

First View

Kiwibank economics.

Matariki rises and so do interest rates

- Last week the Reserve Bank increased the cash rate to 2.50% on Wednesday. Several commentators (us included) disagree with this move. Households most affected by the hike are the ones doing it toughest.
- Domestic manufacturing data printed stronger than expected. Some of that strength came from healthy overseas demand. A weak Kiwi dollar also helped, making Kiwi goods essentially go on sale for the rest of the world.
- This week, we are looking out for the Quarterly Survey of Business Opinion. We expect business conditions to have improved compared to last quarter. A decrease in the oil price and stabilising supply chains have given businesses a chance to breathe.
- Although we expect an improvement in sentiment, we don't see things returning to pre-war levels just yet. The economy needs a little more time to recover.

The biggest event last week, other than Matariki, of course, was the RBNZ's Monetary Policy Review.

The Bank lifted the official cash rate by 25 basis points to 2.50%, highlighting its ongoing focus on inflation risks. While economic activity remains soft in parts, The BusinessNZ PMI printed significantly stronger than expected, seemingly validating the Bank's decision to hike. The Reserve Bank appears increasingly concerned that inflation pressures could persist if policy settings aren't returned to neutral quickly. We disagree; we think the uneven recovery means that the sectors and households most affected by the hike are the ones doing it toughest.

Our manufacturing industry has support from overseas demand and a weak Kiwi dollar, essentially making Kiwi goods go on sale for our closest trading partners. Data from China, our biggest trading partner, showed its manufacturing activity is strong. This adds support for New Zealand's export outlook. Overseas demand is unaffected by changes in our domestic interest rates. Although a hike in interest rates might help support a stronger Kiwi dollar, the domestic demand story is just not there yet.

From a market perspective, attention has shifted toward whether interest rates will continue to follow the Reserve Bank's May monetary policy statement path. We think this is likely, and foresee further tightening to come this year.



Global markets spent much of the week digesting central bank developments and geopolitical risks. In the US, the release of the latest Federal Reserve Bank minutes provided investors with further fuel to debate the balance between inflation risks and slowing economic growth.

Meanwhile, tensions in the Middle East heightened over the weekend. A partial reopening of the Strait of Hormuz and easing concerns about major supply disruptions reduced pressure on energy markets... Until threats and fire were exchanged again. Energy markets remain vulnerable to any renewed escalation. Oil prices initially ticked higher last week before easing off and still didn't exceed normal trading ranges.

This week, the NZIER are set to publish their Quarterly Survey of Business Opinion. The survey canvases around 10,000 New Zealand businesses. It asks questions about whether business conditions are expected to deteriorate, improve, or worsen. It therefore provides an indication of how businesses believe the Kiwi economy will perform over the near to medium term.

The first quarter survey was fielded during the period at the start of the conflict in the Middle East. It showed a markedly downbeat mood among businesses off the back of supply chain disruptions, heightened input costs and increased uncertainty.

We're expecting sentiment to improve in the second quarter data, driven by a sharp decline in oil prices. The partial re-opening of the Strait, although tenuous, should alleviate supply chain concerns. This should be broadly consistent with recent business confidence data that shows improvement. We expect businesses to be feeling better



compared to the last survey, but not quite as good as they were before the war in the Middle East kicked off.

Other data out this week includes travel and migration, and selected price indexes. The Reserve Bank's Chief Economist, Paul Conway, is speaking this week on inflation pressures and estimating the neutral interest rate.



Financial Markets

The comments below were provided by Kiwibank traders. Trader comments may not reflect the view of the research team.

RBNZ tightening underway

The past week saw the RBNZ deliberation as the primary focus particularly given the mixed views between economists and markets that saw this decision as perhaps a touch more finely balanced than what was inferred by the pricing. International developments also chimed in, with Fed-speak, FOMC minutes, lower oil, re-escalation in the Gulf, then higher oil, and equity market swings, also considerations.

Rates started the week with incremental gains as the curve traded a little lower in the lead up to the decision. A narrow Shadow-Board recommendation for no change alongside modestly firmer Australian rates supported a small rally with the US market having been out for the 4th of July holiday. The July meeting implied, having closed the prior week at around 80% priced, slid towards 70% pulling bill futures and the rate sensitive front of the curve along with 1-year and 2-year swaps around 2 and 3-points lower. Tuesday saw a continuation of the rally despite some Fed-speak that saw a Fed Funds futures curve pivot a little towards increased 2026 tightening probability and less in 2027, and a story that claimed that the RBA had failed to calm inflation with the prior year's cuts being a mistake. The implied for July continuing around 70% with the dates out to the end of the year working around a point lower seeing year-end OCR priced at around 2.83%, and the curve undergoing a mild steepening of around 2-points 2-year to 10-year.

Wednesday saw views harden a little in the lead up to the decision, with rates on the back foot from the open, a re-escalation in the Gulf along with some further inflation talk from Fed officials contributing seeing higher implied Fed tightening probabilities and higher Treasuries. July tightening probability lifted back towards 80%, year-end implied OCR lifted to 2.86%, with the IRS curve tracking already higher and steeper by mid-day.

The RBNZ raised rates to 2.50% as the market was anticipating. The RBNZ touched on many of the points we highlighted, noting the partial reopening of the Strait, relatively resilient global growth and the market pricing of higher global policy rates likely required to curb persistent inflation concerns, the economic recovery underway prior to the conflict and the likely regain of this momentum in Q3 with improving confidence, and the potential for a lower exchange rate to add to inflation pressures. Overall, they concluded that "[w]ith inflation still above target and economic activity expected to strengthen, some further reduction in monetary stimulus is likely to be required to return inflation to the 2 percent target mid-point." They also noted that future decisions were data dependent. The initial reaction saw meeting dates through to year-end move the most, Sep lifting to 70% priced, with year-end

implied around 2.90%. Initial thoughts were that the final paragraph was seen as perhaps a small dial-back from that delivered in May, though the press conference did firm up the view, with Governor Breman noting that 2.25% was viewed below neutral, hence stimulative. The Chief Economist added that with current inflation and inflation expectations a bit higher, the short-run neutral is probably a bit higher than their long-run neutral assumption while he also noted the impact of the currency on overall financial conditions. By the close, the statement had seen the front of the IRS curve marked higher still compared to pre-statement with 2-year at 3.39% (+6) and 10-year at 4.16% 9-points higher on the day but unchanged since immediately prior to the statement. Thursday trade saw the selling resume with the release of Fed minutes that indicated broad inflation concerns and some making the case for a hike, reported comments from a Governor Breman interview noting the resilience of the economy and that there were signs that the economic recovery was stronger, followed by a manufacturing PMI printing near 60 with an upwardly revised prior month at 51, all compounding. Implied probabilities continued higher, September meeting approaching 90% and year-end implied OCR at 3.00% with these being most sensitive to the statement as we indicated last week. 2-year IRS finished at 3.53% (+13 d/d and +13 w/w) and 10-year at 4.22% (+6 d/d, +12 w/w).

Looking forward, the direction of rates as we have noted several times previously is higher, with the speed at which this is achieved and the ultimate terminal rate, as different from neutral, now the likely debating points. Some points to note: the market moved very quickly to price in two further tightenings, and similarly swaps jumped on the bus. At this stage the data, while having been generally firmer of late, may still see some releases offer something for the more cautious, as such I would expect year-end pricing to roughly trade between 1½ and perhaps to just over 2 25-point moves and timings of such, with trading to the upper end likely to draw out accrual players prepared to trade against their ultimate view on the path against near-term accrual. It is now observed that Q3 26 and Q4 26 implied cash against the May MPS average forecasts are relatively in-line, however these are now calculating higher through the Q1 and Q2 2027 averages.

Some thoughts that may be worth considering: Firstly, the comments in the media conference around the short-run neutral, inflation including noting high current and surveyed expectations, and the impact of the currency on overall financial conditions, this may give additional indication as to current drivers. Secondly, the comments on the resilience and stronger than expected economy, with inflation running above band. Does the cash rate ultimately need to be moved to neutral or through into restrictive territory at



some stage i.e., seeing a higher terminal rate? This may leave the RBNZ's Chief Economist speech this week on inflation and the path back to 2% all the more interesting. Overall, I would anticipate that they would likely adopt a measured approach to the tightening cycle, seeking to avoid the unnecessary instability as per the remit, so that may well mean the market and economists will have the same tough calls to make each meeting ensuring plenty of debate. **Graham Huges – Trader, Financial Markets**

In FX – RBNZ view supports the Kiwi dollar:

Last week, the key domestic event was the RBNZ's Monetary Policy Review. As widely expected, the Bank delivered a 25bp hike, with markets pricing around a 70% probability ahead of the meeting. While the initial NZD reaction was relatively muted given the move was largely anticipated, the Bank's forward guidance was interpreted as hawkish, reinforcing expectations that further policy tightening may be required. This helped lift New Zealand rate expectations and supported the NZD throughout the week.

Additional momentum came from Thursday's strong BusinessNZ Performance of Manufacturing Index, which surged to 59.7 in June from 51.3 in May. The result pointed to a meaningful improvement in domestic economic activity and strengthened the view that the economy is proving more resilient than previously expected. Markets now price almost 75bp of additional tightening by mid-2027.

The combination of higher domestic rate expectations and improving growth indicators saw New Zealand short-end rates outperform their Australian counterparts, driving NZD/AUD higher over the week. The cross reached a high of 0.8320 before failing near key resistance and easing back to 0.8289.

While geopolitical tensions remain a potential headwind for risk appetite, they continue to have only a limited impact on market volatility. Looking ahead, the focus shifts offshore, with US CPI and China's Q2 GDP the key releases. US PPI and retail sales are also due later in the week, while the Bank of Canada announces its latest policy decision.

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The Week's Key Events

- The standout release this week is the NZIER second quarter QSBO on Tuesday. International migration and travel data from Stats NZ is also being released on Tuesday. From Stats NZ we also have electronic card spending data out on Wednesday, and selected price indexes for June are out on Friday.
- RBNZ Chief Economist, Paul Conway, is presenting a speech on Tuesday morning in Wellington. Our ears will be sensitive to what he has to say on inflation pass-through.
- Offshore, the headline global event is likely to be US CPI. And FOMC Chair Warsh will testify before House & Senate. Geopolitical developments in the Middle East and shipping conditions through the Strait of Hormuz will also remain on investors' radar.