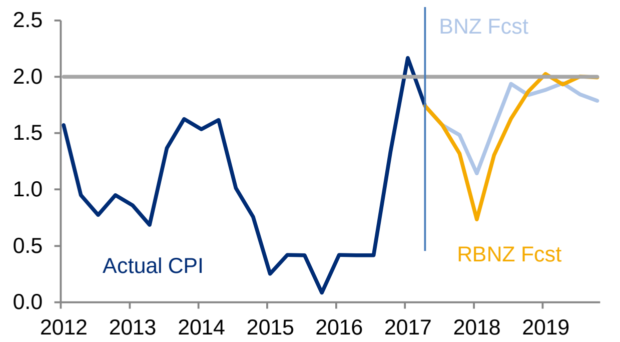
11 August 2017

Outlook for Borrowers: Post August MPS

- With expectations of unchanged monetary policy for an extended period, wholesale floating rates and short-dated wholesale fixed rates should remain flat through the rest of the year. This suggests little need to rush in to protect against higher short term rates
- The fall in longer term wholesale rates to the bottom of their range this year provides an opportunity to hedge some interest rate risk for those looking for certainty on rates. We see risks skewed to the upside for 5-10 year rates over the medium term.

CPI Inflation Under Target Again



Source: BNZ, Bloomberg

August MPS Summary

In the 10 August Monetary Policy Statement the RBNZ reiterated the policy guidance it has maintained all year, that "monetary policy will remain accommodative for a considerable period".

Headline CPI inflation has recently fallen back below the 2% target level and is projected to remain below 2% through to early 2019. The Bank is seeking to stimulate the economy to generate some domestic inflationary pressure to help offset weak projected inflation generated from external forces.

In the Bank's view, this will require the OCR to remain at the current level for at least another two years. Beyond that period the OCR is projected to drift higher, towards a more neutral policy setting.

The change in leadership at the RBNZ from the end of next month and again in just over six months, the forthcoming election and possible change in government, and possible changes to the RBNZ's Policy Targets Agreement mean that the Bank's projections have less significance than usual. Our own projections make the heroic assumption of "business as usual".

Wholesale Floating Rates

There is nothing in the August MPS to suggest that the Bank has changed its "neutral" policy stance, which in practice means an equal chance of a rate hike or a rate cut at this juncture. That said, the Bank was presented with an opportunity to introduce a near-term easing bias, with inflation projected to continue to undershoot the mid-point of the target range and chose not to, consistent with its flexible approach to inflation targeting. The Bank noted that "an easing of policy, seeking to achieve a faster increase in inflation, would generate unnecessary volatility in the economy."

Thus, the hurdle rate to ease policy again is very high and probably would require some sort of global shock to trigger such a move.

Equally, there's a high hurdle rate to tighten policy over the near term, given the lack of inflationary pressure and projections for inflation to remain below 2% for another eighteen months.

The net result is that policy is unlikely to change for some time – certainly not over the next six months, and quite possibly for another year. The market has been pushing out its view of the first rate hike and BNZ's official rate call has been pushed out as well, with August 2018 now pencilled in.

Wholesale floating rates are expected to remain flat over the next year, consistent with a flat OCR view. Bank funding pressures, which have meant business rate increases independent of the OCR, have receded over the last month or two so any possible upside risk from this force has dissipated.

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

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

Any upside risk this year is likely to come via global forces, with other major central banks moving gradually towards monetary policy normalisation, which means higher rates from historically low levels. As we saw in late-June through to early-July, these forces can spill over into NZ rates. Near-term domestic forces are slightly to the downside, providing a fairly balanced overall outlook.

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.

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 rates remain low and are a downward force on NZ rates. While some major central banks are in the midst of a tightening cycle (US, Canada) and others have signalled a bias to remove policy accommodation (UK, Euro-area), the road to more normal rates will be a long one. Global inflation pressures remain moderate, which reduces the urgency to tighten policy settings. This is helping to keep a lid on global rates at this juncture, even though the risks appear one-sided towards the upside.

The current NZ wholesale 5-year fixed rate is consistent with a very muted tightening cycle over coming years – an OCR that steadily rises about a year from now and barely gets to 3% about four years down the track before flattening out. This profile likely under-prices the upside risk to rates over the tightening cycle ahead, with the policy rate barely reaching a so-called "neutral" rate over that time.

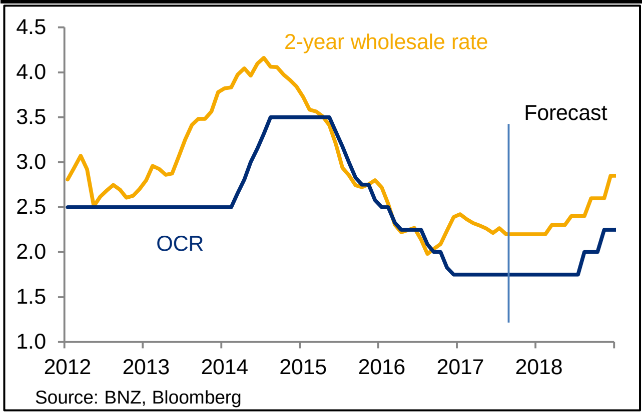
With the RBNZ on hold for an extended period and domestic inflation pressures moderate, any upside to longer term rates isn't likely to come from domestic forces through year-end and into early next year.

We remain alert to upside pressure on global rates, stemming from a pick-up in global inflation that encourages the major central banks to continue along the path towards policy normalisation. The market under-prices the risk of further policy tightening in US monetary policy, in our view. Another upside risk to rates stems from ECB monetary policy. The ECB is expected to soon signal a tapering of its asset purchase programme that has been instrumental in depressing European rates, with spill-over effects on other markets like the US and NZ.

In terms of downside risk to rates, we'd be remiss to ignore the current geo-political tensions between the US and North Korea. Any military action, with likely catastrophic consequences, represents a tail downside risk to long term rates.

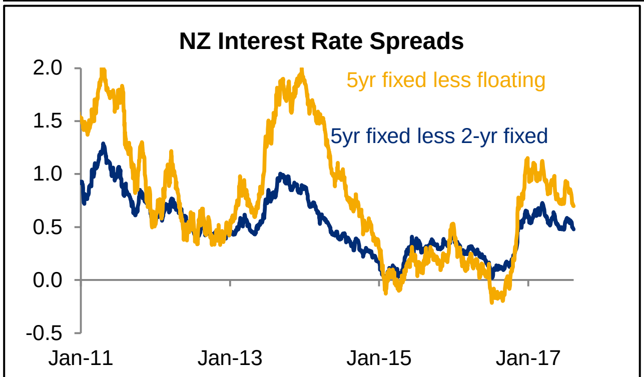
Should one rush to fix at the current long term rates that are close to their lowest level this year? There is certainly some attraction to hedging for those who value the certainty of rates but the interest rate gap (difference between longer rates and shorter term rates) isn't large enough to have a strong view on this. A hedge on dips strategy still seems appropriate, taking opportunities like the present but without going "all-in".

Flat Outlook for Short Term Rates



Source: BNZ, Bloomberg

Interest Rates Spreads Lower, But Not Low



Source: BNZ, Bloomberg

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