Outlook for Borrowers: Post-Sept. OCR Review

- As widely expected, the RBNZ left the OCR unchanged at 1.0% at the September OCR Review, following the shock 50bps easing in August. The Bank has evidently maintained an easing bias and we continue to project another 25bps cut to 0.75% in November. With a softer growth outlook our central view now embeds a final 25bps rate cut in February to 0.5%.
- For borrowers contemplating hedging short-dated interest rate exposure (up to 3-year fixed rates), there remains no rush to do so, with the bias to short-term rates remaining to the downside. Historically short-term fixed rates only begin to move higher near the very end of an easing cycle and we seem some way from that point.
- Long-term rates (5-10 year) have fallen a long way, but the near-term bias remains weighed to the downside, with major central banks apt to cut rates further amidst the global economic slowdown. At historically low levels, borrowers should be alert to opportunities to selectively add hedging cover. While overall we see near-term resistance to higher rates, there are scenarios where rates can reverse course quickly.

Monetary Policy Outlook

After the shock 50bps cut to the OCR to 1.0% in August, the RBNZ believed that new information did not warrant a significant change to the monetary policy outlook. However, an easing bias remains evident with the comment “there remains scope for more fiscal and monetary stimulus, if necessary, to support the economy and maintain our inflation and employment objectives”.

The uncertainties the Bank outlined in the minutes of the meeting were weighed to the downside — global trade, geopolitical tensions, low business confidence, a possible delay to government spending, and lower inflation expectations in response to ongoing low inflation. The list of upside risks was much smaller, noting upside potential for labour and import costs.

The Bank’s pause in the easing cycle was widely anticipated and we continue to project that a 25bps rate cut to 0.75% will be delivered at the November Monetary Policy Statement. This is likely to follow another 25bps cut to the RBA cash rate, in either early-October or early-November.

Over coming months we expect the growth outlook to fall short of RBNZ expectations and we now build in a final 25bps rate cut in February to 0.5% in our central view.
in Australia we think that the RBA could cut the cash rate to as low as 0.25% and the RBNZ will factor that move into its own decision. Furthermore, global and domestic economic risks remain to the downside.

While short-term fixed rate hedges provide certainty over future interest payments, given these downside risks, and the RBNZ’s openness to cutting the OCR further, more attractive opportunities for hedging may arise in the future.

Historically fixed rates only begin to move higher near the very end of an easing cycle. 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)**

The bigger picture remains one of a soggy global economic backdrop and downside pressure on interest rates across the curve, as central banks cut policy rates to stimulate growth in an attempt to drive inflation higher.

Some goodwill measures from both the US and China have seen trade tensions ease a little, ahead of a further round of meetings at a senior level that recommence early October. But expectations remain low for a trade deal and the greater risk is that the additional tariffs already proposed are enacted, continuing to put downward pressure on global trade and growth.

Since our August report, the ECB cut its deposit rate for the first time in 3½ years and looked to restart its bond-buying programme to promote lower rates across the curve; the US Federal Reserve cut its policy rate for the second time this cycle; and market expectations for further RBA rate cuts have been brought forward.

The US Fed was reluctant to project further rate cuts from here, but the committee is clearly divided. The market still sees a good chance of another rate cut this year (more likely December than October) and at least one more, but probably two, rate cuts through 2020.

**5-10 year wholesale rates in a downtrend**

The global backdrop and expectations of further RBNZ rate cuts are helping keep a lid on NZ long term interest rates. The yield curve remains flat with little difference between 2-year and 5-year wholesale fixed rates, or 5-year and floating rates. This reflects a widespread view that interest rates will remain historically low (if not lower at the short end), for a considerable time.

In our view, long-term rates are likely to continue to meet upside resistance. Although long-term rates have fallen a long way, the near-term bias remains weighed to the downside. Under this view, we think that borrowers can remain selective about adding hedging cover.

That said, while we have more conviction in the short end of the curve (downside risk to NZ’s policy rate, which feeds through to at least 2-3 year rates), there is more uncertainty about the longer end of the curve.

On the possibility of upside pressure to rates, one key risk is that the US-China trade war is resolved by some “common sense” policy that sees both sides give a little to put the dispute to bed. Given low expectations for a trade deal, do not underestimate how significant an agreement would be for market sentiment. A significant rise in interest rates would ensue. This is perhaps the biggest risk for borrowers taking a punt and assuming that they have plenty of time to consider whether to lock in current historically low fixed rates.

Another potential upside risk to long term rates is further upside pressure to US inflation. Annual US core CPI inflation has recently picked up, and further upside pressure might encourage a significant reassessment of the risks to US monetary policy. In that scenario, higher US rates would likely feed through into higher NZ rates.

The downside scenario for rates would be that global growth continues to head south, dragging down the US economy with it and the US easing cycle becomes “full-on” and isn’t just a mid-cycle adjustment, as the Fed currently believes. Alternatively or concurrently, the downside risks to NZ growth play out, seeing the OCR cut towards zero and dragging down the rest of the yield curve.

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