RESEARCH
INTEREST RATE STRATEGY

27 September 2018

Outlook for Borrowers: Post-September OCR Review

- **The RBNZ said it expects to keep the OCR on hold for a considerable period and kept its options open by saying the next move could be either up or down.**
- **We continue to forecast the next move by the RBNZ being a hike, in August next year. The risks around our forecast are skewed to a later start date.**
- **We think the risk of a rate cut over the next 6-9 months is now significantly lower after the upside surprise to NZ Q2 GDP earlier this month.**
- **We expect short-term wholesale fixed rates to be range-bound over the remainder of the year. Provided the next move in the OCR is a hike, we think a reasonable case can be made for looking at short-term fixed rate hedges. Borrowers can probably still afford to be opportunistic though.**
- **We expect longer-term NZ fixed rates to be range-bound through the rest of the year before heading higher in 2019. We would consider using dips in longer-term fixed rates to add hedges.**

RBNZ Monetary Policy Outlook

At the September *OCR Review*, the RBNZ said it expected the OCR to remain at an accommodative setting for a considerable period and reiterated that the next move could be either up or down. The message was very similar to the one presented in the August MPS statement. There has been a modest decline in NZ rates today, but mainly in response to overnight moves in the US.

Since August, NZ GDP has surprised on the upside (GDP increased 1% in Q2, well above the RBNZ's 0.5% forecast) but measures of business confidence have remained depressed. While recognising the stronger starting point for the economy than it forecast in August, the RBNZ is clearly wary that weaker confidence could lead to slower growth in the future. Consequently, it has not taken the possibility of rate cuts off the table.

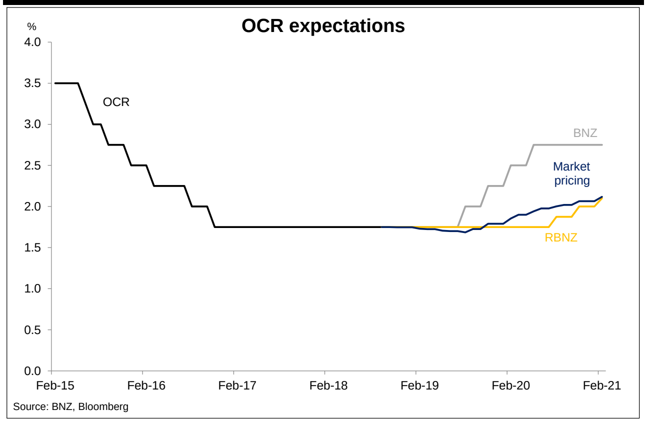
It's worth remembering that when the RBNZ last updated its projections at the August MPS, its central scenario was for the OCR to remain unchanged until the second half of 2020, with rate hikes thereafter. The RBNZ's central scenario is that the next move is a hike, but not for quite some time.

We also forecast the next move by the RBNZ being a rate hike, but in August next year. Compared to the RBNZ, we forecast a faster increase in CPI inflation to the 2% midpoint of the target range. For a start, we expect headline CPI inflation to reach 1.8% next month, above the RBNZ's 1.4% MPS forecast. The risks around our August 2019 rate hike call are tilted towards a later, rather than earlier, start date however. Recent communication from the RBNZ suggests it wants to see core inflation at, or above, target, before contemplating rate hikes.

Following the upside surprise to Q2 GDP, we think the risk of rate cuts over the next six to nine months is relatively low. We think growth would need to weaken significantly (and certainly by more than both we and the RBNZ forecast) to see rate cuts eventuate. The kind of scenario where we could envisage rate cuts would be one in which there is a global shock of some kind, such as a significant and sustained fall-out in global markets from an escalation in US-China trade tensions.

The market prices around a 25% chance of a rate cut by mid-2019, with the first rate hike priced in for mid-2020.

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

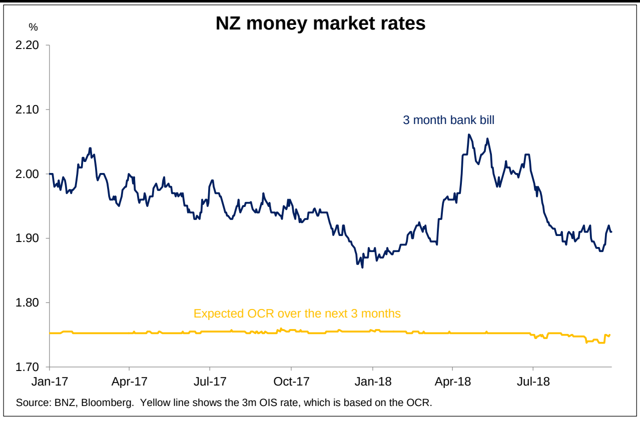


Wholesale Floating Rates

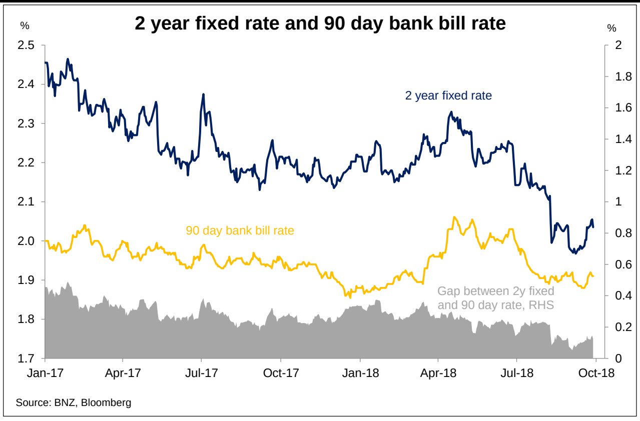
The 90 day bank bill rate has been very stable over the past two months. Our base case is the 90 day rate will remain around these levels for the coming months. First, we expect the OCR to be unchanged for some time yet. Second, we expect funding pressures to remain reasonably stable, so there shouldn't be too much movement in bank bill rates independent of the OCR.

The risks around the 90 day rate are probably tilted to the upside, due to the potential for a re-intensification of offshore funding pressures (such as we saw earlier this year). While it's not our base case, offshore funding conditions are notoriously opaque and difficult to forecast and we can't rule it out.

90-day bank bill has been stable over the last 2 months



2 year fixed rate remains at relatively low levels



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

Short-dated wholesale fixed rates remain near historic low levels, although the GDP upside surprise has seen a modest recovery from the lows seen earlier this month. The market prices around a 25% chance of a rate cut by mid-2019, with the first rate hike fully-priced for August 2020. The market prices a very 'shallow' pace of OCR rate hikes thereafter (around one hike per year).

Our base case is that short-dated wholesale fixed rates should be reasonably stable over the remainder of the year, anchored by expectations of an unchanged OCR. If anything, there is scope for some drift higher in short-dated fixed rates if the market comes to the realisation that the OCR won't be cut.

If the next move by the RBNZ is a rate hike, then one can make a reasonable case for considering short-dated fixed rate hedges. The "premium" for hedging, as implied by the difference between the 3 month bank bill rate and the 2 year fixed rate is relatively low. Short-dated fixed rate hedges offer protection against the potential for OCR rate rises later next year. Moreover, hedges also offer protection against any potential rise in the 90 day bank bill rate independent of the OCR, which could happen if funding pressures offshore flared up again.

Obviously, if NZ growth did weaken markedly, and inflation pressures ease, then market expectations of rate cuts would build quickly. And if OCR cuts did eventuate, borrowers with fixed-rate hedges would 'miss out' on lower floating rates in the future (at least until the hedges rolled off).

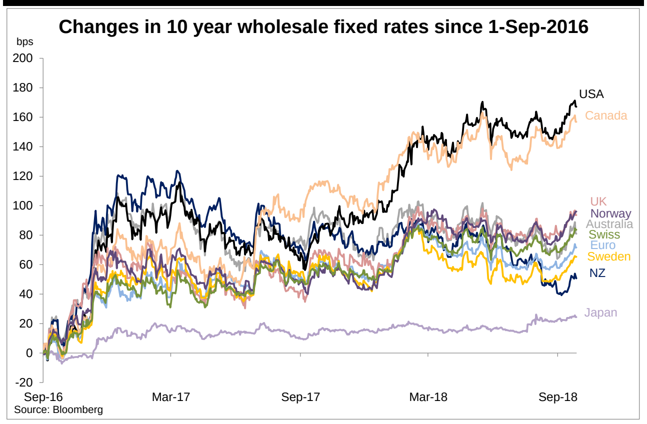
For the market to price-out the risk of rate cuts, we think it would take a succession of stronger domestic data. And as we expect the OCR to be on hold for some time yet, borrowers can probably still afford to be opportunistic with hedging levels.

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

The two major influences on longer-term wholesale fixed rates are the expected path of the OCR and movements in global longer-term yields. So far this year, these forces have moved in opposite directions, with US 10 year Treasury rates rising but OCR rate hike expectations having been pared back. The net impact has been that longer-term NZ fixed rates have declined this year.

NZ longer-term fixed rates have significantly lagged the move higher in US Treasury rates so far this year. But the chart below shows that NZ is not alone in having grown disconnected from the US. The only country which has seen increases in longer-term fixed rates on a par with the US this year has been Canada, which, like the US, has a central bank that is actively engaged in a tightening cycle.

NZ 10 year rate compared to others since Sep-2016

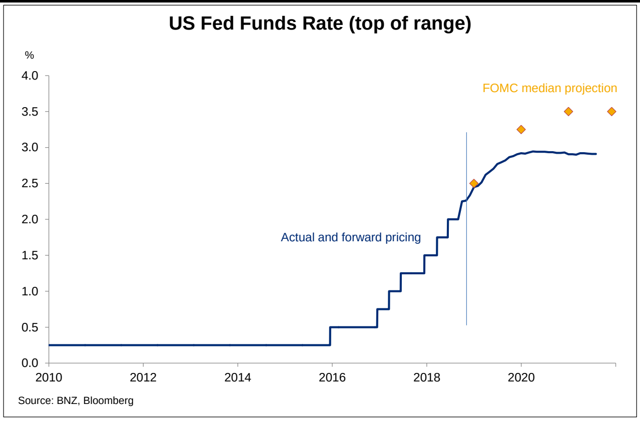


Looking ahead, provided the market comes around to the view that the next move in the OCR is higher, we expect to see NZ longer-term fixed rates gravitate higher over the coming year. We expect this to be driven both by an increase in OCR expectations and some further upward drift in longer-term US, and global rates.

In terms of the US rates outlook, we expect the market to ultimately price-in more tightening by the Federal Reserve. US job growth remains robust, and strong enough to keep exerting downward pressure on the unemployment rate, which is already near its lowest level since the late 1960s. Alongside the continued tightness of the US labour market, there has also been some pick-up in US wage inflation to its highest level since 2009.

While the bulk of the move higher in US 10 year rates is probably behind us now (as the Fed rate cycle matures), there still seems scope for some further increase in longer-term US rates if the market gravitates towards Fed officials' interest rate projections next year (as shown in the chart below). Historically, the US 10 year rate hasn't tended to peak until either the last Fed tightening, or the one preceding it.

The market prices less tightening than Fed officials forecast



There is scope for NZ longer-term fixed rates to rise more appreciably if market expectations of OCR hikes were brought forward into 2019 (the first hike is currently priced for the second half of 2020). Ultimately, we expect that to happen, but it appears more likely to play out next year than this. The other scenario where NZ longer-term fixed rates could rise more sharply is one in which there is a synchronised, global move higher in longer-term rates, say because of an acceleration in global inflation. But we're yet to see much evidence of higher global core inflation outside of the US and Canada, and to some extent the UK (which has Brexit to contend with).

The downside risks to longer-term fixed rates relate to either an increase in OCR rate cut expectations, or a turn-down in the global economic cycle, and with it lower global rates. Over the next year, we think the risks around longer-term fixed rates are tilted more towards the upside than the downside.

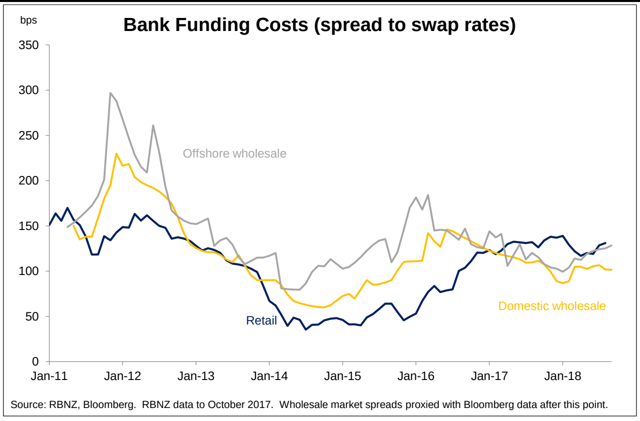
The "premium" for hedging longer-term fixed rates is larger than for shorter-dated hedges. But given our expectation for higher offshore rates over the next 12 months, and the next move in the OCR being a rate hike next year, we would look for dips in rates over the coming months to opportunistically add hedge cover.

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. Retail term deposit rates have remained very stable. Wholesale funding spreads, both in NZ and offshore, have also been reasonably stable. Our estimates of bank funding costs are shown in the chart below.

Bank funding costs have been reasonably stable



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