

New Zealand Fixed Income Monthly July 2022

Economic conditions may prevent the terminal cash rate from reaching the RBNZ's forecast

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Light at the end of the tunnel for the bond market

As we have already mentioned several times, it has been a very tough year for New Zealand bonds. Although there is perhaps light at the end of the tunnel after the market hit a very low point. In our view, good quality assets could outperform cash over the medium term; the Reserve Bank of New Zealand (RBNZ) has been forecasting a terminal cash rate of 4% versus the current 2.5%, but the rate is unlikely to get there unless the central bank takes very quick action. New Zealand had the world's fastest implementation of quantitative easing in 2020 following the outbreak of COVID-19, but many factors that supported the economy, such as high dairy prices and generous government spending, are now headed in the opposite direction. This has resulted in low business and consumer confidence numbers and reduced consumer spending power. Furthermore, demand for goods and services is expected to weaken as a significant number of New Zealanders—more than the number of visitors to the country—are expected to travel abroad as restrictions are eased. Due to such factors the RBNZ may not reach its forecast rate, although it will certainly try.

Firepower for the RBNZ to support the economy if necessary

We believe 2023 could be a relatively difficult year for New Zealand economically; as mentioned earlier factors that supported the economy, such as migration into the country, have been reversed. Prospects are not expected to improve until 2024 or 2025 when a recovery in international tourism is expected to begin. The RBNZ clearing its balance sheet through quantitative tightening will give it the option to ease monetary policy again if economic conditions deteriorate considerably. If the central bank had not tightened monetary policy after their extensive easing, they would not have the firepower to support the economy when necessary. Another option for the RBNZ to support the economy during dire times is to loosen some of the lending criteria in the mortgage market.

Inflation may have peaked

Inflation in New Zealand may have peaked, but we do not expect it to fall steeply. In a slightly worrying sign non-tradable inflation, such as interest rates and insurance, remain sticky. However, we are seeing hints of tradable inflation (such as goods traded across the border which are less affected by domestic economic conditions) coming down. There are also signs of relief in commodities, where we recently saw a surge in oil prices, in turn relieving some of the pressure on shipping costs. Once inflation peaks the RBNZ could begin cutting interest rates in mid to late 2023 in an attempt to take them back to the neutral levels of around 2.25 to 2.50%. If the central bank does take the Official Cash Rate to 4.0%, this may just bring forward the timing of their rate cut.

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