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# Removing central bank stimulus - Implications for fixed interest

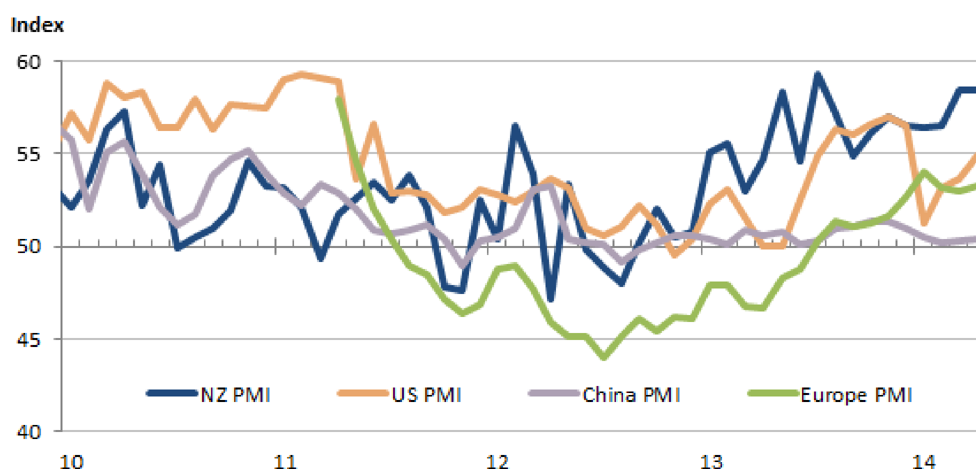
Christian Hawkesby | Harbour Asset Management | 14 May 2014

On 13 March 2014, the Reserve Bank of New Zealand (RBNZ) became the first developed country central bank to begin removing stimulus, when it delivered a 25 basis point hike in the Official Cash Rate (OCR). This paper explores the macroeconomic outlook as we emerge from the GFC and assesses the likelihood of the RBNZ continuing, and other central banks beginning, to withdraw monetary policy support. Finally, the paper highlights the likely impacts on both NZ and global fixed interest markets, and the implications for practitioners managing fixed interest portfolios for clients.

## NEW ZEALAND ECONOMY OUT OF SYNC

The New Zealand economy has spent much of 2013 and 2014 out of sync with the rest of the developed world. While global purchasing manager indices (PMIs) began to recover in 2013, the New Zealand PMI was already high. Similarly, as some global PMIs have taken a breather in 2014, the New Zealand PMI has remained elevated (Figure 1), well into expansionary territory above 50.

Figure 1: Global Purchasing Manager Indices
(2010 to 2014)




Source: Bloomberg

The New Zealand economy has benefited from a number of local tail winds. In addition to the Canterbury rebuild and buoyant Auckland housing market, New Zealand has experienced

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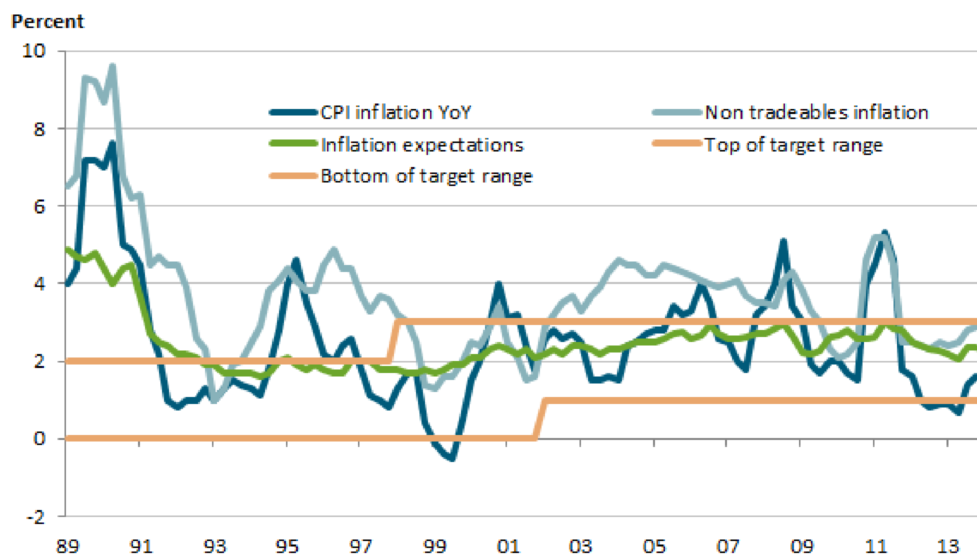
record high terms of trade and net migration, which are lifting domestic incomes and putting pressure of local resources. Both business and consumer confidence are at very elevated levels.[1]

Furthermore, New Zealand CPI inflation has started to rise, as shown in Figure 2. Through much of 2012, CPI inflation was below the bottom of the RBNZ target range, providing breathing space to retain the OCR at record lows. However, by the end of 2013 CPI inflation was edging towards the middle of the target range, with forward-looking pricing intentions in business surveys also lifting.

Figure 2: NZ CPI inflation
(1989 to 2014)




Sources: Bloomberg and RBNZ.

## RBNZ BEGINS REMOVING STIMULUS

As expected, the Reserve Bank of New Zealand (RBNZ) delivered a 25 basis point hike in the Official Cash Rate following its Monetary Policy Statement on 13 March 2014. It was one of the most well-signalled interest rate moves, with the Overnight Indexed Swap (OIS) market putting a 98% chance on the RBNZ embarking on the start of a tightening cycle.

The strength of New Zealand economic data over the past six to nine months made an overwhelming case that is it was time to start withdrawing policy stimulus. The RBNZ followed up with another 25 basis point increase in the OCR at their April 2014 Review. As shown in Figure 3 below, the OIS market is placing some probability of additional increases in the OCR at the June 2014 and July 2014 meetings, with the OCR expected to rise to nearly 4.00% by April 2015.

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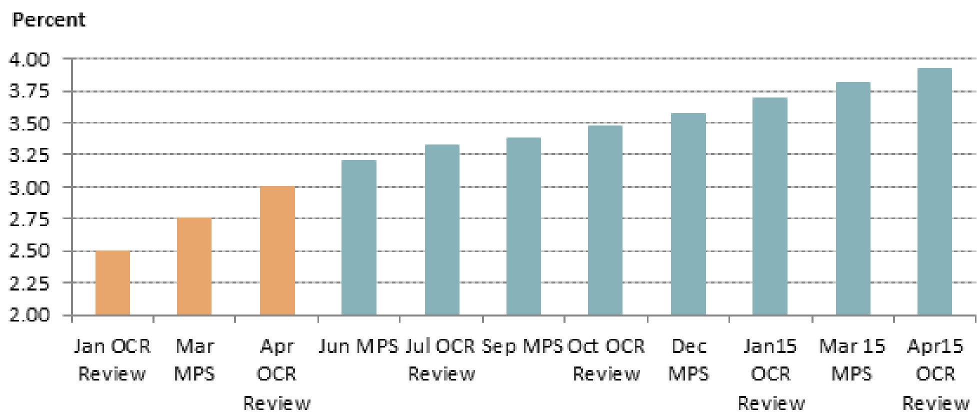
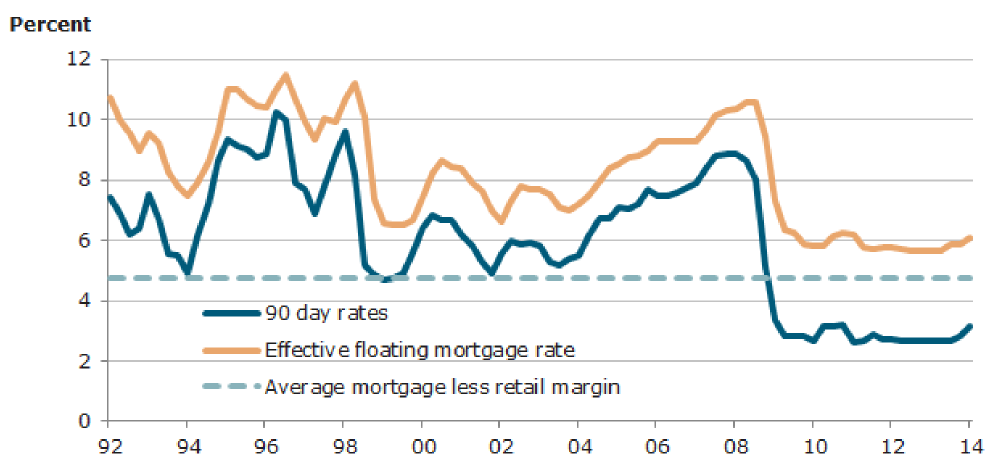
Figure 3: OCR and Overnight Indexed Swaps
(as at 1 May 2014)




Source: Bloomberg

Having started the interest rate hiking cycle, a key consideration for the market is to identify the 'neutral OCR rate', where the OCR may settles once the RBNZ have removed monetary stimulus.[2] One approach to estimate a neutral OCR is to take the average of the OCR over the past 20 years, which is around 6%. However, this misses the way the structure of the fixed interest market has changed since the GFC. An alternative approach, shown in Figure 4, is to take the average floating mortgage rate and subtract the current retail mortgage margin, to give a neutral OCR of 4.50% to 5.00%. That estimate is close to the RBNZ's latest research, presented in a speech by its chief economist.[3]

Figure 4: NZ benchmark interest rates
(1992 to 2014)




Sources: Bloomberg and Harbour Asset Management

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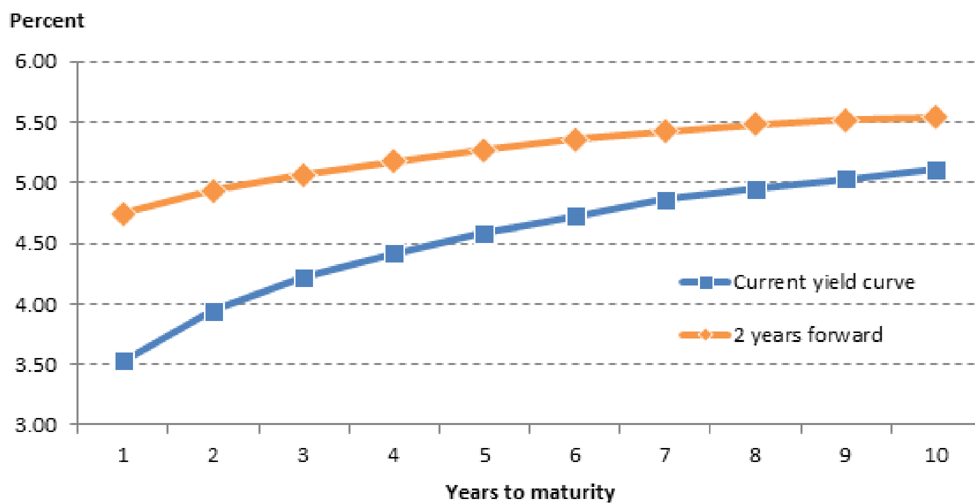
As highlighted in the forward curve in Figure 5 below, the market has already priced in a pathway for the OCR to return to around 4.5% to 5% in two years' time. In other words, investors in New Zealand fixed interest are already being compensated for a further removal of stimulus to around neutral.

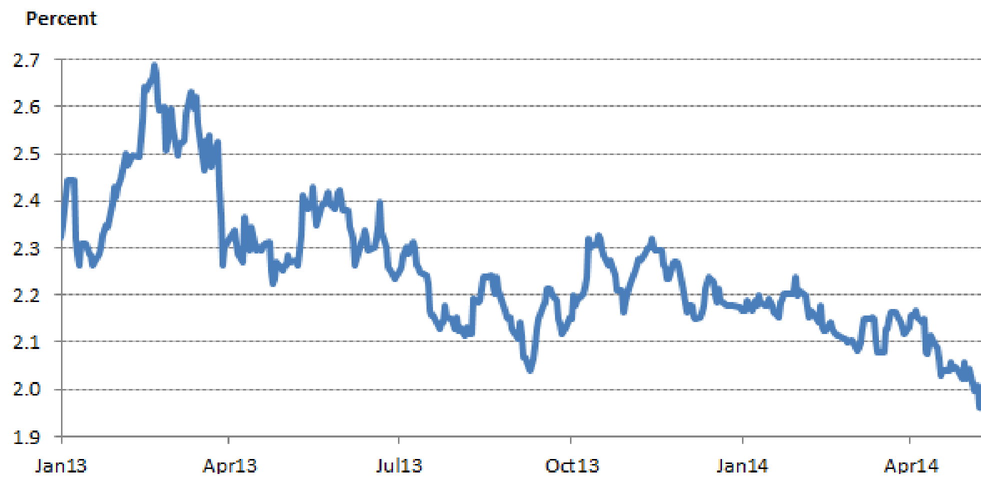
Figure 5: NZ yield curve (from swaps market)
(as at 1 April 2014)




Sources: Bloomberg and Harbour Asset Management

One area where market pricing has arguably not moved in the direction of economic fundamentals is the NZ inflation-linked bond market. Despite growing inflationary pressures, Figure 6 illustrates that inflation breakevens have been falling over 2013 and 2014. One factor influencing the pricing of inflation-linked bonds has been the issuance of the NZ Debt Management Office (NZDMO), as it has attempted to increase inflation-linked bonds to 20% of the NZ government bond market.[4] For investors fearing inflationary pressure, purchasing inflation protection has become cheaper.

Figure 6: NZ 10 year inflation breakevens
(2013 and 2014)

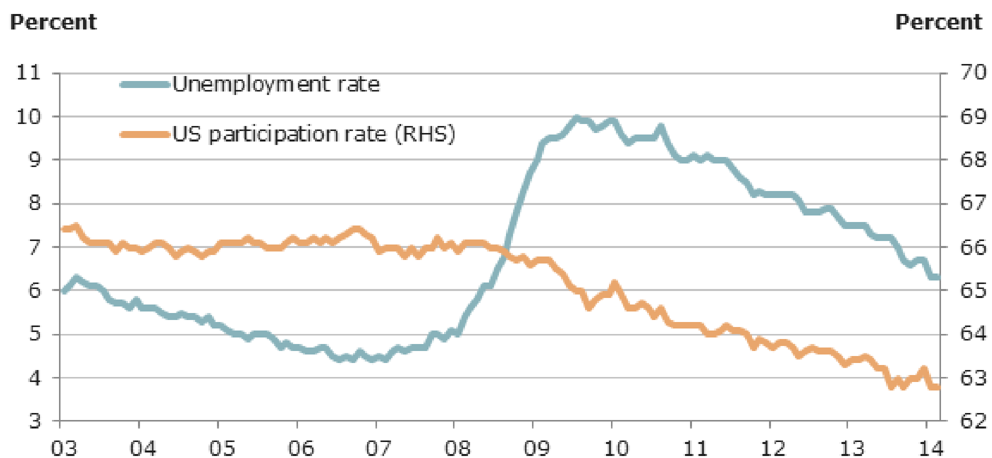



Sources: Bloomberg and Harbour Asset Management

## THE US OUTLOOK AND IMPLICATIONS FOR FIXED INTEREST MARKETS

Like New Zealand, the US and other main economic regions have been in economic expansion in 2013 and 2014 (illustrated by the manufacturing PMIs in Figure 1 above). In the US, the unemployment rate has also fallen toward the US Federal Reserve's target of 6.5%, suggesting less rationale for monetary stimulus.[5] However, around half of the fall in the unemployment since 2009 can be attributed to a fall in labour market participation, shown in Figure 7.

Figure 7: US labour market
(2003 to 2014)




Sources: Bloomberg

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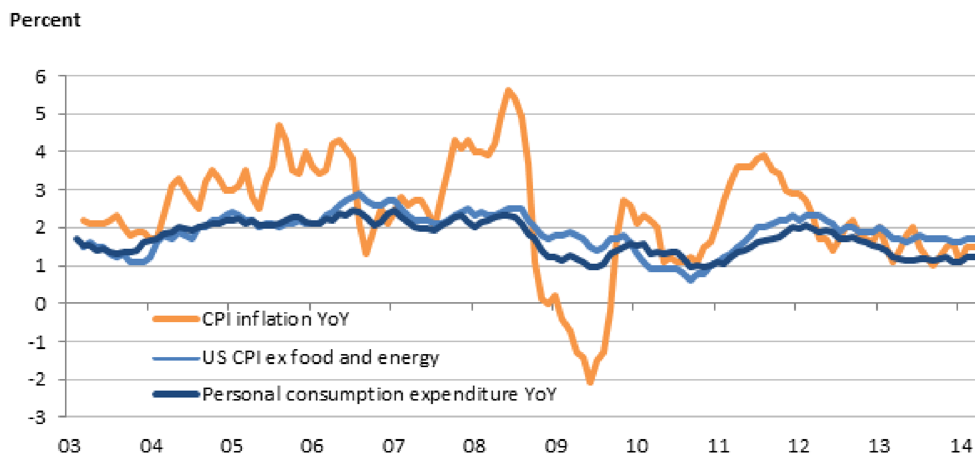
Furthermore, while many market commentators focus on improvements in the US labour market, the other component of the Fed's dual mandate – inflation – has remained well below target. The US Fed's favoured measure of inflation, the US personal consumption expenditure deflator, has remained near post GFC lows a little above 1%, as shown in Figure 8. This provides plenty of headroom above the Fed's 2% target and 2.5% threshold for retaining overnight interest rates near zero.

**Figure 8: US inflation**
(2003 to 2014)

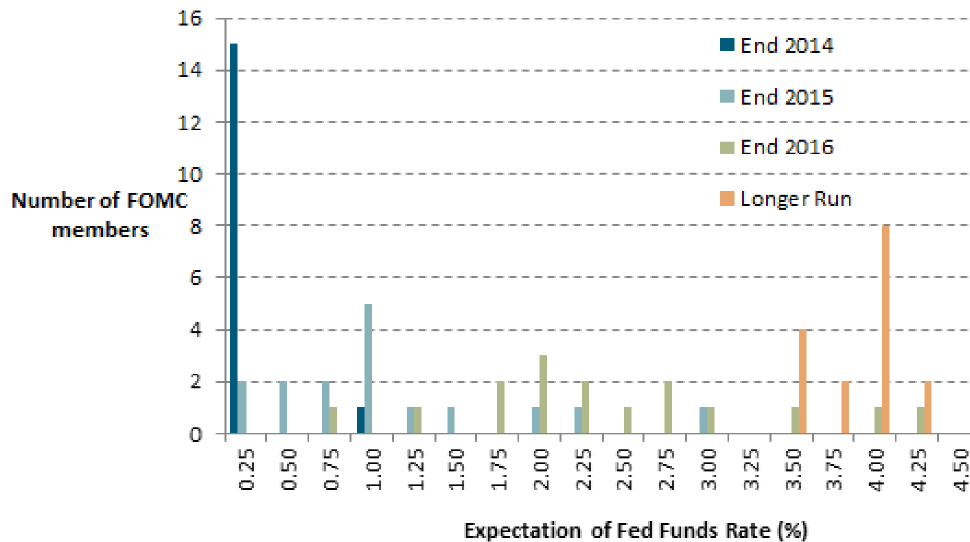



Sources: Bloomberg

In mid March, US Federal Reserve released its economic forecasts, drawn from the 16 members of the Federal Open Markets Committee (FOMC). This is shown in Figure 9 below. Their expectations for the US Fed Funds Rate averaged around 1% by the end of 2015, 2.5% by the end of 2016, and around 4% in the longer run.

The wide dispersion of FOMC expectations for 2015 and 2016 illustrates the high degree of uncertainty on the timing of monetary stimulus being removed in the US.

Figure 9: FOMC expectation of the US Federal Funds Rate (March 2014)




Source: US Federal Reserve Board of Governors

A key theme in global fixed interest markets in 2013 was long-term yields rising as the US Federal Reserve announced that it was considering tapering its quantitative easing (QE) program.[6] Figure 10 highlights that 10-year bond yields increased around one percentage point across much of the developed world in 2013, including the US, NZ and Australia. However, New Zealand was one of the few countries where short-term interest rates also rose. In other countries, investors are not yet being compensated for the chance that official overnight interest rates may be increased before 2015 or 2016.

Furthermore, global bond indices are more sensitive to changes in interest rates, with the duration of the Barclays Global Aggregate Index over six years, compared to around 4.5 years for the NZ Government Stock Index and 2.5 years for the ANZ Corporate A-Grade Index.[7]

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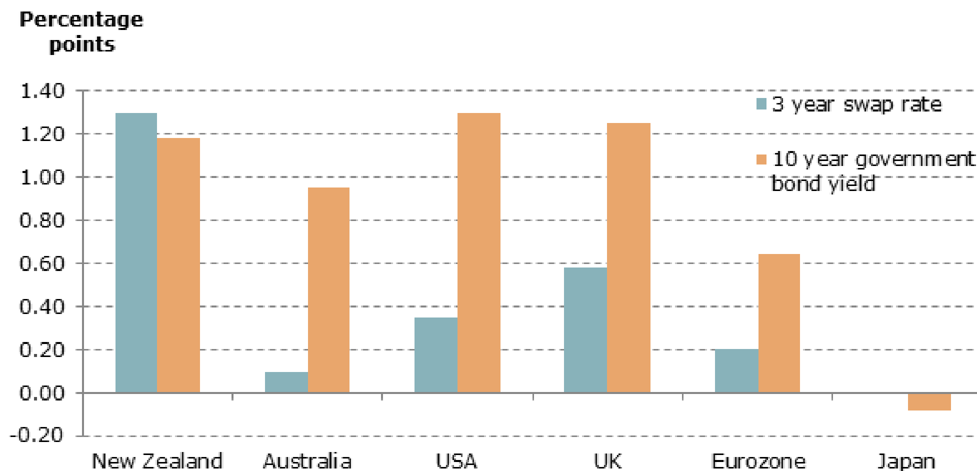
Figure 10: Changes in interest rates
(end 2012 to end 2013)




Sources: Bloomberg

## CONCLUSION

On 13 March 2014, the Reserve Bank of New Zealand (RBNZ) become and first developed country central bank to begin removing stimulus when it delivered a 25 basis point hike in the Official Cash Rate (OCR). It was one of the most well signalled interest rate moves, with market interest rates already rising over 2013 to reflect the improving outlook for the New Zealand economy. Furthermore, the market has already priced-in a pathway for the OCR to return to a neutral level of around 4.5-5% in coming years. This pricing means that investors who are reticent about investing in the short-end of the NZ yield curve must be concerned that the RBNZ will have to push interest rates higher than neutral to contain a NZ inflation problem.

By contrast, with global inflation still low, in the US and elsewhere, the market is not yet expecting the removal of central bank stimulus. The analysis in this paper suggests that investors are not being compensated for the risk that the US Federal Reserve changes its communication and signals that official interest rates could rise towards neutral in 2015 and 2016. Furthermore, global bond portfolios are typically more sensitive to changes in interest rates, with the duration of the global aggregate bond indices considerably longer than NZ bond indices. Investors fearing a rise in global yields could consider allocating into shorter duration alternatives.

## FOOTNOTES

1. See the RBNZ 'Monetary Policy Statement', March 2014. http://www.rbnz.govt.nz/monetary_policy/monetary_policy_statement/2014/MPSmar14.pdf

2. The neutral interest rate is the rate consistent with inflation being steady at, or close to, the midpoint of the inflation target band and the economy running at capacity.

3. "Shifting gear: why have neutral interest rates fallen?", a speech by John McDermott, 2 October 2013. http://www.rbnz.govt.nz/research_and_publications/speeches/2013/5478033.pdf

4. http://www.nzdmo.govt.nz/publications/mediastatements/govtbonds/2012-10-24

5. See Harbour Navigator, 'US Fed regime change: the new Evans Rule', 13 December 2012

6. See "The Economic Outlook: testimony before the Joint Economic Committee, US Congress", Chairman Ben Bernanke, 22 May 2013. http://www.federalreserve.gov/newsevents/testimony/bernanke20130522a.htm

7. https://www.nzx.com/files/assets/ANZ Debt Indices Descriptions.pdf

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