Harbour Investment Horizons

Less urgency to cut the OCR but the bias remains

Harbour Investment Research

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"Prediction is very difficult, especially if it's about the future." - Niels Bohr

The market and economic backdrop has changed noticeably since the RBNZ last cut interest rates in March. As a result there is much less urgency to cut the official cash rate (OCR) at the upcoming 9 June meeting. The market is pricing a 20% chance of a 25 basis point cut. However, looking further ahead, in our view a continued absence of inflation pressures still points to low interest rates for an extended period.

The stars aligned for an OCR cut back in March:

- the IMF and others revised down global growth forecasts;
- global markets wobbled as fears of a recession set in;
- wholesale funding markets became strained;
- global commodity prices fell, including dairy prices to new lows; and
- oil prices dropped below $30 a barrel, putting further downward pressure on global headline inflation in Q1 2016.

Locally, the fate of the OCR was sealed by a softening in Auckland house prices in January and February, and a worrying decline in NZ CPI inflation expectations that risked undermining the RBNZ's inflation targeting credentials. In addition to cutting the OCR by 25 basis points, the Bank projected another 25 basis points of cuts in the pipeline for 2016.

As we approach the June Monetary Policy Statement, the RBNZ is met with a very different backdrop:

- global markets have stabilised and bounced significantly in the case of equities;
- fears of a global recession have subsided;
- dairy prices have risen 3% from their lows;
- oil prices are closer to $50 a barrel, bumping up CPI inflation forecasts for Q2 2016;
- NZ CPI inflation expectations surveys have stabilised, not falling further as was feared; and,
- the US Federal Reserve has signalled that they are actively considering a rate hike at their June meeting, steaming the seemingly relentless tide of central banks cutting rates and easing policy across the globe.

At home the most significant change has occurred in the housing market.

Back in the March MPS, the RBNZ noted that "house price inflation has moderated". It took only one strong month of REINZ data for March for the RBNZ to review its assessment in the April OCR review to "there are some indications that house price inflation in Auckland may be picking up". Another strong month of REINZ data for April now means that the weakness in January and February has been fully unwound. This brings the RBNZ's awkward trade-off between achieving its responsibilities for monetary and financial stability into sharper focus.

Indeed, the RBNZ's Financial Stability Report in May contained a hint of helplessness over the housing market.

Despite the Minister of Finance fuelling expectations that the RBNZ would announce new macroprudential measures, no action was forthcoming in the document. In the press conference there was some discussion of the merits of introducing new loan-to-income (LTIs) restrictions. However, the reality is that these would be much more challenging to introduce, given the political problem of inhibiting first time buyers, the conceptual problem of LTIs making more sense for home owners than investors, and the measurement problem of the RBNZ having only collected a short history of LTI data from banks.

The bottom line is that with the housing market returning as a headache for the RBNZ, and new macroprudential measures at least 6 months away, it becomes more difficult for the Bank to cut the OCR at the June meeting. As a result, the market is pricing only a 20% chance of a June cut, down from around 80% soon after the March meeting. Given the way the economic environment has evolved in recent months, we believe this assessment of the near term outlook is broadly fair.

However, as we look forward ahead, in our opinion the continued absence of underlying inflation pressures still points to low interest rates for an extended period, with the balance of risks skewed toward further cuts.

While surveys of NZ CPI inflation expectations have not fallen further as feared, they still sit uncomfortably below the mid-point of the inflation target. And central banks globally still remain puzzled about why CPI inflation and wage inflation remain stubbornly low, even after taking into account the fall in oil prices. The surprisingly low Australian CPI inflation outturn in April that forced the hand of RBA is useful reminder of the "lowflation" that continues to exist.

While the market is currently focused on the strength of the Auckland housing market, don't rule out the problem of stubbornly low inflation eventually returning to the agenda.

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