Harbour Investment Compass

FIXED INCOME MONTHLY COMMENTARY

Information as at 30 June 2017

Overview for the Month

- Mario Draghi, President of the European Central Bank (ECB), surprised markets with an upbeat speech on Europe shifting from deflation to reflation.
- This was reinforced by the US Federal Reserve (US Fed) announcing a plan to start reducing its balance sheet later this year, and a more positive tone from the Bank of England and Bank of Canada.
- Global yields rose around 15-25 basis points, as markets began to price-in the removal of extraordinary monetary policy stimulus.
- NZ market interest rates also rose, despite local macro-economic data pointing to lower inflation pressures and the Reserve Bank of New Zealand (RBNZ) reinforcing its messages that the Official Cash Rate (OCR) will be on hold for a considerable period.
- While most indicators of NZ economic activity remain solid, a tightening in local credit conditions is emerging as a risk to the outlook.

From deflation to reflation

Through the course of this year, the global bond market appeared to have progressively given up on the 'reflation trade', as faith in the ability of the US Administration to deliver fiscal reform faded, and the US economic data while solid was not beating expectations. As a result, 10 year bond yields, in the US and New Zealand, started the month of June at their lowest since the 2016 US election.

This tone in markets changed sharply towards the end of June when ECB President, Mario Draghi, began a speech at the ECB Forum on Central Banking with the opening sentences. "*For many years after the financial crisis, economic performance was lacklustre across advanced economies. Now, the global recovery is firming and broadening. A key issue facing policymakers is ensuring that this nascent growth becomes sustainable*."[1]

We see this as a clear reminder to the market that central banks in Europe and North America are shifting their focus from deflation to reflation, and will not be retaining the extraordinary post-GFC stimulus forever. These comments from the ECB resonated strongly with the market as they coincided with comments made by Bank of England Governor (Mark Carney) about the potential need to reverse the post Brexit (2016) rate

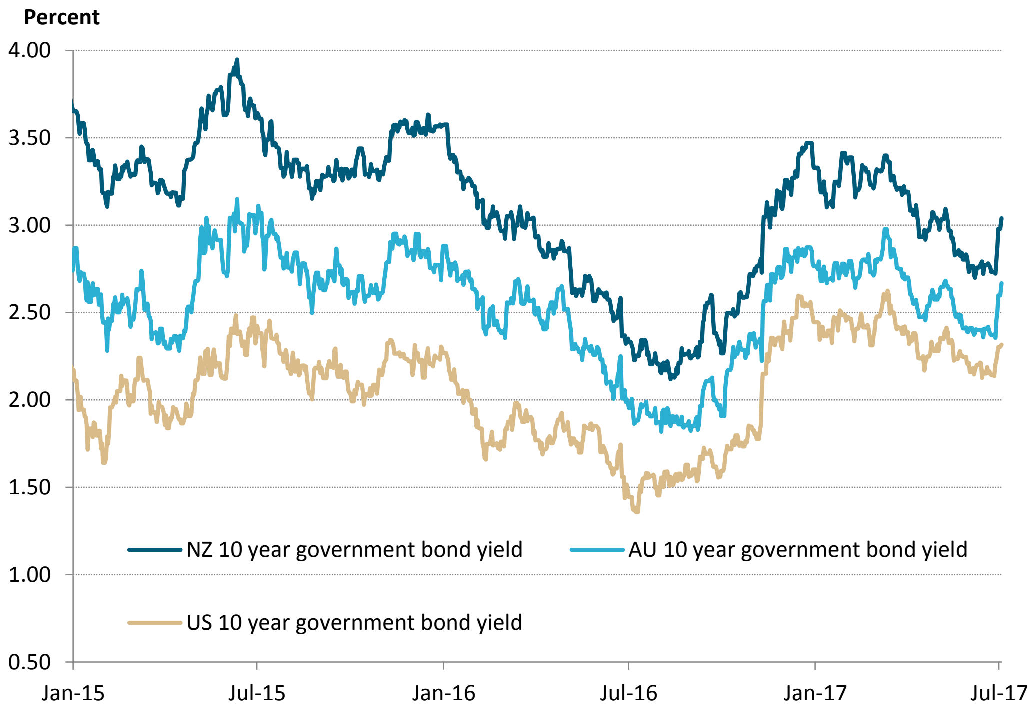
[1] Introductory speech by Mario Draghi, President of the ECB, at the ECB Forum on Central Banking, Sintra, 27 June 2017 https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170627.en.html

cut in the United Kingdom, and comments from Bank of Canada Governor (Stephen Poloz) about the potential need to reverse the post oil price crash (2014/2015) rate cut in Canada.

In addition, earlier in the month the US Fed had already illustrated its own determination to progressively remove stimulus. As expected the US Fed lifted the Fed Funds target range by 25 basis points from 1% to 1.25%. What was less expected by the market was the fact that the US Fed retained their 'dot plot' projections of one more hike in 2017, 3 hikes in 2018, and another 3 hikes in 2019. Furthermore, for the first time, the US Fed released a plan of how they expect to start reducing their balance sheet later this year. Once implemented, this will leave reserve balances at a *"level appreciably below that seen in recent years*."[2]

With economic data in the US and Europe solid but not exceeding economists' expectations, it appears that this change in tone from central banks reflects a combination of two factors. First, a growing recognition that excess capacity since the GFC has progressively being used up, and confidence that inflation pressures will eventually occur as a result. Second, a feeling that continuing to have extraordinary policy stimulus will do more bad than good, particularly from a financial stability perspective. This was reinforced by comments from US Fed officials, including San Francisco President John Williams, who noted in an interview that "*the stock market seems to be running pretty much on fumes*".[3]

Chart 1: Global bond yields



Source: Bloomberg.

In response to this string of comments, global bond yields rose sharply over the last few days of the month, with the US 10 year government bond yield ending around 15 basis points higher at 2.30%. The German 10

[2] US Federal Reserve, Addendum to the Policy Normalization Principles and Plans, 14 June 2017. https://www.federalreserve.gov/newsevents/pressreleases/monetary20170614c.htm
[3] https://www.reuters.com/article/us-usa-fed-williams-stocks-idUSKBN19I2B0.

year yield ended at around 0.45%, which is its highest level since the peak of the global reflation euphoria following the US election. It is likely that some of the sharp move higher in June was due to the market positioning for yields to remain low and stable, which would have accentuated the market reaction to a change in tone. That said, in our opinion, over a 6 month horizon we continue to expect global long-term yields to rise as the market moves further towards the US Fed's dot plot, even if not all the way.

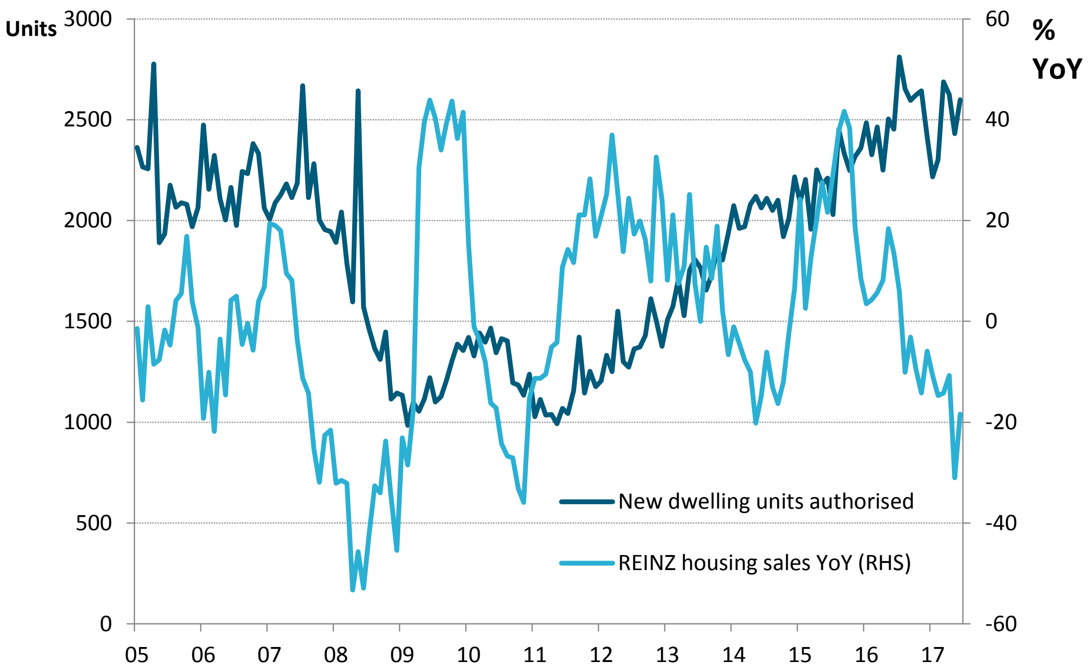
The RBNZ holds its 'on hold' approach

Locally, the RBNZ has again bucked the trend and taken the opposite approach of its central banking cousins.

In last month's Monetary Policy Statement, the RBNZ looked through a string of firmer NZ inflation indicators, including stronger than expected NZ CPI inflation in Q4 2016 and Q1 2017, rising inflation expectation surveys, and market measures of inflation expectations lifting. By sticking to their projections that rates will remain at record lows until 2019, the RBNZ came to the opposite conclusion of the US Fed and others. That is, that tightening too early could undermine growth and forestall the anticipated gradual increase in inflation. Bruised by the experience of tightening in 2014 (and reversing that move in 2015 and 2016), the RBNZ appears to have a high threshold to meet before signalling a new tightening cycle.

This theme was reinforced in the RBNZ's June OCR Review, which continued this message that the OCR is on hold for a considerable period, and policy genuinely neutral, without an upward bias. If anything, the local news since the May MPS reinforced the RBNZ's position, with GDP growth softer than expected, the TWI higher than projected in May, and oil prices lower – all pointing to less near-term inflationary pressures than the Bank's most recent projections.

Chart 2: NZ Housing Activity



Source: Bloomberg.

In addition, in recent months there have been many anecdotes about a tightening in credit conditions in the Australasian banking sector. As well as banks increasing their margins on floating mortgage rates, there have been increasing examples of banks rationing the quantity of credit, either in response to macro-prudential restrictions or new upcoming capital adequacy rules.

There is a delicate interaction with the NZ housing and construction markets. With house sales already falling sharply, the confidence of housing developers could be further eroded by a tightening in credit availability. There are already some signs of this occurring, with construction particularly weak within the latest GDP number, although building approvals have more recently recovered. This area of the economy remains at the top of our watch list.

Over the course of June, the NZ 2 year swap rates rose already 15 basis points to 2.35%, dragged higher by movement in global yields. While global yields may continue to drift higher, we believe that the stable outlook for the OCR should help anchor the NZ 2 year swap rate around current levels.

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