Research

Interest Rate Research

28 November 2024

Outlook for Borrowers: Post November MPS

- **The RBNZ cut the cash rate by 50bp to 4.25% at the November MPS, which was in line with consensus expectations, and fully discounted by market pricing.**
- **The accompanying statement outlined that inflation is converging toward the 2% midpoint of the target band, economic activity is subdued, and the economy is in a position of excess capacity.**
- **The Bank expects it will be able to lower the OCR further early next year if the economy evolves in line with its expectations.**
- **The modelled OCR track implies an even chance of a 25bp or 50bp cut in February. We maintain our 25bp forecast but note there is lots of first-tier economic data to be released ahead of the next MPS.**
- **Terminal OCR pricing appears out of line with domestic fundamentals suggesting there is still some downside for front end fixed rates. We forecast the OCR will find a base at 2.75% next year.**
- **The yield curve is likely to steepen further, as the easing cycle progresses, limiting the downside for longer term fixed rates.**
- **Current levels are attractive to top up fixed rate exposure, particularly for longer tenors.**

RBNZ Monetary Policy Statement

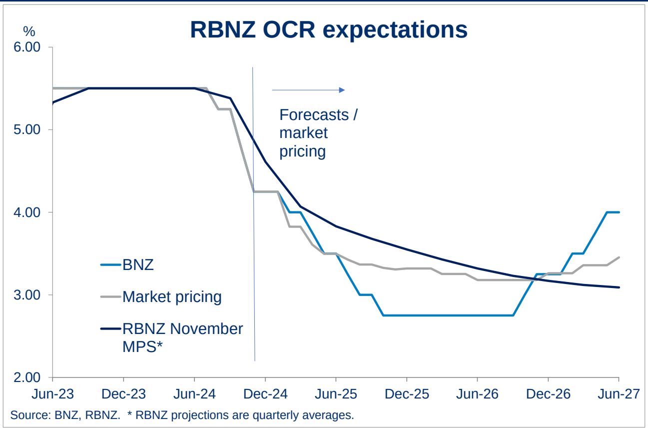
The Reserve Bank of New Zealand (RBNZ) cut the Official Cash Rate (OCR) by 50bp to 4.25% at the Monetary Policy Statement (MPS) on Wednesday. This aligned with consensus expectations - economists were unanimously forecasting a 50bp reduction in the OCR. The overnight index swap (OIS) market fully discounted a 50bp cut and was pricing a small chance of a larger 75bp reduction.

The statement accompanying the decision outlined economic activity in NZ remains subdued and that spare capacity has contributed to inflation declining towards the midpoint of its 1-3% target band. There was a strong consensus amongst the Committee for a 50bp reduction. With headline and measures of core inflation converging to the target, the Committee 'has more confidence to continue removing monetary policy restraint.'

The RBNZ decreased its modelled Cash Rate track, relative to the August MPS, to account for the front-loaded easing already undertaken. The OCR is projected to decline to 3.6% by December 2025 and reaches a base near 3% in 2027.

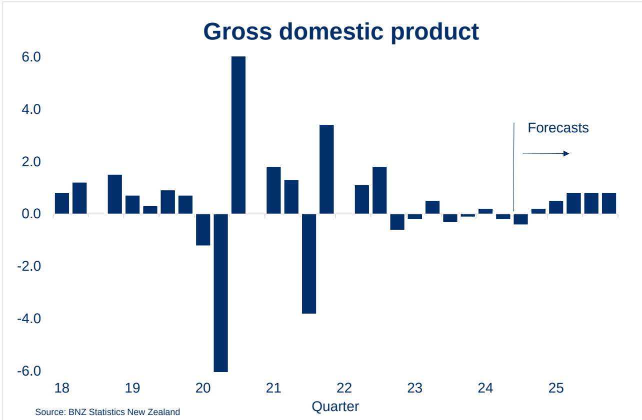
If economic conditions continue to evolve in line with its projections, the Bank expects to be able to lower the OCR further early next year. The modelled rate track implies an even chance of 25 or 50 bp cut at the February meeting and Governor Orr outlined in the press conference there is scope for a 50bp cut at the next MPS.

Expected OCR path



Economic overview

Protracted stagnation

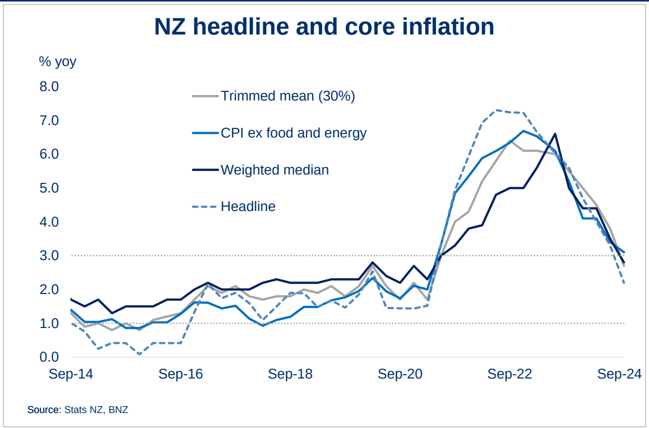


The NZ economy remains weak with still-restrictive monetary policy weighing on activity. Q3 GDP is expected to contract – we forecast by 0.4% - extending the period of stagnation to two years. The prolonged period of economic weakness has been instrumental in driving down domestic inflation.

Although the manufacturing and services PMIs have recovered in recent months, the composite index level of 46.1 indicates private sector activity is still contracting. Furthermore, the index is well below its long term mean of 53.0 which would be associated with trend-like activity.

Coincident indicators support our view that Q4 GDP growth is unlikely to be far away from zero. The economy is expected to recover in 2025 as lower interest rates provide a lift to consumption and investment. A boost from the increase in the terms of trade will also underpin growth.

Headline inflation has converged on mid-point target band



Annual headline inflation declined to 2.2% in the September quarter, notably returning within the RBNZ's 1-3% target band, for the first time since March 2021. Measures of core inflation, while slower to retrace, have broadly returned towards target. A weaker NZ dollar in response to protectionist trade policies could flow through to tradables inflation.

Conversely a cooling labour market - the unemployment rate has reached a four-year high of 4.8% and is expected to increase further – can be expected to supress wages and non-tradables inflation. We forecast inflation will settle near the mid-point of the target range through 2025.

OCR forecast

Our OCR forecast track is unchanged post-MPS. We expect the pace of easing to slow to 25bp per meeting from February, before finding a base at 2.75% in October. OIS pricing largely aligns with our forecast over the first half of next year. However, the 3.25% market-implied terminal rate appears too high, relative to our 2.75% forecast and the RBNZ's 3% estimate for the long-term neutral OCR.

Market pricing for the terminal OCR is still too high

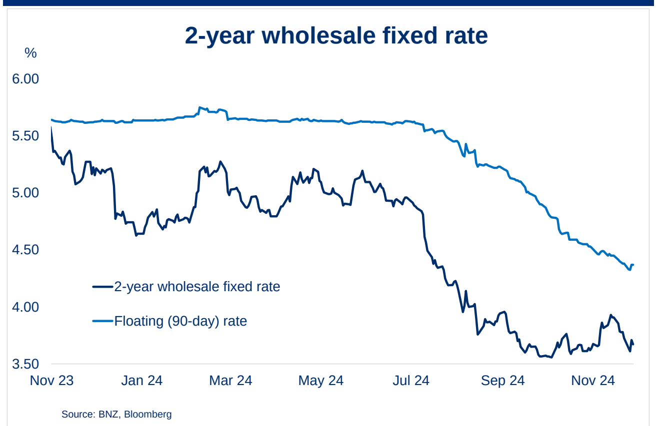
There is an extended period until the next MPS in February with several key domestic and international economic data releases. The most impactful NZ data will be CPI and labour market for the December quarter as well as the Quarterly Survey of Business Opinion. Monthly inflation partials, inflation expectations and higher frequency activity indicators, like the monthly PMIs will also be of interest.

President Trump is inaugurated on 20 January and there is much anticipation about his early executive orders on tariffs. Ahead of the February meeting, there might be more clarity on the US economic policy outlook, which could impact the market and the RBNZ's policy outlook.

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

NZ short dated fixed rates moved higher through the first half of November, and peaked above 3.90%, before retracing. Although domestic fundamentals were largely unchanged, the move higher took place in tandem with global rates and was exacerbated by the unwinding of speculative positioning. The market had subsequently retraced towards 3.60% ahead of the MPS.

2-year fixed rates are back towards the recent low



Although the bulk of the decline in 2-year fixed rates has likely already occurred, we see scope for a modest further move lower, as the market lowers terminal OCR pricing. 2-

year fixed rates are expected to move towards 3.25% in coming months.

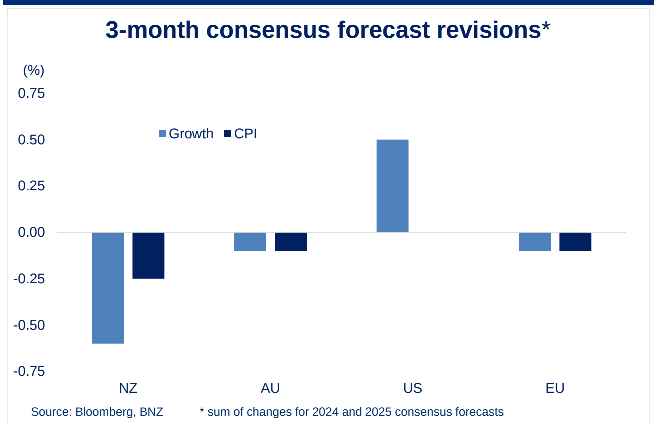
Long-Dated Wholesale Fixed Rates (5-10 yr)

5-year NZD fixed rates

5-year NZD fixed rates briefly traded above 4.0% in November, but have subsequently retraced, and remain within the 3.5 - 4.0% range that has confined price action in the past three months. Unlike the front end of the curve, we think there is limited downside for longer tenor fixed rates. The yield curve has typically steepened in past RBNZ easing cycles, as expectations for higher growth and inflation, is embedded into longer end rates.

In addition, the downside for US yields, which form an important reference for global rates markets, is likely constrained by a relatively shallow Federal Reserve easing cycle. US economic activity has been robust, prompting policy makers to outline a gradual and cautious approach to rate cuts. Consensus growth forecasts for the US have been revised higher, and the Citi economic surprise index indicates activity data has been consistently beating economists' expectations.

Divergent economic outlook

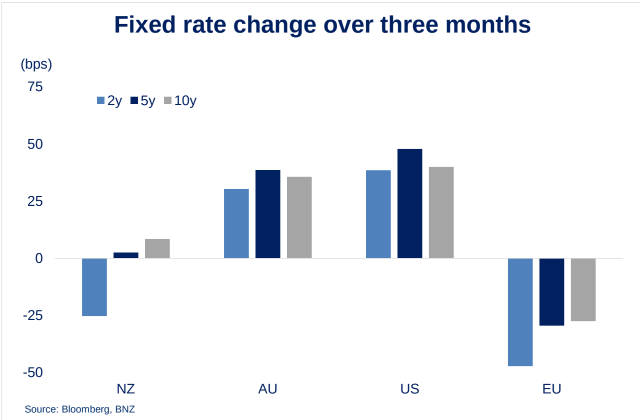


Meanwhile, progress on inflation in the US has slowed and this precedes the implementation of the new administration's economic policies. Although the substance and timing of president-elect Trump's economic agenda is uncertain, the balance of risks are skewed towards a more inflationary backdrop through three channels.

1. **Fiscal** - Tax cuts are expected to widen the fiscal deficit, support activity and could result in higher inflation, although a mitigating factor could be significant spending cuts.
2. **Trade** – An increase in tariffs on imports, aimed at protecting domestic production, is likely to be inflationary.
3. **Immigration** – Immigration curbs could impact prices through higher wages associated with a tighter labour market.

The change in fundamental growth and inflation dynamics has contributed to a significant repricing for the path of the Fed Funds Rate. Futures markets are pricing a terminal rate of 3.70%, 90bp above the September low. Although the Fed retains an easing bias, and still assesses policy settings as restrictive, market pricing implies that the pace of cuts will slow in 2025.

NZ outperformance



NZ longer dated fixed rates have partially absorbed higher global rates by a compression in cross market spreads. However, spreads against key comparison markets like the US and Australia are narrow in the context of historical ranges. This could limit the scope for further outperformance and suggests higher global rates will underpin longer tenor NZD fixed rates.

Furthermore, heavy NZ government bond issuance due to continued fiscal deficits as well as a rising term premium[1] are likely to limit the downside for long end fixed rates. We think that current levels represent an attractive opportunity to top up fixed rate exposure.

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

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