

New Zealand Fixed Income Monthly

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Inflation creating challenges for bond market and economy

In line with bond markets around the world, New Zealand's market has had a difficult start to 2022. Bond yields and interest rates in general have been climbing as central banks hike rates to tackle soaring inflation. In New Zealand, the Consumers Price Index (CPI) rose by a higher-than-expected 1.4% in the final quarter of 2021 compared to the preceding three-month period. The Reserve Bank of New Zealand (RBNZ) had previously forecast quarterly inflation of 1.2% in its November 2021 Monetary Policy Statement. Furthermore, in the last three months of 2021 year-on-year inflation hit a three-year high of 5.9%. This will place further upward pressure on mortgage rates and put wages and salaries at risk of falling in real terms unless they keep up with price rises. General wage increases across the whole economy are currently running at about 3%. This decline in real-terms spending power has clear implications for the strength of consumer demand in 2022. Consumer confidence is also likely to be dampened by weaker price growth for houses and other assets this year.

RBNZ likely to wait out supply constraints while reducing demand

Given that changing interest rates will not free up clogged ports or closed factories, one challenge for markets around the globe is that the usual monetary policy tools deployed by central banks are less effective when inflation is driven by supply constraints rather than soaring demand, as is the case now. However, central banks could risk crashing economies if they try to reduce demand to a greater extent than they normally would with higher and faster rate hikes. The RBNZ is likely to take a similar approach to the US Federal Reserve by waiting for the current supply issues to run their course while also trying to reduce demand. This flexible approach appears to be the correct strategy. New Zealand's Official Cash Rate (OCR) currently sits at 0.75% after two hikes late in 2021 and a further rise is expected on 23 February. The market is currently pricing in about 125 basis points of tightening in the OCR in 2022 and is expecting the OCR to peak at about 2.5-3%. Our view, however, is that interest rates are unlikely to go up as much as the market has been expecting. Even if the RBNZ hikes the OCR in line with or beyond market expectations, that will bring forward the prospect of lower rates later as the economy will not be able to sustain a high OCR.

Positives seen for New Zealand in 2022

New Zealand is well placed to benefit from a number of positives in 2022. Auckland is seeing a multibillion-dollar data centre boom as the pandemic stokes demand for cloud technology. This will bring jobs and investment into the area. Furthermore, the rural sector looks set to continue to underpin New Zealand's resilience to the pandemic as well as its economic performance. In January, the dairy cooperative Fonterra lifted its 2021/22 forecast for farmgate milk prices (the amount paid for milk delivered to the farmgate by farmers) by 50 cents to a record high of NZD 8.90-9.50 per kilogram of milk solids. This will contribute almost NZD 14 billion to the regional economy. Recent depreciation in the New Zealand dollar is also providing a welcome boost for exporters.

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