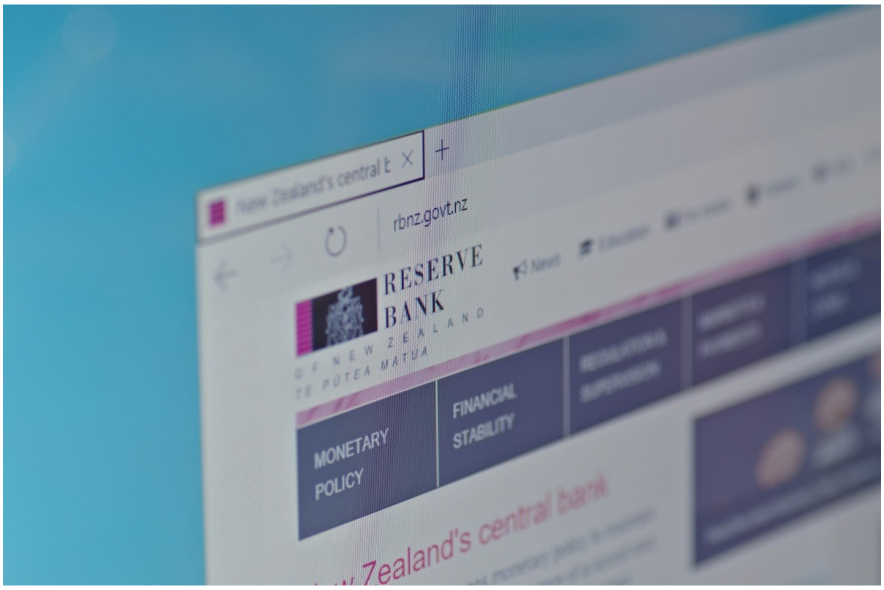
RBNZ Preview: 50bp hike, but the peak is close

We expect the Reserve Bank of New Zealand to hike rates by 50bp to 4.75% next week, in line with market pricing. Peaking inflation and a deteriorating housing market and activity suggest the RBNZ will not reach its projected 5.50% peak rate. A hawkish hike (unchanged projections) should lift NZD, but more NZD strength may soon rely only on external factors



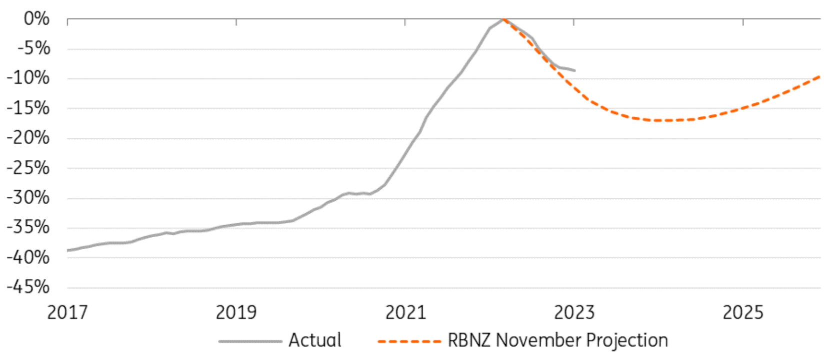
Source: Shutterstock

Some things have changed since the November meeting

On 22 February, the RBNZ will make its first policy announcement of the year. The most recent meeting, held in November, resulted in a 75bp rate increase (to 4.25%) and a significant upward revision to the Official Cash Rate (OCR) estimates, which indicated that rates would have peaked at 5.50%. At the time, the hawkish surprise seemed to be supported by robust CPI and wage figures as well as encouraging activity indicators.

The economic landscape in New Zealand has changed since then. Although the third-quarter GDP numbers were good, activity and consumer confidence surveys began to decline, wage growth slowed, unemployment edged up, inflation did not accelerate further, and inflation expectations dropped. The housing market has continued to deteriorate in line with RBNZ forecasts, with prices falling by 9% since the March 2022 peak.

Change to New Zealand house price index from the peak in March 2022 (% change)



Source: ING, CoreLogic

A (hawkish) 50bp seems appropriate now

We believe that the most important input to the monetary policy decision right now is the growing evidence that inflation has peaked. The headline rate steadied at 7.2% in the fourth quarter of 2022, while the RBNZ had forecast another acceleration to 7.5%. Crucially, falling energy prices, wage growth, and inflation expectations point to disinflation beginning in the first quarter, whereas the RBNZ had predicted 7.5% for the first quarter and a slowdown to 6.90% only in the third quarter of 2023.

The less alarming inflation story argues against another 75bp move next week. Nonetheless, given the low frequency of RBNZ policy announcements, policymakers will want to take the chance to deliver a 50bp hike before hard economic data deteriorates materially.

Markets are fully pricing in a 50bp hike in February, so the references to future tightening will drive most market moves. Updated economic projections will shed some light in this sense. A revision lower in inflation forecasts will be necessary, but we suspect the RBNZ will resist the temptation to scale back peak rate projections, which may be left at 5.50% in an attempt to avert a bond rally similar to the one seen in the aftermath of the latest Fed and ECB meetings.

High chances that 5.50% won't be reached at all

Indeed, the deterioration in the property market has been in line with the RBNZ forecasts, but this does not mean that the Bank is willing to risk facing the repercussions of the estimated 19% house price contraction for the broader economy and financial stability should the disinflation story prove more benign.

With many indications that such improvement in the inflation picture will materialise earlier than previously expected, and the New Zealand economy already feeling the strains of tighter financial conditions, we think the chances that another 75bp of tightening (as per latest projections) will be delivered after 50bp next week have decreased meaningfully.

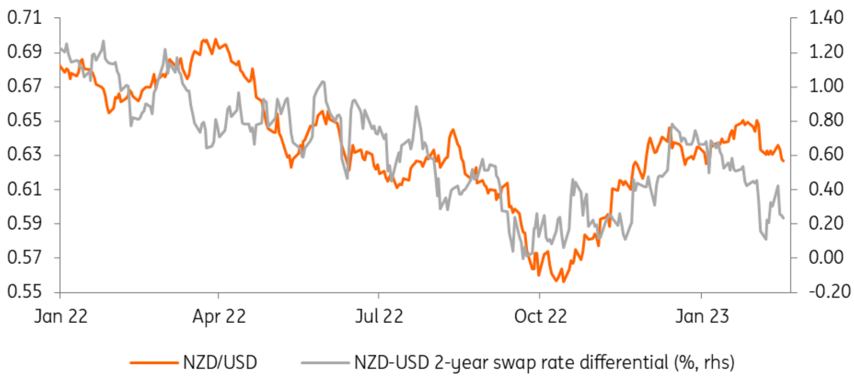
Markets have indeed started to cast doubts on the RBNZ projected rate path, with the peak rate pricing embedded into the OIS curve having declined to around 5.30% from 5.50% starting from mid/late January. Unchanged RBNZ rate forecasts next week see rate expectations staying at least supported in the near term, but we think data will ultimately provide enough evidence to trigger a dovish repricing.

Our base case is only one last 25bp hike in April, so a 5.0% peak rate. There are non-negligible risks of another 25bp in May, but we'd rule out a 5.50% peak rate unless the inflation picture changes dramatically. We think the RBNZ will see more value in stopping earlier and shift to a credible 'higher-for-longer' rhetoric, rather than pushing rates higher and inevitably face rate cut speculation. At the moment, markets are seeing a 60% probability of rates cuts starting already in November this year.

NZD could rise next week, but bullish domestic inputs will fade

The two-year NZD-USD swap rate has been on a steady downtrend in the past three months, having declined from the 75bp December levels to the current 25bp. This has been due to the combination of repricing higher in Fed rate expectations and contracting RBNZ peak rate pricing.

Rate differential and NZD/USD



Source: ING, Refinitiv

However, the rate differential continues to play a secondary role for NZD/USD compared to the relative equity performance and global risk sentiment, according to our short-term fair value model. This means that NZD/USD is not overvalued despite the deterioration in the short-term swap rate differential.

NZD/USD rose after each of the past three RBNZ announcements, and given markets are not fully pricing in the 5.50% projected peak rate, a hawkish 50bp hike may trigger a small NZD rally next week. But, as discussed above, we think the domestic push for a stronger NZD will run out of steam as data should endorse the disinflation story and the RBNZ should ultimately fall short of its expected tightening projections.

Our bullish view on NZD/USD for the remainder of the year is therefore primarily a function of global factors: improved risk sentiment, positive exposure to the China reopening story, a benign USD decline. We target 0.67-0.68 in the second half of 2023.

Author

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Disclaimer