

25 August 2017

## RV analysis of the new NZGB Apr-29

- The NZ DMO is expected to issue a new NZGB Apr-29 before year-end.
- Our fair value analysis suggests a current yield of 3.06-3.07% and a spread to Apr-27 of +17-18bp.
- At this stage, timing of the issue is unknown, but recent cheapening of longer dated NZGBs suggests some speculation the bond is coming soon.
- If the Apr-29 is issued in the near future, we don't expect significant further cheapening in NZGBs against swap.
- Demand for a new Apr-29 is likely to be reasonably solid.

In its 2017-18 funding update, the NZ DMO announced plans to issue a new 20-April-2029 bond via syndication before the end of 2017, subject to market conditions. At the time of writing, there has been no announcement on timing, volume or pricing for the deal.

### RV analysis

We assume a coupon of 2.75% and estimate the fair value range for the bond to be a yield of 3.06-3.07%/spread to the Apr-27 of +17-18bp and ASW (S/Q) spread of -19bp to -18bp. Clearly, estimates are variable and could change significantly depending on the time of the issue. We don't know volume, but assume up to \$2bn based on previous syndicated issues.

The table below shows a range of fair value estimates. Our NSS fair value model points to a yield of 3.08% and this is generally our preferred method for pricing government bonds within an existing liquid curve. The model considers the coupon effect along the NZGB curve as well as the level, slope and curvature of the zero coupon curve.

Alternative methods of pricing suggest a similar level:

- An interpolation on a modified duration basis points to a yield of 3.08%. The Apr-29 sits closer to the Apr-27 on a maturity basis, but on a duration basis is closer to the middle of Apr-27 and Apr-33.
- A maturity matched swap-NZGB interpolation model suggests a slightly lower fair value level of 3.05% (Chart 2).
- NZGB-ACGB interpolated 2029 spread is around 31bp, which implies a yield of 3.05% (Chart 4).

### Summary of FV model and alternative estimates

Method	Yield	Spread to Apr-27	ASW (S/Q)
NSS FV	3.06%	16.5bp	-19bp
Swap Model	3.05%	15.5bp	-20bp
MDur Interpolated	3.08%	18.5bp	-17bp
NZ-AU Interpolated	3.05%	15.5bp	-20bp

Chart 1: NZGB yield curve with new Apr-29

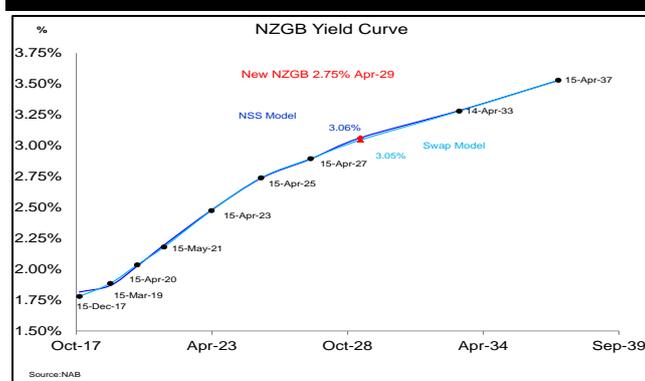


Chart 2: NZGB curve with modified duration axis

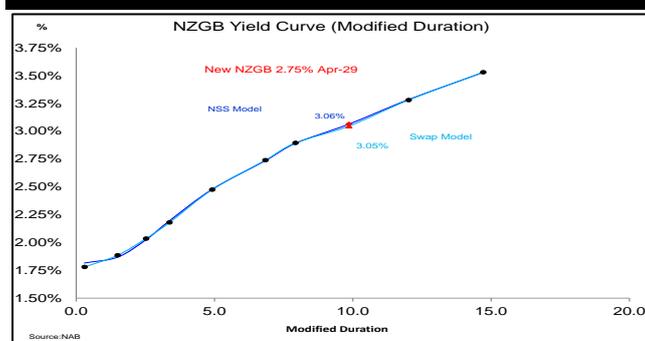


Chart 3: NZGB ASW (S/Q) Curve

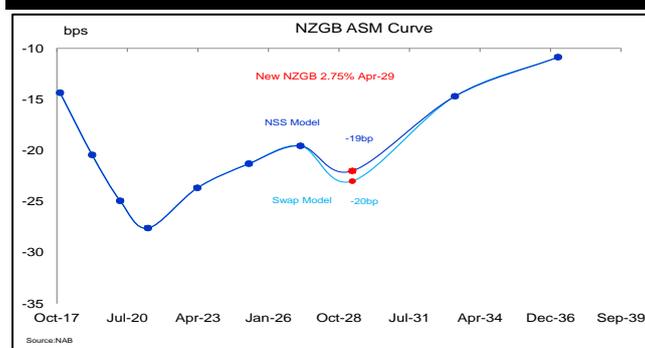
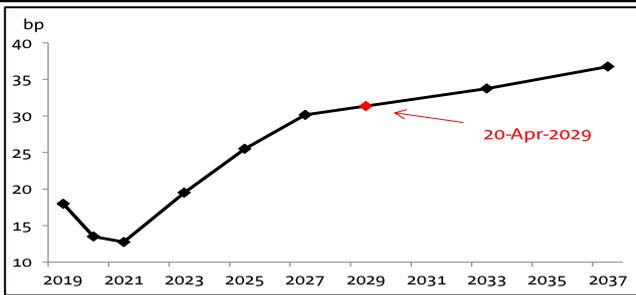


Chart 4: NZGB-ACGB Spreads



**Timing**

Recent cheapening of longer dated NZGBs on the curve and relative to swap appears in part to reflect speculation the bond will come sooner, rather than later in the year. A factor to consider is the timing of the NZ election on Sep 23<sup>rd</sup> – it might be less desirable to launch a new bond too close to that date. If the DMO decided to wait longer, there could be good support in October, which is a large coupon month for NZGBs. The DMO could of course wait even longer to be closer to the maturity of the Dec-17 bond, although liquidity may be an issue too late in the year.

**Demand considerations**

The market has made room for the new Apr-29, so if it's issued soon there is likely to be limited further underperformance at the long end, in our view. The NZGB Apr-27 and Apr-33 bonds have cheapened around 7bp against swap over the last month, longer tenor NZGB curve spreads have steepened and the last three nominal bond tenders have had a lower coverage ratio than the average of the last year.

Charts 6-7 show NZGB spreads to swap (I-spread) 30 days before and after the last three new bond lines were issued in (Apr-25s, Apr-27s and Apr-33s). There has been a tendency for bonds to cheapen against swap prior to a new issue, but moves are not consistent. For instance, bonds cheapened by more ahead of the longer duration Apr-33 line than Apr-25s and Apr-27s which were closer to 10y bonds at the time of issue. Performance of these bonds was also better than the Apr-33s post-issue.

**Key factors supporting demand:**

- The Apr-29 tenor will replace the Apr-27 maturity as the new 10y bond over the next year and the 10y part of the curve typically has wide participation amongst investors.
- A strong NZ fiscal position means the DMO's funding task is expected to be limited over the coming few years (although the fiscal outlook is subject to change after the election).
- The Apr-29 will lengthen the duration of the NZ bond index modestly, which could add to support from passive investors.
- NZGB 10y spreads to UST and ACGB are near the lower end of the last year's trading range (Chart 8),

but prospects for RBNZ tightening have been downgraded since earlier in the year.

- The NZD has fallen sharply in recent weeks and is near its 12m average level on a TWI basis and against the USD – so ought not to be a major barrier for global investors. Offshore holdings of NZGBs have been steady around 61-62% in recent months and the relationship with the NZD has steadily decreased over the last two years.

Chart 5: NZGB spreads to swap (I-Spread)

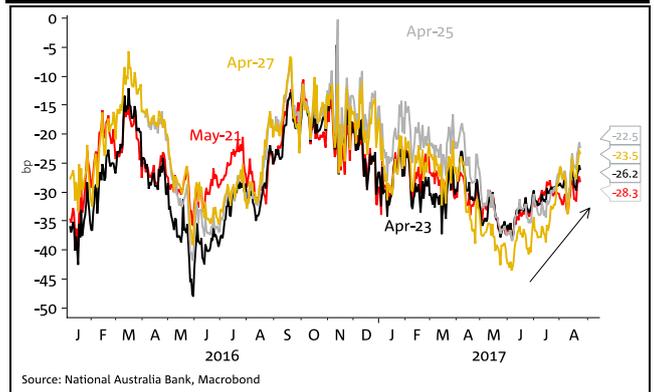


Chart 6: NZGB spreads to swap around prior issues

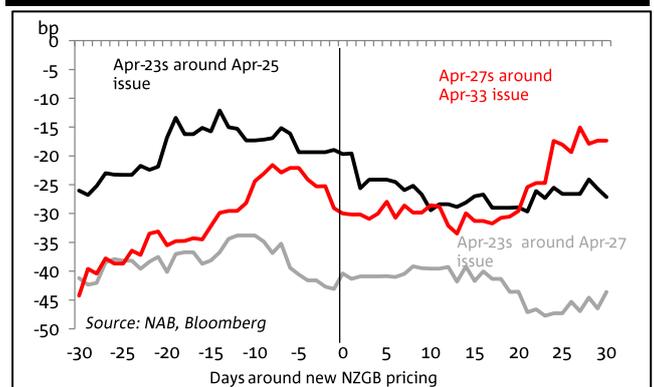
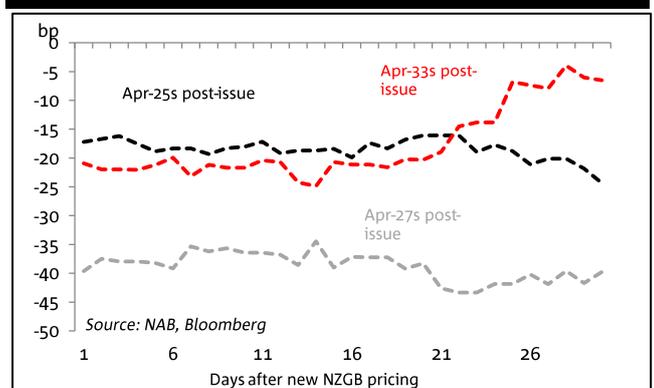
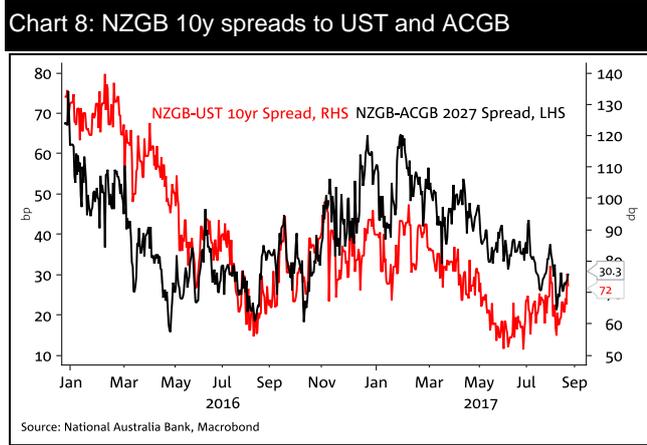


Chart 7: NZGB post-issue performance (swap spread)





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