ANZ Research

RBNZ Monetary Policy Statement Preview

17 May 2022

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Summary

- We expect the RBNZ will raise the Official Cash Rate (OCR) 50bp to 2.00% at its Monetary Policy Statement (MPS) next Wednesday.
- Beyond that, the path is murkier. We continue to expect the RBNZ to switch to the more usual pace of 25bp hikes from July onward as evidence mounts that demand is cooling.
- However, if any more upside surprises to inflation emerge, the hurdle for another 50-pointer in July is low.

Baked in

There seems little doubt that unless something dramatic comes out of left field, the RBNZ will deliver another 50bp hike at its Monetary Policy Statement (MPS) next week. While global news remains very unpredictable, domestic data have come in remarkably close to the RBNZ's expectations. But there are good reasons to get another solid hike under the belt:

- CPI inflation at 6.9% is obviously well beyond the pale, and broad-based, while the OCR at 1.5% is still stimulatory.
- Q1 non-tradables inflation printed at 6.0%, close to the RBNZ's expectation of 6.1%, and core measures have surged – with the RBNZ's sectoral factor model hitting a record high 4.2% in Q1. Inflation expectations in the ANZ Business Outlook and the RBNZ's own survey continue to lift.
- A 50-pointer was well set up in the April Monetary Policy Review (MPR) and is fully priced by the market, making it the path of least resistance on the day.
- There was little pushback to the last 50bp hike and the going is still good. Hikes will get harder to "sell" as the economy more obviously slows.
- Q1 wage growth was a little higher than we expected – though the big surprise was in the QES measure, which the RBNZ puts less weight on. We now anticipate real wage growth will turn positive later this year, rather than next. That'll reduce the cost-of-living squeeze on households a little earlier and do nothing to assuage RBNZ fears of a wage-price spiral.
- The NZD has fallen ~4% on a trade-weighted basis since the April MPR.

The TWI and core inflation developments (and at the margin, QES wages) are likely to result in a slightly higher OCR track endpoint being spat out of the RBNZ's model than that published in the February MPS (3.35%). Any fiscal surprises will also need to be built in. We therefore expect a slightly higher OCR track to be published. However, given the RBNZ is likely to want to put some kind of lid on future OCR expectations (as they did in April), they may decide to do a small fudge to leave the endpoint unchanged. Alternatively, they may just use words to convey the "stitch in time" message.

In any case, we suspect current market pricing has more to do with global volatility, illiquidity and lopsided flows in the market than it does with genuine expectations about how high the OCR is likely to get this cycle. The RBNZ is

likely of similar mind. In that context, trying to fine-tune market pricing is likely an exercise in futility. If recent weeks are anything to go by, waxing and waning US Fed hike expectations will have a huge say in local market moves.

Front and centre for rates markets is the fact that at some point the RBNZ needs to transition to a normal pace of monetary policy tightening (ie 25bp hikes). We continue to predict that will occur at the July Monetary Policy Review. The communications challenge at that point will switch to matching it with a sufficiently "hawkish" tone to prevent forward pricing of future OCR hikes collapsing, resulting in a meaningful easing of monetary conditions rather than just a gentler tightening.

But despite those challenges, and despite the still-large gap between the level of the OCR and the level of CPI inflation, it makes sense for multiple reasons for the RBNZ to soon change to a less-aggressive pace of hikes:

- The RBNZ is shooting the housing market in the back. This is not 2004-07, with the housing market shrugging off hike after rate hike and barrelling onwards and upwards. House sales are down 35% year on year; house prices are down about 5% from their peak and still falling. The debate about where the neutral OCR sits is a valid and important one, but there's no question that hikes are getting traction on the housing market already. Don't underestimate the wealth effect on consumption or the chilling effect of falling house prices on construction. There's a big lag on the latter front, but it's coming.

- Consumer confidence is already sitting around record lows, with key spending indicators dire. It's not showing up in the hard data yet, as it's masked by the Omicron bounce-back, but the correlation is reliable enough (ex-lockdown volatility) that it warrants respect.

Figure 1. Good time to buy major household item and real retail sales

Source: Statistics NZ, Roy Morgan, ANZ Research

- China's growth outlook has abruptly deteriorated as lockdowns and the property slowdown weigh. April data was much weaker than expected.

- The GlobalDairyTrade price index is down 13.4% from its peak, and both ANZ and Fonterra have revised down their milk payout forecast for this season.

- The heat is starting to come out of commodity prices more generally, as fears of a global hard landing and a US recession grow. Plunging PMIs suggest shipping costs should soon drop markedly. The RBNZ is most concerned about non-tradable inflation, as the persistent part of the inflation picture that it can most directly influence, but tradable inflation matters for inflation expectations.

- Global financial markets are experiencing much higher volatility as rates rise quickly, risk spreads start to make a comeback, and the frothier end of risk-taking (crypto) suffers a big shake-out (an estimated USD1.5trn just went up in smoke, hardly pocket change). Quantitative tightening is about to result in a very significant reduction in global liquidity, and recent years have certainly highlighted that the volume of credit is at least as important as its price. Long gone are the days of the "Powell put", the notion that central banks will step in to save financial asset prices. But central banks certainly will take wealth effects into account.

All that said, the July Monetary Policy Review feels a long way off, and things could look quite different by then, one way or another. Downside risks are real, but there's an inflationary war going on, and Covid doesn't care about monetary policy settings either. If the balance of developments suggests more upside risk to inflation overall, another 50bp hike in July would absolutely be game on. The "least regrets" calculation is going to be finely balanced at some point, and whether that's before or after the July MPR is far from clear. Not wanting to blow our own trumpet, but our business and consumer confidence surveys will be important barometers.

One thing to keep an eye out for in the Statement next week is any upward revision to the RBNZ's estimate of the neutral nominal OCR. The last published RBNZ estimate is 2%, but that's looking on the light side given the persistent lift in inflation expectations. The RBNZ's strategy appears to be to get the foot off the accelerator rapidly and then tread more cautiously on the brake. Therefore, any upward revision to where neutral lies (ie the OCR at which the foot moves from one pedal to the other) will be taken by the market as a green light for another 50bp hike in July, all else equal. It would imply that any given level of the OCR is now considered by the RBNZ to be more stimulatory (or less contractionary) than previously assumed.

Markets

With most commenters now calling for a 50bp hike, and markets pricing in around 47bps, markets won't be surprised *per se* by the delivery of another 50-pointer. Instead, what will matter will be the RBNZ's tone, verbal forward guidance and their bill track. As noted above, we expect the Bank to lift its OCR track (which reaches 3.3% by the end of 2023) a smidgen, but they aren't likely to upgrade it to anywhere near what's currently priced in (around 4.15% by the end of 2023). Given that, some sort of upgrade won't likely perturb markets much, especially considering the role higher global interest rates have played in driving local rates and expectations higher.

However, if the RBNZ hints at a need to keep pressing ahead at pace (ie setting up July for a third 50-pointer), that'd likely put further upward pressure on the very short end (there is "only" 85bps priced in by July). If this is signalled, we'd expect the RBNZ to reiterate one of its key messages from April – that the dividend of going hard early now will be fewer hikes over the cycle. That, in turn, should help cap longer-dated expectations, which had gotten out of hand amid thin liquidity. Expectations for November 2023 peaked at around 4.6% in early May, and are still elevated.

Expectations generally trade on the high side of what most forecasters see as reasonable during times of stress, and that's likely to continue while the Fed, RBA, RBNZ and others are hiking. However, we do see early hikes as the first step towards markets trusting central banks to contain inflation. Having gone early should also see NZ bonds outperform their global peers (via spread compression) as other central banks catch up.

If the RBNZ does hint at a third 50-pointer, that'd likely boost the NZD, at least initially. But we think FX markets will be most responsive to where terminal OCR expectations rest, and if the RBNZ's message continues to be that going hard early means doing less later, markets may fade NZD strength, especially as consumers worry about slowing growth, the cost of living, and the state of the housing market.

We are also mindful that domestic considerations have slipped into the background of late. Global FX markets have been extremely volatile, and global cross-market correlations have been high, indicating that bond yields, equities, and currencies are moving in sync on swings in generalised risk sentiment, rather than for fundamental or idiosyncratic reasons. For that reason, we wouldn't want to overplay the importance of next week for FX markets.

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