20 February 2025

Outlook for Borrowers: Post February MPS

- **The RBNZ reduced the cash rate by 50bp to 3.75% at the February MPS which was fully discounted by the market and unanimously expected by economists.**
- **The accompanying statement outlined consumer price inflation is near the 2% midpoint of the target band, economic activity is subdued, and spare capacity is weighing on domestic price pressures.**
- **The Bank maintained a clear easing bias. It expects inflation will remain in the target band over the medium term, providing confidence to continue lowering the OCR.**
- **The modelled OCR track was revised lower and is broadly consistent with 25bp cuts in April and May, and a terminal rate slightly above 3% in late 2025.**
- **We maintain our forecast for a further 25bp rate cut at the April Monetary Policy Review.**
- **The RBNZ OCR track is not materially different from our forecasts. We expect the OCR will find a base at 2.75% in August and remain at the low point for an extended period, biasing front end rates lower.**
- **We think there is limited downside for longer end fixed rates. The yield curve is likely to steepen further as the easing cycle progresses.**
- **Current levels are attractive to top up fixed rate exposure, particularly for longer tenors.**

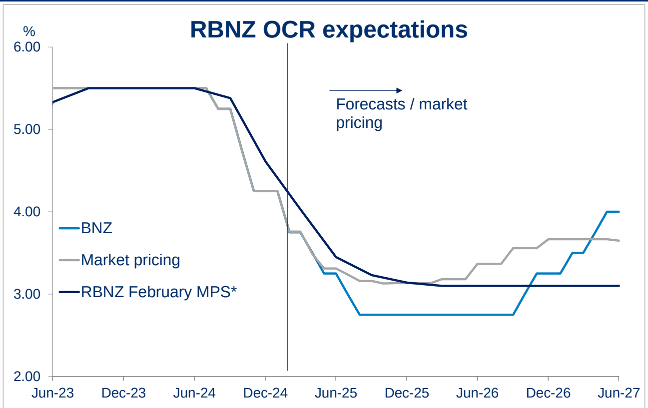
RBNZ Monetary Policy Statement

The Reserve Bank of New Zealand (RBNZ) cut the Official Cash Rate (OCR) by 50bp to 3.75% at the Monetary Policy Statement (MPS) on Wednesday. All 23 economists surveyed by Bloomberg forecast the reduction. The Bank had previously signalled the move in November, conditional on the economy evolving in line with its expectations. Pricing in the overnight index swap (OIS) market implied a near-certain chance of a 50bp cut.

The statement accompanying the decision outlined that annual consumer price inflation remains close to the mid-point of the Bank's 1-3% target range. Economic activity was characterised as 'subdued', and spare capacity is expected to weigh on domestically driven inflationary pressures. The bank noted the risks to the outlook from geopolitics and uncertainty about potential trade barriers. Economic growth is expected to recover during 2025.

The RBNZ decreased its modelled Cash Rate track, relative to the November MPS, to closely align with prevailing market pricing, hence the lack of market reaction to the announcement. The Bank's rate track now approximates a 25bp cut at both the April and May policy reviews, and Governor Orr was happy to outline this conditional forecast outlook. The OCR is projected to decline to 3.1% by December 2025, on a quarterly average basis, and remain broadly stable to the end of the forecast horizon. The Bank maintained an easing bias, stating the outlook remains consistent with inflation remaining in the band over the medium term, which provides confidence to continue lowering the OCR.

Expected OCR path



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

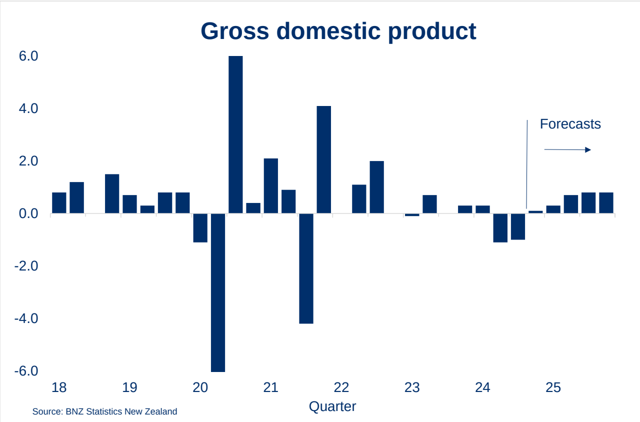
Economic overview

The NZ economy contracted 2.1% in the six months ended September and activity is expected to have remained subdued in the December quarter. Our forecast for Q4 GDP is currently 0.1% q/q. Recent higher frequency activity data has been mixed. Building consents and card spending have been subdued while the composite PMI, which represents the manufacturing and service sectors, has recovered into marginally expansionary territory after an extended period of contraction.

We expect lower interest rates will support consumption and investment and underpin a gradual economic recovery through 2025.

The labour market, which lags the economic cycle, remains soft. The unemployment rate rose to 5.1% in Q4, the highest level since 2016, when pandemic volatility is removed from the series. We forecast a peak unemployment rate of 5.5% in mid-2025. Growing spare capacity in the labour market is expected to supress wage growth and non-tradable inflation.

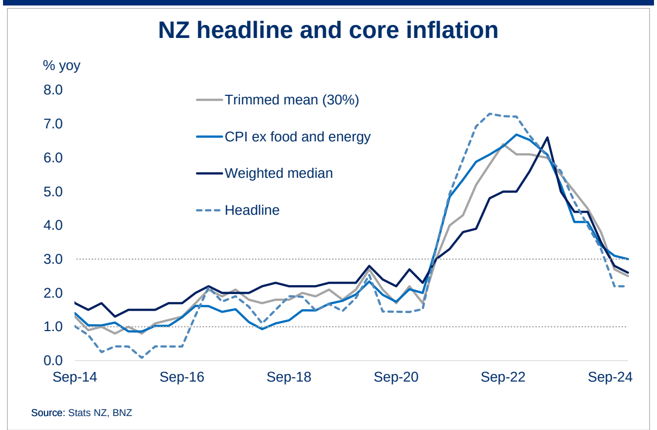
Gradual recovery expected from protracted stagnation



The extended period of weak economic activity has been a key factor driving down domestic inflation. Annual headline inflation remained steady at 2.2% in the December quarter. The lagged impact of the weaker NZ dollar last year and higher commodity prices will lift tradables inflation this year, but domestically driven non-tradables inflation is expected to moderate further through 2025. Inflation expectations appear well contained – the RBNZ's 2-year ahead measure has been stable near 2% since last August.

We forecast CPI inflation to lift to a peak of 2.7% later this year before moderating back towards the midpoint of the RBNZ's target range in 2026.

Headline inflation has converged on mid-point target band

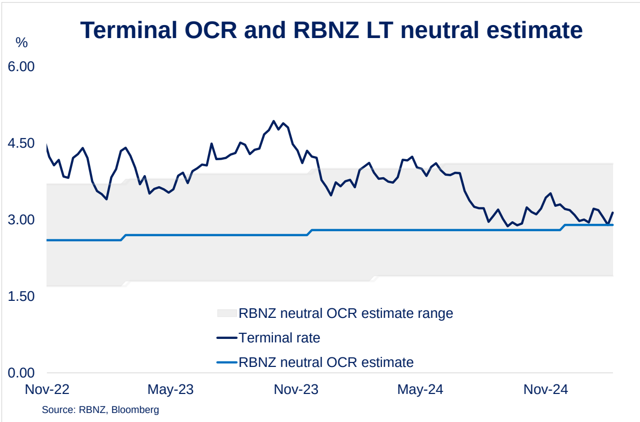


OCR forecast

The updated economic projections and guidance from the RBNZ hasn't been sufficiently different from our base case to adjust our OCR forecast track. After the three consecutive 50bp reductions in the Cash Rate, we expect the pace of easing to slow going forward with incremental 25bp cuts at each policy review to a trough of 2.75% at the August MPS.

At 3.75%, the OCR remains above the RBNZ's 3% mid-point estimate of the long-term neutral OCR, and aligns with other indicators, that suggest financial conditions remain restrictive. The neutral policy rate level is a theoretical concept with a wide confidence interval as indicated by the output from the RBNZ's suite of neutral policy rate models, which is included in the chart below. The RBNZ is expected to act increasingly cautious, and data dependent, as the OCR approaches its neutral estimate.

Terminal OCR priced close to the RNBZ neutral estimate



The OIS market is fully discounting a 25bp cut in April, with a small chance of a larger 50bp reduction.

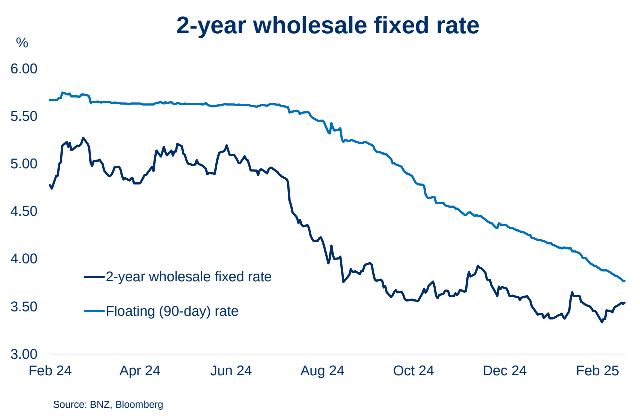
The timing of the 9 April Monetary Policy Review means Q1 CPI data, which is released a week later, won't be available. The higher frequency monthly activity indicators and inflation partials will be important to gauge how the economy is performing, relative to the RBNZ's MPS projections. Q4 GDP is released on 20 March and the Quarterly Survey of Business Opinion is scheduled on 8 April.

The NZ dollar fell, alongside many other major currencies against the USD in the final quarter of last year, reflecting narrowing interest rate differentials and concerns about the new US administration's economic policies. The scale and implementation of the trade barriers remain a key uncertainty for the growth, inflation and monetary policy outlook. As an example, currency forecast dispersion amongst analysts is significantly higher compared with levels that prevailed before the US election, reflecting the uncertain macro backdrop, and highlighting the challenges for central bankers.

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

2-year fixed rates traded to a fresh cyclical low in February but have been broadly moving sideways in a 3.30% – 3.70% range during 2025. The idiosyncratic sharp move higher January was caused by position unwinding by speculative accounts, and reversed after the flow had been absorbed by the market.

Modest downside bias but easing cycle well priced



The market-implied OCR track has a terminal rate ~30bp above our forecast, and an earlier start to the tightening cycle. The RBNZ has typically held the OCR steady for at least twelve months at the end of the cycle. Combining these observations, we think there is still room for lower front end NZ rates. Although we expect 2-year fixed rates to fall towards a low of 3.0%, the outsized moves lower as the RBNZ pivoted towards easing in the middle of 2024, are now behind us.

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

5-year NZD fixed rates

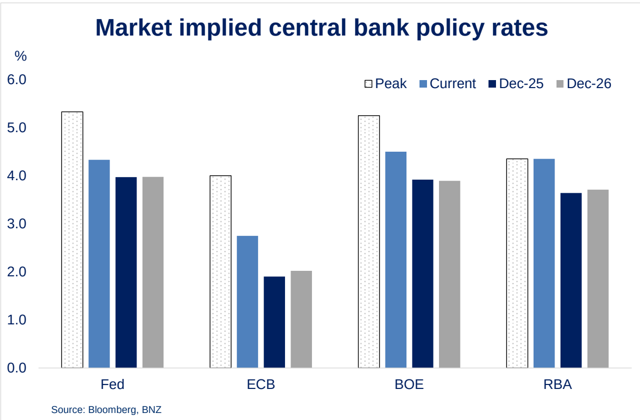
5-year NZD fixed rates have traded back towards the 2025 high near 3.90% in recent sessions. Taking a longer perspective, 5-year rates have been trading sideways in a 3.50% - 4.0% range since reaching a cyclical low last September. Longer dated NZ fixed rates are more impacted by the global economic cycle and actions of major central banks, relative to shorter dated NZ fixed rates, where the RBNZ's OCR forms a tighter anchor.

US fixed rates, which are the most important global reference for international markets, including for NZ, have reversed sharply higher since last September, which is atypical during the early stages of an easing cycle. The Federal Reserve (Fed) left rates on hold at the January FOMC after a cumulative 100bp of cuts. Recent data has pointed to resilience in the US labour market and inflation pressures receding more slowly than earlier projections.

The Fed continues to view policy settings as restrictive and has maintained its easing bias. However, the resilient economy and uncertainty about the new administration's policies, point to an extended pause, while the central bank takes time to assess the incoming economic data. The market is pricing less than 50bp of easing by December 2025 and a terminal Fed Funds rate of 4.0%, well above most FOMC members' estimates of neutral.

While US growth has been robust, activity in other advanced economies has remained subdued. Most have experienced further reductions in inflation, but the implementation of tariffs could reverse some of this progress, while also weighing on growth. After reducing policy rates lower from multi-year highs, major central banks are signalling future easing will be more gradual and conditional on incoming economic data.

Cautious easing bias implied by market pricing



Longer dated fixed rates have moved higher, aligned with the more cautious easing stance by global central banks, and rising term premia, which is a function of uncertainty around US trade, fiscal and immigration policies and their impact on inflation and growth. In addition, elevated sovereign supply to provide funding for fiscal deficits is putting upward pressure on longer dated interest rates. However, the easing bias from global central banks should limit the magnitude to which yields can rise.

In this environment, we expect 5-year NZ fixed rates to remain rangebound. A move back towards the bottom of the range at 3.50% would be attractive to top up hedging. It would likely take a significant slowdown in global activity, or some other low probability tail risk event, for 5-year NZ fixed rates trade back below 3.0%, to levels last seen during the pandemic.

stuart_ritson@bnz.co.nz

Contact Details

BNZ Research

Stephen Toplis
Head of Research

Doug Steel
Senior Economist

Matt Brunt
Economist

Jason Wong
Senior Markets Strategist

Stuart Ritson
Senior Interest Rate Strategist

Mike Jones
BNZ Chief Economist

Main Offices

Wellington
Level 2, BNZ Place
1 Whitmore St
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Toll Free: 0800 854 854