Research

Interest Rate Research

11 April 2024

Outlook for Borrowers: Post April MPR

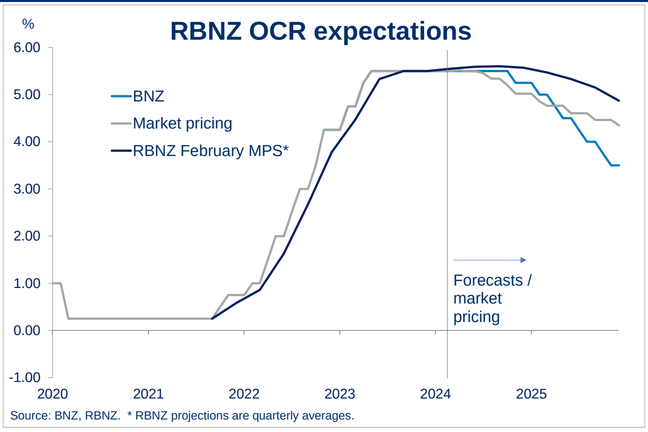
- **The RBNZ left the cash rate unchanged at 5.5% at the April MPR which was unanimously expected by economists. The brief accompanying statement was similar in tone to the February Monetary Policy Statement.**
- **The economy is evolving as anticipated and the Monetary Policy Committee expects the OCR will need to remain at a restrictive level, for a sustained period, for inflation to return to target.**
- **We continue to think that 5.5% will mark the peak OCR level for the cycle and the RBNZ will pivot towards easing later this year.**
- **The market is pricing the first 25bps rate cut by October, and close to 50bps of easing by the end of the year.**
- **The extent of RBNZ easing priced by the market will limit the near-term downside for 2 and 5-year fixed rates.**
- **The turn in the global interest rate cycle – developed market central banks are expected to begin a synchronised easing cycle in coming months – suggests lower fixed rates over the medium term.**

RBNZ Monetary Policy Review

The Reserve Bank of New Zealand (RBNZ) held the Official Cash Rate (OCR) steady at 5.5% at the Monetary Policy Review (MPR) on Wednesday. The statement, accompanying the expected 'on hold' decision, indicated there is little change in the Bank's assessment of the economy and inflation outlook from the February Monetary Policy Statement (MPS). The Monetary Policy Committee is 'confident that maintaining the OCR at a restrictive level for a sustained period' will return inflation to target this year.

The brief statement - there is no media conference or in-depth policy document accompanying an MPR – characterised economic activity as remaining weak. The Bank noted some short-term inflation pressures remain, and acknowledged monthly selected price indicators which were released after the February Statement, point towards upside risks to its Q1 inflation forecasts. The statement implies that recent developments don't present significant challenges to its projected OCR track from February, which maintained a near-term tightening bias, and was consistent with the easing cycle beginning in H1-2025.

Market pricing implies the RBNZ will cut rates in H2-2024



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

Monetary policy settings are restrictive. At 5.5%, the OCR is well above the top of the RBNZ's estimated range for the long-term neutral OCR. Economic activity is very weak. The economy contracted by 0.3% y/y in the December quarter, despite almost 3% population growth, and is expected to flatline through H1-2024. Headline and core inflation are moderating. Annual headline CPI inflation fell to 4.7% in Q4, and we expect it will return to the RBNZ's 1-3% target band by Q3-2024.

The NZIER Quarterly Survey of Business Opinion (QSBO), released earlier this week, was consistent with a subdued economic backdrop and easing inflation pressures. Domestic activity, employment, and investment indicators weakened. Inflation gauges are generally retracing, but still need to fall further, to reach levels consistent with annual inflation at the RBNZ's target midpoint.

In the previous four monetary policy cycles, the RBNZ has held the OCR at the peak for an average of 11 months with a range between 9 and 12 months. The global and domestic macro backdrop is of course different in each case, and this is a small sample size, but nonetheless we think it is instructive the OCR has not been sustained at the peak for an extended period in previous cycles.

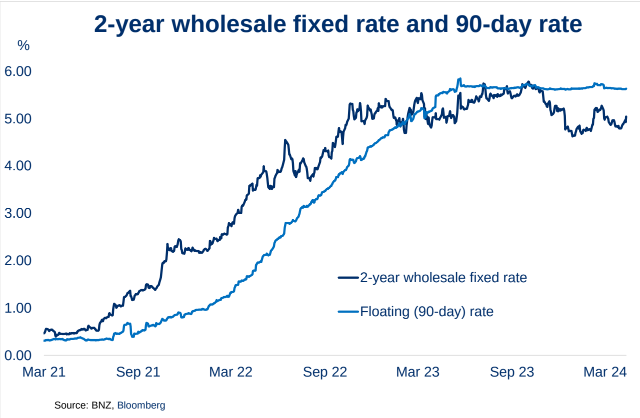
BNZ forecasts for the OCR are unchanged. We expect the policy rate has peaked at 5.50%, and the RBNZ will pivot towards easier monetary policy later this year. We forecast the easing cycle will begin in November, and the OCR will be reduced by 25bps at each subsequent policy meeting, taking rates back to 3% by Q2-2026.

Key domestic economic releases that could impact the outlook are Q1 CPI on 17 April and labour market data on 1 May. The overnight interest rate swap (OIS) is pricing the first 25bps rate cut by October, and close to 50bps of easing by the end of the year.

The main risk to our OCR view is persistent inflation which delays the RBNZ pivot towards easing. Equally, further progress on inflation could bring forward the beginning of the easing cycle to August. The Government's fiscal plans are another source of uncertainty ahead of the Budget on May 30. The RBNZ will have full details from the Budget Economic and Fiscal Update for the July MPR.

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

2-year fixed rates expected to be rangebound near term



Short-dated wholesale rates retraced lower after the RBNZ softened its hawkish tone at the February RBNZ Monetary Policy Statement and changed its assessment of the inflation outlook to 'more balanced'. The decline in 2-year swap rates from the February highs, found a base near 4.80%, and we expect a period of rangebound price action. During the past 4 weeks, the market has oscillated between pricing 50bps to 75bps of RBNZ rate cuts for this year, which corresponded with an approximate 4.8% - 5.0% range in 2-year fixed rates.

We estimate fair value for 2-year fixed rates is close to 4.7% based off our forecast OCR track. This doesn't preclude a further move lower - the NZ economy remains weak, and inflation continues to moderate, and we would not rule out the RBNZ easing cycle beginning in August - but short dated rates are trading well below the 90-day floating rate which could limit the extent of further moves lower.

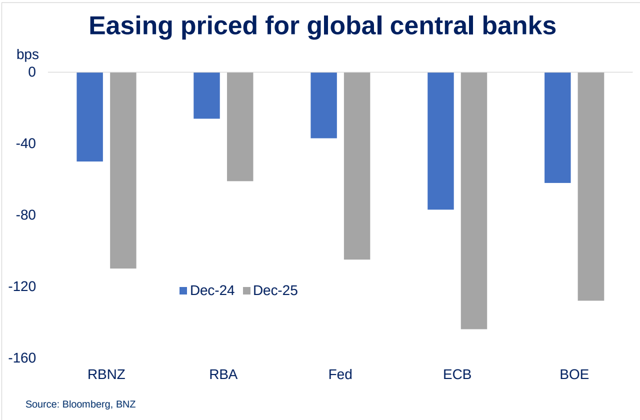
If the RBNZ were to begin an easing cycle in August, we estimate fair value for 2-year rates would be nearer 4.5%. As we outlined in the February edition of the *Outlook for Borrowers,* we think levels around 4.80% are attractive to top up 2-year fixed rate hedging, for those with sub-3-month time horizons. 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 (5-10 yr)

5-year fixed rates biased lower over medium term

5-year NZD fixed rates have been trading in a 4.30%- 4.60% range since retracing from the February highs. Longer dated fixed rates are impacted by the global macro and interest rate outlook as well as domestic monetary policy. Developed market central banks are expected to begin a synchronised easing cycle in 2024, conditional on further evidence of inflation returning sustainably to target. Debate has intensified about when the US Federal Reserve will begin an easing cycle, with the economy proving more resilient than anticipated, and recent inflation data surprising to the topside.

Synchronised easing cycle by global central banks



Global longer dated wholesale rates are likely to move into a lower trading range through 2024 as central banks begin to unwind restrictive monetary policy settings. However, the downside in rates will be limited, relative to most cycles, given the amount easing that is already priced. We estimate fair value for 5-year NZD wholesale fixed rates is close to 4.0%. For those hedgers with flexibility on timing, we think better levels can be achieved by waiting to implement longer-dated hedging. For those with shorter time frames, the base of the recent range at 4.3% is an attractive level to increase hedge levels.

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