15 January 2019

# NZ Rates Outlook: Scaling Back Our Bearish Expectations

- **In early November, we expressed a medium-term bearish bias for NZ swap rates based on limited risk of OCR cuts, NZ valuations looking expensive cross-market, and expectations that global rates would head higher.**
- **Over the past few months there have been a number of bullish developments that means we have scaled back our longer-term NZ rate expectations.**
- **Offshore, we think there is a high chance the Fed cycle has peaked and US Treasury yields will be range-bound, removing one source of upside impetus to NZ rates.**
- **Domestically, the RBNZ's proposal to significantly increase bank capital requirements will lead to a lower neutral OCR if it results in higher rates to the real economy. NZ longer-term swap rates look less expensive on the basis of a lower neutral rate.**
- **While we still think RBNZ rate cuts are unlikely, the market's perception is that the central bank will be quicker to cut and slower to hike.**
- **Our central expectation is that longer-term NZ rates will be range-bound this year. We wouldn't rule out higher rates, but it would likely require an increase in NZ core inflation and the global risk backdrop to improve such that the market expects the next move in the OCR is more likely to be a hike than a cut.**

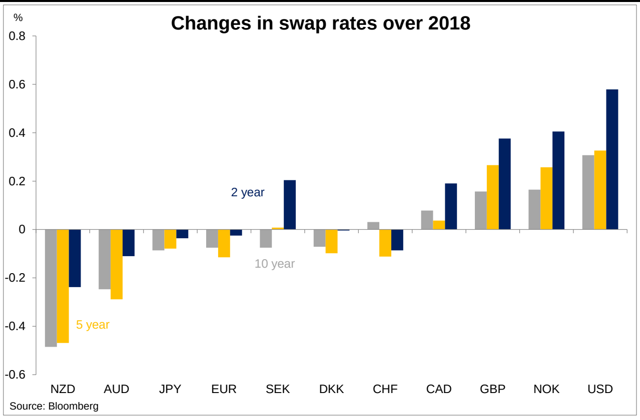
## Revising our earlier bearish NZ rates call

In early November we made the medium-term case for paying NZ swaps. We thought the market would struggle to push out the timing of OCR hikes much further, NZ rates looked expensive on a cross-market basis and in relation to broader macro fundamentals, and the market was positioned long and vulnerable to re-pricing sharply higher in the event macro data made RBNZ hikes look more likely. Additionally, we saw upside risks to global rates and expected the market to ultimately revise up its Fed expectations, helping to push US yields higher.

After initially spiking sharply higher after the NZ labour market report, NZ rates have rallied back, with the 2 year swap now at a record low and 5 and 10 year rates close to the record lows set in mid-2016. The market has reverted to pricing a 50% chance of a rate cut by the end of 2019, with the first hike not priced until well into 2021 (Chart 3).

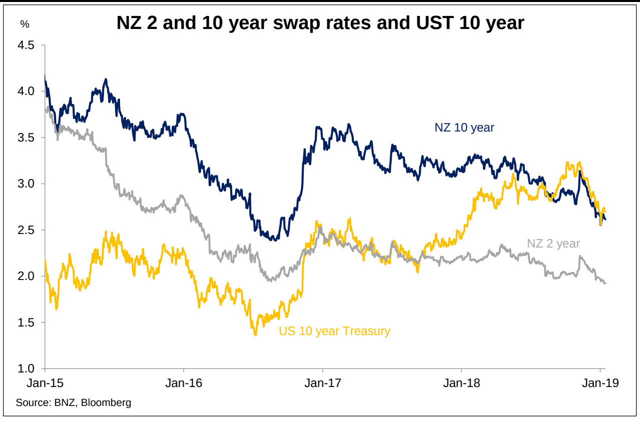
Over the past month, developments have caused us to question the extent to which NZ longer-term swap rates will rise on a medium-term basis. We run through these in turn.

Chart 1: NZ rates outperformed significantly through 2018



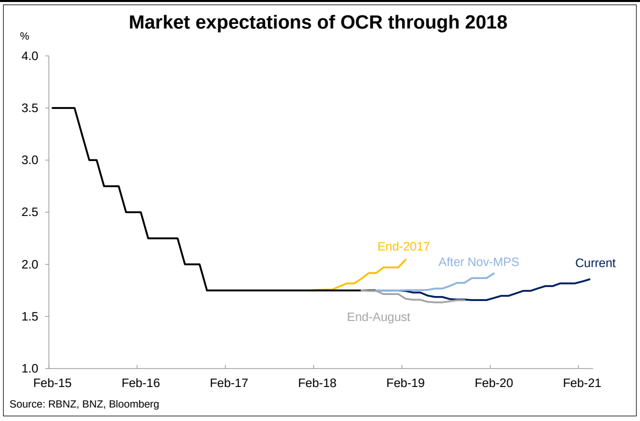
Source: Bloomberg

Chart 2: NZ swap rates now at or close to record low levels



Source: BNZ, Bloomberg

Chart 3: The market prices the risk of OCR cuts



Source: RBNZ, BNZ, Bloomberg

### 1. Less upside for US and global rates

Following the significant tightening in financial conditions over the past few months, Fed rhetoric has taken a decidedly dovish turn in 2019. Chair Powell has said muted US inflation gives the Fed scope to be "patient" as it watches how the economy evolves this year. Other centrist Fed officials such as Evans and Rosengren, who previously signalled support for the policy rate to move into restrictive territory, have also backed away from those calls and urged caution.

The clear message is that the Fed is highly likely to be on hold in the first half of this year. With the Fed funds rate already close to neutral and US growth set to slow later this year, we think the hurdle for the Fed resuming rate hikes is high and the highest likelihood scenario is that the tightening cycle is now complete. A resumption of rate hikes is still possible, but is likely to require an increase in underlying inflationary pressure, above target, and there are few signs of that as yet.

The market has already moved in this direction, with rate hikes largely priced out of the US curve, and a two-thirds chance of a rate cut priced by the end of 2020. We now expect the US 10 year Treasury yield to be contained within a 2.50% to 3% range for most of this year. The upside to US Treasury yields is likely to be capped in an environment where the hurdle for Fed hikes is high. But conversely, if the Fed is done with its tightening cycle, the risk of a policy mistake (i.e. the Fed "overtightening" and a US recession) is reduced; this should limit the scope for US yields to fall sharply from here.

One could ask whether the US rates outlook matters much anyway for NZ rates given there hasn't been much correlation between NZ and US 10 year rates through the Fed's tightening cycle over the past few years. However, Chart 4 indicates that the correlation between NZ and US 10 year rates has been higher during periods when the Fed has been on hold. A more contained US rates profile is still likely to reduce the potential upside to longer-term NZ rates, all else equal.[1] This is especially likely to be the case if the end of the Fed cycle were to lead to a downtrend in the USD, resulting in a higher NZD and lower NZ imported inflation (see Jason Wong's 2019 year-ahead NZD outlook for more on the FX outlook).

Of course, this doesn't preclude NZ rates moving higher, independent of US rates. The historical record of NZ 10 year rate movements around the date of the final hike of previous Fed cycles is mixed (see Chart 5). But it puts more onus on domestic drivers, or global ex-US rates, to trigger higher NZ longer-term rates.

[1] We also find a high correlation between NZ and US 10y rates during Fed easing cycles over the past thirty years.

**Chart 4: NZ 10y better correlated to US when Fed on hold**

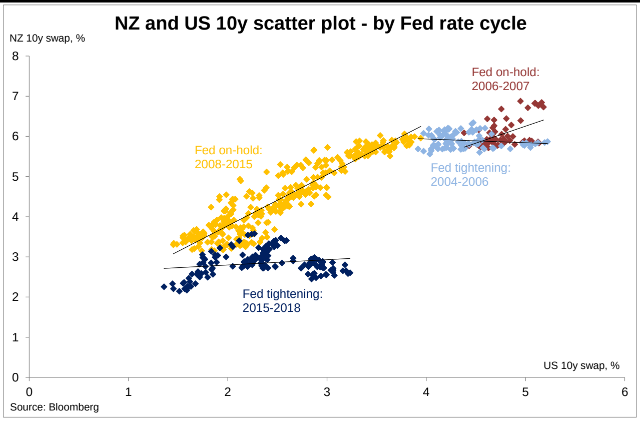
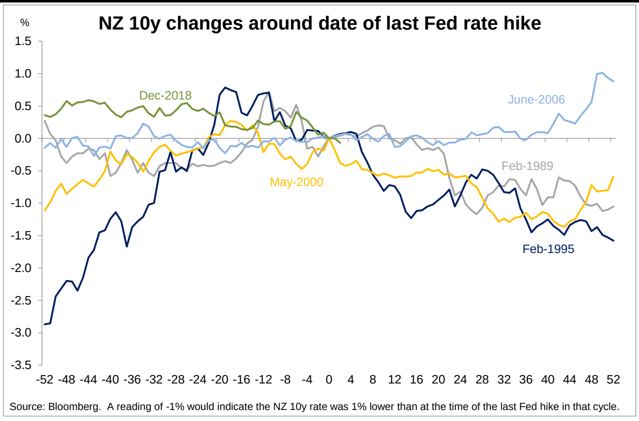



**Chart 5: NZ10y moves after the last hike of prior Fed cycles**




### 2. Higher NZ bank capital may imply lower neutral OCR

On the domestic front, the key event over the past few months has been the RBNZ's proposal to significantly increase capital requirements for NZ banks over five years (see our preliminary thoughts here). If the capital rules were to go through as currently proposed, it will increase the cost to NZ banks to provide credit to the real economy. There is considerable uncertainty around what the precise impact will be, but using multipliers from the RBNZ consultation paper it could ultimately translate to a 25-40bp increase in average funding costs for banks. In turn, this could result in banks passing this through via higher lending rates to the real economy, independent of the OCR.

It's possible the RBNZ might loosen other macro-prudential restrictions (such as LVR limits) to try offset any negative impact on the economy.[2] But to the extent that the proposal results in a permanent increase in borrowing costs for the real economy, it implies a lower neutral OCR. The RBNZ's latest median estimate of the neutral OCR

[2] One could argue that if the banking sector is very highly capitalized, and the risk of bank default is extremely low, then the need for macro-prudential policy is much lower.

from June 2017 was 3.5%. We already thought the risk was that neutral was closer to 3% (see our note from June last year). The RBNZ capital requirements proposal will push even further in that direction (notwithstanding the fact that NZ fixed mortgage rates actually declined during 2018 – see Chart 6).

We compare neutral rate estimates to the 5y5y swap rate as a guide to longer-term NZ swap valuations (see Chart 7). The NZ 5y5y swap rate is around 3.1%, which is consistent with the market pricing a neutral OCR of around 2.9% (assuming a 20bps bills-OIS spread). Based off a 3-3.5% neutral OCR, this would imply NZ rates valuations were expensive. But if the capital requirements proposal were to slice 25-40bps off neutral, NZ longer-term rates valuations look more reasonable. Similarly, it implies cross-market valuations, such as the NZ-US 5y5y spread, look more reasonable than was the case beforehand.

### 3. High hurdle for RBNZ hikes

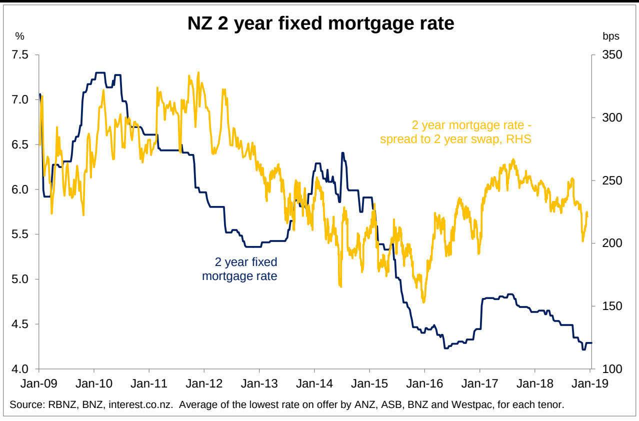
At the end of November, we pushed back, and reduced the extent of, OCR tightening built into our forecasts. We highlighted at the time that the RBNZ was displaying a very real reluctance to even suggest interest rates might rise. Broader macro developments since then are likely to have further pushed the RBNZ in a dovish direction, including falling global growth expectations, a rise in the NZD, and a lower headline CPI profile (given the aforementioned rise in the NZD and fall in oil prices).

While the NZ unemployment rate is sub 4% and core inflation is not far from the 2% midpoint, which under a conventional Taylor rule framework would argue for tighter monetary policy, it's hard to see a catalyst for the RBNZ shifting in a hawkish direction any time soon, especially in an environment of heightened market volatility and concerns around global growth.

Of course, upside surprises to NZ inflation data next week (especially if core inflation) and/or the labour market report in early February could see the market re-contemplate rate hikes. But with the proposed increase in capital requirements lingering in the background, we expect the market will be reluctant to move OCR expectations too far without a signal from the RBNZ itself. The market perception is that the RBNZ is very reluctant to hike rates.

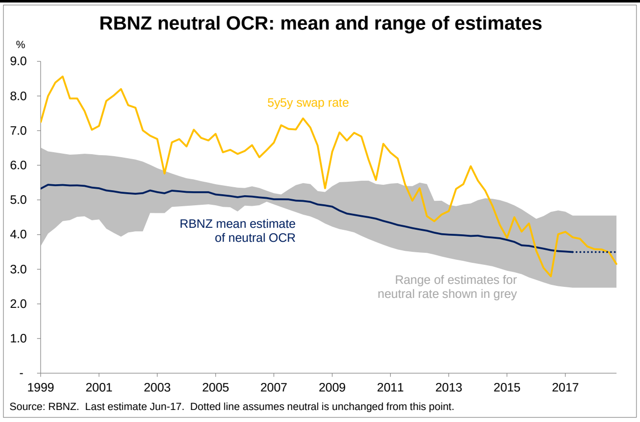
The market has of course moved significantly in this direction already, with an OCR cut now 50% priced and a very shallow path of tightening priced from late-2020. We have low conviction that the RBNZ will shift in a hawkish direction, and tilt the market towards pricing the next move being a hike, any time soon.

Chart 6: 2 year mortgage rates made record lows recently



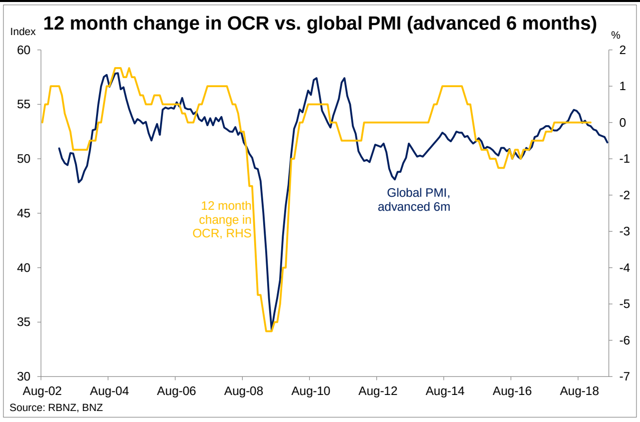

Source: RBNZ, BNZ, interest.co.nz. Average of the lowest rate on offer by ANZ, ASB, BNZ and Westpac, for each tenor.

Chart 7: NZ 5y5y swap vs. RBNZ neutral OCR estimates




Source: RBNZ. Last estimate Jun-17. Dotted line assumes neutral is unchanged from this point.

Chart 8: Fall in Global PMI has dovish OCR implications




Source: RBNZ, BNZ

## Base-case: range-bound NZ rates. Risks both ways.

With the upside to US and global rates likely to be more contained this year, the impending change to NZ bank capital requirements likely to handicap OCR rate hike expectations (and shift NZ swap valuations lower), and the hurdle for the RBNZ to shift in a hawkish direction seemingly very high, we have revised our expected range for NZ swaps in the year-ahead lower. Our forecast range for the 10 year NZ swap rate is now 2.40% to 3%. We no longer see a compelling case that NZ swaps will meaningfully exceed the forwards any time soon.

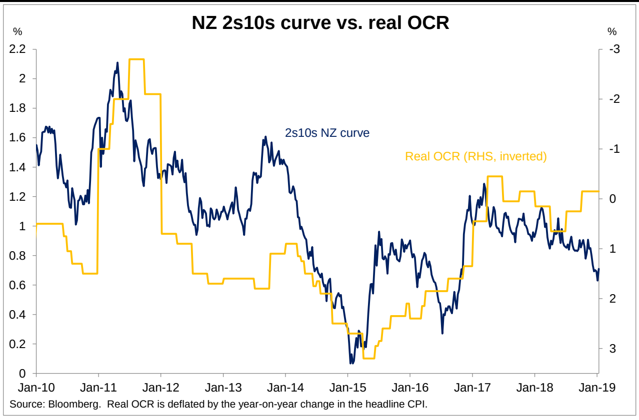
The bearish macro scenario for NZ rates would involve a combination of higher NZ inflation and an easing in concerns around global growth which sees the market bring forward RBNZ tightening expectations. Given the economy is already close to the RBNZ's twin objectives (employment is near its "maximum sustainable level" and core inflation is close to target) and the market is positioned for lower NZ rates, in our view, a hawkish shift from the RBNZ could generate a sizable market reaction. The sharp sell-off in early November after the NZ employment report was an illustration of how quickly the NZ market can re-price when market positioning is offside.

If the RBNZ retained a dovish bias amid higher inflationary pressures and a benign global backdrop, we would expect upward pressure on longer-term rates and a steeper yield curve. Chart 9 shows there has been a relationship between the real OCR and the 2s10s curve over the past ten years (intuitively, higher inflation means lower real rates and increased monetary stimulus, which increases the headroom for future tightening). While we see the risks pointed to higher wage and core inflation in NZ this year, we have lowered our forecasts for headline CPI to 1.4% by Q3. Market inflation expectations are at depressed levels (see Chart 10).

The bullish scenario for NZ rates involves some combination of an intensification of global growth concerns, higher mortgage and business lending rates independent of the OCR (if banks were to pass on the cost of higher capital requirements), and downside surprises in domestic data, which could see a resumption of RBNZ rate cuts and new lows for longer-term swap rates. As long as concerns around global growth linger, we expect NZ to be a recipient of receive flows from offshore, given the NZ curve remains relatively steep by global standards and the RBNZ has room to cut its policy rate in the event of a major downturn, unlike most developed market central banks.

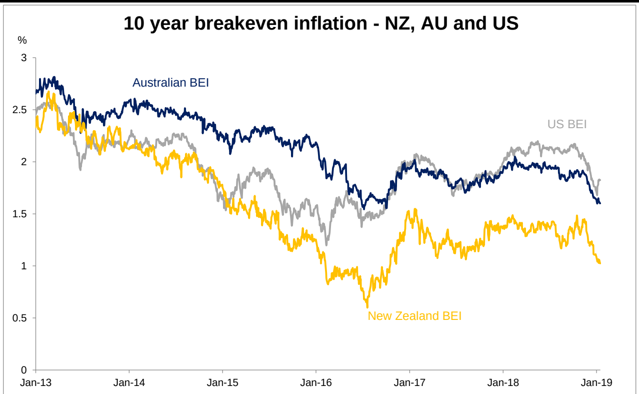
In the absence of an obvious bearish catalyst, we don't think market pricing is extreme enough yet to warrant opposing the rally in rates to date.

Chart 9: NZ 2s10s curve vs. real OCR (deflated by CPI)




Source: Bloomberg. Real OCR is deflated by the year-on-year change in the headline CPI.

Chart 10: NZ breakeven inflation is well below 2% target




Source: BNZ, Bloomberg.

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