

## Targeting Wider NZ Swap Spreads Ahead Of Q1 Maturity 'Wall'

- We have been highlighting the supportive supply backdrop for NZGBs and high grade NZ fixed income for some time.
- This culminates in Q1, when there will be record maturities across NZGBs, LGFA and SSA (over \$15b in total). Ahead of this, there has been very strong demand at recent NZDM tenders.
- Swap spreads have tended to widen in the months preceding recent NZGB maturities. Additionally, swap spreads have shown a seasonal tendency to widen in December.
- We would look to use a pull-back in swap spreads ahead of December to position for widening. Our model, in which net supply is a key variable, points to wider 10y swap spreads ahead.
- We target a long position in the NZGB 4.5% 2027 against swap at an I-spread of -28bps or higher.

Strategy	Entry	Exit	Stop	C&R (1m)
Long NZGB 27 v swap	≥28bps	-42bps	-21bps	flat

### A wall of maturities in high grade NZ FI in Q1...

We have been highlighting the negative net supply dynamics in NZGBs for some time (see [here](#) and [here](#)). The stock of nominal NZGBs and Treasury bills is forecast to shrink by almost 10% this fiscal year (i.e. by the end of June). This culminates in Q1, when close to \$9.5b of the Mar-19 NZGB will mature. Q1 also sees large maturities across other segments of the high grade NZ fixed income market. There is a \$1.2b Mar-19 LGFA maturity alongside almost \$5b of Kauri SSA maturities. The aggregate amount maturing across the high grade universe in Q1 is a record (see Chart 1).

Chart 1: Record maturities across high grade NZ FI in Q1

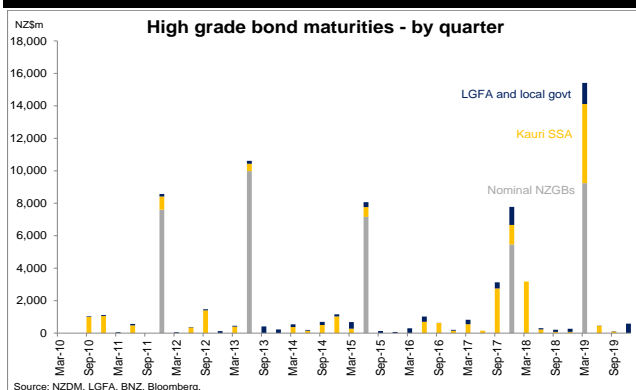
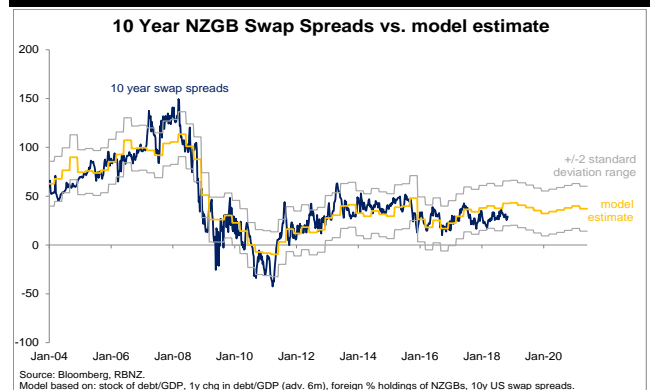


Chart 2: Our model points to wider 10y swap spreads



### ...Supportive of wider swap spreads

Net issuance and the stock of government securities (as a percentage of GDP) are variables in our model of 10 year NZ swap spreads (alongside US 10y swap spreads and foreign ownership of NZGBs). This model has a 'fair value' for 10 year swap spreads around 42bps, around 10bps wider than the market. Accordingly, our bias has been to look for opportunities to position for swap spread widening (see Chart 2 above).

### December seasonality favours wider swap spreads...

Our preference had been to wait for a larger retracement in swap spreads before entering a position (i.e. a two-standard deviation move from our model estimate – around 20bps). But we can see merit in looking for a shallower pull-back in the next few weeks, ahead of December. 10y swap spreads have tended to exhibit a seasonal pattern of widening in December, as charts 3 and 4 show. This is probably due to the NZDM halting

Chart 3: 10y swap spreads have tended to widen in Dec

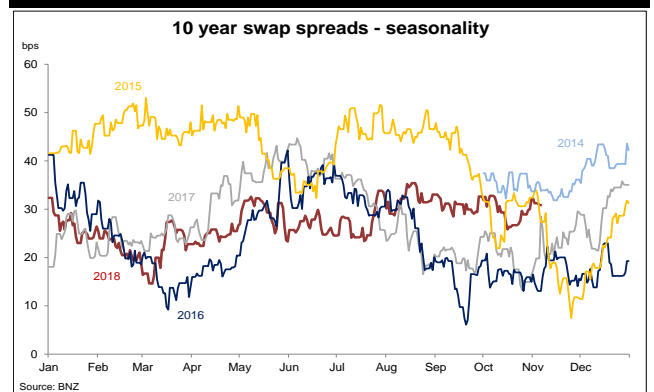


Chart 4: 10y swap spreads widened each Dec since 2012

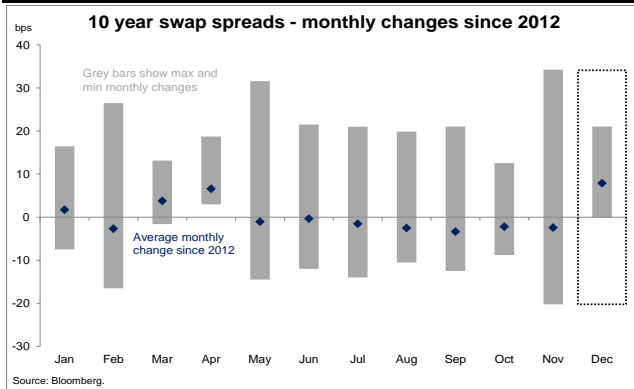
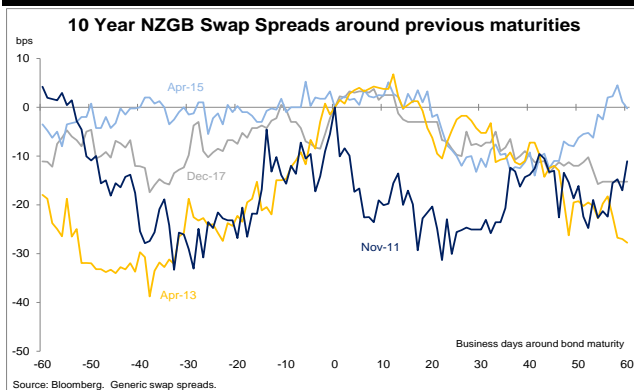


Chart 5: 10y swap spreads around recent NZGB maturities



bond issuance for around a month, starting in mid-December. We observe that 10y swap spreads have widened in December of each of the past six years, with the average move being 8bps.

**...As does the upcoming Mar-19 NZGB maturity**

As we head into Q1, we expect focus to shift to the Mar-19 NZGB maturity. Looking back at the behaviour of NZ 10y swap spreads around the last four NZGB maturities, there has been a historical tendency for 10y swap spreads to widen in the month or two ahead of the maturity (although there was little movement ahead of the Apr-15 maturity). Given there will also be large maturities of LGFA and SSA in Q1, our expectation is that swap spreads will follow this historic pattern and widen ahead of the Mar-19 NZGB maturity (see Chart 5 above).

**NZGB tenders point to strong demand**

Ahead of Q1, there has been evidence of strong demand at recent NZGB tenders. Over the past four nominal bond tenders, the bid-to-cover ratio has averaged more than four-times – its highest level in eighteen months (see Chart 6).

And nominal tenders have also consistently cleared through prevailing secondary market yields at the time, further evidence of strong demand. Chart 7 shows that 10y swap spreads have widened on the day of each of the past nine tenders (by an average of 2bps), the longest run in years. We suspect the aggressive bidding in tenders is partly due to investors seeking to accumulate NZGBs ahead of the Mar-19 maturity.

Chart 6: Recent NZGB tenders have seen high bid-to-cover

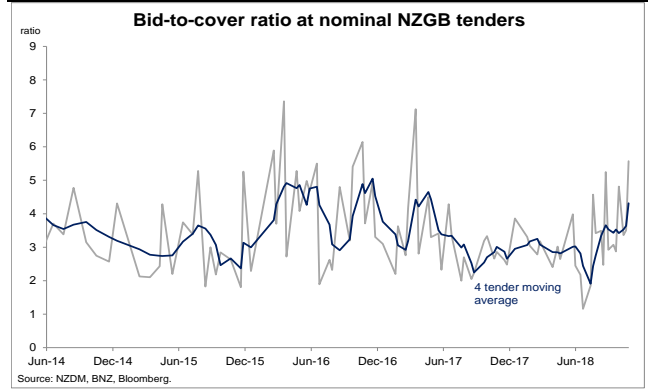
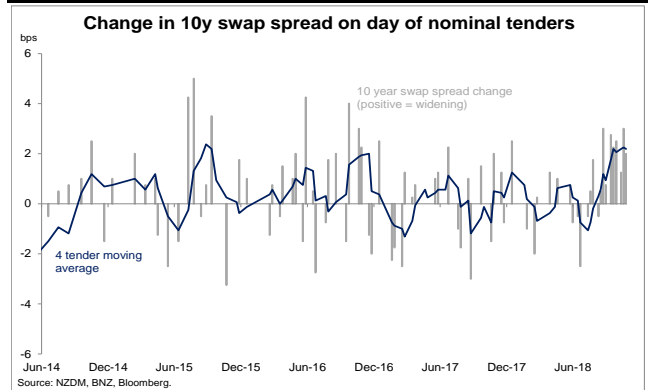


Chart 7: Swap spreads have widened after recent tenders

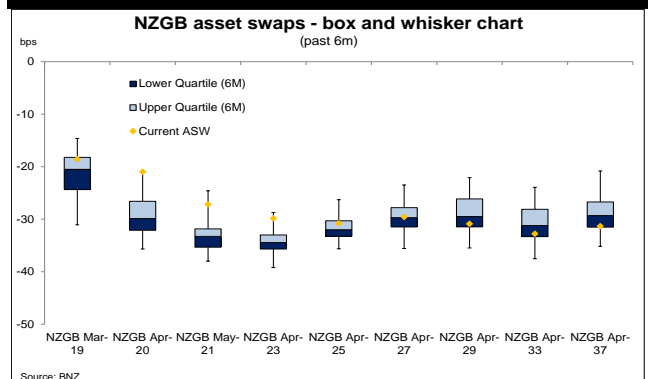


Finally, we note that all NZGBs maturing after 2023 have been trading ‘special’ in repo for months, suggestive of persistent short positioning. There has been some modest upward pressure on GC repo over the past week, but this hasn’t affected the specialness of longer-dated bonds. As long as this remains the case, we don’t expect any increase in funding pressures to transmit to narrower longer-dated swap spreads.

**Targeting wider NZGB 2027 swap spreads**

The NZ swap spread curve is very flat. There is little difference in swap spreads for NZGBs maturing between 2021 and 2037 (see Chart 8). At the margin, we prefer to look for opportunities to position in the 2027s, which are (marginally) cheaper on the asset swap curve compared to surrounding maturities. The 2027s are also not being tendered at present by the NZDM, unlike the 2025s and 2029s.

Chart 8: Asset swap curve is very flat between '21s & '37s



We look for the 2027 I-spread to narrow to -28bps (or more) before entering a position. This would be close to the narrow end of its recent tight trading range (see Chart 9 below). If we enter a position, we would set a stop-loss at -20bps, which would likely be consistent with 10y swap spreads reaching the two-standard deviation lower-bound implied by our model estimate. We would target a move to -42bps, which would be in line with our model 'fair value' estimate.

Chart 9: Inconsistent correlation between yield and spreads

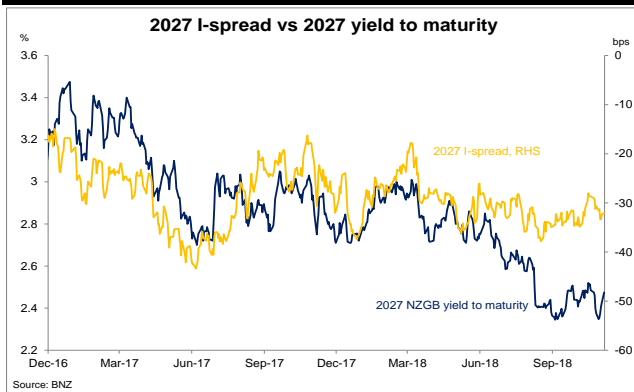


Chart 10: Offshore holdings of shorter NZGBs trending down

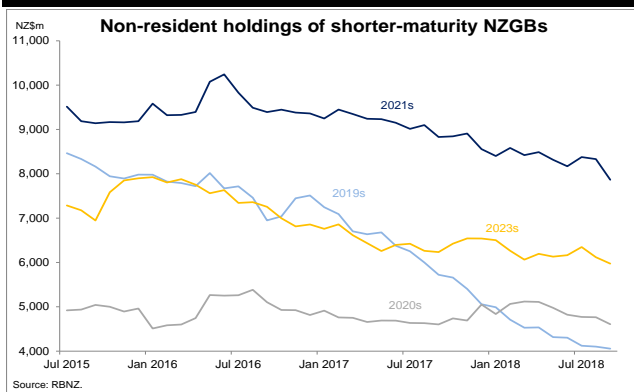
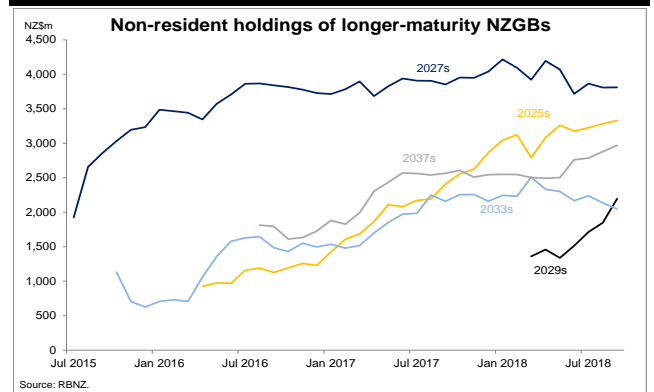


Chart 11: Offshore holdings of longer NZGBs holding up



The risks to a swap spread widening position include:

- A pick-up in foreign selling of NZGBs, which more than offsets the negative net issuance dynamics. We note however that foreign demand for longer-dated NZGBs has held up, with most foreign selling concentrated in shorter maturity bonds ('23s and shorter). See Charts 10 and 11.
- An increase in future NZGB issuance from the NZDM if the NZ Treasury revises down its nominal growth forecasts. The Half-Year Economic and Fiscal Update (HYEFU) is in December and the NZDM will update the NZGB bond programme at that time. We don't expect any change to the bond programme in December however.
- A NZ bond market sell-off, with NZGBs underperforming swap. There has been a loose directionality between NZGB yields and swap spreads over the past few years, as shown in Chart 8. However, the relationship has been notably less reliable over recent months.

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