15 August 2024

Outlook for Borrowers: Post August MPS

- **The RBNZ cut the cash rate by 25bps to 5.25% at the August MPS and made significant downward revisions to its projected OCR track. Furthermore, a reduction by 50bps was discussed by the Committee at this meeting.**
- **The RBNZ's modelled OCR track implies it will make 25bps rate cuts at both remaining policy meetings this year and the easing cycle will take Cash Rate below 4% by the end of 2025.**
- **The Policy Statement noted headline inflation is returning to the Bank's target band and weak activity is contributing to spare capacity in the economy.**
- **Our OCR forecast is unchanged. We expect sequential rate cuts at each policy review, taking the cash rate to 3.0%, by the end of 2025.**
- **The extent of RBNZ easing already priced by the market will likely limit the downside for fixed rates. After the recent decline, current levels are attractive to top up 2 and 5-year 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 Statement

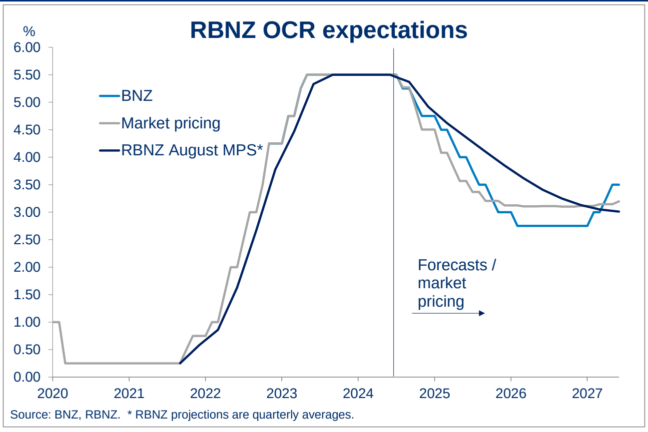
The Reserve Bank of New Zealand (RBNZ) cut the Official Cash Rate (OCR) by 25bps to 5.25% at the Monetary Policy Statement (MPS) on Wednesday. Although the consensus expected rates to remain steady, a significant minority including the BNZ, forecast a 25bps cut. The overnight index swap (OIS) market was pricing an approximate 70% chance of 25bps cut ahead of the decision.

The RBNZ significantly decreased its modelled Cash Rate track relative to the May MPS. It now declines to 4.90% by December 2024, and 3.85% by December 2025, on a quarterly average basis. The new track indicates a frontloaded easing cycle relative to Bank's projections from May. Although the Monetary Policy Committee (MPC) reached a consensus decision, Governor Orr said a larger 50bps OCR cut was also considered.

The statement accompanying the decision outlined that weak domestic activity has become 'more pronounced and broad-based'. The Bank noted that headline inflation has declined, and recent indicators provide confidence that inflation will return sustainably to target within a reasonable time frame. The Bank's inflation projections have been revised lower and its GDP and unemployment forecasts have been adjusted to reflect a weaker outlook. The forecast output gap is assessed to be more negative than was assumed in May given the material weakening in domestic activity in recent months.

Overall, the key message from the MPS is the RBNZ is more cognisant of weak economic activity and confident that inflation is moving sustainably back to its target range. According to the Bank, 'The pace of further easing will depend on the Committee's confidence that pricing behaviour remains consistent with a low inflation environment, and that inflation expectations are anchored around the 2% target.'

Expected OCR path



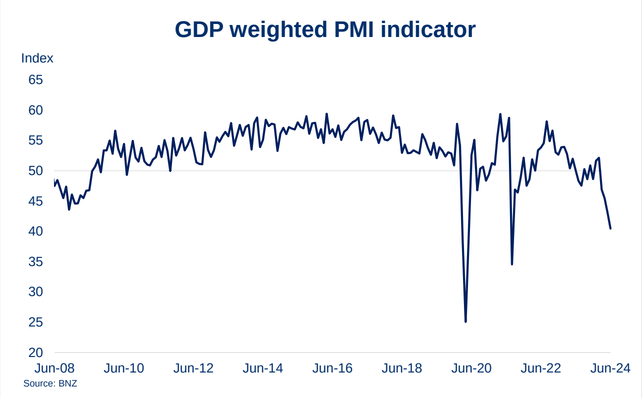
Source: BNZ, RBNZ. * RBNZ projections are quarterly averages.

Economic overview

The NZ economy remains very weak as restrictive monetary settings weigh on activity. GDP has contracted in four of the past six quarters in a protracted recession, which is even more notable, when set against the backdrop of strong population growth. We expect Q2 GDP data, released next month, will reveal the economy has contracted further with risks skewed towards the downside relative to our pick of -0.3% for the quarter.

Private sector business activity is significantly depressed. The composite PMI is at the lowest level since the series began in 2007, when the volatile pandemic period is excluded. The labour market has continued to cool. The unemployment rate increased to a three year high of 4.6% in Q2, and looks set to continue to rise further, while job ads have fallen 32% on an annual basis. Employment lags the economic cycle and weak activity points to more labour market slack ahead - we forecast a 5.5% unemployment rate by mid-2025 – which will put further downward pressure on wages.

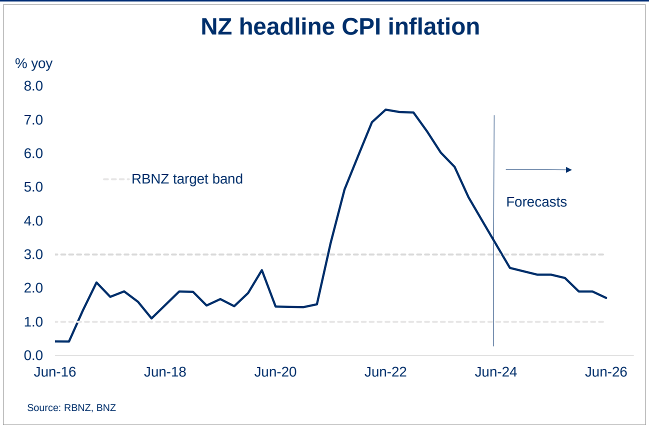
Composite PMI below Global Financial Crisis levels



Headline CPI fell to a 3.3% annual rate in Q2 from 4.0% in Q1. We forecast inflation will be back inside the central bank's 1-3% target band in Q3. This is consistent with pricing indicators from the July Quarterly Survey of Business Opinion (QSBO). Core inflation measures have also trended lower and are heading towards target.

In addition, 2-years-ahead inflation expectations have fallen to 2.0%. This series peaked at 3.6% at the end of 2022 and has now returned to levels that prevailed ahead of the pandemic. This suggests some of the sticky non-tradables inflation within the basket, like local council rates and insurance, are not impacting broader expectations.

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



OCR forecast

Our OCR forecast is unchanged post-MPS. We expect sequential 25bps rate cuts at each policy review, taking the cash rate to 3.0%, by the end of 2025. Given monetary policy remains restrictive, and the MPC discussed a 50bps cut at the meeting, this suggests risks of a larger than 25bps adjustment at any of the upcoming meetings.

Key domestic economic data that could impact the outlook ahead of the October MPR are Q2 GDP data in September and the QSBO at the beginning of October. Monthly inflation partials and the various measures of inflation expectations will also be closely monitored.

Overnight interest rate swaps are pricing ~75bps of easing across the October and November meetings, taking the OCR to ~4.5%, by the end of 2024. Market pricing implies the OCR will trough slightly above 3% by the end of 2025 and remain there through 2026.

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

2-year fixed rates back at January lows

Short-dated fixed rates have moved sharply lower since the RBNZ's Policy Review in July. 2-year fixed rates traded below 4%, the lowest level in more than two years, at the beginning of August. Fixed rates have continued to decline following the MPS with 2-year rates approaching 3.9%. We think the sharp move lower provides an opportunity for borrowers to top up hedging as the market has already priced a move back towards a 3% OCR by the end of 2025.

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

5-year NZD fixed rates fall towards 3.70%

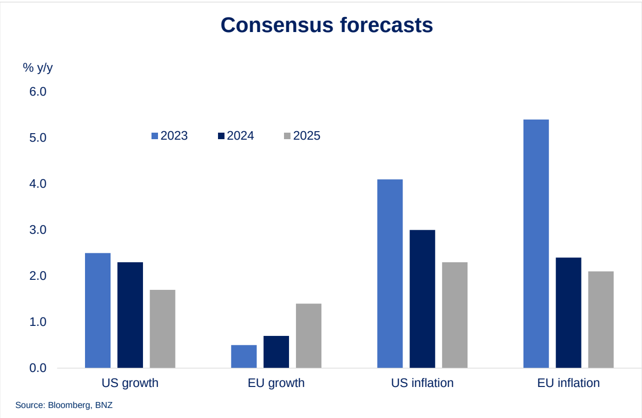
5-year NZD fixed rates fell towards 3.7% in early August, aligned with the recalibration in expectations for RBNZ easing, and the move lower in global rates. Longer dated NZD fixed rates are more sensitive to the global macro backdrop, relative to front end rates, which are anchored by the OCR. Since the local peak in May, longer dated fixed rates have declined as markets have priced in larger easing cycles for the US Federal Reserve (Fed) and other major central banks.

US inflationary pressures have been benign in recent months. This is providing US policy markers with increasing confidence in the disinflation process. The core PCE deflator, which is the Fed's preferred inflation measure, declined to a 2.6% annual rate in June and is expected to fall further towards the central bank's 2% target during 2025.

There have been further signs of cooling in the US labour market. The unemployment rate unexpectedly increased to 4.3% in July. The move higher triggered the widely followed 'Sahm rule' recession indicator - which occurs when the 3-month average jumps more than 0.5% in a year – and raised concerns about the health of the US economy. We expect slower growth through H2, but do not forecast a recession.

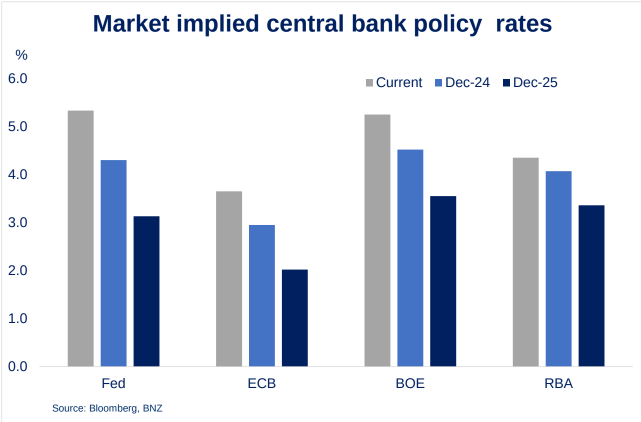
The Fed left rates on hold at the July FOMC but signalled it is getting closer to lowering policy rates. Monetary policy works with a lag and the tightening cycle is still impacting the economy. The rise in the unemployment rate will likely accelerate the Fed's easing cycle. We forecast a 50bps cut at the September FOMC and a cumulative 100bps of cuts before the end of the year.

Subdued growth and moderating inflation



Most developed market central banks, except for the Bank of Japan, are expected to embark on, or continue, an easing cycle this year set against the backdrop of subdued growth and moderating inflation. While we think longer dated fixed rates will maintain current lower levels, the extent of easing already priced, could limit the downside. We expect larger falls in shorter maturity fixed rates, relative to longer dated rates, due to policy rate cuts and the likelihood that term premia will rise in longer rates over time.

Market pricing for central bank policy rates



According to market pricing, the OCR is expected to base close to 3% in Q2-2026. 3% corresponds with the midpoint of the RBNZ's suite of long run neutral OCR[1] models. The average OCR in the 2010 – 2020 period was ~2.5% or near 0% in real terms when using 2-year ahead inflation expectations. There is a broad consensus that the neutral OCR is higher relative to the decade after the Global Financial Crisis.

With an easing cycle that takes the OCR back to the RBNZ's estimate of neutral, this limits the scope for lower NZD longer dated fixed rates, absent an economic recession or crisis. With this in mind, we think current levels represent attractive levels to top up longer dated fixed rate hedging.

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[1] A level of the OCR that neither stimulates nor dampens the economy.

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