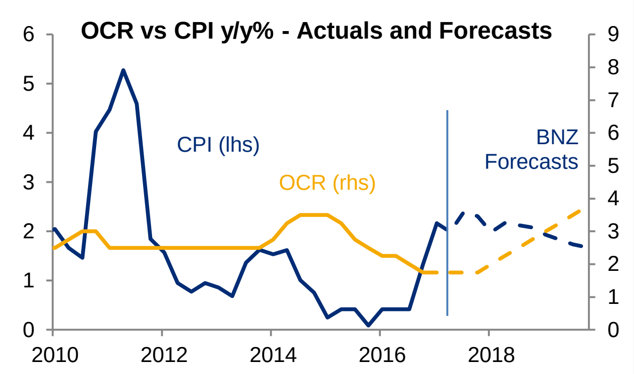
11 May 2017

Outlook for Borrowers: Post May MPS

- Wholesale floating rates should remain little changed alongside a flat OCR through 2017; upside risk prevails through 2018 as an expected tightening cycle gets underway.
- Short-dated wholesale fixed rates should range-trade over the next couple of months, before facing gradual upside pressure in the second half as we move closer to a tightening cycle that is expected to begin in 1H18.
- Borrowers should be looking for dips in 3-5 year wholesale fixed rates to hedge exposure; we see upside pressure to mid-curve rates later in the year, largely reflecting global forces.
- Dips in long-end wholesale fixed rates should be actively considered as hedging opportunities, with risks skewed toward higher rates.

CPI Inflation At Target; Rate Hikes Expected From 2018



Source: RBNZ, BNZ, Bloomberg

Monetary Policy Statement Review

In the 11 May Monetary Policy Statement (MPS), the RBNZ reiterated its view that "monetary policy will remain accommodative for a considerable period". The Bank saw the recent increase in inflation as transitory and believes that an unchanged OCR of 1.75% through to late 2019 will be required to generate headline inflation of 2% over the medium term.

The Bank held the same view at the February MPS and noted that developments since that time have had no impact on its policy outlook. It maintained a neutral stance, which in practice means an equal chance of a rate cut or hike at this juncture.

The Bank's neutral policy stance surprised us and the market, given that data over the last few months seemed to suggest inflation would track much higher than the RBNZ had previously projected.

The Bank recognised the recent increase in global growth, stronger commodity prices and the much weaker NZD. Despite NZ GDP growth coming in weaker than expected in 2H16, the Bank reiterated that the growth outlook was positive. However, all that seemed to have little impact on the Bank's assessment for medium-term inflationary pressure and thus its policy guidance of unchanged rates for the next 2½ years did not budge.

Wholesale Floating Rates

While the RBNZ considers there's an equal chance of a rate hike or a rate cut at this juncture, we strongly disagree, and see the risk heavily skewed towards the next move likely being a rate hike than a cut.

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%?

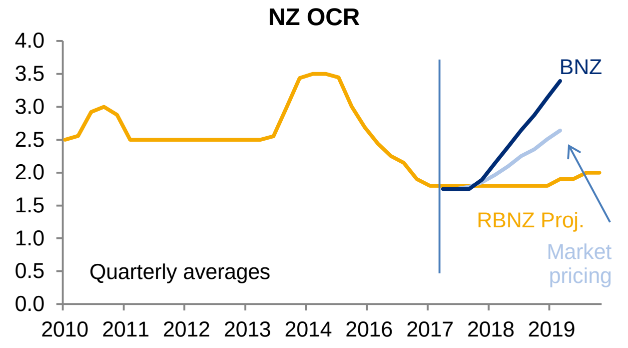
Market pricing suggests some confidence that the RBNZ will keep the OCR unchanged through 2017. Given the timing of the September general election and the exit of the current Governor the same month, any move earlier than the November MPS is seen as extremely unlikely. After the Bank's May MPS, the probability of a November rate hike has diminished to about a 20% probability.

Overall, it is safe to say that the OCR will likely not change this year, suggesting a period of stability in the OCR for at least another nine months.

By the February 2018 MPS, things get more interesting, and the market assigns about a 60% probability of a rate hike at that meeting, while a rate hike by May 2018 is essentially fully priced.

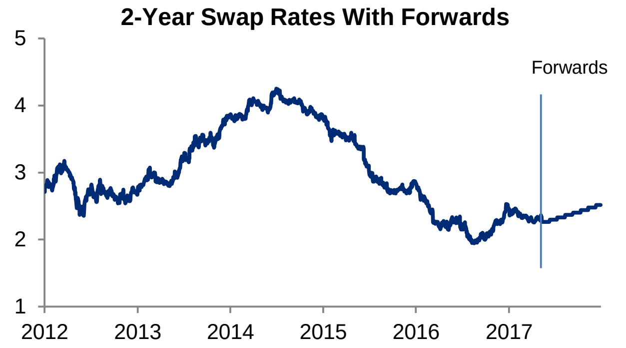
Our view is closely aligned to the market's view that early next year becomes the focal point for the first rate hike this cycle. In financial market terms, that's still a long time away. Our key message is that borrowers can expect a historically low OCR to help keep floating borrowing rates well contained through 2017, but upside risk prevails through 2018. We see plenty of upside potential for the OCR once the tightening cycle likely begins next year.

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

Short-Dated Wholesale Fixed Rates

Unlike the RBNZ, we don't think that the return to 2% CPI inflation simply reflects a passing one-off impact from oil and food. Core CPI inflation has been on an upward trend for more than a year and an average of six measures puts it currently at 1.9%. The RBNZ puts more weight on its own-calculated core CPI measures, one of which has been static at 1.5% for the past 18 months, but most of the official Statistics NZ core inflation measures have been rising and sit just above 2%.

Wage inflation has been low, but higher actual inflation will feed into automatic cost-of-living adjustments. Overlay that with the range of tightening labour market indicators, and we see the recent blip up in inflation being sustained. A robust economy and near-record terms of trade are supporting factors.

Short-dated wholesale fixed rates largely reflect the market's expectations for the OCR over the relevant period. The RBNZ has had some success in restraining wholesale rates out 2-3 years by virtue of its extended flat view of its policy rate guidance. Late last year, the market well over-priced the risk of OCR hikes, resulting in a modest downward correction to short-term wholesale rates earlier this year, and 2-3 year wholesale rates have settled into a trading range over the last couple of months.

Over time, as the RBNZ recognises the need for a less accommodative policy stance, the market is likely to take short-term wholesale rates higher. But before that, the market will want to see a nod to a tightening bias from the RBNZ.

The next couple of months should see short rates range-trading, but as the timing for a higher OCR nears the bias will be towards higher rates over the second half of the year. 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. Once there is more clarity on the timing of the first rate hike, there is likely to be a steeper move up in rates than the chart suggests in the outer period.

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.

Longer-Dated Wholesale Fixed Rates

Mid-long 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.

The current wholesale 5-year fixed rate of around 2.9% is consistent with an OCR that steadily rises from early next year to a peak of about 3% before flattening out. We think that profile is pretty fair at this juncture, but over time there is more likely to be upward pressure on the 5-year rate than downward pressure.

There is an open debate about what constitutes a long-term neutral rate. From a historical perspective a neutral OCR of about 3% would be considered quite low. As the rate cycle gets underway, the market's current perception of the neutral rate is probably also likely to increase.

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 a hedge on dips strategy still seems appropriate. There was plenty of opportunity to do this during April and there should be other opportunities over the next month or two.

In terms of global forces, US 5-10 year Treasury rates have essentially been range-trading so far this year, with no obvious trend, following the significant rise in rates in the December quarter last year. With NZ-US rate differentials tightly bound, the same applies to NZ's 5-10 year wholesale rates.

For these rates we see the balance of risk moving towards the top of their trading range over coming months and then ultimately setting a fresh high later in the year.

In the US, the threat of much easier fiscal policy has significantly reduced, as it has become abundantly clear that Washington gridlock remains in force even with a new President. However, there are still some notable upside pressures on bond rates to consider.

With the US employment rate hitting a decade low and the economic outlook remaining sound, upward pressure on inflation is expected to continue. We see the market underpricing the chance of Fed rate hikes over the next 1-2 years.

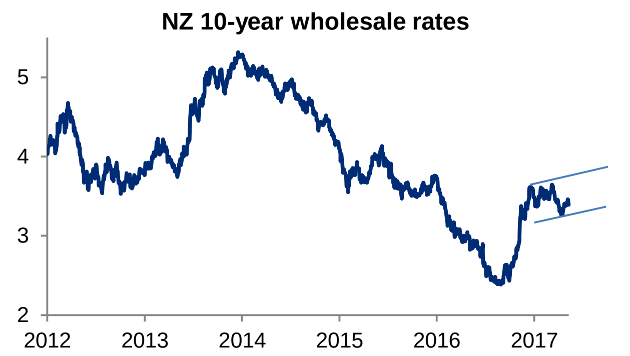
Later in the year, the Fed is expected to turn its attention to the size of its balance sheet and prospect for some shrinkage over the years ahead. While the Fed is planning to fully outline its intentions in a clear way to avoid a market tantrum, the policy will be unambiguously negative for the US bond market, and add to upside pressure on long-term rates at the margin.

Higher European bond rates, as the ECB likely prepares the market for an end of quantitative easing policy later in the year, risks spilling over into the US Treasury market.

All these factors provide upside potential to global bond rates, which are expected to ultimately feed into the long end of the NZ curve.

The NZ 10-year wholesale rate has recently moved up from the bottom of its range for the year towards the middle. Over coming months we see the risk of the 10-year rate moving decisively into the top half of the range and then breaking higher later in the year. Borrowers should be actively looking for opportunities to hedge against this risk of higher long-term rates.

Range-Trading with Upside Bias Through the Year

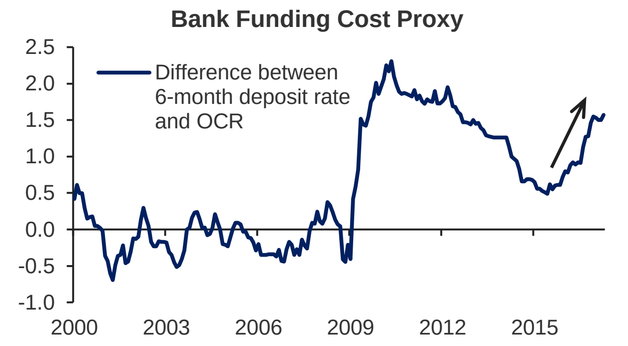


Source: BNZ., Bloomberg

Bank Funding Costs

Most borrowers' total interest rates are constructed as a combination of wholesale rates, credit costs and bank

Bank Funding Costs Have Risen



Source: RBNZ, BNZ

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 two years now.

This has meant only a portion, or in some cases very little, of last year's OCR cuts, were 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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