RESEARCH
ECONOMY WATCH

11 May 2018

Outlook for Borrowers: Post May Monetary Policy Statement

- **We expect the OCR to be on hold through 2018 and have pushed back our expectations for the first hike to May next year.**
- **The 90 day bank bill rate has moved to its highest level since late 2016, but the market doesn't expect it to rise any further.**
- **Offshore funding pressures increase the uncertainty around the outlook for wholesale floating rates (independent of the OCR outlook).**
- **There doesn't seem any rush to add short-term fixed rate hedges given a rate rise is not expected any time soon. We would highlight though that the "premium" for short-term hedges is quite low now.**
- **We continue to see the risks skewed to higher long-term NZ rates this year. We would continue to opportunistically use dips in long-dated fixed rates to add hedges.**

RBNZ Monetary Policy Outlook

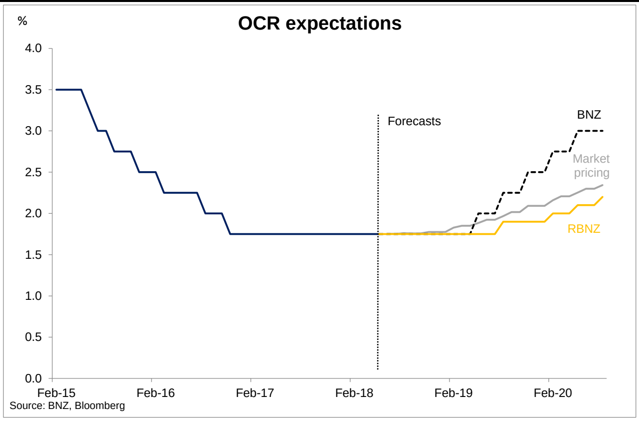
The May *Monetary Policy Statement*, the first under new Governor Adrian Orr, delivered a similar message to previous statements. The key message was that the OCR "will remain at 1.75 percent for some time to come". The apparent decisiveness of the statement – "will remain" – suggests the hurdle for a move in either direction this year is very high. The RBNZ's projections incorporate the full first rate rise in early-2020.

For completeness, the RBNZ said that the next move could be either up or down, with those risks equally balanced at present. The RBNZ highlighted a scenario where it could cut rates might be one in which global financial conditions tighten (i.e. equity markets plunge and banks' borrowing rates rise). Equally, it said that if consumers and businesses were more forward looking in their price-setting (rather than looking back at low inflation over recent years), this might warrant an earlier rate rise than they currently forecast. But the main message appeared to be that we should expect the OCR to be on hold for quite a while.

We also don't expect any change in the OCR this year and have pushed out when we expect the first rate hike to May next year (from February previously). While we expect inflation to get to target sooner than does the RBNZ (we see headline CPI inflation at 2% at year end whereas the central bank doesn't see it getting to target until the end of 2020), the Bank clearly wants to be see underlying inflation much closer to 2% to contemplate raising rates. This seems more likely to emerge in 2019 than this year.

What of the prospects for rate cuts? We tend to think that it would take some unforeseen shock (probably emanating from offshore) to see the RBNZ cut rates. In the absence of some downside shock, the RBNZ expects growth to pick up this year, partly due to the Government's fiscal stimulus. As monetary policy impacts the economy with a lag, this implies any near-term rate cut might start taking effect at the same time growth is strengthening, and need to be reversed.

OCR expectations have been pushed back



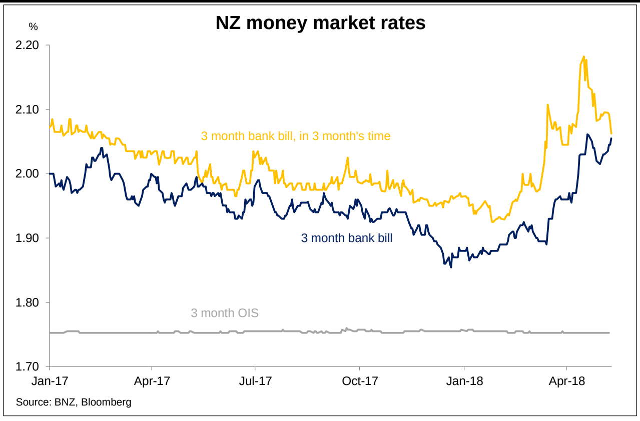
Wholesale Floating Rates

The 3 month bank bill rate has moved around 10bps higher since the time of the March OCR Review. There has been no change in near-term OCR expectations; the entirety of the move higher has been due to an increase in the spread between the bank-bill rate and OIS.[1]

While the 3 month bank bill rate has continued to move higher, the market no longer expects it to keep rising. The market expects the 3 month to be steady at 2.06% in three months' time (see the yellow line in the chart below).

[1] OIS stands for overnight indexed swap. The 3 month OIS rate effectively shows what the market expects the OCR to average over the coming 3 months.

The NZ 3 month bank bill rate has moved higher

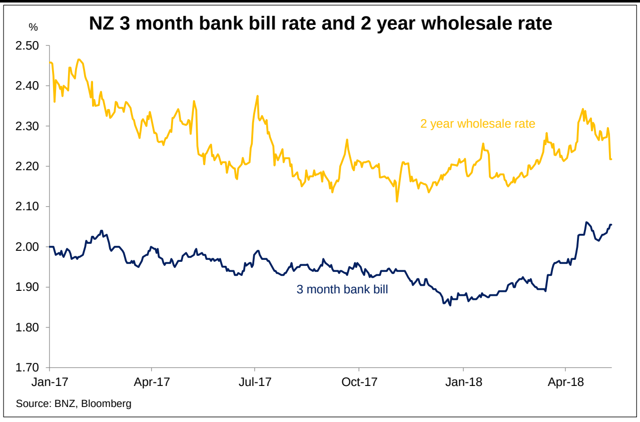


The primary driver of wholesale floating rates continues to be the ebb and flow of funding pressures in the US. US Libor-OIS[2] has started to decline in recent weeks (from very high levels) as US funding pressures have eased, and this should help cap the NZ bank bill rate if that continues. Our central view is that wholesale floating rates should be anchored near present levels for the remainder of the year, given we don't expect any movement in the OCR and NZ bank bill-OIS spreads look broadly fair to us at current levels.

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

Short-term wholesale fixed rates are at similar levels to the time of the last *Update*, despite the increase in NZ floating rates (see chart below). The market continues to push out OCR rate hike expectations – the first hike is now fully priced for September next year. Our base case is that short-dated wholesale fixed rates will be range-bound for most of this year, anchored by our expectation of an unchanged OCR.

The NZ 3 month bank bill rate has moved higher

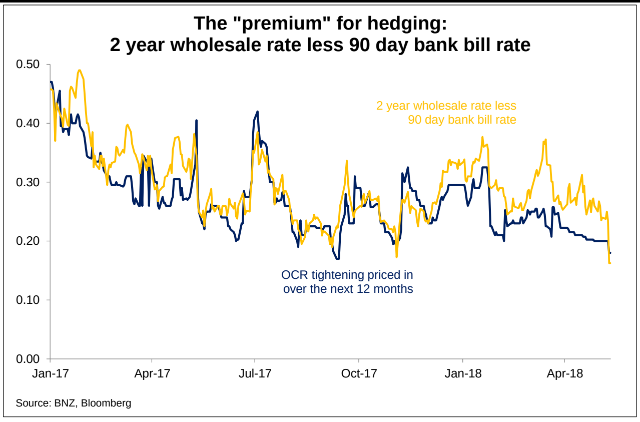


With the clear message from the RBNZ being that we shouldn't expect any move in the OCR for quite a while, there doesn't seem to be any particular rush to put on hedges. We can see the logic in waiting until there is more clarity on the timing of the first hike (either from the data or the RBNZ itself), given there is a "premium" associated with hedging.

However, we would highlight that the "premium" borrowers pay to hedge has shrunk to almost its narrowest level over the past 18 months. The difference between the 2 year wholesale rate and the floating rate is around 0.17%. Essentially, the market doesn't price-in very much tightening into the curve now; just two rate hikes are priced-in over the next two years.

There is greater uncertainty than usual around NZ floating rates given the multitude of forces affecting US funding conditions. For those borrowers who prefer the certainty of fixed interest payments, we can also see the argument for adding some hedges.

The "premium" for hedging is towards recent lows



Longer-Dated Wholesale Fixed Rates (5-10 yr)

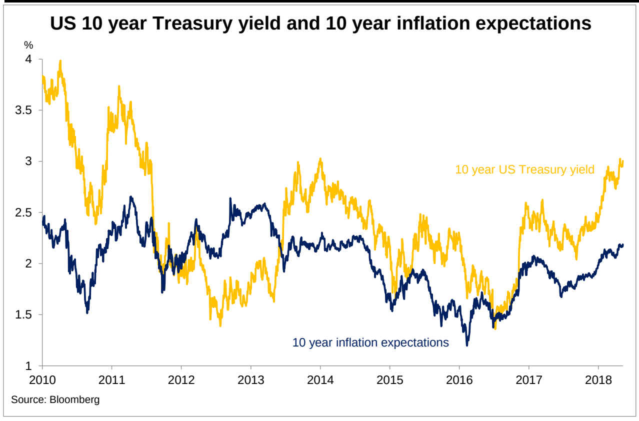
Longer term rates are less influenced by short-term monetary policy factors and more influenced by policy over the next full cycle, along with global forces.

Late last month, the 10 year US Treasury yield reached 3% for the first time since early 2014. The US unemployment rate had continued to decline, and at 3.9%, is the lowest since 2000, while inflation is essentially now at the Fed's target. The supply of Treasury bonds continues to increase as well, mainly to fund President Trump's fiscal stimulus but also to make up for the decline in the Fed's holdings (as the Fed unwinds its QE holdings). The recent increase in oil prices ahead of President Trump's decision to reinstate sanctions on Iran has also boosted market expectations of inflation.

The market has increased its expectations of tightening by the Federal Reserve and now expects the Federal funds rate (currently 1.75%) to reach 2.75% by the end of next year. As rate hike expectations have built, the US yield curve has flattened to its lowest level since 2007, with the

2 Libor is the US equivalent of the 90 day bank bill rate.

US 10y rate and inflation expectations hit post-2014 high



spread between the 2 year Treasury yield and that of the 10 year bond now 45bps. This has generated some discussion in the market about whether further rate hikes could eventually see an 'inverted' yield curve, which historically has been an excellent early warning indicator of US recession. We are obviously still some way off the curve inverting, and even then, US recession would be more a risk for 2020 onwards – interested borrowers can read more here.

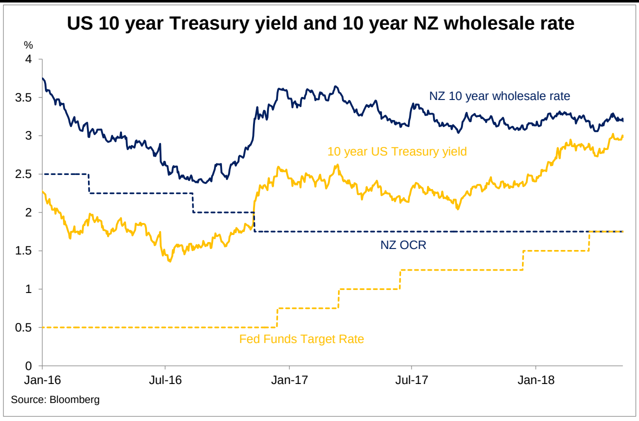
In terms of the outlook, we look for a modest increase in the US 10 year Treasury yield over the remainder of the year and see market expectations of Fed tightening as more reasonable than they have been for a long time. The biggest risk that could cause much higher bond yields is an unexpected increase in US inflation. The market expects a modest overshoot of the Fed's 2% inflation target, which the Fed seems perfectly content with, but an increase in US core inflation above 2.5% would see a significant market reaction.

NZ wholesale longer-term fixed rates are in the middle of the range they have been in over the past year and have lagged the moves in the US. The primary reason for this is the fact that OCR expectations keep getting pushed back, despite the Fed's continued rate hikes.

Looking ahead, we see upside risks to NZ wholesale longer-term fixed rates building over the course of the year. First, we expect an increase in NZ CPI inflation towards 2% later this year, which should boost the depressed inflation expectations embedded in longer-term rates (inflation expectations derived from NZ government bonds are between 1.3-1.4%). The recent fall in the NZD – were it to extend – would be an added tailwind for the inflation outlook and should put some upward pressure on NZ rates.

Second, we see the risks around NZ bond issuance to the upside given the Government's planned fiscal policies. More details will be revealed in the May Budget, and we see the Government bond programme being either unchanged, or if anything, higher.

NZ 10 year rate has lagged the move up in US Treasuries



Finally, we think there is a limit to which NZ longer-term fixed rates can lag the moves in the US. Yes, there are plenty of countries that have lower rates than does the US, but they mostly fall into two categories: either they have lower growth potential (i.e. Japan) or they are countries of savers (i.e. Germany). NZ is neither. We expect further rises in US rates to eventually transmit to higher NZ longer-term fixed rates.

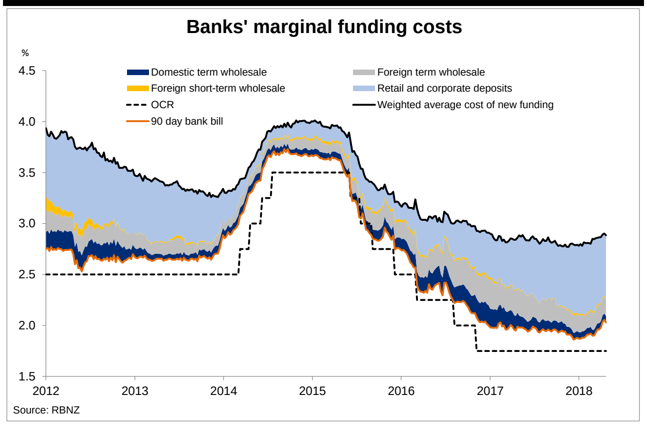
We would consider opportunistically using dips in rates towards the lower end of ranges to put hedges in place.

Bank Funding Costs

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

The cost of market funding has increased moderately in recent months due to the aforementioned increase in US funding pressures, which has pushed up both NZ bank bill rates and credit spreads (hence raising the cost of term debt issuance) globally. In contrast, term deposit rates have been reasonably flat over recent months. The net result has been an increase in banks' marginal funding costs, in the order of around 10bps so far this year.

Banks' marginal funding costs have moved a little higher



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