# Harbour Investment Compass

## FIXED INCOME MONTHLY COMMENTARY

**Information as at 31 May 2017**

## Overview for the Month

- The Reserve Bank of New Zealand (RBNZ) delivered a surprisingly dovish Monetary Policy Statement (MPS), retaining its projection of no change in the Official Cash Rate (OCR) until the end of 2019.
- The market is not pricing the first full hike from the RBNZ until mid-2018.
- The NZ 10 year government bond yield fell over 20 basis points to 2.80%, back to levels last seen before the US election at the start of the Trump reflation trade.
- NZ breakeven inflation rates rose noticeably in May, as the market factored-in a higher chance of the RBNZ's dovish stance lifting future Consumer Price Index (CPI) inflation over the medium-term.
- With the RBNZ seeking to look through any volatility in near-term inflation, it appears that measures of slow-moving core inflation will determine the RBNZ's policy approach.

## An unusual RBNZ surprise

Interest rates continued to fall in New Zealand over the course of May, primarily as the result of the market being wrong-footed by RBNZ signalling.

Heading into the May MPS, the market had been grappling with the question of how far forward the RBNZ would bring their projections of OCR hikes. The analysis of many economists and commentators suggested that the upside news since the February MPS (rising headline CPI inflation above expectations, rising 2 year inflation expectation, rising dairy prices, and falling Trade-Weighted Index (TWI) had more than outweighed the downside news (of moderating house prices and tightening in credit conditions).

Not only did the RBNZ reiterate its line "*monetary policy will remain accommodative for a considerable time*[1]", but it also kept the projections for the OCR unchanged from the February statement, implying the first hike at the end of 2019 – an outcome beyond the most dovish commentator.

We believe there were two main drivers behind the RBNZ's communications.

The first reason may come down to tactics. Few (if any) were arguing for an immediate OCR hike. However if the RBNZ had indeed signalled an earlier start to hikes (even into the end of 2018), the market may have

[1] RBNZ Monetary Policy Statement, 11/05/2017

become over-excited by the shift in communications and taken the New Zealand dollar and medium-term interest rates higher, thereby delivering an effective tightening in conditions that the RBNZ was not ready to deliver.

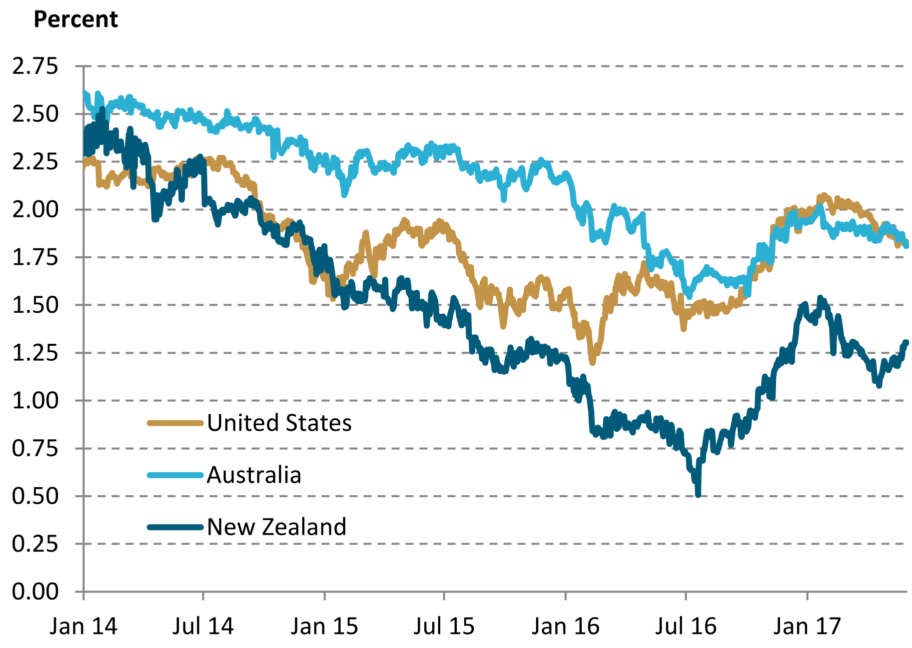
The second reason may be more fundamental. After experiencing CPI inflation surprise on the downside consistently for five years between 2011 and 2016, the RBNZ was perhaps hesitant to read too much into the fact that the last two quarters of CPI inflation have been above expectations. Having witnessed the strength of global deflationary forces in recent years, and having faced criticism for tightening too early in 2014, we believe the RBNZ now requires a very high threshold of evidence about trend inflation to change their view and adjust their communications.

In other words, if the RBNZ is willing to make a mistake, its preference would likely be to keep policy too loose for too long with CPI inflation rising above the target range, rather than tightening too soon and sending CPI inflation back below the bottom of the target range.

We see two main investment implications for fixed interest markets.

First, in our view, the RBNZ's dovish approach reinforces our preference for inflation-indexed bonds, as ongoing accommodative policy raises the likelihood that inflation exceeds the modest 1.10% p.a. inflation, which was at one stage priced into these securities over the next 10 years. Indeed, inflation-indexed bonds performed strongly following the MPS, with inflation breakevens rising to around 1.30%. We see inflation breakevens rising over the medium-term closer towards the RBNZ's 2.00% inflation target.

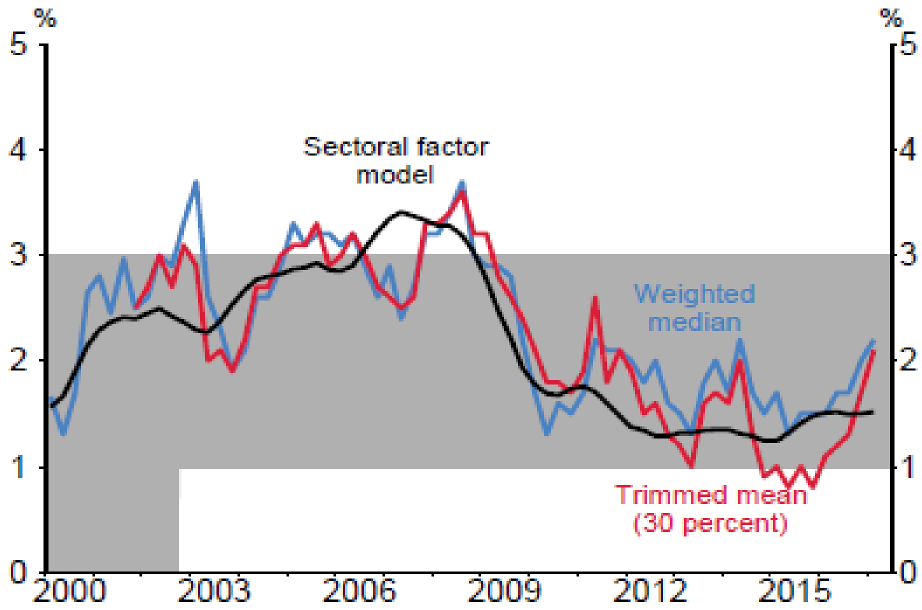
## Chart 1: Breakeven Inflation (BEI) rates




Source: Bloomberg and Harbour Asset Management.

Second, with the RBNZ seeking to look through any short-term volatility in CPI inflation, it further raises the prominence of signals from measures of core, underlying inflation. The RBNZ has made it no secret that its preferred measure is the so-called "sectoral factor model". This is a slow moving, smoothed variable, which will take time to deliver a conclusive signal that inflation is rising. As such, the RBNZ may stay on the side-lines for some time yet, meaning the short-term interest rates look to be relatively well anchored in tight ranges for the months ahead.

Chart 2: Measures of NZ core CPI inflation




Source: Statistics New Zealand, RBNZ estimates.

## The Trumpflation unwind

While inflation has surprised on the upside for two quarters in a row in New Zealand, in the United States the past two monthly inflation readings have disappointed on the downside, raising questions about whether the US Federal Reserve (US Fed) will deliver on its plans to continue lifting the US Fed Funds Rate.

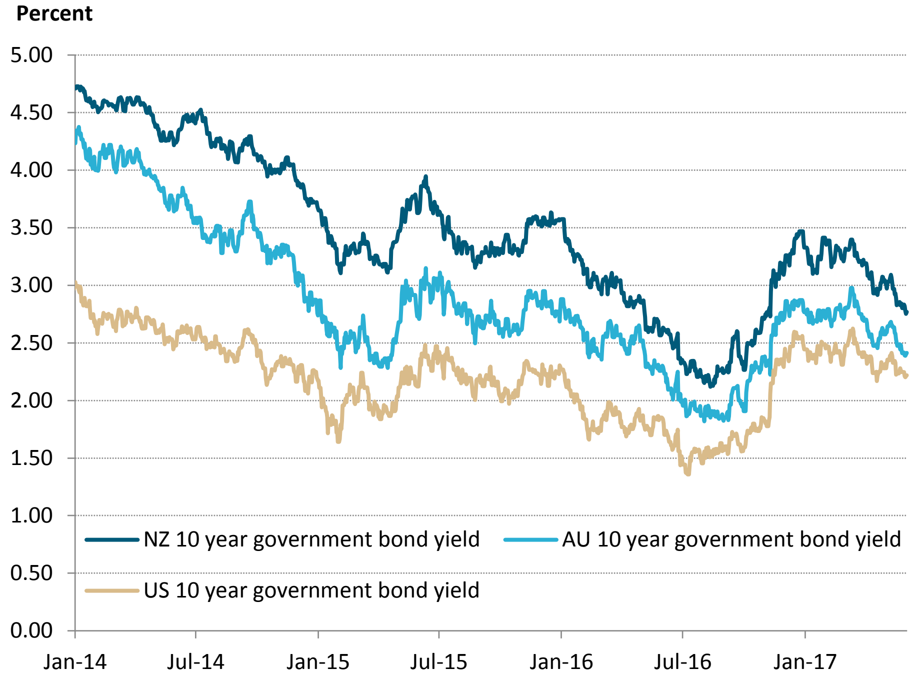
At the moment, the market is placing around an 80% chance of a US Fed Funds hike at the next meeting in June, based largely on the strength of previous signals from US Fed officials. However, beyond then, market pricing for the next full 25 basis point move has been pushed back to mid-2018.

An additional force keeping global yields down, for now, has been a sense that the Trump administration is embattled – fighting political and personal controversies on many fronts, and distracted from the task of building support within Congress to push through far reaching tax reforms and infrastructure spending programmes that would stimulate the US economy.

When these global influences are added to a move dovish RBNZ, the NZ 10 year government bond yield has now fallen to levels lower than those at the US election, before the Trump reflation trade began.

In our view, with yields already at low levels, and with the market already having a low expectation of the chance of US fiscal stimulus, we see the balance of risks to higher long-term yields globally. At the moment, markets appear to be under-pricing the prospect of looser fiscal policy and tighter monetary policy, as the US Fed moves closer to its plan of shrinking its balance sheet.

## Chart 3: 10 year government bond yields




Source: RBNZ, Bloomberg and Harbour Asset Management.

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