

New Zealand Fixed Income Monthly May 2022

Some respite for the beleaguered bond market; RBNZ raises OCR to 2% with more hikes seen ahead

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Bond market gets a bit of respite in May

The New Zealand bond market has been under pressure for most of the year and is facing its most challenging period in recent memory. But there was some positive short-term news: as interest rates have managed to pull back from their highs over the course of May, returns from bond funds were generally up about 1% as of this writing. The market may have realised that it had gone too far in pricing in central bank interest rate hikes. Another factor which may have given the bond market some respite in May is that term deposit rates offered by banks have lagged the rise in bond yields, thereby making bonds more attractive. Inflation remains a big theme with the bond market focused on the central banks rapidly raising interest rates to prevent inflation having a more harmful second-round impact on the economy. Another important theme is the recognition that economic growth may slow, with most commentators acknowledging recessionary risks as central banks rapidly raise interest rates.

RBNZ hikes the OCR to 2%, market prices in more tightening in July and August

In May, the Reserve Bank of New Zealand (RBNZ) raised the Official Cash Rate (OCR) by 50 basis points (bps) to 2%. According to the RBNZ, the neutral rate has been somewhere between 2 and 3%; at the same time, the central bank said that the OCR would need to be above neutral until they are able to bring inflation under control. Like other central banks, the RBNZ seems to be very focused on fighting inflation as a top priority and growth seems to be a secondary consideration at this stage. The market has almost fully priced in the RBNZ hiking the OCR by 50 bps once in July and a second time in August, taking the rate to 3%. Central banks have come under some criticism that they are behind the curve. However, they may deserve some sympathy as the global coronavirus pandemic was unprecedented, and the combination of higher fiscal spending and the slashing of interest rates (now being reversed) was probably the right step to take at the time. Furthermore, if inflation is mainly due to supply chain constraints as the central banks say, the task at hand, from their perspective, might be to lower demand and slow growth.

Developments in China key to New Zealand's economy

Something that the RBNZ should be very aware of is consumer confidence in New Zealand, which is at low or challenged levels. Looking abroad, what happens in China, New Zealand's key trading partner, will certainly resonate at home. Prices of New Zealand's commodities, particularly dairy—of which a large portion is exported to China—have held up relatively well. Going forward, how Chinese demand plays out amid China's zero-COVID strategy will be a concern, as it may impact New Zealand's growth quite significantly.

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