Harbour Investment Compass

FIXED INTEREST MONTHLY COMMENTARY

Prepared on 7th of March 2017

Overview for the Month

- After a sharp rise in Q4 2016, global yields continued to stabilise in February. The US 10 year yield ended down slightly at around 2.40%.
- The Reserve Bank of New Zealand (RBNZ)'s February Monetary Policy Statement continued to set a high hurdle before the Bank will consider lifting the OCR.
- The market is pricing no chance of a change in the Official Cash Rate (OCR) until November, when the odds rise to 50%. The NZ 2 year swap rate remains in a tight 2.30-2.40% range.
- Market pricing for a March rate hike from the US Federal Reserve rose to around 80%, after a series of speeches and testimonies prepared the market for the continued removal of stimulus.

Diverging paths for policy rates

After the sharp 100 basis point rise in global yields over the final months of 2016, bond markets continued to stabilise in February with yields drifting around 10 basis points lower for the month. The main theme over February was the diverging approaches of the RBNZ and US Federal Reserve, resulting in a 5 percent fall in the NZD/USD exchange rate from recent highs.

Back in November 2016 the RBNZ had cut the OCR to a new record low of 1.75% and set out a projection to remain on hold for the next 3 years – a clear message that they intended to be patient before signalling a change of approach. However, with domestic economic data continuing to illustrate healthy economic activity, in the lead up to the RBNZ's February Monetary Policy Statement the market had looked to test this view, pricing in two hikes by early 2018.

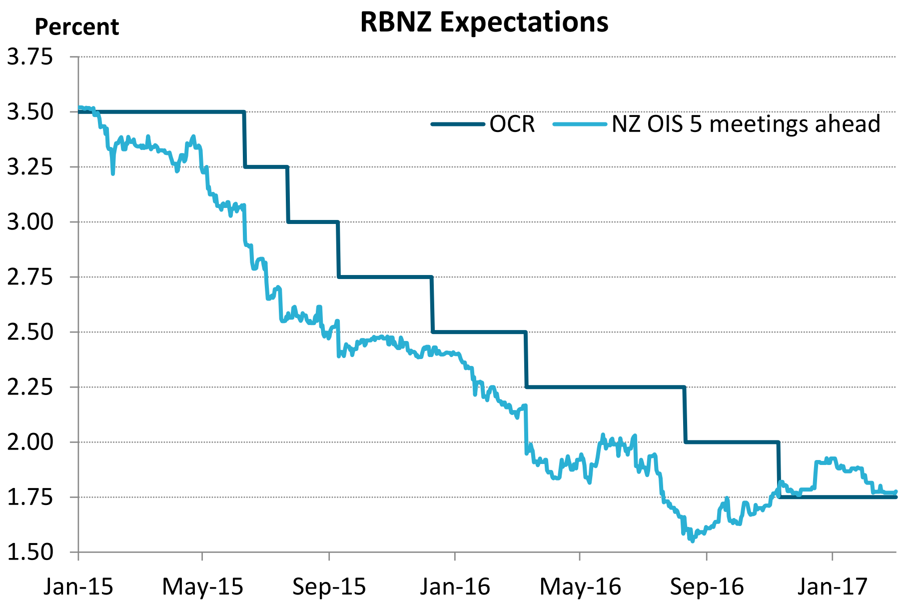
Our own analysis suggested the RBNZ's projections would not change materially: positive surprises on net migration and inflation were offset by a cooling housing market and a stubbornly high NZ dollar. In the end, the RBNZ took a step further, and included an explicit warning about the dangers of starting a tightening cycle too early:

"Premature tightening of policy could undermine growth and forestall the anticipated gradual increase in inflation, raising the risk of declines in longer-term inflation expectations".[1]

[1] *Reserve Bank Monetary Policy Statement, February 2017*

To us, this adds up to a real determination from the RBNZ to be patient about keeping the OCR at a record low in order to get core CPI inflation back to 2%, and to be confident to deal with any overshoot if that risk plays out. This idea that the RBNZ is in no hurry to change policy was reinforced by the announcement that Graeme Wheeler would not be seeking a second term as Governor when his current term ends on 26 September. As a result, the market is now pricing in almost no chance of any change in the OCR until November this year, when the odds move to 50%.

Chart 1: NZ Overnight Indexed Swap (OIS) market



Source: Bloomberg

By contrast, the US Federal Reserve appeared to take the opposite approach in February priming the market for an upcoming Fed Funds hike as soon as the March meeting.

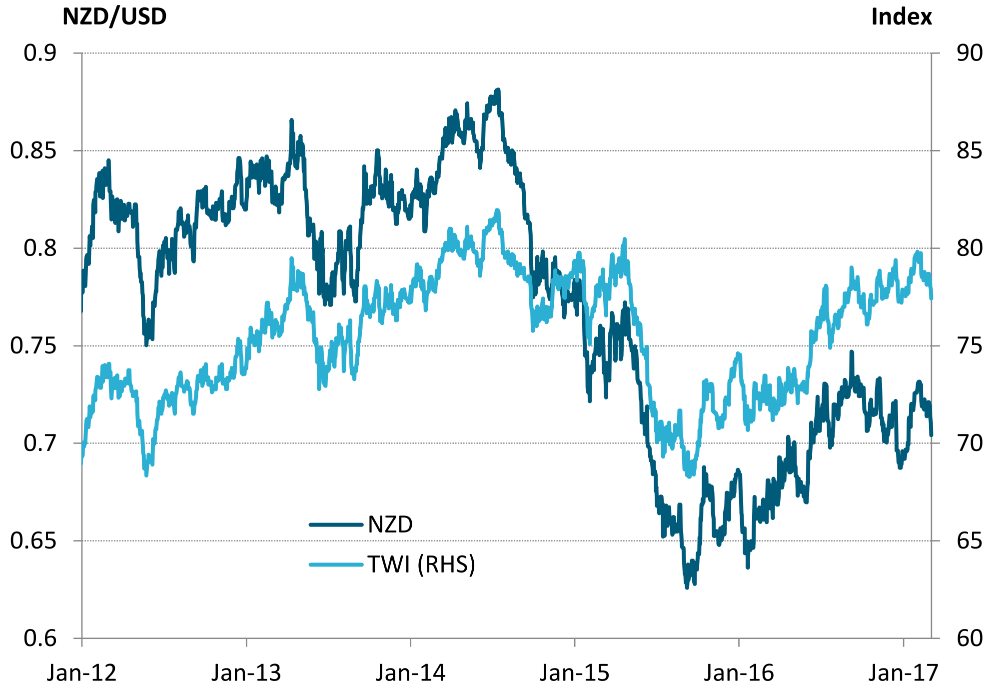
While the US economic data has been encouraging and typically surpassing economists' expectations, it had been felt that the Federal Reserve had not given sufficient signals in January that they would be actively considering a rate hike in March. Things changed during Janet Yellen's testimony to Congress in February when this was clearly put on the table. Indeed, Yellen provided a word of caution that was almost the complete opposite of that offered from the RBNZ:

"…waiting too long to remove accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly... "

This idea that US Federal Reserve was more confident about lifting interest rates was reinforced by New York Fed President, Bill Dudley, who noted that the case for a rate rise in March had become more compelling. Market pricing for a move in March has risen to around 80%, from a low of just 20% early in the month.

The combined effect of a more dovish RBNZ and more hawkish US Federal Reserve saw the NZD/USD fall around 5% from its recent highs.

Chart 2: NZ Dollar



Source: Bloomberg

Despite a more hawkish tone from the US Federal Reserve, 10 year government global bond yields fell marginally over February.

There were a number of factors at play. First, the market remains sceptical that the US Federal Reserve will hike rates as fast as the Federal Open Market Committee (FOMC) projects over 2017 to 2019, in part given the experience of delays since the tightening cycle it was first signalled in 2014. Second, the re-emergence of European and US political risks in February recreated a flight to safety into government bond markets. In Europe, polls showed the first signs of Marie Le Pen having a realistic chance of creating a surprise upset in the French elections. In the United States, the resignation of Trump's national security adviser served as a reminder that, regardless of a pro-growth inflationary agenda, geopolitical risks and uncertainties remain.

We continue to see the balance of risks skewed towards global long-term yields rising through 2017, as the strength of the US economy helps the US Federal Reserve deliver on its plan to remove stimulus. That said, we do not see yields rising sharply from their current levels. In our judgement, that would also require monetary policy at the European Central Bank and Bank of Japan to become less accommodative.

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