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# A BOND MANAGER'S PERSPECTIVE ON THE YEAR AHEAD

**With 2016 rapidly drawing to a close and the prospect of a new year upon us, it is customary to put thoughts of last year behind us and to turn to what may lie ahead.**

**Yogi Berra, the Yankees legendary coach said "It's tough to make predictions, especially about the future", he was right but here goes with some thoughts on what may unfold...**

- NZ Cash rate stays stable at 1.75% over 2017 but expect to see bank term deposit 'wars' keeping deposit rates close to 4%.
- Banks' 'blended' cost of funds increases, putting upward pressure on lending rates.
- The housing market cools enough in the Auckland area for the Reserve Bank to hold-fire on implementing new measures to moderate housing inflation.
- Increasing attention on potential fraudulent foreign student applications sees this sector of the migrant market decline. High migrant levels and high house prices will be linked as discussion heats up during election year.
- Domestic political risk becomes elevated as voters and investors weigh up potential policy changes. The chances of a Labour-led coalition have risen and there is now a new wildcard in the form of Gareth Morgan's The Opportunities Party (TOP).
- Ironically, political risk and potential policy changes could well do what the Reserve Bank has failed to do: weaken the NZD as the General Election draws nearer.
- Interest rates are expected to be more stable than many commentators fear. Ten-year NZ Government interest rates have risen by around 1.0% since their low points in mid-August 2016, with most of this occurring since Donald Trump's victory in November. We believe a repricing has occurred in bond markets to reflect the 'reflating' economic policies of the new US administration. More rate rises may occur, but we believe the 'shock' movements have already occurred in markets.
- The investment performance and risk characteristics of bond markets are different than equity markets. As long as bonds do not default, poor performance in bond markets is often followed by out-sized returns. I am dragging up history here and while we cannot predict the future based on past performance, it is wise to look at key movements in the past. Investors with long memories often reference the bond market 'rout' of 1994 as an example of how investors in bonds can lose money. It is true that over the calendar year of 1994 the NZ Government Stock Index declined by 2.8%. However, it often goes unreported that the return from the Government Stock Index over the following year was 13.2%. More recently, the Government Index declined 2.0% in 2013 but bounced back in subsequent years generating returns of 7.8% and 5.4% in 2014 and 2015 respectively. Returns from investment grade corporate bonds were even higher.*
- Interest rate levels and their likely future direction are key determinants in gauging the attractiveness of many other asset classes, especially those seen as 'bond proxies' or 'yield plays' such as commercial property, infrastructure and high dividend shares. In many cases we have seen the prices of these assets fall as longer term interest rates have risen and investors have priced-in the expectation of even steeper increases.
- Only time will tell if the fear of future rates rises are fully realised. However, for a New Zealand investor faced with the likelihood of the Reserve Bank of NZ keeping short term rates low for all of 2017 and into 2018, it seems safe to invest in bonds issued by high quality issuers at yields over 4%pa out to a maturity of five years.

**With an investment yield at 4%pa or above investors are comfortably exceeding the rate of inflation and we would expect on average to exceed the return on cash**.**

**Best wishes for 2017.**

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* Source: Bloomberg, returns before fees and tax.
**This document contains predictions that may not materialise.

## Important Information