Economic Weekly

18 November 2019

RBNZ puts on its rose-tinted glasses

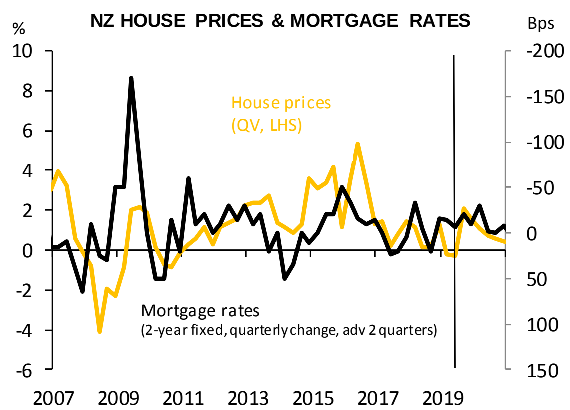
The RBNZ surprised financial markets by deciding to leave the OCR unchanged on Wednesday afternoon last week. As at the morning of the decision, all market economists had expected the RBNZ to cut the cash rate by 25 basis points because business confidence remained weak, growth forecasts had been slashed and inflation expectations had declined. But it appears the RBNZ begs to differ on the economic outlook, and maintained a relatively rosy view. Despite it appearing to be a close decision from the committee (at least according to the Summary Record of the Meeting), the **RBNZ has subsequently signalled it has a high threshold for further OCR cuts**. On Friday, Assistant Governor Hawkesby commented it would take "something material" to make them change their mind and cut the OCR in February. Focus over the next few months now turns to business confidence, NZ economic data, offshore events (in particular US-China trade war developments) and the Government's Half Year Economic and Fiscal Update.

Key events and views

Key Insights	We still believe further OCR cuts are a matter of when, rather than if.
Foreign exchange	NZD consolidation inside 0.6280-0.6445 range to continue.
Interest rates	Domestic rates higher following the RBNZ's unexpected no change decision.
Domestic events	We expect prices to rise at this week's global dairy trade auction.
International events	RBA and Federal Reserve meeting minutes are released this week.

Chart of the Week: Housing market to simmer, not sizzel

Spring has sprung, and with it the housing market comes back to life from its winter hibernation. **We expect this summer's house selling season will see an additional boost from lower mortgage rates** and the benefit of clarity around some of the Government's proposed housing market policies. **But we do expect this summer's heat will be contained, in the housing market at least.** Mortgage rates are lower, but the size of the fall is only **consistent with a fairly modest pick-up in house price growth (see chart opposite).** For the record, we continue to expect national house price inflation to accelerate to 5-6% by mid-2020.



Source: QV, ASB

Furthermore, risks to this outlook have shifted – with the RBNZ now backing away from its August all guns blazing approach – there is some risk that our forecast falls in mortgage rates will not transpire and housing market momentum will underperform our expectations.

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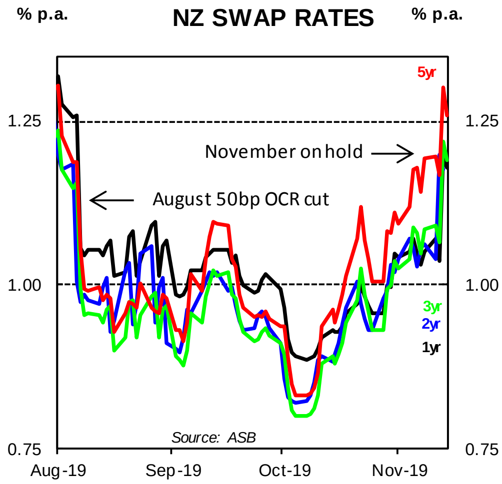
Key insights this week: When keeping interest rates steady pushes them up

Well, we didn't even get last week's OCR decision half right. We were a full 25/25 wrong. Recall back in August when the RBNZ cut by 50bps, we had expected a 25bp cut. Given we still expect the RBNZ will eventually cut the OCR, perhaps we can console ourselves by saying that **we still believe it's a matter of when, rather than if, the OCR hits another record low.**

Our opinion – for what it is worth – is that the RBNZ 'should' still cut the OCR further. After last week it is clear the RBNZ doesn't think there is a strong case at the moment. **There is certainly the risk that the 50bps of OCR cuts we expect by May 2020 gets delayed again.**

What then might change the mind of the Monetary Policy Committee?



One key reason is that we do not see NZ's growth picking up quite as soon as the RBNZ expects. Yes, the RBNZ had assumed growth in Q3 this year would be weak, but that is now behind us. We expect a more prolonged period of subpar growth given persistent weakness in business confidence, and low growth in businesses' capital expenditure. Employment growth looks set to soften and core inflation pressures are likely to pick up more slowly than what the RBNZ is factoring in. **The RBNZ seems to be putting a lot of weight on the government riding to the rescue with added fiscal spending. So far, there have been no public hints from the Government of an added spend-up,** but even if the chequebook comes out it is likely to be slower in supporting the economy than monetary policy would be.

A second reason is that the RBNZ has yet to factor in any economic drag from its impending bank capital increases. The RBNZ makes its final decision on bank capital requirements on December 5. With the changes made official at that point, **the RBNZ's first opportunity to incorporate the capital changes into its monetary policy outlook will come in February 2020.** Our view is that the new bank capital regime will require an offset via a lower OCR. Even, the RBNZ's own estimates suggest its proposed capital increases would raise retail lending interest rates by 20-40bps. Our estimates suggest a much larger impact (50+bps) and we expect the new regime will significantly dampen the availability of credit in sectors with high capital requirements. **The RBNZ's survey of lenders already indicates credit conditions are tightening for sectors with higher capital requirements.**

A third reason is that monetary conditions have tightened, most obviously in the few minutes after the on-hold OCR decision was announced. It is always hard satiating markets. Like a child in an ice cream parlour, they always want more and at some point disappointment inevitably arrives. But, tactically, it would have been wiser in our view to have doled out a single-scoop ice cream to appease the demanding market. Instead, the upshot is wholesale interest rates are pretty much back where they were before the RBNZ's surprise 50bp OCR cut back in August.

The RBNZ now enters a 3-month decision-making hiatus with the risk that mortgage rates start to lift, jolting those that have been waiting for further rate falls to rush and fix. Crucially, a lot of mortgage rate re-fixing will be happening in coming months. The associated balance sheet risk management of that re-fixing will in itself put upward pressure on wholesale swap rates, compounding the recent wholesale market pressures**. It is quite possible we are at the lows in most fixed rate mortgage terms for this cycle.** The mortgage rate cuts made in October coincided with a bout of global risk aversion that dragged NZ interest rates lower as well as the local market pricing in an OCR low of 0.5%. The global market environment currently looks better than it did a month or so ago, but a flaring up of trade tensions between the US and China and further signs of weaker global growth could still see global yields retrace recent climbs. Then again, the global economy might be able to muddle through. With the benefit of hindsight we might look back and note that the last few months have provided a perfect storm to the benefit of borrowers. Even if the RBNZ does eventually cut the OCR to 0.5%, as we still assume, term interest rates may not drop back to the levels of last month**. At present, our 2-year special mortgage rate of 3.45% looks to be an attractive option for borrowers.**

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6409	0.6345	0.6371	0.6822	FLAT/UP	0.6280	0.6445	FLAT
NZD/AUD	0.9399	0.9255	0.9324	0.9381	FLAT/DOWN	0.9320	0.9520	FLAT
NZD/JPY	69.72	69.20	69.16	77.38	FLAT	68.30	71.10	UP
NZD/EUR	0.5800	0.5756	0.5725	0.6017	FLAT	0.5680	0.5910	UP
NZD/GBP	0.4960	0.4961	0.4957	0.5333	FLAT	0.4910	0.5060	FLAT
TWI	71.0	70.1	70.5	74.51	FLAT	N/A	N/A	FLAT/UP

*^ Weekly support and resistance levels * Current as at 9.30am today; week ago as at Monday 5pm*

NZD Recap

The NZD topped the G10 currency performance rankings last week. Against a backdrop of USD weakness, the RBNZ's surprise on-hold decision lit a fire under the currency.

NZD/USD was propelled back up through 0.6400, but it was NZD/AUD that shouldered most of the burden. The RBNZ decision, coupled with a fairly miserable Aussie employment report the next day, saw NZD/AUD lift almost two cents last week, bringing to an abrupt halt the recent gentle downtrend.

Interest rate decisions always get the most attention, but we note that NZ-AU relative commodity prices – another key driver of the NZD/AUD - have been quietly moving in NZ's favour over the past two months. This further shores up fundamental support for the cross.

Near-term outlook

Local markets have revised up their OCR expectations (see interest rate section below), lifting NZ wholesale interest rates and widening (slightly) NZ-US relative interest rate differentials. We expect this extra interest rate support to keep the NZD/USD well supported on any dips. In addition, this week's GDT dairy auction may well serve as a reminder to investors of NZ's strong commodity price and terms of trade outlook, further solidifying NZD sentiment.

Notably, "fair-value", according to our short-term valuation model, is currently estimated in a 0.6700-0.7100 range.

In time, we suspect the NZD/USD will press up to test 0.6445 resistance again, but this might be a story for later in the month. This week is reasonably quiet on both the domestic and international fronts. As such, consolidation inside the now familiar 0.6280-0.6445 range is likely to continue.

Medium-term outlook

Our forecasts have the NZD/USD essentially trending sideways for the best part of the next nine months, to a low of 0.6200 in March 2020. This slow and low forecast profile reflects the drag from the NZ growth slowdown and associated RBNZ interest rate cuts, and the subdued global backdrop. From late 2020, we expect the currency to begin trending higher again as fiscal and monetary stimulus eventually drive a recovery in the NZ economy, and NZ's Terms of Trade remain elevated.

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ASB foreign exchange forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.67	0.63	0.63	0.62	0.67	0.68	0.68
NZD/AUD	0.96	0.93	0.94	0.94	0.94	0.94	0.94
NZD/JPY	72	68	66	64	70	71	71
NZD/EUR	0.59	0.57	0.57	0.57	0.59	0.60	0.60
NZD/GBP	0.53	0.51	0.49	0.46	0.51	0.52	0.52
NZD TWI	73.2	70.2	69.1	67.9	71.5	72.0	72.0

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.00	1.00	1.00	1.75	UNCH/DOWN	UP
90-day bank bill	1.24	1.15	1.05	2.00	UNCH/DOWN	UP
2-year swap	1.19	1.06	0.94	2.18	UNCH/DOWN	UP
5-year swap	1.26	1.20	1.01	2.57	UNCH/DOWN	UP
10-year swap	1.54	1.54	1.34	3.03	UNCH/DOWN	UP
10-year govt bond yield	1.40	1.39	1.24	2.15	UNCH/DOWN	UP
Curve Slope (2s10s swaps)	0.35	0.48	0.40	0.85	UP	UNCH/UP

** Current as at 9.30am today; week ago as at Monday 5pm. Key UNCH = Broadly unchanged*

Market Recap

The RBNZ surprised the market and left the OCR on hold at 1.00% in the November Monetary Policy Statement, deeming that economic developments had not warranted a change in stance since the August statement. The published OCR projections in the November Statement were little changed from August, having a 0.9% trough in 2020 and ending at around 1.6% by 2022. **Market reaction was sizeable.** NZ swap rates spiked 20bps following the decision, moving back to levels prior to the RBNZ's surprise 50bp cut back in August (they ended up 10-15bps on the day). NZ swap rates have rallied since then (yields lower), but yields are still roughly 30-40bps above their October lows. In various interviews, RBNZ voters Orr, Bascand and Hawkesby did not rule out future OCR cuts, but hinted it will take a material weakening in the outlook to do so. Australian yields, by contrast, eased after a weak labour market report. US Treasury yields arrested recent falls and equity markets finished the week on a strong note after US Commerce Secretary Ross noted that a US/China trade deal will get done "in all likelihood".

Near-term NZD interest rate outlook

Market pricing has shifted from fully pricing in a 25bp cut by February 2020 and an OCR floor of around 0.6% a week ago to now pricing in around one-third odds of cut by February and an OCR floor of 0.85%. **We still expect 50bps of OCR cuts, but have shifted back the timing to February and May next year, with risks of a later start.** The domestic event calendar is light ahead of next Wednesday's RBNZ Financial Stability Report. The RBA Board minutes are unlikely to surprise given they preceded the weak labour market data and the Statement on Monetary Policy was also published last week. **The direction of longer-term yields over the next few weeks will largely depend on whether the US and China agree to the first phase of a trade deal by the December 15 deadline.** A successful outcome could push US 10-year Treasury yields above 2% and firm longer-dated NZ yields, but an escalation in trade tensions could push US and NZ longer-term yields lower. This week's global dataflow is light and Thursday's Federal Open Market Committee (FOMC) meeting minutes will likely note (downward) risks to the US economy have eased, reiterating that a "material reassessment" of the economic outlook will be needed for them to cut rates again. Christine Lagarde presents her first speech as President of the ECB on Friday, but this is unlikely to materially rock the boat.

Medium-term outlook

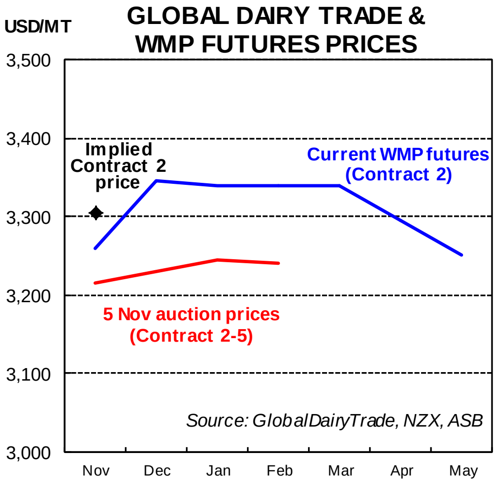
We still expect 50bps of OCR cuts to be delivered, with 25bp cuts in February and May next year, and the OCR to plateau at 0.5% this cycle. This will be followed by mild and gradual OCR hikes from 2022, with an OCR endpoint of just 2%. We also expect a further 25bp cut by the RBA in February (0.5% floor). We have pushed back our FOMC calls by 3 months and now expect the 1.50%-1.75% Federal Funds to be trimmed by 75bps from early 2020 (Mar 20, Jun 20, Sep 20). **Low inflation, low global growth and a negatively skewed risk profile should cap NZ and global long-term interest rates at historically-low levels.** mark.smith4@asb.co.nz

ASB interest rate forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.50	1.00	0.75	0.50	0.50	0.75	1.25
NZ 90-day bank bill	1.7	1.2	1.0	0.9	0.8	1.0	1.5
NZ 2-year swap rate	1.4	0.9	1.1	1.0	0.9	1.2	1.4
NZ 5-year swap rate	1.4	0.9	0.9	0.8	0.9	1.3	1.7
NZ 10-year swap rate	1.8	1.2	1.2	1.1	1.2	1.6	2.0
NZ 10-year Bond	1.6	1.1	1.0	0.9	1.0	1.4	1.8

Domestic events

Data	Date	Time (NZT)	Market	ASB
GlobaDairyTrade auction, whole milk powder, % change	19/11	-	-	+3.0

We expect whole milk powder (WMP) prices to lift 3.0% at the GlobalDairyTrade auction overnight Tuesday. A fortnight ago WMP prices firmed 3.6%. At this stage, the futures market is pointing to a similar lift in prices at next week's auction. NZ production growth is slowing and it's likely this will help push dairy prices higher. In the November Monetary Policy Statement, the RBNZ alluded to robust commodity export prices and robust Terms of Trade as key supports to the NZ economic outlook. We share the RBNZ's optimism over the export commodity price outlook.



Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
RBA Minutes of November Policy Meeting	19/11	1:30 pm	-	-
RBA Kent speech at Sydney Panel Discussion	19/11	11:05 am	-	-
US Federal Reserve Meeting Minutes	21/11	8:00 am	-	-
Japan CPI, October, %yoy	22/11	12:30 pm	0.3	0.4
CBA Australia Manufacturing PMI, November	22/11	11:00 am	-	-
Eurozone PMI, October	22/11	10:00 pm	-	-

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The Reserve Bank of Australia's (RBA) Meeting Minutes are due out this week (from the latest meeting where the RBA left the cash rate at 0.75% after cutting in October). There are unlikely to be any surprises, given the Statement on Monetary Policy (which details the RBA's economic forecasts) has been released since the meeting took place. The central bank expects underlying inflation to remain below-target over their forecasting horizon, which runs to the end of 2021. This reinforces our view that more easing is likely. We have another 25bp cash rate cut in our forecasts in February 2020.

The RBA's Chris Kent will be on a panel at the Australian Securitisation Conference. The topic of discussion is "regulatory update on benchmarking" and will cover changes to financial market benchmarks.

The **Japanese** government increased the rate of VAT from 8% to 10% on 1 October, though some products were exempted. The VAT increase will lead to a shift up in the level of prices and a temporary increase in **inflation**. Nevertheless, inflation will remain well below the Bank of Japan's 2%yoy target.

Both the **CBA Australia manufacturing and services PMIs** for October were at, or very close, to the 50 level, suggesting activity neither expanded nor contracted in the month. The trade war and other uncertainties are weighing on business capex and consumer spending. These trends are being felt by the business sector.

The **US Federal Reserve meeting minutes** will elaborate on the central bank's view that the downside risks to the US economy have eased. The minutes will also elaborate that a "material reassessment" of the economic outlook will be needed for the Federal Reserve to cut the Fed Funds rate again.

The **Eurozone's manufacturing PMI** is projected to remain below 50 – the threshold consistent with a contraction in manufacturing activity. The manufacturing sector accounts for about 20% of the Eurozone economy. And the main reason behind the ECB's gloomier economic outlook is ongoing weakness in the manufacturing sector. The services PMI is expected to remain resilient, above 50.

Key Forecasts

ASB NZ economic forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
	<< actual	forecast >>					
GDP real - Q%	0.5	0.4	0.3				
GDP real - A%	2.1	2.2	1.8	1.6	2.6	2.5	2.5
GDP real - AA%	2.4	2.3	2.2	1.9	2.1	2.6	2.5
CPI - Q%	0.6	0.7	0.3				
CPI - A%	1.7	1.5	1.7	2.1	1.7	1.8	1.8
HLFS employment growth - Q%	0.7	0.2	0.3				
HLFS employment growth - A%	1.4	0.8	1.1	1.5	1.5	1.5	1.3
Unemployment rate - %sa	3.9	4.2	4.1	4.3	4.3	4.2	4.4
Annual current account balance as % of GDP	-3.4	-3.4	-3.3	-3.1	-2.7	-2.9	-2.9

Q% = percentage change on previous quarter

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

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NZ 5-year swap rate	1.4	0.9	1.2	1.1	1.1	1.5	1.9
NZ 10-year swap rate	1.8	1.2	1.4	1.3	1.2	1.5	1.9
NZ 10-year Bond	1.6	1.1	1.3	1.2	1.1	1.3	1.7

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NZD TWI	73.2	70.2	69.1	67.9	71.5	72.0	72.0

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