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Westpac

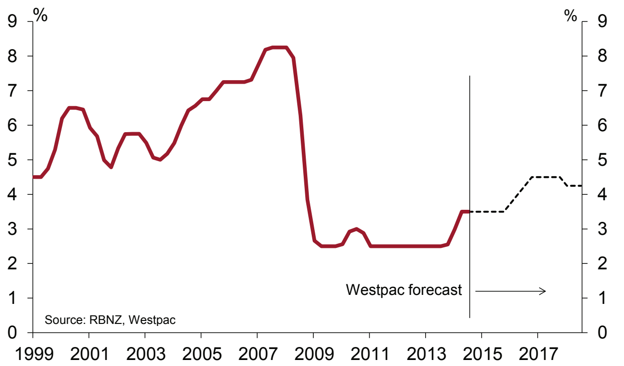
Institutional Bank

A new phase begins

January 2015 OCR Review: OCR on hold at 3.50%

- The Reserve Bank has abandoned any talk of OCR hikes, and is now ambivalent about the direction of the next change in the OCR.
- Today's press release was a dovish surprise for markets, because the RBNZ failed to argue against the possibility of OCR cuts.
- We see no need to change our OCR forecasts. The most likely scenario is no change in the OCR until a June 2016 hike. However, we assign roughly a 20% probability to OCR cuts this year.
- Markets reacted strongly and swap rates are falling hard. This will lead to lower fixed mortgage rates and will further stimulate the already-hot housing market.
- The RBNZ's explicit reference to the housing market picking up serves as encouragement for our forecast of macroprudential tightening later this year.

Westpac OCR forecast



Today marks the beginning of a new phase for Reserve Bank watchers. Having held a tightening bias in one form or another since July 2013, the Reserve Bank today shifted to deadpan neutral guidance with the following key phrases:

"In the current circumstances, we expect to keep the OCR on hold for some time. Future interest rate adjustments, either up or down, will depend on the emerging flow of economic data."

While we expected the RBNZ to drop any talk of OCR hikes, we still judge this press release a dovish surprise because the RBNZ failed to argue against the possibility of OCR cuts. The RBNZ did note that the impending drop in headline inflation is likely to be temporary, and that inflation is expected to move back towards 2 percent over a longer time period. However, the RBNZ did not take the next step and rule out OCR reductions on the basis of this medium-term inflation outlook. Instead, the RBNZ explicitly mentioned the possibility of cuts.

Although the RBNZ's language was a shade weaker than expected, we see no cause to alter our OCR forecasts. The RBNZ agrees with our assessment that the OCR is most likely to remain on hold for some time – we are forecasting no change until June 2016. In our assessment, OCR cuts this year are possible, but are not the most likely outcome. Judging by its choice of words today, the RBNZ roughly shares that assessment.

The detail of today's press release was lengthier than usual, and served as an accurate description of current conditions. On the downside, the RBNZ noted the weaker-than-expected world economy, financial market volatility, falling oil prices, fiscal consolidation, the reduced dairy payout, the risk of drought, and the high exchange rate. On the upside, the RBNZ noted that cheap petrol would boost the NZ economy, the housing market was picking up, and it mentioned rising construction activity and household incomes.

The RBNZ evidently judged the downside developments to be more important than the upside developments, concluding that the outlook was for inflation to move back towards 2 percent *"more gradually than previously anticipated."* Again, we agree with the RBNZ's assessment in this regard.

One cannot overstate the importance of the RBNZ's admission that the housing market is *"showing signs of picking up, particularly in Auckland."* Previously, the RBNZ was resolute in describing the housing market as having slowed in response to LVR restrictions. This serves as significant encouragement for our forecast that a tightening of macroprudential policy will occur later this year. Our thinking has long been that falling mortgage rates, combined with a strong economy, booming population growth and cheap petrol, will create a renewed environment of rising house prices. With the OCR pinned down at 3.5% by low inflation, the RBNZ will be left with only one option – macroprudential tightening.

Late last year the RBNZ appeared to shoot down our forecast, explicitly saying that macroprudential tightening was not currently under consideration. But now that the RBNZ has changed its assessment of the housing market, it must surely also be changing its assessment of the required policy response.

As usual, the RBNZ judged the exchange rate to be "unjustified" and "unsustainable". The possibility of exchange rate intervention remains live.

Financial markets reacted strongly to the RBNZ's admission that rate cuts are a possibility. In the immediate aftermath the NZD/USD fell from 0.7430 to 0.7365, and we expect further falls during the day ahead. Interest rate markets reacted significantly, and are now pricing in 20bp of OCR cuts this year. That amounts to a 40% chance of two OCR cuts this year. The NZ 2yr swap rate fell 7bp from 3.62% to 3.55%, and should continue lower to at least 3.50% during the days ahead. The 10yr fell 5bp from 3.71% to 3.64% and will remain under downward pressure.

RBNZ statement:

The Reserve Bank today left the Official Cash Rate unchanged at 3.5 percent.

Trading partner growth in 2015 is expected to be similar to 2014, though the outlook is weaker than anticipated last year. Divergences continue among regions, with growth in China, Japan and the euro area easing in recent quarters, while growth in the US has remained robust.

World oil prices have fallen 60 percent since June last year, which will boost spending power in oil importing economies but reduce incomes for oil exporters. The oil price decline, together with uncertainties around the transition of US monetary policy, has led to an increase in financial market volatility.

The lower oil price will have a significant impact on prices and activity in New Zealand. The most direct and immediate effects are through fuel prices, with the price of regular petrol falling from a national average of $2.23 in mid-2014 to $1.73 currently. This will increase households' purchasing power and lower the cost of doing business.

Annual economic growth in New Zealand is above 3 percent, supported by rising construction activity and household incomes. The housing market is showing signs of picking up, particularly in Auckland. However, fiscal consolidation, the reduced dairy payout, the risk of drought, and the high exchange rate will weigh on growth.

While the New Zealand dollar has eased recently, we believe the exchange rate remains unjustified in terms of current economic conditions, particularly export prices, and unsustainable in terms of New Zealand's long-term economic fundamentals. We expect to see a further significant depreciation.

The high exchange rate, low global inflation, and falling oil prices are causing traded goods inflation to be very weak. Non-tradables inflation remains moderate, despite buoyant domestic demand and an improving labour market. Headline annual inflation is expected to be below the target band through 2015, and could become negative for a period before moving back towards 2 percent, albeit more gradually than previously anticipated.

In the current circumstances, we expect to keep the OCR on hold for some time. Future interest rate adjustments, either up or down, will depend on the emerging flow of economic data.

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