amova Asset Management

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Oil shock and inflation risks seen testing path to neutral interest rates

By Matthew Johnson, Senior Fixed Income Manager, New Zealand

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Closure of Strait of Hormuz keeping monetary policy and inflation outlook in focus

The rise in oil prices due to tensions in the Middle East is a key market driver with clear implications for New Zealand's monetary policy. It also frames our view on inflation. Given that the Strait of Hormuz accounts for about a quarter of the world's oil needs, we consider its closure to be a historically significant "black swan" market event comparable with the OPEC-related oil shocks of the 1970s and the 2008 spike in oil prices. These rare, unpredictable and potentially severe occurrences can broadly be grouped into six key categories, including the commodity and energy shocks mentioned above. This would place the closure of the Strait of Hormuz alongside sovereign and fiscal shocks such as the European sovereign debt crisis of 2010–2012; financial and systemic shocks including the 2008 Global Financial Crisis; geopolitical conflict and terror, notably the 9/11 attacks in 2001; COVID-19 and other pandemics; and natural disasters, one example of which is New Zealand's 2011 Christchurch earthquake. Given the closure's scale and significance, it is understandable that many analysts initially expected it to lead to oil prices above US dollar (USD) 150 per barrel, severe global inflation and material damage to economic growth. However, it is worth examining why the impact has, to date, been less severe than feared.

Mitigating factors seen containing oil price shock for time being

Oil flows out of the Strait of Hormuz were significant before the closure, but we feel three key mitigating factors have helped contain the shock. The first of these is pipeline capacity from the East-West Crude Oil Pipeline and the Abu Dhabi Crude Oil Pipeline, which provide bypass routes and have meaningful spare capacity relative to 2025 flow rates. The second is continued tanker traffic, as vessels have still been crossing the strait and allowing some oil to exit the area. The third is supply and demand dynamics, including China's ability to reduce purchasing based on its sizeable strategic reserves, additional production from the Americas and elsewhere, and strategic reserve releases by International Energy Agency members. Taken together, these factors may cover a meaningful share of the supply gap. At the same time, Middle Eastern oil-producing nations are likely to have strong incentives to resume shipments because their economies depend on oil revenues.

Contained demand backdrop may support measured interest rate approach

Closer to home, the key question is how the oil shock impacts the thinking of the Reserve Bank of New Zealand (RBNZ). The central bank is weighing whether persistent tensions will keep oil prices high and risk a de-anchoring of inflation expectations, or if weaker oil prices will ease cost pressures while cheaper energy and lower interest rates revive demand. The RBNZ has been clear that it intends to guide New Zealand's Official Cash Rate (OCR) towards its neutral level (where interest rates are neither stimulatory nor restrictive), and recent above-target headline inflation explains why it has started raising rates. However, excluding items over which central banks have little influence, such as food, government charges and household energy, inflation has been low and stable for some time. Furthermore, given that discretionary spending is weak, the labour market appears soft and the housing market looks subdued, we feel demand is not the key inflation driver at present. This may allow the RBNZ to manage inflation pressures with moderate changes to the OCR.

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