Westpac

Institutional Bank

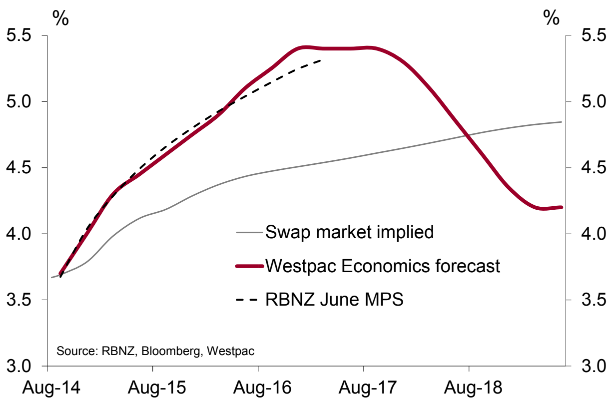
2 September 2014

Kicking the can down the road

September 2014 *MPS* preview: OCR to remain 3.5%

- The OCR will be left unchanged at 3.5% next week.
- Given the looming election, the RBNZ may opt for a low profile in its communications. Now is not the time to put a stake in the ground.
- We expect the RBNZ to signal that the OCR will remain on "pause", thus ruling out an October hike.
- But the RBNZ will also reiterate its overarching expectation that the OCR will rise substantially over the coming years.
- Markets may be surprised when the forecast of 90-day interest rates doesn't move much. We expect interest rates to rise a little on the day.
- The New Zealand dollar reaction to the MPS is more uncertain, depending on the RBNZ's choice of words regarding the exchange rate.
- We expect the next OCR hike will occur in January 2015.

90-day rate forecasts: market, RBNZ, and Westpac



The Reserve Bank announced a "pause" in its programme of OCR hikes in its last monetary policy dialogue, the July OCR Review. That renders next week's September *Monetary Policy Statement* a dead rubber – the OCR will be left unchanged at 3.5%, end of story.

But there is still plenty of interest in the communique that will accompany the on-hold OCR decision. Judging by current market prices, financial markets are convinced that the Reserve Bank is about to back down on its earlier forecast that the OCR will rise substantially over the coming couple of years.

We are not so sure that the RBNZ has cause to acquiesce. As we explain below, recent economic developments are actually quite ambiguous. Economic growth, inflation and dairy prices are all lower than expected. But net immigration has snowballed unexpectedly, fixed mortgage rates are falling, and the exchange rate has dropped. It is not entirely clear which of these developments dominates so far as the medium-term inflation outlook is concerned.

That said, now is not the time for the RBNZ to push the point. We doubt that the RBNZ will go out of its way to "correct" errant market pricing, the way it did in June. The *Monetary Policy Statement* falls only nine days before a general election – any forecast issued now could well be rendered obsolete by the election outcome. At this juncture firm commitments and bold forecasts are best avoided in favour of a softly-softly approach.

The best course available to the RBNZ is to "kick the can down the road" until the election has passed. The RBNZ can tackle the market head-on in December, if the data still warrants.

We expect the RBNZ's press release will repeat the July comment that it "is prudent that there now be a period of assessment...." This would effectively rule out a October hike, and would cast doubt upon a December hike. But the statement will probably also reiterate the broad themes that the RBNZ has promulgated all year, including its expectation that the OCR will rise to a more normal level over the years ahead. The overall tone of the press release may fall somewhere between the June press release (which sounded very keen to raise the OCR) and the July press release (which was more contrite).

The RBNZ's 90-day interest rate forecast

Convention dictates that the RBNZ must issue a forecast of 90-day interest rates, along with a comparison to the forecast from the June MPS. Markets seem to expect that the new forecast will be much lower than the old one. We are not so sure. We do expect that the new forecast will feature lower 90-day rates in 2014, consistent with the OCR remaining at 3.5% for a while yet. But we suspect that the 90-day interest rate forecast for 2016 will be little changed from the June MPS – or at most, 10 to 20 basis points lower.

To understand where the RBNZ might land on this, it is useful to consider recent economic developments from the RBNZ's point of view. First the negatives:

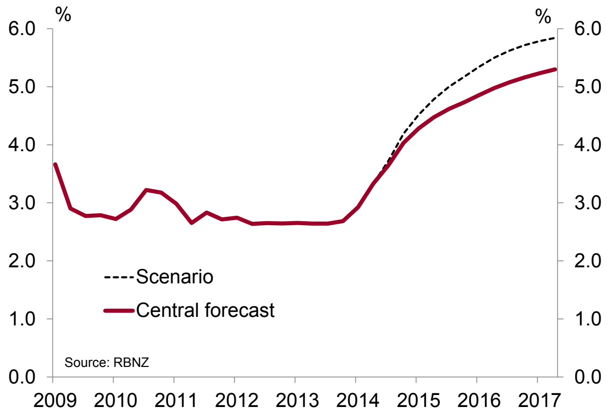
- The New Zealand economy has lost momentum – quarterly GDP growth has dropped from above 1% to about 0.7%.
- Global auction prices for dairy products have continued to plunge in recent weeks. The June *Monetary Policy Statement* contained an alternative scenario in which export prices fell 4% over and above the substantial fall already factored into the main forecast. Recent experience has not been quite that severe, but it isn't far off. In that alternative scenario the RBNZ indicated that the pace of OCR hikes would be attenuated by 20 basis points over two years.
- The near-term outlook for inflation has moderated. June quarter inflation data was in line with expectations, but the detail revealed that underlying inflation was subdued while headline inflation was propped up by transitory factors. In addition, data last week showed that food prices unexpectedly dropped in July. And changes to the Government's plans mean that next year's ACC levy reductions will knock more off inflation than previously allowed for. All of this has caused us to lower our forecast for inflation in 2015 to just 2.0%.
- Surveys of inflation expectations have moderated slightly in recent months.
- The housing market is in recovery mode after the pasting it took earlier this year. However, the pace of recovery has been a little more modest than the RBNZ anticipated (house prices are presently rising at approximately 2% per quarter, compared to the RBNZ's forecast of 2.5% per quarter).

Impressive as this list of negatives is, there have also been important developments on the "positive" side:

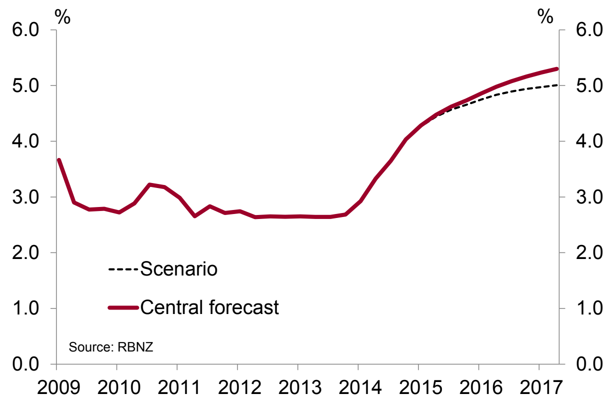
- On a trade-weighted basis the exchange rate has fallen almost 4% from its peak, and now stands a little lower than the RBNZ's forecast from the June MPS. Regular readers will know that the exchange rate is always a crucial part of deliberations at the RBNZ.
- Net immigration continues to surge, and on our forecasts will reach an all-time high of 50,000 people per annum early next year. The most recent surprise has been extra arrivals coming into the country, rather than fewer departures (inflation is most sensitive to arrivals). The June MPS contained an alternative scenario in which net immigration rose by an extra 4,000 people per quarter. The recent surprise has been almost, but not quite, of that magnitude. In the scenario, the OCR had to rise by an extra 55 basis points over two years.
- Fixed mortgage rates have fallen recently, and mortgage borrowers are taking the opportunity to fix their interest rates (a wise move, in our opinion). The average advertised two-year mortgage rate is now nine basis points lower than it was on the eve of the first OCR hike. Of course, lower fixed mortgage rates risks reigniting the housing market.

Our assessment is that the negatives and positives in this list roughly offset one another. The outlook for medium-term inflation is lower than it was back in June, but is higher than it was in July. There is, of course, scope for the RBNZ to come to a different judgement than we have. But it seems extremely unlikely that the RBNZ would come close to the view encapsulated by current interest rate market pricing.

90-day interest rates under stronger net immigration scenario, June MPS



90-day interest rates under weaker export price scenario, June MPS



Market reaction

A *Monetary Policy Statement* along the lines we expect would surprise financial markets. However, if the RBNZ does take a softly-softly approach to its rhetoric, then the scope for interest rates to rise on the day will be limited – especially with an uncertain election looming the near future. We think the most likely market reaction is a small rise in swap rates on the day.

The likely exchange rate reaction is more uncertain. Normally, the exchange rate would move in the same direction as interest rates, and a good argument can be mounted to suggest that the currency will rise on this occasion also. But there is a good chance that the RBNZ will use code-words for currency intervention in the press release, such as “unjustified” (even though the exchange rate has fallen, the RBNZ will still regard it as too high). Depending on the intensity of such language the currency reaction could differ to the interest rate reaction, up to and including the possibility of the exchange rate falling on the day.

Dominick Stephens
Chief Economist

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

Disclaimer

Things you should know: Each time someone visits our site, data is captured so that we can accurately evaluate the quality of our content and make improvements for you. We may at times use technology to capture data about you to help us to better understand you and your needs, including potentially for the purposes of assessing your individual reading habits and interests to allow us to provide suggestions regarding other reading material which may be suitable for you.

If you are located in Australia, this material and access to this website is provided to you solely for your own use and in your own capacity as a wholesale client of Westpac Institutional Bank being a division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ('Westpac'). If you are located outside of Australia, this material and access to this website is provided to you as outlined below.

This material and this website contain general commentary only and does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material and this website may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material and this website does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. The forecasts given in this material and this website are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Transactions involving carbon give rise to substantial risk (including regulatory risk) and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. Statements setting out a concise description of the characteristics of carbon units, Australian carbon credit units and eligible international emissions units (respectively) are available at www.cleanenergyregulator.gov.au as mentioned in section 202 of the Clean Energy Act 2011, section 162 of the Carbon Credits (Carbon Farming Initiative) Act 2011 and section 61 of the Australian National Registry of Emissions Units Act 2011. You should consider each such statement in deciding whether to acquire, or to continue to hold, any carbon unit, Australian carbon credit unit or eligible international emissions unit.

Additional information if you are located outside of Australia

New Zealand: The current disclosure statement for the New Zealand division of Westpac Banking Corporation ABN 33 007 457 141 or Westpac New Zealand Limited can be obtained at the internet address www.westpac.co.nz. Westpac Institutional Bank products and services are provided by either Westpac Banking Corporation ABN 33 007 457 141 incorporated in Australia (New Zealand division) or Westpac New Zealand Limited. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activity.

Disclaimer continued overleaf.

Disclaimer continued

Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

U.K.: Westpac Banking Corporation is registered in England as a branch (branch number BR000106), and is authorised and regulated by the Australian Prudential Regulatory Authority in Australia. WBC is authorised in the United Kingdom by the Prudential Regulation Authority. WBC is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority in the United Kingdom. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. This material and this website and any information contained therein is directed at a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services Act 2000 (Financial Promotion) Order 2005 or (b) high net worth entities, and other persons to whom it may otherwise be lawfully communicated, falling within Article 49(1) of the Order (all such persons together being referred to as “relevant persons”). The investments to which this material and this website relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this material and this website or any of its contents. In the same way, the information contained in this material and this website is intended for “eligible counterparties” and “professional clients” as defined by the rules of the Financial Services Authority and is not intended for “retail clients”. With this in mind, Westpac expressly prohibits you from passing on the information in this material and this website to any third party. In particular this material and this website, website content and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission (“CFTC”) as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC (‘WCM’), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 (‘the Exchange Act’) and member of the Financial Industry Regulatory Authority (‘FINRA’). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

For the purposes of Regulation AC only: Each analyst whose name appears in this report certifies that (1) the views expressed in this report accurately reflect the personal views of the analyst about any and all of the subject companies and their securities and (2) no part of the compensation of the analyst was, is, or will be, directly or indirectly related to the specific views or recommendations in this report.