

# Markets Monthly

05 February 2018



## Bond yields press higher and USD sinks in January

- US long-term bond yields lifted over January, and the US 10-year yield is now at its highest level since 2014.
- Australian and New Zealand bond yields rose with the global move higher, which was driven from the US.
- US shares soared higher on solid earnings results and the positive impact of December's tax cuts for companies.
- In contrast, Australasian sharemarkets took a breather in January, with main indices recording modest dips.
- The NZD continued to recover from its post-Election slide, and gained 4% against a softening USD.

**Bond yields are on the rise both here and abroad.** The big question now is will the move continue? ASB has been expecting long-term US interest rate increases for a while but over recent years, every bond sell-off that has sent yields higher has subsequently reversed.

**The US 10-year government bond is the highest it's been since 2014, trading with a yield near 2.8%.** The 10-year yield increased 28 basis points (bps) over January, and is nearly 1.5% above the all-time low of 1.318% touched back in mid-2016. These are big moves for US bond yields.

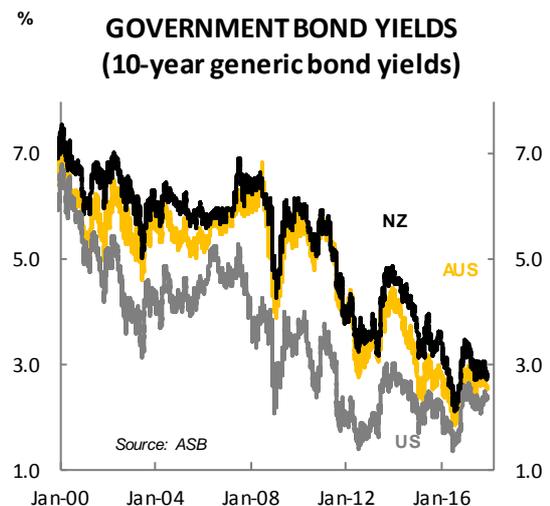
Over January the New Zealand 10-year yield followed the US move higher, but the increase in yield here was not quite as significant as the US move - the NZ 10-year yield lifted 18bps to 2.91%. One interesting consequence of recent bond market developments is the convergence of US and NZ yields. New Zealand bonds typically trade at a premium to their US counterparts, with the NZ-US 10-year yield advantage averaging 1.3% or 130 bps since 2012. At the end of January that spread had converged to 0.2% or 20bps.

Australian yields are following a similar convergence. US, Australian and NZ 10-year yields are all converging on 3%.

This convergence doesn't happen too often. We have to go back to the early 1990s to find a time when New Zealand long term yields were lower than their US equivalents. It is possible we will see that occur again in 2018, although there is still a wee way to go yet: watch this space over the coming months.

Turning to foreign exchange rates, the declining interest rate premium New Zealand has against the US suggests a

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lower NZD/USD. However the opposite occurred in January - the NZD appreciated 4% against a weakening USD. Other drivers, including a positive outlook for NZ exports and strong NZ economic performance are offsetting weak USD sentiment and lifting NZD/USD at present. The impact of post-election uncertainty has also faded.

Meanwhile, the US sharemarket had a stellar start to the year, with the S&P 500 index of US shares up 5.6% for the month, taking the index 23.5% higher over the year to 31 January. Solid earnings growth as well as the passage of US tax reforms in late December offset concerns about rising interest rates. In contrast, Australasian markets dipped modestly during January.

The US Federal Reserve Open Market Committee met on the last day of the month, and held the Federal Funds rate target range steady at 1.25-1.50%, as expected. The Reserve Bank of New Zealand holds its first Official Cash Rate review on 8 February, and is unanimously expected to maintain the record low 1.75% policy setting.

Date	Instrument	31-Jan-18	Month %	Quarter %	Year %	5-Year %
Cash	NZ Official Cash Rate	1.75	0.00	0.00	0.00	-0.75
	NZ 90-day bank bill	1.89	0.01	-0.06	-0.10	-0.79
Fixed Interest	NZ 5-year gov't stock	2.40	0.15	-0.03	-0.31	-0.62
	NZ 10-year gov't	2.91	0.18	-0.01	-0.45	-0.79
	AUS 10-year gov't	2.85	0.18	0.17	0.12	-0.61
	US 10-year gov't	2.72	0.28	0.35	0.25	0.73
Australasian	NZ - NZX50 Capital (NZ\$)	3875	0.5%	3.1%	15.1%	60.4%
	- NZX50 Gross (NZ\$)	8387	-0.1%	3.0%	19.0%	97.2%
Equities	AUS - All Ords (A\$)	6147	-0.3%	2.8%	8.3%	25.4%
International	JAP - Nikkei (¥)	23098	1.5%	4.9%	21.3%	107.4%
Equities	UK - FT100 (£)	7534	-2.0%	0.5%	6.1%	20.0%
	US - S&P500 (US\$)	2824	5.6%	9.7%	23.9%	88.5%
	WORLD - MSCI (US\$)	2213	5.2%	8.7%	23.5%	57.5%
	MSCI in NZD (NZ\$)	3000	1.2%	0.8%	22.0%	78.2%
	Exchange Rates	NZD/USD	0.74	4.0%	7.8%	1.2%
	NZD/AUD	0.91	0.4%	2.4%	-5.1%	13.8%
	NZD/JPY	80.32	0.3%	3.7%	-2.9%	5.9%
	NZD/GBP	0.52	-1.4%	0.4%	-10.7%	-1.5%
	NZD/EUR	0.59	0.0%	0.9%	-12.8%	-3.4%
	NZ TWI	75.10	1.3%	3.4%	-5.7%	-0.6%

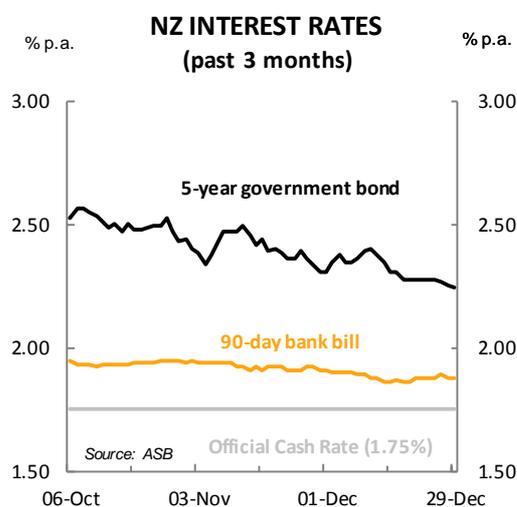
Equity indices are the respective end-of-month closes. Interest rates and exchanges rates are at 5pm NZ.

## Income Assets

### Cash

The RBNZ's first OCR announcement in 2018 is on 8 February, and at the same time the Bank will release a fresh set of economic forecasts. The RBNZ is widely expected to leave the OCR on hold at 1.75% at this meeting. We think its forecasts will show a balanced assessment of the outlook and continue to emphasise that interest rates are likely to remain low for a considerable period.

If OCR hikes are still a long way off, most short-term fixed interest returns on term deposits will likely stay near current levels over the coming quarters.



**Term deposit rates** for the popular terms out to 18 months were little-changed over 2017, largely reflecting the low, stable OCR. At the time of writing, term deposit rates are between 2.75% to 4.2% for terms between 90 days and 5 years for term deposits over \$10K. Over the past 10 years rates have been on average around 0.9 to 1.6% higher than the current rates available for the various respective terms. The upward pressure on long-term global rates, if sustained, could translate to higher interest rates on some of the longer term deposit rates. However, even factoring that pressure in, our current forecast is for term deposit rates for all terms to remain low relative to the long-term averages mentioned above.

The latest ASB term deposit rates [can be found here](#).

## NZ Fixed Interest

Demand for NZ bonds remains strong, and that's compressing spreads between NZ and US equivalent bonds, as shown in the chart to the right. New Zealand bonds typically trade at a premium to their US counterparts, but that premium is low at present.

The dominant force during the month was rising US (and global) yields, which are discussed in the international section below.

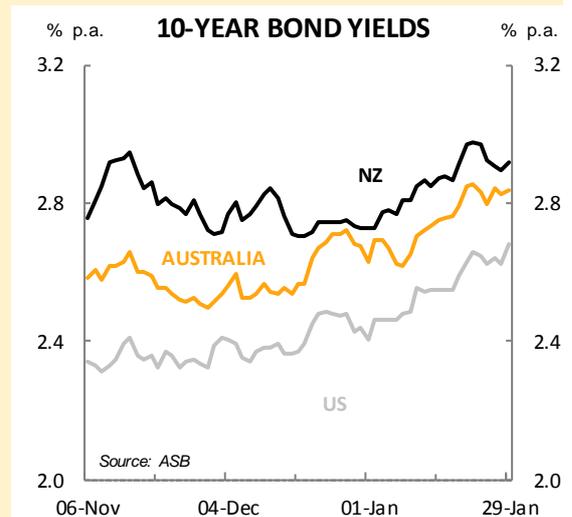
We expect long-term local bond yields to rise over the year ahead, which will boost the income for investors receiving income from fixed interest investments. However, over the year ahead, we expect the return on NZ fixed income investments will remain lower than long-term averages.

Bond valuations move in the opposite direction to yield, so the expected increase in yield are a potential headwind for valuations within bond portfolios.

## International Fixed Interest

The US Federal Open Market Committee (FOMC) lifted the Federal funds rate to a 1.25% -1.50% range on 15 December, and maintained that setting at its review on the last day of January. That meeting was the last meeting to be chaired by Janet Yellen; the next meeting's Chair of the Board of Governors of the Federal Reserve System will be Jerome Powell, who takes over from Yellen on 3 February. The change of Chair isn't expected to change the course of US monetary policy. The direction is up for the FOMC's target rate over the year ahead, the question is by how much. The FOMC is expected to deliver the first rate hike of 2018 at its March meeting. The rate hikes delivered, and the expectation of more to come, have been putting upward pressure on short-term debt investments in the US, including 2-year government bonds. The 2-year yield rose above 2% in January, the first time it has done so in a decade. At the "long end" of the US interest rate market, US 10-year government bond yield is currently trading just shy of 2.8%, which is the highest yield since 2014. The 10-year yield lifted 28 basis points (bps) over the month, and bonds are now trading with a yield nearly 1.5% above the all-time low of 1.32% touched back in mid-2016.

Long-term bond yields in other major bond markets such as the UK, Germany and Japan also lifted in January.



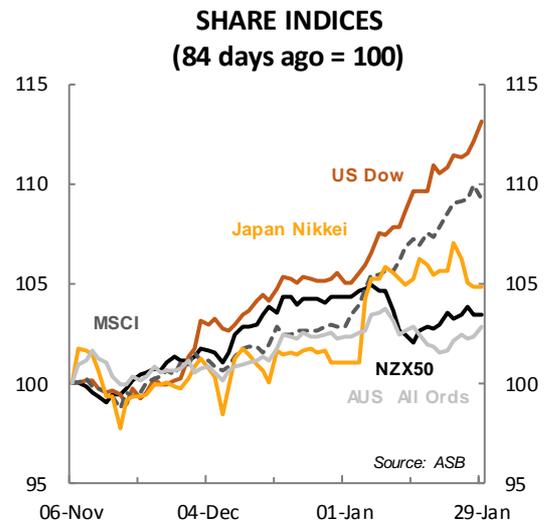
## Growth Assets

### Australasian Equities:

The local sharemarket took a breather in January, with the NZX50 (Gross Index) down 0.1% over the month, after gaining 21.8% over the full 2017 year. The Australian S&P/ASX200 index also eased modestly over the month, but the index remains above the 6,000 point level, which it only recently reached (in December) for the first time since the start of the Global Financial Crisis.

Despite the January dip, the New Zealand and Australian markets have lifted significantly over the past 12 months, with the NZX50 (Gross Index) up 19% and the Australian S&P/ASX200 index up 8.3%.

Drivers of the positive returns include a positive outlook for the Australian and NZ economies, improving global growth and the associated strength in the outlook for key exports, and a supportive outlook from a fiscal and monetary policy perspective.



### International Equities:

The S&P 500 rose +5.6% on the month, down from intra-month highs of +7.2%. This represents the strongest start to the year for US equities in over 20 years. Furthermore, the January month's gain was the 15th straight gain, which is the longest winning streak recorded for the index.

US earnings results were strong over January - Reuters reports that 80% of companies were beating earnings forecasts.

Elsewhere, key equity indices have been largely positive, although the UK sharemarket was down over the month. The MSCI index of global shares was up 1.2% over the month, and 22% over the year to 31 January, when measured in NZD terms.

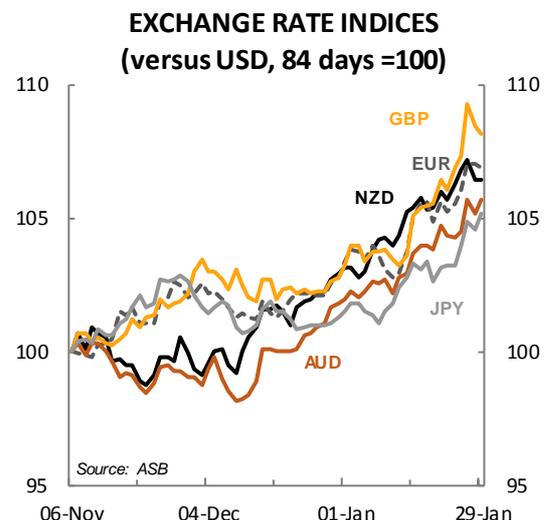
ASB Securities has more information on sharemarkets and trading [here](#).

### Exchange Rates:

The NZD has bounced back from its post-election slide, and posted strong gains against a weakening USD - NZD/USD was up 4% over January. The NZD has essentially recovered the ground lost in reaction to the 2017 General Election uncertainty: on a trade-weighted basis, the NZD is back trading where it was in early September 2017.

Saying that, this bounce-back is not all about domestic events – the USD has also been weak. That USD weakness is reflected in the January drop in the USD vis-a-vis the EUR, GBP and JPY, as well as the AUD.

All these USD FX declines over January were over 3%: as the chart on the right shows, all the major currencies have been strengthening against the USD over recent months.



For more insights into currency issues, our latest **ASB Kiwi Dollar Barometer** can be downloaded [here](#).

**ASB Economics & Research**

Chief Economist  
Senior Economist  
Senior Economist  
Senior Rural Economist  
Senior Economist, Wealth  
Economist  
Data & Publication Manager

Nick Tuffley  
Mark Smith  
Jane Turner  
Nathan Penny  
Chris Tennent-Brown  
Kim Mundy  
Judith Pinto

[nick.tuffley@asb.co.nz](mailto:nick.tuffley@asb.co.nz)  
[mark.smith4@asb.co.nz](mailto:mark.smith4@asb.co.nz)  
[jane.turner@asb.co.nz](mailto:jane.turner@asb.co.nz)  
[nathan.penny@asb.co.nz](mailto:nathan.penny@asb.co.nz)  
[chris.tennent-brown@asb.co.nz](mailto:chris.tennent-brown@asb.co.nz)  
[kim.mundy@asb.co.nz](mailto:kim.mundy@asb.co.nz)  
[judith.pinto@asb.co.nz](mailto:judith.pinto@asb.co.nz)

**Phone**

(649) 301 5659  
(649) 301 5657  
(649) 301 5853  
(649) 448 8778  
(649) 301 5915  
(649) 301 5661  
(649) 301 5660

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