Outlook for Borrowers: Post-August MPS

- The RBNZ surprised the market by cutting the OCR 50bps to 1% at the MPS.
- The RBNZ has signalled a soft easing bias. We forecast a follow-up OCR cut in November.
- The RBNZ has signalled that it is wants to ‘get ahead of the curve’ and therefore further easing is likely if the global or NZ economies worsen or there is another market meltdown.
- This is unchartered territory for NZ wholesale fixed rates, which are at record low levels.
- We’re not convinced fixed rates will stay this low forever but, at least in the near-term, the risks are skewed lower. It will take a material improvement in the global backdrop to trigger higher NZ fixed rates.
- In that environment, borrowers may want to remain selective with hedging interest rate exposures.

RBNZ Monetary Policy Outlook

Against economist expectations and market pricing for a 25bp rate cut, the RBNZ's pruned a big surprise by cutting the OCR by 50bps, to 1%, at the August MPS. The RBNZ cited the slowing domestic economy and global growth as the reasons behind the OCR cut. In the press conference, Governor Orr said the committee had weighed up cutting 25bps now and signalling another cut in the future versus an immediate 50bp move at this meeting, and said the “path of least regret” was “more, sooner” rather than the risk of “doing too little and too late.”

The RBNZ made its OCR decision against a backdrop of worsening trade relations between the US and China, with President Trump having recently announced new tariffs on the remaining $300b of Chinese imports and the Chinese renminbi having subsequently weakened sharply. The escalation in the trade war, which is likely to exacerbate already sluggish global growth, may have influenced the Monetary Policy Committee in its decision to cut the OCR by a larger-than-usual 50bps. Historically, the RBNZ has only reduced the OCR by 50bps during times of crisis, such as after the 9/11 terrorist attacks, the GFC, and in the immediate aftermath of the Christchurch earthquake.

The RBNZ didn’t signal a policy bias in the statement wording, but the forward OCR track – which indicates the OCR reaching a low of 0.9% by Q3 2020 - and the Governor’s comments in the press conference, in which he said “nothing is ruled out in the future”, suggests the Bank retains a soft easing bias. The Bank has not signalled any near-term policy action, and our interpretation would be that the 50bp move was intended to get ‘ahead of the curve’. The Bank’s central scenario would be for no change to the OCR in September and we think such a move is unlikely, although it can’t be ruled out if global conditions were to worsen materially.

The market now prices the OCR to fall to a low of around 0.65% by mid next-year, implying around a nearly 50% chance that the cash rate falls to 0.5% (see Chart 2). The Governor said in the press conference that the RBNZ’s work on possible unconventional policy options (such as quantitative easing and negative interest rates) was well advanced, although the Bank hopes that by acting decisively now, it reduces the chances it will need to go down that route.
We have pencilled in a further and final OCR rate cut in November, to 0.75%. However, the RBNZ’s revealed behaviour suggests it will act aggressively and pre-emptively if global conditions or domestic data were to worsen. That means we certainly can’t rule out the OCR going even lower, or instead that unconventional policy is not used in New Zealand. The global backdrop will remain a key driver.

The main scenario in which the RBNZ doesn’t cut further is where the US and China come to a trade agreement and the global economy starts to improve. Such a scenario can’t be completely ruled out given the US Presidential election is next year, and a major economic downturn would likely be harmful to Trump’s re-election prospects. That said, the most likely scenario at present appears to be a continuation of heightened tensions between the two countries, which will continue to weigh on business sentiment.

Short-Dated Wholesale Fixed Rates (1-3 yr)
Short-dated wholesale fixed rates have unsurprisingly fallen substantially since the June OCR Review (Chart 3). NZ’s short-dated wholesale fixed rates are below the 90 day bank bill rate, reflecting the market’s expectations of future rate cuts. The market prices the 90 day bank bill rate to fall around 0.9% by mid-next year.

We expect the market to persist with pricing the balance of risks towards more RBNZ rate cuts unless the global outlook improves materially. This should continue to cap short-term fixed rates.

Longer-Dated Wholesale Fixed Rates (5-10 yr)
Long-dated NZ wholesale fixed rates have continued to fall sharply over the past six weeks. That’s not just a NZ-centric phenomenon, despite the larger-than-expected OCR cut by the RBNZ (see Chart 4). Global long-term rates have reached record low levels in most developed markets – the entire German yield curve out to 30 years now trades with negative yields while the 10 year US Treasury yield has fallen below the levels that prevailed before the US Presidential election in 2016.

The US easing cycle has commenced, with the Fed cutting its cash rate by 25bps last month, its first rate cut since 2008. Fed Chair Powell described the rate cut as part of a “mid-cycle adjustment” and not necessarily the start of an extended easing cycle. Those comments predated the trade war escalation however, and the markets expect a series of rate cuts by the Fed over the next twelve months.

With Trump planning more tariffs on China, the prospect of a trade deal between the two countries before the US Presidential election next year now looks bleak. The chances are that China will now decide to hold out until the outcome of the election is known – the Chinese government may be asking itself if there is any point in negotiating with Trump at this point if he won’t necessarily be in charge at the end of next year and, in any case, has shown a track record of changing his mind suddenly.

Global growth has continued to slow across major economies, especially in the trade-exposed manufacturing sector (see Chart 5). The deterioration in trade relations between the US and China, with the additional forthcoming tariffs to impact a far wider range of consumer goods than prior rounds, suggests the risk of a more pronounced slow-down in US and global growth. Global inflation remains subdued, and below target in
most major economies. Against that backdrop, the market has increased its expectations of monetary easing from key central banks, including the Fed, to support growth. The European Central Bank is expected to announce new easing measures at its meeting next month and the Reserve Bank of Australia is priced to lower its cash rate to 0.35%.

There is considerable uncertainty surrounding the outlook for longer-term fixed rates, both in NZ and globally. Further slowing in US and global growth could prompt a deeper Fed easing cycle, triggering further declines in global long-term rates. Were the US economy to slip into a recession—which, to be clear, is not our forecast—the Fed would likely cut rates back to zero, or even slightly below, and restart quantitative easing. Central banks have less conventional ‘ammunition’ to fight a major downturn than in previous cycles (historically, the Fed has typically cut its cash rate by 5% in such instances), raising the risk that inflation gets ‘stuck’ at persistently low levels. There are other downside risks as well, notably Brexit, with new UK Prime Minister Boris Johnson seemingly intent on leaving the EU ‘come what may’ at the end of October.

The obvious near-term scenario that could trigger a move higher in global rates is a trade deal, or at the very least a return to constructive negotiations, between the US and China. As mentioned earlier, this looks unlikely at present, but given the potential ramifications for Trump’s re-election prospects from a major US downturn, not least a recession, this can’t be ruled out. Some speculate that Trump’s decision to suddenly impose tariffs on Chinese imports was motivated more by a desire to force the Fed to ease aggressively (indeed, his announcement happened the day after Fed Chair Powell said the 25bp rate cut wasn’t the start of an extended easing cycle) than China specifically. It is conceivable that Trump attempts to forge a new trade deal heading into the end of the year, to boost the economy and markets heading into the election.

The greater medium-term risk that could cause higher global rates is the potential for more activist fiscal policy. Indeed, it was Trump’s election in 2016, and his campaign promises of sweeping tax cuts, that led to the sharp increase in US Treasury yields from late 2016 to early 2018. Monetary policy has had to shoulder most of the weight of supporting global economies in recent times, and if fiscal policy were to play a more active role, that would take pressure off central banks to ease policy further. As some central banks, such as the ECB and BoJ, get closer to the limits of what monetary policy can do, there is even the chance of coordination between fiscal and monetary policy (that is, more fiscal spending, financed by central bank purchases of government bonds, or QE). The emergence of “modern monetary theory” is an extension of this thinking. If policymakers were ever to head in this direction, inflation risks would increase significantly.

The near-term risks to long-term rates appear to be to the downside, given the recent escalation in trade tensions, notwithstanding rates having already fallen a long way.

For NZ, the market prices the OCR will eventually, after 10 years, lift to just 1.5% (see Chart 6). We’re not convinced that the OCR is destined to go to zero and stay there permanently, but, by the same token, the more immediate risks to NZ longer-term fixed rates are to the downside. In that environment, we think borrowers can remain selective about adding hedge cover. However, uncertainty is high and the range of possible outcomes is very wide. The change in rates over just the last 12 months is a reminder that conditions can change quickly and unexpectedly.

Chart 5: Global manufacturing activity continues to worsen

![Global manufacturing and services PMIs](chart5.png)

Source: Consensus Economics, Bloomberg.

Chart 6: The market prices the OCR will only get to 1.5%

![OCR and market expectations](chart6.png)

Source: Bloomberg. OIS used for expectations to 2 years, thereafter forward 3m swap rates adjusted for 25bp BKBM-OIS. Market expectations based on OIS and forward swaps.

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