11 July 2024

Outlook for Borrowers: Post July MPR

- **The RBNZ left the cash rate unchanged at 5.5% at the July MPR which was unanimously expected by economists.**
- **However, the accompanying statement showed a distinct change in tone from May, and seemingly opens the way for a lower OCR in coming months.**
- **There was no discussion of a rate hike, and the Bank noted that restrictive monetary policy has 'significantly reduced consumer price inflation'.**
- **We have updated our OCR forecast post-MPR and expect the easing cycle will begin in November. However, an earlier rate cut cannot be ruled out.**
- **The market is pricing the first 25bps rate cut by October, and close to 60bps of easing by November.**
- **The extent of RBNZ easing priced by the market could limit the near-term downside for 2 and 5-year fixed rates.**
- **Current levels are attractive to top up fixed rate exposure.**
- **Global central banks, including the RBNZ, are at the beginning of a synchronised easing cycle, which suggests lower fixed rates, over the medium term.**

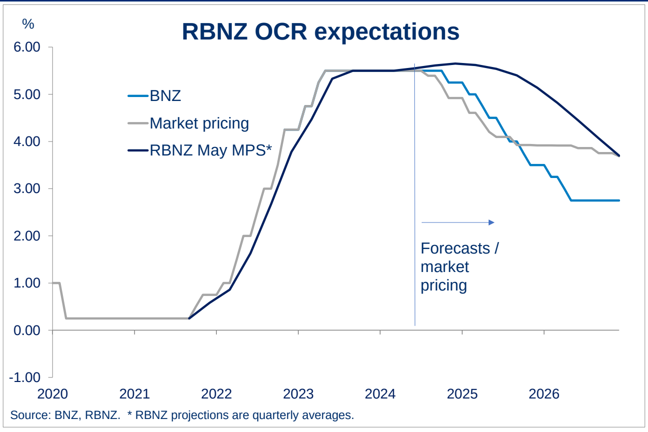
RBNZ Monetary Policy Review

The Reserve Bank of New Zealand (RBNZ) held the Official Cash Rate (OCR) steady at 5.5% at the Monetary Policy Review (MPR) on Wednesday. The statement accompanying the expected 'on hold' decision represented an overhaul in the Bank's hawkish stance from the May Monetary Policy Statement (MPS). Unlike May, a rate hike wasn't discussed, and it was noted that restrictive monetary policy has 'significantly reduced consumer price inflation'.

The RBNZ expects headline inflation to return within its target band in the second half of this year. The risks on the inflation outlook were seen as two-way, and indications of growing excess capacity in the domestic economy, is providing the Bank greater certainty that persistent domestic inflation measures will decline.

The Monetary Policy Committee (MPC) agreed that monetary policy will need to remain restrictive but dropped 'for a sustained period' which featured in previous statements. In a dovish development, the MPC outlined the extent of restrictive policy 'will be tempered over time consistent with the expected decline in inflation pressures'. Overall, the key message from the statement is the Bank's assessment of the economy and inflation risks have evolved, increasing the probability of easing this year.

Market pricing for the OCR path

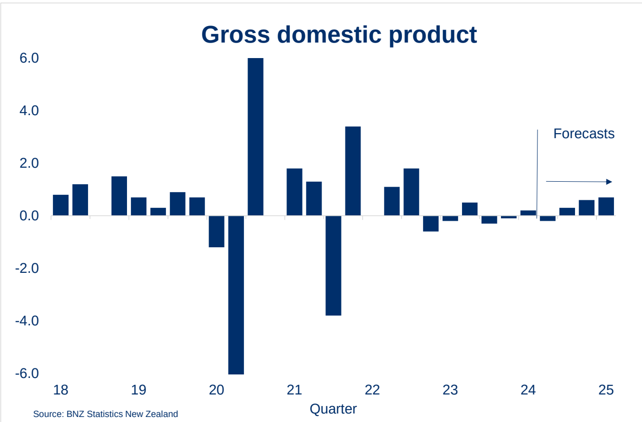


Source: BNZ, RBNZ. * RBNZ projections are quarterly averages.

Economic overview

The New Zealand economy is in a protracted period of stagnation. The composite PMI, covering private-sector services and manufacturing sectors, reached a record low in May after excluding pandemic volatility. Notably, the index is below levels reached in the Global Financial Crisis. Restrictive monetary settings are weighing on activity. A 5.5% cash rate is well above neutral according to estimates from the RBNZ's suite of models.

NZ economy in protracted recession

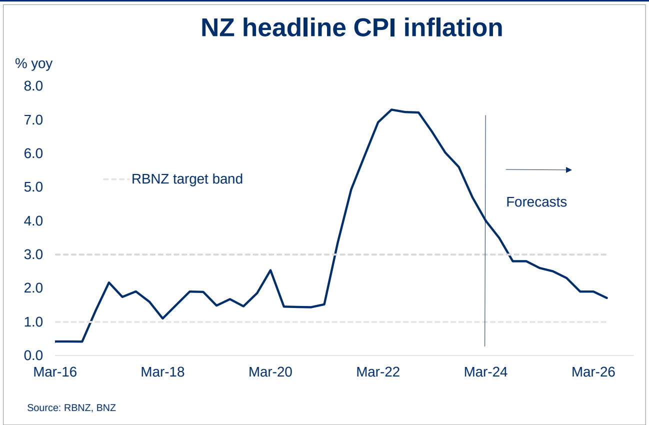


Source: BNZ Statistics New Zealand

Although the economy expanded modestly in Q1, it has contracted in four of the last six quarters and timely monthly data suggest the recession deepened in Q2. Economic activity at the end of the March quarter was still 0.5% lower than September 2022. The labour market is cooling rapidly. The unemployment rate has risen to 4.3% and leading indicators point towards a further sharp increase – we estimate to 5.5% by mid-2025 – which will put downward pressure on wages.

We forecast headline inflation will fall to 3.5% in Q2 and back inside the central bank's 1-3% target band in Q3 (the data is released in October). Pricing intentions in the Quarterly Survey of Business Opinion are consistent with CPI returning to well inside the band. The RBNZ has focused on domestically driven, non-tradables inflation which has been slow to retrace. Further signs of progress on this measure – excluding the double-digit gains for local authority rates and insurance, which are outside the RBNZ's control – will give the Bank greater confidence to push ahead with an easing cycle.

Headline CPI expected back in RBNZ's target band in Q3



OCR forecast

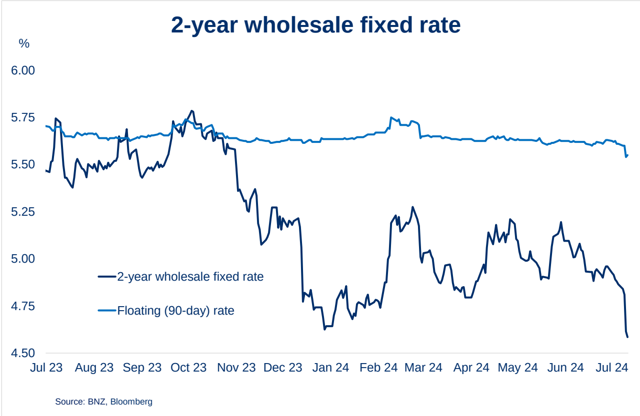
After the dovish messaging from the MPR, we have reverted to our previous forecast and expect the RBNZ to begin to ease policy in November, with a 25bps cut to the OCR. We see risks to our baseline scenario as skewed towards an earlier start to the easing cycle or a larger 50bps rate cut if the Bank delays easing until November, should the woeful run of economic activity data continue. After the cycle begins, we expect sequential cuts at each meeting, taking the OCR to 3% by Q2-2026.

Key domestic economic data that could impact the outlook ahead of the MPS on August 14 are Q2 CPI next week and labour market data on 7 August. Overnight interest rate swaps (OIS) are pricing the first 25bps cut by October and close to 60 bps of easing by November. We think the market will face increasing headwinds to pricing further rate cuts, unless there is a downside surprise in the inflation data, and particularly the non-tradables component, relative to the RBNZ's May projections.

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

Short-dated fixed rates have moved steadily lower since the spike to the top end of the trading range – close to 5.20% - following the hawkish May MPS. The sharp move lower after the MPR has seen 2-year fixed rates dip below the January lows at 4.60%.

2-year fixed rates back at January lows



Based on our OCR projections, we estimate fair value[1] for 2-year NZD fixed rates to be near 4.50%. This is not far below the current market. That said, risks are skewed towards an earlier start to the easing cycle relative to our baseline scenario. For example, if the RBNZ began to cut rates in August, and followed our forecast profile with sequential 25bps adjustments at each meeting, we estimate fair value for 2-year fixed rates is closer to 4.15%.

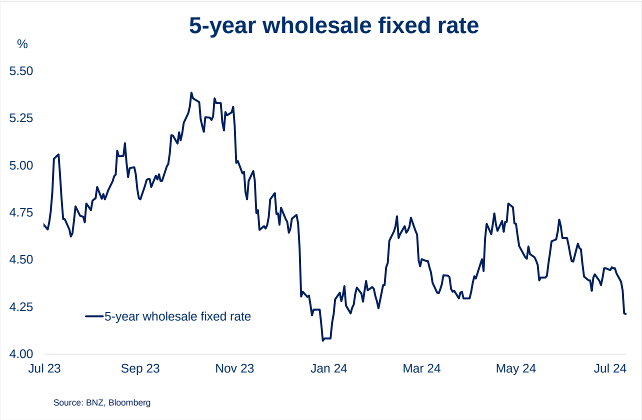
We think the sharp move lower in fixed rates provides an opportunity for borrowers. While rates are asymmetrically skewed lower over broader time frames, it is prudent to top up fixed rate exposure at current levels. Short dated fixed rates are trading well below the 90-day floating rate, and could limit the extent of further moves lower in the near term, with some caution required ahead of CPI data due next week.

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

In the aftermath of the MPR, 5-year NZD fixed rates have fallen to the lowest level since the start of the year, down towards 4.20%. The drivers of longer dated NZD fixed rates are typically a combination of domestic monetary policy and global macro factors. Although the directional moves have broadly aligned, the very weak domestic economy has contributed to a narrowing in interest rate differentials between NZ and comparison markets like the US and Australia.

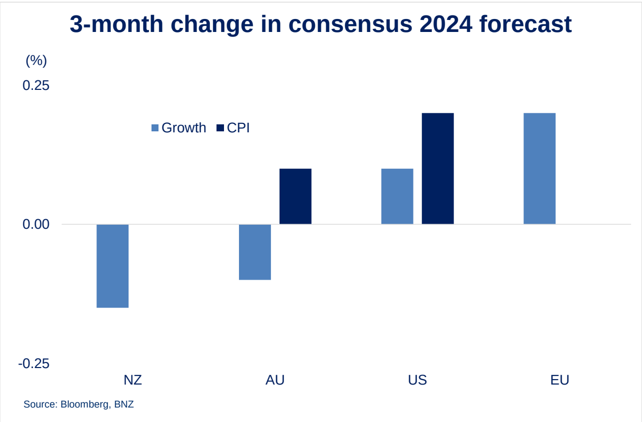
[1] Fair value refers to the fixed rate level where a borrower would be theoretically indifferent between paying floating and fixed based off the discounted cashflows.

5-year fixed rates fall towards 4.20%



The global interest rate cycle has definitively turned. After the most aggressive and synchronised tightening cycle in a generation, the focus for major developed central banks has shifted to the timing, pace and magnitude of rate cuts from what are restrictive policy settings. The European Central Bank began its easing cycle in June and the US Federal Reserve appears on track to follow later this year.

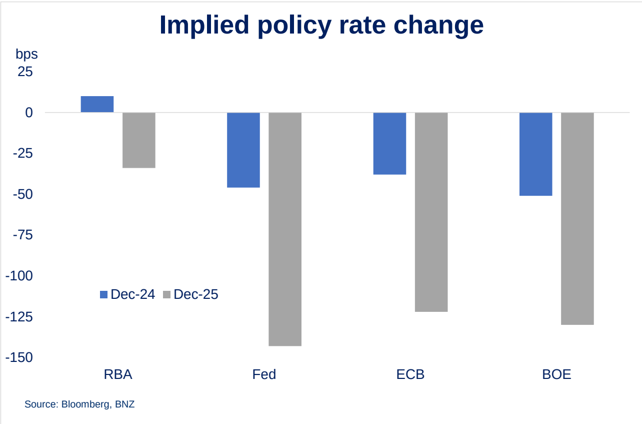
Evolution of 2024 consensus economic forecasts



There hasn't been a material shift in consensus growth or inflation forecasts over the past three months to fundamentally alter the outlook for longer-term fixed rates. The upward revisions to US growth forecasts, while positive, have stabilised relative to earlier in the year. Furthermore, recent US activity data has been surprising on the downside, relative to expectations, suggesting the economy is cooling more than expected, perhaps due to the lagged impact of tight monetary policy. The US unemployment rate increased for a third consecutive month in June, and is more than 0.5% above the cycle low it set early last year.

After a series of upside surprises in Q1, the most recent US inflation readings have been more favourable, and Fed Chair Powell said there has been modest further progress toward the central bank's inflation objective. However, US policy makers will need to see more evidence that inflation is moving sustainably towards its 2% target to cut rates. We expect the Fed will reduce rates at its September meeting.

Significant central bank easing already priced



A synchronised easing cycle by major central banks will likely result in longer dated fixed rates moving to a lower trading range later this year. However, this interest cycle is atypical, given the extended period of yield curve inversion and the amount of easing already priced. This will limit the extent longer dated rates can fall, absent an economic recession or crisis. Alongside lower global long-term fixed rates, we anticipate NZD 5-year rates will move into a lower 3.75%-4.25% range over the medium term.

For those borrowers with shorter time frames, current levels towards the yield lows for the year are an attractive level to increase longer dated fixed rate exposure.

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