressures evolve in both the non-traded and traded sectors. It would be appropriate to lower the OCR if demand weakens, and wage and price-setting outcomes settle at levels lower than is consistent with the inflation target. **[this is new, i.e. only discussing the hurdles to easing, hence should be interpreted as a contingent easing bias].**

The Bank will continue to monitor and carefully assess the emerging flow of economic data.

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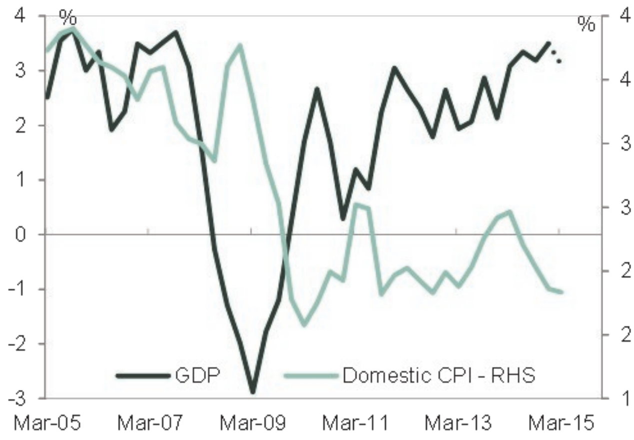
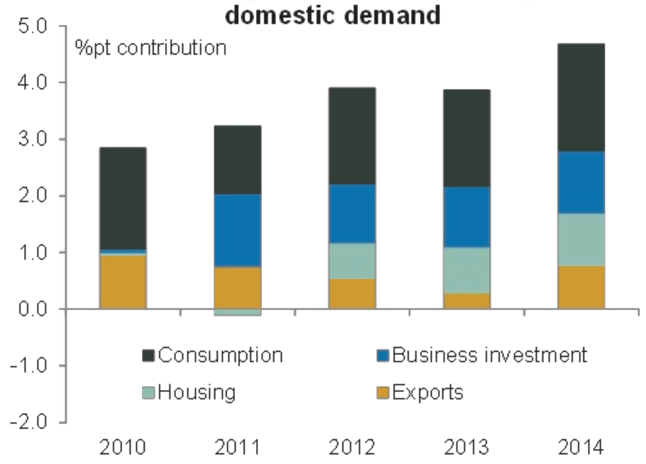
NZ: above-trend GDP growth not sparking (domestic) inflation



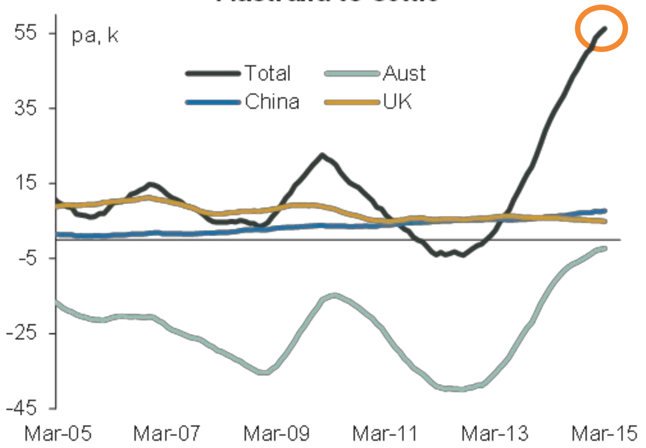
Source: StatsNZ; TD Securities (CPI adjusted for GST increase)

NZ: GDP growth driven by strong domestic demand



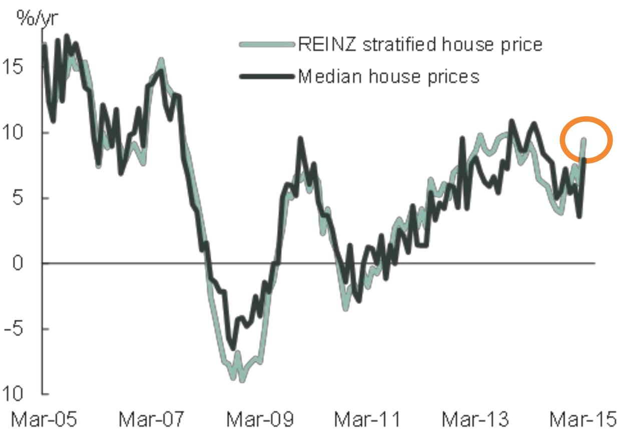
Source: StatsNZ; TD Securities

New Zealand more attractive than Australia to settle



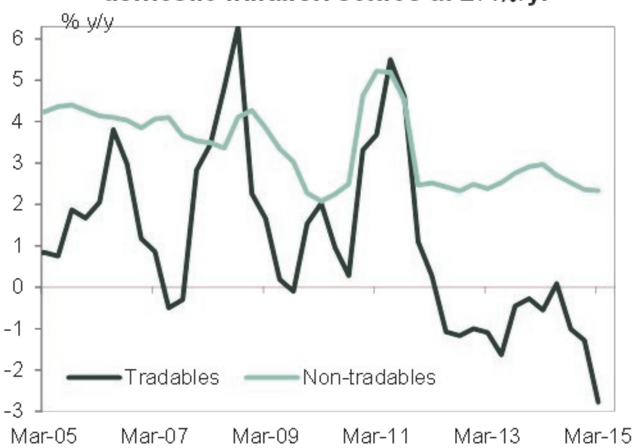
Source: StatsNZ; TD Securities

NZ house prices reaccelerated in early 2015



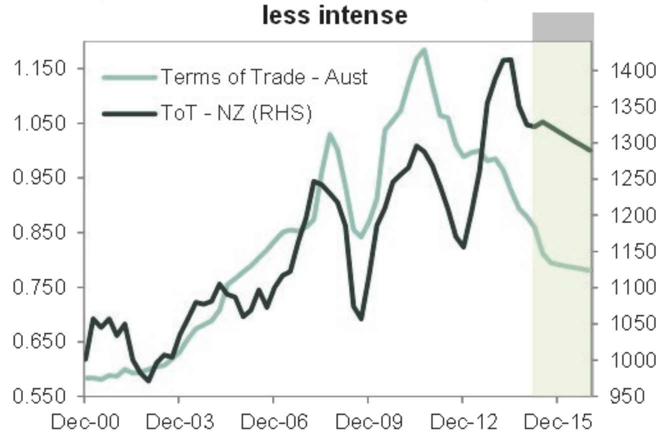
Source: REINZ; TD Securities

NZ: tradable inflation retreats via fuel; domestic inflation settles at 2¼%/yr



Source: StatsNZ; TD Securities

New Zealand's terms of trade decline is years behind Australia and likely much less intense



Source: ABS; StatsNZ; TD Securities (f/c after Q1 2015)

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