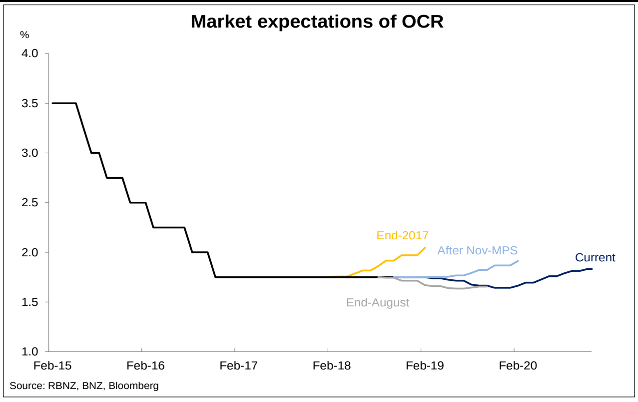
24 January 2019

bnz

Outlook for Borrowers: January Interim Update

- **There have been several key market developments over the holiday season.**
- **These include: the RBNZ has proposed to significantly increase capital requirements for NZ banks; the US Federal Reserve has signalled "patience" and there is a good chance the US tightening cycle is complete; the global growth outlook has deteriorated.**
- **Compared to November, these factors point towards a later start date to OCR hikes and less upward pressure on longer-term NZ rates.**
- **We still think OCR cuts are unlikely, given the labour market remains extremely tight and core inflation is gradually increasing to target.**
- **We think the most likely outcome is that NZ wholesale fixed rates are relatively stable for most of the year amidst an unchanged OCR. There are scenarios where wholesale fixed rates are higher and lower.**
- **Short-term wholesale fixed rates are close to the 90 day rate, and are attractive for hedging based on our view the OCR is not cut. Compared to November, we're less convinced longer-term fixed rates will move higher this year, but given they are near record-low levels, borrowers may want to consider dips to put on hedges.**

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



Summary of Developments since November

Since the November Borrowers Update, there have been substantial declines in wholesale fixed rates. Short-term wholesale fixed rates declined to their lowest levels on record a few weeks back, while longer-term fixed rates have fallen to within vicinity of record lows. The market has reverted to pricing an almost 50% chance of an OCR cut by the end of 2019 (see chart).

There have been a number of important developments that have taken place over the past two months, both domestically and offshore, which have driven these market movements.

1. RBNZ proposes higher capital for banks

Domestically, the key event has been the RBNZ's proposal that NZ banks should significantly increase their capital.[1] Banks hold capital to protect against the risk of losses on the loans they make. If banks don't hold enough capital, an economic downturn could cause losses severe enough to cause a bank to fail, putting peoples' deposits at risk.

The RBNZ has proposed a significant increase to the minimum amount of capital that NZ banks hold, in order to reduce the risk of bank failure. The changes are proposed to take place over a five year period, over which time the RBNZ envisages that the big NZ banks might retain their profits to increase their capital levels (rather than paying profits out as dividends to shareholders).

Banks raise funds in two ways – through debt (including wholesale funding and deposits) and equity (including retained earnings and issuing shares to investors). Equity is the most expensive way for banks to raise funds, as it is more risky for investors than debt. The RBNZ's proposal to increase the proportion of equity that banks use to fund themselves is therefore likely to increase the costs to banks to provide credit (i.e. make loans) to the economy.

The RBNZ said it expects only a minor change to borrowing rates for banks' customers, possibly because it expects shareholders to accept lower returns on their investments in NZ banks. However, if banks sought to maintain their margins, it raises the risk that they might pass on their higher average cost of funding to borrowers, in the form of higher lending rates.

It is this latter scenario which has possible implications for the OCR. If banks increased lending rates to the real economy independent of the OCR, the RBNZ wouldn't need to tighten the OCR by as much, and it could, in principle, even consider cutting the OCR to offset it.

The actual impact on the OCR outlook depends on the final form of the capital requirements (the RBNZ will announce its decision by the end of June) and the reaction of the banks (how much, if any, of the cost increase they pass on to borrowers and over what time period). There is considerable uncertainty around the magnitude of the impact on lending rates, but the direction is likely to be upwards.

[1] Interested borrowers can read more on our preliminary thoughts here. The RBNZ's non-technical summary also contains an overview of the proposal.

The RBNZ proposes that the capital changes are phased in over a five year period and broader macroeconomic developments are likely to still be the major driver of the OCR over this time. But, realistically, the uncertainty around the impact of higher bank capital requirements is likely to increase the hurdle for OCR hikes this year.

2. Federal Reserve signals "patience" with monetary policy

December saw significant volatility in global financial markets. The S&P500 fell 15% between the start of December and Christmas eve. Even after a recovery over the remainder of the month, December ended up being the worst month for US equities since Lehman Brothers collapsed in October 2008. In another sign of broader jitters, the spread between yields on corporate bonds and US Treasuries reached their widest levels since 2016.

The sharp market movements reflected investor concerns about slowing growth in Europe and China and increased speculation that the US economy could fall into recession in late-2019 or 2020. The Federal Reserve hiked its cash rate to 2.5% in mid-December, but the subsequent tightening in financial conditions and some signs of slowing in US economic data has seen Fed officials switch to more dovish rhetoric. Chair Powell has said muted US inflation gives the Fed scope to be "patient" as it watches how the economy evolves this year.

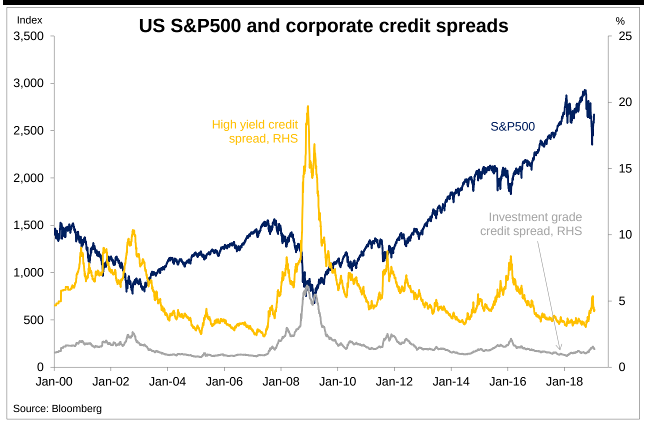
The Fed is highly likely to be on hold in the first half of this year. With US growth set to slow later this year, we think there is a good chance that the Fed's tightening cycle is now complete. A resumption of rate hikes is still possible, but is likely to require an increase in US inflation pressure, above target, and there are few signs of that as yet.

The market now expects the Fed to be on hold this year and prices a 50% chance of a rate cut by the end of 2020. We now expect the US 10 year rate to be contained within a 2.50% to 3% range for most of this year. The upside to the US 10 year is likely to be capped in an environment where the hurdle for Fed hikes is high. But conversely, if the Fed is done with its tightening cycle, the risk of a policy mistake (i.e. the Fed "overtightening" and a US recession) is reduced; this should limit the scope for US yields to fall sharply from here. We think the risk of a US recession over the coming few years is still quite modest.

3. NZ data mixed, but RBNZ unlikely to move in a hawkish direction any time soon

At the end of November, we [pushed back](), and reduced the extent of, OCR tightening built into our forecasts. We remarked at the time that the RBNZ was displaying a very real reluctance to even suggest interest rates might rise. Broader macro developments since then have been mixed. On the one hand, NZ non-tradables inflation surprised on the upside which, taken in conjunction with

Financial conditions tightened sharply at the end of 2018



the extreme tightness in the labour market, suggests domestic inflationary pressures are building. On the other hand, global growth expectations have been marked down and the risks from offshore have risen. That's an environment where central banks globally, including in NZ, are likely to be more cautious about raising rates. We forecast two rate rises, starting in November, although the risks are to a later start date.

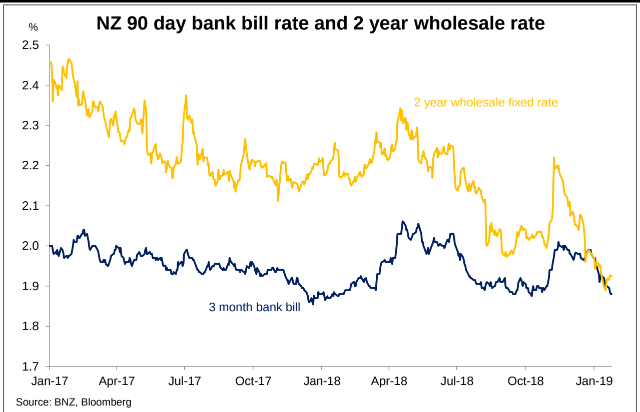
While the NZ unemployment rate is sub 4% and core inflation is not far from the 2% midpoint, which would usually argue for rate hikes, it's hard to see a catalyst for the RBNZ shifting in a hawkish direction any time soon, especially in an environment of heightened market volatility and concerns around global growth. Additionally, the uncertainty around what that the RBNZ's proposed increase to bank capital might mean for mortgage and business lending rates is another factor that argues for the RBNZ keeping rates on hold for some time.

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

Short-term wholesale fixed rates have declined to record low levels this year. There have been two drivers of this. First, OCR expectations have declined, with the market now pricing a 50% chance of an OCR cut and only a very gradual pace of rate hikes from 2020 onwards. Second, the 90 day bank bill rate has declined this year (over and above the change in OCR expectations), putting further downward pressure on short-term wholesale rates.

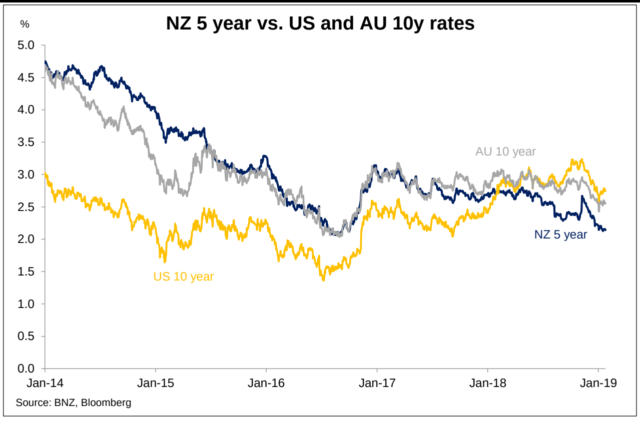
The 2 year wholesale fixed rate is now at similar levels to the 90 day bank bill rate, implying that there is little "cost" to hedging for short-terms. If the next move in the OCR is a hike, then wholesale fixed rates at current levels present an attractive, low-cost opportunity to put on short-term hedge cover. Short-term fixed rate hedges also provide protection against any potential rise in the 90 day rate independent of the OCR outlook, for instance if pressures on bank funding were to emerge.

2 year wholesale fixed rate reached record low levels



Source: BNZ, Bloomberg

NZ longer-term fixed rates are also near record-low levels



Source: BNZ, Bloomberg

Clearly, if the RBNZ were to cut rates over the next few years, then borrowers would be better off sticking to floating rate exposure. In our view, it would likely take a material deterioration in the global economy to trigger RBNZ rate cuts this year. Admittedly, offshore risks have risen, but we still view OCR cuts as unlikely, given the NZ economy is basically at "full employment" (not a situation central banks would usually consider rate cuts) and underlying inflation is gradually moving towards target.

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. The fall in NZ longer-term fixed rates over the past few months has been similar to that seen in the US and Australia, suggesting global factors have been at play (see chart).

We have had a consistent view over the past 12 months that the Federal Reserve would hike by more than that priced-in by the market and this would push US rates higher. This trend towards higher US rates played out through much of 2018, with the US 10 year rate hitting a high of 3.25% in November. But the recent change in tone from Federal Reserve officials and likely slowing in US growth later this year (as the Trump fiscal stimulus wanes) means we have revised our outlook lower, and we now expect the US 10 year rate to go broadly sideways this year. This removes one potential source of upside impetus for NZ longer-term wholesale fixed rates.

Of course, this doesn't preclude NZ rates moving higher, independent of US rates. But it puts more onus on domestic drivers (i.e. the OCR outlook) to trigger higher NZ longer-term rates.

On that front, we have low conviction that the market will shift towards pricing a more aggressive OCR tightening cycle any time soon. First, the global outlook is more uncertain, and that's an environment where the RBNZ is likely to remain cautious. Second, the RBNZ's proposed changes to NZ bank capital requirements will linger in the background for some time. The market is unlikely to shift towards pricing rate hikes until there is more clarity on the effects of the policy. Third, longer-term NZ wholesale rates embed expectations of where the OCR will ultimately end up. If banks were to pass on higher costs to borrowers, then this would imply the RBNZ wouldn't need to raise the OCR by as much this cycle, which might in turn keep longer-term NZ rates from rising too much.

Our core view now is that NZ longer-term wholesale fixed rates will go broadly sideways this year, like US rates.

There are risks in both directions. The scenario where longer-term NZ rates move higher might involve a combination of higher NZ inflation and an easing in concerns around the global economy. It might transpire that banks don't raise mortgage and business lending rates in response to the RBNZ's bank capital proposal. Given the economy is already close to the RBNZ's twin objectives (employment is near its "maximum sustainable level" and core inflation is close to target), it's conceivable the RBNZ could shift towards a tightening bias later this year. This would generate a large increase in NZ longer-term fixed rates, in our view.

The alternative scenario involves some combination of a material downturn in the global economy, banks raising lending rates for households and businesses, and weaker NZ economic data which could prompt the RBNZ to cut rates. NZ longer-term wholesale fixed rates would fall to record-low levels.

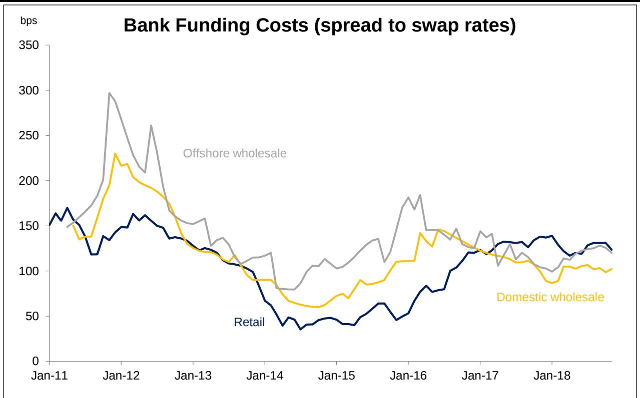
Given that longer-term wholesale fixed rates are higher than the 90 day bank bill rate, there is a "cost" to hedging for borrowers. That "cost" of hedging for longer-terms is at its lowest level since the middle of 2016. Provided the next move in the OCR is indeed a rate hike, we think longer-term hedges make sense over a multi-year horizon (even if we don't expect much movement for most of this year). Borrowers may want to consider using dips to put on hedges.

Bank Funding Costs

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

There has been little change to bank funding costs over the past few months (see chart). Retail term deposit rates have been stable. The volatility in global markets has pushed up wholesale funding costs offshore for NZ banks, but this has been partially offset by a lower cost of hedging FX risk. Our estimates of bank funding costs are shown in the chart below.

Bank funding costs have remained reasonably stable



Source: RBNZ, Bloomberg. RBNZ data to October 2017. Wholesale market spreads proxied with Bloomberg data after this point.

While there hasn't been much movement over the past few months, there are potentially major changes coming in the future due to the RBNZ's bank capital proposal. The potential consequences from a bank funding perspective are:

- If NZ banks are better capitalised, they should be seen by investors as "safer". Therefore they should be able to borrow in wholesale funding markets at lower spreads.
- If NZ banks retain profits over the next five years to increase their capital levels, it implies they will have less need to use other funding channels (i.e. deposits and wholesale funding) to raise money. This might see banks reduce term deposit rates and face lower wholesale funding spreads.

In isolation, these two effects would lower bank funding costs. Working in the other direction, NZ banks would need to hold significantly more equity, or capital, and this is the most expensive form of funding available to banks. The RBNZ thinks the net effect would likely be an increase to banks' overall costs of providing credit to the real economy.

There is still a lot of uncertainty. First, the RBNZ's proposal is still being consulted on; it expects to announce the conclusion of its review by the end of June. Second, there is a five year implementation period proposed, so the effects may not be visible for some time. We will keep borrowers abreast with developments in this space.

nick_smyth@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

Ivan Colhoun
Global Head of Research
+61 2 9237 1836

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