23 March 2017

Outlook for Borrowers: Post March OCR Review

- **Wholesale floating rates should continue to have a slight upside bias reflecting ongoing upward pressure on bank funding costs while the OCR remains unchanged.**
- **While in a tight range at present, short-dated wholesale fixed rates face gradual upside pressure in the second half of the year as we move closer to a tightening cycle that is expected to begin in 1H18.**
- **There is no urgency for those looking to hedge mid-curve wholesale fixed rates, but we see upside pressure to rates later in the year, largely reflecting global forces.**
- **Dips in long-end wholesale fixed rates should be considered as hedging opportunities.**

Official Cash Rate (OCR) Review

At the 23 March OCR Review, the RBNZ reiterated its view that "monetary policy will remain accommodative for a considerable period". In an early-March speech, Governor Wheeler reiterated that the Bank's neutral policy stance was truly neutral, meaning an equal chance of a rate hike as a rate cut. This messaging was essentially repeated.

The Bank's last set of projections showed that any possible increase in the OCR remains a distant prospect. Its February forecasts showed a possible tightening more than two years away, from late 2019. The Bank's current view on policy is likely little changed from that.

The Bank maintains a positive outlook for the NZ economy, with the soft Q4 GDP outcome seen to be temporary. But it still sees the global environment facing major challenges, with so-called "extensive" geo-political uncertainty.

The Bank conceded that headline inflation might be inflated over the short-term due to one-off effects from recent food and import price movements. But it has no real concern that inflation will materially overshoot the mid-point of the target band.

Wholesale Floating Rates

While the RBNZ considers there's an equal chance of a rate hike or a rate cut being the next policy move, we disagree, with the risk heavily skewed towards the next move likely being a rate hike than a cut. Market pricing is in agreement with our view, with the short-term interest rate curve upward sloping.

We see a low probability of the OCR being cut again this cycle – such an outcome would require a significant global shock, which isn't forecast by definition. So the key question that remains is for how long will the OCR be maintained as low as 1.75%?

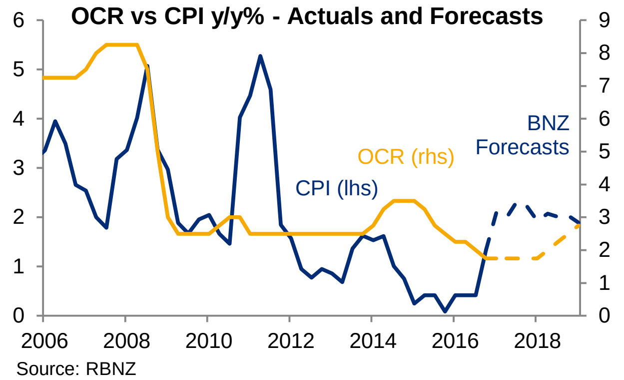
BNZ economists are picking May 2018 for the timing of the first rate hike, while the market continues to see the balance of risk skewed towards an earlier date. Market pricing shows a 36% chance of a rate hike as soon as this coming November and a full 25bps hike priced in by this time next year. The trend over the past few weeks has been for the market to be a little less aggressive in its rate hike expectations.

Given the timing of the September general election and the exit of the current Governor, any move earlier than the November Monetary Policy Statement is seen as highly unlikely, meaning a period of stability in the OCR for *at least* the next six months and likely longer.

NZ economic activity data have softened of late but that is off a strong base and the growth outlook remains sound. More important for the monetary policy outlook is the path of inflation. We see the 2% mid-point inflation target already met, with Q1 CPI data released on 20 April expected to confirm that. Core inflation is expected to continue to drift higher and we wouldn't be surprised to see it return to 2% during the course of the year.

The return of inflation to the mid-point will test the resolve of the RBNZ to keep the historically low OCR unchanged for an extended period. Economic theory suggests that if inflation is expected to be sustained around the current 2% mark, then policy should be close to neutral. Needless to say, we see plenty of upside potential for the OCR once the tightening cycle begins.

CPI Inflation Soon Near Target



Source: RBNZ

While we're debating whether the RBNZ first tightens policy early next year or more than two years henceforth, let's not lose sight of the likelihood of the OCR remaining steady for some time yet. Borrowers can expect a historically low OCR to help keep floating borrowing rates well contained through 2017. A little upside risk still prevails, given the upward pressure on bank funding costs, as noted below.

Short-Dated Wholesale Fixed Rates

Short-dated wholesale fixed rates largely reflect the market's expectations for the OCR over the relevant period. The current market pricing for the first tightening this cycle is earlier than BNZ's May-2018 forecast, but over the next two years our view is more or less aligned to the market and differs mainly with respect to timing (see chart below). This projected tightening remains well ahead of the RBNZ's view of a flat OCR track throughout.

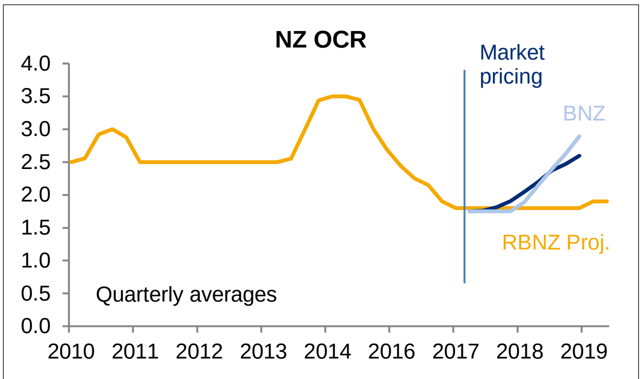
Thus, we see short-dated wholesale fixed rates e.g. 2-year, as very close to 'fair value'. There is expected to be upward pressure on short-dated wholesale fixed rates as the timing for a higher OCR nears. The next chart shows the 2-year wholesale (swap) rate along with forward pricing. With our view not far out of whack with the market over this time horizon, the forward track provides an illustration of how 2-year wholesale fixed rates might behave over the next year or two.

The outlook over coming months is probably a little flatter than suggested by the forwards, given our view that the market is slightly too early in pricing in rate hikes, while the latter period is likely to see a slightly steeper increase in the 2-year rate the closer we get to the first rate hike.

Given the expected upside pressure over time, borrowers seeking interest rate protection at this short-dated horizon should consider hedging any dips in fixed rates, as we have seen over the last few weeks.

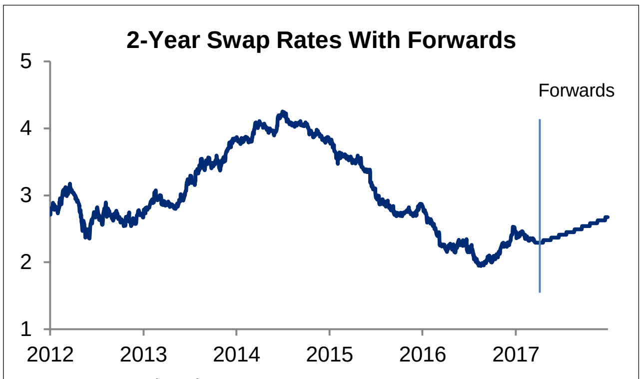
Mid-curve rates will be less influenced by short-term monetary policy influences and more influenced by policy over the next full cycle, along with global forces.

Market Pricing is Well Ahead of the RBNZ's View



Source: BNZ, Bloomberg

A Tighter Policy Outlook Suggests Higher 2-Year Rates

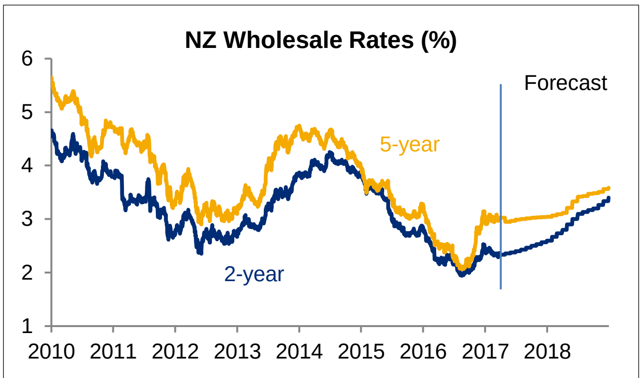


Source: BNZ, Bloomberg

The current wholesale 5-year fixed rate of a little under 3% is consistent with an OCR that steadily rises from early next year to a peak of about 3.25% before flattening out. We think that profile is pretty fair, considering the open debate about what constitutes a long-term neutral rate.

In terms of global forces, after the significant rise in 5-year wholesale rates in the December quarter last year, we see them consolidating through much of this year. At some point we see upside pressure returning, in a world where the US Fed is tightening policy (one hike done, two more to go this year) and other major central banks (namely, the Bank of England, European Central Bank and Bank of Japan) look to end or wind down their quantitative easing policies. But that might be more of an issue late in the year and into next year.

NZ 5-Year Rates to Consolidate Then Drift Higher



Source: BNZ, Bloomberg

Our forecasts show a fairly flat profile for 5-year fixed wholesale rates over coming months, with a modest upside bias over the next year or two. For borrowers who like the certainty of 5-year fixed rates there is probably no urgency to hedge rates, following the sell-off late last year, but a hedge on dips strategy seems appropriate.

Longer-Dated Wholesale Fixed Rates

NZ long-term rates are strongly influenced by US rates. The US 10-year Treasury rate has settled into a 2.30-2.60% range since the beginning of December, after the near 100bps surge over the prior five months. The US Fed has stepped up its path towards more normal monetary policy, with last week's rate hike expected to be followed by two more hikes this year, which is well priced by the market.

The biggest threats to US long term rates are much easier fiscal policy and higher European bond rates, as the ECB prepares the market for an end of quantitative easing policy and, eventually, higher rates. Low global long term rates such as those in the euro area and, to a lesser extent, Japan are helping to contain US long-term rates, as global investors seek the highest returns on offer.

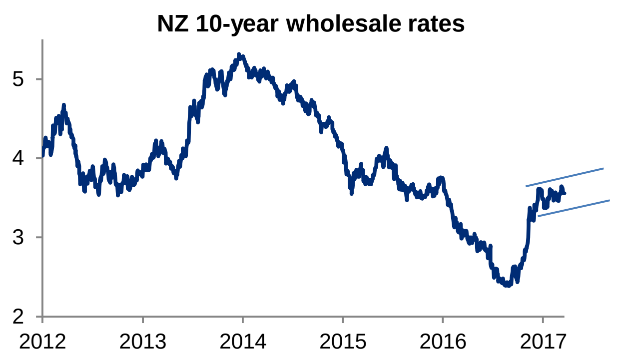
A much easier fiscal stance by the US during a time when full employment has effectively been reached would be inflationary, leading to higher inflation expectations and a more aggressive stance by the Fed. These factors would lead to higher US long term rates. Add into the mix higher European rates at some point and the balance of risk for longer term US rates are to the upside. The question is one of timing.

Our projections suggest that the US 10-year range of 2.30-2.60% range will largely hold over coming months. But the balance of risk is skewed towards higher rates later in the year.

To the upside risk stemming from easier US fiscal policy and European rate dynamics we can add a further possible factor. Another couple of rate hikes under the belt of the Fed would see attention turn to the size of its balance sheet and prospect for some shrinkage over the years ahead. This would be unambiguously negative for the US bond market, and add to upside pressure on long-term rates at the margin.

Thus, at some stage during the year the US 10-year rate could well break through current resistance of 2.60%, with the 2.75% mark being the next level in sight.

Range-Trading with Upside Bias Later in the Year



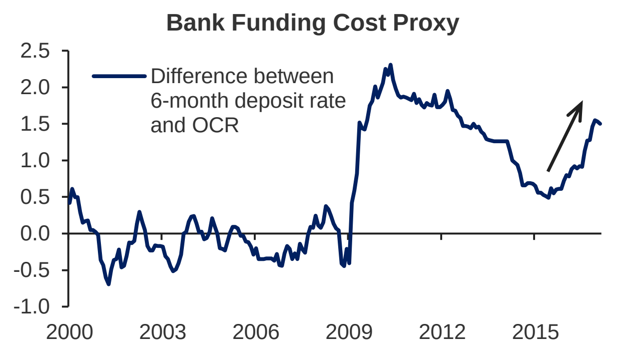
Source: BNZ., Bloomberg

These projections for US rates imply a circa 3.35-3.60% trading range for NZ 10-year wholesale (swap) rates over coming months, with upside risks later in the year.

Bank Funding Costs

Most borrowers' total interest rates are constructed as a combination of wholesale rates, credit costs and bank funding costs. Increased competition in the domestic deposit market (to fund high domestic credit growth) continues to apply upward pressure on bank funding costs. For the banking system as a whole, over 50% of funding comes from retail deposits, with much of it short term in nature. The spread between the 6-month deposit rate and wholesale rates has been on an upward trajectory for over a year now.

Bank Funding Costs Have Risen



Source: RBNZ, BNZ

This has meant only a portion, or in some cases very little, of last year's OCR cuts, have been able to be replicated in reductions to borrowing rates. And over recent months, we have seen a lift in floating lending rates against a backdrop of a steady OCR.

To the extent that these funding pressures remain, wholesale lending rates can increase independent of the OCR. Strong credit growth well in excess of deposit growth suggests that the bias remains for upside pressure on bank funding costs.

Paying fixed rates allows the borrower to lock in the wholesale, credit and funding cost components of their rate, making them resilient to these sources of pressures until the next reset date.

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