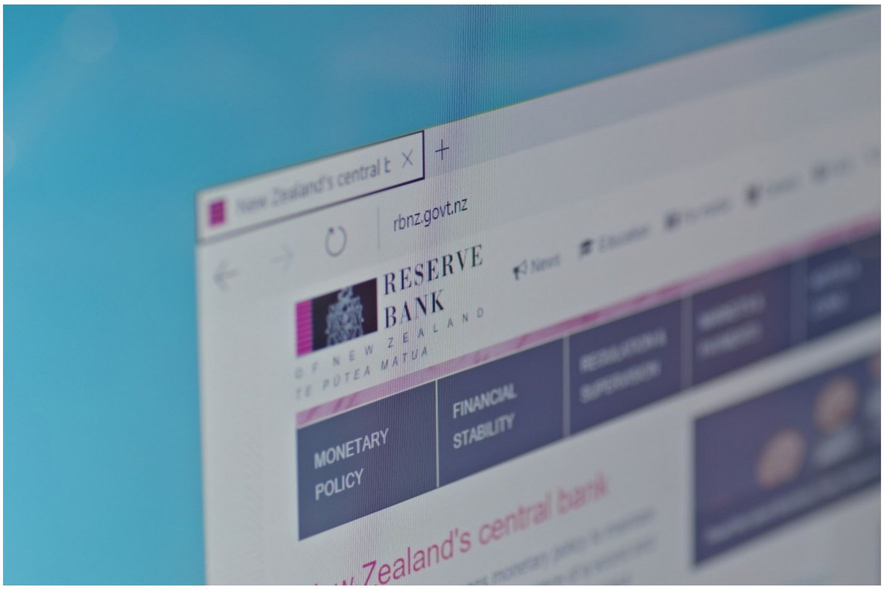
New Zealand’s central bank paves way for 2021 hike

The Reserve Bank of New Zealand surprised markets as it announced its QE programme will end on 23 July, acknowledging the brighter economic outlook no longer requires extensive monetary stimulus. Such a hawkish tone suggests an imminent hike, either in August or October, and NZD could therefore benefit from an attractive carry earlier than expected



Source: Shutterstock

RBNZ ends asset purchase programme...

After having significantly scaled back weekly asset purchases under the LSAP (Large Scale Asset Purchase), the RBNZ announced this morning that the programme will end on 23 July. The move comes amid a significant improvement in New Zealand's economic outlook, with activity back above pre-pandemic levels, and household spending and investments also proving robust.

Most importantly, the Bank drastically changed its view on inflation. It introduced the notion that inflation spikes will likely be observed for 2Q and 3Q. While these spikes are expected to have a transitory nature, the statement reads: “more persistent consumer price inflation pressure is expected to build over time". A reference to the need for long-lasting monetary stimulus to reach its inflation objectives was dropped, simply acknowledging some degree of stimulus does remain necessary, but acknowledging that the economic outlook warrants a reduction of such stimulus.

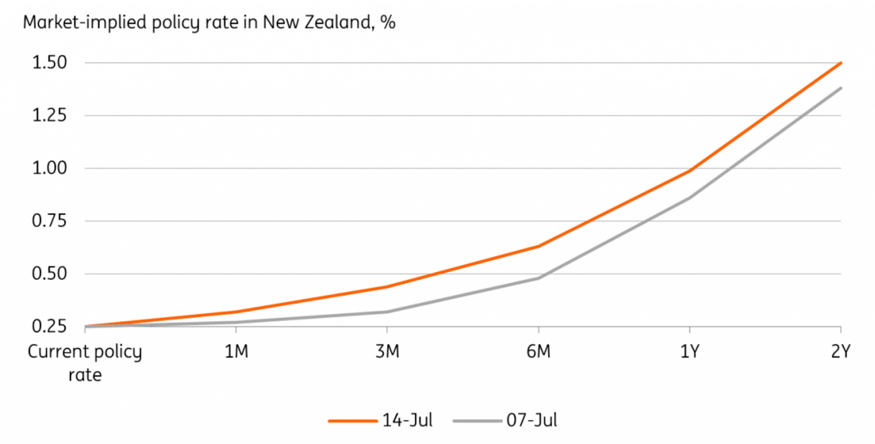
While there was no explicit reference to house price inflation, we think that resilience in the market - despite measures taken by the government to curb the housing bubble - played a role in prompting the hawkish shift. The NZ House Price index by CoreLogic has continued to rise on a year-on-year basis, moving from 20.5% in May to 22.8% in June. Remember, the NZ government added housing affordability considerations to the RBNZ remit in February.

...paving the way for a 2021 rate hike

Today's policy statement was as close as you can get to a rate hike without actually hiking, as all parts of the statement reflected a significantly more hawkish tone compared to the May meeting.

This meeting, in our view, has paved the way for a rate hike in 2021. This is something that the market was already pricing in before the meeting, but expectations were likely centred around a move in 4Q. Considering how drastically the RBNZ changed its tone, dropping any reference to a patient approach, markets are now likely expecting an earlier start to the hiking cycle.

As shown in the chart below, the swap market is now pricing in 19 basis points of tightening in the next three months and 38bp of tightening in the next six months, with expectations having clearly shifted towards an earlier hike after today's RBNZ announcement.



Source: Refinitiv, ING

We agree with the market that the RBNZ statement's tone clearly paves the way for a rate hike in 2021. There are three RBNZ meetings left this year – 18 August, 06 October, 24 November – and market pricing suggests that an August hike (we're talking about 25bp hikes here) is around 65% priced in, an October hike is 86% priced in and a November hike is fully in the price.

We think the probability of a rate hike already in August is approximately 50%, and will depend on incoming data. There are two main releases that will be watched, both referring to 2Q21. First off is the inflation report due on Friday: consensus is at 2.7% YoY for headline CPI, and any upside surprise may fuel speculation around an August hike. However, we think jobs data will be more important, as the RBNZ has already addressed the topic of inflation spikes in 2Q and 3Q and sees them as temporary. The jobs report will be released on 4 August, and that's when we'll be able to tell with a greater degree of confidence whether a rate hike is likely over the summer.

Should the Bank decide to hold rates steady in August, we think the first 25bp rate hike will be delivered at the 06 October meeting, barring any unexpected material downturn in data or in the global recovery story.

FX considerations: NZD set to have an enviable carry

A weaker New Zealand dollar (against both the USD and on a trade-weighted-basis) compared to the early 2021 peaks should also make the Bank more comfortable in starting a tightening cycle this year.

However, we do not expect the current choppy environment for the Kiwi dollar to linger, especially considering the prospect of an earlier hiking cycle by the RBNZ. An August hike would surely prove very supportive for the NZD as this would convey the implicit message that the Bank is getting concerned about an overheating economy and thus prompt markets to retain aggressive hawkish bets for the coming quarters. So incoming data (inflation and employment) for 2Q will likely have a material impact on the currency as it will drive expectations around an August hike.

Even if the rate hike is delayed to later in 2021, the RBNZ is clearly standing at the very hawkish end of the spectrum in the G10. In line with our view that a consolidation of the global reflationary story will allow local stories to push some activity currencies higher and revamp interest for carry trades, NZD looks set to benefit from its enviable rate profile.

In our latest forecasts, we have pencilled in 0.75 as a year-end NZD/USD target. An earlier than expected hike by the RBNZ makes us more confident that the pair will be able to reach such a level.

AUD/NZD is another pair where the RBNZ should have a significant impact. Currently trading around 1.06/1.07, we think there is room for a drop to the 1.04/1.05 region by the end of the year as the policy divergence between the hawkish RBNZ and the stubbornly dovish Reserve Bank of Australia makes NZD more attractive once risk sentiment stabilises and reflationary trades resume.

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