

New Zealand Fixed Income Monthly

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Yields move higher as inflation rises and more expected

October was a tough month for the New Zealand bond market with yields rising in anticipation of further increases in cash rates and in response to global markets bracing for the possibility of central banks reducing stimulus by tapering bond purchases. New Zealand's Q3 CPI surprised to the upside at 2.2%, for an annual increase of 4.9%—the highest level in more than a decade. Inflationary pressures are expected to persist, with the CPI seen peaking at 5.5% or higher around mid-2022 before receding back to the Reserve Bank of New Zealand's (RBNZ) 1–3% target band. The RBNZ is of course looking to the future when it sets interest rates, but history tells us that central banks often do not get to fully follow through on the extent of rate hikes that markets have priced into yield curves. Unseen events—such as the 2008 global financial crisis and the 2011 Christchurch earthquake—frequently get in the way of the best laid plans.

Auckland house prices could have implications on inflation and economic activity

Developments in the New Zealand housing market could become one of those events interrupting the RBNZ's forecasts and plans. Recent data showed that rapid population growth in Auckland, the country's largest city, came to a halt in the year through June 2021. The population decline was due to people moving out of the city combined with a lack of migrants from overseas. The drop in Auckland's population is important as it has implications for the city's house prices and ultimately for interest rates. Building consents are up in Auckland, so housing supply is still increasing, but this is taking place when the population is declining and demand is falling. Combine that with the previously favourable influence on asset prices from declining interest rates now being reversed by higher rates, we could see Auckland house prices becoming stuck in the doldrums around the start of 2022. Given that housing market activity flows through to retail spending, weaker housing market activity and lower asset prices could curb consumer and economic activity in general. Toward the end of 2022 and into 2023 economic growth and domestic inflation could therefore fall back to more normal levels, and interest rates are thus likely to peak sometime between now and that time.

Eventual removal of stimulus may create positive environment for longer-dated assets

From an economic perspective, in our view New Zealand is still on life support in the form of the government's significant stimulatory measures; the focus is on whether businesses, as some expect, will revive and take up the slack of government spending when the stimulus is eventually reduced. In the longer term, however, the government taking back its stimulatory measures could actually contain inflation and limit the economic growth rate. That would actually provide a favourable environment for longer-dated fixed income assets, in our view.

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