Harbour Investment Compass

FIXED INTEREST MONTHLY COMMENTARY

Prepared on 4th of April 2017

Overview for the Month

- After a sharp rise in Q4 2016, global yields have remained range bound year to date. The US 10 year yield ended March little changed at around 2.40%.
- The Reserve Bank of New Zealand (RBNZ)'s March OCR Review continued to stick to the line that they have a high hurdle before considering a rise in the Official Cash Rate.
- The market is pricing no chance of a change in the OCR until November, when the odds rise to 30%. The NZ 2 year swap rate remains in a tight 2.27-2.40% range.
- The US Federal Reserve (US Fed) delivered on a well-signaled rise in the US Fed Funds Rate in March, and continued to stick to the line of expecting 2 more hikes in 2017.

Sticking to the line

After the sharp 100 basis point rise in global yields over the final months of 2016, bond markets have been relatively subdued and range bound so far in 2017.

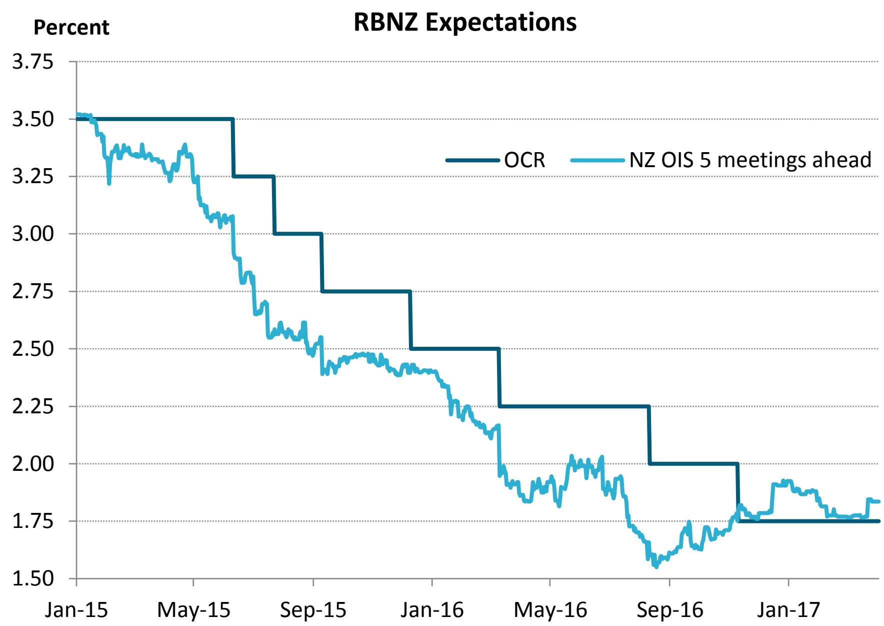
Locally, the main event in fixed interest markets was the Reserve Bank's March OCR Review. While the decision to keep the OCR unchanged at 1.75% was widely anticipated, we thought there were 3 key out-takes from their statement:

- First, the RBNZ appeared to downplay all the main economic developments since their February projections. For example, the NZ TWI falling 4% from its highs was discounted in part as a reaction to lower dairy prices, and December quarter GDP coming in well below forecast was dismissed as being distorted by temporary factors.
- Second, the RBNZ used the word "uncertainty" in 4 out of the 6 paragraphs in the statement. The international outlook, geo-political landscape, dairy prices and housing market outlook all remain uncertain. While most authors would look in the dictionary for a synonym, to us this use of repetition seemed more like a deliberate literary device to hammer home the point.
- Finally, the paragraph at the end of the statement was exactly the same as February, reiterating that "monetary policy will remain accommodative for a considerable period".

In our view, this all adds up the RBNZ sticking to its line, and having a very high threshold before changing its strategy or communication. As a result, the front end of the yield curve has become very well anchored. The NZ 2 year swap rate traded in a tight 2.30-2.40% range for much of March, with the market almost completely ruling out the chance of a change in the OCR until November, when the odds rise marginally to 30%.

Rather than data on NZ economic activity, we continue to see the inflation outlook as being key to the RBNZ decision making. NZ CPI for Q1 2017 will be released in April, with many economics picking a jump in headline annual CPI inflation, possibly all the way back to the 2% target. However, we believe the RBNZ is likely to look through these oil and currency related moves, and instead emphasise the importance of core inflation and inflation expectations. We suspect that it will be until at least September that the RBNZ has enough evidence to declare victory on stubbornly low inflation, and look ahead to a period where the OCR normalises to higher levels.

Chart 1: NZ Overnight Indexed Swap (OIS) market



Source: Bloomberg

Holding the market's hand

The US Fed undertook a similar hand holding exercise in March, delivering a "dovish" hike by lifting the US Fed Funds Rate to a new range of 0.75% - 1.00%, but leaving their projections of future monetary policy unchanged for the end of 2017, 2018 and 2019.

This was a very well telegraphed move from the US Fed. A little over a month before, the market was only placing a 20% - 30% probability on the chance of a rise in the US Fed Funds at the March meeting. However, in recent weeks pricing jumped to 90% - 100%, after a series of speeches and testimonies from FOMC members left the market with no doubt that a March move was a done deal.   The continued US job creation and convergence of US inflation to the 2% target had made a compelling case for the US Fed to deliver on the first of 3 hikes that they had projected for 2017 back in December.

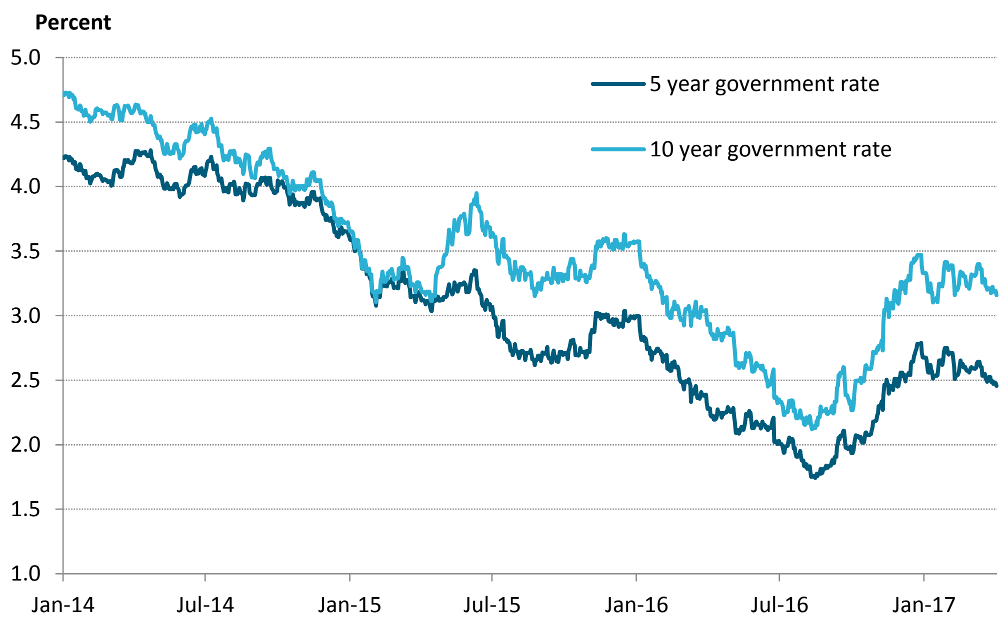
The market's fear going into the US Fed decision was that the US economic data had been so encouraging that it would prompt the US Fed to signal a more aggressive path of hikes in years to come. This did not happen. The median 'dot plots' for the end of 2017, 2018 and 2019 were unchanged at 1.375%, 2.125% and 3.0% respectively. Indeed, the main change was that the range of dot plots for individual FOMC members has converged closer to these median forecasts, implying more consensus amongst the committee on the outlook.

Central banks are always at pains to emphasise that future monetary policy decisions are 'data dependent'. If the economic data changes, so does the outlook for interest rates. The FOMC statement was once again silent on the inflationary implications of the US administrations agenda for fiscal, infrastructure and trade policies. As more concrete policy details and progress with Congress becomes clearer, the US Fed will be able to formally incorporate the implications into their own projections. In this sense, monetary policy may have moved from being 'data dependent' to being 'policy dependent'.

Over the course of March, global long-term yields, including in New Zealand, have been at the mercy of sentiment around the ability of the US administration to deliver on a more reflationary policy agenda. The inability of the White House and Republicans in Congress to agree on a replacement healthcare bill illustrated the challenges of making policy deals in Washington, and resulted in a blow to the market's confidence in meaningful tax reform being forthcoming.

In our view, the underlying economic data in the US and Europe has been strong, even before the prospects of an expansionary fiscal package are considered. In that environment, and with yields near the bottom of the 2017 range, we see the risks skewed more towards bond yields re-establishing the upward path that began in mid-2016. That said, continued monetary stimulus in Europe and Japan is likely to cap how far global and New Zealand yields can rise in the medium term.

Chart 2: NZ Government Bond Yields



Source: US Federal Reserve Board.

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