ANZ Research

# NZ Insight – Where to now for interest rates?

9 June 2021

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## Where to now for interest rates now that the Reserve Bank is projecting rate hikes starting next year?

### Summary

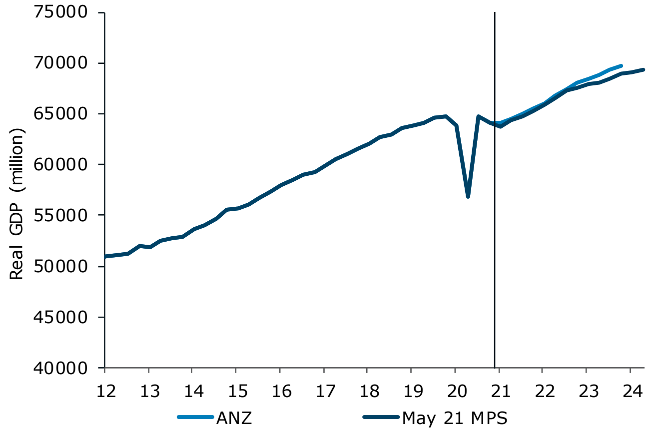
In this Insight we discuss the outlook for New Zealand interest rates in the wake of the Reserve Bank's (RBNZ) May Monetary Policy Statement, which projected that the overnight cash rate might rise by around 1.50%pts to 1.75% by mid-2024. We also expect the Official Cash Rate (OCR) to rise, taking wholesale and retail interest rates higher in the process. There are caveats, and uncertainties remain, but with global interest rates also rising, borrowing costs are likely to rise from here. We think it would be prudent for households and businesses to plan ahead for the possibility that higher borrowing costs are on the cards.

### Economic backdrop

New Zealand's economy has recovered extraordinarily well from the COVID-19 crisis that was thrust upon it. While the initial hit to the economy was huge (mostly due to the initial nationwide lockdown), the recovery was equally as spectacular (figure 1). Given that the whole reason why the RBNZ cut the OCR and started buying bonds was to cushion the downturn and promote a recovery, now that it is underway, at a high level, one should ask, how much longer does monetary policy need to remain stimulatory for?

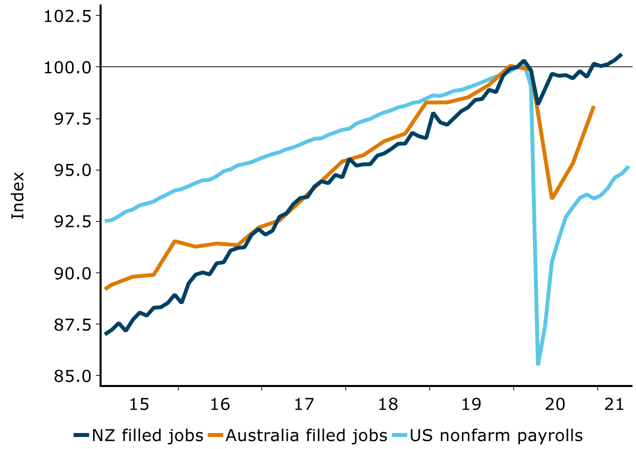
Thankfully, the unemployment rate did not rise by nearly as much as many forecasters (including ANZ) feared it might. That was in part due to the wage subsidy, which not only helped keep workers attached to their employers, but also kept cash flowing into households. This supported spending, and ultimately demand for labour in those sectors of the economy that recovered. Not all industries prospered with the border closed and some parts of the labour market were disproportionately affected, but in aggregate, the number of people employed in New Zealand now exceeds the number employed pre-COVID. This is a remarkable fact in its own right, and importantly, it puts New Zealand in a better position than other countries (Figure 2).

**Figure 1. GDP outlook (ANZ vs RBNZ)**




Source: Statistics NZ, ANZ Research, RBNZ

**Figure 2. Employment indicators (Jan 2020 = 100)**




Source: ABS, BLS, Stats NZ, Macrobond, ANZ Research

Like the growth outlook, the labour market outlook is important for borrowers, because one of the RBNZ's two objectives is supporting maximum sustainable employment (which is a concept rather than a numeric target). At a high level, things are going well on this front.

High inflation is also around the corner. We are forecasting headline inflation to peak at 3.0% in Q3 2021 (figure 3). This largely reflects persistent (not permanent) factors, including COVID-induced shipping disruptions, which are feeding through into higher costs and prices in New Zealand, as well as a tighter labour market. For good measure, there is some transitory stuff in there too, with base effects as weak inflation in 2020 drops out of the annual calculation, and a large minimum wage rise in Q2 all helping the headline number reach 3% (figure 3).

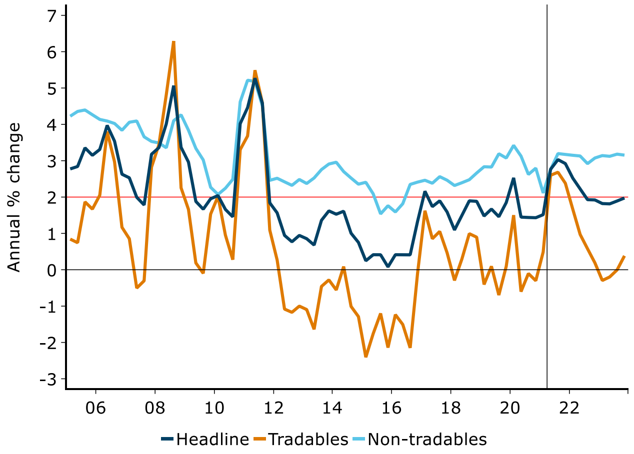
Exactly how transitory or persistent (or even permanent) the lift in inflation proves to be remains to be seen, and there are plenty of mixed views out there, as we discuss next. And it matters crucially for borrowers given that the RBNZ's other objective is to get inflation sustainably to 2%. And things are going well (almost too well) on this front. Indeed, it's looking like inflation is at more risk of overshooting than undershooting at this point. While we are yet to see actual CPI outturns above 2%, the survey data suggests this is just around the corner (see figure 4).

Of course, there are risks in both directions. Inflation may slump as the economy softens, and shipping disruptions ease. The housing market might cool more than expected, dampening demand. On the other side, inflation pressures could prove more persistent than expected if they feed into inflation expectations and wage growth. Economists and financial market participants (who make significant decisions in part based on where inflation is going) continue to fiercely debate the outlook for inflation.

It's difficult to argue that inflation isn't here at the moment. Whether it's coffee, food, cars or mountain bikes, everything seems more expensive. The question is; how transitory is the inflation pulse? Remember, prices have to keep going up from their already expensive levels for inflation (which is the change in prices, not the level of prices) to be sustained.

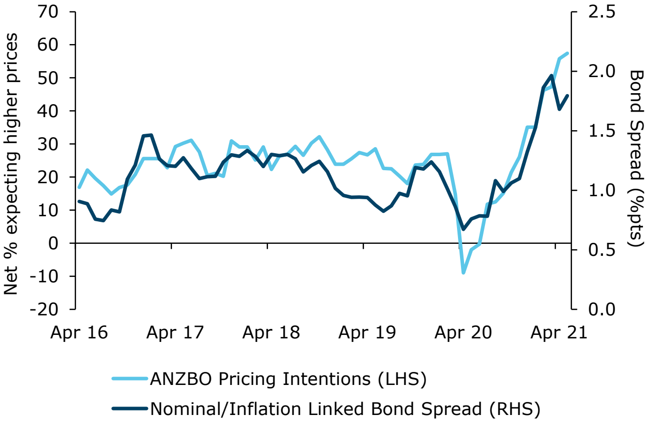
Complicating the picture further is the fact that some prices are being impacted by supply disruptions, caused by shortages of things like shipping containers and computer chips. These issues will take time to iron out, but they will dissipate. However, the longer it takes, the longer headline inflation prints will be distorted by these persistent, but temporary, factors.

**Figure 3. Inflation outlook**




Source: Statistics NZ, Macrobond, ANZ Research

**Figure 4. ANZBO Pricing Intentions and Spread between nominal and inflation-linked 10yr bonds**




Source: Bloomberg, ANZ Business Outlook Survey

In some cases, competition from elsewhere has driven up prices. Many New Zealanders spent money on homewares and physical goods like bikes after lockdown, and in some cases these were purchased with funds that might have been spent on an overseas holiday. As countries like the US and UK have re-opened, people there have done the same thing. But once every American who wants a new mountain bike has one, will prices hold up? We don't know, but there's a decent chance that at some point retailers are going to find themselves with far too much stock and have to discount. And in broader terms, it's difficult to think that the forces that drove those prices down to competitive levels pre-COVID are all gone forever – though some, like efficient but fragile just-in-time global supply chains, are certainly getting a rethink.

There are risks to inflation in both directions, but for now, markets are more fearful of higher, rather than lower inflation, because they are more fearful of higher than lower interest rates. This asymmetry is being borne out in surveys, and in the spread between NZ government bonds that pay interest plus inflation and those that pay a flat rate of interest.

This latter spread (known as a break-even inflation rate) can be affected by things like market positioning and illiquidity, and is not a perfect measure of money-where-your-mouth-is inflation expectations. But the same sorts of trends are being seen overseas, and it is no wonder, given how much extra cash is now in the banking system.

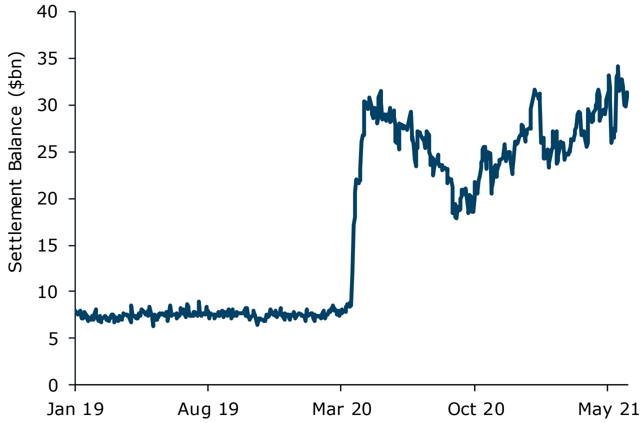
## What might limit how far rates can rise?

Thus far, most of what we have discussed has been pretty upbeat. And given the strong inflation and employment backdrop, we certainly see the risks as skewed towards higher interest rates. We don't, for example, expect to see interest rates fall again, unless another economic catastrophe comes along.

But there are reasons to think that this cycle won't be like the boom-bust cycles of old, where interest rates fell a long way, which then stoked a recovery, which the RBNZ then leaned against with higher rates, with the goal of engineering a soft landing at 2% inflation (and now full-employment). That didn't always go smoothly - if we take the 2004-2008 cycle as an example, back then, the RBNZ had to take the OCR from 5% to 8.25% before the economy slowed (and when it did, the GFC saw it collapse – which, we should add had nothing to do with the RBNZ).

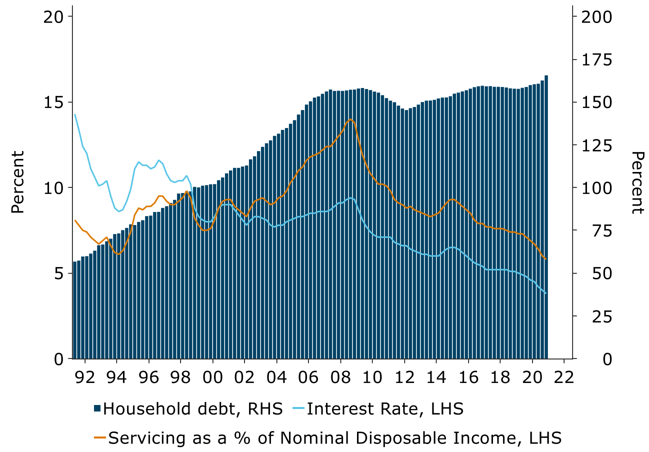
In 2014, after the GFC, the RBNZ hiked by 1% from 2.5% to 3.5%. That wasn't much of a hike, but for various reasons – some local and some global, that was it as far as that hiking cycle was concerned.

**Figure 5. Settlement cash (in the New Zealand interbank payments system)**




Source: RBNZ, ANZ Research

**Figure 6. Household debt to income**




Source: RBNZ, Macrobond, ANZ Research

This time around, the starting point for the OCR is lower (0.25%). On the face of it, that suggests the OCR could go a lot higher before it gets back to more 'normal' levels (it was at 1% pre-COVID). That makes logical sense, but given the growth in household debt since then, the economy's sensitivity to interest rates is a lot higher too. The household debt to income ratio has risen significantly over recent years (figure 6). In simple terms, more debt means more sensitivity to a change in interest rates. That will likely mean the RBNZ has to hike by less to cool spending.

Households also have less time-certainty with regard to how long they have locked in fixed mortgage rates for. Data for April showed that around 76% of mortgage debt is either floating or up for rollover within the next 12 months. Less than a quarter of mortgage debt is fixed for more than 1 year, and that's low by historic standards (figure 7). It means that when the RBNZ does start raising interest rates, it'll bite sooner for most people. This traction will likely lessen how much they have to hike by, but it'll come at a cost to many individuals.

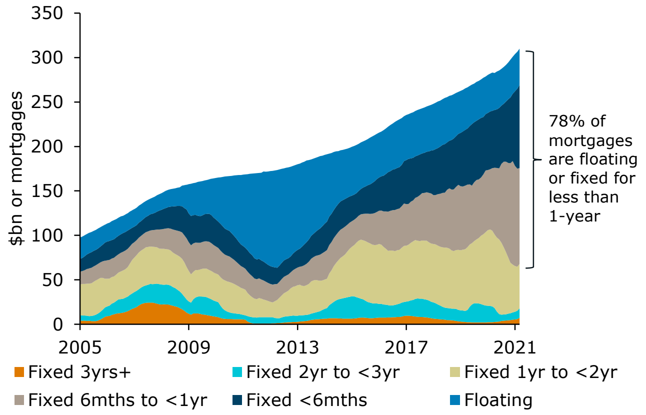
## What is the Reserve Bank saying?

At the moment, the RBNZ's judgement is that the OCR will need to rise by around 1.5%pts from mid-2022. Indeed, their projections have the OCR holding steady for the next year or so, and then rising from 0.25% to 1.78% by mid-2024 (figure 8).

It is worth noting that these projections are extremely conditional. They should not be seen as a commitment in any sense, but rather an indication of what the monetary policy response could be, should the economy evolve as the RBNZ expects. At a high level, the message from the RBNZ is that higher interest rates are coming – not immediately, but not that far down the track either. Our own expectations are similar – we also expect the OCR to go higher next year, as we have noted in recent publications like Quarterly Economic Outlook and weekly Data Wraps.

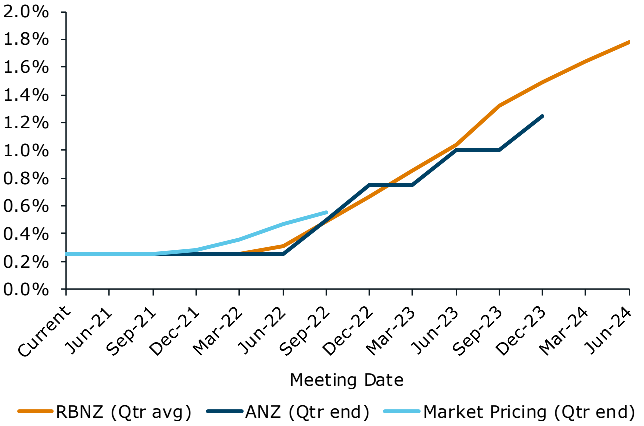
What happens to the OCR is important, as forward expectations for the OCR are the "building blocks" of interest rates for longer terms.

**Figure 7. Residential mortgages by fixed term**




Source: RBNZ, ANZ Research

**Figure 8. RBNZ OCR projections, ANZ forecasts and market expectations**




Source: RBNZ, Bloomberg, ANZ Research

Let's say, for example, that financial markets broadly (ie the consensus) expected that the OCR was going to average 0.25% this year, 0.65% next year, and 1.20% the following year. If that was the case, it'd be reasonable to assume that the wholesale 1-year rate would be close to 0.25% (ie the average of where people think the OCR will be for a year), and the wholesale 2-year rate would be near 0.45% (the average of 0.25% for the first year and 0.65% for the second year). Similarly, you'd expect the wholesale 3-year rate would be near 0.70% (the average of 0.25% for the first year, 0.65% for the second year, and 1.20% for the third year). This is the main reason why financial markets care so much about what the RBNZ (and forecasters like ANZ and other banks) say, because they help inform expectations.

While technically, the RBNZ's projections are their 'best guess', most economic modellers don't try to forecast economic "accidents" because they're inherently wildly unpredictable. The old joke goes that economists have forecast ten out of the last three recessions – in practice they didn't forecast any. In that regard, it's fair to say that these (and any) projections assume that everything goes to plan (ie nothing adverse and unexpected comes along) over the next three years. But of course there is no guarantee of that. Things could easily sour again (especially if we had another COVID scare or lockdown). But equally, the rapid improvement in the economy that we have seen in recent months could gather momentum, forcing the RBNZ to hike earlier (especially, for example, if inflation and employment hold up, driving up wages and inflation expectations).

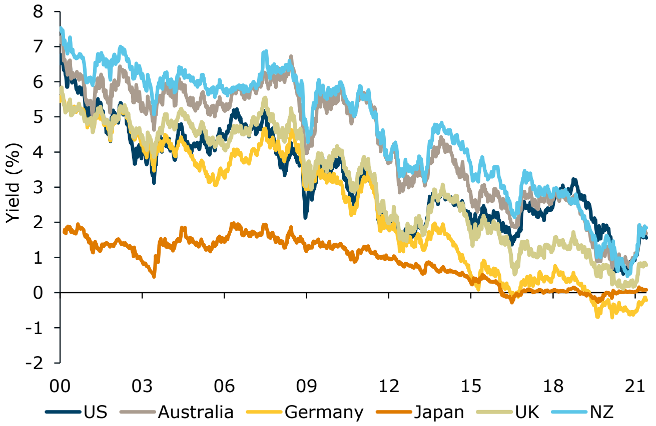
## What about global interest rates, and why do they matter?

Global interest rates have also moved higher in recent months, and many forecasters, including ANZ, expect them to continue to rise. The US 10-year Treasury bond is the bellwether interest rate to watch, and global financial markets hang off its every move.

It has risen off all-time lows reached in 2020 and we expect it to rise by another 50-75bps over the next 18 months or so. That matters because New Zealand 10-year interest rates tend to follow US rates very closely. That's mostly because more than half the New Zealand bond market is offshore owned, so when US rates rise, that in turn tends to make investors a bit pickier about what rate they want to earn when investing in NZ bonds. That's a very simple view of it, but the history of strong correlation speaks for itself (Figure 9).

That being the case, if US interest rates rise, as we expect them to, that'll take longer-term rates here with them. Alongside expected rises in the OCR, which will push up short-term rates, this pressure from offshore will help drive all interest rates higher over time.

**Figure 9. Global 10-year government bond yields**




Source: Bloomberg, ANZ Research

**Table 1. 10-year government bond yields**

| Term | Government Bond* | Wholesale (Swap)# | Mortgage^ | Term deposit^ |
|---|---|---|---|---|
| 1 day | 0.25 | 0.25 | N/A | N/A |
| 1 year | N/A | 0.37 | 2.25 | 1.00 |
| 2 year | 0.27 | 0.57 | 2.58 | 1.11 |
| 3 year | 0.53 | 0.84 | 2.89 | 1.24 |
| 5 year | 1.03 | 1.28 | 3.62 | 1.54 |
| 7 year | 1.45 | 1.62 | N/A | N/A |
| 10 year | 1.82 | 1.97 | N/A | N/A |

* This is the rate the government borrows at (and thus the rate buyers of government bonds earn).

# This is the rate at which banks hedge ("swap") floating and fixed exposures with each another.

^ Average special rate across the "big four" banks.

Source: RBNZ, ANZ Research

## Where are interest rates now?

At the moment, wholesale and retail yield curves (ie a plot of interest rates ordered by how long you're borrowing or lending for) have a textbook upward slope. In all cases, the lowest interest rates are associated with the shortest terms (table 1).

Yield curves of this shape are common (because lending for longer terms is inherently riskier, so lenders tend to want to be rewarded more for doing so). However, one interesting aspect of yield curves right now is how steep they are. To be fair, we have seen steeper curves before (like back in 2014, as shown in figure 10). However, yield curves have never been this steep *and* this low before, and as a consequence, rates for some terms are multiples of others. The 10-year swap rate (which are the wholesale rates where banks hedge floating and fixed exposures with one another at) is, for example, around four times the 2-year swap rate and around eight times the OCR!

**Figure 10. Spread between 2yr and 10yr swap rate**


Source: Bloomberg, ANZ Research

This steepness creates a real conundrum for borrowers and investors alike. For borrowers, the "problem" is that on the one hand, you can still borrow very cheaply if you select a short term, but if interest rates rise, you won't be on that cheap rate for long. The alternative is to borrow for longer – but of course that costs more – in some cases a lot more. There is no obvious win-win.

## Bringing it all together

A lot of forecasters, including the RBNZ and ANZ, expect the OCR to go higher next year. Most forecasters also expect global interest rates to rise as central banks in other countries move into hiking mode eventually too. Right here, right now, there is certainly a lot of talk about higher interest rates in policy circles, across financial markets, and in boardrooms. As we progress down the track, the outlook could change, and it does seem likely that where we will end up (in terms of the level of interest rates) will be lower than in past cycles. But that's no reason to be complacent, or worse still, reckless when borrowing.

The RBNZ Governor has implored people not just to think about where interest rates are now, but to also think about where they might go in the future, and what the rate might be on average over time when borrowing. We think that's sage advice.

There are reasons to think OCR hikes may come sooner than August next year, but there are also reasons to think the upcoming hiking cycle will be more muted than earlier ones. So there is give and take, and it comes down to a question of what risks you can live with.

We have been writing about the implications of higher interest rates for borrowers in our Property Focus publication for some months now. Given the possibility that interest rates do rise over coming months, we think it makes sense for borrowers to think about how exposed they are, and to consider fixing at least a portion of their borrowing for longer terms. The converse is true for term deposit and bond investors, who are likely to benefit from higher interest rates over coming quarters if they hold off investing for a while. But again, no guarantees! Hedging your bets is generally advisable with financial risks of any kind, and in this context that's splitting up your mortgage or your capital and putting a bob each way.

With leverage at an extreme, inflation rising and interest rate sensitivity very high, even if we are fairly confident that we have seen the lows in interest rates, we would caution against blindly extrapolating interest rate trends. Rather, we think it will be important to have a balanced perspective of the near-term risks while also recognising that there are structural issues that will constrain the level of interest rates over the coming decade.

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