1 December 2023

Outlook for Borrowers: Post November MPS

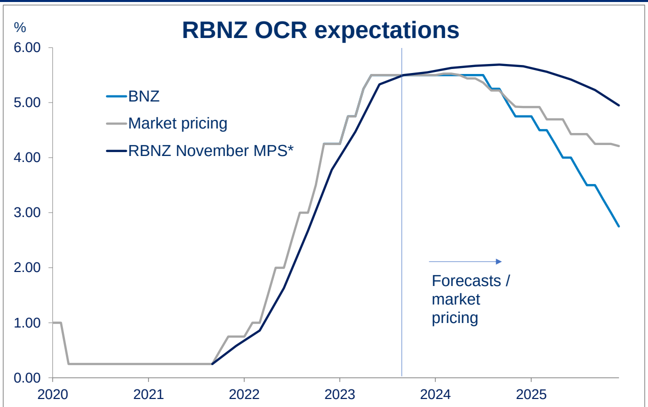
- **The RBNZ left the cash rate unchanged at 5.5% but the accompanying statement was significantly more hawkish than expected.**
- **The RBNZ made an upward revision to its projected OCR track. The modelled peak is 5.69%, up from 5.59% in the August MPS. Strong population growth has contributed to a change in the Bank's perceived risks around inflation.**
- **We have revised our OCR forecast in response to the hawkish tone in the MPS. We continue to think that 5.5% will mark the peak cash rate for the cycle but have pushed back the first cut to August 2024 from May 2024.**
- **The market is pricing the OCR will remain steady at 5.5% until the middle of 2024. There is a full 25bps cut priced by August of next year.**
- **We expect short-dated wholesale rates to stabilise at current levels in the near term after the 60bps fall since October. Further downside is expected medium term.**
- **The global interest rate cycle is turning after the most aggressive and synchronised tightening in several decades. Long-term wholesale rates are expected to move lower after a period of consolidation.**
- **Short-term wholesale rates have greater scope to fall when the RBNZ easing cycle nears. We expect the yield curve to steepen and return to a positive slope.**

RBNZ Monetary Policy Statement

The Reserve Bank of New Zealand (RBNZ) held the Official Cash Rate (OCR) steady as expected, at 5.5%, at the Monetary Policy Statement (MPS). However, the accompanying statement was significantly more hawkish than we, and the market, had anticipated. The Bank noted that inflation is too high, and it remains 'wary of ongoing inflationary pressures.' It even debated a rate hike at this meeting and outlined the OCR would likely need to rise further if inflationary pressures were to be stronger than expected.

The RBNZ made an upward revision to its projected OCR track. The modelled peak is 5.69%, up from 5.59% in the August MPS. Although Governor Orr didn't endorse a probabilistic interpretation, the risks of a hike clearly have risen from the Bank's perspective. The upward revision to the OCR track relative to the August MPS were progressively larger the further out the forecast period and is impacted by the Bank's updated estimate for the neutral OCR, which increased from 2.25% to 2.50%.

Market pricing and the RBNZ's projected OCR track



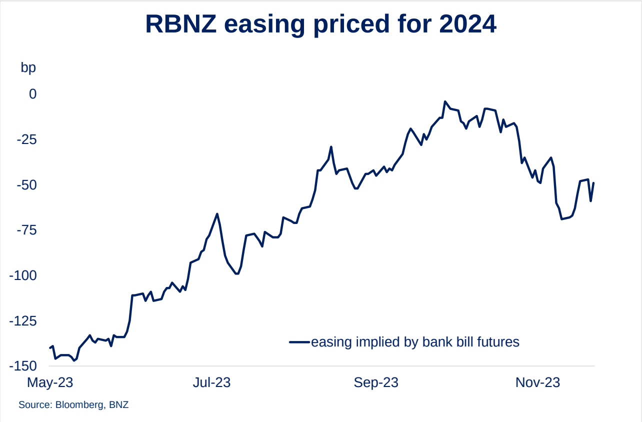
Source: BNZ, RBNZ. * RBNZ projections are quarterly averages.

The MPS pointed to the impact of population growth and government investment on aggregate demand and in turn the risks that inflation remains above target. Although Q3 CPI was below the Reserve Bank's projection from the August MPS, non-tradable inflation is only easing slowly and remains elevated. In addition, inflation expectations have not fallen as much as the RBNZ would have liked. Despite the rise in the unemployment rate, the labour market was characterised by the RBNZ as 'tight' and employment still being above its maximum sustainable level.

We have revised our OCR forecast in response to the hawkish tone in the MPS. We continue to think that 5.5% will mark the peak cash rate for the cycle but have pushed back the first cut to August 2024 from May 2024. Monetary policy settings are restrictive. The policy rate is above the RBNZ's updated long-run neutral OCR and is set against the backdrop of sluggish economic activity. There has been a clear abatement in labour market tightness. Forward looking indicators of labour demand, in conjunction with increasing supply, point to the unemployment rate rising faster than the RBNZ's forecasts. We also expect economic growth, as well as Q4 CPI inflation, will turn out below RBNZ projections.

The market had at one point during November priced close to 75bps of rate cuts for 2024 although that had reduced to nearer 50bps ahead of the MPS. The RBNZ view implies it is not comfortable with recent market pricing, given the potential impact on financial conditions, and where it sees the balance of risks on inflation. One of the objectives of the hawkish MPS tone may have been to discourage the pricing of further easing.

Estimate of OCR cuts priced for next year

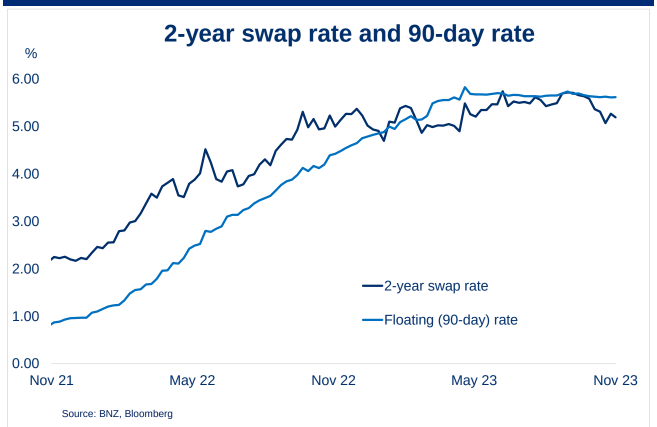


The market is pricing the OCR will remain steady at 5.5% until the middle of 2024. There is a full 25bps cut priced by August of next year which aligns with our updated forecast. However, we think the easing cycle will be deeper and play out more quickly than is currently priced by the market which biases our expectations for short and long-dated wholesale rates lower over the medium term.

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

Short-dated wholesale rates have fallen quickly from the multi-year highs reached ahead of the Monetary Policy Review (MPR) at the start of October. 2-year rates hit a peak near 5.80% and have subsequently fallen to 5.20% with most of the adjustment taking place during the month of November. The move lower has coincided with lower global rates amid increasing expectations that central bank policy rates have peaked for the cycle.

2-year rates to consolidate before lower



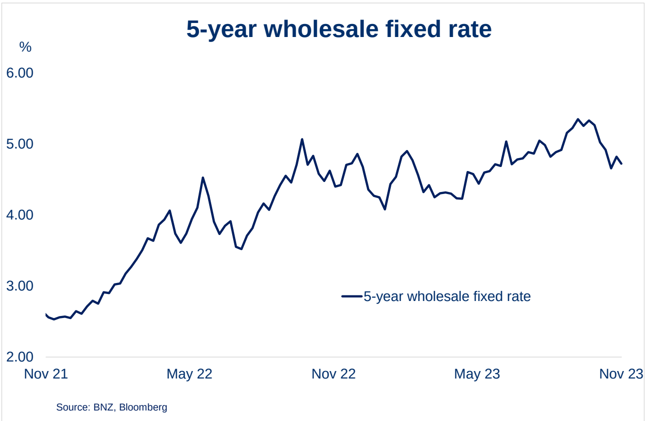
Domestic data have supported lower short-dated wholesale rates. As noted previously, there has been a clear shift in the labour market. The unemployment rate increased to 3.9% in Q3, up from 3.6% in Q2 and 3.2% a year ago. Strong migration has eased the tightness. And indicators such as the difficulty in finding workers component of the Quarterly Survey of Business Opinion are pointing towards a further increase in the unemployment rate ahead. Inflation is moderating, albeit gradually. Annual CPI inflation fell to 5.6% in Q3. We forecast a drop to 4.7% in Q4 and a return to the RBNZ's 1.0 to 3.0% target band by Q4 2024.

Our OCR forecasts, which incorporate an eventually faster easing path than priced by the market, suggest that 2-year wholesale rates have room to move lower. Our core view is that the interest rate cycle has decisively turned both in NZ and globally. However, the nearly 60bps fall in 2-year rates since the October peak, alongside the hawkish tone from the RBNZ, points towards a period of consolidation. 2-year rates are trading close to 30bps below the OCR which may provide a headwind to further declines in the near term.

For borrowers with near-term hedging needs we believe that levels in the 5.0.-5.2% range are attractive to top up hedges. For those with more flexibility around timing, we expect to see opportunities below 5% in 2-year wholesale rates in coming months. The catalyst for a larger leg lower in yields could be a more pronounced domestic economic slowdown or amplified global risks – though much will depend on the trajectory for inflation.

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

5-year rates retrace from multi-year highs

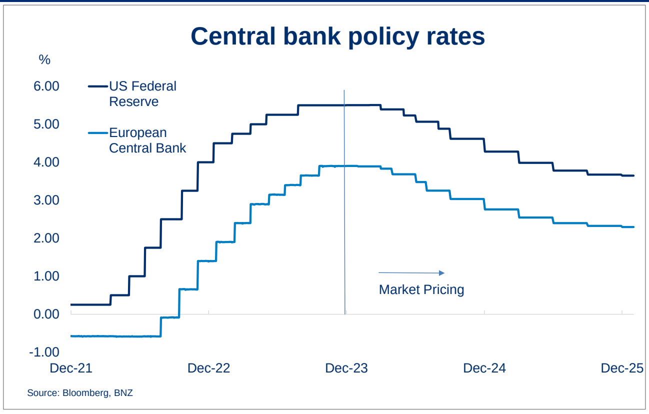


NZ and global long-term wholesale fixed rates are sharply lower than they were at the time of the RBNZ's October MPR. In October 5-year rates traded to the highest level since the Global Financial Crisis, near 5.4%, and have since fallen to 4.70%. Long-dated wholesale fixed rates are driven by a combination of domestic monetary policy and global macro factors. There are increasing signs that the global policy rate cycle is complete after the most aggressive and synchronised tightening campaign in several decades.

The US Federal Reserve (Fed) left rates on hold for the second consecutive meeting in November and recent data suggest a slowdown in US economic activity. Closely watched surveys of business activity in the manufacturing and services sector are subdued. US labour market data is gradually weakening with the unemployment rate rising to

3.9%, which is 0.5% above the cyclical low of 3.4% in April. Restrictive global monetary policy settings are gaining traction. Consensus estimates for growth and inflation in major economies are expected to moderate in 2024. The market has increasingly incorporated rate cuts for developed market central banks in 2024.

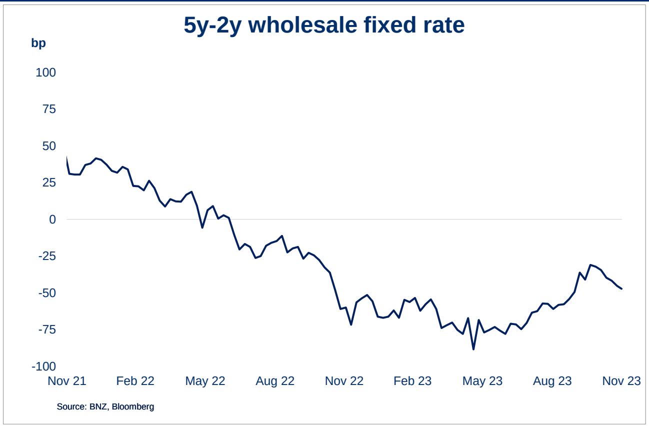
Major central banks expected to ease policy in 2024



There are more than 100bps of cuts priced in the US with a 25bp cut priced for May which has contributed to lower long-end rates. US 5-year rates have retraced almost 80bps from the October highs which is the largest fall since the banking stress back in March. Although NZ rates have also moved lower, they haven't kept pace with the US. The NZ-US 5-year spread has rebounded towards 80bps from recent lows near 50bps.

The move lower in NZ rates since November has been more pronounced in longer maturities contributing to the curve becoming more inverted (flattening). Going forward, we think there is larger potential for downside in shorter-dated wholesale rates and the curve is likely to return to a positive slope. The long end already incorporates expected easing by the RBNZ. In addition, heavy supply of government bonds due to large funding requirements and quantitative tightening are likely to contribute to a steeper curve.

Yield curve expected to return to a positive slope



While our central case is that long-term rates are biased lower in coming months, the pace of the adjustment to date suggests a period of consolidation is due. While we shouldn't expect long term rates to return back down to pre-covid levels, 5-year rates are likely nearer the top of the cycle when viewed from a longer-term perspective. We think that borrowers with flexibility could look for levels down towards the 2023 lows near 4.30% to top up hedging.

Bank funding

Bank funding costs expected to rise

Banks have faced rising funding costs in recent months which may impact rates for borrowers independently from OCR movements. There have been several drivers underpinning this adjustment.

Alternative monetary policy tools, implemented by the RBNZ during the pandemic are beginning to unwind. Specifically, the Funding for Lending Programme (FLP) provided banks with NZ$18.8 billion of borrowing from the RBNZ at the OCR. Each tranche of funding had a maturity of 3-years and will begin to be repaid from December. The increased reliance on relatively expensive deposits and wholesale debt instruments is expected to contribute to higher funding costs.

Higher interest rates have altered the behaviour of depositors. There has been a migration from transactional accounts to savings and term deposit products which have a higher interest cost from a bank's perspective. Term deposit rates have been rising relative to wholesale fixed rates. The spread between 1-year term deposits and equivalent maturity wholesale rate increased above flat in July and is now close to 50bps and is reverting to more normal levels after being distorted though the pandemic.

These drivers will likely lead to upward pressure on rates for borrowers through time, as distinct from the influence of expected OCR changes.

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