New Zealand fixed income outlook 2025

Long-duration bond outlook offers some light amid the economic gloom

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Desperately seeking reasons to be cheerful?

As our economy sucks on the last fumes of its post-COVID stimuli, you do not have to try too hard to see the glass as half empty right now in Aotearoa.

What was striking in the aftermath of the pandemic was that central bank actions and economic outcomes were remarkably synchronised across the globe. However, as a small, geographically remote export nation, we simply do not have the engine room to keep the revs going from this kick start. With government fiscal policy here now set to neutral or even contractionary, we anticipate seeing a growing divergence in international policy actions and therefore economic strength through 2025.

Market consensus here is that with a weak currency and compressed interest rate spreads relative to offshore bond markets, New Zealand's economy is already in a much more fragile condition than those of bigger nations such as the US or Australia. Unlike the US, we cannot rely on a boost from coordinated monetary and fiscal policy—and so put simply, the ball is uniquely in the Reserve Bank of NZ (RBNZ)'s court.

There are a number of factors conspiring to make the RBNZ's task more difficult. Productivity growth has suffered from a lack of investment and will take time to reinvigorate. Furthermore, our once robust immigration rate, which has historically provided a crutch to growth if only by having more people spending money in the economy, has slowed meaningfully. Alongside this, more and more New Zealanders are leaving the country for better opportunities, convinced that the grass is very much greener elsewhere.

So as you can see, it is quite easy to be negative about our outlook for 2025. But shafts of light are visible amid the doom and gloom.

There is good news in that after a prolonged high, interest rates in New Zealand are now trending down as the RBNZ held firm in the face of intense pressure from the markets in 2024 until it was convinced that it had inflation on the run. This pressure had in fact started to tell even before RBNZ Governor Adrian Orr announced the 25 and 50 basis points cuts to the official cash rate in August and October, with the market repeatedly trying to take rates lower—and we can expect rebounding business and consumer confidence to continue to accelerate the impact of this monetary policy stimulus.

Nevertheless, while business and consumer confidence may be returning, it will likely take time and determined efforts for this to flow through to actual investment and a recovery in consumer spending, especially given our softening labour market.

Similarly, while the reduction in mortgage rates from over 7% to around 5.75% will provide welcome relief for homeowners, it is a long way short of being a "yippee" moment for a generation of borrowers who had become accustomed to seeing 3% as a ceiling. With two-year swap rates having fallen from 5.8% to 3.8%, though there is room for the banks to drop rates down closer to 5% as the cash rate falls further and still maintain a comfortable margin.

From a fixed income perspective, this means that there is potential for further gains in longer maturity bonds. The New Zealand yield curve has taken a more positive shape since the rate cuts began, and historically, a positively-shaped yield curve has been a bond investor's friend, with carry and roll a reliable value add as credit margins narrow and yields lower as you roll down the curve. As the cash rate moves lower towards neutral or even stimulatory territory, we would expect investors to seek value along the curve, attracted by the higher yields on offer for these longer maturity bonds.

This is where investors here can benefit from the respective strength of other larger economies. Whereas the front of the yield curve is more influenced by RBNZ actions and local economic data, longer maturity bonds are far more aligned with offshore bond moves. In fact, the New Zealand 10-year bond rate has an approximately 70% correlation with the US one, and this has kept our rates higher.

This is one of many reasons why eyes are focused on the US right now. The Biden presidency's influence on financial market volatility has been negligible. However, president-elect Donald Trump has already demonstrated that he has an entirely different modus operandi and markets have been quick to react. With a predicted higher fiscal spending needing to be funded by greater US bond issuance, and with pro-growth policy and trade protectionism potentially inflationary, we expect the market will experience increased volatility and will have priced the next few years as being less bond friendly—again placing value in the longer-term outlook.

Back here in New Zealand, we expect that banks' funding costs will increase as the monies borrowed under cheaper COVID funding schemes (such as the RBNZ's Funding for Lending Programme) roll off. This will push banks to compete more for retail term deposits and return to issuing bonds in the market.

With limited recent bond issuance, New Zealand credit margins have erred on the tight side. While we do not predict a near-term catalyst to significantly change this, we think an increase in bond issuance supply from both banks and corporate borrowers will see some gradual widening of margins, which would be healthy to support returns at better levels over the medium term.

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