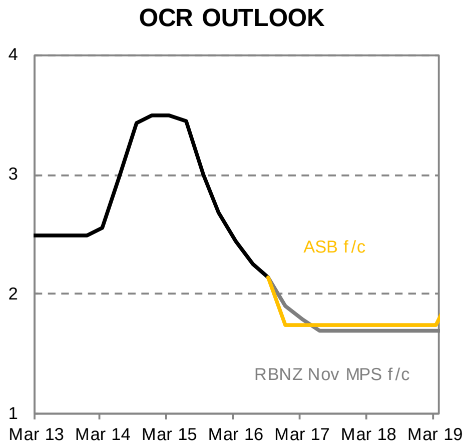
All done barring a Trump wild card

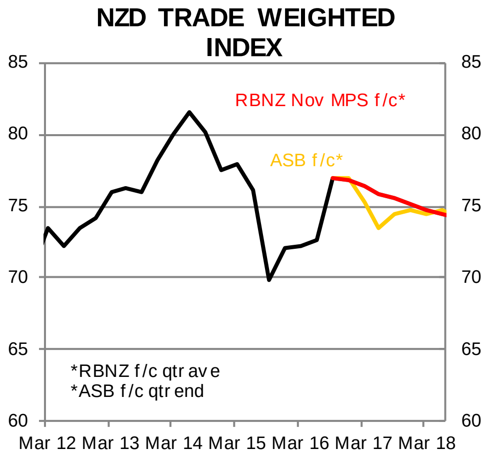
- **The RBNZ cut the OCR to 1.75%, in line with our expectations.**
- **Risks remain slightly skewed to another cut next year, but we think the RBNZ is on hold for now.**
- **The change of US Presidency will be a wild card over the longer term.**

Summary and Implications
The **RBNZ cut the OCR to 1.75%** in a statement that was very much in line with our expectations. The RBNZ's **OCR forecast settles at 1.7%,** with a **mild easing bias** of "*numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly*". From here we **continue to expect the RBNZ will remain on hold**, which is the RBNZ's current base case. **Inflation is likely to be back within the 1-3% target band at the next read** (due in January). Dairy prices have recovered considerably. The labour market is tightening. Growth is running at an above-trend pace. It is not an economy that is crying out for a sub-1.75% cash rate to boost inflation a little swifter at the margin.

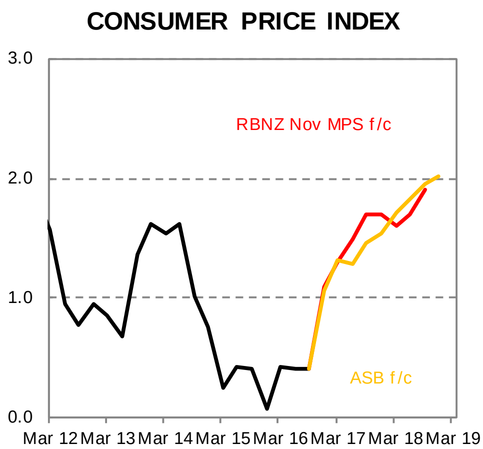
But the **risks to the OCR remain slightly skewed towards another cut next year** (and a fan chart of OCR scenarios was slightly skewed down). Key risks are the strength of the NZ dollar, bank funding costs, any further weakness in inflation expectations, and any deterioration in the global growth outlook. The change of US Presidency will also be a wildcard over the longer term, with its mix of potential fiscal stimulus and potential trade protectionism.



OCR forecast 1.7%
The RBNZ's new OCR forecast track outline, replacing the 90-day bank bill guidance provided previously, shows a low in the outlook of 1.7% vs. the current 1.75% rate, suggesting the RBNZ believes it is done in the current easing cycle. At the press conference, **Governor Wheeler clarified the OCR track implies a 20% chance of a further rate cut.**



Decline in the exchange rate is needed
The **RBNZ stated once again that "*a decline in the exchange rate is needed*".** The RBNZ remains concerned that the strength in the NZD is "higher than sustainable" for a balanced economic growth outlook, as well as the consequences for tradable inflation. Interestingly, it removed comments about the strength in the NZD being somewhat due to improved export prices (i.e. dairy prices). The TWI track was revised up only slightly. **The RBNZ reminded that, if the NZD exceeds the RBNZ's assumptions going forward, the reasons for that lift matter for any response – stronger NZ fundamentals wouldn't imply a need for offsetting OCR cuts.**



The Trump factor
There was **no explicit mention of Donald Trump's victory** in the statement, though the RBNZ referred to **uncertainties about the global outlook**. Like many, the RBNZ will need time to see what actually happens and how that changes the NZ inflation outlook. At face value, **Donald Trump's fiscal policies are inflationary through tax cuts and added government spending** that would stimulate US growth, though the impact depends on how big the policy shifts are. The mix of monetary conditions for NZ would likely shift in a favourable way to a lower NZD/USD and higher term interest rates. **But these impacts could be tempered or even swamped by any protectionist trade actions** that impact broader global economic growth. The RBNZ's next meeting is in February, less than 3 weeks after Donald Trump is sworn in as President, which gives little opportunity for US policy changes and for any monetary response.

Dairy outlook conservative – upside risk to outlook

On the dairy front the RBNZ has remained conservative, wary that the recent surge in spot dairy prices could be reversed. The RBNZ has retained its long-term whole milk powder price forecast of $3,000 per tonne, despite the recent lift in dairy prices. **We remain more bullish on the long-term price outlook but, given Fonterra's expected pay-out remains $5.25/kg, we can see why the RBNZ is reluctant to 'bank' the improvement at this stage.** Even so, should dairy continue to fall in line with our estimates, there is **upside potential for the economy and domestic inflation, as well as the NZD**.

Funding costs – downside risk to OCR outlook

The **RBNZ noted the current pressure banks are facing in terms of funding costs**. Increasing offshore yields and weaker domestic deposit growth (meaning that banks are having to compete more aggressively to attract and retain deposits) are impacting on funding spreads. This **slowing in deposit growth and subsequent competition to attract deposits are putting a floor under lending rates.**

Inflation expectations –stabilised but still a risk

Inflation expectations remain a key concern for the RBNZ. However, the RBNZ noted in the November MPS **that inflation expectations have stabilised since March.** While the RBNZ is relieved that the inflation expectations have not fallen any further, it remains aware of the risks to the inflation outlook should they fall any further. As such, inflation expectations are likely to remain key to policy decisions over the coming few months.

The **RBNZ is forecasting inflation to return to the target band of 1 – 3% by the end of this year** (1.1% yoy in December). Inflation is then forecast to hit 2% in December 2018, as 2015's fuel price declines fall out of the annual calculation. This represents a slightly stronger near-term inflation forecast than in August. However, the RBNZ's longer-term forecast now takes a few months longer to hit 2% through ongoing low import prices and the high exchange rate.

Market reaction

Market reaction to the rate cut and statement was mixed in with the continued fallout from the surprise US election result. Markets initially reacted to Trump's victory with a move away from risky assets. However, this was completely reversed overnight, with a strong lift in equities and a lift in global interest rates. As such, NZD/USD has been very volatile but the NZD is generally slightly firmer, despite the rate cut.

Rates markets saw short-dated swap rates drop decline around 5 basis points immediately following the release. However, the RBNZ's indication that this is the **end of the current easing cycle** (although downside risks remain) **lifted the long end, with the 5-year swap rate climbing around 7 basis points.**

Key Rates	8:55am	9:20am	9:50am
NZD/USD	0.7297	0.7341	0.7338
NZD/AUD	0.9540	0.9588	0.9577
NZD/EUR	0.6675	0.6712	0.6720
NZD/JPY	77.23	77.71	77.66
NZD/GBP	0.5867	0.5903	0.5903
NZ TWI	78.89	79.32	79.30
AUD/USD	0.7652	0.7657	0.7662
AUD/EUR	0.6997	0.7000	0.7017
NZ 90 day Bank Bill	2.12	2.07	2.07
NZ 1 year swap rate	2.12	2.12	2.13
NZ 3 year swap rate	2.42	2.45	2.46
NZ 5 year swap rate	2.66	2.72	2.73

RBNZ Statement:

The Reserve Bank today reduced the Official Cash Rate (OCR) by 25 basis points to 1.75 percent.

Significant surplus capacity exists across the global economy despite improved economic indicators in some countries. Global inflation remains weak even though commodity prices have come off their lows. Political uncertainty remains heightened and market volatility is elevated.

Weak global conditions and low interest rates relative to New Zealand are keeping upward pressure on the New Zealand dollar exchange rate. The exchange rate remains higher than is sustainable for balanced economic growth and, together with low global inflation, continues to generate negative inflation in the tradables sector. A decline in the exchange rate is needed.

Domestic growth is being supported by strong population growth, construction activity, tourism, and accommodative monetary policy. Recent dairy auctions have been positive, but uncertainty remains around future outcomes. High net *immigration is supporting growth in labour supply and limiting wage pressure.*

House price inflation remains excessive and is posing concerns for financial stability. Although house price inflation has moderated in Auckland, it is uncertain whether this will be sustained given the continuing imbalance between supply and demand.

Headline inflation continues to be held below the target range by ongoing negative tradables inflation. Annual CPI inflation was weak in the September quarter, in part due to lower fuel prices and cuts in ACC levies. Annual inflation is expected to rise from the December quarter, reflecting the policy stimulus to date, the strength of the domestic economy, and reduced drag from tradables inflation.

Monetary policy will continue to be accommodative. Our current projections and assumptions indicate that policy settings, including today's easing, will see growth strong enough to have inflation settle near the middle of the target range. Numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly.

View the Monetary Policy Statement here.

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