29 May 2025

Outlook for Borrowers: Post May MPS

- **The RBNZ reduced the OCR by 25bp to 3.25% at the May MPS which was expected by economists and fully discounted by market pricing.**
- **The decision was reached by 5-1 majority. The dissenter preferred to leave the OCR unchanged. A 50bp rate cut was not discussed.**
- **Although the RBNZ's modelled OCR track was revised lower, there was no explicit guidance for further easing.**
- **We maintain our forecast for a 25bp rate cut in July and August, taking the Cash Rate to a 2.75% base.**
- **We have a modest downside bias for fixed rates, but the bulk of the decline has likely occurred as the RBNZ easing cycle enters the final stage.**

RBNZ Monetary Policy Statement

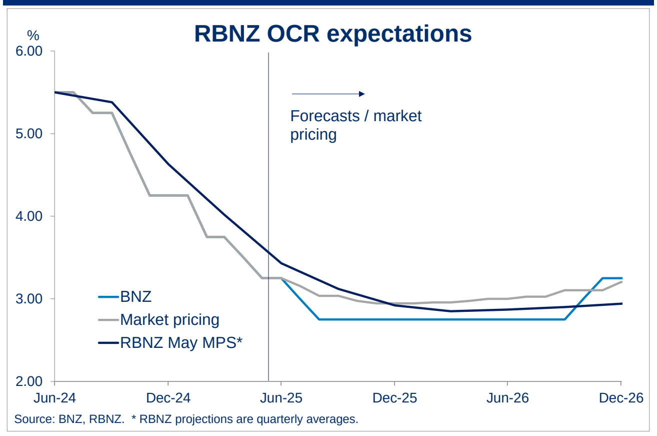
The Reserve Bank of New Zealand (RBNZ) reduced the Official Cash Rate (OCR) by 25bp to 3.25% at the Monetary Policy Statement (MPS) on Wednesday. The rate cut was expected by economists and fully discounted by overnight index swap (OIS) market pricing. The decision was reached by a 5-1 majority. The dissenting Committee member preferred to leave the OCR unchanged at 3.50%. There was no discussion of a 50bp cut.

The statement accompanying the decision noted the recent increase in headline inflation, but also that core inflation is declining due to spare capacity in the economy, which is consistent with inflation returning to the 2% target over medium term. The Bank highlighted risks around the economic outlook are heightened given the uncertainty created by protectionist trade policies.

On balance, the Committee expects the increase in global tariffs to reduce inflation pressures in the NZ economy and weigh on the economic recovery. The Bank has downgraded its growth forecasts while headline CPI still peaks at 2.7% in the September quarter. As a reflection of the uncertain backdrop, the RBNZ presented two alternative scenarios for the domestic economy.

The Bank's modelled OCR track was revised lower compared with the February MPS. The projected low point is 2.85% at the beginning of 2026, compared with 3.10% previously. Despite this revision, there was no explicit forward guidance for further easing. The Committee outlined that policy settings are well placed to respond to both domestic and international developments to maintain price stability over the medium term.

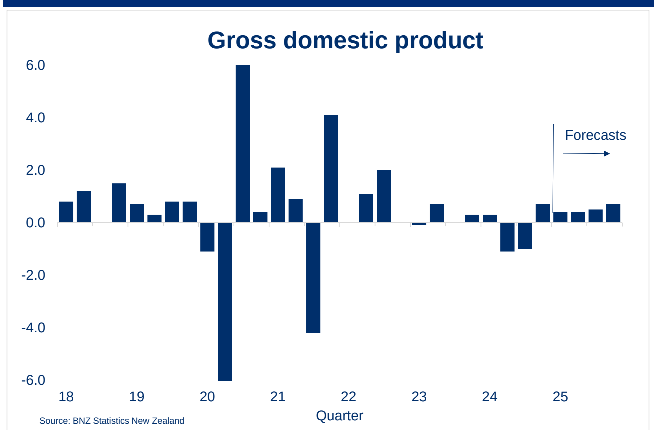
Expected OCR path



Economic overview

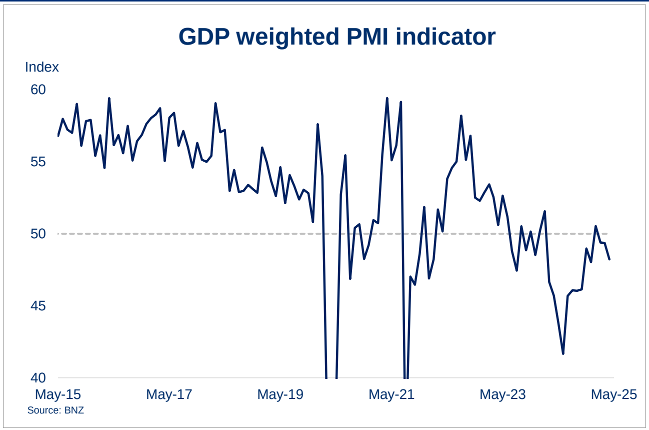
NZ economic growth is expected to gradually recover through this year, as the lagged effect of lower interest rates and stronger net exports support activity. The increase in US tariff rates, although lower than initially proposed, have led to increased uncertainty and will weigh on global growth, which is expected to constrain NZ economic activity. We forecast the economy will expand 0.4% in the March quarter and 2% in 2025, a subdued recovery after the period of stagnation in the preceding two years.

Gradual recovery expected



Higher frequency domestic activity indicators are showing signs of weakness, and consumer confidence will need to recover from current depressed levels, to be consistent with trend-like economic activity. The unemployment rate reached 5.1% in the March quarter, indicating there is now a significant degree of slack in the labour market. We forecast unemployment will peak at 5.3% in the second half of the year, and other measures like the fall in participation and hours worked, point towards underlying weakness.

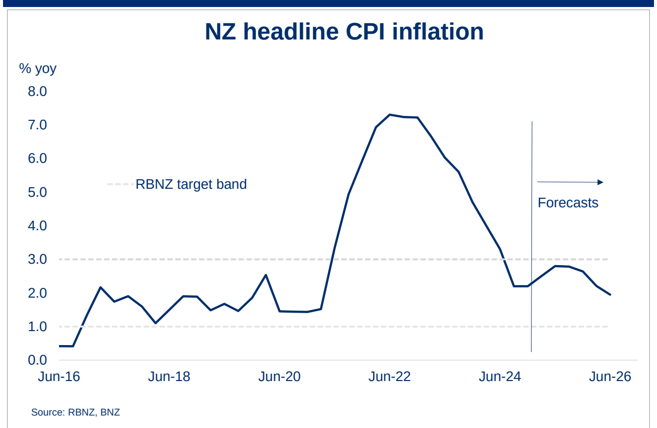
Rebound in the composite PMI faltering



Headline CPI, which was released after the April Policy Review, increased to a 2.5% annual rate in Q1, up from 2.2% in Q4. The lift was driven by tradeables prices rising to 0.3% from -1.1%. Non-tradeable inflation declined to 4.0% from 4.5% in Q4. This is consistent with domestic inflationary pressures easing, given the large and persistent negative output gap. Wage growth has declined more quickly than anticipated and should constrain inflation pressures.

We forecast annual headline CPI to reach a near term peak of 2.8% in both Q2 and Q3, before declining towards the midpoint of the target range over the medium term. If inflation expectations remain contained, during what is expected to be a transitory lift in headline CPI towards the top end of the target range, this shouldn't be an impediment to a further easing of monetary policy to support the economic recovery.

Headline inflation forecast near top of band in Q2 and Q3



OCR forecast

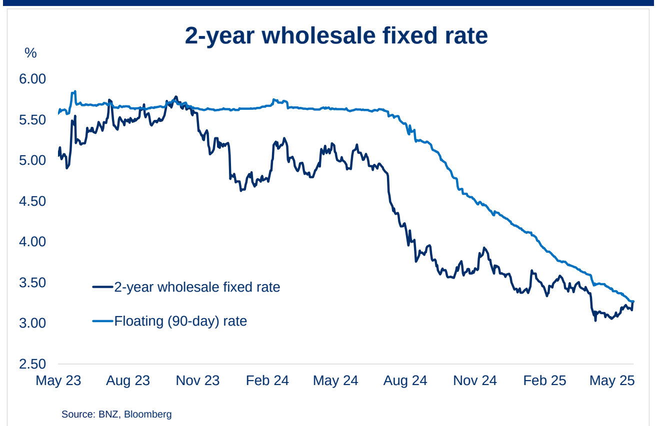
Market pricing above our 2.75% forecast for terminal OCR

Our forecast for the OCR is unchanged. We expect the RBNZ will cut by 25bp in July and August, taking the Cash Rate to a 2.75% base. The OIS market is pricing around 10bp of easing in July and a terminal Cash Rate near 2.95%. The macro backdrop suggests there are downside risks to terminal pricing, but from a broader perspective, the easing cycle is likely entering the final stages.

Monthly activity and employment data, inflation partials for May, March quarter GDP and the Quarterly Survey of Business Opinion are the key releases ahead of the July Policy Review. In addition, global developments will be impactful for the outlook. Q2 CPI (21 July) and labour market data (6 August) won't be available until after the July meeting.

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

Modest lower bias for front end rates



After declining to a fresh cycle low towards 3.0% in April, NZ 2-year wholesale fixed rates have consolidated in a lower trading range. The partial de-escalation in trade tensions had a relatively limited impact on the front end of the NZ curve, which has been anchored by the expectation for further easing by the RBNZ.

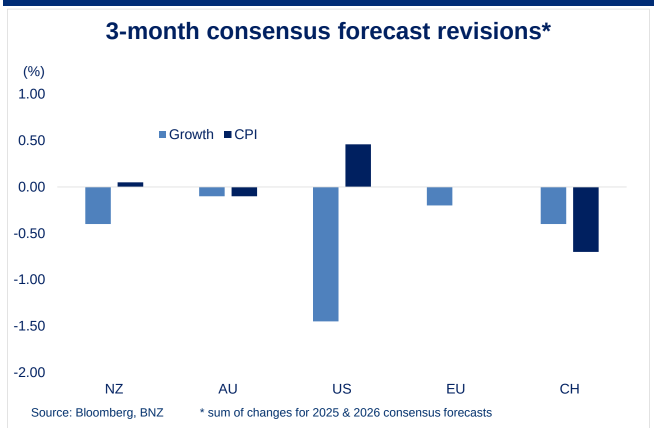
We have a bias for lower front end fixed rates, but any move is expected to be modest in the context of the large fall in 2024, when the RBNZ pivoted towards easing. 2-year fixed rates have traded towards 3.25% in the aftermath of the RBNZ MPS, and a return to levels near the 3% cycle low, would represent an opportunity to top up hedging.

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

5-year NZD fixed rates rangebound

5-year NZD fixed rates traded to a fresh cycle low, near 3.40% at the beginning of May, but have since rebounded back to the midpoint of the broad 3.40% – 3.80% trading range. There has been continued pressure for the curve to steepen. Shorter maturities have been anchored by RBNZ policy while longer dated NZ rates have a greater sensitivity to international markets.

Growth expectations slump

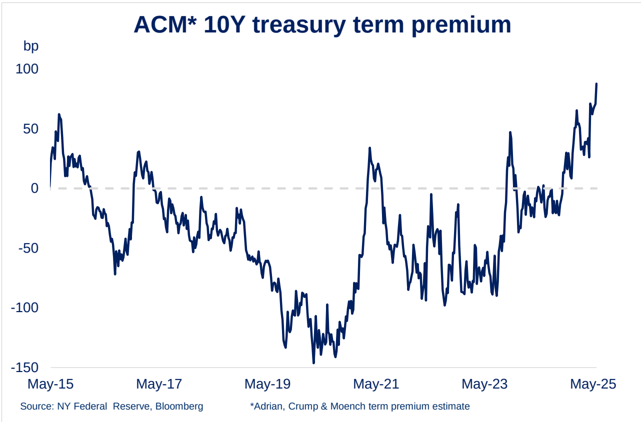


The global economy is facing headwinds from increased trade barriers and uncertainty about US economic policy. Although negotiations are ongoing and some of the worst-case scenarios have been avoided, the trade and related uncertainty shocks are likely to weigh on global economic activity while the impact on inflation is more nuanced. Consensus economic growth forecasts have been revised lower for all of NZ's major trading partners.

Consensus inflation forecasts haven't been as impacted by the macro developments for most economies. The exception is the US where inflation is expected to increase in the short term as higher tariffs are passed through to consumers. Outside of the US, weaker growth is expected to dampen inflation pressures, though disruptions to global supply chains, could increase prices for some goods.

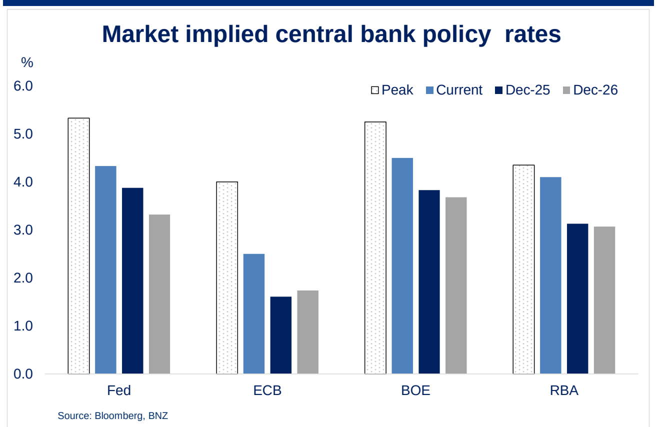
Estimates of the term premium – the compensation required by investors to take exposure to longer maturity interest rates – has moved higher both in NZ and in other markets. This reflects concerns about fiscal deficits and elevated issuance of government bonds, the impact of quantitative tightening as central banks reduce their bond holdings and an uncertain macro backdrop. The higher term premium is likely to maintain a curve steepening bias.

Estimate for 10Y US treasury term premium increasing



Markets have partially unwound the easing priced for major central banks at the peak of the trade tensions. However, most have retained an easing bias given the weaker growth and general progress on disinflation. The Federal Reserve, European Central Bank, Bank of England and Reserve Bank of Australia are all expected to ease further in 2025. Lower policy rates should limit the scope for further increases in longer end yields.

Global central banks maintain easing bias



We think NZ 5-year fixed rates are likely to remain range bound for now and borrowers should target levels towards the April lows to top up hedging. It would likely take a more material slowdown in global growth, prompting global central banks, including the RBNZ taking policy rates below neutral, for NZ 5-year rates to trade towards 3.0%.

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