

RESEARCH

INTEREST RATE STRATEGY

1 February 2019



Trade Idea: Sell NZGB 23s against 21s and 29s

- The belly of the NZ curve has significantly outperformed over the past few months, with 2s5s10s in swaps reaching post-GFC lows at -25bps.
- We see an opportunity to position for a reversal in NZGBs, selling 23s against 21s and 29s. Unlike swaps, the NZGB fly is positive carry and roll.
- We think the fly offers an asymmetric risk-reward profile from here and can perform in both bullish and bearish scenarios.
- With 2023s trading below the OCR we expect offshore investors to extend down the curve in search for yield.
- Investor holdings data suggests that NZ banks are reasonably well positioned for the upcoming Q1 high-grade maturities, meaning domestic demand for the belly of the curve may be more restrained going forward.
- We appreciate a NZGB fly isn't for everyone. Investors may want to consider a 23s29s flattener, which should work in a 'rolling flattening' environment. Investors looking to position for a reversal in NZ rates may want to consider selling 2023s outright.

Strategy	Entry	Exit	Stop	C&R (1m)
Sell NZGB 23s vs. 21s and 29s	-43bps	-30bps	-50bps	+0.5bps

Belly-led outperformance on the NZ curve

The NZ curve has rallied significantly over the past few months, with the belly outperforming. 2s5s has flattened to its lowest level since 2016 amidst declining OCR expectations. 5s10s in contrast has remained relatively steep. 2s5s10s has reached -25bps in swaps, its lowest level since the GFC (see Chart 1).

We think selling the belly of 2s5s10s can reasonably perform in both bullish and bearish scenarios from here.¹ With 2s5s now very flat and the positive carry being gradually squeezed out of the belly, we expect to see some receiving interest extend along the curve if the rates rally extends, which should result in some normalisation in 2s5s10s. And if rates were to sell-off for whatever reason, we would also expect the 5 year point to underperform and 2s5s10s to move higher (as we saw in November after the NZ labour market surprise).

Our only hesitation with paying the belly is the negative carry and roll the position entails (around -3bps over 3 months). In an environment of subdued rates volatility and range-bound markets, 2s5s10s will likely roll adversely down the curve. This makes timing important.

¹ See *NZ Curve Outlook: Are We Near A Point Of Inflection?* from 30th August, where we discussed a framework for thinking about the directionality of 2s5s10s.

Chart 1: NZ 2s5s10s in swaps makes post-GFC lows

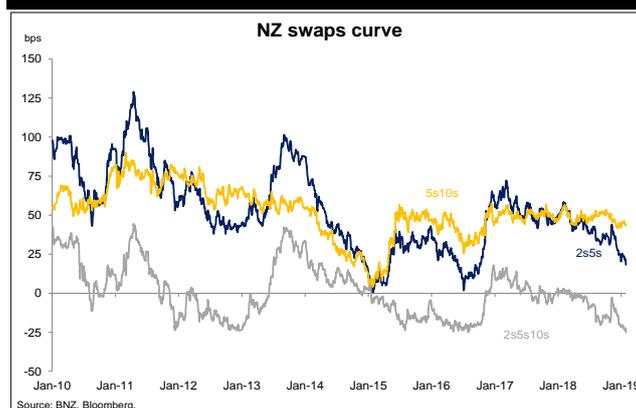


Chart 2: NZGB 21s23s29s fly is also towards the lows



NZGB fly offers positive carry and roll version of 2s5s10s

However, we see an opportunity to position in NZGBs, where the carry and roll from selling 23s against 21s and 29s is positive (around +0.5bps per month²). The 21s23s29s fly is also towards the lows (see Chart 2), like swaps, and offers the same asymmetric profile, in our view. In fact, the 21s23s29s fly has moved slightly higher the past few days, reinforcing our view that 23s will underperform on the curve on any further rally in rates from here.

Demand dynamics likely to favour NZGB 23 underperformance

The outperformance of the belly of the NZ curve has seen the 2023 NZGB trade down to just 1.73% in yield, below

² These carry and roll calculations are based on an assumed repo rate of 1.75% on the 2023 NZGB short. The 2023s are trading marginally special in repo (around 10bps below GC). Using a 1.65% repo rate on the short in the 2023s reduces the carry and roll to +0.1bp per month.

the 1.75% cash rate. At current yield levels, we expect investors to extend down the NZGB curve in search for yield. Were rates to rally further, we would expect a “rolling flattening” to ensue.

In terms of demand dynamics, offshore investors have been consistent sellers of shorter-dated NZGBs over the past few years (see Chart 3). We think this selling has been largely soaked up by bank balance sheets, which hold NZGBs for prudential liquid asset purposes, and have a preference for sub-5 year maturities.

Bank demand for NZGBs has been strong ahead of the swathe of high grade NZ bond maturities in Q1 (including ~\$5b of the NZGB Mar-19, \$1.2b of LGFA and almost \$5b of SSA). Chart 4 shows bank holdings of NZGBs, LGFA and SSA have increased significantly over the past six months.

Our back-of-the-envelope calculations suggest that banks might lose around \$5b via NZGB, LGFA and SSA bond maturities in Q1 and the reduction in Treasury bills planned by NZDM. A \$5b reduction would see banks’ combined holdings of NZGS, LGFA and SSA return to similar levels as July last year.³ This suggests to us that banks are reasonably well pre-positioned for the upcoming maturities this quarter, and that their demand may be more restrained going forward. Any further selling from offshore investors of the belly of the NZGB curve may have a greater impact on yields going forward.

NZGB 23s29s flattener is an alternative

We appreciate that a NZGB fly isn’t for everyone. Cash investors may want to consider a NZGB 23s29s flattener, which should perform in an environment of “rolling flattening” of the curve if investors were to extend in search for carry. The 2029s offer the highest carry and roll on the NZGB curve (+1.2bps per month) and are the cheapest bond on the curve according to our NSS model (by around 1.6bps). The 23s29s flattener carries and rolls positively by around +1bp per month.

While 23s29s has flattened much less than 21s23s, and offers a substantially greater yield pick-up, it is nevertheless towards the lower-end of the range seen over the past twelve months. While our broader view is that NZ rates will be range-bound ahead, and we think the flattener is a reasonable trade, an unexpected move higher in global rates would likely see the NZGB curve steepen. We see the fly as a more protected structure with better risk-reward.

For investors who want to fade the rally in NZ rates, we think selling the 2023s outright is an attractive option, given it has outperformed on the curve, is trading below the OCR, and the negative carry and roll is minimal.

Chart 3: Declining offshore holdings of short-dated NZGBs

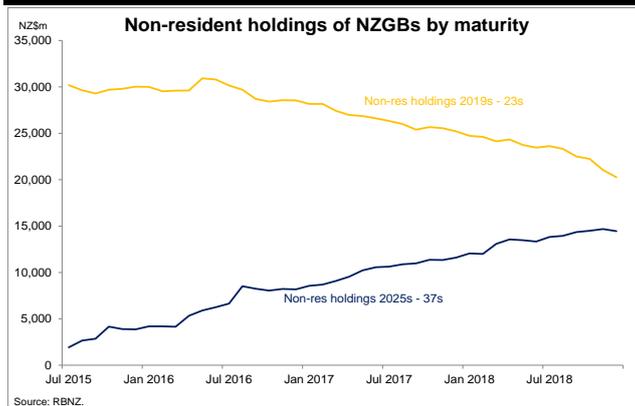


Chart 4: Banks HQLA holdings have increased sharply

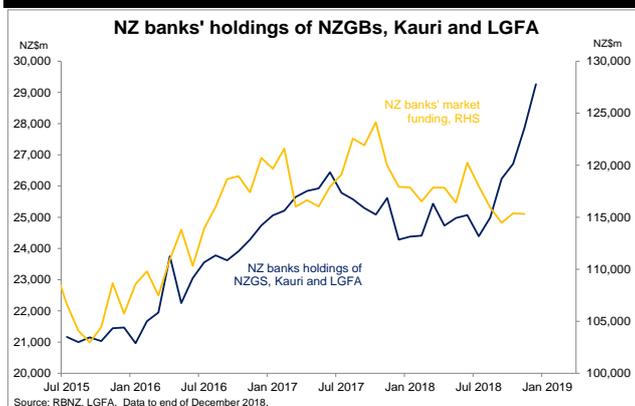
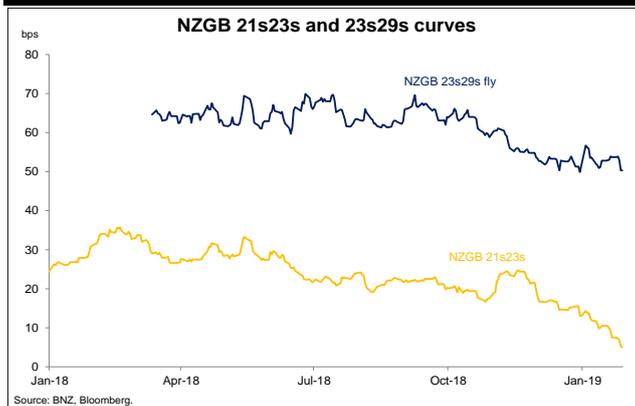


Chart 5: NZGB 23s29s is towards its flattest level in 1 year



nick_smyth@bnz.co.nz

³ Clearly, this doesn't take into account any prospective purchases of new bond issues.

Contact Details

BNZ Research

Stephen Toplis

Head of Research
+64 4 474 6905

Craig Ebert

Senior Economist
+64 4 474 6799

Doug Steel

Senior Economist
+64 4 474 6923

Jason Wong

Senior Markets Strategist
+64 4 924 7652

Nick Smyth

Interest Rates Strategist
+64 4 924 7653

Main Offices

Wellington

Level 4, Spark Central
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland

80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Toll Free: 0800 283 269

Christchurch

111 Cashel Street
Christchurch 8011
New Zealand
Toll Free: 0800 854 854

National Australia Bank

Ivan Colhoun

Global Head of Research
+61 2 9237 1836

Alan Oster

Group Chief Economist
+61 3 8634 2927

Ray Attrill

Head of FX Strategy
+61 2 9237 1848

Skye Masters

Head of Fixed Income Research
+61 2 9295 1196

Wellington

Foreign Exchange +800 642 222
Fixed Income/Derivatives +800 283 269

Sydney

Foreign Exchange +61 2 9295 1100
Fixed Income/Derivatives +61 2 9295 1166

London

Foreign Exchange +44 20 7796 3091
Fixed Income/Derivatives +44 20 7796 4761

New York

Foreign Exchange +1 212 916 9631
Fixed Income/Derivatives +1 212 916 9677

Hong Kong

Foreign Exchange +85 2 2526 5891
Fixed Income/Derivatives +85 2 2526 5891

Analyst Disclaimer: The Information accurately reflects the personal views of the author(s) about the securities, issuers and other subject matters discussed, and is based upon sources reasonably believed to be reliable and accurate. The views of the author(s) do not necessarily reflect the views of the NAB Group. No part of the compensation of the author(s) was, is, or will be, directly or indirectly, related to any specific recommendations or views expressed. Research analysts responsible for this report receive compensation based upon, among other factors, the overall profitability of the Global Markets Division of NAB.

NAB maintains an effective information barrier between the research analysts and its private side operations. Private side functions are physically segregated from the research analysts and have no control over their remuneration or budget. The research functions do not report directly or indirectly to any private side function. The Research analyst might have received help from the issuer subject in the research report.

New Zealand: This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. To the extent that any information or recommendations in this publication constitute financial advice, they do not take into account any person's particular financial situation or goals. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication. **National Australia Bank Limited is not a registered bank in New Zealand.**

USA: If this document is distributed in the United States, such distribution is by nabSecurities, LLC. This document is not intended as an offer or solicitation for the purchase or sale of any securities, financial instrument or product or to provide financial services. It is not the intention of nabSecurities to create legal relations on the basis of information provided herein.