Tuesday 27 August 2024

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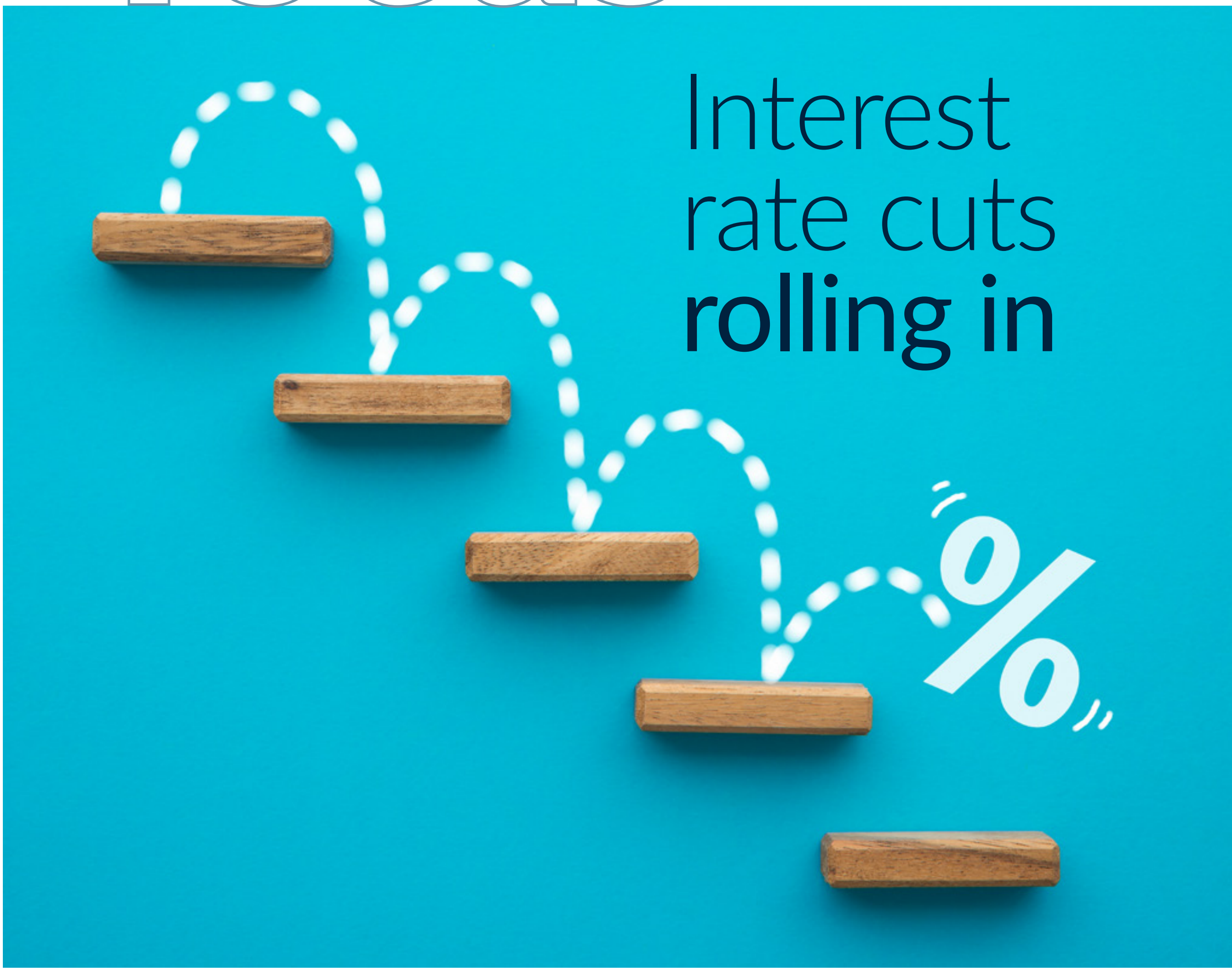


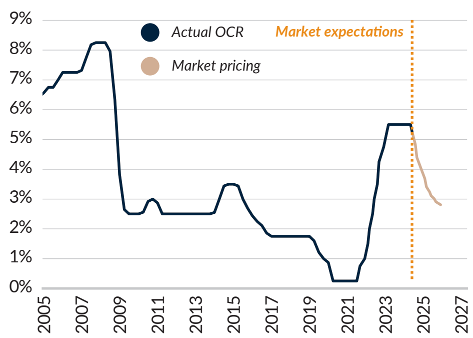
Interest rate cuts **rolling in**

The New Zealand economy has been bouncing in and out of recession for the past 18 months. Households and businesses are experiencing a significant slowdown, while at the same time, the government is tightening its purse strings. It's clear that lower interest rates are needed to revive demand. With inflation finally easing, the Reserve Bank of New Zealand (RBNZ) cut the Official Cash Rate (OCR) from 5.50% to 5.25% in August. Interest rate markets are pricing the OCR to fall to 3% by the end of 2025.

FORSYTH BARR

...inflation now expected to fall below 3% by September 2024...

OFFICIAL CASH RATE (OCR) AND MARKET PRICING (%)



Source: RBNZ, Bloomberg, Forsyth Barr analysis

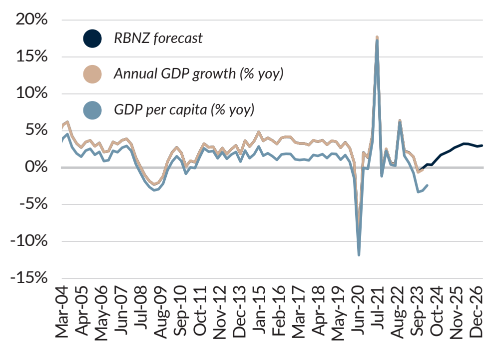
Delivering some stimulus, at last

New Zealand's economy has been struggling, with declining business activity and rising unemployment. Given the economic environment has been challenging for some time, you might have expected interest rate cuts to have already begun. However, the RBNZ's ability to cut rates was constrained by its mandate to keep inflation in a 1% to 3% target range – inflation has consistently exceeded the target for the past three years. With inflation now expected to fall below 3% by September 2024, the path to interest rate cuts has opened. In August, the RBNZ delivered the first of what we expect to be numerous OCR cuts.

Economic challenges, but light at the end of the tunnel

The New Zealand economy is in a tough spot, with the RBNZ forecasting a 0.5% contraction in the June quarter and another 0.2% drop in the September quarter—potentially marking the third recession in two years (a technical recession is when GDP contracts for two consecutive quarters). If it hadn't been for strong migration things would have been a lot worse. GDP per capita fell 2.4% over the year to March 2024. However, the outlook for 2025 is more optimistic. As interest rates fall, households with debt may find some financial relief.

NZ GDP GROWTH (% YOY) AND RBNZ FORECASTS



Source: RBNZ, Statistics NZ, Forsyth Barr analysis

WHAT IS THE OFFICIAL CASH RATE (OCR)?

The OCR is a critical tool used by the RBNZ to influence economic activity. Lowering the OCR makes borrowing cheaper, which can stimulate spending and investment, but it also reduces returns on savings. Conversely, raising the OCR can cool down economic activity by making borrowing more expensive.

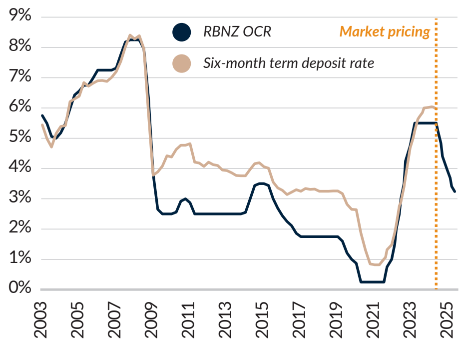
...lower rates mean reduced mortgage payments...

What does this mean for New Zealanders?

1. Falling bank interest rates

For savers, the most immediate impact of a lower OCR is reduced returns on savings accounts and term deposits. This can be challenging, especially for retirees relying on interest income. Savers may need to spend less or explore alternative investment options. For borrowers the story is positive; lower rates mean reduced mortgage payments, freeing up disposable income.

RBNZ OCR AND SIX-MONTH TERM DEPOSIT RATES (%)



Source: RBNZ, Bloomberg, Forsyth Barr analysis

2. Lower interest rates on fixed-income investments

The NZ bond market has already seen strong capital gains in recent months (prices of fixed rate bonds rise when market interest rates decrease), a trend likely to continue with further interest rate cuts. For now, bond interest rates remain relatively elevated compared with history. In time, the interest earned from investing in bonds is likely to move lower.

3. Potential boost for the stock market

The New Zealand equity market is quite sensitive to the level of interest rates due to its high weighting in sectors like real estate, telecommunications, and utilities. These sectors typically pay reliable dividends, and investors often view them as alternatives to fixed interest investments such as bonds and term deposits. When the OCR rapidly rose from 0.25% to 5.50%, the NZ equity market struggled and underperformed relative to its international peers. During this time, fixed-income investments became more attractive, and the appeal of NZ stocks for dividend yields declined. Over the past 18 months a tough operating environment for many NZ companies has also been a major headwind which has been emphasised during the current company reporting season.

...savers will need to adapt to lower returns...

Falling interest rates can provide several forms of support to the local equity market:

Encouraging spending and investment: Lower rates can boost economic growth, leading to stronger sales and higher corporate profits.

Increasing company valuations: As interest rates drop, investors use a lower discount rate to value future cash flows, boosting valuations.

Reducing debt costs: Lower interest rates reduce borrowing costs for leveraged companies, reducing their interest expenses.

It's crucial to remember the fact that OCR cuts are happening reflects underlying economic weakness in New Zealand. While the stock market doesn't directly mirror the economy, the challenging environment continues to weigh on many companies' earnings.

What does the future hold?

The RBNZ has indicated that more rate cuts are likely, with the OCR possibly dropping to around 3% over the next 18 months. The pace of these cuts will depend on how the economy performs. If conditions worsen, the RBNZ may cut rates more quickly; if they stabilise, the pace could slow.

Navigating the changing financial landscape

With lower interest rates now a reality, borrowers can expect some interest rate relief on the horizon. On the other hand, savers will need to adapt to lower returns on traditional savings products. Bonds still offer the opportunity to lock in longer-term interest rates. For those holding cash it might be a good time to consider alternative options.

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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