

New Zealand Fixed Income Monthly

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Interesting developments along the curve as the bond market experiences a rough start to 2022

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A rough start to 2022 for the bond market

The New Zealand bond market has experienced a rough start to 2022. The two primary domestic bond indices, the Bloomberg Composite and Bloomberg Credit, have been through one of the worst periods of returns since their inception in 2011. The chief driving market factor has been the upward movement in reference interest rates, with the swap and government curves all moving up as central banks turn hawkish to fight inflation for the first time in a generation. At the same time domestic credit margins have moved up between 20 and 30 basis points (bps) since the start of the current tightening cycle in mid-2021, which is relatively benign compared to the rise of almost 200 bps seen across the government bond yield curve. This highlights the fact that increases in reference rates are the market drivers, rather than credit worthiness concerns.

Interesting developments along the curve

We have seen some interesting developments along the curve. Regarding the shorter end of the curve, the 2- and 3-year swap terms have come under strong upward pressure, driven by residential mortgage fixing. The rise in swap rates has been exacerbated by one-sided flows as banks want to pay fixed on all the mortgage flow and receivers have mostly exited the market due to a very hawkish central bank. The 5-year sector of the swap curve, on the other hand, is not exposed to such upward pressure as mortgages in general are not fixed at such a term. As for the long-end, interest from international investors in this part of the curve has receded significantly amid a rise in global yields and the Russia-Ukraine conflict. Domestically, fatigue with rising interest rates has seen real money appetite for the long-end dwindle; as a result, some domestic names in the high-grade space have dropped their issuance plans in the tenor. As global yields rise, we expect the relative yield advantage of New Zealand's long-end to diminish. For New Zealand's long-end to regain its attractiveness we may need downward forces on inflation—notably aging of the population, innovation, globalisation and more normal supply chains—to reassert themselves.

Economy performing well, but headwinds increasing

The New Zealand economy has been performing well, but headwinds are increasing. Inflation is sapping the spending power of consumers as wages fail to keep up. Personal tax burdens are increasing as tax brackets remain static in the face of inflation, along with additional tax from an upcoming unemployment insurance scheme. Furthermore, international borders are beginning to reopen and this may result in an exodus of skilled labour from New Zealand. Any such exodus, however, is likely to be a short-term risk and not a long-term structural trend. We expect New Zealand to remain a desirable destination for immigration.

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