7 October 2021

Outlook for Borrowers: Post-October MPR

- **The RBNZ raised the OCR to 0.5% at the October MPR, as expected by economists and market participants.**
- **We expect follow-up hikes in November and February and have pencilled in the OCR getting to 2.25% in 2023.**
- **Market pricing is still below our forecast OCR path, although the gap has narrowed.**
- **Our forecasts still incorporate higher short-term fixed rates. But the risks are now more balanced.**
- **We expect higher NZ long-term fixed rates because we think global interest rates are likely to increase as other central banks get closer to tightening.**
- **Fixed rate hedges offer certainty around interest payments in an environment where floating rates are now increasing and there remains significant uncertainty around how high the OCR needs to go.**

RBNZ Update

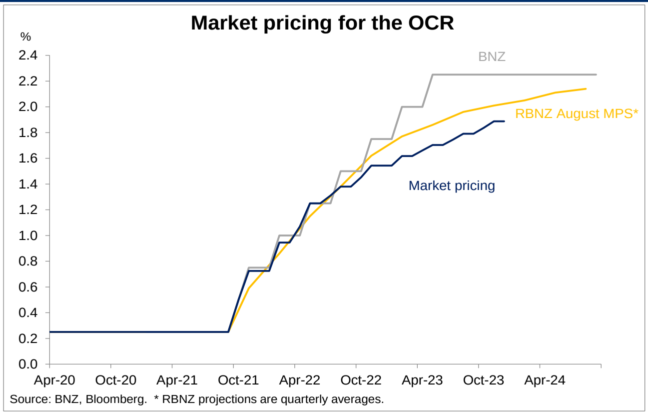
The RBNZ raised the OCR by 25bps, to 0.5%, at the MPR yesterday. This was the RBNZ's first interest rate hike since 2014. The OCR hike had been well-flagged in previous RBNZ communications, including in interviews by Governor Orr and his deputies after the August MPS, and it was universally expected by economists and priced by the market.

The ongoing lockdown in Auckland and, more recently, large parts of the Waikato, clearly didn't deter the RBNZ from raising the OCR. Indeed, the RBNZ noted that its medium-term outlook was little changed from what it was back in August. This is because the RBNZ expects economic activity to rebound strongly once restrictions are eventually removed, as happened after the original lockdown in 2020, with fiscal policy adding support in the interim. Ultimately, with core inflation above the RBNZ's 2% target midpoint (and rising) and the labour market extremely tight, the RBNZ could not justify having the OCR at 'emergency' settings of 0.25%.

The RBNZ reiterated that it expects to further raise the OCR over time, conditional, as always, on the medium-term outlook for inflation and employment. The RBNZ's August projections and post-meeting comments from Governor Orr suggest the RBNZ is planning to lift the OCR to something closer to its 'neutral' level, seen as around 2%, over the coming few years. A recent speech by Assistant Governor Hawkesby implied that the RBNZ intends to get there in 25bps increments, rather than larger, 50bps, moves.

The BNZ Research team expects follow-up 25bps OCR hikes at each of the upcoming two meetings, in November and February, with quarterly rate hikes thereafter eventually taking the OCR to 2.25% by mid-2023.

Chart 1: The market prices a high chance of hikes in Nov, Feb



The market prices the OCR to reach around 1.50% by the end of 2022 and around 1.85% by the end of 2023. This is still below the BNZ Research team's forecast path and the RBNZ's most recent projections from the August MPS, although the gap has narrowed.

There is broad agreement that the economy doesn't need an OCR this low at present. There is much less agreement around exactly how high the OCR needs to go to get inflation sustainably back to the 2% target. One key uncertainty is around how the economy will react to a series of rate hikes.

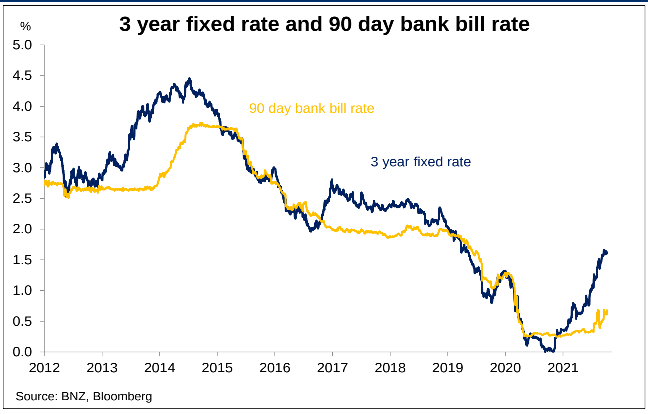
One side of the argument is that high household debt levels mean the OCR won't need to get as high as the 2% projected by the RBNZ. Certainly, rate hikes are likely to have a greater impact on household interest payments (and potentially the housing market) than in the past. The post-lockdown recovery in the economy may also be less vigorous than it was last year if Covid-19 becomes endemic in New Zealand, as seems likely, and hence the amount of monetary policy tightening required might not be as much as the RBNZ is projecting.

The other side of the argument is that the RBNZ is leaving it much later to raise the OCR this cycle than it has done in the past, potentially allowing inflation to become entrenched at higher levels. This might mean the RBNZ needs to raise the OCR above 2% to get inflation (and inflation and wage expectations) back in-line with its 2% target.

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

Short-term wholesale fixed rates recently reached fresh 2½ year highs although they are only modestly higher than they were before the last RBNZ meeting in August. Short-term fixed rates tend to increase heading into, and during the early stages of, a tightening cycle. The 90-day bank bill rate has pushed higher and will continue to do so while the RBNZ is raising the OCR.

Chart 2: New highs for short-term fixed rates



As we noted in our last update, whether short-term fixed rate hedging is financially beneficial, compared to staying on floating, depends mainly on whether the RBNZ raises the OCR by more than what is already priced by the market.

The market prices the OCR to reach around 1.50% by the end of 2022 and around 1.85% by the end of 2023. This is below what the BNZ Research team has pencilled in, which is 1.75% and 2.25% respectively. Our wholesale interest rate forecasts, which are based on these BNZ Research forecasts, have short-term fixed rates increasing by more than what the market currently prices in.

That said, with the market now pricing a significant amount of OCR hikes over the next few years, we think the risks are more balanced here. There are scenarios where the RBNZ needs to raise the OCR above the 1.85% priced by the market for the end of 2023, such as where NZ (and global) inflation stays higher for longer. But, equally, there are scenarios where the RBNZ doesn't end up raising the OCR this high, for instance if consumer spending slows sharply in response to rate hikes and endemic Covid-19.

Since we see the risks around short-term fixed rates as being more balanced, the decision to hedge or not will come down, in part, to borrowers' preference for having stability and certainty in interest payments. This is more likely to be a key consideration for borrowers with larger debt loads.

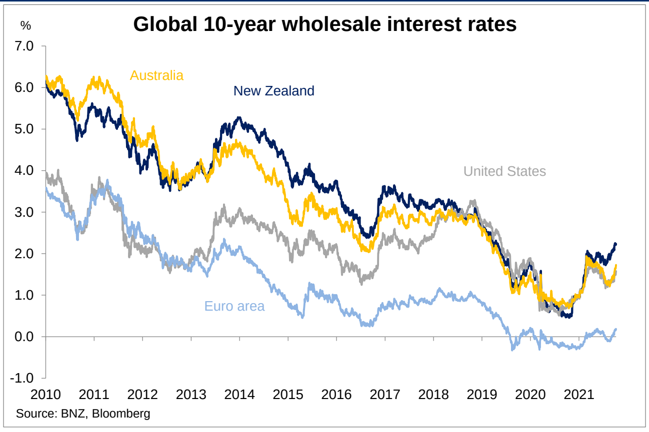
Another consideration for borrowers is the correlation between business income/profit and interest rates. The consequences of higher interest rates are likely to be less troublesome for borrowers with highly cyclical business models (with revenues correlated to the OCR) and for those businesses which can more easily pass on cost increases.

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

Long-term New Zealand wholesale fixed rates have also reached fresh multi-year highs in recent weeks. This largely reflects the recent pickup in global long-term interest rates and, to a lesser extent, the increase in the market's near-term OCR rate hike expectations.

The recent increase in global rates has occurred against a backdrop of continued higher than expected inflation. US core inflation is at its highest level since the early 1990s while headline inflation in Europe is above 3%, its highest level since late 2008. In the UK, headline inflation is expected to top 4% later this year.

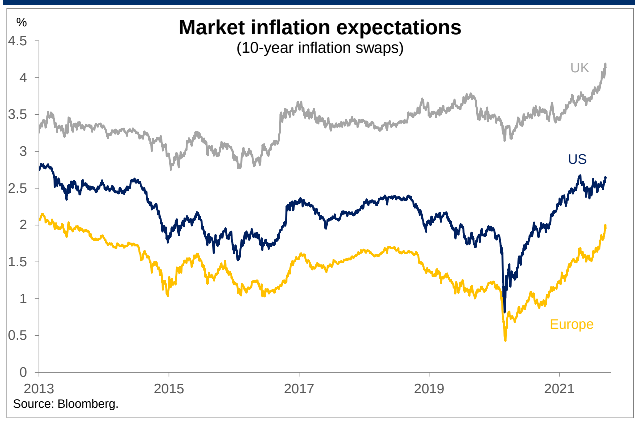
Chart 3: NZ 10-year rate makes fresh multi-year high



The market's inflation expectations have noticeably picked up in Europe and are trading near multi-year highs in the US.

There are several factors at play here, including supply-chain disruptions (e.g. shortages of semiconductors) and extremely high shipping and transportation costs. Added to that, energy prices, especially natural gas and coal, have exploded higher over the past few months, most visibly in Europe. Underlying inflation and wages are also picking up, albeit nowhere near as dramatically as headline inflation. Fed Chair Powell acknowledged that inflation has been higher than expected although the Fed continues to run the line that most of the inflationary pressures are eventually expected to be "transitory" and will ease when supply chains normalise. The verdict is still out on that one.

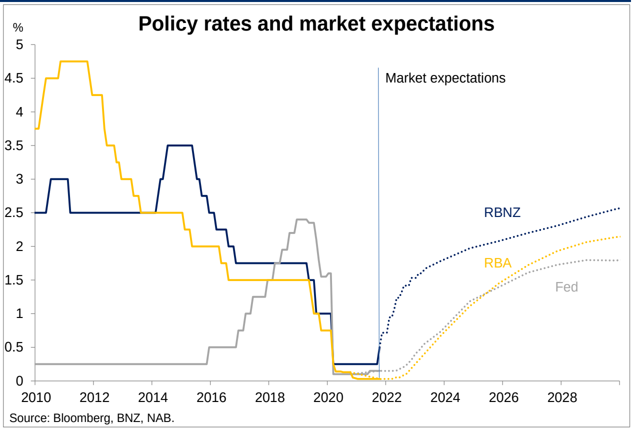
Chart 4: Inflation expectations on the rise



Against this backdrop, central banks have started to turn more hawkish. In September, the Fed indicated that it expects to start tapering its large bond buying programme later this year, with its purchases expected to end by the middle of 2022, clearing the path for a rate rise after this point. Furthermore, 9 of the 18 committee members were seen to favour a rate increase in 2022, up from 7 previously, with the median official seeing 75bps of rate increases in both 2023 and 2024. In the UK, the Bank of England pointed to some modest tightening being required, with markets now pricing a chance of this later this year. In contrast, the Reserve Bank of Australia continues to suggest rate hikes are unlikely before 2024, although the market expects rate hikes earlier than this, while the European Central Bank, which has been struggling with too-low inflation for years, remains dovish.

While they have increased recently, global long-term interest rates remain very low by historical standards because markets think central banks will be slow to increase their cash rates and/or won't need to raise rates particularly far. For instance, the market expects the Fed's cash rate to only reach around 1.75% in 5 to 10-years' time, well below the levels reached in the last cycle.

Chart 5: Markets price the OCR to eventually get back above 2.5%



Our core view is still that global interest rates will move higher from here as the global recovery continues, inflationary dynamics remain strong, and offshore central banks get closer to (and eventually start) raising rates.

The main upside risk to global rates is still inflation, and the risk that it remains elevated for a prolonged period, eventually leading to more aggressive tightening from central banks. Even if central banks are slow to tighten, if markets worry about inflation remaining high for an extended period, long-term interest rates are likely to rise to reflect higher inflation risk premia (since inflation erodes the real purchasing power of bond holders).

Downside risks to global rates include a slowdown in global growth, with markets particularly attuned to the risks around China's economy in particular, the potential for new Covid-19 variants (especially if one were vaccine resistant), and a faster than expected normalisation in inflation pressures, which would take some pressure off central banks raising rates. But, given where global long-term rates are (still very low), we think the risks are skewed to the upside from present levels.

New Zealand long-term rates have a head start on most other advanced economies because the market prices much more tightening for the RBNZ than it does for other major central banks. Hence, while we think New Zealand long-term rates are likely to follow global trends and head higher from here, we suspect they will rise by less than global peers such as Australia and the US. Given they start from a higher level, the risks around long-term New Zealand rates are not as clearly skewed to the upside as they are for other countries.

With the market pricing the OCR to eventually get to around 2.50% in 5 to 10-years' time, some borrowers may be wary about locking in at current long-term fixed rates.

However, the longer-term outlook, especially for inflation, remains very uncertain and some borrowers will value having the certainty around interest payments that long-term fixed rate hedges provide.

Bank funding

Bank funding costs remain low by historical standards. Term deposit rates have picked up, but by less than wholesale interest rates for terms out to 12 months, while banks have accumulated significant transaction and savings balances, which pay lower (in some cases 0%) interest rates. The cost of wholesale debt issuance is relatively low. And the RBNZ's Funding for Lending Programme (FLP), continues to offer cheap three-year loans to banks, albeit with the cost linked to a now rising OCR.

While bank funding costs may remain low in the near-term, we would expect to see some upward pressure in the medium-to-long term as the RBNZ's FLP comes to an end (initial allocations close in June 2022 and additional allocations in December 2022) and as the RBNZ runs down its large LSAP bond portfolio (the first major bond maturity is in 2023). Also on the horizon from mid-next year is the planned phasing in of the RBNZ's new bank capital rules. These will require banks to hold more high-quality capital which will increase the cost to banks of providing credit, all else equal.

Chart 6: TD rates ticking higher, wholesale bank spreads steady

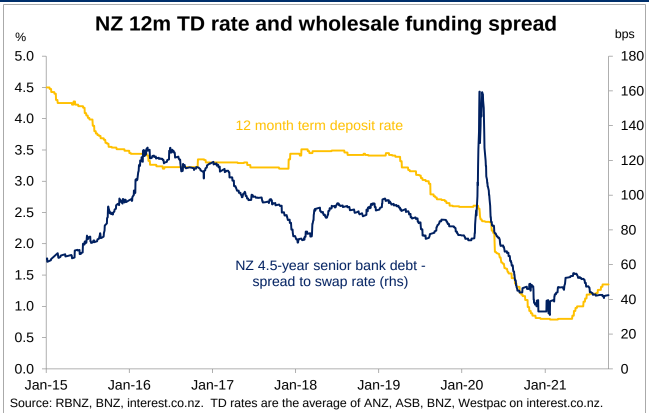
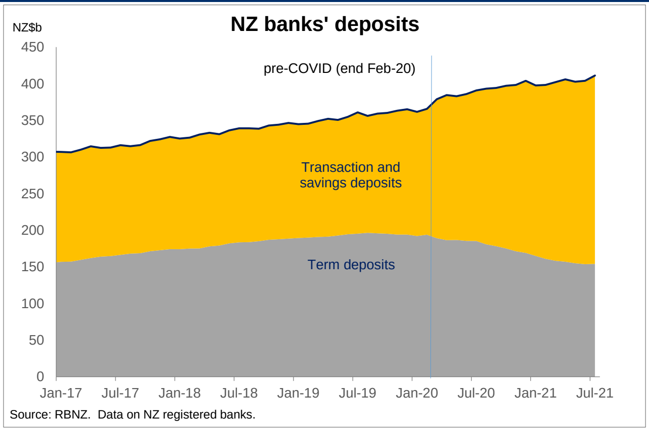


Chart 7: Transaction, saving deposits increase sharply post-Covid



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