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New Zealand Fixed Income Monthly January 2024

Inflation concerns remain, but next OCR move likely to be downward

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RBNZ has been playing down rate cut expectations amid persistent inflation

Recent comments by Reserve Bank of New Zealand (RBNZ) Chief Economist Paul Conway highlighted the challenge still posed by inflation as the central bank looks for cues to ease the Official Cash Rate (OCR) from its current level of 5.5%. In a speech on 30 January, Conway moved to dampen market expectations for imminent rate cuts by emphasising that there was still "a way to go" before New Zealand's inflation weakened to the central bank's targeted level of 2%. The RBNZ has set a medium-term inflation target of 1% to 3% with a focus on 2% as the target's "midpoint". Separate comments by US Federal Reserve Chair Jerome Powell on 31 January provided a reminder that persistent inflation has been blocking the path to rate cuts throughout the world. Speaking at a press conference, Powell stated that the US central bank would need to see continued evidence that inflation was falling sustainably towards its target level of 2% before lowering rates. Given the current global environment and the RBNZ's continued commitment to the hawkish stance that has maintained the OCR at 5.5% since May 2023, we think that interest rates are unlikely to conform to recent market expectations by falling in the first half of 2024.

Non-tradable inflation currently largest obstacle on path to lower rates

Although New Zealand's consumers price index (CPI) eased from an annual rate of 5.6% in the September 2023 quarter to 4.7% in the December 2023 quarter, the RNBZ remains focused on the risk posed by non-tradable inflation. This component of CPI, which is taken as an indicator of inflation generated inside New Zealand's economy as it focuses on final goods and services whose prices are not driven by foreign competition (such as insurance and rent), came to an annual rate of 5.9% in the December 2023 quarter. In his 30 January speech, RBNZ's Conway drew attention to the figure and acknowledged that it was higher than the central bank had forecasted. Inflation could also be exacerbated by immigration to New Zealand, which came to a record high in the year ended November 2023 with 249,500 migrant arrivals according to provisional official figures released on 19 January. Although immigration is positive as a supply-side element as it helps to cool the labour market with an increase in supply, it also feeds through to higher accommodation costs and other such price rises on the demand side.

Downward movement in OCR still likely in next 12-18 months

Despite continued struggles with inflation in New Zealand and elsewhere, our view is that the RBNZ's next change to the OCR is likely to be downward, albeit at a later timing than the market has recently been expecting. Although inflation remains high, it is also true that the annual CPI figure was on a downward trend throughout 2023 before dropping from 5.6% to 4.7% between the September and December 2023 quarters. We have a high level of conviction that New Zealand will see lower interest rates in the next 12 to 18 months. We have therefore priced in approximately one percentage point of interest rate cuts for New Zealand in the latter part of the year.