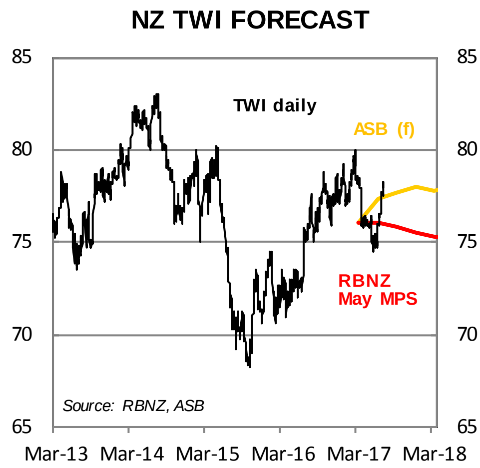
RBNZ on hold and comfortable with the outlook

- **The RBNZ left the OCR on hold at 1.75%, as widely expected.**
- **The RBNZ remains upbeat on growth outlook, despite the weaker Q1 GDP outcome.**
- **Market reaction suggests some expected stronger language on the NZD.**

Summary

The RBNZ left the OCR on hold at 1.75% as widely expected. The focus was on the tone of the statement, which was still **neutral and reiterated that policy was to remain accommodative** for a considerable period. We continue to expect the **RBNZ to remain on hold until late 2018**.

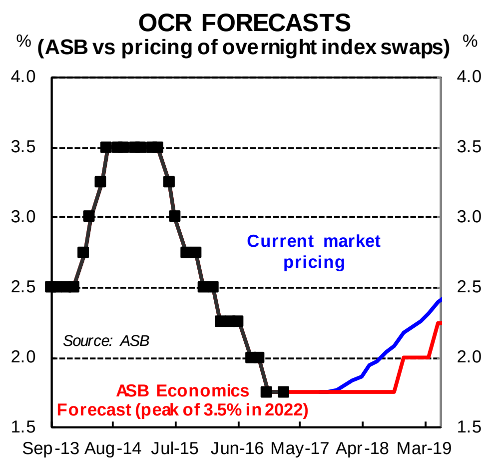
The RBNZ remains **upbeat on the growth outlook** despite the weaker Q1 GDP outcome. While the RBNZ's **language around the higher NZD remained factual and similar in tone to previous statements**, some market participants may have been looking for a stronger attempt to talk the currency down.



NZD

The NZD lifted following the release of the RBNZ OCR Review, as the statement was not quite what some participants in the market had positioned for. In particular, the NZ Trade Weighted Index has risen around 3% since May and **markets were likely expecting the RBNZ to take a more hard-line approach** to this development. Instead, the RBNZ merely noted the lift, but refrained from stating that the NZD was unjustifiably high. However, **the RBNZ's matter-of-fact NZD dollar comments were in line with our expectations** as economic fundamentals (such as higher export prices) are responsible for some of the recent strength.

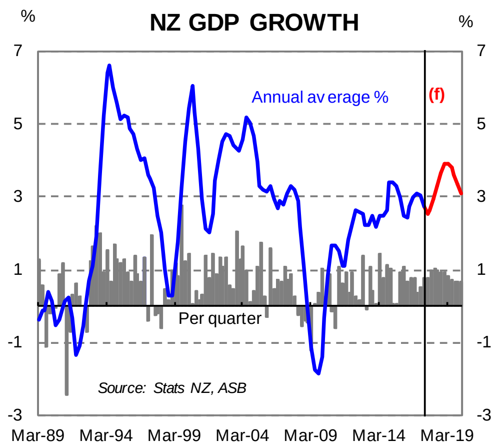
The market reaction also likely reflected the fact that the **RBNZ largely discounted the recent weakness in GDP growth**. Instead, the RBNZ remains upbeat on the growth outlook, noting that the high Terms of Trade and Budget 2017 will be supportive of growth going forward.



Growth

The RBNZ remains upbeat on the growth outlook despite the weaker Q1 GDP outcome. The RBNZ added **high Terms of Trade as a driver of stronger growth**, along with low interest rates and population growth. In addition, the RBNZ said **Budget 2017 (released after the May MPS) would also support the growth outlook**. We are also upbeat on the medium-term growth outlook. However, the fact the RBNZ was relatively unconcerned by weaker Q1 GDP growth potentially took the market by surprise.

What was missing from our perspective was a comment on Fonterra's upbeat milk price forecast for the upcoming season. We believe the **RBNZ's May Monetary Policy Statement (MPS) assumption about milk prices was conservative** and thought that Fonterra's upbeat view may sway the RBNZ to revise this higher. At the May MPS we saw dairy prices as a key source of upside risk to the RBNZ's consumer spending and investment forecasts. While the RBNZ did refer to high Terms of Trade, there was no explicit reference to dairy prices in the June statement. At this juncture, our more optimistic dairy view partly explains why we expect a sooner start to the RBNZ's tightening cycle.



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Inflation

The RBNZ's view of the inflation outlook remained unchanged from the May MPS and OCR Review. The RBNZ reiterated that the Q1 strength was largely due to temporary rises in petrol and food prices and that inflation was likely to be volatile over the next few quarters. This is in line with our view and we are expecting inflation to dip back below 2% in Q2 as the recent falls in oil prices weigh on tradable inflation. Looking forward, we expect tightening domestic capacity pressures and improving global growth to lift inflation back towards the 2% mid-point of the target band by late 2019.

Housing

The RBNZ remains wary of the Auckland housing market, despite noting that house price growth had moderated further. The Bank again acknowledged that the ongoing imbalance between demand and supply means a price resurgence in the market remains a risk.

Key Rates	8:50am	9:05am	9:50am
NZD/USD	0.7222	0.7258	0.7252
NZD/AUD	0.9561	0.9608	0.9601
NZD/EUR	0.6466	0.6503	0.6495
NZD/JPY	80.43	80.85	80.78
NZD/GBP	0.5699	0.5737	0.5724
NZ TWI	78.13	78.58	78.46
NZ 90 day Bank Bill	1.95	1.95	1.95
NZ 1 year swap rate	2.03	2.03	2.03
NZ 3 year swap rate	2.39	2.39	2.39
NZ 5 year swap rate	2.70	2.70	2.70

RBNZ media release

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent.

Global economic growth has increased and become more broad-based. However, major challenges remain with on-going surplus capacity and extensive political uncertainty.

Headline inflation has increased over the past year in several countries, but moderated recently with the fall in energy prices. Core inflation and long-term bond yields remain low. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has increased by around 3 percent since May, partly in response to higher export prices. A lower New Zealand dollar would help rebalance the growth outlook towards the tradables sector.

GDP growth in the March quarter was lower than expected, with weaker export volumes and residential construction partially offset by stronger consumption. Nevertheless, the growth outlook remains positive, supported by accommodative monetary policy, strong population growth, and high terms of trade. Recent changes announced in Budget 2017 *should support the outlook for growth.*

House price inflation has moderated further, especially in Auckland. The slowdown in house price inflation partly reflects loan-to-value ratio restrictions, and tighter lending conditions. This moderation is projected to continue, although there is a risk of resurgence given the on-going imbalance between supply and demand.

The increase in headline inflation in the March quarter was mainly due to higher tradables inflation, particularly petrol and food prices. These effects are temporary and may lead to some variability in headline inflation. Non-tradables and wage inflation remain moderate but are expected to increase gradually. This will bring future headline inflation to the midpoint of the target band over the medium term. Longer-term inflation expectations remain well-anchored at around 2 percent.

Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly.

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