You Gotta Know When to Hold 'em

I don't recall a period when New Zealand market pricing of the near-term outlook for monetary policy has changed so dramatically in such a short period of time.

Cast your mind back to December last year and the release of September quarter GDP data, showing a massive miss on the quarterly forecast relative to the RBNZ's forecast and downward revisions to prior data. That had market pricing and many analysts bringing forward expectations of the first cut in the Official Cash Rate (OCR).

Fast forward to earlier this month and the release of December quarter labour market data, which was stronger than expected and the market, and at least one notable retail bank forecasting team, is now expecting the next move to be an OCR hike. That repricing was helped along by what was perceived to be a hawkish speech from the RBNZ's Chief Economist.

So, are we in for more hikes?

As a starting point and for the record, our broad developed market monetary policy view, as articulated in the January edition of Global Outlook, can be summarised as follows:

- Good progress is being made on the process of disinflation, especially at the headline level.
- The last mile will be the hardest as core service sector inflation remains sticky so that a long period of below-trend growth is still required to get inflation back to 2% sustainably.
- Central banks have done enough tightening but be wary of calls for early interest rate cuts.
- Expectations of significant interest rate reductions in the years ahead are also likely to be disappointed. Neutral interest rates are now higher than they were pre-pandemic, though how much higher is moot, but this will ultimately limit the scope for interest rate reductions.

The implications of that view for the RBNZ at that time were that we were satisfied that an OCR of 5.5% was the peak in rates, but that interest rate cuts before November this year were optimistic.

We retained that view even after the November 2023 Monetary Policy Statement (MPS) was more hawkish that expected in projecting another hike early this year, and the weaker-than-expected GDP out-turn. We had, however, previously made the point that if the RBNZ were to do anything in the first half of 2024, it was more likely to be a hike than a cut.

It's noteworthy that the RBNZ made a small tweak to their estimate of the neutral interest rate in the November MPS, lifting it from 2.25% to 2.5%. Technically this means that the RBNZ sees an OCR of 5.5% as slightly less stimulatory. Key word there is "technically". The neutral rate is a wonderful concept, but impossible to determine on any given day of the week. That said, expect further upward revisions in the period ahead, and not just from the RBNZ. WE think higher neutral rates will be a global phenomenon.

More importantly, in his recent speech to the New Zealand Economics Forum hosted by Waikato University, the RBNZ Governor delivered a speech extoling the merits of a 2% inflation-targeting regime and the RBNZ's commitment to achieving that outcome.

His comments were, as you would expect, light on messaging about near-term monetary policy deliberations.

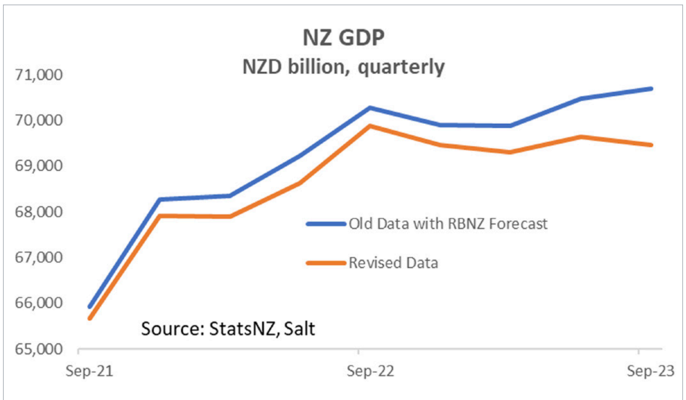
But there was useful guidance in the sense that he highlighted the Monetary Policy Committee would need to be focussed on core inflation, inflation expectations, and the degree of spare capacity available in the economy.

In that regard, the following points are noteworthy as we head toward the February MPS this Wednesday.

Growth

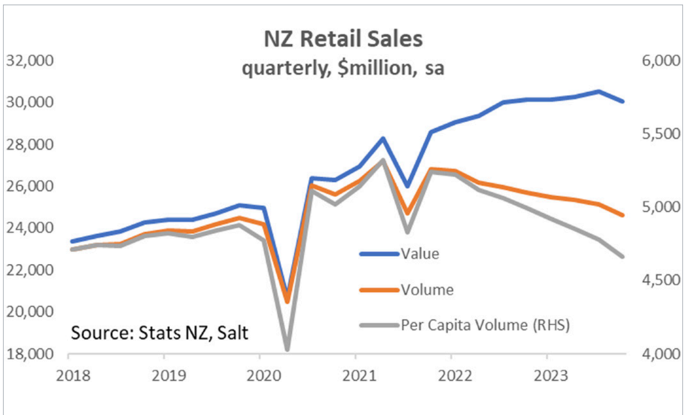
September 2023 quarter growth came in at -0.3%, significantly lower that the RBNZ's forecast of +0.3%. To be fair to the RBNZ, their forecast is printed long before we see the release of all the partial indicators that make up GDP. As these were released, market expectations of the likely result were revised down, though the actual number still undershot the consensus pick.

Furthermore, prior data was revised down to the extent that, along with the forecast miss on the quarter itself, the economy was around 1.7% smaller at the end of the quarter than the RBNZ was expecting.



In his speech the RBNZ Chief Economist downplayed the revisions to some extent, arguing they were in components of GDP that didn't really change their view on how the RBNZ was thinking about the economy and the drivers of inflation risk.

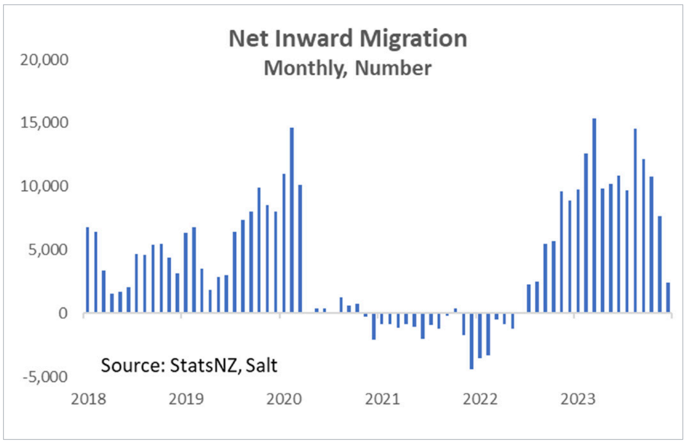
Regardless, the NZ economy has now contracted in three of the last four quarters up to September last year with the weakest part of the cycle still to come. We are expecting modestly negative GDP outcomes for the three quarters from December 2023 to June 2024. This view is supported by the release of weaker than expected retail sales data for the December quarter. The bottom line is the economy is running well below trend.



Migration

Net inward migration has surged significantly higher than we or anyone else, including the RBNZ, were expecting. This time last year we were expecting an annual peak net inflow of around 90,000. Latest data has the peak at around 134,000 people in the year to October 2023.

Latest data to December has the annual total falling to 126,000, though this data is subject to revision. Inflows themselves are slowing and we are now entering a period in which very strong net inflows from the earlier months of last year will start dropping out of the annual calculation, replaced with significantly lower numbers.



There is ongoing debate about the impact on growth and inflation of this surge in population growth. There is of course a positive impact on demand but there is considerable conjecture about how much growth impetus results, and when it will come through.

In our view it is already coming through. To argue that it isn't assumes your prior forecasts for domestic demand without the migration surge were right. A year ago, our NZ growth forecasts were considerably weaker than the consensus. As we have added in more private consumption due to the higher migrant numbers, our forecasts have come closer to the consensus, though probably we are still on the soft side. That said, the key risk to our growth forecasts is that we have under-estimated the population impact on consumption.

The impact on inflation is more difficult to assess. There are two opposing forces, stronger demand isn't helpful as the RBNZ tries to slow the economy down, but stronger population growth adds supply to the labour market which will assist in easing pressures in the labour market, especially with respect to wage growth. Anecdotal evidence from companies we talk to is that better labour availability is playing a significant role in normalising cost pressures.

Labour market

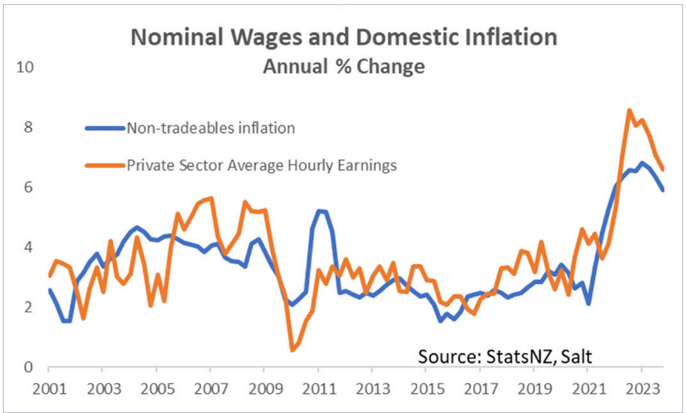
The December quarter Household Labour Force survey was stronger than expected across most indicators. The unemployment rate rose to 4.0% from 3.9% in September, lower than the RBNZ's forecast of 4.2%. That reflected stronger than expected employment growth of +0.4%.

Without wanting to appear dismissive of the latest result, it did come after a weaker-than-expected September quarter result in which employment fell -0.1% and the unemployment rate rose from 3.6% to 3.9%.

Looking across the six-month period, that means employment has risen 0.3% and the unemployment rate has gone from 3.6% to 4.0%. Furthermore, the overall rise in the unemployment rate from a low of 3.2% in September 2022. This is a significant increase. We expect the unemployment rate to be over 5% by the end of the year.

Wage inflation, as measured by the combined sectors (public plus private) Labour Cost Index, appears to have peaked but is yet to show any downside and came in stronger than RBNZ expectations in the December quarter.

It's important to note that the stubborn part of the LCI comes from the public sector which continues to reflect recent large pay settlements that are outside the influence of the RBNZ (other than through inflation expectations). Private sector wage inflation peaked at 4.5% in March 2023 and has since fallen to 3.9%. Private sector nominal wage growth is also retreating.



Fiscal policy

With a new government which hasn't delivered its first Budget, nor Budget Policy Statement, there is more than the usual uncertainty about the fiscal outlook.

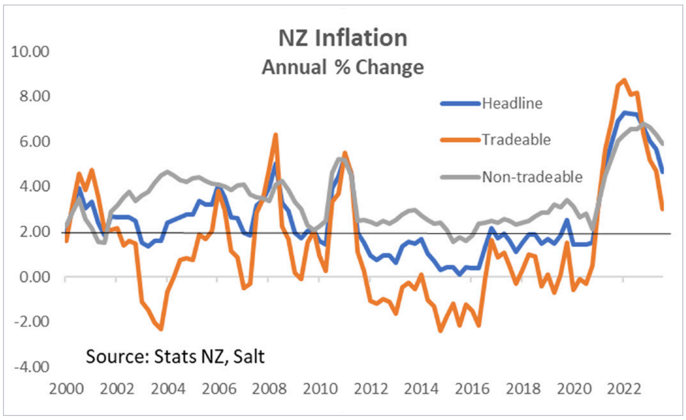
What we do know from the Government's policy agenda, the Half-Year Economic and Fiscal Update and the accompanying Mini (Mini Mini) Budget is that tax cuts are coming, the Government has already identified $7.5 billion in savings, and that government departments have been asked to find an average 6.5% in savings.

How that all come out in the wash and its implications for the near- and medium-term fiscal impulse relative to what the RBNZ has already assumed will have potential meaningful implications for monetary policy. The precise mix between the potential stimulus of tax reductions versus the contractionary impulse of trimmed Core Crown expenditure is of crucial importance, in terms of its likely effects on future inflation. But we won't know the details of that till the end of May. The good news is the new Minister of Finance will be acutely aware of this risk.

Inflation and Inflation expectations

Headline CPI inflation has come in under RBNZ expectations in each of the last two quarters (September and December 2023).

The issue for the RBNZ is all the surprise has come through on the tradeable goods side. As we suspected right from the start of the process, non-tradeable, or domestically generated inflation pressures are proving more intransigent.



The following table compares what the RBNZ was forecasting for headline, tradeable and non-tradeable inflation for calendar 2023 in the August MPS (i.e. before the two better-than-expected headline results) with the actual out-turn.

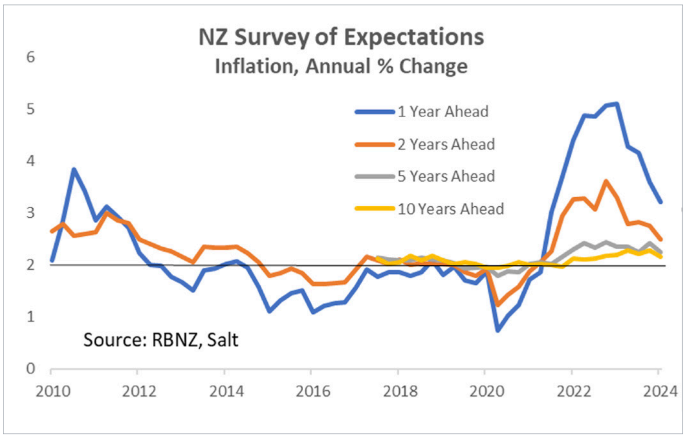
NZ Inflation as at Dec 2023	August MPS Forecast	Actual
Headline	5.2%	4.7%
Tradeable	4.9%	3.0%
Non-tradeable	5.5%	5.9%

So, great progress at the headline level, but the detail is quite unbalanced in terms of how the RBNZ thought the disinflation would play out. Non-tradeable inflation is where monetary policy has most direct influence and its stubbornness (relative to forecast) is why the RBNZ is delivering hawkish messaging right now.

We don't think the RBNZ is necessarily aiming to get non-tradeable inflation back to 2%, but if they are genuinely aiming for a sustained return to a 2% headline inflation handle, and we have no doubt they are, the non-tradeable part is going to have to get a lot closer to that level than it currently is. That's especially the case if, like us, the RBNZ expects we are not going to get as much help in achieving that goal in the future from low global inflation.

The good news is that non-tradeable inflation is moving in the right direction, albeit more slowly than the RBNZ was expecting. Indeed, all key measures of core inflation the RBNZ monitors are moving in the right direction.

At the same time, inflation expectations are also moving in the right direction. The RBNZ puts a lot of weight on inflation expectations, as indicated by the Governor's recent remarks. They will be no doubt pleased to see the ongoing progress of expectations moving toward 2% across all time periods.



This is where lower headline inflation is important, regardless of its make-up. Lower current headline inflation will be influencing the progress towards lower inflation expectations which, in-turn, influences future wage growth outcomes. And of course, for any given level of nominal interest rates, lower inflation means higher real (inflation adjusted) interest rates, adding increasing braking power to activity.

So where does this leave us right now?

- Monetary policy is restrictive and is leaning against too-strong demand
- Growth in the economy is running below trend despite strong population growth, and is expected to remain so throughout 2024.
- Pressures in the labour market are unwinding: the unemployment rate is rising and wage inflation is easing, however the pace of these developments is coming through more slowly than the RBNZ was expecting.
- Headline inflation is falling faster than the RBNZ was expecting, but domestic inflationary pressures are proving to be more stubborn.
- Core measures of inflation are falling.
- Fiscal policy is a source of uncertainty and will remain so until the May Budget reveals more details.
- We have no doubt in the RBNZ's commitment to achieving 2% inflation and their willingness to hike interest rates further, should that be required.

The bottom line is we remain happy with our view that the RBNZ has done enough, but that interest rate cuts are a long way off. We still have November pencilled in for the first cut, but the balance of risks points to later.

The key risks to our view are that the recent strong population growth is yet to show up in the growth numbers, and the uncertainty around fiscal policy. The final risk, and one that is harder to assess, is simply that the RBNZ is disappointed with progress to date (especially with respect to the labour market) and is looking for a speedier and more certain return to target.

We thus expect the RBNZ to hold the OCR at 5.5% this week, but to retain a hawkish bias. We think the RBNZ just needs to give the adjustment process more time. That means they can be expected to retain further hikes in their interest rate projections.