

RBNZ Changes Tack

Fixed Income Market Commentary

June 2011 | christian@harbourasset.co.nz¹ +64 4 460 8309

Key points

- Official Cash Rate (OCR) left on hold, but RBNZ signals interest rate hikes set to occur sooner and go further.
- RBNZ's worst fears post-quake not realised. Business confidence rebounds and commodity prices expected to remain strong.
- RBNZ no longer waiting for downside risks to abate – taking a more balanced view of risks.
- RBNZ sees wobbles to global growth as temporary and record NZ inflation expectations as a blip. These assumptions are both key risks.
- We are monitoring the risk that a widespread shift to fixed rate mortgages causes a sharp rise in the swaps curve.

Interest rate hikes sooner and higher...

The MPS back in March was written in the direct aftermath of the 22 February Christchurch quake, and dedicated almost entirely to the risks, challenges and uncertainties it created– with almost no mention of inflation. In response, the RBNZ cut the OCR by 50 basis points to 2.50% as an insurance measure, pointing explicitly to the timing of the Christchurch rebuild as gauge on when this might be unwound.

While leaving the Official Cash Rate (OCR) unchanged yesterday, the RBNZ changed tack in its June Monetary Policy Statement (MPS). It brought forward the forecast of its first hike to December, with a full 50 basis points by Jan 2012, an additional 150 basis points over 2012 to bring its forecast of the 90-day rate to near 5 percent by the end of 2013.

¹ Thanks to input from Mark Brown and Darryl Briggs.

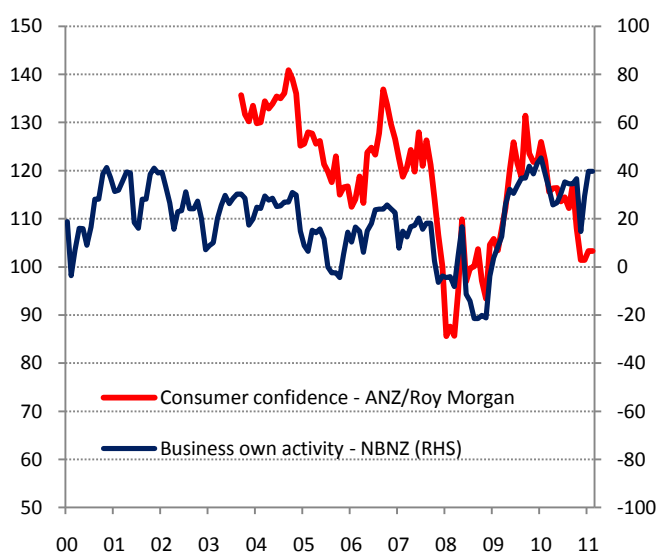
In response to the MPS, the NZ dollar rose to a post-float high touching 83 cents, and 2-year bond yields rose around 5-10 basis points. In responding to these moves in the media, the Governor is clearly more worried about the reaction of the currency.

Worst fears not realised, while commodity prices march on...

Since the March MPS, the RBNZ's worst fears have not been realised. While they still expect consumers to remain relatively subdued while they pay down debt, the RBNZ have taken a lot of comfort from the quick rebound seen in business confidence (Chart 1).

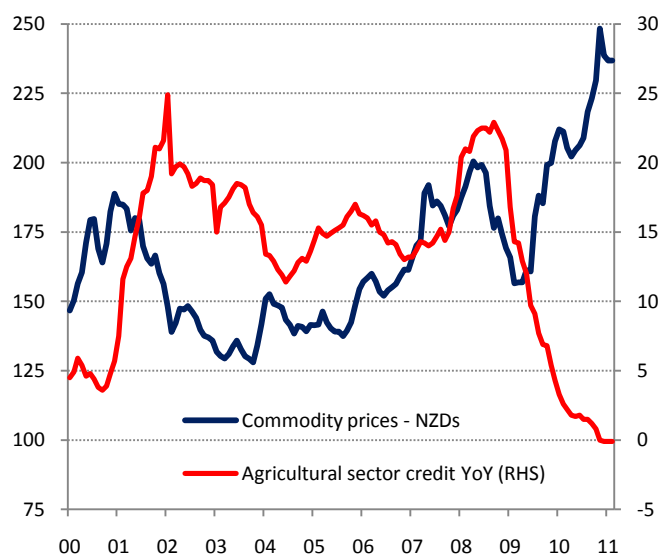
They also see the continuing rise in NZ commodity prices as broad based and with a strong persistent element. Up until now, that rise in commodity prices has largely been used by pay down debt, but the RBNZ sees the first signs of this wealth effect spilling over in the rest of the economy (Chart 2).

Chart 1: Confidence surveys



Source: Bloomberg

Chart 2: Commodity and agriculture



Source: Bloomberg

Downplaying the wobbles to global growth...

A key assumption underlying the RBNZ's view is that the recent deterioration the global outlook (through weaker US economic data and the European sovereign crisis) proves temporary, and the global recovery reasserts itself from the second half of the year. This in itself is a change in tack, given the RBNZ have long been pessimistic about global growth and worried about a sharp fall in the terms of trade.

In another key change, the RBNZ have also downplayed the importance of the timing of the Christchurch rebuild, which feels as difficult to guess as it did back in March. What seems more important now is that before the Christchurch quake the economy was building positive momentum, and now that business confidence has bounced, the RBNZ is returning to its pre-quake view of the world. Once the rebuild starts, it will become an additional economic driver the RBNZ lean against to keep inflation at bay.

No longer waiting for downside risks to abate ...

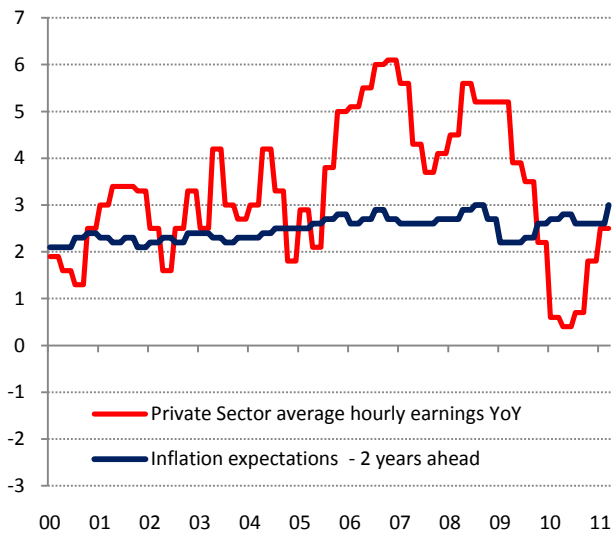
Since their March decision, the RBNZ has spoken about waiting for downside risks to abate before removing the post-quake insurance cut. The decision yesterday set out a much more evenly balanced view.

The key downside risk to the RBNZ's view is global economic activity. If the recent growth slowdown in the US economy is not temporary and gains more traction, it could spill over into Asia and other engines of growth, and see NZ commodity prices retrace their gains. This would be very significant given the importance of the strong terms of trade to their NZ growth and interest rate forecasts.

The key upside risk is from inflation expectations. The RBNZ's own 2-year-ahead survey spiked to a record 3% in June (Chart 3). They have assumed this is a blip, reflecting headline inflation numbers influenced by one-off rises in GST and petrol prices. But if the rise in inflation expectations turns out to be more persistent and spills over to wage demands, it would give generate a lot more worry about the difficulty of getting inflation back to target.

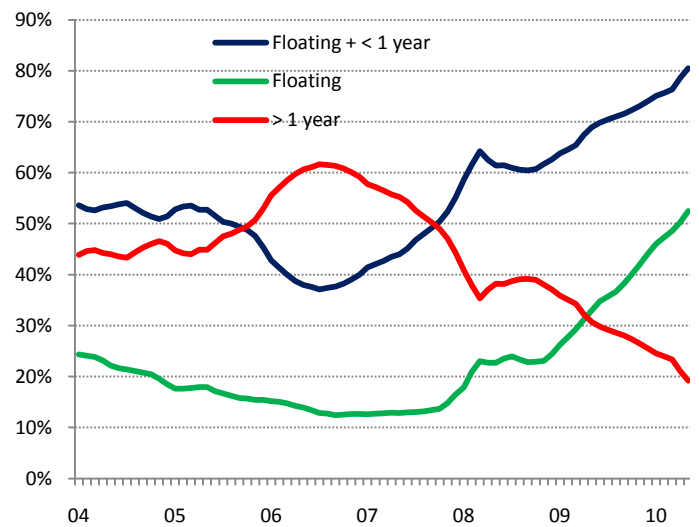
By holding back from hiking rates now, the RBNZ provides itself a bit more time to see if the improvement in confidence translates into hard economic data. The record proportion of mortgages on floating rate also provides them with more time to make that assessment (chart 4). Once the OCR is increased, it should impact more quickly than in the past, when there was a higher proportion of fixed rate mortgage holders.

Chart 3: Inflation expectations



Source: Bloomberg

Chart 4: Floating rate mortgages



Source: RBNZ

Reducing duration risk and credit risk...

Anticipating tighter NZ monetary policy pushing up interest rates, we had shortened the duration of our NZ Core Fixed Interest Fund. While local developments have seen higher short-term interest rates, the weak global outlook and ongoing foreign demand has kept NZ long-term interest rates relatively stable at their lows.

In the NZ Corporate Bond Fund, we have been taking the recent strength of NZ credit markets as an opportunity to further lighten our holdings of sub-ordinate and perpetual debt. Given the shortage of new supply, the NZ corporate bond market has performed strongly, at odds with global credit markets. We are watching carefully for any spill over from the weakness of global credit markets following renewed European sovereign worries.

Looking ahead, the economic data, as always, will be paramount. We expect a continuation of evidence that the economy is growing steadily, although unspectacularly. This should reinforce the sense of impending OCR hikes. In interest rate markets, the greatest risk is the swaps curve, where widespread talk of mortgage hikes could develop, prompting a wave of homeowners to look to lock in at 2-3 year fixed rates. This would in turn force banks to hedge through funding costs in the swaps market, pushing these rates higher. This is by no means a certainty, but a risk we are watching closely.

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