Harbour Investment Compass

High hurdle for an RBNZ hike or cut

April 2015 | **Fixed Interest Monthly Commentary**

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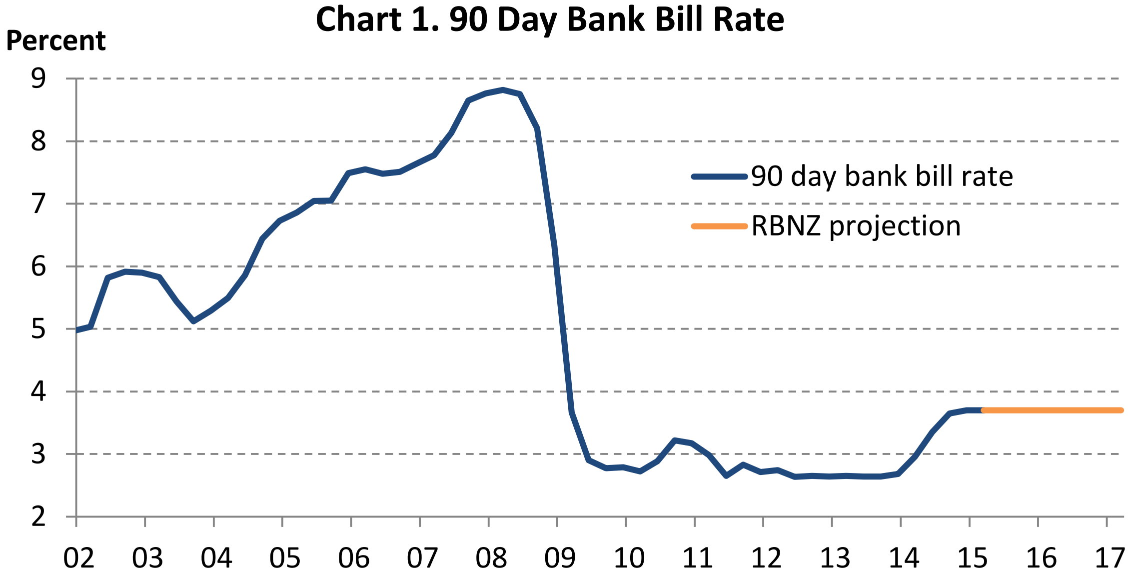
- Global fixed interest markets continued to calm in March, after being gripped in early February by falls in oil price, fears of deflation, and surprise rate cuts.
- The RBNZ left the OCR unchanged at 3.50% and published a flat 90 day rate forecast till 2017. The NZ 2 year swap rate fell marginally to 3.50%.
- We believe these forecasts highlight that the RBNZ has a high hurdle to hike or cut interest rates, given strong arguments on either side of the equation.
- We suspect that the direction of the next move in the OCR may be time dependent: if the next move is in 2016 or 2017, it is more likely to be a hike; if the next move is this year, it is more likely to be prompted by a surprise cut.
- Reflecting this asymmetry of risk, the Overnight Indexed Swap (OIS) is pricing around a 75% chance of a 25 basis point cut in the OCR by September.
- Global bond yields remain anchored at low levels, as the US Federal Reserve cut its GDP growth forecasts and the ECB began its sovereign bond purchase for QE.
- The maturity of the NZ government April 2015 bond may provide some additional support to the local fixed interest market in April.

High hurdle for an RBNZ hike or cut

The main event for New Zealand interest rates in March was the RBNZ's Monetary Policy Statement. This was the first chance for the central bank to review its economic forecasts and policy outlook, since fears of deflation have gripped Europe, and a swathe of foreign central banks cut interest rates through January and February. The RBNZ left the OCR unchanged at 3.50% and published a flat 90 day rate forecast for the next 2 years, implying the OCR is on hold for some time (Chart 1).

Fixed interest markets were little changed on this news. However, the NZ dollar jumped, as the foreign exchange market held out more hope the RBNZ would hint that it planned to lower the OCR in sympathy with foreign central banks. Graeme Wheeler's off the cuff comments at the press conference were also seen as hawkish – or at least illustrative that cutting interest rates is not 'front of brain' at the moment.

Chart 1. 90 Day Bank Bill Rate



Source: RBNZ.

We believe that the RBNZ's forecast for a flat interest rate track masks a vigorous internal debate about the direction of the next OCR move, where there are strong offsetting forces at play. On the one hand, strong business and consumer confidence, and housing market strength, point to an OCR hike; whereas the high NZ dollar, low inflation and low inflation expectations, all point to the need for a lower OCR. We interpret the RBNZ's flat 90 day rate track as signifying a high degree of uncertainty, and therefore a high hurdle to move one way or other.

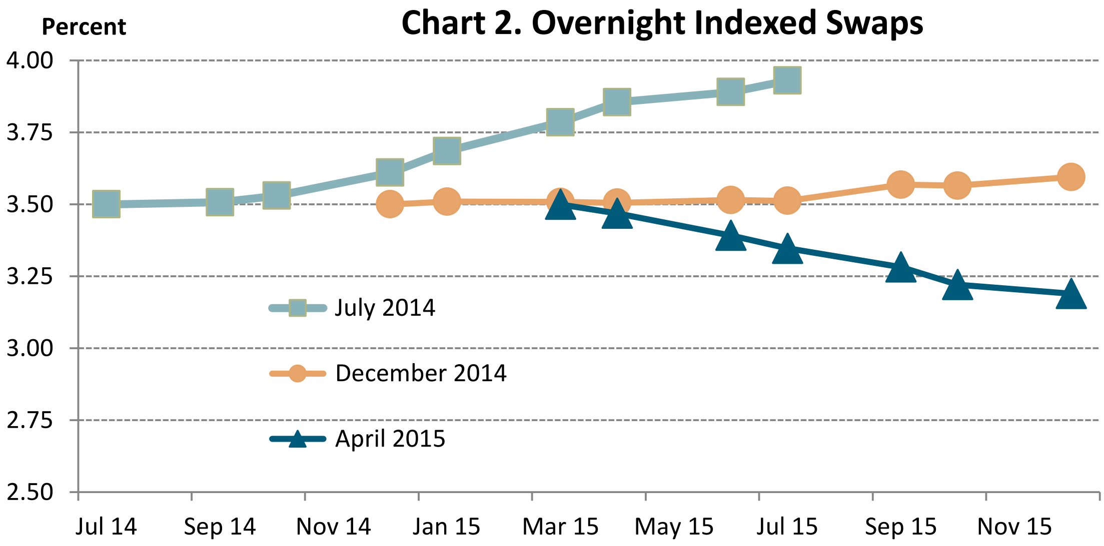
We suspect that the direction of the next move in the OCR may depend on timing.

If the RBNZ do not move until 2016 or 2017, in our opinion, the next move is most likely to be up, as they gain confidence about the strength of the NZ economy, deflation fears are avoided, and they continue their journey towards a more neutral OCR setting around 4.5%. In this scenario, the US economic expansion continues, and the US Federal Reserve begin their long awaited process of lifting the US fed funds rate, removing US monetary stimulus and strengthen the US dollar.

By contrast, if the next move in the OCR is in 2015, it is most likely to be to the downside – as it would take a larger event to prompt them the RBNZ action in the near term. It is never easy to identify economic surprises, but candidates to watch include a further round of deflation worries in Europe, a return of political turmoil in Greece, a property market correction in China, or further sharp falls in New Zealand's commodity prices.

Perhaps the most immediate pressure point for the RBNZ is the strength of the NZ dollar, particularly as the currency flirts with parity against the Australian dollar. If the US Federal Reserve was to delays its process for lifting the US fed funds rates, or the Reserve Bank of Australia were to signal the prospect of further rate cuts over the ditch, this could finally tip the RBNZ into action in 2015.

This asymmetry of risks is broadly reflected in market pricing taken from the Overnight Index Swaps (OIS) market. In the middle of 2014, the market was expecting the RBNZ to continue the journey of lifting the OCR higher over this year; by December, with European-led deflation fears emerging, the market saw the OCR on balance unchanged in 2015; and now in April the market is pricing the OCR to be closer to 3.25% by the end of this year. This does not reflect a point estimate of where the OCR will end up, but rather an assessment of the RBNZ's pressure points and the balance of probabilities.

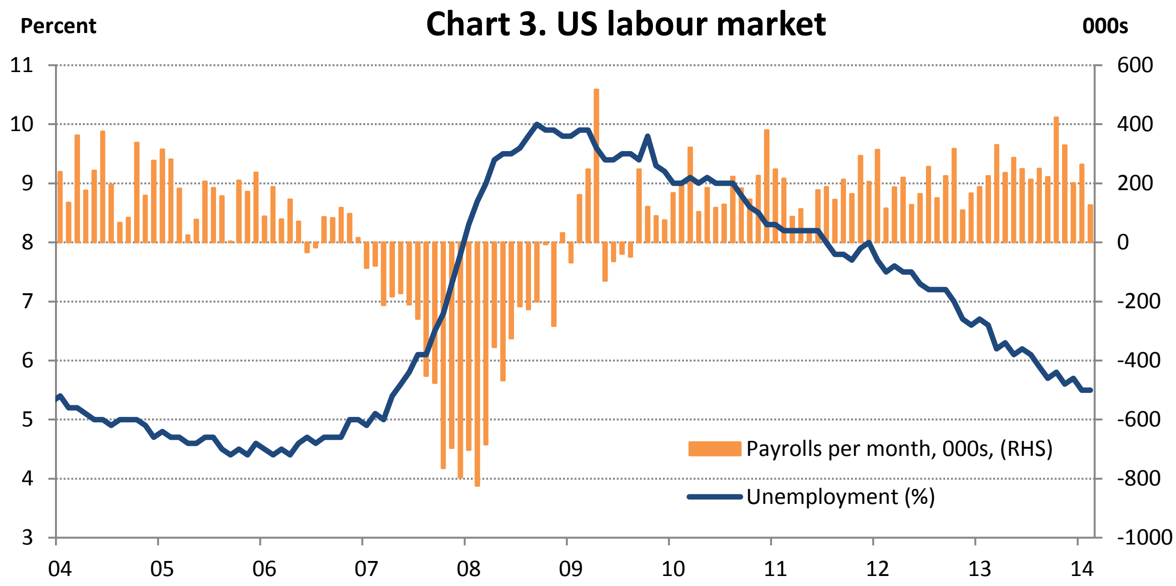


Source: Bloomberg.

US Federal Reserve removes 'patience' but revised down forecasts

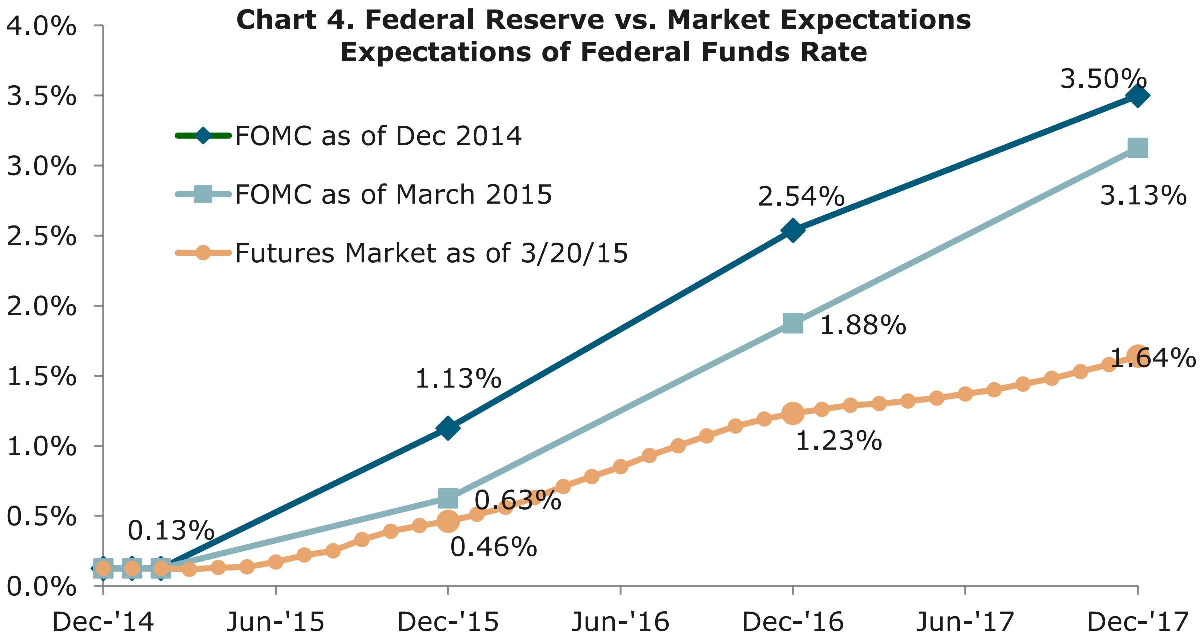
At the beginning of April, the US non-farm payrolls number came in at 126,000, which was much weaker than market expectations of around 250,000 new jobs. Furthermore, there were downward revisions to previous months. However, some moderation in US job growth is consistent with other US economic data, which has recently been missing lofty expectations. Despite the soft April outturn, US job growth has averaged 200,000 over the past 3 months, which is still a healthy pace (Chart 3).

As expected the US Federal Reserve left the fed funds rate unchanged in March in its 0.00 to 0.25% range. Reflecting the improvement in the US labour market, US Fed removed the reference in its press release to being patient before lifting the fed funds rate. This was largely anticipated, and provides the option for them to start this process following their June meeting.



Source: Bloomberg.

However, at the same time, reflecting that other economic data have been softener than expected, the US Federal Reserve lowered their US GDP growth forecasts for 2016 and 2017, and revised down forecasts for the US fed funds rate at the end of 2015 outwards (Chart 4). On balance this tilts the chances away from a June start, and toward a September start for the process of lifting the US fed funds rates from its ultra-low levels.



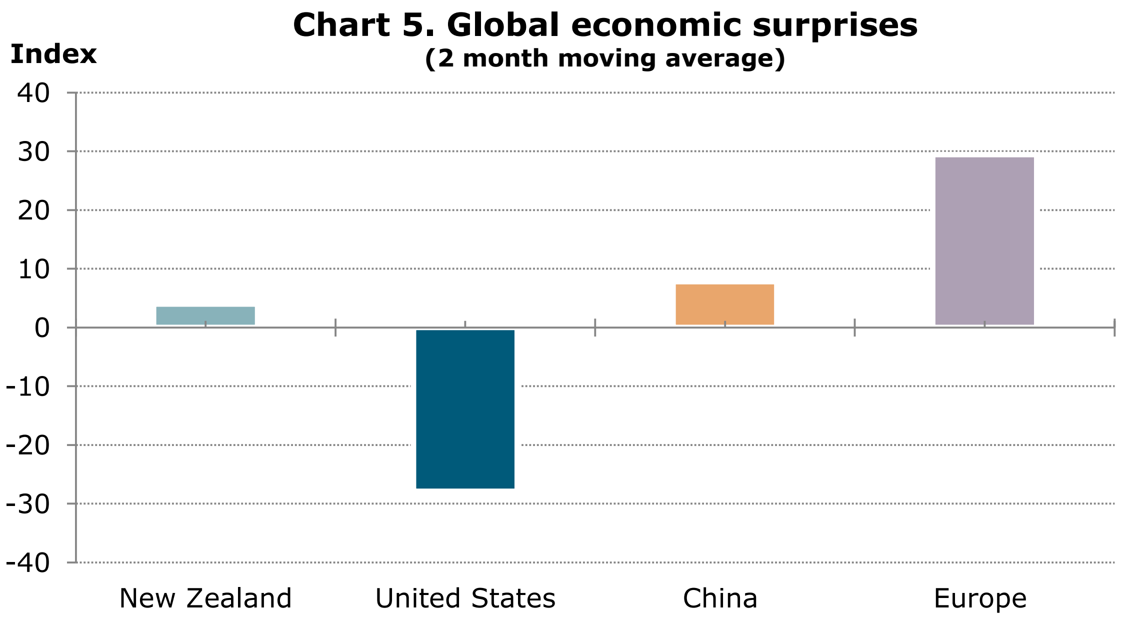
Source: US Federal Reserve Board and Bloomberg.

Europe: tug of war between QE and improving economic data

A key lesson of investors over 2014 was the ability for developments in Europe to drag down global long-term bond yields, including the US, Australia and New Zealand.

Since the beginning of 2015, monetary policy in Europe has become even more extreme, with more countries experiencing negative policy interest rates and the ECB beginning to implement its QE program, buying long maturity assets to expand its balance sheet. Against this backdrop, the macroeconomic data in Europe has started to improve (Chart 5), particularly in German where unemployment is at record lows and consumer confidence has advanced for 5 consecutive months.

We see low European government bond yields continuing to anchor global bond yields, while this tug of war continues between the weight of QE purchases lowering yields and improving economic data providing confidence for yields to eventually rise.



Source: Citigroup and Bloomberg.

Market outlook

At the short end of the yield curve, we continue to expect a period of near term stability. We believe the RBNZ's forecast for a flat 90 day rate track highlights the high hurdle to hike or cut interest rates, given strong arguments on either side of the equation.

We suspect that the direction of the next move in the OCR may be time dependent: if the next move is in 2016 or 2017, it is more likely to be a hike; if the next move is this year, it is more likely to be prompted by a cut. The strength of the New Zealand dollar remains an immediate pressure point for the RBNZ.

At the long end of the yield curve, we believe that bond yields are likely to remain relatively low while policy rates are near zero in Europe and the ECB is embarking on QE. The US Federal Reserve's decision to revise down its growth forecast for 2016 and 2017 also tilts the chances of the first move in the US fed funds being in September, rather than June. Locally, we also see some scope for the maturity of the NZ government April 2015 bond to provide some additional demand from investors.

If macroeconomic data in Europe continues to recover over the next 6 months, and optimism builds that the ECB's QE has been successful, then this opens the door to bond yields rising over the medium term.

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