

30 January 2014

Outlook for Borrowers: Post January OCR Review

- The RBNZ is now officially 'neutral'
- Implying its next move could be either up or down
- We still see the OCR at its current level (3.50%) or higher over the next couple of years
- But near-term, market likely to increase pricing of rate cuts, which will see short-dated fixed rates fall further
- NZ 5-year wholesale rates now close to floating
- Presenting opportunities for longer-term fixing
- Declines in bank funding costs may also provide some marginal relief for borrowers

OCR Review

This week the RBNZ left its Official Cash Rate (OCR) unchanged at 3.50%. It officially moved to a neutral position, when it stated that the next interest rate move could be "either up or down". However, it expects to remain on hold "for some time".

The statement acknowledged NZ growth is still above trend, at about 3%/y/y. However it pointed to fiscal consolidation, reduced dairy payout, risk of drought and the high exchange rate as drags on growth.

The Bank continues to see the NZD as "unjustified" and "unsustainable" at its current level despite recent falls. It expects significant further depreciation. Indeed, much of this week's statement appeared specifically designed to bring the NZD down.

A large chunk of the statement was dedicated to discussion of recent declines in world oil prices. While these will improve consumers' spending power and lower the cost of doing business, they also contribute to keeping inflation very weak. Annual inflation is expected to stay low, or even become negative in 2015, before very gradually moving back toward 2% (the RBNZ's mandated target).

Floating Rate Outlook

At the start of the year we pushed back our expectation for the next OCR hike from December this year to March next. We saw the RBNZ delivering 0.75% of further hikes to complete this cycle and take the cash rate back to 'neutral', at 4.25%. This remains our central case.

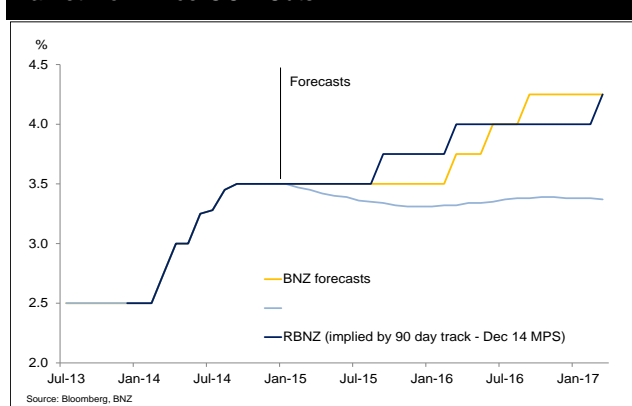
The increasing risk to this view is that the RBNZ delays rate hikes beyond Q1 2016. In so doing, hikes could ultimately become unnecessary. i.e. when inflation

ultimately picks up in late 2016, GDP growth is already falling back below trend. In this scenario, 3.50% could well be the peak OCR for this cycle.

However, we maintain high conviction that the RBNZ is unlikely to cut rates this year. Despite the low-side Q4 CPI inflation reading (0.8%q/q) we emphasise the following factors:

The RBNZ targets the medium-term inflation outlook not the current reading; Indicators confirm the NZ economy remains strong, growing above trend; The NZ housing market is showing signs of re-heating; The falling NZD has, and will likely continue to provide monetary policy easing.

Market Now Price OCR Cuts

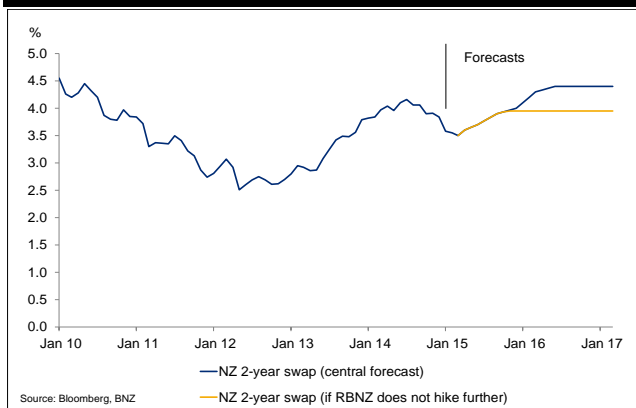


Wholesale Short-Dated Fixed Rates

The market had begun to price RBNZ rate cuts in recent weeks, after the low-side Q4 CPI release and a series of surprise rate cuts from Central Banks globally e.g. the Bank of Canada. After this week's RBNZ meeting the market now price around a 75% chance of a rate cut by year-end. Recall, that as recently as mid-December the market was still looking for further rate hikes. This change in expectation has dragged wholesale fixed rates lower.

NZ 2-year wholesale fixed rates have fallen a further 0.25% over the past month and now sit around 3.60%. We expect in the near-term these rates will fall further. Despite expected continued strong domestic growth data we believe the market will remain fixated on low inflation. This may culminate in the Q1 CPI reading (20 April) that we expect to record negative (-0.2%) annual inflation.

Short-End Fixed Rates May Dip Further Before Rebounding



We therefore do not see any urgency to pay short-dated fixed rates. However, later in H1 an opportunity may arise to fix 2-3-year rates, before an expected rebound later in the year when the RBNZ does not meet the market's expectations for cuts.

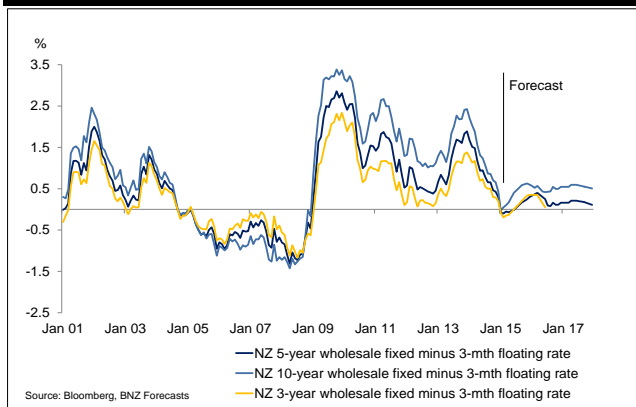
Long-Dated Wholesale Fixed Rates

Long-dated NZ rates have been influenced by the double-whammy of increased expectations for RBNZ rate cuts and falling global long rates.

The catalyst for the latter have been the plunge in global oil prices; declining long-term inflation expectations; a lowering of the expected 'terminal' US Fed Funds Rate, and anticipation followed by delivery of the ECB's extensive quantitative easing package.

This has seen the likes of NZ 5-year wholesale fixed rates fall around 0.50% over the past month. There is now virtually no difference between 5-year fixed and floating rates. We see 5-year rates pushing higher, after the US Federal Reserve begins hiking around mid-year, and the market becomes less convinced the RBNZ will imminently cut rates. We therefore see attractive opportunities currently to pay 5-year fixed rates.

Now Little Difference Between 5-Year and Floating Rate



But borrowers may be tempted to hold off and wait for 5-year rates to fall below the floating rate. The last time this occurred was in the period from 2005-2009. At this time the OCR was moving from 6.25% to 8.25%. The market was anticipating that it could not stay this high for long and rate cuts would necessarily follow.

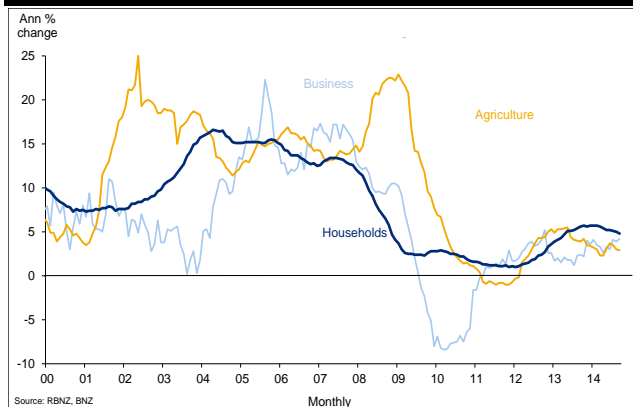
This time the OCR is at 3.50%. We think the market is getting a bit carried away with expecting imminent rate cuts. Also, if in fact rate cuts were delivered floating rates would fall more sharply than 5-year rates i.e. the difference between them would increase.

The only way we will likely see 5-year rates move much lower than floating rates will be if offshore long rates continue to fall. While this is possible, we tentatively see US long rates in the process of finding a base as the plunge in the global oil price is running out of momentum.

Bank Funding Costs

We continue to see potential for limited further reductions in bank funding costs to ease rates faced by some borrowers. The two main factors contributing to this trend remain unchanged. First, wholesale funding costs are declining as expensive post-GFC funds mature and are able to be refinanced at lower levels. Second, there is currently only limited competition for domestic deposits. This is because overall economy-wide credit growth remains modest.

Still Only Modest Credit Growth Across All Economy Sectors



Summary

The RBNZ has now officially adopted a neutral position suggesting its next rate move could be either up or down. However the market has moved to price a 75% chance the OCR will be cut by year-end. In the near-term these expectations for cuts will likely extend, dragging short-dated fixed rates lower. However, we do not think the RBNZ will ultimately deliver any cuts this year.

We therefore see fixed rates rebounding later in the year. Ahead of this we would look to increase short-dated fixing, although we see no urgency at present.

NZ 5-year rates have now fallen close to floating rates. This presents opportunities to now increase longer-dated hedging. We do not expect 5-year rates to fall much below floating rates at this point in the cycle.

Meanwhile, marginal further declines in banks funding costs may see some borrowers benefit, independently of moves in wholesale rates.

kymberly_martin@bnz.co.nz

Contact Details

BNZ Research

Stephen Toplis

Head of Research
+(64 4) 474 6905

Craig Ebert

Senior Economist
+(64 4) 474 6799

Doug Steel

Senior Economist
+(64 4) 474 6923

Kymerly Martin

Senior Market Strategist
+(64 4) 924 7654

Raiko Shareef

Currency Strategist
+(64 4) 924 7652

Main Offices

Wellington

60 Waterloo Quay
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 473 3791
FI: 0800 283 269

Auckland

80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch

81 Riccarton Road
PO Box 1461
Christchurch 8022
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly

Global Head of Research
+(61 2) 9237 1406

Alan Oster

Group Chief Economist
+(61 3) 8634 2927

Ray Attrill

Global Co-Head of FX Strategy
+(61 2) 9237 1848

Skye Masters

Head of Interest Rate Strategy
+(61 2) 9295 1196

Wellington

Foreign Exchange +800 642 222
Fixed Income/Derivatives +800 283 269

Sydney

Foreign Exchange +(61 2) 9295 1100
Fixed Income/Derivatives +(61 2) 9295 1166

London

Foreign Exchange +(44 20) 7796 3091
Fixed Income/Derivatives +(44 20) 7796 4761

New York

Foreign Exchange +1 212 916 9631
Fixed Income/Derivatives +1 212 916 9677

Hong Kong

Foreign Exchange +(85 2) 2526 5891
Fixed Income/Derivatives +(85 2) 2526 5891

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