22 March 2018

Outlook for Borrowers: Post March OCR Review

- We expect the OCR to be on hold through 2018.
- The 90 day bank bill rate has drifted higher, driven by funding pressures in the US.
- These offshore funding pressures increase the uncertainty around the outlook for wholesale floating rates (independent of the OCR outlook).
- In spite of this, we're not convinced that borrowers need to rush to hedge short-term wholesale fixed rates. Our central expectation is that short-term wholesale fixed rates will be range-bound this year amid an OCR on hold.
- We expect higher US rates this year to drive higher longer-term NZ fixed rates. NZ longer-term rates have moved lower over the past 6 weeks and we would consider using any further dip to put on longer-term hedges.

RBNZ Monetary Policy Outlook

At the March OCR Review, the RBNZ kept the OCR on hold at 1.75%, as universally expected by economists. The Statement was largely a repeat of the version from February, with the Bank reiterating its expectation that growth should firm this year and inflation should eventually rise, after a dip in the coming quarters. The Bank finished by noting "numerous uncertainties" and reiterating a neutral policy stance. For reference, the last projections from the RBNZ in February had the first full rate hike in early-2020.

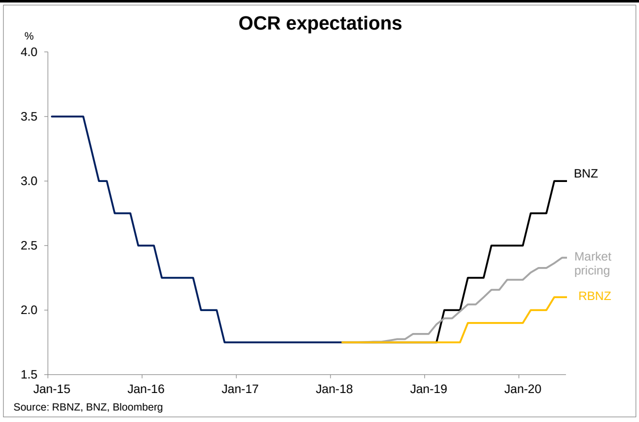
The OCR Review was the last under Grant Spencer, and Adrian Orr will become Governor of the RBNZ on March 27th. Orr's first meeting as Governor will be the May 10th MPS, complete with new projections and a press conference.

Notwithstanding the change in personnel at the RBNZ, our base case is that the central bank will keep the OCR on hold this year. We think the hurdle for moving rates in either direction in the coming months is very high.

Headline inflation is likely to fall to low levels over the coming few quarters, partly due to some policy-induced factors (such as the start of fees-free tertiary education) and base effects. We expect CPI to fall to 0.9% YoY in Q1 before rising to just 1.2% in Q2. We don't believe the RBNZ would want to raise the OCR with inflation at such low levels, especially with the NZD still relatively strong (a rate hike would likely strengthen the NZD, adding to disinflationary pressures).

Even with headline inflation at very low levels in the coming quarters, we think the hurdles for rate cuts are also very high. The global growth backdrop remains strong and the trend offshore is towards tightening monetary policy (including the US Federal Reserve just raising rates for the 6th time). Domestically, economic growth should pick-up later this year on the back of more fiscal spending and the unemployment rate, at 4.5%, is at its lowest level since 2009 – not normally circumstances one would associate with rate cuts. Finally, the RBNZ is cognisant of the longer-term financial stability risks associated with low interest rates and may be wary that rate cuts could reignite the NZ housing market.

We Expect The OCR To Be Unchanged In 2018



Ultimately, we expect domestic capacity pressures to feed through to higher inflation, with the Labour government's planned policies likely adding to inflationary pressure in time. The minimum wage goes up 4.8% on 1st April and probably by more next year, while there remains the possibility of wage increases for public sector workers such as teachers and nurses. But we think higher NZ inflation is more a story for later this year and next – we expect the first rate rise from the RBNZ in February 2019.

Changes at the RBNZ

Besides the appointment of a new Governor, the Labour government is planning a number of changes to the RBNZ this year:

- Moving to a 'dual mandate' by adding employment as a monetary policy goal, alongside inflation. The government plans to change the RBNZ Act, but the soon-to-be-signed Policy Targets Agreement will likely have a stronger emphasis on employment than the previous version
- Moving to a committee structure for deciding on the OCR, with a likely mix of senior RBNZ officials and external members.

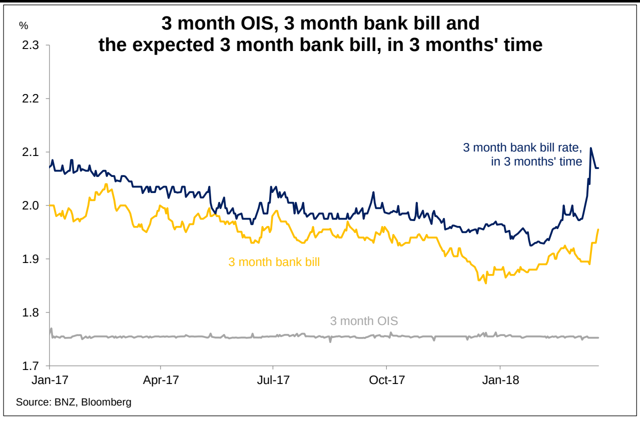
It's worth noting that most central banks globally have committees for deciding on interest rates (rather than single decision makers) and several have 'dual mandates', including the Federal Reserve and the Reserve Bank of Australia. We don't think the changes should materially affect the OCR outlook.

How the new Governor sees the economic outlook and how he thinks monetary policy should respond (what economists term the "reaction function") is more uncertain. We will learn more at the May MPS.

Wholesale Floating Rates

The 3 month bank bill has increased around 10bps from the end of last year. Furthermore, the market anticipates the 3 month bank bill rate will increase another 10bps by June. The moves in bank bills came despite unchanged OCR expectations (the 3 month OIS[1] rate was flat, as it has been for a long time).

The NZ 3 Month Bank Bill Rate Has Moved Higher

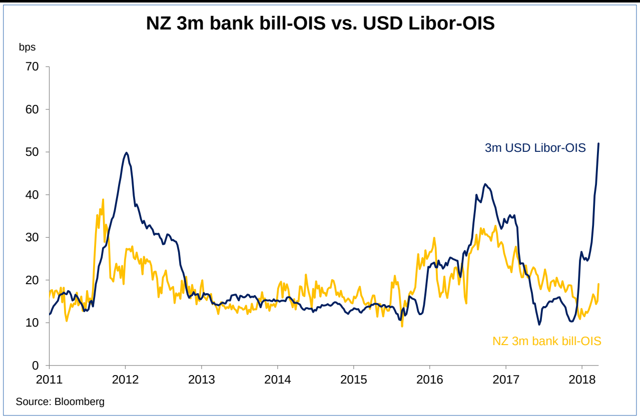


The increase in the NZ bank bill rate follows moves in the US. The spread between 3 month Libor and 3 month OIS has increased from 10bps late last year to over 50bps now. For those interested, we discussed some of the reasons for the move higher in US Libor-OIS and the implications for NZ bank bill rates in a recent note.

The volatility in US-Libor OIS and latterly NZ bank bills means there is more uncertainty around short-term wholesale rates for the coming few months. Despite our expectations for an unchanged OCR this year, it's possible that the NZ 3m bank bill rate could continue to rise if funding pressures in the US worsen.

In the big scheme of things, the moves in NZ bank bill rates have been reasonably modest and our central expectation is that they will remain range-bound for most of this year (anchored by an OCR unchanged at 1.75%).

NZ Bank Bill-OIS Spread Has Lagged The Move In The US



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

Short-term wholesale fixed rates have also moved higher recently, driven by the increase in floating rates. OCR expectations have been very stable – the market prices around 2 hikes by the end of 2019.

Notwithstanding the recent volatility in floating rates, our central expectation is that short-end wholesale fixed rates (such as the 2 year swap) will be reasonably anchored amid an unchanged OCR in 2018.

The difference between NZ short term fixed wholesale rates and floating rates (an indication of the "premium" borrowers pay to hedge) is around the middle of the range seen over the past year. On this basis, the cost of hedging doesn't look particularly "cheap".

Borrowers should be aware that there is a risk that floating rates could continue to rise, if US funding conditions worsen. That's not something we're forecasting though, and for those borrowers that have the risk appetite, we would consider sticking to floating rate borrowing, rather than locking in the higher short-term fixed rates (which are near their highest levels since mid-last year).

[1] OIS stands for "overnight indexed swaps", which reflect market expectations of the OCR in the future.

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.

After increasing sharply earlier this year, The 10 year US Treasury yield has consolidated near the top end of the range seen for the past five years, some 80bps higher than 6 months ago. We continue to believe the medium-term forces argue in favour of higher longer-term bond yields:

- A synchronised global growth upswing;
- Some emerging signs that US inflation is starting to pick-up;
- A fiscal boost to the US economy at a time when the US unemployment rate is at its lowest level since the early 2000s, which should add to inflationary pressures;
- More US Treasury issuance due to the fiscal changes;
- We think there is a good chance the Federal Reserve will raise rates by more than the market currently expects.

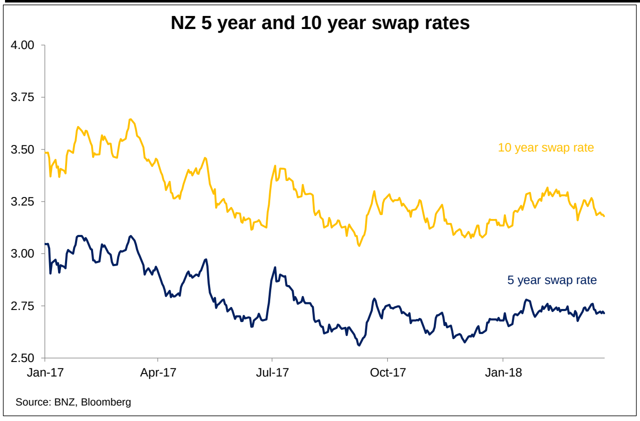
NZ longer-term fixed rates have fallen modestly over the past 6 weeks, but remain up on the year. NZ longer-term fixed rates remain caught between the opposing forces of higher global rates and an unchanged OCR.

Ultimately, we expect NZ longer-term fixed rates to move higher this year. The US is the anchor for all long-term rates globally, and as NZ is a net borrower in international capital markets it suggests that NZ long-term fixed rates should follow the US higher this year (albeit it is possible NZ continues to lag the moves offshore until OCR hikes come into clear view).

NZ wholesale longer-term fixed rates are consistent with the RBNZ eventually raising the OCR to around 3.5%. This is the same level the RBNZ raised the OCR to during its 2014 tightening cycle and is also consistent with what the RBNZ thinks is the 'neutral rate' (i.e. the level of the OCR that is neither simulative nor restrictive). But we think NZ long-term fixed rates can build-in some more "risk premium" this year in an environment where our rates follow the US higher.

Longer-term fixed rates have fallen over recent weeks and are not far from where they were at the start of the year. We would consider using any further dip in rates to put hedges in place.

Long-term fixed rates consistent with OCR getting to 3.5%

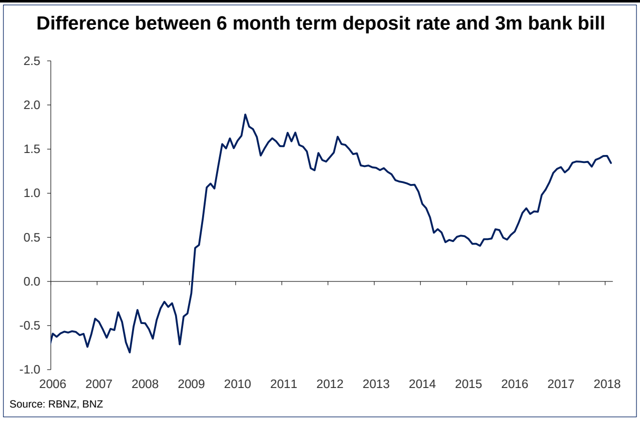


Bank Funding Costs

Most borrowers' total interest rates are constructed as a combination of wholesale rates, credit costs and bank funding costs. After rising over the preceding two years, bank funding costs have been broadly stable over the past year.

There have been some modest declines in retail term deposit rates and fixed mortgage rates recently, suggestive of NZ banks trying to encourage more net lending (credit growth slowed through 2017 as the housing market cooled).

Term Deposit Rates Have Fallen Slightly



nick.smyth@bnz.co.nz

Contact Details

BNZ

Stephen Toplis
Head of Research
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Jason Wong
Senior Markets Strategist
+64 4 924 7652

Nick Smyth
Interest Rates Strategist
+64 4 924 7653

Main Offices

Wellington
Level 4, Spark Central
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +64 9 976 5762
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Phone: +64 3 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+61 2 9237 1406

Alan Oster
Group Chief Economist
+61 3 8634 2927

Ray Attrill
Head of FX Strategy
+61 2 9237 1848

Skye Masters
Head of Fixed Income Research
+61 2 9295 1196

Wellington
Foreign Exchange +800 642 222
Fixed Income/Derivatives +800 283 269

Sydney
Foreign Exchange +61 2 9295 1100
Fixed Income/Derivatives +61 2 9295 1166

London
Foreign Exchange +44 20 7796 3091
Fixed Income/Derivatives +44 20 7796 4761

New York
Foreign Exchange +1 212 916 9631
Fixed Income/Derivatives +1 212 916 9677

Hong Kong
Foreign Exchange +85 2 2526 5891
Fixed Income/Derivatives +85 2 2526 5891