New Zealand Fixed Income Monthly
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Increasing mortgage rates a key concern; protective function of bonds back in focus amid rising rates

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Increasing mortgage rates expected to impact consumer spending

As New Zealand grapples with inflation and the spectre of a recession, we highlight the impact increasing mortgage rates may have on consumer spending. This is an important theme as it ties in with how we need to consider absolute interest rate levels. Firstly, household indebtedness has been increasing in New Zealand and a 1% increase in interest rates today now has much more impact than in the past. Reserve Bank of New Zealand (RBNZ) data shows that the total amount of outstanding mortgages stood at New Zealand dollar (NZD) 331 billion as of March. From the data we can infer that the average interest rate on mortgages outstanding was only slightly above 3% in March, but currently major banks' mortgage rates are approximately at 5.4% for a one-year term and 5.7% for two years. If the RBNZ's Official Cash Rate (OCR), currently at 2.5%, was to rise to 4%, that could push up the average interest rate on all outstanding mortgages to 6%, representing an additional interest burden of NZD 10 billion per year. This is a significant sum when considering that the country's annual retail trade amount is NZD 105 billion. All in all, we see consumers who are under pressure in terms of their discretionary spending power. Net migration may remain negative as the higher cost of living could prompt an exodus to Australia and other parts of the world by New Zealanders searching for lower living costs and higher wages.

Rise in rates painful but helping restore traditional function of bonds

Central banks, in our view, may continue to hike rates aggressively for now, although in the longer run they could struggle to deliver the level of interest rates the markets have priced in. We expect the RBNZ to keep hiking in 50 basis point increments, perhaps taking the OCR to 3%; after that, we expect further tightening to be more data dependent. The rise in rates have been painful but it has helped restore the traditional function of bonds and provide investors with protection during economic downturns. Regarding such downturns, the probability of a recession has increased. Historically, downturns have provided good opportunities for investors to add duration or move cash into bonds.

BOJ policy and its broader impact a key concern for bonds

Adding duration, however, warrants caution as the long-end of the New Zealand's yield curve is influenced by global forces, notably US Treasuries. Japanese investors are currently in focus; they are large holders of US Treasuries and a concern is that they may repatriate their funds if the Bank of Japan (BOJ) relents to market forces and allows a higher ceiling for its yield curve control (YCC) scheme, currently set at 0.25% for the 10-year government bond yield. The BOJ raising the YCC ceiling will have a number of consequences, but for the New Zealand bond market the chief concern is an outflow of funds from the US back to Japan placing upward pressure on Treasury yields.

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