22 March 2011

Inflation Threat Will Force OCR Reversal

- RBNZ 'emergency' 50 point cut, takes OCR back to low of 2.50% seen during Global Financial Crisis
- We believe it will be forced to reverse tack more aggressively than the market currently expects
- Inflation threats to emerge, and GDP to pick up, in spite of major disruption from the Christchurch earthquake
- Hedges of debt positions need assessing, as the NZ rate curve is strongly biased upward from here

RBNZ provides catalyst to reconsider rates outlook

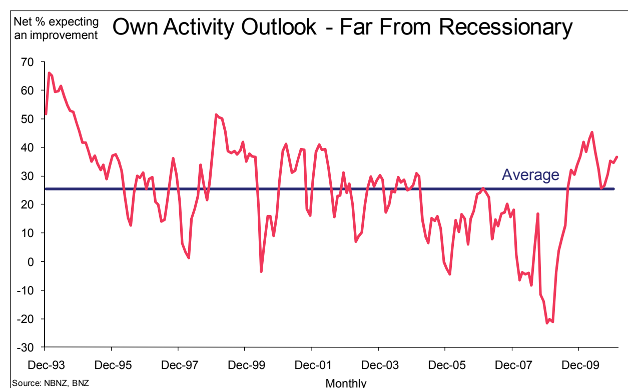
The recent 50bps rate cut by the RBNZ provides a catalyst for rethinking interest rate expectations, from a new OCR starting point low of 2.5%. We believe it is also a useful point to reconsider debt hedging strategies.
NZ interest rate curves are about as low as they will get, and upside pressure will begin to reassert sooner than the market appreciates.

1. The Macroeconomic Backdrop

At its scheduled 10 March meeting, the RBNZ cut its OCR by 50bps – at the aggressive end of market expectations. The Bank's accompanying statement focussed primarily on the recent Christchurch earthquake, and fears that the tragedy might derail the national economy's nascent recovery. However, the Bank was clear in stating that the cut was an 'insurance' measure, and would be reversed as Christchurch reconstruction gets underway.

The Bank also suggested it had some concerns regarding softness in nationwide data even prior to the earthquake, with the disaster providing additional impetus to trim its cash rate.

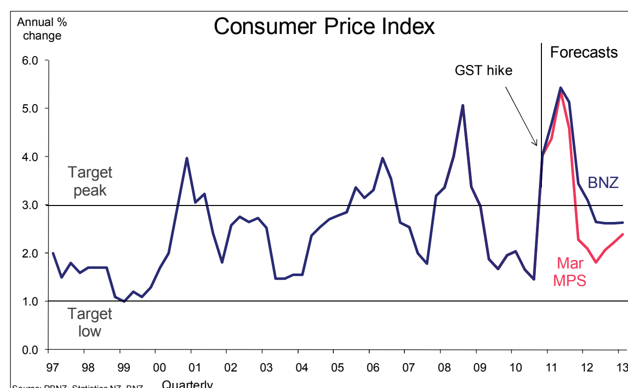
While it is undeniable that there had been some disappointing data prior to the 22 February earthquake, we were not of the view this meant a meaningful double-dip recession. The economy was showing good underlying momentum leading into the February earthquake, as a reasonable interpretation of the month's NBNZ business survey makes clear. This survey pointed to a very strong pick-up in activity through this year – with much of this momentum still likely to be sustained, notwithstanding the obviously damaging impacts of the Christchurch earthquake.



So, while we have taken a full 2.1% off GDP this year on account of the earthquake, we still have GDP expanding nationwide. The recovery will simply be more muted than we previously expected. We forecast that 3.0% annual growth this year will build to 3.4% in 2012, partly as the reconstruction effort gets underway.

But while there are timing issues in respect to GDP growth to consider, we believe inflation pressures can only strengthen.

As we have emphasised from the start, the recent Christchurch earthquake represents a supply shock (destroyed buildings, businesses and homes) as much as a demand shock – so no obvious slack as a result. In fact, arguably less relative supply. And the massive rebuilding programme will certainly put immense pressure on the economy's resources over the medium term. On balance, then, nationwide inflationary pressures are increased.



Of course, the RBNZ is permitted to, and certainly should, look through the near-term impacts of the earthquake on headline CPI inflation. However, the Bank will also need to be conscious of the potential for this to trigger ongoing price and wage hikes, and expectations thereof. The last thing we would want is for the tragedy of the Christchurch earthquake to be compounded by inflation being allowed to spiral up across the economy. We think this is the risk the Reserve Bank is taking, were it not to reverse the recent cut at the soonest possible opportunity.

2. Implications for Interest Rates

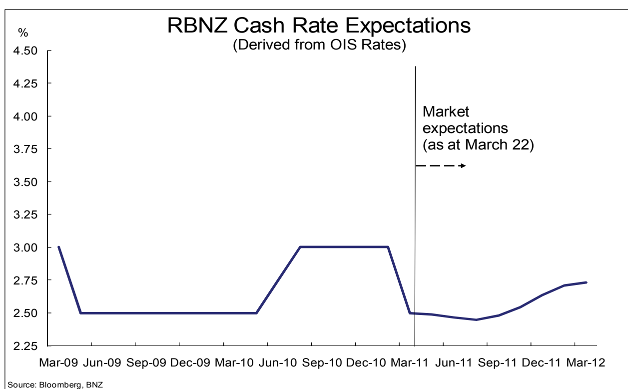
We should start by saying we think the chances of further rate cuts are almost zero in the absence of a major slowdown in global growth (something we don't presume on the basis of Japan's woes alone). Comments from RBNZ Governor Bollard, post the rate cut, certainly downplayed the potential for any further easing.
The OCR set at 2.5% is clearly seen as an 'emergency' level which is not sustainable for a prolonged period.

From current levels, then, the direction of NZ interest rates is clearly upward, in our view. However, three valid questions remain: When will the RBNZ begin to hike rates? How quickly will it do so? And what will prove the eventual OCR peak?

RBNZ to hike sooner, go further, than market expects

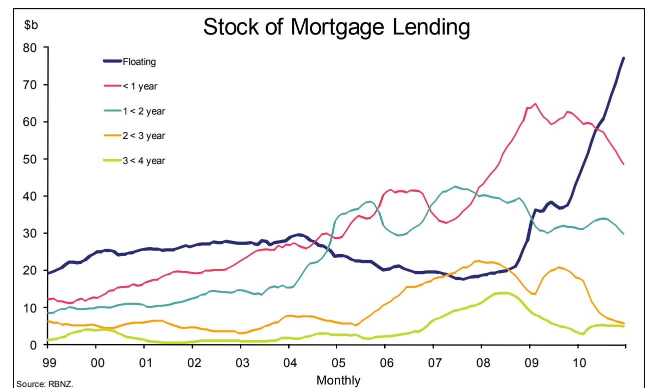
Given our outlook for growth and, importantly, inflation, we expect the RBNZ to resume its broader stimulus-removing cycle in December, steadily taking the OCR to 4.75% by the end of 2012, with a cyclical peak of 5% creeping into early-2013.

This is a more aggressive view than the market currently has priced. Currently, the swaps markets infer a near term peak of the OCR, at around 4.5% in early 2013.
For guidance over the more immediate term, OIS markets are not fully pricing the OCR being just 25bps higher in a year's time. We believe there is upside risk to the market view that the cash rate won't budge from its historic low level of 2.5% until well into next year.



Moreover, if we're right about the next OCR hike occurring before the end of this year then the current "window of opportunity" is not very wide, given rate curves typically steepen well ahead of the first hike.

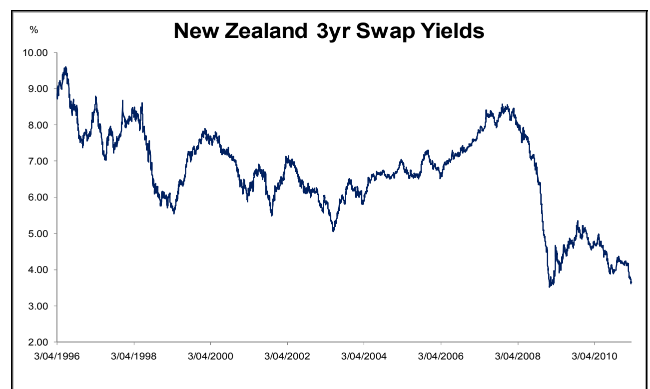
In this vein, it is also worth appreciating the proportion of NZ borrowing that has migrated to short-term rates over the last couple of years. Indeed, there are now over 75% of mortgages on floating or fixed rates of less than one year. We suspect a similar trend has transpired in the wholesale/business sector. This all suggests that once sentiment shifts to fixing rates, the volume of demand will be very high, and the rate moves may be abrupt.
Again, there may not be as much time to wait as the point of the "next hike" suggests.



Summary

While economic activity will be further hampered by the Christchurch earthquake, we still believe a recovery is in train across the wider economy. As importantly, we believe inflation will arise during the year as a significant threat. Accordingly, we believe the recent OCR cut by the RBNZ marks the low of the current rate cycle and that markets will be surprised by how quickly the RBNZ recommences rate hikes, and how rapidly it progresses to a 5% peak. Our forecasts suggest it would be prudent to reassess debt hedging positions ahead of the market moving toward our view.

3. Scenario Analysis



We believe it is useful to assess what our central view implies for the interest rate curve (we have chosen the NZ swap curve as representative for this purpose).
In addition, to understand the risks around our central forecasts we assess the implications for swap rates of three alternative scenarios.

Central Case – Early start and 5% peak

- RBNZ hikes rates at end 2011, as inflationary pressures return to focus
- Rates rise rapidly to 4.75% by end 2012
- OCR peaks at 5% by early 2013, before tapering off to 4.5% from late 2013

swap rates	Market (22 March)	Implied by BNZ OCR forecasts	difference
1 year	2.74%	2.79%	0.04%
2 year	3.29%	3.58%	0.29%
3 year	3.75%	4.11%	0.36%
4 year	4.08%	4.28%	0.20%
5 year	4.36%	4.38%	0.02%

Our OCR forecasts imply that swap rates will move meaningfully higher, suggesting it would be prudent to hedge positions, ahead of our view being realised.

Scenario 1 - Slow start to hikes but 5% peak

- RBNZ remains on hold until September 2012 as NZ growth falters and global risks abound
- Rise in rates is quite gradual with OCR peaking at 5% at end of 2013, and tapering off to 4.5% from late 2014

swap rates	Market (22 March)	Implied by Scenario 1	difference
1 year	2.74%	2.67%	-0.08%
2 year	3.29%	2.86%	-0.43%
3 year	3.75%	3.52%	-0.23%
4 year	4.08%	3.92%	-0.16%
5 year	4.36%	4.09%	-0.26%

This scenario suggests a later start to the rate hiking process than is currently priced by the market, and therefore there is no urgency to hedge debt positions at current rates.

Scenario 2 – Early 2012 start to low peak

- RBNZ starts to hike rates in March 2012
- Rates rise steadily to 4% by October 2012, and stay steady at this low peak level

The market is close to pricing this scenario for the near term however a 4% peak in rates is below current market expectations. If this case were to be realised it suggests the curve is currently too steep, and it would therefore not pay to hedge at longer rates. It is worth bearing in mind that previous rate cycles have *bottomed* at rates that begin with a '4'. Therefore a 4% cyclical peak would imply, either extremely subdued inflation, or that NZ interest rates have made a significant structural move lower.

swap rates	Market (22 March)	Implied by Scenario 2	difference
1 year	2.74%	2.68%	-0.07%
2 year	3.29%	3.23%	-0.06%
3 year	3.75%	3.57%	-0.18%
4 year	4.08%	3.74%	-0.34%
5 year	4.36%	3.85%	-0.51%

Scenario 3 – Chunky start, higher peak

- RBNZ reverses 'emergency' cut by year end
- Aware of rising inflationary pressures it hikes in four 50bp moves to 4.5% by April 2012
- In early 2013 the RBNZ hikes further to head off rebounding growth and inflation, taking the peak in the OCR to 6% by late 2013, with tapering from mid 2015

swap rates	Market (22 March)	Implied by Scenario 3	difference
1 year	2.74%	2.91%	0.17%
2 year	3.29%	3.84%	0.55%
3 year	3.75%	4.57%	0.82%
4 year	4.08%	5.00%	0.93%
5 year	4.36%	5.15%	0.80%

This case is more aggressive than our own view, but is by no means unrealistic. A series of 50bp hikes early on, to reverse highly accommodative policy is feasible, and a 6% peak is relatively low compared to history. This scenario illustrates that our own case, fits within an array of plausible outcomes, some of which present even greater upside risk to current swap rates than our own.

4. What To Look Out For?

In the weeks and months ahead we think it is useful to have pointers, to help gauge how our central scenario is tracking relative to other plausible outcomes.

Growth

We expect data such as confidence indicators will be weak in the immediate term, in response to the Christchurch earthquake and evolving 'risk' events globally. Weak confidence indicators in themselves will not undermine our view.

While headline numbers for releases such as the National Bank Survey may be weak we would look for 'own business' indicators to hold up better than broader measures of economic outlook.

We look for 0.2%q/q GDP growth in Q1 and 0.3% in Q2.

Inflation

- In order to see whether our views on inflation are tracking as expected we would look to wage inflation data, and 'labour constraint' variables in surveys.

- Inflationary indications will also be seen in housing data such as Barfoot and Thomson, where house sales data will provide a leading indicator for house prices. Rental data from this source will also provide information about marginal increases in rents.

- The RBNZ 2 year inflation expectations survey, released in May will provide useful information, with actual CPI inflation readings for Q1 and Q2 available in April and July respectively. We forecast CPI inflation to rise 1.0%q/q in Q1 and Q2.

Global Backdrop

- Our forecasts also assume a benign global backdrop. Any collapse in global growth due to deteriorating risk events could undermine our central view.

- Our central case is also premised on global commodity prices remaining at elevated levels, even if prices do not rise significantly from here. A collapse in global commodity prices, would also present downside risk to our view.

kymberly_martin@bnz.co.nz

Contact Details

BNZ

Stephen Toplis	**Craig Ebert**	**Doug Steel**	**Mike Jones**	**Kymberly Martin**
Head of Research	Senior Economist	Economist	Strategist	Strategist
+(64 4) 474 6905	+(64 4) 474 6799	+(64 4) 474 6923	+(64 4) 924 7652	+(64 4) 924 7654

Main Offices

Wellington	**Auckland**	**Christchurch**
60 Waterloo Quay	80 Queen Street	129 Hereford Street
Private Bag 39806	Private Bag 92208	PO Box 1461
Wellington Mail Centre	Auckland 1142	Christchurch 8140
Lower Hutt 5045	New Zealand	New Zealand
New Zealand	Phone: +(64 9) 976 5762	Phone: +(64 3) 353 2219
Phone: +(64 4) 474 6145	Toll Free: 0800 081 167	Toll Free: 0800 854 854
FI: 0800 283 269		
Fax: +(64 4) 474 6266		

National Australia Bank

Peter Jolly	**Alan Oster**	**Rob Henderson**	**John Kyriakopoulos**
Head of Research	Group Chief Economist	Chief Economist, Markets	Currency Strategist
+(61 2) 9237 1406	+(61 3) 8634 2927	+(61 2) 9237 1836	+(61 2) 9237 1903

Wellington		**New York**	
Foreign Exchange	+800 642 222	Foreign Exchange	+1 800 125 602
Fixed Income/Derivatives	+800 283 269	Fixed Income/Derivatives	+1877 377 5480
Sydney		**Hong Kong**	
Foreign Exchange	+800 9295 1100	Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(61 2) 9295 1166	Fixed Income/Derivatives	+(85 2) 2526 5891
London			
Foreign Exchange	+800 333 00 333		
Fixed Income/Derivatives	+(44 20) 7796 4761		

24 HOUR FOREIGN EXCHANGE SERVICE

Phone Toll Free	6am to 10pm NZT – Wellington Office
0800 739 707	10pm to 6am NZT – London Office – Sam Hehir

ANALYST DISCLAIMER: The person or persons named as the author(s) of this report hereby certify that the views expressed in the research report accurately reflect their personal views about the subject securities and issuers and other subject matters discussed. No part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in the research report. Research analysts responsible for this report receive compensation based upon, among other factors, the overall profitability of the Markets Division of National Australia Bank Limited, a member of the National Australia Bank Group ("NAB"). The views of the author(s) do not necessarily reflect the views of NAB and are subject to change without notice. NAB may receive fees for banking services provided to an issuer of securities mentioned in this report. NAB, its affiliates and their respective officers, and employees, including persons involved in the preparation or issuance of this report (subject to the policies of NAB), may also from time to time maintain a long or short position in, or purchase or sell a position in, hold or act as advisors, brokers or commercial bankers in relation to the securities (or related securities and financial instruments), of companies mentioned in this report. NAB or its affiliates may engage in these transactions in a manner that is inconsistent with or contrary to any recommendations made in this report.

NEW ZEALAND DISCLAIMER: This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.

US DISCLAIMER: This information has been prepared by National Australia Bank Limited or one of its affiliates or subsidiaries ("NAB"). If it is distributed in the United States, such distribution is by nabSecurities, LLC which accepts responsibility for its contents. Any U.S. person receiving this information wishes further information or desires to effect transactions in the securities described herein should call or write to nabSecurities, LLC, 28th Floor, 245 Park Avenue, New York, NY 10167 (or call (877) 377-5480). The information contained herein has been obtained from, and any opinions herein are based upon, sources believed to be reliable and no guarantees, representations or warranties are made as to its accuracy, completeness or suitability for any purpose. Any opinions or estimates expressed in this information is our current opinion as of the date of this report and is subject to change without notice. The principals of nabSecurities, LLC or NAB may have a long or short position or may transact in the securities referred to herein or hold or transact derivative instruments, including options, warrants or rights with securities, or may act as a market maker in the securities discussed herein and may sell such securities to or buy from customers on a principal basis. This material is not intended as an offer or solicitation for the purchase or sale of the securities described herein or for any other action. It is intended for the information of clients only and is not for publication in the press or elsewhere.

National Australia Bank Limited is not a registered bank in New Zealand.