13 August 2018

Outlook for Borrowers: Post-August MPS

- **The RBNZ now forecasts the OCR to be on hold until the second half of 2020 and reiterated that the next move could be up or down.**
- **We have pushed back when we expect the first OCR rate rise to August next year, but the risks are skewed to an even later start date.**
- **In response to the MPS, wholesale fixed rates have declined to their lowest levels in almost two years.**
- **Our base case is that short-term fixed rates should be anchored this year by an on-hold OCR. But the RBNZ has indicated that if growth doesn't pick-up then rate cuts are potentially 'on the table'. The "premium" to put on short-term fixed rate hedges is now very low.**
- **We expect longer-term NZ fixed rates to be range-bound through the rest of the year (unless RBNZ rate cuts become a real possibility). We think borrowers can be opportunistic in adding hedge cover at present.**

RBNZ Monetary Policy Outlook

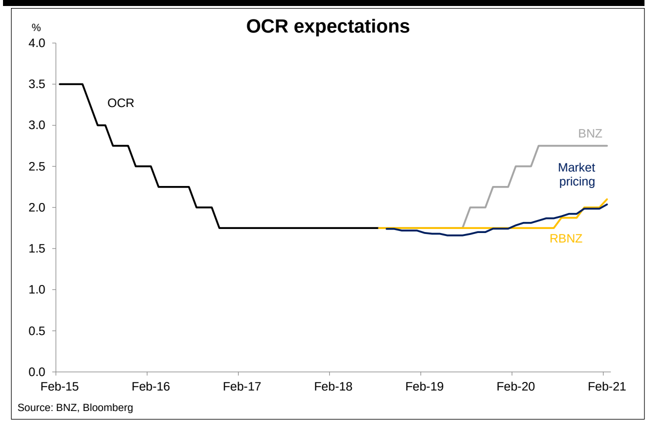
At the August Monetary Policy Statement, the RBNZ again said that the next move in the OCR could be up or down. Economic data since the last RBNZ Statement had been mixed, with core inflation surprising to the upside but business surveys pointing to downside risks to growth. The RBNZ seemingly put more weight on the latter and, consequently, it does not indicate a rate hike in its published track until the second half of 2020, a year later than previously suggested. In a post-MPS interview, Assistant Governor McDermott said the RBNZ wanted the market to understand that a rate rise was "off the table for the foreseeable future."[1]

In reiterating that the next move could be up or down, the RBNZ has said that this central forecast of an on-hold OCR is not set in stone. One of the striking features of the MPS for us was the extreme nature of the rate cut scenario (note: the RBNZ always includes both up and downside scenarios). In this scenario, the RBNZ cuts the OCR by 100bps in response to a slower than projected pick-up in growth. Even if these scenarios are only illustrative (and don't take account of the other moving parts of the economy), it does highlight that the RBNZ is genuinely open-minded about cutting rates if growth doesn't pick-up as expected, something reiterated by McDermott in that same post-MPS interview ("we've been pushed nearer to that trigger point").

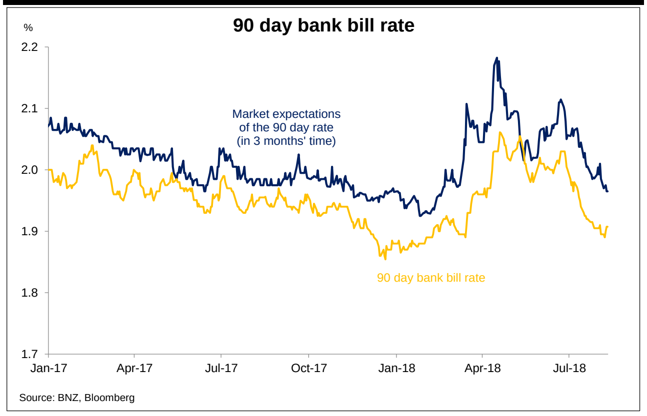
Given the RBNZ lowered its GDP growth forecasts over the remainder of this year, we think the hurdle for cutting is still reasonably high. But it is clearly a possibility (the market prices a 35% chance in the first half of 2019). If growth weakens over the remainder of this year (i.e. the fiscal stimulus doesn't provide the boost to growth we expect) and inflation remains subdued then rate cuts could possibly come into play from early next year.

From where we sit, we expect higher cost/wage pressure to lead to higher CPI inflation later this year (above that which the RBNZ expects) and for the next move to be a hike. But we've pushed out when we expect that first hike to occur from May to August next year, with the risk that it comes even later than that or, indeed, not at all.

The market prices a 35% chance of a rate cut by mid-2019



90 day bank bill rate back to lowest levels since March



[1] See *RBNZ Says Rate-Cut Chances Have Increased on Weaker Growth* – Bloomberg, 9th August 2018.

Wholesale Floating Rates

The 90 day bank bill rate has declined to near its lowest levels since mid-March. The move lower in the 90 day rate has coincided with an apparent easing of funding pressures in both the US and Australia. Domestically, credit growth has slowed over the past year, likely leaving the banking system in a healthy liquidity position. And some of this excess liquidity has likely found its way into short-dated money market instruments, helping to push down on the 90 day bank bill rate. We provided an update on the NZ funding backdrop in mid-July.

In the coming months, our base case is the 90 day rate will stabilise around these levels. First, the OCR will likely be unchanged, which will anchor wholesale floating rates. Second, we don't see much room for the 90 day rate to compress further against the OCR, as the current difference between the 90 day rate and the OCR is already towards the lower end of where it has been since the GFC. However, there is a risk that offshore funding pressures could flare up again, as they did earlier this year, and this could transmit through to a higher NZ 90 day rate.[2]

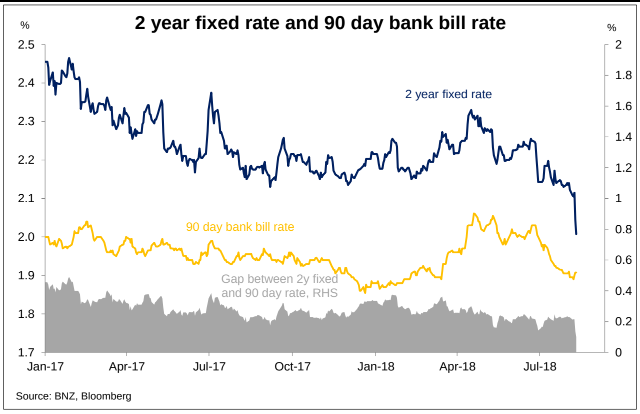
Short-Dated Wholesale Fixed Rates (1-3 yr)

Short-dated wholesale fixed rates have declined sharply since the MPS. The 2 year fixed rate has moved to its lowest level since late 2016, and is now close to its all-time low. The market has pushed out the date of the first hike to February 2021 and now prices a 35% chance of a rate cut by mid-2019.

Notwithstanding the recent sharp falls, our central scenario is that wholesale short-term fixed rates should be reasonably anchored this year. This is based on our central expectation that the OCR is unchanged at 1.75% for an extended period.

The "premium" for hedging is now very low; the 2 year fixed rate is only 8bps higher than the 90 day bank bill.

2 year fixed rate is towards its lowest level over past year



If the RBNZ's next move is indeed a hike next year, then short-term fixed rates at current levels look attractive for hedging. Short-term fixed rate hedges also provide protection against any re-intensification of funding pressures that could flow through to a higher 90 day rate. For borrowers that prefer the certainty of fixed rate payments, one can certainly make a stronger case for fixing now given the lower rates on offer and reduced "premium" to hedge.

Of course, if growth does soften and rate cuts become a more real possibility, then there is room for short-term fixed rates to move lower still. Over the coming six to nine months, the balance of risks around our on-hold central scenario seems more tilted towards a rate cut than a hike. For now, we don't think there is any urgency to put on short-term fixed rate hedges, but would reconsider if rates move even lower.

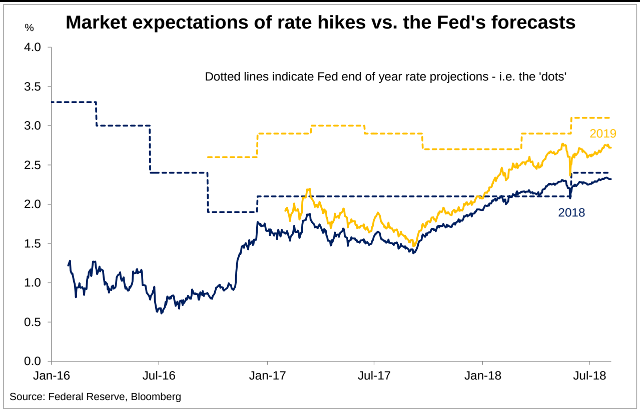
Longer-Dated Wholesale Fixed Rates (5-10 yr)

Global bond yields have come under some mild upward pressure over the past six weeks, with the 10 year US Treasury yield back near 3%. Some of this upward pressure has emanated from Japan, where the Bank of Japan announced that it would tolerate slightly higher 10 year Japanese government bond yields.

In the US, with the unemployment rate below 4% and core inflation near target, Chair Powell told US lawmakers that a gradual path of rate rises remained appropriate "for now". We think that means the Fed will raise rates twice more over the remainder of this year (barring a shock) bringing the cash rate to 2.50%. But with the Fed's cash rate likely to be close to 'neutral' at the end of this year, we expect Fed policy to be more data-dependent in 2019.

The market prices a high chance of two additional rate hikes over the remainder of this year and close to two further rate rises in 2019. Given the uncertain Fed outlook for 2019, we see this pricing as broadly fair and expect the US 10 year yield to be range-bound over the coming months. We still expect a higher US 10 year yield in 2019.

Market's 2018 rate expectations have converged to the Fed



[2] It's possible for instance that the Federal Reserve's actions to reduce its US Treasury bond holdings, which reduces the amount of US dollar liquidity in the market, might lead to a situation where banks have to pay up more for funding.

Trade tensions between the US and China have not had much impact on US economic data to this point, nor Fed rate expectations. There remains a risk that the trade conflict escalates, leading to declines in equities and other risk assets, and in turn likely leading to lower offshore bond yields. On the other hand, a faster than expected pick-up in US core inflation (towards 2.5%) would likely lead the market to price a faster series of rate rises from the Federal Reserve and result in higher bond yields.

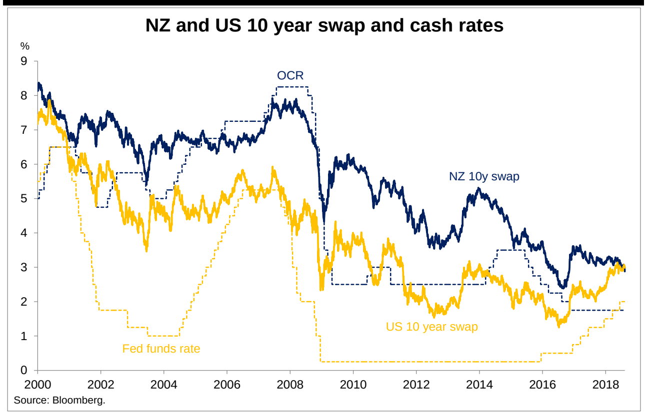
Offshore interest rates are one influence on NZ wholesale longer-term fixed rates. The other influence is the expected path of the OCR. Over the past six weeks, it is the sharp fall in OCR expectations that has dominated and pushed the NZ 10 year rate to its lowest level in two years.

There has been a significant divergence between the NZ and US 10 year rates over the past year reflecting the divergence in monetary policy. The OCR has been on hold and this has anchored the entire NZ curve. Meanwhile, the increase in the US 10 year rate has been driven by increased expectations of Fed tightening, rather than an increase in the risk premium on US bonds. The NZ 10 year rate has historically been more sensitive to increases in the US risk premium (such as during the "taper tantrum")[3].

Our central case for the remainder of this year is that longer-term NZ fixed rates should be range-bound amid an on-hold OCR and range-bound US Treasury yields.

Were the market to start building in a greater chance of RBNZ rate cuts, we would expect long-dated NZ rates to move lower, but lag the move in short-dated rates (i.e. the yield curve will steepen). Ultimately, a more pro-active and aggressive RBNZ should boost inflation, but in the first instance long-dated rates would likely move lower.

NZ 10 year rate has de-coupled from the US the past 12m



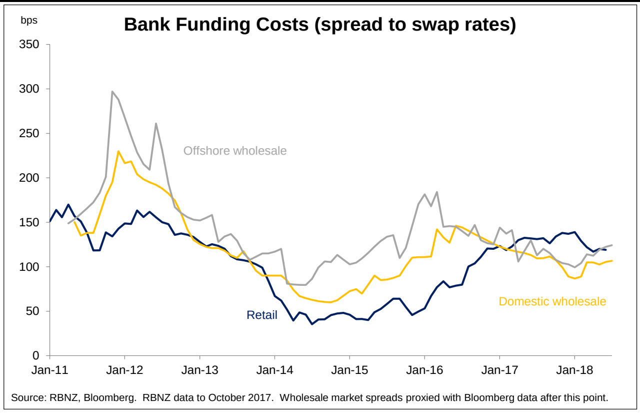
There is still a scenario where NZ growth improves, inflation picks up, and the market builds in a later and steeper RBNZ tightening cycle, but we think this is more likely to come into play next year than this. In the meantime, we think borrowers can be opportunistic in terms of adding hedge cover, even though longer-term fixed rates have fallen significantly.

Bank Funding Costs

Most borrowers' total interest rates are constructed as a combination of wholesale rates, credit costs and bank funding costs.

There has been little change in bank funding costs over the past six weeks. On the retail side, term deposit rates have been reasonably stable. In terms of market-based funding, the decline in the NZ 90 day bank bill rate has reduced funding costs but this has been partially offset by a modest widening in credit spreads. Our estimates of bank funding costs are shown in the chart below.

Bank funding costs have been reasonably stable



nick_smyth@bnz.co.nz

[3] See *How Long Will the NZ 10 Year Remain Decoupled from the US* here

Contact Details

BNZ Research

Stephen Toplis
Head of Research
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Jason Wong
Senior Markets Strategist
+64 4 924 7652

Nick Smyth
Interest Rates Strategist
+64 4 924 7653

Main Offices

Wellington
Level 4, Spark Central
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+61 2 9237 1406

Alan Oster
Group Chief Economist
+61 3 8634 2927

Ray Attrill
Head of FX Strategy
+61 2 9237 1848

Skye Masters
Head of Fixed Income Research
+61 2 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+61 2 9295 1100
Fixed Income/Derivatives	+61 2 9295 1166

London

Foreign Exchange	+44 20 7796 3091
Fixed Income/Derivatives	+44 20 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+85 2 2526 5891
Fixed Income/Derivatives	+85 2 2526 5891