22 June 2017

Outlook for Borrowers: Post June OCR Review

- With expectations of unchanged monetary policy for some time, wholesale floating rates and short-dated wholesale fixed rates should remain fairly flat through the rest of the year. A slight upward bias prevails due to upward pressure on bank funding costs. Next year, the possibility of higher wholesale rates increases as the first expected policy tightening by the RBNZ approaches.
- For those looking to hedge against rising rates, we see current levels of mid-long curve wholesale fixed rates at relatively attractive levels to do so. Risks appeared skewed toward higher rates later in the year.

June OCR Review Summary

In the 22 June Official Cash Rate (OCR) review, the RBNZ reiterated the policy guidance it has maintained all year, that "monetary policy will remain accommodative for a considerable period". The Bank sees the recent increase in inflation as transitory and believes that an accom-modative policy stance for some time is required to help lift inflation to 2% on a sustainable basis. In the May MPS, the OCR was projected to remain steady at 1.75% through to late 2019 and we have no reason to suspect that this view has changed.

The Bank maintains a positive growth outlook, recognising the more broadly based global economic expansion and domestically thinks that an easy mometary policy stance, strong population growth and high terms of trade will support the economy. The June review noted the growth-supporting Budget released last month.

The Bank is still playing the "numerous uncertainties" card and recognises its policy stance may need to adjust accordingly. Globally, the Bank sees "major challenges" and "extensive policy uncertainty". Such language gives the Bank plenty of wriggle-room to change its policy outlook, and the change in leadership from late-September, and then again in March, offers that scope anyway.

Wholesale Floating Rates

There is nothing in the June review 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.

We continue to strongly disagree with the Bank's prognosis. Alongside the market view, we see the risk skewed towards the next move being a rate hike than a cut.

CPI inflation has risen to sit close to the mid-point of the target range and the same applies to various Statistics NZ measures of core inflation. Lower oil prices are likely to drive weaker headline inflation through the rest of this year, but core inflation is expected to settle around the 2% mark. While GDP growth slowed late last year and early this year, timelier indicators suggest that economic momentum remains robust.

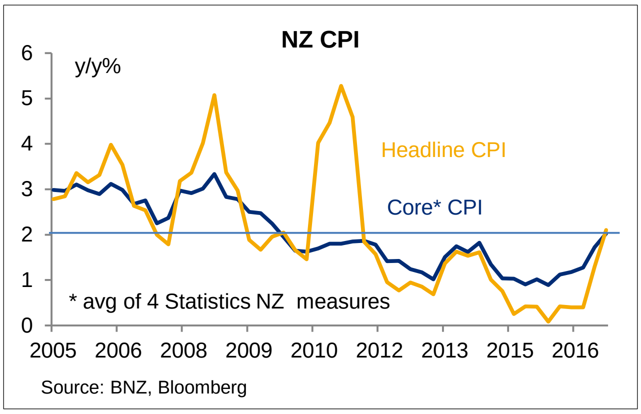
In our view, capacity pressures in the economy have increased, and that raises the possibility of increased inflationary pressure ahead. Facing this economic backdrop and the OCR remaining at a historically low level, we see a very low probability of another rate cut from here. Such a scenario would likely have to be in the context of some global recessionary shock.

The key question to us is for how long will the OCR be maintained as low as 1.75%? We agree with market pricing that any rate hike through this year is highly unlikely, suggesting a period of OCR stability until at least February 2018.

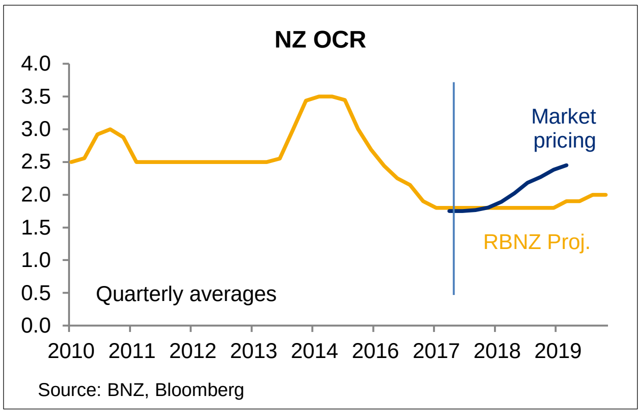
From that point onwards, the market prices in an increasing chance of a rate hike, but the curve is relatively flat, with the first full hike not priced until August 2018. In our view, the balance of risk favours an earlier possible hike than that, possibly sometime in the first half of the year.

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.

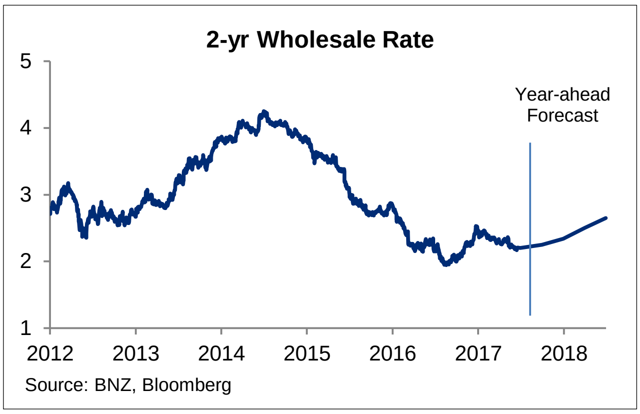
CPI Inflation At Target



Market Pricing is Well Ahead of the RBNZ's View



Tighter Policy Outlook to Push 2-Year Rate Higher



However, a steady OCR doesn't necessary mean steady floating borrowing rates for businesses, as noted in our final section on bank funding costs. A changing regulatory environment means that borrowing rate increases can occur independently of OCR moves.

Short-Dated Wholesale Fixed Rates

As noted, inflation pressures are higher than they were a year or two ago and we still believe that economic momentum remains sound. The global economic backdrop is positive, and global monetary policy is close to an inflexion point.

The US Federal Reserve is in the midst of a tightening cycle, the Bank of Canada recently moved to a tightening bias, the European Central Bank recently removed its easing bias and the last Bank of England vote only slightly favoured a move to keep policy unchanged, with notable dissention towards higher rates. The Reserve Bank of Australia has a neutral policy bias.

So the mood of global central banks has shifted towards a less accommodation policy stance. We expect the RBNZ to eventually move in that direction, but probably not until next year. In anticipation of tighter monetary policy next year, short-dated wholesale fixed rates are expected to eventually drift higher.

However, the near term bias is for 2-year fixed wholesale rates to range trade. The market is not confident that the Bank is going to move to a tightening bias anytime soon, which should contain rates for now. From late this year we see the 2-year rate begin to drift higher, with the rate of change accelerating through 2018.

The next chart shows the 2-year wholesale rate along with our forecast for the next 12 months.

With the RBNZ likely to sit on its hands for a while yet, there seems no rush for borrowers to fix rates yet at this short-dated horizon. However, borrowers should consider increasing look to fix rates later in the year to hedge against the risk of higher rates through 2018.

Longer-Dated Wholesale Fixed Rates

Mid-to-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 2.7% is consistent with only a muted tightening cycle over coming years – an OCR that steadily rises about a year from now and barely gets to 3% about 4-years down the track before flattening out. We think that profile under-prices the upside risk to rates over the tightening cycle ahead and therefore we see the current 5-year rate as a good opportunity to hedge against possible future interest rate increases.

Obviously, given the downward trend in the 5-year rate this year, borrowers might be tempted to wait until rates fall even further. We aren't going to rule out that possibility. Oil prices have recently come under significant downward pressure, and a continuation of that trend would lead to lower interest rates.

We simply point out that current rates are already historically low – to be sure, not as low as they got in Q3 last year – but if one believes that eventually we head down the path towards more "normal" rate levels, then the risk for mid-curve rates is skewed to the upside.

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 hike cycle gets underway next year, the market's current perception of the neutral rate could well increase.

In terms of global forces, US 5-10 year Treasury rates are near the bottom of the range they have traded so far this year. This backdrop has been a strong influence in driving NZ's 5-10 year wholesale rates lower.

We see the balance of risk skewed towards higher US longer term rates over the balance of the year. We continue to see the market as under-pricing the risk of tighter US monetary policy over the next couple of years. The US Fed recently suggested that its plans for normalisation of policy hadn't changed, despite some softer data, but still the market is reluctant to support the Fed's outlook.

A recent focus on President Trump and his inability to get his pro-growth agenda off the ground has been a factor in taking US bond rates down this year. But we expect easier fiscal policy measures to eventually come through, adding some upside pressure to rates from that source.

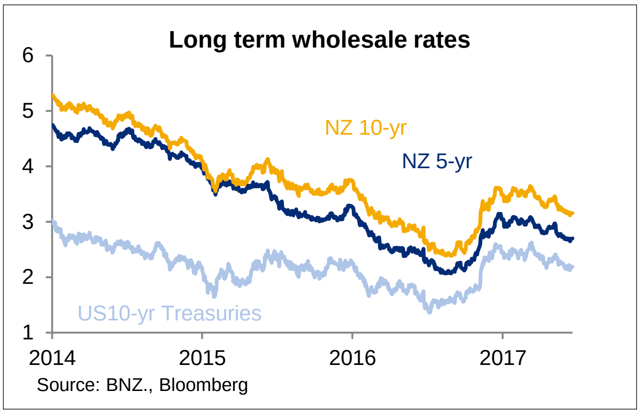
The Fed has also provided more information on its plans to reduce the size of its balance sheet. The process could kick off as soon as September. One year into the process, the extent of the rundown will be as large as $50bn per month, which is expected to add upward pressure to rates.

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.

In our view, lower NZ 10-year wholesale rates over the past month provide a good opportunity for borrowers to consider hedging against the expected recovery in long term rates we eventually see.

Long term Rates Lower, But For How Much Longer?

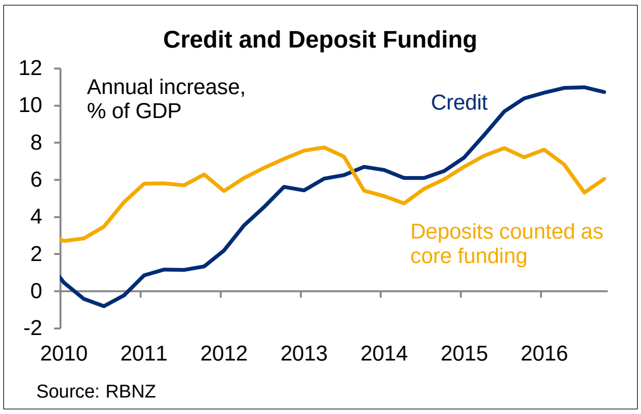


Bank Funding Costs

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

Credit costs are usually specific to a firm or industry, reflecting the risk of repayment of a loan. Bank funding costs have a much broader impact on lending rates across the economy and upward pressure remains. This reflects the current imbalance of credit and deposit growth in the domestic economy and the pressure coming from regulatory policy changes.

Credit Growth Exceeds Deposit Growth



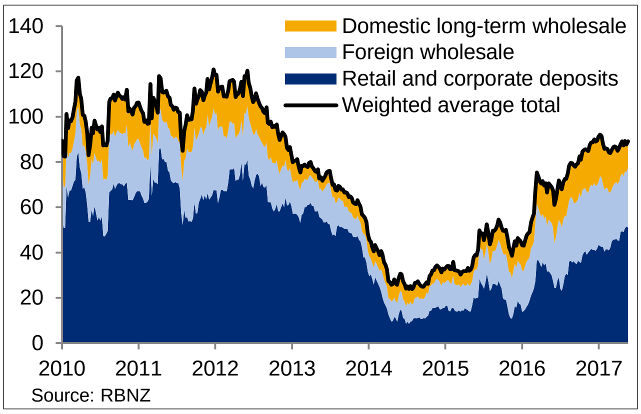
Credit growth might well be slowing but it remains well in excess of deposit funding. The shortfall of deposits to meet credit supply is as large as it has been over the past decade (see chart).

From 1 January 2018, banks must comply with the net stable funding ratio limits imposed by the Australian banking regulator. This demands that banks fund credit with so-called more stable funding sources like retail deposits and long-term funding wholesale funding.

As banks move towards this new regulatory regime, there is increased competition to attract retail deposits, adding to the cost of funding. For the banking system as a whole, over 50% of funding comes from retail deposits. The next chart shows the rising cost of bank funding, measured as a margin over the 90-day bank bill rate. The rising cost of retail and corporate deposits has played a key role in pushing up total funding costs.

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 lending rates against a backdrop of a steady OCR.

Bank Funding Costs on a Rising Trend



To the extent that these funding pressures remain, wholesale lending rates can increase independent of the OCR. Until the regulatory backdrop settles down and as long as credit growth remains in excess of deposit growth, these funding pressures will continue.

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 fixed rate matures.

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