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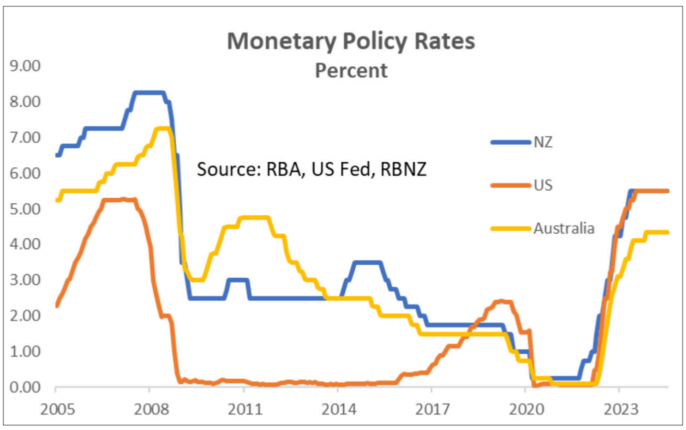
Antipodean monetary policy juxtaposition

Central bank action (mostly) centres on the southern hemisphere in August when the Reserve Banks of Australia and New Zealand hold their next meetings. There will be an interesting juxtaposition between the two: the Reserve Bank of New Zealand (RBNZ) will be considering a cut, while the Reserve Bank of Australia (RBA) will be considering a hike.

This harks back to the approach both central banks took during the tightening phase of the cycle. Along with most developed central banks who came late to the realisation that post-pandemic inflation was a problem, the RBNZ took an aggressive "take no prisoners" approach to the tightening cycle. Indeed, the RBNZ ended up hiking more than we thought they needed to. We thought an Official Cash Rate (OCR) of 5.0% would be enough to do the job. In the end the OCR peaked at 5.5%.

Conversely, in Australia, we expected the cash rate to peak at least at 4.60% and we wouldn't have had a problem with 4.85%. Instead, the RBA stopped at 4.35%, still restrictive but less restrictive than seen in other similar economies. This signalled a desire to do less harm to activity and the labour market, though acknowledging this meant the path back to target would take longer with interest rates also necessarily remaining high for longer.

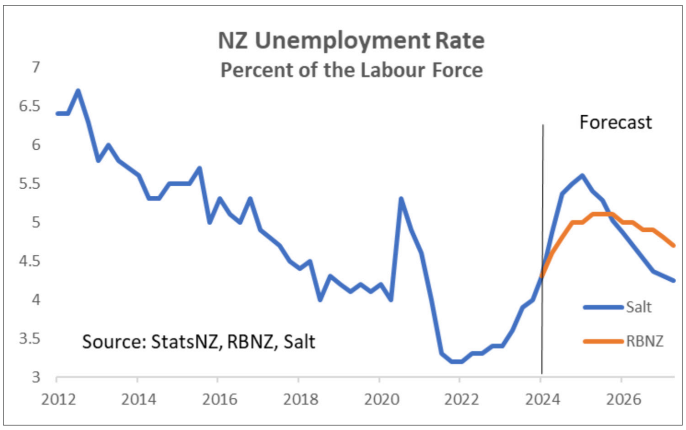


Both approaches carried benefits and risks. In New Zealand the benefit was a faster return to target inflation and earlier interest rate relief, but the risk was unnecessary collateral damage during the disinflation process. Meanwhile, in Australia, the benefit was less damage to activity and employment, but the risk was they hadn't tightened enough and might have to resume hikes.

New Zealand cuts coming soon

Right now, there is no reason why the RBNZ shouldn't cut interest rates at its earliest possible opportunity. That would be the August meeting where the next full set of economic projections will be produced. Whether they will have sufficient confidence to do so remains to be seen.

Our GDP growth and labour market forecasts have been consistently weaker than the RBNZ's (and Treasury's for that matter). While that doesn't mean we have been expecting faster disinflation, it does mean that we have been expecting the RBNZ would be able to make an earlier than indicated judgment that the broad range of conditions were in place for ongoing disinflation and a sustained return to target.



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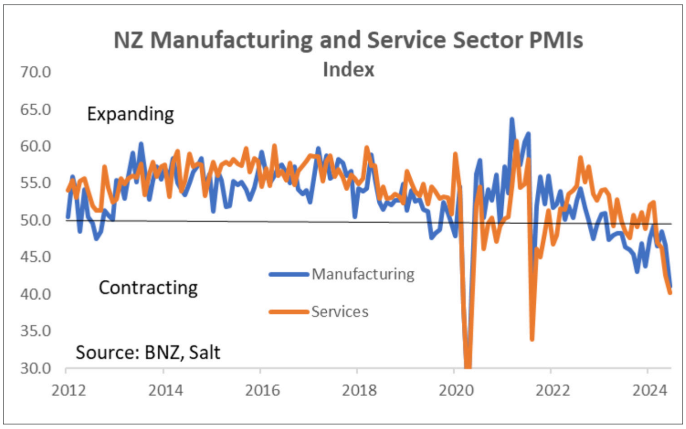
That has always had us expecting an earlier start to the rate cutting cycle than the RBNZ was projecting. In fact, we have not deviated from our forecast of a November start to interest rate cuts. As market pricing and expectations have shifted, we have at times been at the dovish end of expectations, while at other times at the hawkish end.

The most recent data has been unequivocally weak. The March quarter GDP release managed to eke out a small positive of +0.2%. This put annual growth at +0.3% for the year to March and -2.4% in per capita terms. Data since then has been much weaker on all fronts including activity, housing, sentiment and the labour market.

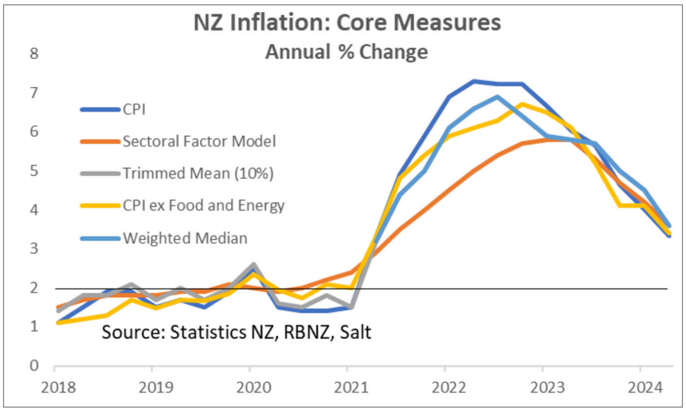
The BNZ's manufacturing and service sector PMIs are going from bad to worse. The manufacturing index has been weak (to varying degrees) for some time now, though that weakness appears to be accelerating. The bigger news has been the sharp deterioration in the services index over the last few months. Tighter monetary policy is finally hitting the service sector. This is important because this is where the last vestiges of sticky inflation reside.



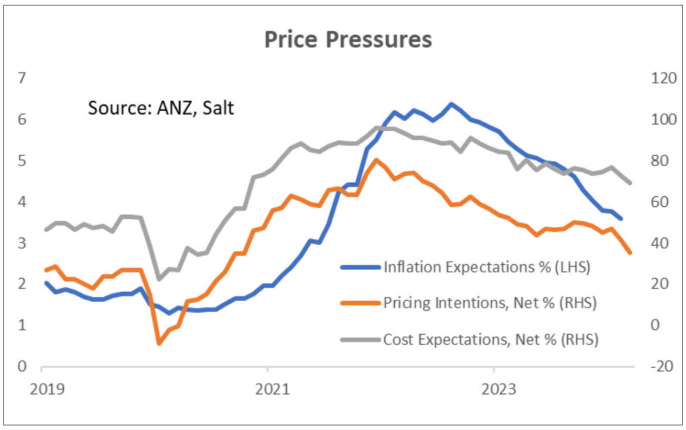
Of course, the RBNZ's ultimate target is inflation. But there too the data has been better, though not universally so. June Consumer Price Index (CPI) had the annual rate of inflation come in at 3.3%, below the RBNZ's out-dated forecast of 3.6%. This has reinforced our expectation that annual inflation will be back inside the 1-3% target band by the September quarter, with that data scheduled for release in mid-October.

While the decline in the headline inflation rate was a welcome development, the split between tradeable (imported) and non-tradeable (domestic) inflation showed that, as has been the case in prior quarters, all the downside surprise was in tradeable inflation.

Non-tradeable inflation pressures have remained sticky and have continued to surprise to the upside. This component of the CPI came in at +0.9% in the June quarter, higher than the RBNZ's forecast of +0.8%. This was, however, this components' lowest quarterly increase since March 2021. Furthermore, all the core measures of inflation the RBNZ monitors were lower in June and are converging on the target band.



Looking ahead, recent business sentiment surveys have indicated an accelerated decline in firms' pricing power. This is in an important development in the outlook for domestic inflation and, along with the recent softer data, will have had a significant bearing on the RBNZs dovish pivot at their July Monetary Policy Review (MPR), only six-weeks after disclosing they had considered a hike at the May Monetary Policy Statement (MPS).

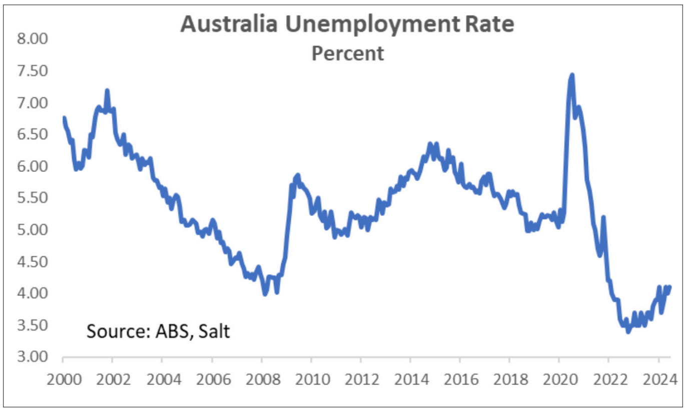


Australia finely balanced

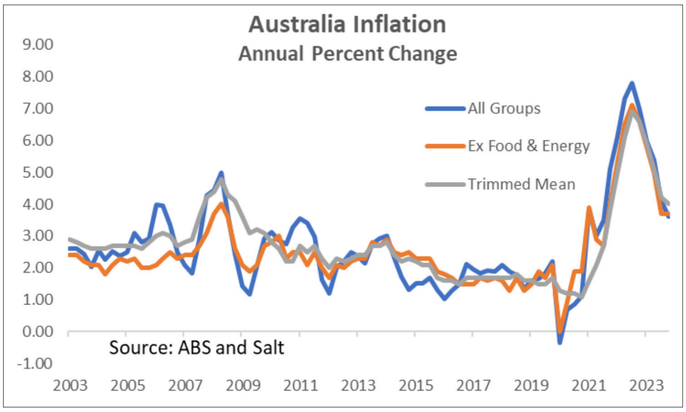
As the effects of the tightening in monetary policy have flowed through the economy, growth in activity has slowed and the labour market has started to ease. However, progress on inflation has been less than expected, as admittedly it has everywhere.

GDP growth came in weaker than expected in the March quarter with an annual rate of 1.1% y/y, the lowest since 1992 (outside of the Covid period) and the fifth consecutive quarterly decline in per capita GDP. This result was a bit below what was implied in the RBA's May forecasts. That said, it is unlikely to shift the RBA's narrative that growth is weak and below trend, and that monetary conditions are restrictive.

Recent labour market data has had something for everyone. June data released last week showed stronger-than-expected jobs growth of 50k (consensus forecast 20k), the third consecutive strong jobs beat. A rise in participation to 66.9% led the unemployment rate to tick up from 4.00% to 4.05%. Loosening is happening, but only gradually.



Recent data from the May Monthly CPI indicator (a partial release of some of the data that makes up the full quarterly CPI) is indicating some upside potential to RBA inflation projections that have already been revised up once before. This makes June quarter CPI data (due July 31st) critical in the lead up to the RBA's August meeting.



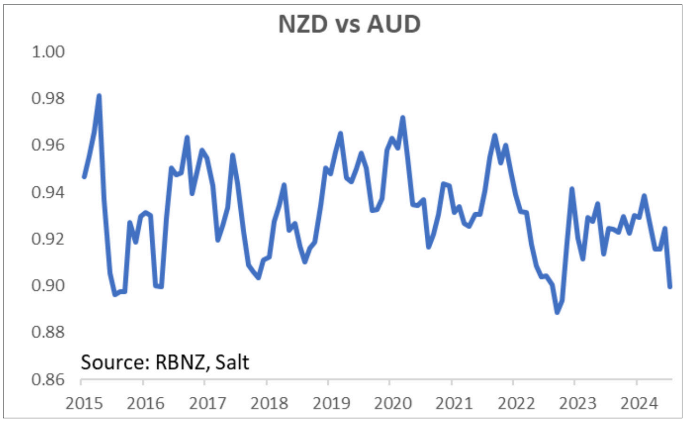
What to expect in August

Things are clearly moving in the right direction for the RBNZ. The conditions for a sustained return to 2% inflation are increasingly in place and there is no reason why they shouldn't cut in August. That said, we will stick to our view of a first cut in November. The RBNZ will probably want to see the annual rate of inflation below 3% before moving. That means the RBNZ will use the August meeting to set things up for a cut at the following MPS. There is also an MPR scheduled for October.

There is still important June quarter labour market data scheduled for release on August 7th, a week before the MPS. If this is significantly weaker than the RBNZ's forecast of 4.6%, it may prompt them to go in August. Our forecast is 4.8%.

In Australia the debate is less clear cut. Having thought they should have hiked more, monetary conditions are restrictive, and things are moving in the right direction, albeit slowly. Arguing in favour of holding is that monetary conditions are evidently restrictive, the RBA doesn't really want to hike and there is therefore a high hurdle to go again. Arguing in favour of a hike is that if they are going to have to do it, better to do it now. On balance I think they hold rates unchanged

The most obvious market signal of the respective trans-Tasman monetary policy conundrums has been the NZD/AUD cross. This is great news if you export to Australia but bad news if you are an importer.



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