ECONOMIC BULLETIN

Travel notes UK and Europe, November 2024.

26 Nov 2024 | **Kelly Eckhold**, Chief Economist | economics@westpac.co.nz

Summary.

I travelled to have discussions with key foreign clients from November 11-22. Discussions were held with a variety of market participants including central banks, asset managers, insurance companies, hedge funds and bank treasuries.

Most clients indicated they saw significant opportunities 9-12 months ago to be invested at what seemed like very attractive interest rates. Since then, views have diverged. Some clients still expect further significant easing in NZ given the still-flat economy. Others were more circumspect, noting that NZ rates are no longer as relatively high, and much is priced into the yield curve. There was significant uncertainty on the RBNZ's reaction function given the large change in policy direction seen in 2024.

Global issues are front of mind with clients, including the higher level of interest rates in major markets, the potential for higher government debt loads from easier fiscal policy in the US and Europe, and the potential for greater exchange rate volatility given that it seems more likely that the correlation between interest rates across jurisdictions could be lower than seen in recent years.

NZ economic outlook.

The perceived weak economy was seen as driving the OCR lower.

Clients generally saw NZ growth as very weak. This was the key factor driving client expectations of lower interest rates in 2025. More dovish clients took the view that interest rates would need to fall some way below neutral levels to generate a meaningful economic rebound. There were varying views on how far the OCR would need to fall to achieve this. Many seemed to have an OCR trough around 3% in mind while others saw 2-2.5% as possible.

Inflation concerns took a backseat.

The inflation outlook seemed to be of lesser focus. Clients were aware that local non-tradables inflation was still too high, but thought this was less important now headline inflation is lower. The RBNZ's perceived reduced focus on inflation in recent statements was also a factor guiding client perceptions. Some thought that factors such as large increases in insurance and local authority charges driving non-tradables inflation meant this reduced the importance of it as a factor.

Increased demand for NZ commodities was an underappreciated factor.

The recovery in commodity prices was an underappreciated factor in clients' minds. Most thought that weak Chinese growth was translating to weakness in commodities demand and were surprised to learn this has not been the case for New Zealand this year. Clients were interested in our forecast of a $10/kg milk payout this season, adding 1% of GDP to incomes.

Clients are attuned to any potential housing rebound.

Clients are wary of a return in housing demand, and the implications for growth and bank hedging demand in the interest rate swaps market if mortgage holders lengthen the maturity of their mortgages and if credit demand increases. There was considerable interest in indicators of returning housing and mortgage demand such as monthly housing and credit data and mortgage approvals.

The neutral interest rate was seen as decidedly higher than pre-Covid.

Clients were very interested in views of where the neutral interest rate might lie. Clients found the argument that NZ rates should sit at a margin above Australian and US neutral rates compelling and accepted our house estimates for those. There was strong agreement that global interest rates were set to remain considerably higher than pre-Covid levels and this would have implications for NZ interest rates.

The NZD was seen as set for a period of relative weakness.

Clients were interested in the potential for a lower exchange rate and asked how this might impact interest rates looking ahead. There seemed an acceptance that the NZD was set for a period of underperformance. Clients agreed that the combination of low or negative short term interest rate differentials, a high current account deficit and high structural fiscal deficit made a strong case for a weaker NZD. Clients seemed to accept that significant weakness in the NZD might constrain the extent to which interest rates could fall in the period ahead.

A 50bp cut by the RBNZ was seen as the path of least resistance.

There seemed a strong consensus that a 50bp cut by the RBNZ in November was the most likely scenario and the path of least resistance. Some were interested in the potential for a 75bp cut, with the long gap to the February 2025 meeting being a key factor motivating that possibility. Most though agreed that a 75bp cut was unrealistic and would be out of step with recent data and messaging.

Clients find reading the RBNZ's reaction function as challenging.

Clients perceive the RBNZ's behaviour as hard to read. Most cited the very hawkish stance taken in the May meeting followed by the August cut as the key factor here, although the pace of tightening post Covid was another factor cited.

The pickup in the pace of easing in October with apparently little data to support it was another issue raised. There was a sense that the RBNZ was being led by the market.

Clients seemed apprehensive about a 25bp cut in the November meeting, as this would conflict with their views that the OCR would move relatively quickly towards 3%. Clients noted that most high-profile data on output and the unemployment rate were stronger than the RBNZ expected in August, hence the risk this might see the RBNZ revert to the 25bps easing camp.

More generally, the difficulties in understanding the RBNZ's reaction function were seen as reducing client appetite to trade tactically in NZ. Rather, the preference was to wait for very compelling opportunities when rates in NZ seemed out of line with fundamentals or alternative markets before jumping in.

NZ's exposure to US tariffs was a key area of discussion.

New Zealand's exposure to tariffs in the US was of significant interest. Most didn't expect New Zealand to be a target of tariffs, but there was a recognition that tariffs might not be discriminating and that our exports to the US were substitutable for domestic supply. Clients agreed such risks might add to downside risks to the New Zealand dollar.

Key global issues of focus.

Global interest rates were seen as set to remain high.

There was a strong sense that Trump's emphatic election win cemented a higher global interest rate environment. This view was translated to NZ markets as reducing the chances of larger interest rate falls.

A stronger USD was seen as likely.

There was also agreement that a stronger USD was more likely and that there would be divergent performances of currencies versus the USD depending on their fundamentals. The sense was that we are in for a period of much more differentiation in FX and interest rate markets. The strong correlation in global rates seemed set to break down a bit.

Tariffs and trade restrictions were seen as having FX, interest rate and inflation consequences.

Tariff and trade policies were of key interest. Most expected tariffs in some form but views varied on their intensity. The choice of Treasury secretary was seen as relevant with some expecting that a more conservative pick might indicate less disruptive actions on the trade front. Most agreed though that tariffs would drive USD appreciation, add to inflation in many jurisdictions (even though in some cases there could be offsets from weaker manufactured goods prices redirected by China), as well as interest rates.

The potential for more lax fiscal policy was of key interest.

Fiscal policy was of keen interest. Clients noted that there would be additional spending pressures in the US, UK and Europe coming from the changed outlook. This was seen as steepening yield curves and putting upward pressure on government bond rates compared to interest rate swaps. Clients noted the adverse reactions to changed fiscal stances in the UK and France this year as signalling the way ahead elsewhere. This fiscal focus was translating to the NZ setting and generated a lot of questions on risks to the NZ fiscal outlook.

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