Outlook for Borrowers: Post-November MPS

- The RBNZ provided another surprise to markets yesterday, leaving the OCR on hold at 1%.
- We have revised our forecasts and expect the RBNZ to keep the OCR on hold for the foreseeable future.
- The RBNZ retained an easing bias. The risks are still heavily skewed towards the next move being a cut.
- We think we are still a long way off the RBNZ considering rate hikes. For borrowers, there remains no rush to hedge short-dated interest rate exposure.
- Long-term rates (5-10 year) have increased over the past 6 weeks as the global outlook has brightened. We think the near-term risks are reasonably balanced. There is a wide range of possible outcomes in the medium-term, but in our view the risks are more to the upside for yields. Borrowers should consider using dips to add hedge cover.

Monetary Policy Outlook

The RBNZ threw another significant surprise to financial markets yesterday, in keeping the OCR unchanged at 1%. Prior to the decision, the market had priced around a 75% chance of a rate cut, a view shared by a large majority of economists (ourselves included). There was a significant market reaction, with wholesale interest rates rising by up to 16bps and the NZD appreciating by 1%.

The Monetary Policy Committee (MPC) debated an on-hold decision and a 25bp cut but decided, on balance, that economic developments since August did not justify a cut. Crucially, the RBNZ revised down its assumption around potential GDP growth (this is the rate of growth that the economy can sustain without generating above-target inflation pressure). Previously, the RBNZ had forecast that growth would need to reach 3% in 2020 to get inflation to target. It has now lowered the hurdle rate for GDP growth to 2.2% - 2.5%.

We had previously forecast the OCR falling to 0.5% in February because we expected growth to undershoot the RBNZ’s forecasts by a significant margin. Following the change to the RBNZ’s potential growth assumption, we now view the RBNZ’s growth forecasts as much more achievable. Consequently, we have revised our OCR forecast and our base case is that the OCR is on hold for the foreseeable future.

The RBNZ retained an easing bias. It said the near-term risks were still to the downside and it would add further monetary stimulus “if needed.” We agree that the balance of risks around the next move is heavily skewed towards a cut rather than a hike. We think that current market pricing, which factors in around a 40% chance of a cut by mid-2020, is reasonably fair for what we know now.

There are still a number of scenarios where the RBNZ could be brought back to the table to cut rates. The global outlook, and the actions of the Fed and the RBA in particular, will remain influential. Both central banks have indicated a pause in their easing cycles, but were they to resume rate cuts next year, the case for RBNZ cuts would grow stronger. There are still downside risks to NZ growth, even with the RBNZ’s lower forecasts, due to subdued business confidence and broader economic uncertainty, including around government policy and the RBNZ’s bank capital review. The latter is due to be announced on the 5th of December.

The prospect of rate hikes still looks a long way off. The RBNZ said it expected interest rates to remain at “low levels for a prolonged period” and its projections incorporate the first rate hike in Q1 2022. In general, the ‘burden of proof’ for rate hikes appears much greater than it is for rate cuts. This is because the RBNZ doesn’t have much (conventional) ammunition to fight a downturn if rate hikes inadvertently cut short the economic expansion.

It will likely require a combination of a significant pick-up in the global economy, an acceleration in NZ growth to an
above-trend pace (perhaps due to additional fiscal stimulus next year), and an increase in core inflation to at least 2% to see the RBNZ consider rate hikes. This scenario seems much less likely than the downside ones over the next 12 months.

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

Short-dated wholesale fixed rates have increased as much as 40bps over the past six weeks. In early October, when wholesale rates were at their record lows, the market priced a terminal OCR below 0.5%. After the RBNZ meeting, the terminal OCR has increased to 0.9%.

Looking ahead, we think the market will persist in pricing the balance of risks around the next OCR move towards a rate cut. The hurdle for the market to price-in rate hikes for the RBNZ is significant, especially since other key central banks, such as the Fed and RBA, have indicated that their hurdle for raising rates is very high. This means that short-term fixed rates shouldn’t rise too far from present levels unless there is a major change in global circumstances.

Short-term fixed rates remain slightly below the 90 day bank bill rate, although the gap has narrowed over the past few months (see chart above). On the basis of our central forecast of an unchanged OCR, this implies it is slightly more cost-efficient to hedge for short-term tenors than it is to remain on floating. But we think borrowers might get more attractive opportunities to hedge in the future. We don’t think there is a rush to hedge short-term interest rate exposure.

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

The global backdrop has improved over the past six weeks, with the main driver being more positive US-China trade relations. The US and China agreed to work towards a so-called Phase-One trade agreement, signalling a major de-escalation in the trade war. According to reports, China has agreed to buy large quantities of US agricultural goods, alongside other commitments, in exchange for the suspension of import tariffs. Trump suspended the tariffs that were due to go into effect in October and we expect that he will also suspend those planned for December. China is also lobbying for the removal of those tariffs that were implemented in September. Trump and Chinese President Xi are expected to sign the Phase-One deal within the next few weeks, although there is always a chance – as seen earlier this year – that the agreement could fall down at the last minute.

The other positive development over the past six weeks has been the Brexit deal negotiated between UK PM Boris Johnson and the EU. While the UK heads to the polls again for a general election in December, the deal has effectively taken the risk of a no-deal Brexit off the table, reducing the downside risks to the European and global economies. Adding to the positive sentiment, there have been tentative signs of bottoming in global growth data.

Late last month, the Fed cut rates for a third time, to 1.75%, but it signalled a pause in its easing cycle. Chair Powell indicated that there was a high hurdle to raising rates again. Closer to home, the RBA also cut rates in October for the third time, to 0.75%. But markets pared back RBA easing expectations and now expect it will also be on hold over the remainder of the year as it assesses the effect of its rate cuts to date.

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**Have we seen “peak tariffs”?**

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**Markets pare back Fed and RBA rate cut expectations**

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Global equities, bond yields and market-implied inflation expectations have all risen over the past six weeks, signalling that markets perceive a more positive growth outlook looking ahead. We think this move higher in longer-term fixed rates over the past six weeks is justified by the improvement in the global backdrop. With the benefit of hindsight, the sharp fall in global rates in August following Trump’s announcement that he would put tariffs on $300b of Chinese imports looks like an overreaction.

Global bond yields reverse their falls in August

NZ longer-term wholesale fixed rates have increased in-line with these global movements, taking rates back to where they were before the RBNZ cut the OCR in August. On a historic basis, longer-term rates are still very low.

In the near-term, we see the risks around longer-term fixed rates as reasonably balanced. Market pricing of the OCR over the next 12 months looks reasonably fair. And the excessive decline in global and NZ rates in August has now almost fully reversed.

In terms of the risks to the outlook, were the provisional Phase-One US-China trade agreement to collapse, longer-term rates can fall sharply and challenge their recent lows. Likewise, if global growth data worsens, raising renewed fears of a recession, then the market will expect the Fed and other major central banks to renew their easing cycles and longer-term fixed rates can fall sharply. We think both these risks have receded recently, although the past year has taught us that anything is possible with Trump in charge of trade policy.

On the upside, there is the potential for the US to cancel previously implemented Chinese tariffs, proving that there is a route to tariff reduction (and raising market hopes that other tariffs could also be scrapped). Likewise, the recent easing in financial conditions points to the risk that global growth could not just bottom out, but experience another upswing.

For NZ specifically, there is also the possibility of additional fiscal stimulus from the government next year, which would take some of the pressure off the RBNZ to support the economy and increase the supply of government bonds to the NZ market. Indeed, were fiscal stimulus to be forthcoming, it’s possible the market could start to contemplate that we have seen the low in the OCR. Historically, longer-term wholesale fixed rates have bottomed in the three months preceding the final cut of the cycle.

On balance, we see the medium-term risks around longer-term wholesale fixed rates to the upside. We think it’s worth considering using dips to add hedge cover. But we acknowledge that while the RBNZ is likely to be very reluctant to raise rates any time soon, some borrowers may prefer to stick to the lower floating rates.

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