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RBNZ likely to join Fed in responding to economic strength with earlier rate rises

New Zealand's bond market was relatively flat in June, although most sectors were on the positive side. Looking ahead, New Zealand appears set to track the US, where interest rate hikes could now happen as early as 2022. New Zealand GDP jumped 1.6% in the March quarter, doubling the most optimistic forecast of 0.8% and showing year-on-year growth of 2.6%. Given that the increase was far stronger than the Reserve Bank of New Zealand (RBNZ) had expected, we could see an Official Cash Rate (OCR) of 1% in 2022, with the rate possibly peaking at around the 2% mark in 2023. New Zealand's monetary tightening cycle is therefore likely to start in early 2022 rather than the previously assumed timing of 2023. We continue to expect a modest tightening cycle, however, with the OCR peaking at 2%.

Despite the higher-than-expected GDP growth, the New Zealand dollar (NZD) actually weakened during the same period. This is possibly because other central banks also brought forward rate rises or indicated earlier hikes. Although New Zealand's economy is quite strong after running ahead of global peers with a V-shaped recovery, the rest of the world may outperform it over the balance of 2021 and into 2022.

Yield curve set to flatten when OCR peaks

The yield curve is likely to flatten when the official rate peaks, with long-term government bond rates rising to around the same level as the OCR or close to the 2% mark. Given that 10-year bond yields are currently hovering at around 1.8% after bottoming at 0.4% or so in September-October 2020, long-term interest rates have already increased quite considerably from their lows. Now may be the time for a similar climb in short-term rates. During other tightening cycles the best time to buy long bonds has been before the cycle starts. This means that the timeframe for buying longer bonds may have shortened now that the tightening cycle has been brought forward. We currently see value if 10-year government bond yields move to about 2% from their current level of 1.8%. The very short-term and very long bonds are the safest parts of the yield curve for us given that long bonds have already priced in the tightening cycle to a large extent. The very long-term bonds and 2041 New Zealand Government Bonds are currently at around the 2.6% mark, and the Treasury is also set to issue an even longer-term 2050 bond, which could hover near to the high 2% to 3% level.

NZDMO to increase government bond tenders from July

The New Zealand Debt Management Office (NZDMO) increased its government bond tenders from NZD 300 million to NZD 500 million starting in July, which is the beginning of New Zealand's financial year. The NZDMO may be pre-funding some of its requirements as in the previous year, and its requirements are likely to lessen as the year progresses if performance and tax revenues remain strong. The government has set aside a NZD 50 billion pot to support the economy through the pandemic, but has used some of it for other purposes. That may be one of the reasons for the larger tenders.

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