29 June 2018

Outlook for Borrowers: Post-June OCR Review

- **We expect the OCR to be on hold through 2018 and don't expect the first RBNZ hike until May next year (with risks tilted to a later start date).**
- **Following the *OCR Review*, the market now prices a very small (around 5%) chance of rate cuts over the next six months.**
- **We expect short-term fixed rates to be reasonably anchored amid an unchanged OCR. We don't see any urgency to add short-term fixed rate hedges even though the "premium" for hedging is now quite low.**
- **We expect longer-term fixed rates to be range-bound over the coming months. From a hedging perspective, we think borrowers can be opportunistic in adding long-term fixed rate cover.**

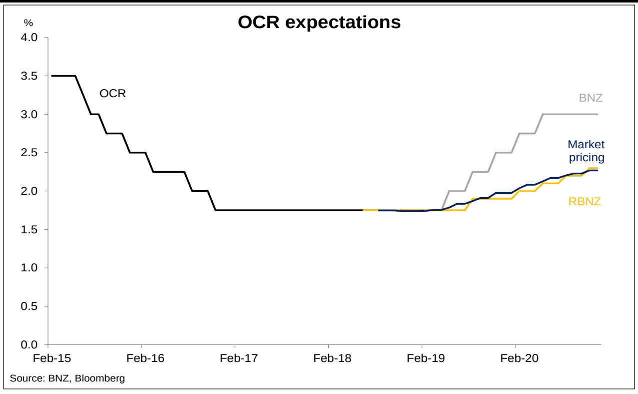
RBNZ Monetary Policy Outlook

At the June *OCR Review*, the RBNZ kept the OCR on hold at 1.75%, as universally expected. There were some subtle changes in language however. The RBNZ said the OCR will remain at 1.75% "for now", in the May MPS the wording used was "for some time". The RBNZ also said the next move could be a rate cut or rate hike, but removed the previous reference to the risks being equally balanced.

The RBNZ said its outlook for the NZ economy remained intact, although it did highlight trade tensions, a slightly lower (and later) fiscal impulse, and the recent Q1 GDP reading, which printed slightly lower than its expectations. It also noted inflation was set to pick up in the near-term due to higher fuel prices.

The market interpreted the wording changes dovishly, and now prices a very small (around 5%) chance of rate cuts over the next six months. The market has pushed out the timing of the first rate rise, which is now fully-priced for March 2020.

The market expects the first OCR rise in February 2020



We think the most likely outcome is that the RBNZ keeps the OCR on hold at 1.75% for an extended period. We have pencilled the first rate hike for May next year, but the risks are clearly tilted towards a later, rather than earlier, start date.

Given the changes in wording in this Statement follow recent weak business confidence readings (which point to GDP growth closer to 2% than the 3+% forecast by the RBNZ), we wouldn't be surprised if there was a bit more chatter about the chance of rate cuts. From our perspective, we continue to think that the likelihood of rate cuts is unlikely for the following reasons:

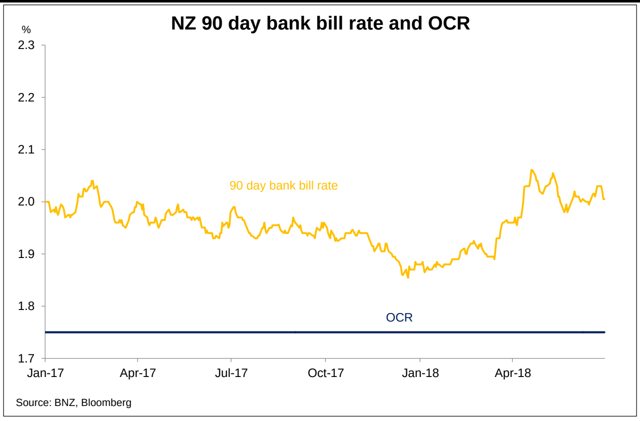
- We think business confidence is understating growth (as is typical when a Labour government is in power);
- We expect the Government's fiscal stimulus to boost growth later this year;
- The unemployment rate is below the RBNZ's latest estimates of NAIRU;
- We forecast headline CPI to rise faster than the RBNZ, and to exceed 2% by Q3 this year.

We think it would probably take some kind of shock to financial markets, conceivably related to a serious escalation in global trade tensions, to see the RBNZ cut rates. We note that the rate cut scenario presented by the RBNZ in its May MPS involved a tightening in financial conditions which would be expected to result in lower prices for NZ exports and higher costs of funding for banks (in turn leading to higher mortgage rates).

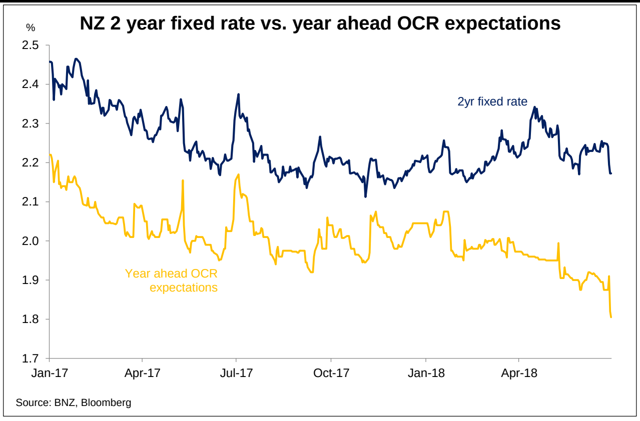
An earlier OCR rate rise than we forecast could eventuate if core inflation picks up towards 2% (it is currently 1.5%) and growth accelerates later this year (due to the fiscal stimulus). While we expect headline CPI inflation to increase over the coming twelve months, the Governor has previously indicated that he wanted to see core inflation rising towards 2% before contemplating rate rises.[1] Greater wage pressure, which we are hearing more anecdotes about, would be key to core inflation rising. But we think this is more likely to be a story for next year.

1 See "RBNZ's Orr Wants Core Inflation to Pick Up Before Tightening", Bloomberg, 10th May 2018.

90 day rate remains relatively elevated compared to OCR



The NZ 2 year fixed rate has been range-bound



Wholesale Floating Rates

The 90 day bank bill rate is at similar levels to the time of the May MPS. Funding costs remain quite high relative to the last few years, keeping the 90 day rate relatively elevated compared to the OCR – see chart above.

US funding pressures have been the main driver of the NZ 90 day rate so far this year. US funding pressures appear to have improved modestly over the past six weeks and we expect the NZ 90 day bank bill rate to be reasonably stable around current levels for the remainder of this year, anchored by an unchanged OCR.

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

Following the *OCR Review*, short-term wholesale fixed rates have moved towards the lower end of recent trading ranges. OCR expectations continue to be pared back – the first OCR hike now fully-priced for March 2020.

We expect short-term wholesale fixed rates to remain reasonably anchored for the remainder of this year. While we expect a steeper profile of rate rises than does the market, we don't expect any material re-pricing of short-term wholesale fixed rates until there is more clarity on the timing of the first hike. This will require either domestic data to improve significantly, thus leading the market to bring forward its rate hike expectations, or the RBNZ to provide a signal to the market – we don't expect either in the coming months. There is even a risk that the market starts to price the balance of risks more towards rate cuts rather than hikes if domestic data softens or concerns around trade tensions rise.

We don't think there is any great urgency to hedge at present given our expectation that both the 90 day rate and short-term fixed rates should be reasonably anchored this year. We note that the "premium" that borrowers pay to hedge is close to its narrowest levels over the past 18 months, implying the "cost" of hedging is now relatively low, but we think borrowers can be opportunistic in adding hedge cover.

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 mostly traded within a 2.75% to 3% range since February. US economic data continues to paint a positive picture, with the unemployment rate near its lowest level since the 1970s and inflation near the Federal Reserve's target. In response, the Federal Reserve raised its cash rate to 2% this month, and signalled that it expects to hike a further two times this year (one more than it had previously signalled).

However, the recent escalation in trade tensions between the US and China has tempered expectations of further rises in US yields. While higher tariffs have the potential to increase short-term inflationary pressures, much like an increase in GST would, we expect a material escalation in trade tensions to result in lower yields offshore due to the negative read-through to global growth, commodity prices and risk assets. In a recent panel, Fed Chair Powell said that "changes in trade policy could cause us to have to question the outlook", raising the prospect that the Fed could become more cautious about future rate rises in the event the trade conflict starts affecting economic activity.

So far, the market fall-out from the escalating trade feud has been reasonably modest (the market perhaps anticipating an eventual compromise solution between the US and its trading partners). The market expects the Fed to raise its cash rate from its current 2% level to around 2.75% by late next year after which the market sees rates on hold – see chart below.

We see the US 10 year Treasury yield, and the market's pricing of the Fed Funds rate, as broadly fair at current levels, but with medium -term upside risks. The main scenario where we envisage US yields going higher is where US inflation picks up further, as suggested by some leading indicators, and the Fed tightens according to its rate projections (taking the Fed funds rate into "restrictive" territory at 3.5% in 2020). But we don't expect a material re-pricing in US rates in the near-term while the spectre of trade tariffs hangs over the market.

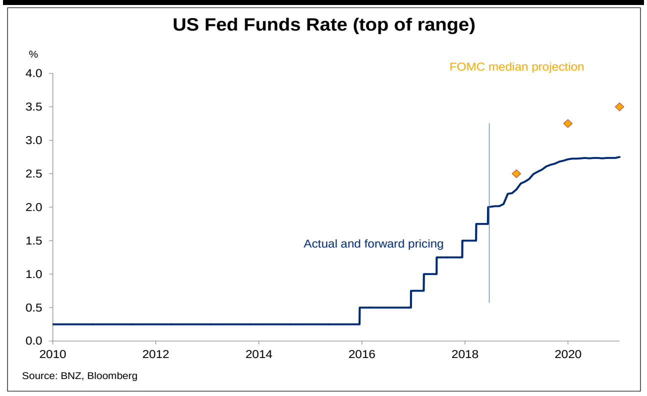
The main near-term downside risk to US yields relates to the uncertainty created by trade tensions and the potential for this to adversely affect business confidence and financial markets. A slow-down in US economic data could cause the Federal Reserve to slow or conceivably even stop its tightening cycle.

NZ wholesale longer-term fixed rates have remained within a tight range over the past year, as shown by the yellow line in the chart to the upper-right. Post the *OCR Review*, they have moved towards the lower end of that range. We see medium-term upside risks to NZ longer-term fixed rates related to:

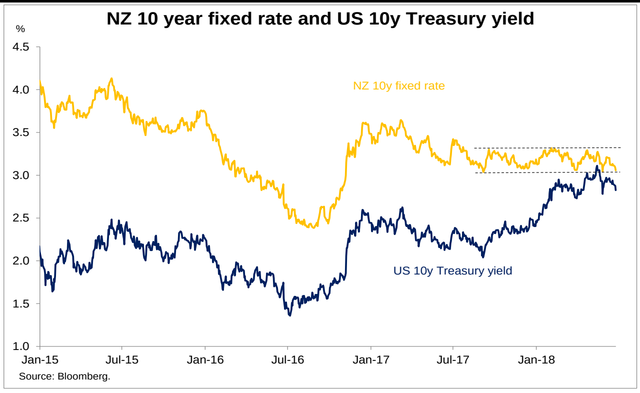
- The aforementioned medium-term upside risks to US Treasury yields. In the event US inflation picks up further and Treasury yields rise, we would expect this to exert some upward pressure on NZ longer-term interest rates;
- Our expectation that headline inflation will rise to above 2% later this year, which should help bolster the inflation expectations component of longer-term fixed rates.

But it may take some time for these themes to play out, and in the meantime we expect longer-term fixed rates to be range-bound. From a hedging perspective, we think borrowers can be opportunistic in looking to add hedge cover.

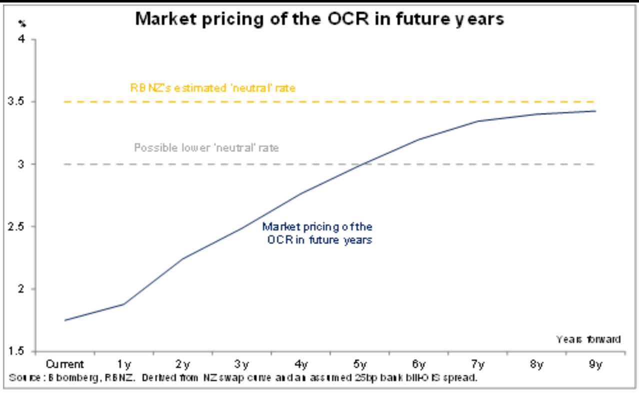
Market pricing of Fed Funds Rate vs. Fed projections



NZ 10 year fixed rate has been range-bound for some time



The market prices the OCR to eventually rise to 3.4%



The market prices the OCR to eventually rise to around 3.4%, as shown in the chart above. This is slightly below the 3.5% that the RBNZ currently judges to be the "neutral cash rate", i.e. the level of the OCR that is neither stimulatory nor restrictive. Our analysis though points to the risk that the neutral rate might be lower than 3.5%, possibly closer to 3%, due to the high level of household debt and elevated mortgage spreads (which drive a bigger "wedge" between the OCR and the rates at which households can borrow). If we are right, and the RBNZ neutral cash rate is closer to 3%, it implies longer-term NZ fixed rates currently embed some risk premium.

This 'risk premium' for long-term fixed rate hedges has at times been much higher than it is now, and if for instance US yields move higher, we would expect the premium on NZ longer-term rates to rise. But our analysis of the neutral rate adds support to the view that borrowers can be opportunistic with hedging levels.

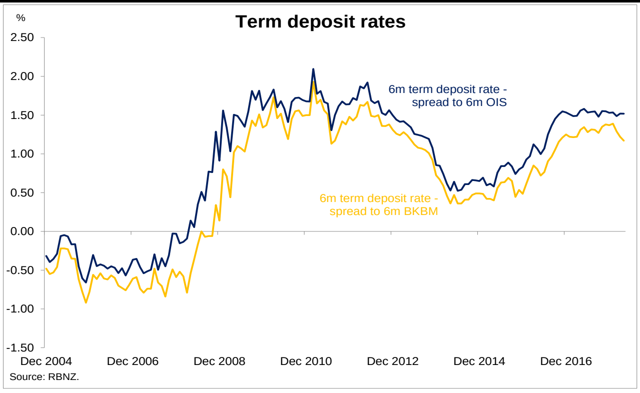
Bank Funding Costs

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

There hasn't been too much change in bank funding costs over the past six weeks. Term deposit rates have remained sticky, as shown by the chart to the right. The difference between the 6 month term deposit rate and the 6 month OIS rate (which embeds expectations of the OCR) remains elevated.

The cost of market funding has pushed slightly higher in the past few months due to some widening in credit spreads offshore (which raises the cost of issuing term debt for NZ banks). There are some growing headwinds to credit markets offshore given ongoing Fed tightening and balance sheet reduction, the risk of trade war escalation and corresponding weakness in risky assets, and reduced demand for US corporate bonds from large multi-nationals after the recent US tax reform.

Term deposit rates remain elevated relative to the OCR



Source: RBNZ.

Doug_Steel@bnz.co.nz

Contact Details

BNZ Research

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
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
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