

New Zealand Fixed Income Monthly September 2022

New Zealand bond market stable despite volatility overseas; dramatic rate hikes unlikely

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New Zealand bond market relatively stable amid overseas turbulence

September was a month of significant change in overseas bond markets. While the US 10-year Treasury yield started the month at around 3.2% before peaking close to 4%, an even larger story was the turmoil in the UK, where the 10-year gilt surged from a low of 2.8% to a high of 4.5%. The UK bond market also underwent some dramatic overnight moves during the month, with the 10-year yield seeing changes of up to 50 basis points and longer dated bonds experiencing even larger swings. The New Zealand bond market was stable in comparison, with the 10-year yield starting the month at 4% and peaking at 4.35%. In the coming months, the New Zealand market is unlikely to see UK levels of volatility; one factor behind the turmoil in the UK, for example, was the country's very high rate of inflation and associated pressure from energy issues. Uncertainty over a potentially large public fiscal outlay was similarly UK-specific.

Dramatic interest rate hikes unlikely

As had been widely expected, the Reserve Bank of New Zealand (RBNZ) raised the Official Cash Rate (OCR) by 50 basis points to 3.5% at its meeting on 5 October. However, this was one of only three monetary policy meetings scheduled by the RBNZ in the next five months, with the central bank set to meet again in November followed by another meeting February next year. In terms of the outlook, New Zealand's economy has not slowed down as much as the central bank had been expecting. In addition, consumer confidence is holding steady and business confidence is improving, albeit from a low base. Businesses are primarily concerned with New Zealand's low unemployment rate and the related shortage of quality manpower. At the same time, New Zealand's economy is missing the boost it would normally get from inbound tourism, migration is currently subdued, and the economies of its major trading partners (Australia and China) are slowing down. These factors are likely to restrain interest rate rises as the RBNZ has indicated that its heightening cycle has matured. Although we feel that there are still between two and four OCR hikes to come, we now have greater clarity over the direction the rate is likely to take.

New Zealand bond market in relatively strong position

The outlook for the bond market is likely to depend on the direction of the economy. Inflation remaining a problem for longer (leading to an OCR of about 4-4.5%) would result in some term premium in the bond curve, with longer-dated bonds seeing yields 20-30 basis points above the cash rate. Significant weakening of the economy would lead to an inverted curve in which longer bonds were 20-30 basis points below the cash rate. Either way, we feel that there is little potential for rates to move much. The bond market has become more attractive both in terms of absolute return and yields from an accrual basis given that the heightening cycle has largely been priced in. Bonds are also benefitting from the contrast with risk assets such as equities in view of the volatility and challenges those markets still have ahead of them.

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