NZ OCR Call Change: Hikes in Oct, Feb & Mar taking OCR to 3.50%

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Three hikes to come Oct/Feb/Mar to take OCR to 3.50%

Summary

- We are adding in hikes in February and March in addition to October, which would take the OCR to a peak of 3.50%. The track then flatlines.
- There are three main drivers of the change in forecast: higher oil prices and crack spreads, a lower exchange rate, and a better starting point for the economy than the RBNZ assumed.
- This is the track that balances upside and downside risks to medium-term inflation, in our view. It certainly does not mean downside risks have gone away. The higher oil price means both upside risks to inflation and downside risks to growth have intensified.

The view

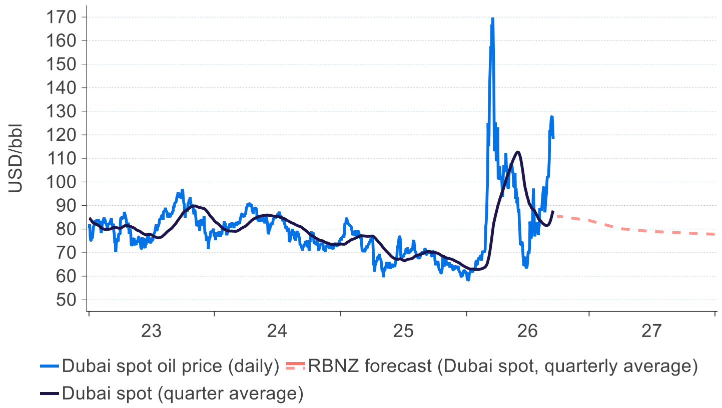
We are updating our OCR call to centralise risks we have been talking about for some time. As well as a 25bp hike at the next meeting in October, we are adding in two more hikes, pencilled in for February and March, taking the OCR to 3.50%. That's the upper end of the RBNZ's range of estimates for the neutral OCR.

The timing is highly uncertain but our baseline story builds in the RBNZ's long-held narrative of getting promptly to 3%, the midpoint of the RBNZ's range of estimates of the neutral rate, and waiting and seeing for a period from there, given the impacts of oil price shocks on medium-term inflation are ambiguous. However, by early next year we expect the RBNZ will conclude it does need to deliver more tightening to balance inflation risks. The RBNZ's September track already peaked at 3.28% (albeit getting there gradually), so this is only one additional hike versus that forecast.

There are three main drivers of the call change.

First, the crude oil price has lifted sharply: the spot Dubai price is now more than 40% above the RBNZ's assumption for Q4 of USD83.7/bbl (figure 1). In addition, the refining spread has blown out, meaning global fuel prices (particularly diesel) could be considerably higher than the crude oil price would normally imply.

Figure 1. Dubai crude oil versus RBNZ MPS assumption

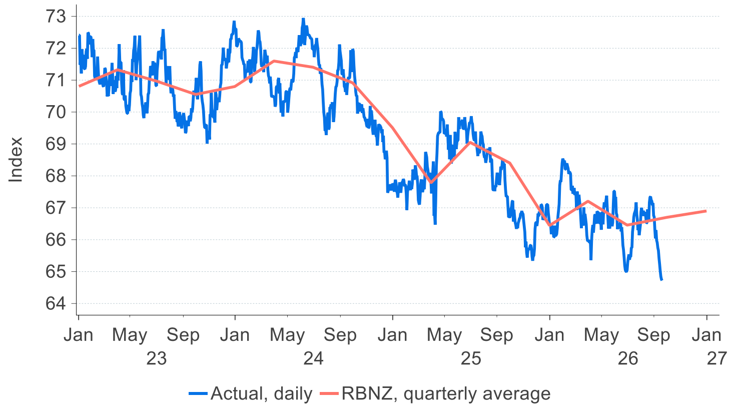


Source: RBNZ, Bloomberg, Macrobond, ANZ Research

The recent surge in fuel prices raises the odds of second- and third-round spillovers across the CPI basket. While the RBNZ is already expecting non-tradable inflation to accelerate, we think there are decent odds the oil shock will spill over into core inflation measures over coming quarters. The core measures will likely be mixed (and we don't forecast them), but with the Sectoral Factor Model already at 2.7%, even a small hint of a change in trajectory would likely make the Monetary Policy Committee uncomfortable. Well-anchored inflation expectations thus far have provided a degree of reassurance, but we'd characterise that more as a risk that hasn't come to fruition rather than a risk averted.

Second, the NZD has dropped out of favour as global risk aversion has increased. The trade-weighted index is now 3.3% below the RBNZ's Q4 assumption (figure 2). This will raise the price of not only fuel but all imports. The RBNZ's focus is on domestic inflation, but they are also worried about spillovers from high headline inflation into wage- and price-setting behaviour. A lower exchange rate will also provide a boost for exporter incomes and the import-competing/tradable sector. It represents a meaningful easing of monetary conditions.

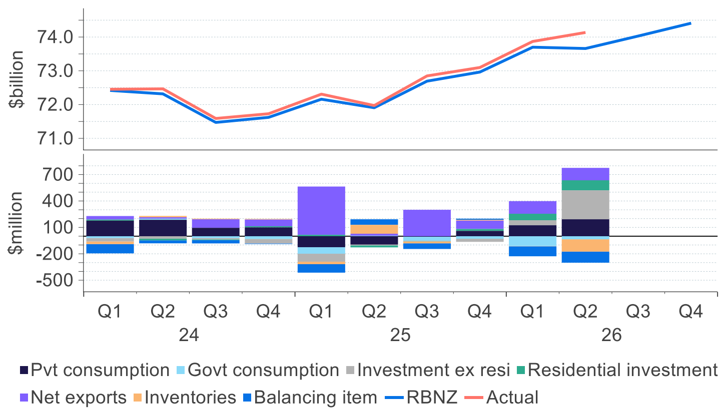
Figure 2. NZD trade-weighted index versus RBNZ MPS assumption



Source: RBNZ, Bloomberg, Macrobond, ANZ Research

Third, the New Zealand economy currently has a bit more momentum than expected. With an upside surprise in Q2 (certainly not 'strong' at 0.2% q/q, but more resilient than anticipated – the RBNZ forecast flat) and an upward revision to Q1, annual growth in Q2 GDP was 2.6% versus the RBNZ's expectation of 2.2% (figure 3). That implies the negative activity impacts of the oil shock have so far been less disinflationary (all else equal) than previously assumed. Certainly, some of the upward shift in GDP will be ascribed by the RBNZ's model to potential output, rather than pure demand. In addition, how long the lift in momentum will last is highly questionable – the last big oil spike in late-February saw forward-looking activity indicators in our Business Outlook survey tank. However, all else equal, the RBNZ's Monetary Policy Committee will be revising their estimate of the output gap to be less negative, and the output gap assumption is crucial in their forecasts to offset the inflationary impacts of the oil shock.

Figure 3. Expenditure GDP vs RBNZ forecast and components of growth



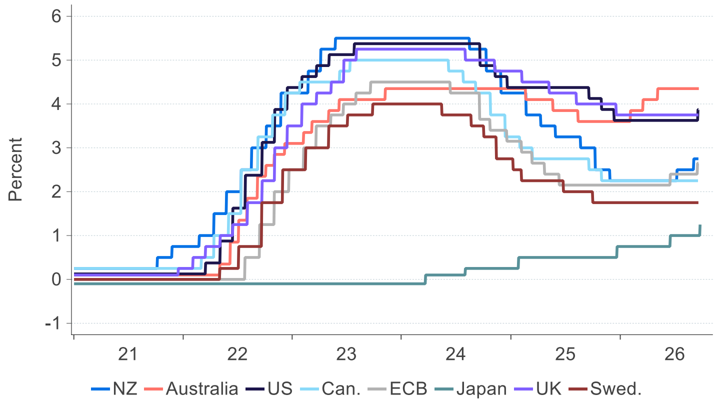
Source: Stats NZ, RBNZ, Macrobond, ANZ Research

We're also mindful that risks to the neutral OCR are skewed higher, and we know from meeting minutes that the Monetary Policy Committee sees the risks as tilted in that direction. This is a gradual creeping higher risk rather than an expectation that the RBNZ is suddenly going to revise its neutral assumption by a significant clip in one go – neutral is unobservable and slow moving, but if it's higher than the RBNZ is assuming (described as in a range of 2.5% to 3.5%), OCR hikes to date will be getting less disinflationary traction. If that is the case it should become evident in the data over time.

Our updated forecast, in our view, balances the upside and downside risk to medium-term inflation. It certainly does not mean that the downside risks have gone away. There are plenty to worry about, and any of these could mean the OCR stops short of our updated forecast:

- Housing: the combination of higher rates, policy uncertainty, rising user costs (insurance and rates) are likely to keep the market flat for some time, dampening the cyclical recovery.
- Global bond yields have been marching higher, tightening financial conditions and presenting downside risks to asset valuations and global growth.
- A wave of hawkishness globally (and a Fed hike) has seen rates rise at the short end too, on expectations of more hikes. New Zealand rates have been taken for the ride regardless of any nuance domestically. The RBNZ charts its own path, but in this environment not keeping up with the Joneses could have exchange rate repercussions.

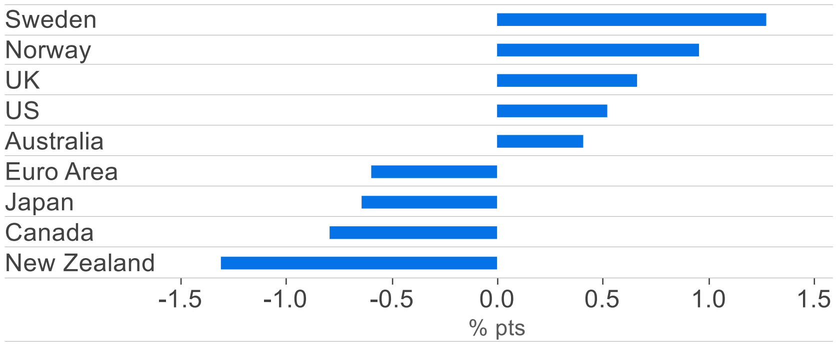
Figure 4. Global policy yields



Source: RBNZ, Bloomberg, Macrobond, ANZ Research

New Zealand's policy rate has been lower than peers for a very good reason (the economy has been underperforming and there is a much greater degree of estimated slack in the economy). Nonetheless, in the face of a global shock one would expect a degree of convergence. Currently, New Zealand is an outlier if one looks at the policy rate setting versus the current headline inflation rate (figure 5).

Figure 5. Policy rate minus inflation rate



Source: Macrobond, ANZ Research

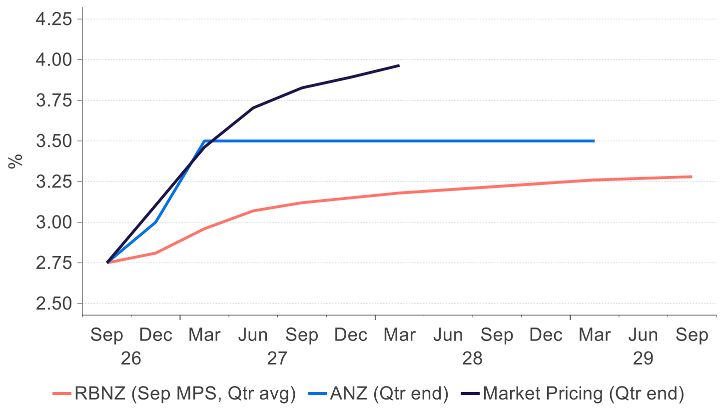
The market is now pricing a peak OCR of around 4%, and swap yields have risen markedly (figure 6). All else equal, tighter monetary conditions reduce the need for urgency in delivering hikes. That is a part of the reason we have built in a short pause after 3%, to see what impact higher rates are having. But one also does need to bear in mind the circularity – if the RBNZ didn't deliver, or at least maintain a firm tightening bias, yields at the short end would decline again. But it buys time.

Figure 6. Swap yields and the OCR

Source: RBNZ, Bloomberg, Macrobond, ANZ Research

Our revised OCR forecasts also have implications for our broader short-term interest rate forecasts. As a result of our higher OCR endpoint forecast (3.50% by March, rather than just 3.00% by October), we expect 90-day bill rates to continue tracking higher before levelling out at 3.90%. By contrast, we expect the 2-year swap rate to hold around current levels. While a pullback would technically be on the cards if markets moved to price a 3.50% terminal OCR, as we expect, rather than the circa 4% currently priced in, we see little scope for a meaningful correction given ongoing inflation concerns, both locally and globally. Our bond forecasts have not changed.

Figure 7. ANZ OCR forecast vs. currently market pricing



Source: RBNZ, ICAP, Bloomberg, Macrobond, ANZ Research

Table 1. Interest rate forecasts

	Actual			Forecast (end month)					
	Jul-26	Aug-26	21-Sep	Sep-26	Dec-26	Mar-27	Jun-27	Sep-27	Dec-27
NZ OCR	2.50	2.50	2.75	2.75	3.00	3.50	3.50	3.50	3.50
NZ 90 day bill	2.94	3.06	2.54	3.30	3.55	3.88	3.90	3.90	3.90
NZ 2-yr swap	3.68	3.72	3.50	3.95	4.00	4.00	4.00	4.00	4.00
NZ 10-yr bond	4.67	4.74	4.72	5.00	5.00	5.00	5.00	5.00	4.75

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We welcome your questions and feedback. Click here for more information about our team.

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