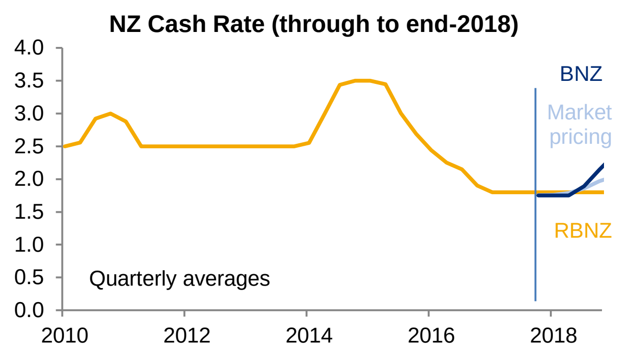
9 November 2017

Outlook for Borrowers: Post November MPS

- With expectations of unchanged monetary policy for at least another nine months, wholesale floating rates and short-dated wholesale fixed rates should remain flat through the rest of the year and into early next year. This suggests little need for businesses to rush in to protect against higher short term rates.
- We still think that the low in 5-10 year wholesale rates this year has probably passed. With the balance of risk skewed to the upside for long-dated rates, an active strategy of hedging dips in rates seems entirely appropriate.

Cash Rate On Hold For Some Time Yet



Source: BNZ, Bloomberg

Monetary Policy Outlook

In the November Monetary Policy Statement, the RBNZ significantly revised upwards its CPI inflation track through to the end of next year, a reflection of the weaker NZD and higher oil prices, amongst other factors. So inflation is now projected to reach and settle at the 2% mark some nine months earlier than previously projected, around mid-2018.

The RBNZ maintained its view that "monetary policy will remain accommodative for a considerable period". The Bank is aiming to stimulate the economy to drive non-tradeables inflation a lot higher to offset soft tradeables inflation (after their near-term lift). The Bank sees the need to keep the OCR steady at a stimulatory level of 1.75% through to mid-2019, and in this statement bringing forward ever so slightly the possibllity of the first rate hike in the cycle.

The RBNZ continues to note the "numerous uncertainties" about the outlook, with one particular area of uncertainty pertaining to government policy. The Bank has incorporated only preliminary estimates of the impact of new government policies in the areas of increased government spending, the Kiwibuild programme, tighter visa requirements and increases in the minimum wage.

Wholesale Floating Rates

We continue to believe that monetary policy will remain on hold through to at least the middle of next year. We see a pretty high hurdle rate to ease policy, against a backdrop of rising inflation. For that to happen, we'd likely need to see some sort of global "tail-risk" shock to trigger such a move. But the current global backdrop is one of a broadly-based economic expansion with improving momentum and little threat of recession.

Restrained inflationary pressure in the non-tradeables sector of the economy, including modest wage inflation despite a tightening labour market, limits the near-term upside pressure to short rates. The RBNZ sees no urgency to raise rates as it needs to create a highly stimulatory domestic environment to help meet its inflation objective.

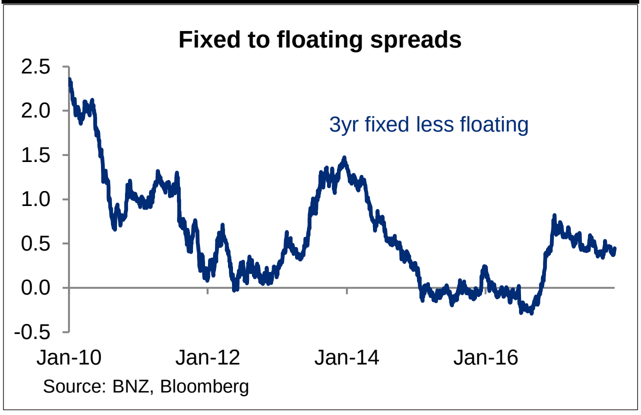
We see policy unlikely to change for some time. BNZ's official rate call is for a hike in August 2018, slightly ahead of current market expectations. As well as the usual economic uncertainties that exist, a change to a new Governor in March 2018 (yet to be announced) and a proposed move to appoint external advisors to the policy-making committee are additional factors that cloud the policy outlook.

Wholesale floating rates are expected to remain flat for at least another nine months, with a chance of nudging higher beyond that period, consistent with our OCR view.

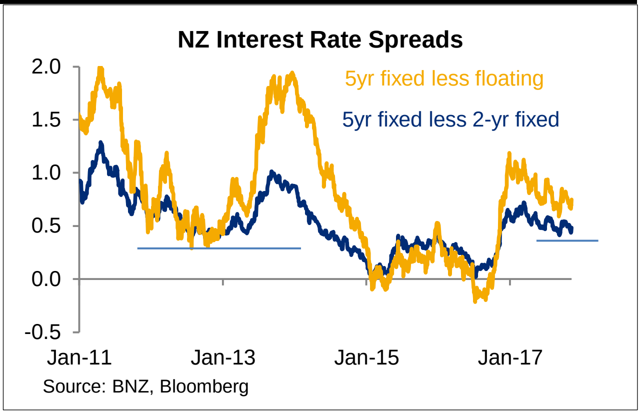
Short-Dated Wholesale Fixed Rates (1-3 years)

A stable OCR should help underpin short term wholesale fixed rates close to current levels for the rest of the year and into early 2018. As the first tightening comes into focus, we'd expect to see 2-3 year rates drift higher, but that's more a story for next year.

Premium For Fixing 3-years Reduced Through 2017



Some Appeal to Hedge Rate Risk Given Modest Spreads



With clear (steady) guidance from the RBNZ and the next MPS not until February 2018, any short-term gyrations in short-dated rates are more likely to come via global forces. We saw temporary upward blips in rates in late-June and September, as other major global central banks adopted a more hawkish tone, with some spillover impact into the NZ market. More of these can't be ruled out as the global mood improves towards higher policy rates.

With the RBNZ likely to sit on its hands for a while yet, there seems no rush for borrowers to fix rates at this short-dated horizon. But we note that the gap between short-dated fixed rates and floating rates has been closing steadily for much of this year, reducing the "premium" to fix rates. Furthermore, for each month that passes the timing of the next rate hike cycle gets a little closer. Thus, we wouldn't bet on the "premium" to fix rates falling much further than already seen this year.

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 forces on rates remain skewed to the upside. US monetary policy has been tightening since December 2015. We expect a fifth rate hike for the cycle next month and three more hikes next year. While a rate hike for December is well priced by the market, only about half of the increase we see next year is currently priced in. Both the Bank of Canada and Bank of England have recently kicked off the process of tightening monetary policy. The global tightening cycle is expected to be long and drawn out, but it is clear the direction short term policy rates are headed.

The US Fed began its quantitative tightening programme in October, which sees its balance sheet gradually shrink over coming years to a set formula. Other things constant, we estimate that this policy is equivalent to about 80-100bps of upward pressure on the US 10-year rate over the next four years.

Another source of upward pressure on US rates includes Trump's tax reform plan. There is still a lot of work to get tax reform passed into law, and while we don't yet know its final form, easier fiscal policy would add to US debt issuance, add to inflationary pressure in a fully-employed economy and add to the chance of Fed rate hikes.

Global economic momentum is currently the best in more than five years and growth in key regions like the US and euro-area is running above trend. But a missing link so far has been any notable increase in core inflation pressure, reflecting a lack of wage inflation. While US 5-10 year rates are currently above their average of the past six months, we likely need to see a positive inflation surprise before we see another leg higher in global bond rates.

The ECB will halve its monthly bond purchases to €30n per month from January and keep buying until the end of September 2018. The "taper" announcement was more dovish than expected, with the ECB signalling that the asset purchase programme might be extended and any policy rate hikes will only come well after the end of the programme. This will keep a lid on European bond rates and is a policy that is currently having spill-over effects into other markets, being a restraining force on the otherwise upward pressure on US long term yields.

The upward skew to long bond yields also applies to NZ, with local rates largely driven by global forces. In terms of domestic forces, the formation of a new government adds to upside pressure.

Fiscal policy will be on an easier path, and this will lead to much higher government bond issuance, in the order of an average $2-3 billion per annum compared to previous Budget forecasts. At the margin, this adds upside pressure to government bond rates, more so than corporate borrowing rates.

We see the government's policies on raising the minimum wage, redistributive policies, higher taxes (eg. regional petrol tax) and easier fiscal policy adding to inflationary pressure in the economy. In time, higher inflationary pressure and greater debt issuance will add some modest upward pressure to rates.

The current NZ wholesale 5-year fixed rate is consistent with a muted tightening cycle over coming years – an OCR that eventually rises about a year from now and barely goes up more than 100bps near the peak of the rate cycle. This profile likely under-prices the upside risk to rates over the full tightening cycle ahead, with the policy rate barely reaching a so-called "neutral" rate over that time.

As we've seen over the past six months, opportunities arise for borrowers to hedge interest rate risk at what we see as attractive levels, just like the present. Such a strategy would provide protection against the skewed upside pressure to rates when looking 6-12 months ahead. A hedge on dips strategy remains entirely appropriate.

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