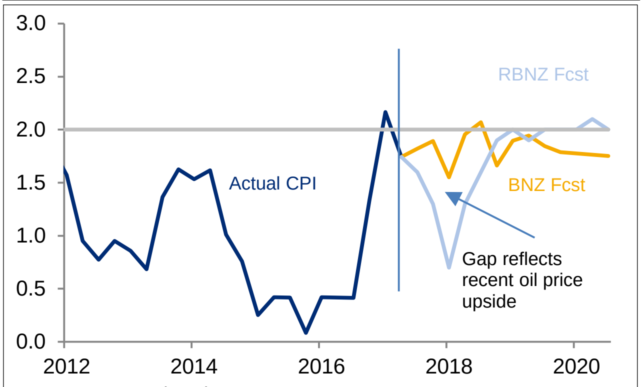
28 September 2017

Outlook for Borrowers: Post September OCR Review

- **With expectations of unchanged monetary policy for an extended period, wholesale floating rates and short-dated wholesale fixed rates should remain flat through the rest of the year and into early next year. This suggests little need for businesses to rush in to protect against higher short term rates.**
- **Borrowers have had plenty of opportunity to hedge longer-term interest rate risk at attractive levels over the last month or so. Anyone who "missed the boat" should look to reset their expectations. We think the low in rates this year has now passed. With the balance of risk to the upside for rates through to the end of next year, we still consider a hedge on dips strategy entirely appropriate.**

Annual CPI Inflation Under Target Again



Source: BNZ, Bloomberg

Monetary Policy Outlook

The September OCR Review was the first one with a new Acting Governor in charge, Grant Spencer, but there were clear signs of policy continuity, with only minor tweaks from previous statements. Importantly, the language in the final paragraph remained unchanged, with the Bank commenting that "monetary policy will remain accommodative for a considerable period".

The NZD is tracking a little weaker than the RBNZ projected in August and petrol prices have recently risen, suggesting that headline inflation will run a little higher than the RBNZ previously projected, but not strong enough to change the course of monetary policy.

The RBNZ is seeking to stimulate the economy to generate some domestic inflationary pressure to help offset weak projected inflation generated from external forces. In August, the Bank projected the OCR to remain at the current level for another couple of years, before drifting higher towards a more neutral policy setting. We don't think that the Bank's view has changed at all.

In the September Statement there was no hint that the Bank is looking at beginning the tightening cycle earlier, following the recent lead of the Bank of Canada or Bank of England. Post election we still don't know the make-up of the next government and it will be some time before the Bank will be able to incorporate any changes to fiscal policy into its projections.

Wholesale Floating Rates

We continue to believe that there is a high hurdle to ease or tighten monetary policy at this juncture. For the Bank to ease policy again, we'd likely need to see some sort of global shock to trigger such a move. The current global backdrop is one of a broadly-based economic expansion with little threat of recession. Something like a US-North Korea war would be a big shock, but it is still very much considered a "tail-risk".

The lack of inflationary pressure, particularly in the non-tradeables sector of the economy, and projections for only a slow grind up in underlying inflationary pressure limit the near-term upside pressure to short rates.

We see policy unlikely to change for some time – certainly not over the next six months. BNZ's official rate call is for a hike in August 2018, slightly ahead of current market expectations. As well as the usual economic uncertainties that exist, additional uncertainties are the change to a permanent Governor from March 2018, the make-up of the next government and likely fiscal policy settings, and any possible changes to the Policy Targets Agreement.

Wholesale floating rates are expected to remain flat for much of the next year, consistent with a flat OCR view.

Bank funding pressures have receded over the last couple of months. Earlier in the year we saw business rate increases independent of the OCR. The risk of further increases has dissipated, but hasn't gone away completely.

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

A long period of a stable OCR should help underpin short term wholesale fixed rates close to current levels for the rest of the year. As the first tightening comes into focus, we'd expect to see 2-3 year rates to drift higher, but that's more a story for next year.

Any upside risk this year is likely to come via global forces, with other major central banks moving gradually towards monetary policy normalisation, which means higher rates from historically low levels. As we saw in late-June through to early-July and again from early-mid September these forces can spill over into NZ rates at times.

With the RBNZ likely to sit on its hands for a while yet, there seems no rush for borrowers to fix rates at this short-dated horizon. But we note that the gap between short-dated fixed rates and floating rates has been closing steadily for much of this year, reducing the "premium" to fix rates. Furthermore, for each month that passes the timing of the next rate hike cycle gets a little closer. Thus, we wouldn't bet on the "premium" to fix rates falling much further than already seen this year.

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

Longer term rates are less influenced by short-term monetary policy factors and more influenced by policy over the next full cycle, along with global forces.

US 5 and 10-year Treasury rates, which have a significant impact on NZ long-term rates, reached their lowest levels this year in early September, influenced by a couple of catastrophic hurricanes, increased US-North Korea tensions and downbeat sentiment towards further rate hikes from the US Federal Reserve.

Market sentiment has changed significantly since then, and we think that there is a reasonable chance that we won't see such low rates again this year or next year.

We see upside pressure on US long term rates from the following sources:

— Further Fed rate hikes through to the end of next year, which the market still under-prices in our view.

— An increased chance of Trump's tax reform plan being passed into law, which not only adds to pressures on US debt issuance but also to the chance of Fed rate hikes, in a fully employed economy.

— The Fed beginning its quantitative tightening programme in October, which sees its balance sheet gradually shrink over coming years to a set formula.

— The ECB likely reducing its bond buying programme from early next year and ending it from the middle of 2018, adding upside risk to European bond rates.

— And a general rise in global inflation pressures, as the broadly based global economic expansion continues.

Finding downward forces on US bond rates is a lot harder. High on the list would be some sort of global shock, such as military action between the US and North Korea. Much of those upward forces above could be eliminated if war developed on the Korean peninsula.

Those same risks apply to NZ long term rates, as much of the movement in US rates spills over into local rates. The bottom line is that the risk for rates remains skewed towards the upside as we look ahead through to the end of 2018.

Thinking about specific NZ risks, a change in government (whether led by National or Labour) is likely to lead to easier fiscal policy and more chance of higher bond issuance, adding upside risk to long bond rates, at the margin.

The current NZ wholesale 5-year fixed rate is consistent with a muted tightening cycle over coming years – an OCR that steadily rises about a year from now and barely gets to 3% about four years down the track before flattening out. This profile likely under-prices the upside risk to rates over the tightening cycle ahead, with the policy rate barely reaching a so-called "neutral" rate over that time.

Borrowers have had plenty of opportunity to hedge interest rate risk at attractive levels since our last report following the August MPS. Anyone who "missed the boat" should look to reset their expectations, given the modest chance that those attractive levels are returned anytime soon. With the balance of risk to the upside for rates, we still consider a hedge on dips strategy entirely appropriate.

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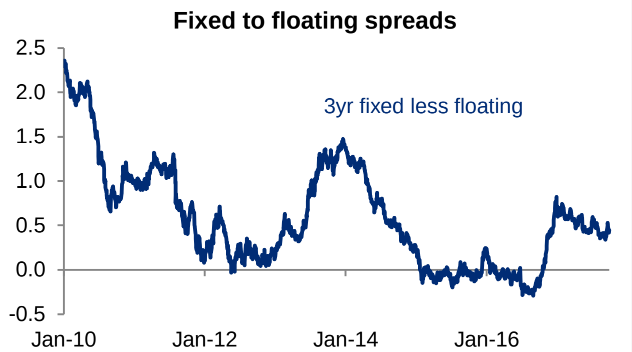
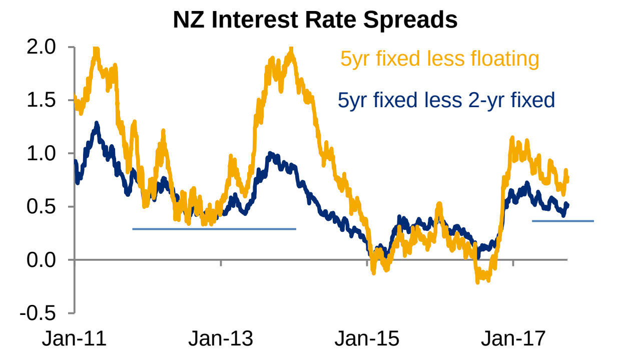
Premium for Fixing 3-years Reduced Through 2017



Source: BNZ, Bloomberg

Have We Seen the Last Dip in Spreads for this Year?



Source: BNZ, Bloomberg

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