Interest Rate Research

23 May 2024

Outlook for Borrowers: Post May MPS

- **The RBNZ left the cash rate unchanged at 5.5% at the May MPS which was unanimously expected by economists.**
- **The Bank notably strengthened its hawkish bias citing stubborn domestic inflation pressures. Its modelled cash rate track, which now peaks at 5.65% in December, implies a higher chance of a rate hike, relative to the February Statement.**
- **We continue to think that 5.5% will mark the peak OCR level for the cycle. However, recognising the strong RBNZ messaging, we have pushed back our forecast for the first rate cut from November to next February.**
- **Despite the hawkish tilt, we expect that wholesale rates are likely to trade within recent ranges. Dips towards 4.80% (2-year fixed) and 4.30% (5-year fixed) offer opportunities to top up hedging.**
- **The turn in the global interest rate cycle – developed market central banks are expected to begin a synchronised easing cycle in H2-2024 – suggests lower fixed rates over the medium term.**

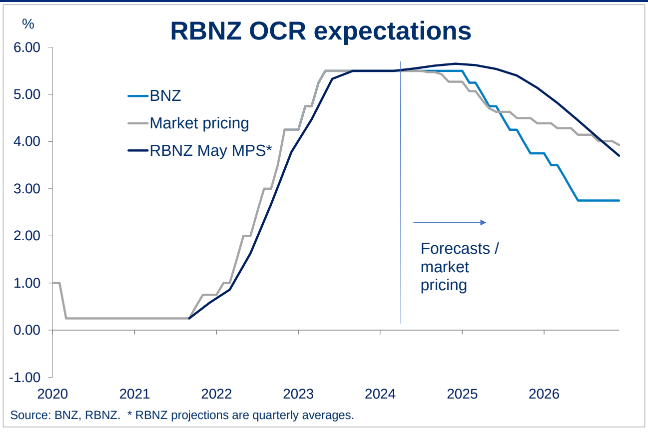
RBNZ Monetary Policy Statement

The RBNZ left the Official Cash Rate (OCR) steady at 5.5% at the May Monetary Policy Statement. However, the Bank upgraded its hawkish bias, referencing domestic inflation pressures, which have fallen more slowly than it had expected. The RBNZ raised its modelled cash rate track, which now peaks at 5.65% in December, implying a higher probability of a further rate hike, relative to the February Statement. As a result, the first projected rate cut has been pushed back to H2-2025. Although the Committee reached a consensus decision to leave rates on hold, a hike was discussed.

The hawkish pivot reflects the Bank's view that the near-term balance of risks around inflation are skewed higher. It highlighted there is limited room for upside surprises and the slow progress on non-tradable inflation, which declined less than expected in Q1, and is still elevated at a 5.8% annual rate. The Budget was also highlighted as a risk for the monetary policy outlook. In updated inflation forecasts, headline CPI inflation doesn't return into the 1-3% target band until December, a quarter later compared with February.

Although the RBNZ's growth forecasts have been downgraded, so have productivity growth assumptions, reducing the size of the forecast negative output gap and the associated downward pressure on inflation. The RBNZ also increased its estimate of the long-run nominal neutral OCR by 25bps to 2.75%, reflecting the Bank's suite of indicators. The Committee reiterated that the OCR needs to stay at a restrictive level, for an extended period, to ensure that inflation returns to the target range.

RBNZ higher for longer OCR profile



Source: BNZ, RBNZ. * RBNZ projections are quarterly averages.

BNZ OCR forecast update

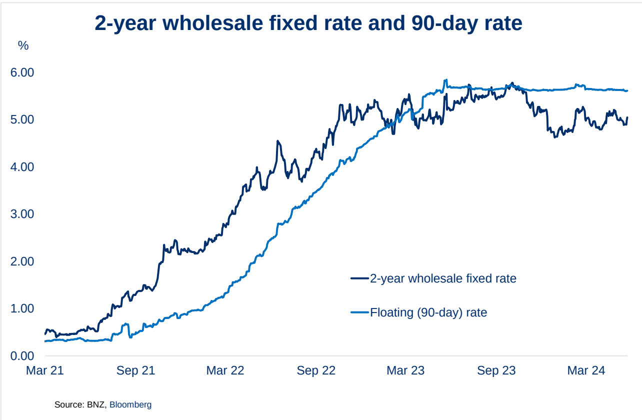
We continue to think that the OCR has peaked for the cycle at 5.5%. Policy settings are restrictive – the cash rate is well above the updated estimate of the long run neutral OCR – and previous hikes are still transmitting through the economy. We also expect the RBNZ will lower rates ahead of what is implied by its updated OCR track. However, given the statement yesterday, we have pushed back our forecast for the beginning of the easing cycle from November to next February.

Despite the distinct change in the RNBZ's tone from the April Monetary Policy Review, we think there is a high hurdle for a further hike. The unemployment rate increased to a 3-year high of 4.3% in Q1 and leading indicators point to a further rise - we forecast 5.5% by mid-2025. Business activity is significantly depressed. The composite PMI, covering manufacturing and service sectors remains in contractionary territory, and suggests downside risks to our already below-trend GDP forecasts. Core inflation is still falling, and we forecast annual headline CPI inflation will be back within the RBNZ's target band in the third quarter of this year.

The main risk to our OCR forecast is persistent inflation - the RBNZ has indicated it has limited patience for further upside surprises. Q2 CPI is released mid-July and the evolution of inflation expectations, which have been falling, are also important. The MPS also highlighted the Government's fiscal policy as a key uncertainty for monetary policy, ahead of the Budget Economic and Fiscal Update next week.

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

2-year fixed rates: Rangebound before lower

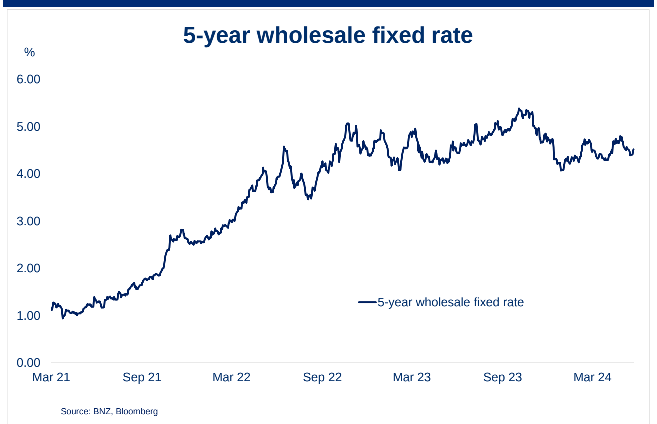


Short-dated wholesale fixed rates have generally been range-bound in 2024. Moves in 2-year fixed rates up towards the top end of the range in the 5.2%-5.3% region have quickly reversed lower. The market has been reluctant to price less than one 25bps RBNZ rate cut by year-end, given the weak economic backdrop and expectations for a further moderation in inflation. The bottom end of the range corresponds with the March lows at 4.8%.

We estimate fair value for 2-year fixed rates close to 4.90%, not far below current market levels. This incorporates our baseline OCR scenario of a first rate cut at the February MPS, and a series of 25bps cuts at each RBNZ policy review meeting, taking the OCR to 3.0% by the June quarter in 2026. An alternative scenario, where the RBNZ begins the easing cycle at the November MPS, which certainly can't be discounted, would imply fair value closer to 4.70%.

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

5-year fixed rates: Biased lower over medium term

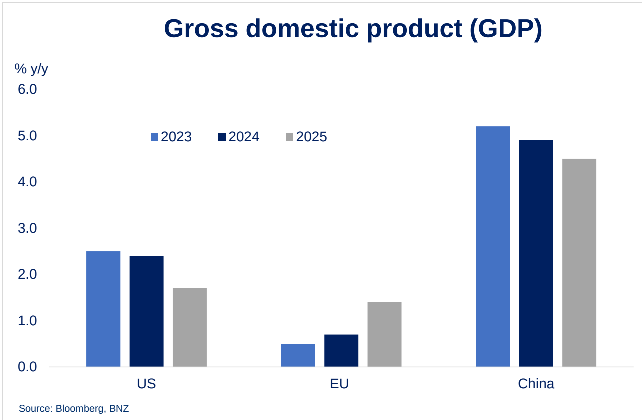


As we outlined in the April edition of the *Outlook for Borrowers*, we think levels around 4.80% are attractive to top up 2-year fixed rate hedging, for those with sub-3-month time horizons. For those with more flexibility on timing, we favour keeping hedge levels towards the lower end of policy bands and expect that 2-year fixed rates will decline into a lower range later this year.

5-year NZD fixed rates peaked near 4.8% in late April, and have since retraced towards the mid-point of the 4.30%-4.80% trading range, that has contained price action in recent months. The yield decline can mainly be attributed to global factors. US economic activity has consistently surprised on the downside relative to expectations during the past month – the Citibank index of economic surprises is at the weakest level in two years – and after three consecutive upside surprises, April CPI data reassured investors that inflation was not accelerating.

Although US activity data have been softer than expected, there are few indications that this is a precursor for a more pronounced slowdown. The median consensus forecast for 2024 US GDP has been consistently upgraded and is now 2.4%, up from 1.3% in January. After the series of upside surprises to inflation prints through Q1, Fed officials have pushed back against the prospect for near term easing and have indicated they will need to see evidence of a sustained move toward its 2% inflation target before cutting rates.

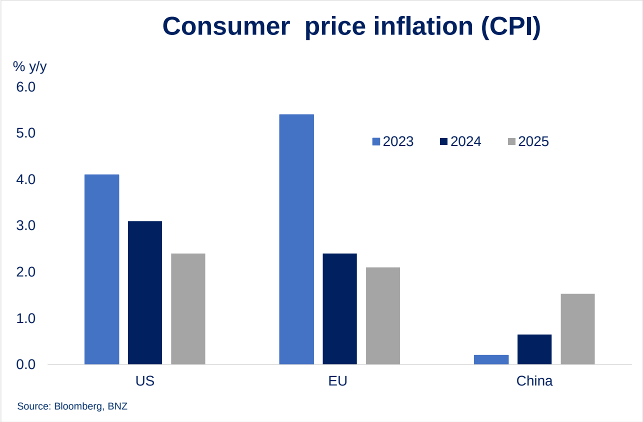
Consensus forecasts - subdued growth outside of the US



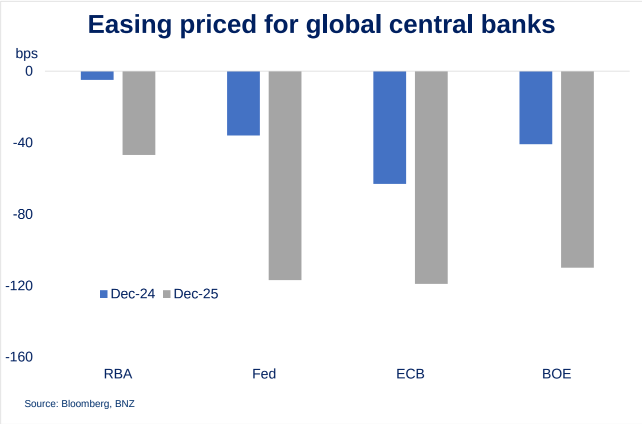
The extended period of restrictive monetary policy settings is expected to weigh on aggregate demand. Moderating growth and further progress on inflation should allow the Fed to begin easing by the September quarter. While there are differences across regions, global growth is expected to remain subdued. The number of developed market central banks easing monetary policy is likely to pick up through the second half of this year.

Our view is the central banks are biased towards easing and the outlook for global and NZ longer dated wholesale fixed rates is skewed lower. However, the downside in rates will be constrained by the amount of easing already priced, and a widespread expectation that long-term neutral policy rates, are higher than levels that prevailed in the decade following the Global Financial Crisis.

Consensus forecasts - inflation slowly moderating



Market pricing for central bank rates



For those hedgers with flexibility on timing, we think better levels can be achieved by waiting to implement longer-dated hedging. In the case where cover is required in shorter time frames, we continue to think levels towards the base of the recent range at 4.3% is an attractive level to increase hedge levels.

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