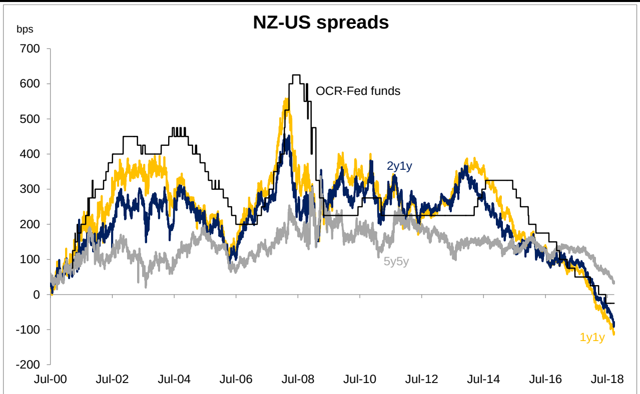
21 September 2018

Trade Idea: NZ-US 5y5y Widener

- NZ-US spreads have tightened sharply over the past 12 months, driven by the divergence in monetary policy between the Fed and RBNZ.
- The tightening in NZ-US spreads has not been confined to the short-end; longer-term forwards, such as 5y5y, have moved sharply tighter as well. The correlation between short and long-dated forward spreads has been particularly high the last 18 months.
- In terms of valuations, we continue to think that NZ should have a higher cash rate in the long-run than the US. Notwithstanding the current divergence in monetary policy, we don't think the 5y5y spread should trade meaningfully lower than current levels (around 35bps).
- The one year decline in the NZ-US 5y5y spread is near the largest on record. Historically, the NZ-US 5y5y spread has tended to reverse over the 3 months following a move of this magnitude.
- The risk is that the NZ-US 5y5y spread remains highly correlated to front-end rate expectations, and monetary policy continues to diverge. However, we see yesterday's NZ GDP upside surprise as meaningfully increasing the hurdle for RBNZ rate cuts over the next 12 months. And with market expectations of the terminal Fed funds rate approaching 3%, we think there is less upside in longer-term US forward rates from current levels. Accordingly, we enter a 5y5y spread widener, targeting a 30bps move.

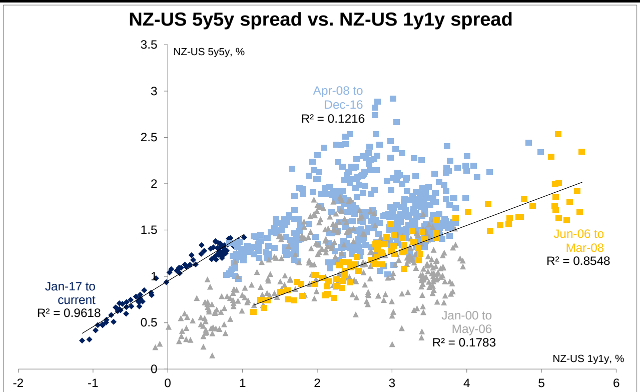
Strategy	Entry	Target	Stop	Carry and roll (1m)
NZ-US 5y5y widener	35bps	65bps	20bps	-1bp

Chart 1: Large tightening in NZ-US forward spreads



Source: Bloomberg.

Chart 2: High correlation in 1y1y & 5y5y spreads past 2yrs



Source: Bloomberg.

Sharp tightening in longer-dated NZ-US forward rates

NZ-US spreads have tightened aggressively across the curve over the past 12 months. The NZ-US 1y1y spread has declined from +60bps to -105bps, as Fed tightening expectations have increased and RBNZ rate cut expectations have built. Longer-dated NZ-US forward spreads have also tightened aggressively. The NZ-US 5y5y spread has tightened almost 100bps over the past 12 months, to near record tight levels – see Chart 1.

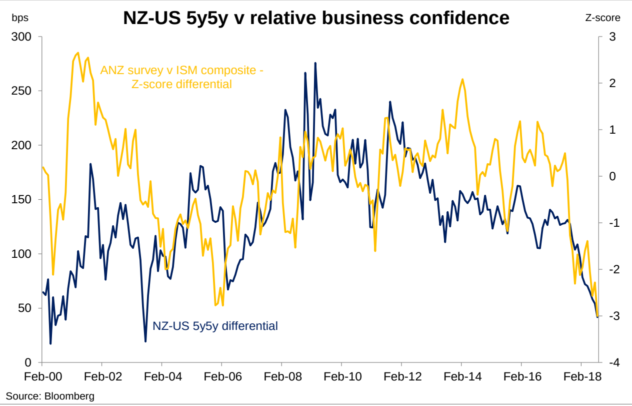
The correlation between short and long-term forwards has been very high since the start of last year – see the dark blue dots in Chart 2. i.e. near-term monetary policy expectations have had a pronounced impact on longer-run expectations of the NZ-US cash rate differential. A similarly high correlation was also evident between Jun-06 and Mar-08 (shown by the yellow dots), which was another period of major monetary policy divergence between the Fed and RBNZ.

But it's not always the case that 1y1y and 5y5y NZ-US spreads are highly correlated. Outside of the two periods mentioned, there has been a relatively weak correlation between 1y1y and 5y5y NZ-US spreads since 2000 (as shown by the light blue and grey dots). This makes some sense to us; it's quite possible for Fed and RBNZ policy to diverge cyclically without affecting longer-run expectations of the policy rate differential (as embodied by the 5y5y differential).

NZ and US economies in different cyclical positions

In terms of the current cyclical picture, the US economy is growing strongly at present, partly due to the fiscal stimulus, inflation is at the Fed's target and the US unemployment rate is almost at its lowest levels since the late 1960s.

Chart 3: Relative NZ-US business confidence near extreme



In contrast, NZ core inflation (as measured by the Sectoral Factor Model) has been below target for eight years (currently 1.7%), unemployment has fallen to 4.5%, but is well above its trough in the mid-2000s, and the change in government has resulted in a shock to business confidence. The difference between the Z-scores of the ANZ Activity outlook and a weighted average of the ISM manufacturing and non-manufacturing surveys is near an extreme – see Chart 3.[1]

We still think NZ should have a higher cash rate than the US in the long-run

While the NZ and US economies are in different cyclical positions, so the RBNZ is unlikely to follow down the Fed's path of rate hikes any time soon, we remain sceptical that NZ will have a lower cash rate in the long-run than the US. Historically, NZ nominal GDP has averaged more than the US, even if that hasn't been the case the last few quarters (see Chart 4). Looking ahead, the Fed's longer-run estimate of potential growth is 1.8%, whereas the RBNZ and NZ Treasury put NZ potential GDP around 2.7-2.8% by 2021/22. This would argue for NZ having a higher neutral cash rate than the US. The difference between the RBNZ and Fed's estimates of their respective neutral cash rates is 60bps, above the 5y5y differential of 35bps, as shown in Chart 4.

Second, NZ is a current account deficit country with a net international investment position (NIIP) of -55% of GDP. While the current account deficit has been more modest of late (it's currently -3.3%) and the NIIP has been gradually improving over many years, it still points in the direction of NZ having a higher neutral cash rate than the US. And unlike the US, which also has a current account deficit, the NZD does not have reserve currency status.

As we discussed in a note a few months back, we pointed to NZ's household debt burden and the relatively wide spread between NZ mortgage rates and the OCR as reasons to believe the NZ neutral cash rate might be lower than the RBNZ's 3.5% central estimate. The US household sector has, in contrast, deleveraged since the GFC, as shown in Chart 5.

[1] We use the "Activity outlook" sub-index of the ANZ Business Survey, rather than the headline business confidence reading. The Activity outlook is better correlated to GDP, as it asks respondents about their own businesses, rather than the broader economy.

Chart 4: NZ-US 5y5y trading below neutral rate estimates

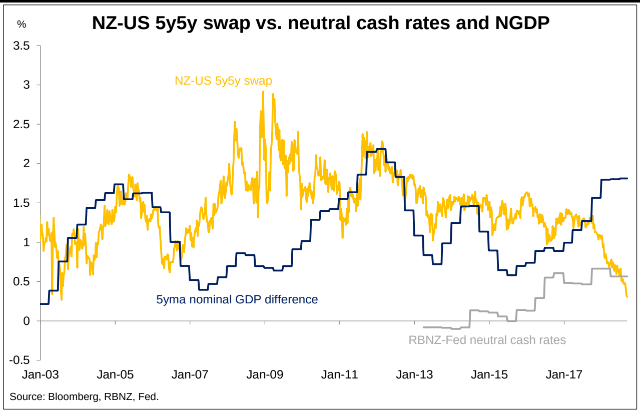
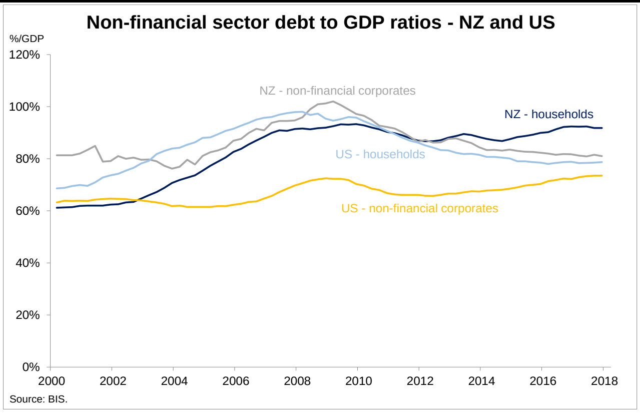


Chart 5: Debt-to-GDP ratios for NZ and the US



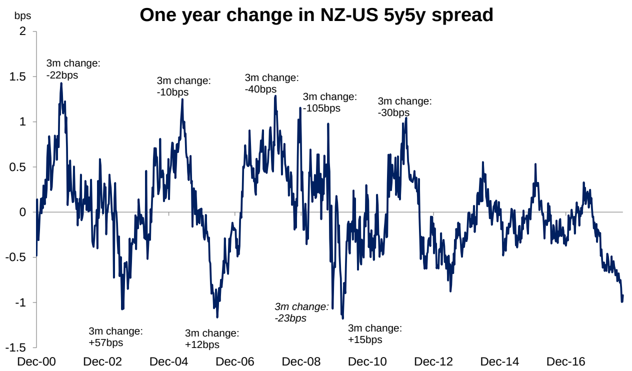
But the trend in non-financial corporate sector debt has been the reverse – deleveraging in NZ and re-leveraging in the US since the GFC. While US household and corporate debt is likely more longer-dated than in NZ, making the NZ non-financial sector more immediately sensitive to interest rate rises, we think the implication for NZ vs. US neutral cash rates is more nuanced than looking at the relative levels of household debt alone.

Sharp move in NZ-US 5y5y spread might provide reversal signal

The NZ-US 5y5y spread has declined almost 100bps over the past year, one of the largest annual changes since 2000 – see Chart 6. We tested to see what the subsequent three month change in the NZ-US 5y5y spread was after previous occasions when the annual change first reached 100bps. On all but one occasion, the NZ-US 5y5y spread reversed course in the subsequent three months, sometimes appreciably. This doesn't mean that NZ-US 5y5y can't extend further, but given the current tightness of the spread and our view that NZ should have a higher longer-run neutral rate than the US, it adds to our sense that the risk-reward is tilted to wideners.

We see a NZ-US 5y5y widener as a more protected way of playing for a normalisation in OCR-Fed rate expectations than the front-end. While the market will probably continue to price the risk of RBNZ rate cuts in the coming few months

Chart 6: 1yr change in NZ-US 5y5y near largest on record



Source: Bloomberg.
Text shows the subsequent 3m change in 5y5y NZ-US spread, after the annual change reaches 100bps for the first time.

given the backdrop of weak business confidence and below target core inflation, market expectations of the NZ economy and the RBNZ are arguably pessimistic at the moment. Coming after the strong NZ Q2 GDP result yesterday (which came in at 1%, above the RBNZ's 0.5% MPS forecast), any further pick-up in the domestic data over the coming few months (especially if there is a bounce in business confidence), should see a further correction in future OCR rate hike pricing and terminal rate expectations. For a start, we expect headline CPI inflation to rise to 1.8% when the Q3 data is released next month, above the RBNZ's 1.4% forecast.

While we think the risk of actual RBNZ rate cuts is very low, we estimate that if the RBNZ cut rates by 50bps, then NZ 5y5y might decline by 15-20bps based off the historical relationships between 5s and 10s and the short-end. We suspect that NZ 5y5y might decline by less than historical relationships imply in such a scenario however, if rate cuts were seen as pro-active, inflationary, and out of sync with the global cycle.

In terms of the US, while there is the risk that the Fed hikes by more than the market is currently pricing in the next few years, there might be less movement in longer-run Fed rate expectations (currently nudging up towards 3%[2]). And while it's not our expectation, if US data does turn down, there is certainly scope for US rate expectations to fade.

We target a 30bp move wider from current levels, to 65bps, and set a stop-loss at 20bps, which would be close to the historic lows. The position rolls negatively by -3bps over 3 months, although we see that as manageable in the context of the historical volatility of the NZ-US 5y5y spread.

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[2] US 5y5y OIS is around 2.85%. Adjusting for the current basis between the Fed funds effective rate and the upper end of the Fed Funds Target Range of 8bps, puts the implied longer-run Fed Funds expectations at 2.93%.

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