

# New Zealand Fixed Income Monthly February 2022

RBNZ monetary policy having greater impact on front end of yield curve; longer durations look to USTs

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## RBNZ raises OCR to 1%, signals more hikes ahead

On 23 February the Reserve Bank of New Zealand (RBNZ) raised the Official Cash Rate (OCR) by 25 basis points to 1% and signalled there were more hikes to come. The central bank can continue tightening on an incremental basis and that is how we hope they will proceed. New Zealand already has a significant amount of rate increases priced in, but it seems like the market wants to keep pricing in even more hikes into the yield curve. We think the New Zealand bond market looks very attractive relative to the rest of the world given how high our interest rates are, and we are seeing more offshore investing in the country's rates market. At the same time, we certainly aren't immune to developments in the rest of the world, particularly the US, where the Federal Reserve is poised to begin raising rates.

As for the impact monetary policy is having on the market, the actions of the RBNZ are having more of an effect on the front end of the New Zealand yield curve. In February the central bank revised upward its projection for the "terminal" cash rate—that is, the level at where the OCR is expected to peak—from the previous forecast of 2.5% by 2024 to around 3.3%, which was higher than expected. Beyond the 10-year maturities, the yield curve is impacted more by developments in US Treasuries (USTs). We therefore expect that a rise in US yields will nudge their New Zealand counterparts up further.

## Tug of war between inflation concerns and geopolitical risks

The Russia-Ukraine conflict certainly has the potential to have a significant impact. However, judging from how bonds are priced currently, the market appears to be taking the situation in stride for now. A tug of war appears to be taking place between inflation concerns and worries over geopolitical risks. The government bond yield curve is very flat, so we do not see a significant amount of value to be found by chasing yield along this curve. High quality credits that offer higher yields, in theory, could outperform lower-yielding government bonds under these circumstances.

## Various factors seen affecting bond market's supply/demand balance

Regarding the supply side, the market expects less government debt to be issued this year. On the other hand, the RBNZ has indicated that they will be unwinding some of the bonds they bought through their quantitative easing (QE) programme, in effect shifting to a quantitative tightening approach. The RBNZ is expected to sell back NZD 5 billion worth of bonds a year to the Debt Management Office starting around July, so that will be a negative factor from a supply perspective. On the positive side, New Zealand appears on track to be included in one of the major global government bond indices. Past experience shows that a certain amount of investor demand is generated for a country's bonds upon inclusion into such indices.

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