9 November 2018

Outlook for Borrowers: Post-November MPS

- **The RBNZ said it still expects to keep the OCR on hold into 2020.**
- **After stronger GDP, inflation and employment data, the market has now priced-out the risk of rate cuts. The first hike is fully-priced for mid-2020.**
- **With the chance of rate cuts now looking remote, we have greater conviction in short and longer-term wholesale fixed rates heading higher.**
- **While wholesale fixed rates have risen sharply over the past week, we think there is a strong case for considering fixed rate hedges. Our preference is for the 5 year point of the curve.**

RBNZ Monetary Policy Outlook

At the November MPS, the RBNZ reiterated that it expected to keep the OCR on hold into 2020. It said the timing and direction of any future OCR move would be data dependent.

The November MPS was preceded the day before by an exceptionally strong NZ labour market report. The NZ unemployment rate fell to 3.9%, its lowest level since 2008. While we think the report probably overstates the strength in the labour market to a degree, the underlying message is that the NZ labour market is very tight. The data provided a further argument against the RBNZ cutting rates (following upside surprises to GDP and inflation data).

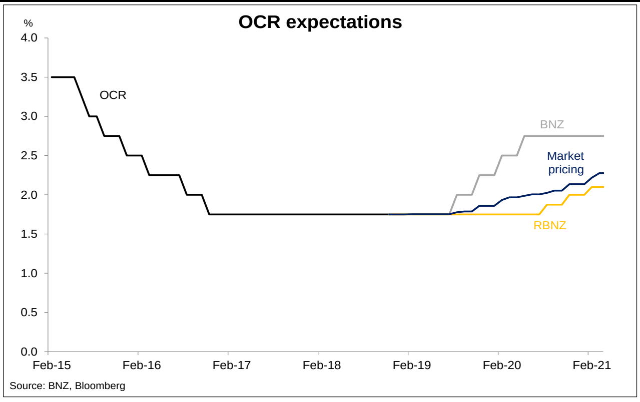
At the post-MPS press conference, Governor Orr refused to rule out the possibility of rate cuts, saying "it would be pointless to do that, to remove an option." But we think the chances of the RBNZ actually cutting rates are now remote (absent a global shock of some sort).

The market had already priced-out the risk of RBNZ rate cuts after the stronger labour market data. The market now prices the first hike by the RBNZ in mid-2020, which is similar to the RBNZ's forecast OCR track (see chart).

We forecast the first hike in August next year, which is earlier than both market and RBNZ expectations. Our forecast is conditional on a further increase in core and non-tradables inflation. Underlying this, we expect some of the rising cost pressure in the economy to translate through to higher wage and price inflation. We would also note that the OCR is below 'neutral', so prospective rate rises should be seen as a shift to a less accommodative stance of policy, rather than a 'tightening' as such.

The risk to our forecast is that the RBNZ delays hikes beyond August, even with the labour market already near its "maximum sustainable level" and core inflation close to the 2% mid-point of the target range. The RBNZ has indicated a willingness to tolerate inflation above the 2% midpoint, so it's possible the threshold for raising rates is greater than we currently assume. We are still learning how the RBNZ approaches monetary policy under the new Governor and with a dual mandate.

The market is back to pricing rate hikes into the NZ curve



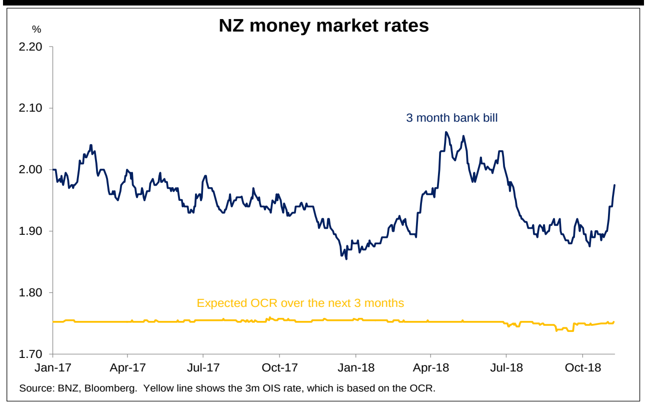
Source: BNZ, Bloomberg

Wholesale Floating Rates

The 90 day bank bill rate has picked up over recent weeks and is at its highest level since July. Near-term OCR expectations have been stable over this time. Instead, the increase in the 90 day rate has been due to a modest increase in funding pressures ahead of year-end. A similar pattern has been seen offshore, with US short-term funding spreads rising by a similar amount.

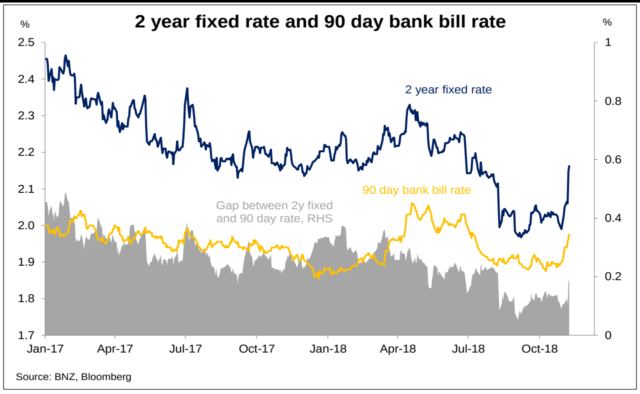
Our base case is that these funding pressures, both in the US and NZ, abate after year-end. We don't think the broader funding backdrop has changed materially for NZ banks. But as always, funding markets are opaque and notoriously difficult to forecast. There is a risk that US funding pressures intensify further into year-end, and this transmits into a higher 90 day bank bill rate.

90-day bank bill has risen due to funding pressures

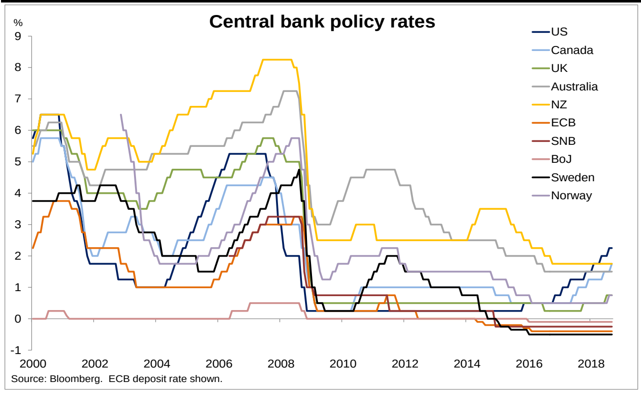


Source: BNZ, Bloomberg. Yellow line shows the 3m OIS rate, which is based on the OCR.

Sharp move higher in 2 year fixed rate over the past week



More central banks have joined the Fed in raising rates



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

Short-dated wholesale fixed rates have moved higher since the time of the last *Borrower's Update*, with most of that move coming after the surprise fall in the NZ unemployment rate (see chart). The market has shifted from pricing-in some risk of an OCR cut by the end of next year to now pricing-in some chance of a *hike*. The increase in the 90 day rate, independent of OCR expectations, has added some upward pressure to short-dated fixed rates as well.

We have an upward bias to short-dated fixed rates from here. First, we think the chances of an OCR cut are now remote. Second, we think there is some scope for the market to bring forward its pricing for the first hike from mid-2020. Third, we think the market is still positioned for lower, rather than higher, short-term fixed rates, and unwinds of these positions could exacerbate any shift higher.

Short-dated fixed rate hedges offer protection against OCR rate rises later next year, which in our view have become a more realistic possibility. Hedges also offer protection against any further rise in the 90 day bank bill rate independent of the OCR, were funding pressure to intensify.

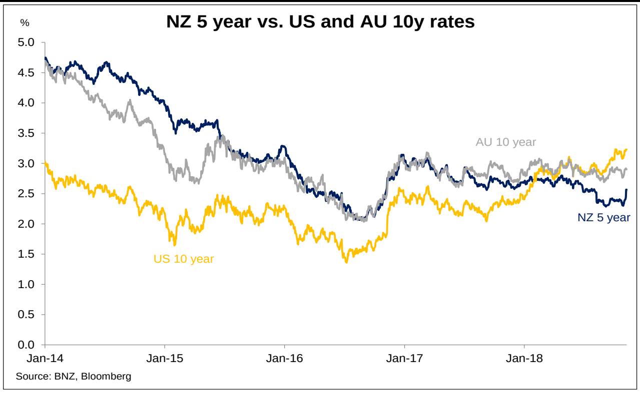
The "premium" for hedging, as implied by the difference between the 3 month bank bill rate and the 2 year fixed rate, is higher than it was (see chart). That reflects the shift in the market's perception towards thinking the next move is more likely to be a rate hike, which we think is appropriate. We think it is worth considering short-term fixed rate hedges.

We do note however that there is a high degree of uncertainty over what the threshold is for the RBNZ to raise rates. There is a scenario where the RBNZ delays rate rises beyond 2020. While this isn't our expectation, borrowers would likely be better off in such a scenario by sticking to floating. And, clearly, in the event that there is a global shock and the RBNZ does cut rates, borrowers would also be better sticking to floating.

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

The two major influences on longer-term wholesale fixed rates are the expected path of the OCR and movements in global longer-term yields.

NZ 5y rate fixed rate has declined this year, unlike the US



US longer-term rates have continued to push higher over the past six weeks. The US 10 year Treasury yield hit its highest level since 2011 last month. US economic data continues to point to a US economy growing very strongly, and this has increased market confidence that the Federal Reserve will continue raising rates through 2019.

Elsewhere, more central banks have either started raising rates or indicated that they intend to start soon. Rates are rising in Canada, the UK and Norway while in Sweden its central bank has prepared the market for rate rises in the next few months. What started with the Fed raising rates in 2015 has started to morph into a global tightening cycle. That is a backdrop in which we expect some continued upward pressure on global long-end rates.

NZ is the only developed market country that has seen its 10 year wholesale fixed rate fall this year. Initially, we could put this down to Governor Orr alluding to the risk of rate cuts in NZ, whereas other countries were moving in the opposite direction. However, with RBNZ rate cuts now looking a remote possibility, we think longer-term wholesale fixed rates in NZ are due to correct higher.

We outlined our medium-term view for higher longer-term NZ fixed rates last week. Interested borrowers can read the full note here. But some of the points we made were:

- The market prices a very gradual pace of rate rises after 2020 in NZ (little more than one hike per year). We see scope for the market to price a faster pace of tightening.

- We note that the NZ 5 year fixed rate is still within vicinity of its 2016 lows (albeit less so after the moves over the past week), which seems out of line with that change in the global and NZ backdrop since then. Mid-2016 was a time when the US 10y rate hit a record low, inflation globally was very low and market participants were sceptical central banks would ever raise rates. In NZ, inflation was barely above zero, dairy prices were much lower than they are now, and the RBNZ was still cutting rates. Fast forward to now, and the Federal Reserve has raised rates by 1.75%, inflation in NZ is close to target, and unemployment is at its lowest since 2008.

- Longer-dated wholesale fixed rates indicate that the market prices little difference between the OCR and the Fed Funds rate in the long-run. We instead think NZ will have a higher cash rate in the long-run than the US because NZ has historically grown faster than the US and this is expected to remain the case going forward. We see this as another indication that NZ longer-term fixed rates look too low on a relative basis.

We think borrowers should consider longer-term fixed rate hedges, with our preference being the 5 year point on the curve. Given the uncertainty over what the threshold is for the RBNZ to raise rates for the first time, we prefer the 5 year point to shorter-dated hedges. If the RBNZ were to delay rate rises, the market should price-in more tightening into subsequent years, meaning longer-term fixed rates should be higher in the future. The market should also build-in greater inflation risk premium into longer-term wholesale fixed rates if the RBNZ delays tightening even with inflation at (or even above) target.

Like with shorter-dated hedges, the "premium" for hedging has risen quite sharply over the past week. This "premium" is also higher for longer-term fixed rates than for shorter-dated hedges given the upward sloping yield curve. But given our expectation for higher offshore rates over the next 12 months, and the increased likelihood of an RBNZ rate hike later next year, we would consider adding hedge cover.

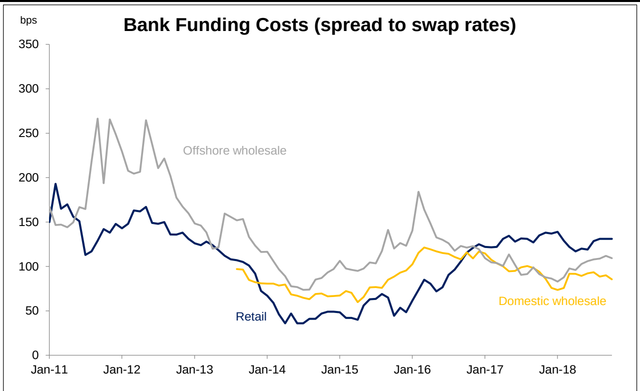
The primary risk in hedging for longer-terms is that the global economy cycle turns down sharply, seeing central banks offshore switch from tightening to cutting rates. In such an environment, it is probable that the RBNZ would also switch to cutting rates to shore up growth in NZ. We still see the global environment as reasonably positive, despite the ongoing stand-off between US and China over trade, and see the risk of US recession as very low over the next 18 months.

Bank Funding Costs

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

Aside from the recent pick-up in the 90 day bank bill rate, there has been a slight increase in overall bank funding costs over the past six weeks. Retail term deposit rates have remained very stable. Offshore wholesale funding costs have risen somewhat due to an increase in the cost of hedging FX risk (i.e. via cross-currency basis swaps). Our estimates of bank funding costs are shown in the chart below.

Bank funding costs have been reasonably stable



Source: RBNZ, Bloomberg. As of October 2017.

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