

New Zealand Fixed Income Monthly February 2023

Although the market has adjusted to higher interest rates, a peak is in sight for investors

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14 March 2023

Reaction to February hike suggests market has adjusted to higher rates

Market reaction was muted when the Reserve Bank of New Zealand (RBNZ) hiked the Official Cash rate (OCR) by 50 basis points from 4.25% to 4.75% on 22 February 2023. Given the size of the hike and fact that it was the first OCR update since November 2022, the reaction suggests that market expectations were already in line with the RBNZ's intentions. Even so, the central bank's February Monetary Policy Statement contained less content on the impact of the severe storms affecting the North Island earlier in month than had been expected. Instead, the RBNZ simply observed that the storms' impact would be inflationary and disruptive in the near term, and that more activity would be generated by the rebuilding work. It also commented that the best monetary response to the emergency would be to free up resources elsewhere in the economy by slowing demand and to curb medium-term inflation through higher interest rates. While this demonstrates that controlling inflation is still the central bank's primary concern, it is also clear that the market is now used to the prospect of interest rates being higher for longer.

Yield curve likely to remain inverted in medium term with OCR peak in sight

Although interest rates are expected to climb further, the RBNZ forecasts the OCR to peak at 5.5% at the end of 2023. At the same time, the front end of the bond yield curve (showing yields on short-term securities) is currently the highest point of the curve. Under normal conditions we would expect an upwardly sloping yield curve, with the back end (showing yields on longer-term securities) creating its highest point. This is a function of the "term premium" based on which investors expect to see higher yields on longer-term bonds in return for the higher risk of changes such as interest rate movements during the term of a bond. However, the yield curve is currently behaving in the opposite way, with higher yields on short-term bonds and lower yields on longer-term securities. This is usually taken as a sign that investors expect to see interest rates move down again in the future. Given the likelihood that the OCR may peak at around 5.5%, we have a high degree of conviction that the yield curve will continue to slope downward in the medium term. We see this continuing to cause challenges for bond investors seeking to secure temporal gains by locking in higher rates for longer periods.

Bonds seeing high demand on yields and lower equity prices

Bonds have been attracting more attention from investors recently in view of their higher yields and the possibility of capital gains. In addition, as equities have lost their shine for now amid higher interest rates, bonds are expected to continue to benefit from an asset allocation perspective.

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