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Interest rates seen peaking as RBNZ shifts focus to easing inflation

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Global markets unsettled by political events in May, but bright signs emerging

May was an eventful month for fixed income markets. Political developments had more of an impact than would normally be the case as the tug-of-war over the US debt ceiling in Congress unsettled markets and pushed up US Treasury yields. In response to the deadlock, the credit rating agency Fitch Ratings placed the US's Long-Term Foreign-Currency Issuer Default Rating on Rating Watch Negative on 24 May. This prepared the ground for a possible downgrade for the US from its top-tier "AAA" rating depending on further deterioration in the situation. Even so, US consumption remained resilient and downgrades to forecasters' expectations of US economic growth were not as large as had been feared. Another bright sign was provided by Europe, where the energy crisis resulting from Russia's war with Ukraine was less severe than anticipated. In addition, China saw its GDP grow by a faster-than-expected rate of 4.5% year-on-year in the first quarter of 2023 as it recovered from the impact of COVID lockdowns. This was an important development for New Zealand given its high reliance on China as an export market.

OCR likely to have peaked at 5.5%

In another encouraging sign for New Zealand, the Reserve Bank of New Zealand (RBNZ) signalled in its 24 May Monetary Policy Statement that the Official Cash Rate (OCR) is likely to have peaked at its current level of 5.5%. Although the RBNZ raised the OCR to its current level with a hike of 25 basis points on the same date as the statement, it also commented that inflation is likely to return to the target range of 1-3% per annum if it keeps interest rates at a restrictive level for some time. The lower probability of further hikes is positive news for mortgage holders, who have been seeing rapid rises in borrowing interest rates at a time when inflation is close to 7%. At the same time, relief is still a long way off given that cuts in the OCR appear just as unlikely as further hikes in the near future. Looking ahead, the RBNZ has built in a modest rate cut in approximately a year's time and sees the OCR falling to 3.3% by the middle of 2026.

RBNZ focus shift, government spending outlook support rate peak view

The likelihood that rates have peaked was given further support by an indication in the RBNZ's Monetary Policy Statement that the central bank has shifted its focus from inflationary pressures to the factors that will drive inflation down. Factors cited by the RBNZ include weak global growth, easing inflationary pressures among New Zealand's trading partners and reductions in supply chain constraints. In our view, this shift in focus suggests that the RBNZ is highly unlikely to hike the OCR above 5.5% unless significant surprises on the upside occur in the economy. The RBNZ also commented that it expects government spending as a percentage of GDP to decline over the coming years as expenditure is normalised following the soaring levels seen during the pandemic. This also supportive of the view that interest rates have peaked given that lower spending will ease an additional source of inflationary pressure in the economy.

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