Research

Interest Rate Research

1 March 2024

Outlook for Borrowers: Post February MPS

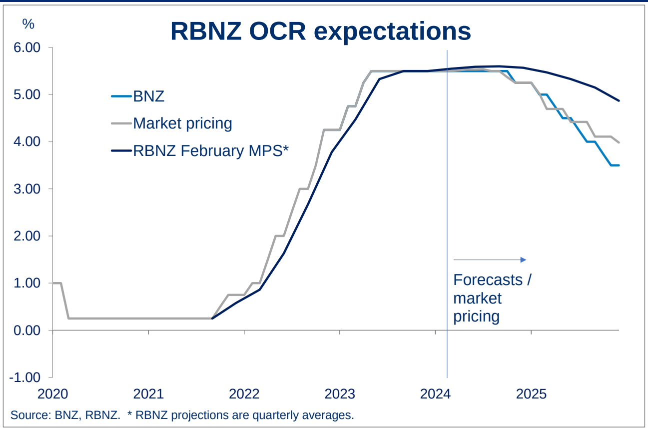
- **The RBNZ left the cash rate unchanged at 5.5% but the accompanying statement softened the hawkish bias from November. The MPC noted that risks to the outlook for inflation are more balanced.**
- **The RBNZ made a downward revision to its projected OCR track. The modelled peak was reduced to 5.59%, from 5.69% in the November MPS. The OCR track brought forward the first rate cut to H1-2025, from H2-2025 previously.**
- **We continue to think that 5.5% will mark the peak cash rate for the cycle and the RBNZ will pivot towards easing monetary policy later this year.**
- **The market is pricing the OCR will remain steady at 5.5% until the middle of 2024. There is a full 25bps rate cut priced by the October MPR and close to 50bps of cuts priced by year-end.**
- **Based on our forecast OCR track, we think that fair value for 2-year fixed rates is closer to 4.80%, 20bps below current market levels. Risk scenarios are skewed towards a larger downside move.**
- **The global interest rate cycle has definitively turned. Major central banks are expected to pivot towards cuts from mid-year. We assess fair value for 5-year fixed rates to be below prevailing levels.**
- **Bank funding costs, which are expected to rise, can impact borrowing costs independent of OCR changes.**

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 February Monetary Policy Statement (MPS). The Bank, although remaining hawkish, eased its rhetoric from the previous MPS in November. A mild tightening bias was retained but Monetary Policy Committee (MPC) members noted that overall, risks to the outlook for inflation were more balanced than at the time of the November 2023 Statement.

The decision to leave rates on hold was in line with consensus expectations. A small minority forecast a 25bps rise, and there was a low probability (<25%) of a hike, priced into Overnight Index Swaps (OIS) markets. The accompanying statement outlined the economy is broadly evolving in line with its projections, and that restrictive monetary policy is contributing to an easing in capacity pressures.

Market pricing and the RBNZ's projected OCR track



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

The statement also emphasised the Bank's asymmetric reaction function to inflation surprises. It noted there is less tolerance from a policy perspective to absorb an upside inflation surprise relative to downside surprises. RBNZ forecast headline inflation to return to the 1-3% target band in the September quarter, and back to the 2% target midpoint, in 2025. A further moderation in the labour market is expected.

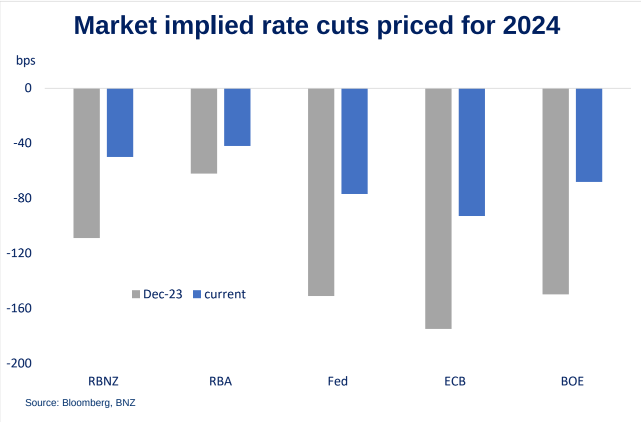
The RBNZ made a ~10bps downward revision to its projected OCR track. The modelled peak was reduced to 5.59%, from 5.69% in November. The OCR track implies the first-rate cut in H1-2025, from H2-2025 previously. Although a rate hike was discussed at the meeting, there was a 'strong consensus' to leave rates unchanged. Furthermore, the change in the projected OCR track suggests the probability of a further rate hike has clearly declined from the Bank's perspective.

BNZ forecasts for the OCR are unchanged. We expect the policy rate has peaked at 5.50%, and the RBNZ will pivot towards easier monetary policy later this year. Monetary policy is restrictive, economic activity is soft and inflation, both headline and core, is falling. The labour market is easing and forward-looking indicators suggest a further deterioration ahead. We forecast the unemployment rate will rise rapidly from here to a peak approaching 6.0% in 2025. The OIS market is pricing the OCR to remain steady at 5.5% until the middle of 2024. There is a full 25bps rate cut priced by the October MPR, and close to 50bps of cuts priced by year end.

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

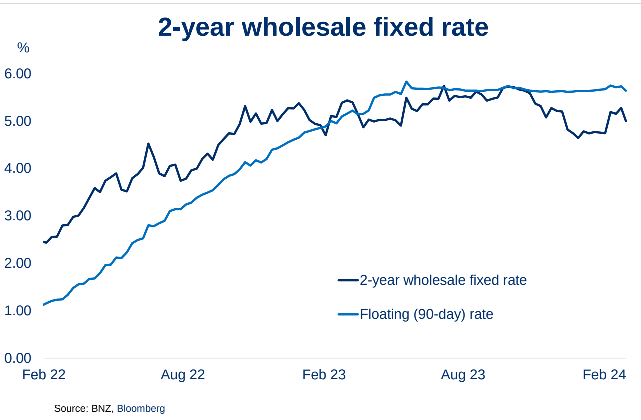
Short-dated wholesale rates have rebounded from the lows in late December. The upward adjustment gained momentum in February after stronger than expected labour market data. This was set against the backdrop of rising global rates as policy makers pushed back against the prospect of near-term rate cuts. Central bankers want to see further confirmation inflation is sustainably returning to target before easing policy.

Expected easing for 2024



At the start of January, OIS markets priced close to 100bps of OCR cuts by the end of the year. As of yesterday's close, the amount of implied easing has been significantly reduced, both for the RBNZ, and other major central banks. Based on our forecast OCR track, we estimate fair value for 2-year fixed rates is ~20bps below current levels. And this doesn't incorporate risk scenarios, which are skewed towards an earlier pivot towards easing and a faster return towards neutral policy levels.

2-year wholesale rates biased lower



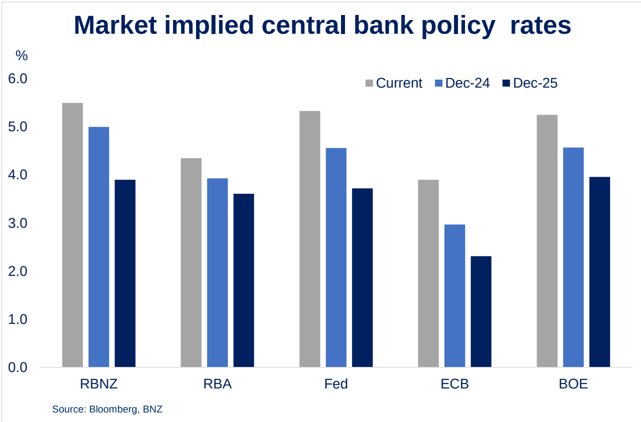
The softening in the RBNZ's hawkish bias reduces the risks short-end rates move higher. Levels near 5.20% are expected to form the top of the range. We see potential for the post-RBNZ rates pullback to extend further and would target levels down towards 4.80% to top up hedging, for those with sub-3-month time horizons. For those with more flexibility on timing, rates down towards the December lows (4.60%) would be attractive levels to increase cover.

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

Long-dated rates are impacted by the expected OCR track as well as global macro factors. 5-year fixed rates have moved higher, alongside shorter rates through 2024, as the market unwound overly optimistic expectations for central bank easing. With easing priced by the market closer to central bank projections, global yields will require a fresh catalyst to continue moving higher.

Market pricing implies the US Fed Funds rate will end 2024 nearly 75bps lower. This aligns with the median projection from FOMC policy makers. The market has been reluctant to price rates higher than the Fed's projection over the interest rate cycle, limiting the upside for US rates. Policy makers could increase their forecasts for the end-24 policy rate, but the disinflationary process is continuing, albeit not in a linear fashion, and US growth is expected to slow through 2024.

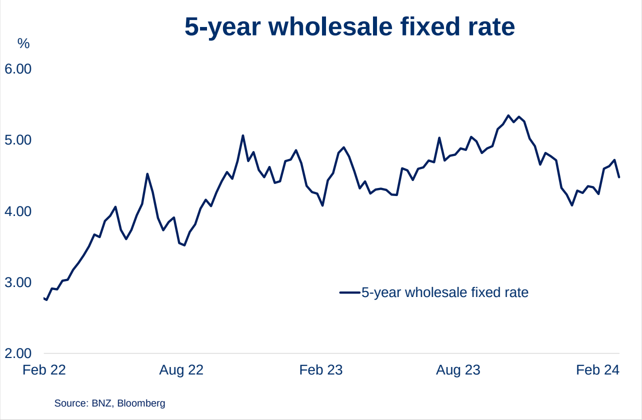
Interest rate cycle has turned



The global interest rate cycle has definitively peaked, and the focus is turning to the timing, pace and magnitude of the easing cycle. The global growth outlook is subdued, particularly in Europe and China. Consensus forecasts show growth slowing from 2023 levels, as restrictive monetary policy dampens activity. Inflation is forecast to moderate towards central bank targets. Set against this backdrop, developed market central banks look set to begin easing policy around mid-year.

We believe the next trend in global yields will be to the downside, as central banks adjust restrictive monetary settings. An alternative scenario, where inflation remains sticky is likely to see a 'higher for longer' bias for central banks, rather than a restart to hiking cycles. We assess fair value for NZ 5-year fixed rates to be closer to 4.0%, which would be an attractive level for those with longer time frames (> 3-month) to top up hedging. Shorter term, levels closer to 4.30% are attractive.

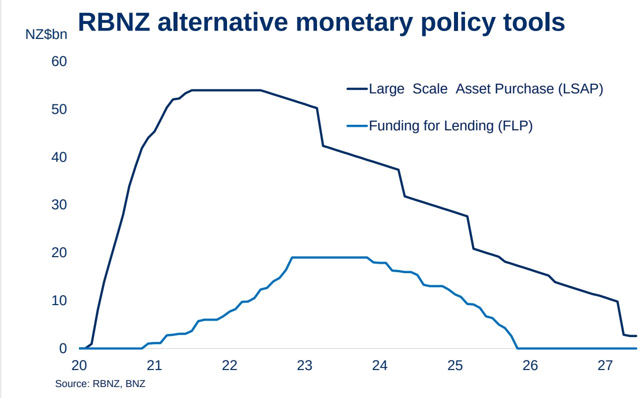
5-year fixed rates are above our assessment of fair value



Bank funding

Banks' cost of funding can impact a borrower's interest rate, independent of adjustments in the OCR. Although banking system liquidity is abundant, the unwinding of COVID era alternative monetary policy tools will increase banks' reliance on relatively expensive deposits and wholesale debt instruments. The RBNZ's Funding for Lending programme (FLP) is beginning to mature. The NZ$19 billion programme allowed banks to borrow from RBNZ on a securitised basis at the OCR. As this programme is unwound, banks will need to raise higher cost funding.

Unwind profile for Funding for Lending programme



The higher interest rates backdrop has altered the behaviour of savers. There has been a migration from transaction accounts to term deposits, as the opportunity cost of holding deposits in relatively low yielding accounts increased. This adjustment can also contribute to higher funding costs for banks.

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