

New Zealand Fixed Income Monthly November 2023

Weaker economy among signs that “year of the bond” is still to come

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Weaker economy suggests bond market revival is still to come

Amid significantly negative returns in both the equity and fixed income markets at the end of last year, it was thought that 2023 would be the “year of the bond”. As we near the end of 2023, however, the bond market is still yet to live up to those expectations. Even so, our view is that the upswing for bonds has been deferred but not cancelled. Although cash has been king for the last two to three years, we believe bonds are now poised to take the crown. November 2023 was a strong month for fixed income globally and New Zealand was no exception to that trend. In addition, although New Zealand narrowly avoided a technical recession (defined as two straight quarters of negative growth) this year when its economic growth for the March 2023 quarter was revised upward from -0.1% to 0.0%, the country is effectively in a per capita GDP recession. This is illustrated by the contrast between official retail sales figures and population estimates for New Zealand. The former show that retail sales have declined in six out of seven of the past quarters, while the latter show New Zealand’s population rising by 2.7% in the year between September 2022 and September 2023. Although the population has grown, each person is buying and selling less, and this points to a per capita recession. As interest rates generally move downwards when the economy weakens and bond prices typically have an inverse correlation with interest rates, this augurs well for the fixed income market.

Weaker CPI data also point to cooling conditions

In another sign of the New Zealand economy cooling, the consumers price index (CPI) is also on a downward trend. After seeing consistent falls since the December 2022 quarter, when the annual rate was 7.2%, New Zealand’s CPI had declined to 5.6% as of the September 2023 quarter. Furthermore, the levels to which US inflation figures have dropped suggests that this will continue, with US core inflation currently hovering at approximately 4% and US CPI close to 3%. We see US CPI as an effective leading indicator for New Zealand inflation as the US figures are released monthly whereas New Zealand uses quarterly releases. New Zealand’s data also have a relatively strong correlation with CPI in the US. The US data therefore point to further cooling in New Zealand’s inflation rate.

Next OCR move likely to be downwards given tightening already in effect

The degree to which monetary tightening is already at work in the economy also suggests that the next movement in New Zealand interest rates is likely to be downwards. The Reserve Bank of New Zealand (RBNZ) has already raised the Official Cash Rate (OCR) from 0.25% to its current level of 5.5% in a series of hikes between October 2021 and May 2023. In addition, although the RBNZ has stood pat since then, the tightening effect from those rises is still being felt in the economy through the mortgage market, which is the main mechanism by which monetary policy impacts households. At the time of the RBNZ’s May rate hike, one-year mortgage rates were 6.5%, whereas they now stand at 7.25%. This means that we have in effect seen tightening of 75 basis points even without any further OCR hikes. We think that downward movement in interest rates will start in the fourth quarter of 2024 and expect the cycle to end with the OCR in the 3–3.5% range. If this holds true, bonds could outperform cash by approximately 1% per annum on average over the next one to three years.

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