Research

Interest Rate Research

10 April 2025

Outlook for Borrowers: Post April MPR

- **The RBNZ reduced the cash rate by 25bp to 3.50% at the April MPR, 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 and core inflation is consistent with Bank's target over the medium term.**
- **On balance, the RBNZ expects US economic policy creates downside risks for global activity and NZ inflation.**
- **The RBNZ signalled it will monitor how global developments impact the economy and there is scope to reduce the OCR further.**
- **We maintain our forecast for a further 25bp rate cut at the May MPS and note the possibility of a larger 50bp reduction given the global backdrop.**
- **NZ fixed rates have broken outside of the multi-month ranges. We have a downside bias for fixed rates, but macro uncertainty is high, and it is prudent to top up some hedging after the move lower.**

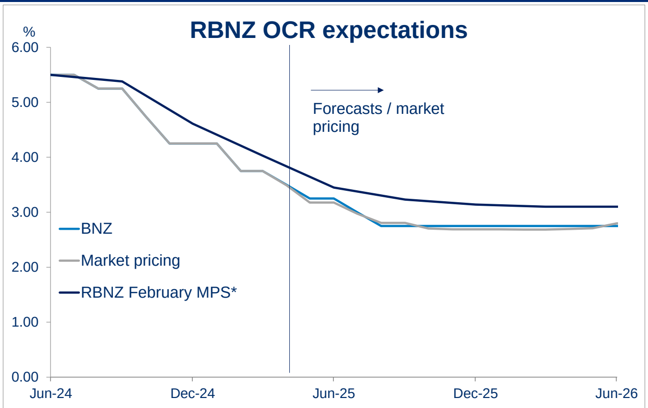
RBNZ Monetary Policy Statement

The Reserve Bank of New Zealand (RBNZ) reduced the Official Cash Rate (OCR) by 25bp to 3.50% at the Monetary Policy Review (MPR) on Wednesday. This was unanimously anticipated by economists. The Bank had previously provided guidance for the 25bp move during the February Monetary Policy Statement (MPS). The overnight index swap (OIS) market implied a chance of a larger 50bp cut, given the recent increase in global trade barriers.

As this was a Policy Review meeting, the RBNZ didn't release updated forecasts. The statement accompanying the decision noted headline inflation is near the midpoint of the 1-3% target range, and core measures are consistent with inflation remaining near target, over the medium term. On balance, the Bank expects the trade war to reduce global activity and create downside risks to the outlook for domestic inflation over the medium term.

With inflation on target and significant spare capacity in the economy, the RBNZ said it was appropriate to ease policy further, taking the cumulative reduction in the OCR to 200bp from the 5.50% peak. The Bank will monitor the impact of escalating trade tensions and indicated there is scope to lower the OCR further as appropriate.

Expected OCR path



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

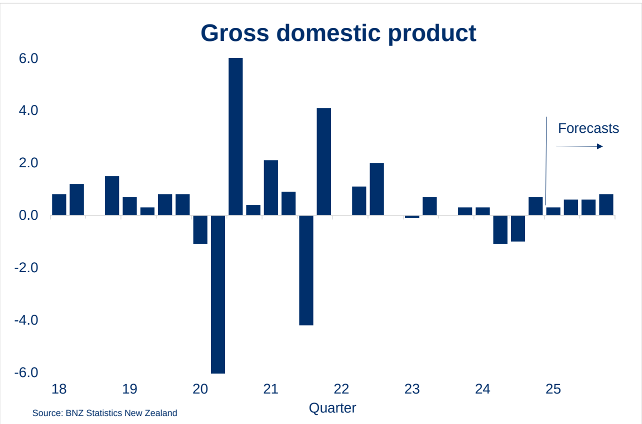
Economic overview

The economic outlook will be impacted by the major policy shift in the US. Our pre-tariff announcement base case for the NZ economy, was for a gradual recovery through 2025, after an extended period of stagnation. The economy expanded by 0.7% in the December quarter, easily beating the consensus estimate. However, private consumption barely grew, and consumer confidence will need to recover from depressed levels, to support a return to trend like economic activity.

While the details on US tariffs are highly changeable, a 10% baseline levy for all its trading partners, and the potential for higher levels for some countries, will reduce growth and have increased the chance of a recession. This will have a dampening impact on NZ activity. Quite apart from the actual tariff increases, uncertainty from US economic policy is likely to constrain consumer and business sentiment, which was already showing some weakness.

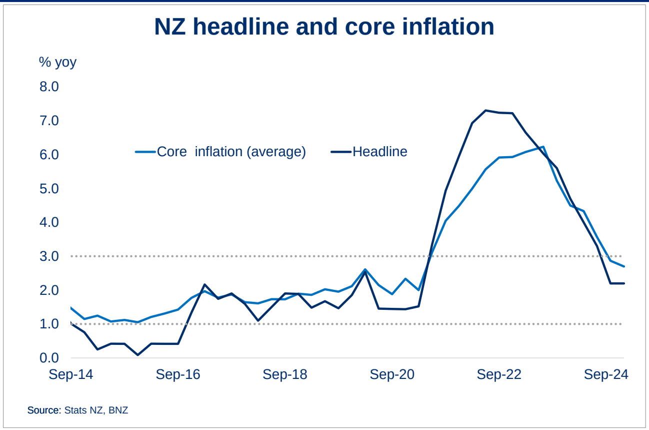
The labour market, which lags the business cycle, remains soft. There are clear signs of a material negative output gap. Firms reported it is easier to find both skilled and unskilled labour in the Q1 Quarterly Survey of Business Opinion (QSBO). We forecast the unemployment rate will reach a peak of 5.5% by mid-year, up from 5.1% in Q4, which is already the highest level since 2016, when the pandemic volatility is excluded.

Economy expands in Q4 after a protracted stagnation



Annual headline CPI inflation held steady at 2.2% in the December quarter, trivially above the mid-point of the RBNZ's 1-3% target range. Monthly partial CPI data are tracking in line with our forecast for a modest increase in the annual rate to 2.4% in Q1. The extended period of weak economic activity has been a key factor driving down domestic inflation, which is expected to moderate further, during 2025.

Inflation has converged near target



We forecast CPI inflation will peak at 2.7% later this year before moderating back towards the midpoint of the RBNZ's target range in 2026. The forecast increase reflects a rise in tradables prices due to the lagged impact from a weaker currency and higher commodity prices. However, the QSBO highlighted firms are finding it difficult to pass on higher costs. The impact from US tariffs on inflation is not clear, but the QSBO indicated a clear disinflationary tone as the starting point.

OCR forecast

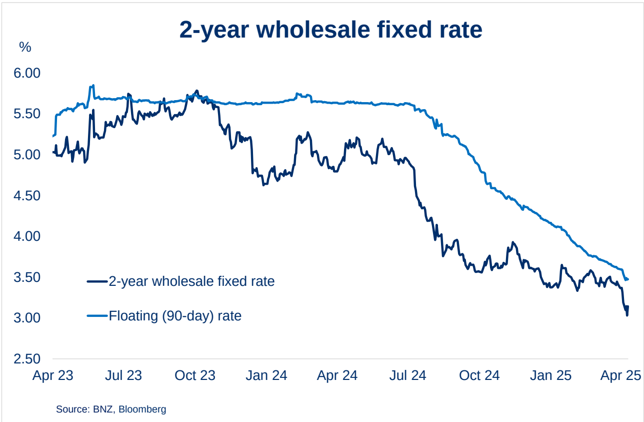
Our OCR forecasts remain unchanged. We expect the RBNZ to reduce rates by a further 25bp at the MPS in May. The macro backdrop is clearly fluid, and the RBNZ's assessment of the impact from the trade war skews the risk towards a larger 50bp reduction. By the next meeting, the central bank will have greater clarity on the trade war and the impact on the economy. We continue to forecast the OCR reaching a trough at 2.75% in August. The OIS market is pricing around 30bp of easing in May and a terminal OCR near 2.70%.

Terminal OCR repricing lower

Ahead of the May MPS, the RBNZ will have key Q1 CPI and labour market reports. However, this data will only form the baseline for the pre-tariff escalation period. Higher frequency activity indicators and partial inflation data will be important to monitor, amid a period of significant uncertainty. The odds of a global recession have risen and skew the risks around our 2.75% terminal OCR forecast to the downside.

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

Lower bias for front end rates



NZ front end fixed rates have declined to fresh cycle lows, after gaining downside momentum, as global growth concerns have intensified. Market pricing for the terminal OCR is below the RBNZ's projected rate track from the February MPS but rightly incorporates the significant shift in the macro backdrop. Without a further de-escalation in trade tensions, we expect the market to price an even lower terminal rate.

In the previous edition of *Outlook for Borrowers* in February, we outlined a bias for lower front end NZ fixed rates. With recent data introducing uncertainty about the strength of the domestic economic recovery, and overlaying the expected global growth shock, we maintain our bias for lower front-end rates. 2-year fixed rates have dropped to towards 3.15%, largely aligning with our base case for the OCR. A further extension below 3% would require the market pricing a 2.50% terminal OCR. Notwithstanding our bias for lower rates, current 2-year levels at the cycle lows, represent an opportunity to top up hedging.

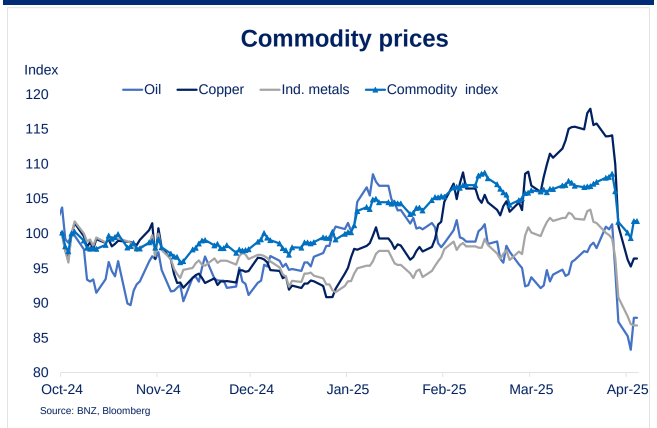
Long-Dated Wholesale Fixed Rates (5-10 yr)

5-year NZD fixed rates have traded back towards the low end of the range at 3.50%. Although rates further out the curve have moved lower, they have underperformed front end rates, which are more closely anchored to the OCR. Recent curve moves have been extremely volatile, and we expect the curve will steepen further, as the easing cycle proceeds. The 2y/10y curve has continued steepening until the final rate cut in the five of the six RBNZ easing cycles since 2000, with 2019 the exception.

5-year NZD fixed rates

Falling commodity prices illustrate the expected hit to global activity from US economic policy. Brent crude has traded below US$65 per barrel for the first time since August 2021. An index of industrial metal prices has fallen close to 15% from a month ago, although some rebound can be expected, after the pause in reciprocal tariffs. Consensus forecasts for US growth this year have been revised lower, prior to the implementation of 10% baseline tariffs, which will act as a tax on consumers.

Growth expectations slump



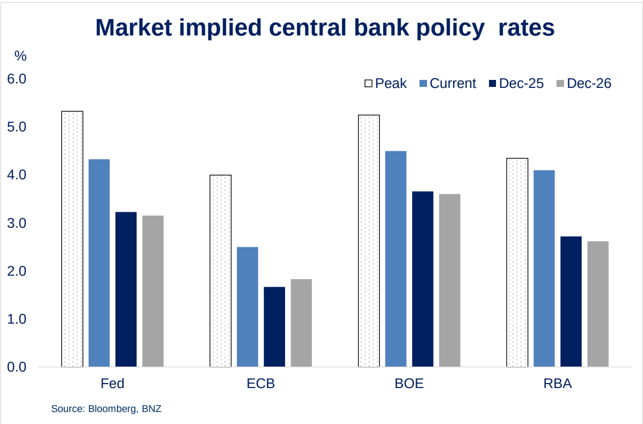
A key question for interest rates markets is how the US Federal Reserve (Fed) and other major central banks will respond to a complex macro backdrop. The Fed will have to assess the trade off from a near term rise in inflation, and potential increase in inflation expectations, against significant headwinds for growth and rising unemployment.

Fed Chair Powell has said the tariff increases would result in higher inflation and slower growth. He outlined tariffs could result in a more persistent rise in inflation, and the Fed is obligated to keep inflation expectations anchored. Powell said the central bank was well-positioned to wait, and that it is very difficult to assess the economic impact of the Trump administration's policies, until there is greater clarity on the details.

Money market pricing suggests that investors do not believe that higher inflation will delay Fed easing.

The market is pricing 75bp of rate cuts for this year. The pricing for terminal policy rates for major central banks has moved sharply lower. The growth scare and ongoing uncertainty will limit the extent longer end rates can move higher with central banks maintaining an easing bias.

Global central banks expected to cut rates



Global rates (including NZ) have typically declined in the lead up, and during, pronounced economic slowdowns. We think there are downside risks for NZ 5-year fixed rates but current levels at bottom end of the trading range provide an opportunity to top up hedging levels. There is scope for greater easing to be priced for global central banks, suggesting borrowers maintain some capacity to top up hedging, in a scenario where there is a further decline in longer maturity NZ fixed rates.

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