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RBNZ provides more policy insight; New Zealand bonds poised to join the World Government Bond Index

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Market uncertainty persists, RBNZ provides more policy insight

Although July was a great month for New Zealand bonds in terms of performance, fortunes changed, and the market went through a tough period in August. The rough patch reflects continuing uncertainty, with the bond market undecided about whether it should focus on inflation itself or pay more specific attention to the measures that central banks are adopting to deal with it—with the implication that the latter will have an impact on domestic demand and economic growth. Regarding central banks, as expected the Reserve Bank of New Zealand (RBNZ) raised the Official Cash Rate (OCR) by 50 basis points (bps) to 3% on 17 August, recognising an increase in domestic inflationary pressures. This was the RBNZ's fourth consecutive 50-bps rate increase. The central bank provided a little more insight into its thinking following its monetary policy decision. It marginally raised its terminal cash rate forecast from 3.95% to 4.1%, where it expects it to remain into 2024. But it also suggested that there will be some flexibility regarding the peak rate.

The RBNZ now appears certain to raise the OCR to 4% by the end of 2022. RBNZ Governor Adrian Orr, however, suggested that the end of the tightening cycle was visible, so even if the rate does reach 4%, or even 4.25%, the market focus is shifting towards whether the OCR will remain elevated for an extended period and for how long the economy can withstand the higher interest rates. There is a slightly odd situation in New Zealand: the RBNZ is crushing domestic demand through rate hikes to control inflation, while the government's policy of limiting migration numbers is keeping the labour market tight and pushing up wages, ultimately increasing inflation. Inflation without productivity would obviously put the country in a no-win situation, and the RBNZ would want to avoid a wage price spiral.

New Zealand poised join the World Government Bond Index

Another development that could influence longer-maturity domestic interest rates was the inclusion of New Zealand's sovereign bonds into the FTSE World Government Bond Index on 31 October. New Zealand bonds, which were chosen for the index due to their high credit rating and the recent growth of the sovereign debt market, will comprise 0.2% of the index. The inclusion should mean a significant inflow of funds into the New Zealand bond market, with some analysts estimating an initial amount of New Zealand dollar (NZD) 1 billion–2 billion flowing in, with the figure potentially rising to NZD 5 billion–6 billion over a six-month period. The inflow of funds would naturally supress interest rates; at the same time, it could result in a wider gap between government bond interest rates and the swap curve (and potentially the credit curve as well) due to buying pressure being exerted on sovereign debt. That said, if a significant amount of funds flow into the country, the New Zealand Debt Management Office may use the opportunity to issue more debt.

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