An Almost Impossible Balancing Act

New Zealand Fixed Income Monthly Commentary

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- Both global and New Zealand long-term global bond yields rose sharply in May, driven by fears that the US Federal Reserve may begin to taper Quantitative Easing (QE) sooner than expected.
- As the US economy continues to recover from the GFC, the US Fed faces the almost impossible balancing act of drawing back the extreme level of policy stimulus without sending the economy back into recession or sparking financial panic.
- Closer to home, the RBNZ faces its own dilemma: if it threatens to raise the Official Cash Rate (OCR) to cool off an overheating Auckland housing market, it could fuel a further rise in the overvalued NZD.
- As these imbalances grow, the RBNZ appears increasingly willing to use macroprudential tools to help resolve its balancing act. However, we suspect that these tools will not be a panacea, and other direct policy action may be required.
- Another way that New Zealand's policy dilemma may be resolved is through the actions of foreign policymakers. It may take the US Fed to start QE tapering to strengthen the US dollar and finally take upward pressure off the NZ dollar.

Influential Market Quote of the Year Award

Most market commentators would agree that the most influential quote in financial markets in 2012 was ECB President Mario Draghi's commitment to "do whatever it takes" to save the euro. At the height of the European sovereign crisis, it was a commitment to highly supportive policy measures.

It may turn out that Fed Chairman Ben Bernanke's acknowledging that "it was possible that the Fed could taper its QE purchases in the next few meetings" is the most influential quote of 2013. In contrast to last year, his statement was about navigating an exit strategy from the highly supportive policy measures we have seen in recent years.

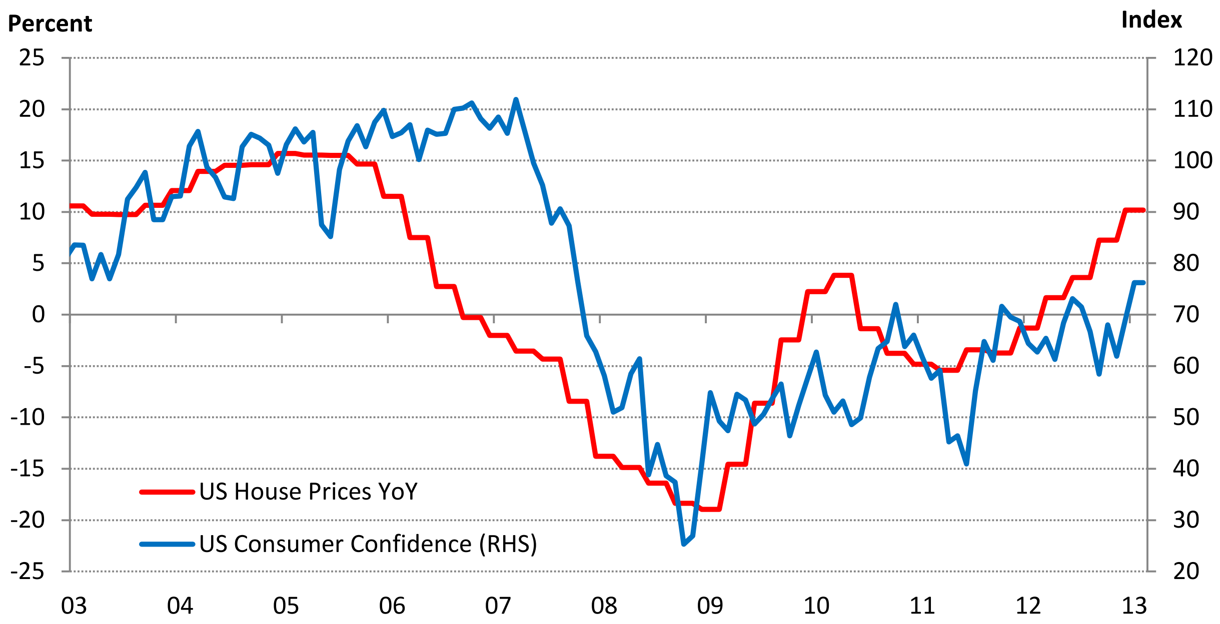
At the beginning of May, the US 10 year government yield had reached near all-time lows of 1.60%, driven by view that QE would continue almost indefinitely. This was motivated by a view that not only was US unemployment still well north of the Fed's target, but the underlying US inflation was well south of the Fed's target. However, during the course of May two factors rattled that view of low stable interest rates.

Improving US Household Wealth and Consumer Confidence

First, there were more concrete signs that the US economy was coming out of a post-GFC healing process.

The GFC was initially sparked by the collapse of US housing prices, which started in 2006. Seven years down the track, there are growing signs that the US housing market is in much better shape, with housing inventories cleared, and the S&P/Case-Shiller House Price Index up over 10% from a year earlier. Combined with the strong rise in equity prices, the rise house prices has improved US household wealth, which was one of the drivers of the Conference Board measure of consumer confidence reaching its highest level since 2008.

Chart 1. US House Price Inflation and Consumer Confidence



Source: Conference Board and Bloomberg.

The Prospect of QE Tapering

The second factor that rattled the market's view of low stable interest rates was a reminder that QE would not continue forever.

At the beginning of the year, Ben Bernanke explained that the Fed has a commitment to assess the cost and benefits of further QE, where one of the costs includes the chance that further QE undermines the public's confidence in the ability of the Fed's to safely exit QE.[1] During Bernanke's latest testimony to the US Congress in May, he surprised markets by

[1] Ben Bernanke, "Semi-annual Monetary Policy Report to the Congress", 26 February 2013.

acknowledging that it was possible that the Fed could taper its QE purchases in the next few meetings. [2]

In our view, this latest testimony marked a significant change in the Fed's communication strategy. Previously, the Fed has emphasized its quantitative targets for unemployment and inflation, and commitment to keep policy very accommodative until these are achieved. The downside to this approach is that it could have set up a rush for the door in the bond market at the first sign from the Fed that it intended to end QE.

In an effort to smooth the eventual path to exit from QE, the Fed has changed its approach so that decisions on QE will be made each month with an open mind. This involves a more incremental approach of changing their QE settings and then checking the impact on the economy. They want to keep their options open, enabling them to taper QE if the economy improves and turn the taps back on if the economy falters.

In that spirit, even US Fed regional governors that were seen as being at the dovish end of the spectrum, like John Williams, have highlighted the chance that QE is tapered back in coming months to acknowledge the better recent economic data.

Table 1. US Federal Reserve Presidents and FOMC members

FOMC voters	**Position**	**Hawk/Dove**
Ben Bernanke	Chairman	Dovish
Bill Dudley	Vice Chair, New York	Very Dovish
Janet Yellen	Board of Governors	Very Dovish
Charles Evans	Chicago	Very Dovish
Eric Rosengren	Boston	Very Dovish
Daniel Tarullo	Board of Governors	Very Dovish
Elizabeth Duke	Board of Governors	Dovish
Sarah Bloom Raskin	Board of Governors	Dovish
Jeremy Stein	Board of Governors	Dovish
James Bullard	St Louis	Centrist
Esther George	Kansas City	Hawk
Jerome Powell	Board of Governors	Hawk
FOMC alternate members (current non voters)		
Richard Fisher	Dallas	Very Hawkish
Charles Plosser	Philadelphia	Very Hawish
Narayan Kockerlakota	Minneapolis	Hawk
Christine Cumming	New York, Vice President	Dovish
Other Fed Presidents		
Jeffery Lacker	Richmond	Very Hawish
Dennis Lockhart	Atlanta	Dovish
Sandra Pianalto	Cleveland	Dovish
John Williams	San Francisco	Dovish

Source: Thomson-Reuters and Harbour Asset Management.

[2] Ben Bernanke, "The Economic Outlook", Before the Joint Economic Committee", US Congress, 22 May 2013.

The Fed's Almost Impossible Balancing Act

The problem is that this subtle change in approach is a difficult message to get across to markets, which see in black and white, and that want to be forward looking to get in front of every policy move.

While the intention was to make the QE exit smoother, volatility in fixed interest markets increased substantially in May. After starting the month at 1.60%, the US 10 year government bond yield rose to over 2.20% during the month. According to research firm Lipper, US funds that invest in higher-rated bonds with average maturities of under 10 years lost an average 1.8% in May. This was their fourth worst monthly performance behind periods in 1994 and 2003.

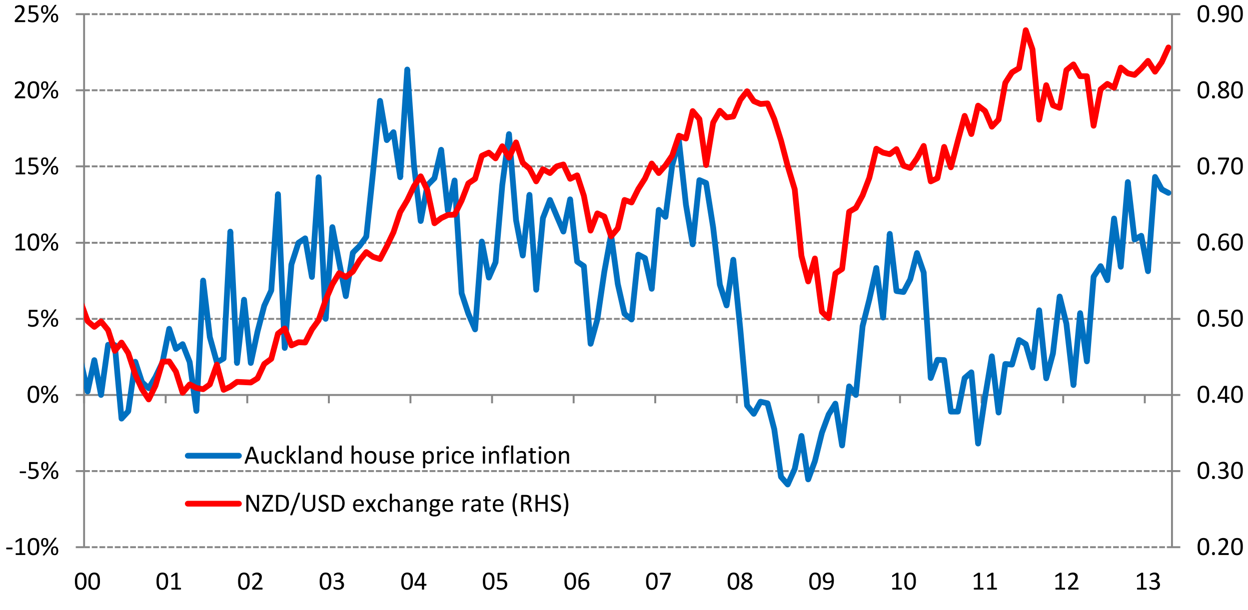
Equity markets also weakened in the second half of May, in part as the reality sunk in that support from the Fed will not be indefinite. But the big story in equities was the rotation into cyclical stocks and out of defensive stocks.[3]

The reaction of bond and equity markets in May highlight the almost impossible balance act faced by the US Fed now that the amount of monetary stimulus is so extreme. As the US economy continues to recover, the challenge is to draw back the level of stimulus without sending the economic back into recession or sparking a financial panic.

The RBNZ's Almost Impossible Balancing Act

In our part of the world, the RBNZ faces its own almost impossible balancing act, linked to QE and its affect on the NZD exchange rate.

Chart 2. NZ Dollar and Auckland House Prices



Source: REINZ and Bloomberg.

[3] See Forthcoming Harbour Monthly Equity Commentary, June 2013.

In a speech at the end of May, the RBNZ Governor, Graeme Wheeler, highlighted that the two big factors facing the NZ economy are the overvalued NZD dollar hurting exchange rate sensitive sectors and the NZ housing market that is at the risk of overheating.[4] The policy dilemma facing the RBNZ is that if they raise the Official Cash Rate (OCR) to cool off the housing market they risk fuelling a further rise in the NZD.

The reality is that that, with CPI inflation already through the bottom of the 1-3% target range, the RBNZ is in no hurry to raise the OCR to meet its monetary policy objectives. With the OCR on hold, this leaves the RBNZ dealing with the growing imbalances in the economy, and trying to ensure that they do not cause a problem that will threaten financial stability.

In that spirit, since Graeme Wheeler first started as Governor, the RBNZ has gone from explaining the concept of macro-prudential tools to fast tracking their use. In the May Financial Stability Report, the RBNZ announced that it would increase risk weights applying to high loan-to-value ratio (LVR) housing loans for the four major banks.[5] We see this change as a precursor to more regulatory tweaks to cool the housing market.

However, while macroprudential tools may help alleviate imbalances on the margin, they are no panacea. In its latest edition, *The Economist* highlights the limits of macroprudential policy in curbing risk-taking, due to controls on financial institutions being too hard to design and too easy to circumvent.[6]

One factor that could help alleviate the RBNZ’s balancing act would be growing talk of QE being tapered in the US, which led to the US dollar strengthening.

A lower NZD/USD exchange rate could feed through to higher inflation for tradeable goods and may bring CPI inflation closer to the middle of the target range. That could provide a more appropriate environment for the RBNZ to start bringing the OCR back to a more normal level, especially with a backdrop of Auckland housing market heating up, the Canterbury rebuild getting into full swing, and the NZ government’s current fiscal contraction drawing to a close.

Like the standard ending of an episode of *Yes Minister*, one problem (QE tapering) ends up becoming the solution to resolve another problem (the high NZ dollar).

Market Outlook

We retain our view that over the medium-term global bond yields will continue to rise to more normal levels. However, we are expecting a bumpy ride now as the market adjusts to the Fed’s new communication strategy and the Fed’s actions each month becoming more conditional on the latest economic data outturns.

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[4] Graeme Wheeler, “The Forces Affecting the NZ Economy and Policy Challenges”, 30 May 2013.
[5] See Harbour Navigator: “RBNZ Official Concerned by the Housing Market “, 8 May 2013.
[6] *The Economist*, “Macro Control, Micro Problems”, 1 June 2013.

Closer to home, we continue to see the RBNZ as having a high threshold to either cut or hike the OCR. However, we expect that the next move will be an OCR hike.

We suspect that this could become more widely anticipated as we move into the final quarter of the year, especially if talk of Fed tapering QE strengthens the US dollar, helping the NZ dollar fall and leaving the way clearer for the RBNZ to act on its housing market concerns with its most powerful policy tool – the OCR.

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