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2023 New Zealand fixed income outlook

Markets to eye the possibility of rate cuts

By the New Zealand Fixed Income Team
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It has been a terrible time for investors in bond markets since the second half of 2021 as cash rates have been hiked from pandemic emergency levels of 0.25% to the market pricing in an Official Cash Rate (OCR) peak of 5.25% by mid-2023. Over the same time period 10-year government bond yields have moved from a low point of 0.44% in September 2020 to a high point of 4.64% in October 2022. Two-year swap rates, which are important when banks set their fixed mortgage rates, have also soared from 0% in October 2020 to a high of 5.4% in October 2022. At the time of writing in mid-November 2022 the rate was 5%. These are large moves by any measure but what if central banks go too far and what if they have possibly over tightened already?

The Reserve Bank of New Zealand's (RBNZ) projected OCR increases are the largest and quickest since the rate was introduced in March 1999. The previous largest move was a progressive increase of 3.25% between 2004 and 2007 in the pre-Global Financial Crisis (GFC) tightening of monetary policy conditions. Rates at that time were held at a high of 8.25% for a year and readers with a long memory will recall that as the GFC mauled the global economy rates were quickly cut to support economic activity, jobs and the financial system in general. Cash rates fell from 8.25% in June 2008 to 2.5% one year later.

While we are not facing a GFC type scenario, interest rates and mortgage rates could be near their peaks, and they will be held at high and restrictive levels for a year or so, providing enough time for air to be let out of inflation's tyres.

Globally, central banks have a tendency to overreact primarily because of the uncertain delay between their actions and the time it takes to see the subsequent effect on the economy. Bankers and investors alike seem to determine the effectiveness of their actions by today's conditions even though the estimated lag between central bank action and its impact is anywhere between one and two years. Unfortunately, not only is the timing uncertain but so is the extent of the overall impact on the economy. Central banks try and overcome these pitfalls by looking at surveys of expectations of future activity including inflation, but unfortunately many respondents' future expectations are also often influenced by current conditions.

Meanwhile, the cumulative impact of prior interest rate rises continue to weigh on economic growth, corporate profits, consumer spending power and the housing market.

Inflation is the reason interest rates are so high. So what might happen if inflation falls and falls quickly? It seems far-fetched to think about it at the moment as we face a "cost of living crisis", but remember that inflation as measured by the consumer price index (CPI) is a measure of the rate of change in prices. If the prices of the basket of goods and services that make up the CPI remain constant at today's elevated levels then after one year the rate of inflation falls to zero. If growing conditions are good then perhaps even food price inflation could fall, especially if we see globally traded dairy prices continue to decline. The risk to this scenario is that if a wage and price spiral becomes embedded, it would make the RBNZ's job even harder to contain inflation. That would lead to an even longer period of living with high interest rates and an increased risk of a hard economic landing.

Rising interest rates are starting to bite. Asset prices have fallen, households' spending power has fallen, business and consumer confidence are weak and the New Zealand dollar has fallen; while inflation is stubbornly high, could it be next to fall?

On the positive side for economic growth are the tourism industry showing signs of life, migration flows increasing and the still tight labour market. Government spending and a pipeline of infrastructure projects will help support the economy even if residential building activity declines.

As we gaze into 2023, we see a difficult year economically although we believe that a full-blown recession is unlikely. The OCR and short-term interest rates may stay elevated but longer-term interest rates are increasingly likely to decline in the second half of the year and into 2024 as financial markets start to price in the possibility of rate cuts. Falling rates, or the expectation of falling rates, should see a stabilisation of the housing market and an improving outlook for the economy and financial market returns.

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