Interest Rate Research

29 September 2025

Outlook for borrowers: September update

- **NZ swap rates declined sharply following the dovish pivot from the RBNZ at the August MPS. Weak Q2 GDP data contributed to a further leg lower.**
- **A subdued economic recovery and inflation, which is expected to return to the midpoint of the target band over the medium term, support further easing.**
- **The QSBO is scheduled for the day before the RBNZ's October meeting and is the last major economic release in the run up to the decision.**
- **We think a 25bp cut is more likely than 50bp. However, if activity and tightness indicators are sufficiently weak in the QSBO, raising concerns about the recovery and medium-term inflation, they could tip the balance.**
- **A 2.50% terminal OCR in November remains our base case, but the risks are skewed towards the downside, which is already reflected by market pricing.**
- **From a broader perspective, the RBNZ easing cycle is entering the final stages. The decline in yields provides borrowers with an opportunity to top up hedging.**

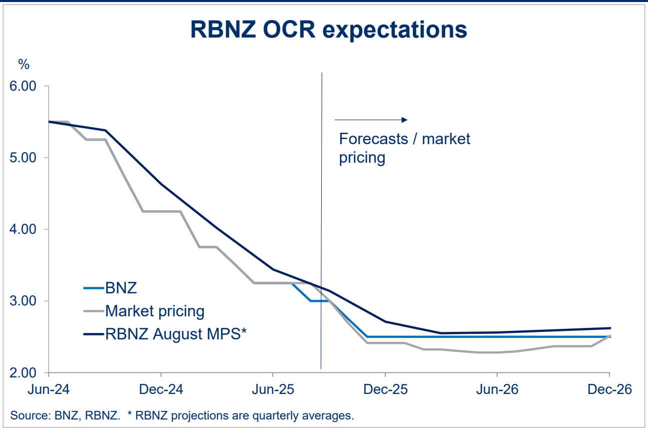
RBNZ Monetary Policy Outlook

NZ interest rates have declined to new lows for the cycle against a backdrop of weak domestic activity and expectations that inflation will return to target over the medium term. The dovish pivot by the Reserve Bank of New Zealand (RBNZ) at the August Monetary Policy Statement (MPS) was the initial catalyst for the move lower. Recently, weak GDP data for the June quarter raised concerns about the contours of the economic recovery and contributed to a further leg lower in rates across the yield curve.

Developments for the economy have been mixed since the August MPS. The manufacturing and service sector PMIs declined in August. Both series are below 50 and are in contractionary territory. The GDP weighted composite index declined to 47.9, well below the long-term mean that would be consistent with trend like economic activity. Q2 GDP contracted 0.9%, considerably weaker than expected. However, there are several factors which will likely reverse in Q3, albeit in the context of still subdued economic activity overall.

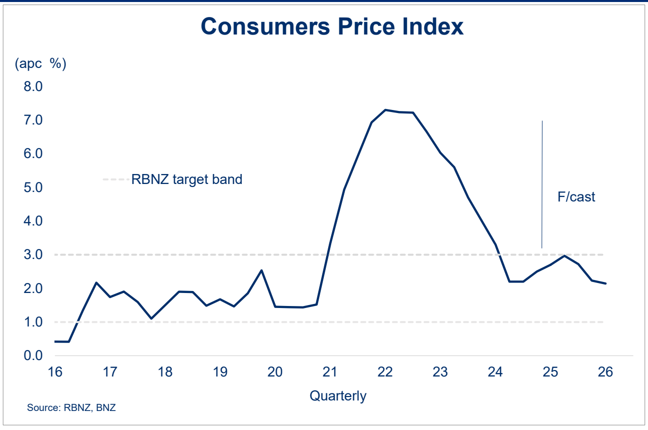
Lower interest rates are expected to support consumption and investment through the second half of the year and underpin the economic recovery. The lagged impact from previous rates cuts is still transmitting through the economy. One example is the mortgage channel. The average rate on the stock of outstanding mortgages is 5.55%. A 1-year fixed rate mortgage, which is currently the most popular tenor amongst households, is 4.75%. About half of existing fixed-rate mortgages are expected to re-fix onto lower rates over the next six months. Strong primary sector earnings will also support the recovery.

Expected OCR path



Partial inflation indicators have largely evolved in line with our projections. We are forecasting a 0.9% increase in headline CPI for the September quarter, taking the annual rate to 3.0%, which corresponds with the top side of the RBNZ's target band. However, the move higher in headline CPI is expected to be temporary. We forecast a return towards the Bank's 2.0% target over the medium term as the negative output gap weighs on non-tradables inflation.

Headline CPI to peak in Q3 and return to target in 2026



We are forecasting a 25bp reduction for the Official Cash Rate (OCR) at the October and November meetings before an extended pause. Market pricing in the overnight index swap market implies close to a 20% chance of a 50bp rate cut at the October Monetary Policy Review (MPR), and a cumulative 59bp of easing for the two remaining meetings this year. After the weak Q2 GDP data and retracement in the PMIs, risks are skewed towards the downside to our 2.50% terminal OCR projection.

The Quarterly Survey of Business Opinion (QSBO), which is scheduled one day ahead of the MPR, is the last significant economic release before the next RBNZ meeting. While a further cut is highly likely after the guidance at the August MPS, the QSBO will be pivotal in making the case, or otherwise, for a larger 50bp cut. We would caution about placing too much weight on the Q2 GDP data with most of the quarterly weakness expected to unwind in Q3.

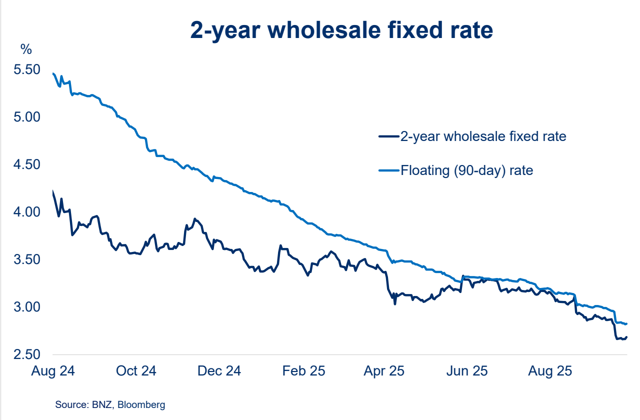
There aren't any clear implications for the near- and medium-term monetary policy outlook from the announcement that Dr Anna Breman is the new RBNZ Governor and will begin on 1 December. In addition, Hayley Gourley will replace external MPC member Bob Buckle when his term finishes at the end of this month and will take part in the October RBNZ meeting. The changing composition of the Committee creates some uncertainty about the Bank's reaction function, but ultimately the outlook for the economy and inflation will be the key determinant of the rates outlook.

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

Terminal OCR pricing approaching 2.30%

The market implied OCR has declined to around 2.30%. This is well below the 2.55% trough in the RBNZ's modelled OCR track from the August MPS. The move lower fairly represents the balance of risks in our opinion but appears to have incorporated enough easing for now. We expect a period of consolidation after the recent decline in yields. Q3 CPI and labour market data are not released until after the October MPR.

2-year fixed rates decline as more RBNZ easing expected

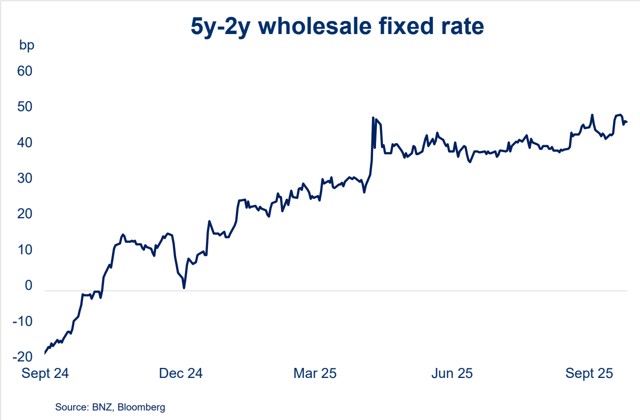


The decline in front end NZD fixed rates has accelerated in recent weeks. 2-year swap rates have traded below 2.70%, to the lowest level in more than three years. Rates fell in the aftermath of the August MPS and gained additional momentum as the market priced additional easing after the Q2 GDP data. A 50bp cut or dovish forward guidance in October could contribute to a further decline in front end rates.

However, if we are correct and the RBNZ is in the final stages of the easing cycle, it would be prudent for borrowers to top up hedging levels. Our assessment of fair value for 2-year swap rates is close to the current market level of 2.70%.

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

Steeper NZ curve as 5-year rates lag the front-end rally

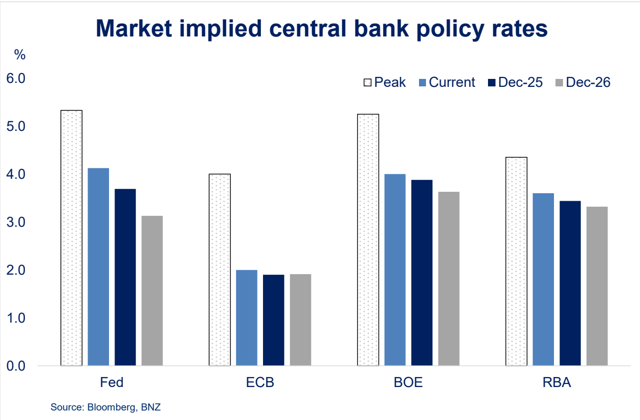


After being range bound through much of this year, 5-year fixed rates have broken comprehensively to the downside after the August MPS. The move lower has continued to be driven by the front end of the curve, and the spread between 2- and 5-year fixed rates has reached a fresh cycle high of nearly +50bp.

Longer maturity NZ fixed rates are driven by a combination of RBNZ monetary policy and global factors. The decline in 5-year rates has corresponded with a broadly supportive backdrop for global fixed income. Consecutive weaker than expected US labour market reports contributed to a shift in the perceived balance of risks for the Federal Reserve (Fed). The central bank restarted its easing cycle, having paused for nine months, at the September FOMC. The median US policy maker now expects an additional 50bp of easing over the remaining two meetings in 2025 and a cumulative 100bp by the end of 2027.

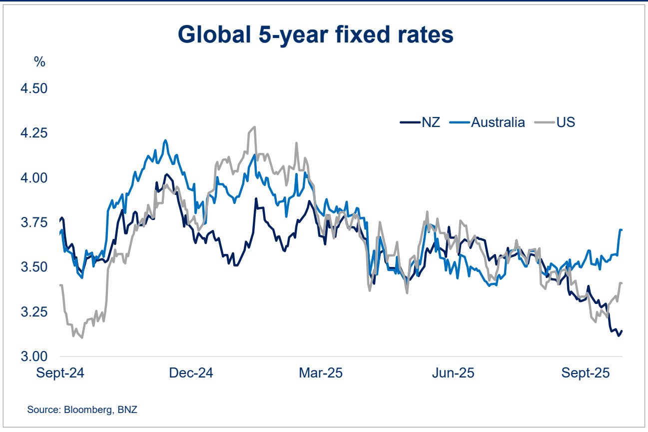
The Fed's base case is that the impact on inflation from tariffs will be short lived and the balance of risks suggests monetary policy should be moving towards neutral. The market is pricing the terminal Fed Funds Rate near 3.0% which closely aligns with the median FOMC member projection for where rates will settle over the longer term. With a further 100bp 'insurance easing' already implied by market pricing, and absent a further deterioration in the labour market, we think US 5-year rates are likely to remain rangebound.

Global central banks maintain easing bias



Outside of the Fed, global central banks typically retain a bias for lower policy rates but easing cycles in many countries are becoming mature. The European Central Bank is expected to remain on hold after taking its policy rate to 2%, and there is only modest easing priced in the UK and Australia. Stable to lower global central bank policy rates are expected to limit the upside for global yields.

NZ rates outperform US and Australia



After the recent decline, we think NZ 5-year rates are likely to consolidate within in a new lower range. If the market were to price in additional RBNZ easing, the 5-year sector should lag any the move lower in front end rates, leading to a steeper curve. NZ spreads against key comparison markets like the US and Australia have contracted which may reduce investor appetite to push NZ yields lower.

5-year NZD fixed rate extends lower

We think the recent drop in yields creates an opportunity to increase hedge ratios at attractive levels.

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