Harbour Investment Compass

FIXED INCOME MONTHLY COMMENTARY

Prepared on 2nd of May 2017

Overview for the Month

- Global geopolitical developments drove bond markets during the month, with the New Zealand 10 year Government bond yield falling below 3% for the first time in 2017.
- While US and European economic activity is providing less upside surprises, there are early signs of inflation pressures re-emerging in the US and Europe.
- New Zealand annual Consumer Price Index (CPI) inflation rose to 2.2% for Q1 2017, ahead of the Reserve Bank of NZ (RBNZ)'s February projection of 1.5%, and through the 2% mid-point target.
- The market is pricing no chance of a change from the RBNZ until November, when the odds of an Official Cash Rate (OCR) hike rise to 30%. A full hike is not priced for nearly 12 months.
- The upcoming May Monetary Policy Statement will test the RBNZ's view that the outlook for the OCR is evenly balanced.

The rise of global geopolitical risks

While the media can often become fixated on the geopolitical issues on the horizon, unless there are material macroeconomic implications, these themes can often be minor or fleeting issues for markets.

Last month provided the exception to this rule, with a number of geopolitical events in Europe, the Middle East, Asia and the United States occurring at the same time, creating a heightened sense of risk aversion and driving global bond yields lower for much of April.

In Europe, markets worried about the first round of the French presidential election, where a convergence of candidates at around 20% in the opinion polls increased the risk of both the extreme left and extreme right representatives making make it through to the second round of voting. In our view, the surprise outcomes in the 2016 Brexit vote and the US presidential election have made the market wary of taking any comfort from opinion polls or betting odds.

At the same time, the current US administration undertook a wave of aggressive geopolitical actions, including their first military intervention in the Syrian conflict, dropping the 'mother of all bombs' on a network of ISIS tunnels in Afghanistan, and upping the 'war of words' with North Korea over their nuclear aspirations.

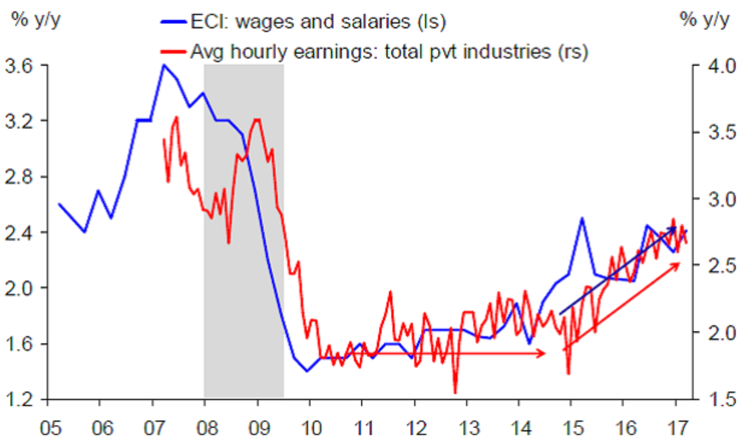
Just as these geopolitical risks intensified, there were also a couple of US economic data releases that surprised on the downside, creating some doubt about the strength of the US economy. In particular, US monthly non-farm payrolls came in at a disappointing 98k (its lowest reading since June 2016). This continues the theme of divergence between soft economic data (pointing to building strength) and hard economic data (pointing to a more mixed picture).

As a result of these themes, the US 10 year bond yield fell to 2.15% during April, its lowest level since last year's US election. This also saw the NZ 10 year Government bond yield fall below 3% for the first time in the same period.

Looking ahead, we see the outlook skewed towards higher long-term bond yields, driven partly by the US and Europe.

After data on economic activity surprising economists on the upside for much of the past 6 months, it will be difficult for this momentum to be maintained. We believe the narrative and focus is moving from economic activity to inflation. As a result of solid economic growth in recent years, there is less spare capacity, and there are early signs that inflation pressures are finally beginning to build. This was seen during April, with both Eurozone CPI inflation and US employment costs coming in stronger than expected.

Chart 1: US employment costs



Source: Deutsche Bank.

Looking forward, the ability of the US administration to get key policy initiatives enacted will likely be important. The failure to repeal Obamacare has reminded the market of the challenges of the political environment in Washington. With scepticism now high, bond yields appear more vulnerable to rise if the US administration surprises markets by having success in implementing policy changes.

Similarly, the market also appears to have taken its eyes off the outlook for US monetary policy. In March, reflecting these growing inflation pressures, the US Federal Reserve was conditioning the market for further hikes in the US Federal Funds rate (as soon as June), and preparing the market for a plan to start shrinking its balance sheet. By contrast, the market only has one further US Federal Funds hike fully priced for 2017.

NZ CPI inflation surprising on the upside

This divergence between market pricing and inflation pressures is also a theme that is starting to develop locally in New Zealand.

The NZ 2 year swap rate remained in a very narrow range over the course of April, centred around 2.30%.

This tight range has been driven in part by the RBNZ's strong signal that they are on hold for an extended period as they assess the outlook. At the same time, global geopolitical risks have kept local wholesale interest rates at the bottom of their recent range.

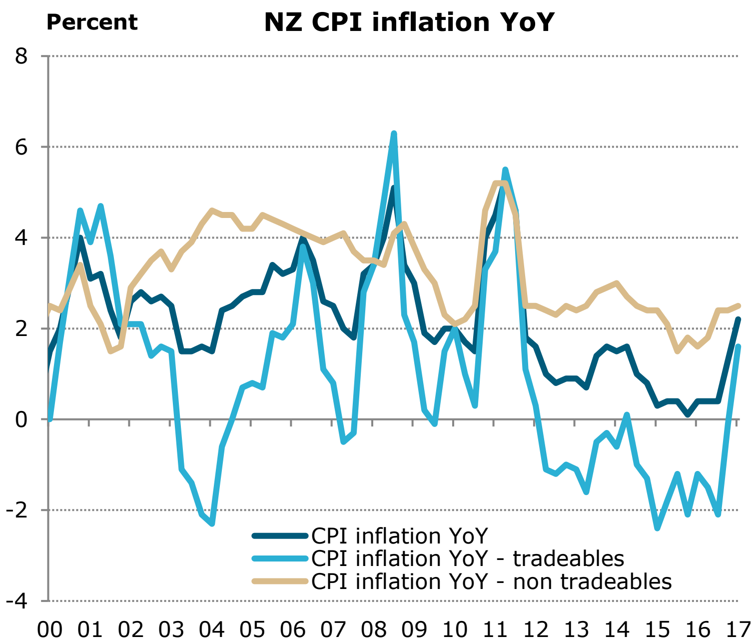
However, there are some signs that the New Zealand inflation outlook is changing. After continually surprising on the downside for nearly 5 years between 2011 and 2016, the last two NZ CPI inflation outturns have surprised on the upside. The latest Q1 annual CPI number of 2.2% is not only back in the RBNZ's 1-3% target range, but also noticeably above the 1.5% projection released by the RBNZ in February, and right through the 2% mid-point of their target.

To be sure, there were some one-off factors that inflated the CPI number, and the RBNZ has a very high threshold for claiming victory over the threat of deflation that has lingered in recent years. Thus we believe the RBNZ is unlikely to change their communications materially any time soon.

That said, a lesson from the fall in CPI inflation through 2014 to 2016 was that headline inflation has a powerful influence on inflation expectations. Not only have the mean and medians of inflation expectations surveys started to rise with headline inflation in 2017, but there is a much smaller proportion of respondents worried about the tail-risk of inflation getting stuck under 1%. In addition, the Government has announced a range of policies (wage settlements for aged-care workers, tighter immigration rules, increased infrastructure spending) which, on the margin, all point towards higher rather than lower inflation pressures.

While we expect the RBNZ to keep the OCR on hold at 1.75% for the rest of 2017, it is getting more difficult to say that the outlook is evenly balanced. In our view, there is a growing chance that the RBNZ will start to acknowledge the prospects for a higher OCR within their projection horizon.

Chart 2: New Zealand CPI inflation



Source: Bloomberg.

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