10 October 2024

Outlook for Borrowers: Post October MPR

- **The RBNZ cut the cash rate by 50bps to 4.75% at the October MPR, which was in line with consensus expectations, and largely discounted by market pricing.**
- **The accompanying statement outlined that the economy is largely evolving in line with the Bank's August projections. CPI is converging toward the 2% midpoint of the target band, activity is subdued, and the economy is in a position of excess capacity.**
- **The respective benefits of a 25bps and a 50bps rate cut was discussed with the latter preferred in part to avoid market volatility.**
- **We expect the RBNZ will follow up with a further 50bps rate cut at the November MPS.**
- **The market continues to price a front-loaded easing cycle, and a terminal OCR near 3.0%, which broadly aligns with our interest rate forecasts.**
- **Short end fixed rates will continue to move lower as the easing cycle progresses, but this is already discounted by the market. We think there is limited downside for long-term fixed rates and that yield curves are likely to steepen further.**
- **Current levels are attractive to top up fixed rate exposure.**

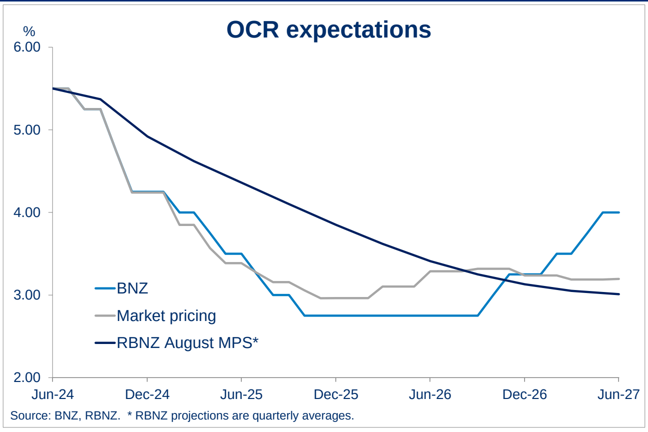
RBNZ Monetary Policy Review

The Reserve Bank of New Zealand (RBNZ) cut the Official Cash Rate (OCR) by 50bps to 4.75% at the Monetary Policy Review (MPR) on Wednesday. This aligned with consensus expectations where most economists had anticipated a 50bps reduction in the OCR. The overnight index swap (OIS) market was pricing an approximate 90% chance of 50bps cut ahead of the decision.

The statement accompanying the decision outlined that the economy is largely evolving as expected at the August Monetary Policy Statement (MPS). Annual CPI is converging towards the 2% midpoint of the Bank's target band. It noted that economic activity is subdued, in part due to restrictive policy, and that the economy is in a position of excess capacity.

Altohugh the Committee discussed the benefits of a 25bps and a 50bps cut, a larger reduction was thought to be 'consistent with its mandate of maintaining low and stable inflation while avoiding unnecessary instability in output, employment, interest rates, and the exchange rate'. Future changes to the OCR will be conditional on the Bank's evolving assessment of the economy.

Expected OCR path

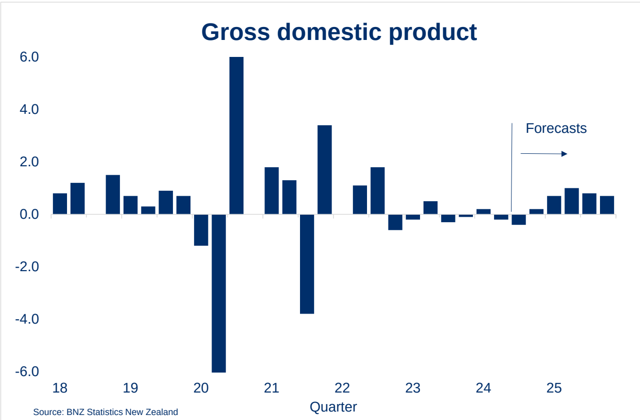


Source: BNZ, RBNZ. * RBNZ projections are quarterly averages.

Economic overview

The NZ economy remains very weak amid restrictive monetary policy settings. GDP contracted in the June quarter, albeit by less than consensus expectations. An extended period of stagnation has seen GDP contract in five of the past seven quarters, and we forecast a further decline in the September quarter. Service and manufacturing sector PMIs have recovered from near record lows, but remain below 50, and are consistent with soft activity. Easier financial conditions, via lower interest rates, should contribute to an economic recovery in 2025.

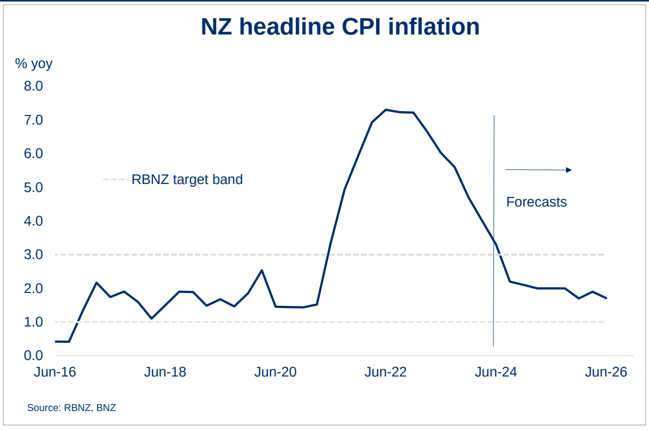
NZ economy in protracted stagnation



Source: BNZ Statistics New Zealand

Annual headline inflation, which has been above the topside of the RBNZ's 1-3% target band since March 2021, is expected to decline towards the midpoint in the September quarter. Our 2.2% forecast is marginally below the RBNZ's 2.3% projection from August. Indicators within the Quarterly Survey of Business Opinion highlight risks that headline inflation could ultimately fall below the target midpoint. Pricing intentions amongst private sector businesses have fallen sharply, and weakness in labour market indicators will contribute to lower wage growth, a key driver of non-tradables inflation.

Q3 CPI to converge on midpoint of RBNZ's target



OCR forecast

Our OCR forecast track is unchanged post-MPR. We expect a further 50bps rate cut at the November MPS, then sequential 25bps reductions at each policy meeting, which takes the Cash Rate to 2.75% next October. Overnight interest rate swaps largely align with our forecasts. A 50bps cut is fully priced for November and there is a cumulative ~90bps of easing priced by the February MPS.

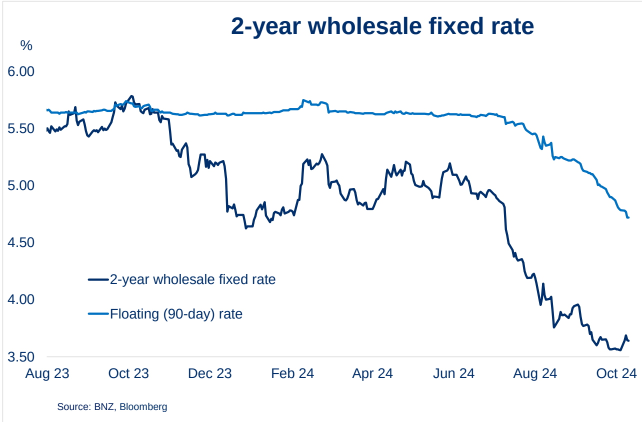
Market pricing implies the OCR will trough near 3% at the end of 2025 and remain there through 2026.

Key domestic economic data that could impact the outlook ahead of the November MPS are Q3 CPI data next week and labour market data at the beginning of November. Other considerations will be monthly inflation partials, inflation expectations and higher frequency activity indicators, like the monthly PMIs.

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

Short-dated fixed rates have been moving steadily lower since the first RBNZ rate cut in August. The market has increasingly priced a front-loaded easing cycle, given the weak economic backdrop, and with inflation tracking back towards the Bank's target. 2-year fixed rates reached a low near 3.5% before rebounding modestly.

2-year fixed rates have fallen sharply



2-year fixed rates will likely continue to decline but this is already discounted by forward curve pricing. Current levels are close to where we see fair value based on our forecast OCR track. It would take a significant, and likely global economic shock, that requires a rapid pace of easing beyond 50bps increments, for front end fixed rates to move meaningfully lower from what is already priced by the forwards.

We think that current levels are an attractive level to top up short term fixed rate cover.

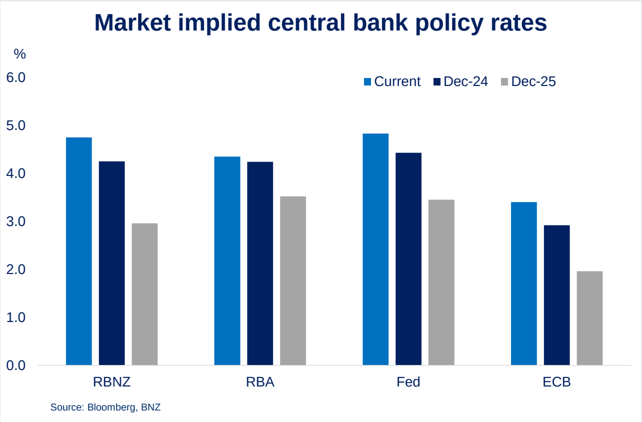
Long-Dated Wholesale Fixed Rates (5-10 yr)

5-year NZD fixed rates

5-year NZ fixed rates briefly dipped below 3.50% in September but have lagged the decline in shorter maturities. Longer dated fixed rates are typically influenced by domestic monetary policy and global factors including growth, inflation and policy settings from major central banks like the US Federal Reserve (Fed) and European Central Bank.

The Fed began an easing cycle in September with a 50bps cut to the Fed Funds Rate. US inflation is moderating towards target, and policy makers have become more attentive, to the employment side of its mandate. There have been increasing signs of a weakening trend in the US labour market notwithstanding unexpectedly strong payroll growth in September.

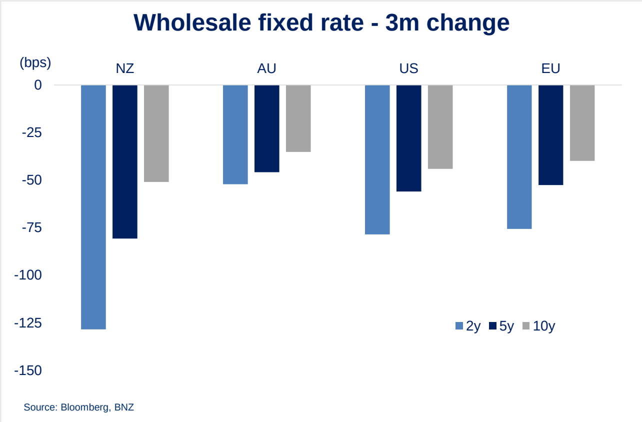
Synchronised easing cycle



The Fed has joined other developed market central banks in a synchronised easing cycle from what are restrictive policy settings. Economic activity is differentiated across countries, but is generally below trend, while inflation is gradually converging on central bank targets. However, the easing cycle is largely priced for key global central banks, suggesting the trend lower in long end rates since the end of 2023, may be nearing completion.

Market pricing implies the Fed will cut its policy rate towards 3.4% by the end of 2025. This is above the 2.9% level, where Fed policy makers estimate the long term neutral[1] policy rate, based on projections from the September FOMC. We expect market pricing for the terminal fed funds rate will gravitate towards 3%, which suggests there is room for modest downside in US rates, from current levels.

Steeper yield curves as easing cycle priced



Overall, the global easing cycle will predominantly impact shorter maturities, and yield curves are expected to continue to steepen. As is typical in previous cycles, the sensitivity of longer maturities to short rates reduces, as the market embeds rate cuts, and central banks move to a more accommodative monetary policy stance. Heavy government issuance and rising term premium[2] are likely to limit the downside for long end fixed rates.

We think there is limited downside for long end NZ rates and that current levels represent an opportunity to top up fixed rate exposure.

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

[2] Compensation required by investors to take exposure to longer maturity interest rates.

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