9 February 2018

Outlook for Borrowers: Post February MPS

- We expect the OCR to be on hold through 2018. As a result, wholesale floating rates and short-dated wholesale fixed rates should remain anchored for most of this year. We don't think there's a great rush to put on shorter-term hedges in the coming months.
- In contrast, we see upside risks to NZ longer-dated wholesale rates, which we expect to be driven by developments offshore. While levels for hedging are not as attractive as earlier this year, we would consider using dips in these rates to put on longer-term hedges.

RBNZ Monetary Policy Outlook

At the February Monetary Policy Statement (MPS), the RBNZ kept the OCR on hold at 1.75%, as universally expected by economists. Interim Governor Grant Spencer said the next move in the OCR could be either up or down, but the Bank's main scenario is that the next move is a tightening. Consistent with this, the Bank retained the same OCR projection as it had in November, which shows the first full rate rise in early 2020.

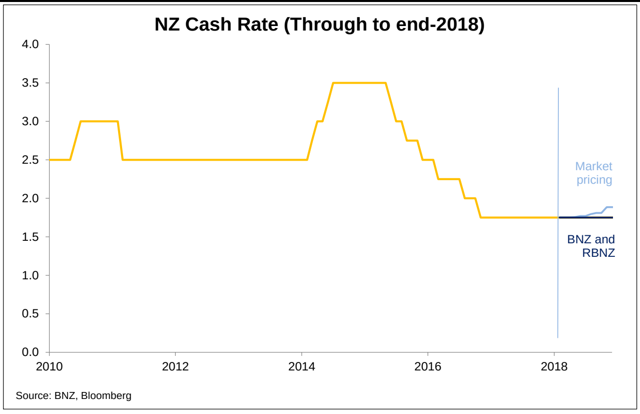
The Bank lowered its CPI projections compared to the November MPS and it now expects CPI inflation to be below the 2% target until the second half of 2020. In its November forecasts it had expected CPI to reach the 2% target in the middle of this year.

The Bank – as it always does – highlights a range of risks that could influence the path of monetary policy. The scenarios where it envisages raising the OCR earlier than its current projections include a pick-up in global inflation that feeds through to the NZ CPI, and stronger household spending (potentially as a result of the new government's policies) leading to higher domestic inflation. Conversely, it highlights that a shock to global financial markets, weaker housing investment (leading to slower growth) or, under certain conditions, a higher NZD could be scenarios where it considers OCR cuts. As we outline below, we think the hurdle for a move in either direction in the first half of the year is very high.

Wholesale Floating Rates

Our central expectation is now that the RBNZ will keep the OCR on hold this year. After the lower than expected CPI release in January (the annual rate fell to 1.6% from 1.9%)

We Expect The OCR To Be Unchanged In 2018



we pushed back the timing of the first RBNZ hike from August to February 2019.

The hurdle for moving the OCR in either direction is very high, at least in the first half of this year. The RBNZ is cognisant that further rate cuts could generate additional gains in house prices, which could increase longer-term risks to financial stability. And although inflation is currently low, the economy is still doing relatively well and the unemployment rate is now down at 4.5%, its lowest level since 2009. Finally, other central banks globally are moving in the direction of tightening monetary policy. That doesn't mean the RBNZ has to follow the crowd, but it probably raises the hurdle for rate cuts. The scenario where the RBNZ cuts the OCR is probably one in which a global shock hits.

Likewise, we think OCR hikes are very unlikely for the immediate future. We expect headline CPI inflation to fall to 1.2% for the next two quarters, some distance from the RBNZ's 2% target. And for now at least, the NZD remains resilient (partially because the USD has been weakening, despite the Fed raising rates). We doubt the RBNZ would want to encourage further NZD strength by raising the OCR at a time when inflation is below target.

While we have a high degree of confidence the OCR will be on hold in the first half of this year, the outlook later in the year is a bit more uncertain than usual amid changes at the RBNZ:

- Former RBNZ Deputy Governor Adrian Orr will take the helm as RBNZ Governor after the March OCR Review;
- The Labour-led coalition government is proposing to amend the Policy Targets Agreement and RBNZ Act to formally include employment within the RBNZ's mandate (alongside inflation);
- The Labour-led coalition is also proposing to shift to a committee structure for OCR decisions at some point. The committee is likely to comprise a mix of internal RBNZ staffers and external members.

These changes haven't affected our OCR outlook as yet and we will need to wait until the new Governor comes in to get a better sense of how he sees the economic outlook.

Short-Dated Wholesale Fixed Rates (1-3 years)

We expect short term wholesale rates to be reasonably anchored this year amid an unchanged OCR. Only later in the year do we expect 2-3 year rates to start to drift up, ahead of when we expect the first rate rise by the RBNZ, in February 2019.

Further moves upwards in offshore interest rates could potentially put some upward pressure on NZ short-dated wholesale rates. More central banks are expected to join the global tightening cycle this year including the Reserve Bank of Australia (our NAB colleagues expect the first RBA hike in August). In this environment, it's possible that the market may speculate that the RBNZ will follow suit, pushing up NZ rates in anticipation of earlier OCR rate rises. But at least for the first half of the year, we expect NZ short term wholesale rates to be reasonably stable.

The difference between NZ short term wholesale rates and floating rates (an indication of the "premium" borrowers pay to hedge) is around the middle of the range seen over the past year. On this basis, the cost of hedging doesn't look particularly "cheap", especially as we don't expect floating rates to rise this year.

For borrowers that have the risk appetite, we would consider sticking to floating rate borrowing rather than hedging at these higher short term wholesale fixed rates. In the second half of the year, when there is more uncertainty around the OCR outlook, we might consider a more active hedging strategy.

Longer-Dated Wholesale Fixed Rates (5-10 yr)

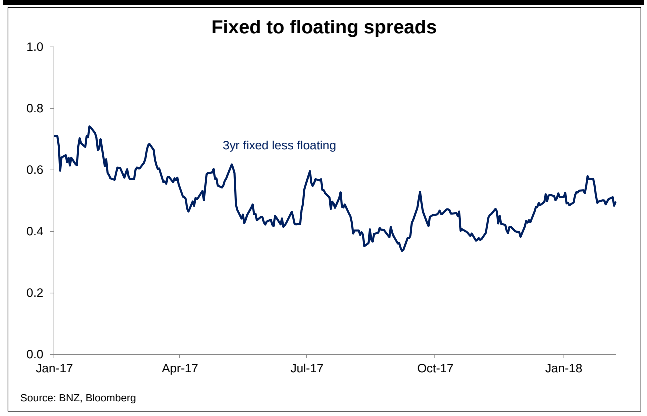
Longer term rates are less influenced by short-term monetary policy factors and more influenced by policy over the next full cycle, along with global forces.

Global interest rates have moved sharply higher so far this year. The 10 year US Treasury rate has increased 40bps since the end of last year to 2.80%, its highest level in more than 3 years. The rise in US interest rates has been driven by a combination of factors:

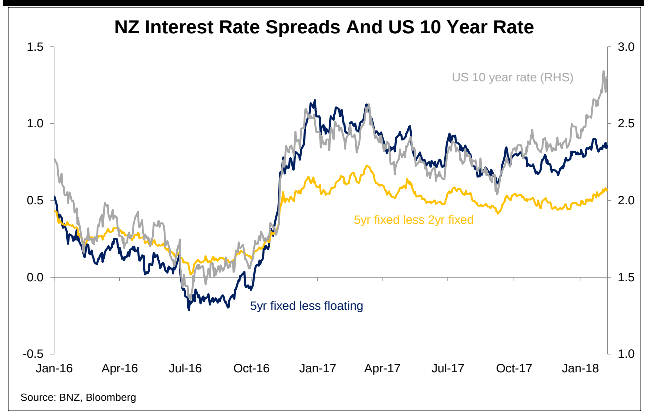
- The global economy has picked up steam over the past year and growth looks set to be its strongest since 2011. In the US, economists have upgraded growth expectations after President Trump secured his tax reform plan;
- The strengthening in growth comes at a time when the US unemployment rate is just 4.1% and wage growth is starting to pick-up. Market expectations of inflation have risen;
- Trump's tax plan will lead to a wider US budget deficit and more bond issuance by the US Treasury at the same time as the Federal Reserve is reducing their purchases of bonds. This means more supply and less demand (from the Fed).
- Amid strengthening growth and (gradually) rising inflation, the market now expects the Federal Reserve to raise its cash rate three times this year, more than previously expected. The next hike is expected to come next month.

The risks around global interest rates are still to the upside in our opinion, even after the moves seen year to date. We think there is a reasonable chance that the Fed raises its cash rate four times this year, even though our base case is in line with market pricing for three hikes. And

Premium for Fixing 3-years Has Been Broadly Stable



Global Rates Are Pushing Up Longer-Term NZ Rates



elsewhere, we expect more central banks to start tightening monetary policy this year, joining the Fed, the Bank of Canada and the Bank of England.

Locally, the Labour-led government provided its first fiscal update in December but contrary to expectations it did not lead to an increase in bond issuance for this fiscal year. While the Treasury included the cost of the policies the government is implementing in its first 100 days of office, the funds for other campaign promises have yet to be allocated. We expect government bond issuance will ultimately be increased, but we will need to wait for May's Budget to get a fuller picture of the government's fiscal plans.

In time, looser fiscal policy and increased bond issuance should add a bit of upward pressure to NZ long term wholesale rates. But it's worth noting that the government remains in a very strong fiscal position by international standards.

The current NZ wholesale 5-year fixed rate is consistent with the RBNZ raising the OCR to around 3.5%. This is the same level the RBNZ raised the OCR to during its 2014 tightening cycle and is also consistent with what the RBNZ thinks is the 'neutral rate' (i.e. the level of the OCR that is neither simulative nor restrictive).

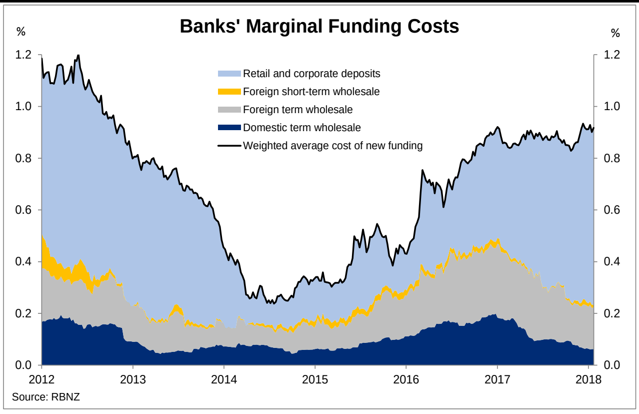
With the RBNZ expected to be side-lined this year, NZ longer term wholesale rates will likely be primarily driven by those moves offshore. We see upside risks to global rates and consequently NZ longer term wholesale rates too. We would consider using dips in rates to put hedges in place in order to protect against these upside risks.

Bank Funding Costs

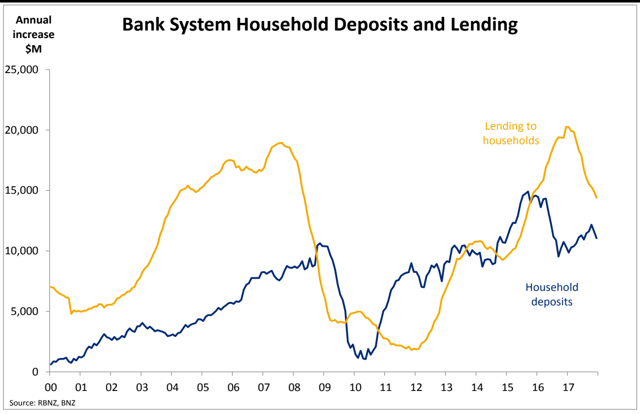
Most borrowers' total interest rates are constructed as a combination of wholesale rates, credit costs and bank funding costs. After rising over the preceding two years, bank funding costs were broadly stable in 2017.

The mix and cost of different sources of funding has continued to change however. Deposits now account for

Banks Funding Costs Reasonably Stable in 2017



Household Credit Growth Has Slowed



a larger proportion of banks' marginal funding costs than in recent years.

Bank lending to households slowed through 2017 as the housing market cooled, whereas deposit growth picked up – see chart above. This helped to partly close the 'gap' between household borrowing and lending. If the housing market remains subdued this year, which limits domestic credit growth, this should help to keep a lid on bank funding costs for 2018.

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