

9 November 2018



Mind the Trans-Tasman Gap: NZ-AU spreads to widen further

NZ rates underperform significantly over the past week – this move ultimately has further to go

Over the last week, NZ 2y swap has increased 15bps, 5y by 26bps and 10y by 23bps. The catalyst for this move was the much larger-than-expected fall in the NZ unemployment rate (3.9% v. 4.4% exp.), to its lowest level since 2008. We see the sharp move higher in NZ rates as largely correcting for the large outperformance of NZ vs. other markets after RBNZ Governor Orr suggested the possibility of rate cuts, which now look remote. Ultimately, we think the NZ move has further to go, and there is scope for the market to price a steeper RBNZ tightening path, albeit rates may now consolidate for a period after such a large move. See our [note](#) from last week on the medium-term rationale for paying NZ swaps.

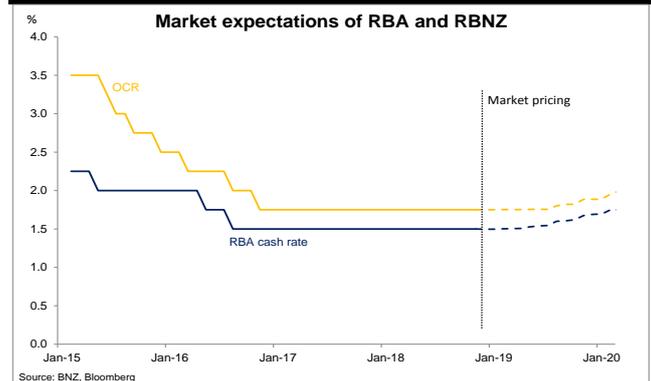
Relative risks to RBA vs RBNZ pricing suggest AU OIS pricing should not be as tight to NZ

OIS curves price the first RBA hike in Feb-2020 and the first RBNZ hike in May-2020. We think more rate hike risk should be priced into the NZ than the AU curve. Both central banks are navigating a long and slow path to tightening and are hesitant to risk a policy mistake given the difficulty in meeting inflation targets over recent years. The RBNZ are arguably more sensitive to moving early given the 2014 experience. Even so, AU core inflation (around 1.75%) is 0.75% below the middle of the RBA's target band, while NZ core inflation (around 1.7%) is just 0.3% below the middle of its target band. Sharp falls in both NZ and AU unemployment rates over last month probably overstates the true extent of improvement in both countries. However, as a long term indicator, the magnitude of improvement in NZ (3.9%) vs AU (5.0%) suggests wider NZ-AU spreads.

Risk/reward suggests targeting NZ-AU 5y spreads

Both central banks remain some way off commencing tightening cycles, which suggests the 5yr part of the curve will continue to underperform 2yrs in sell-offs. The RBNZ's lack of commitment to signalling higher rates compared to the RBA may also sustain richness in

Similar tightening priced into both NZ and AU next 12m

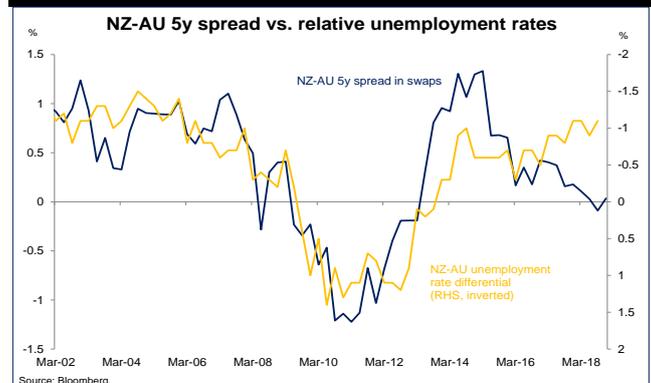


NZ rates out to 2yrs compared to 5yrs in the short term. In addition, AU FRA-OIS volatility is at risk of rising relative to NZ into year-end. Longer dated NZ-AU spreads are likely to widen, but we think valuations for the likes of 5y5y are less mispriced than the outlook for the next cycle.

Carry and volatility considerations also favour NZ-AU 5y.

On a vol-adjusted carry basis, the 5 year point stands out as the optimal point for wideners. The 3m carry-to-vol ratio for receiving 5y NZ swap is only marginally higher than the 5y AU swap (mainly because volatility has been very high in the NZ 5y point over the past 3 months – see the blue dots in the chart on the next page).

NZ-AU 5y out of line with relative unemployment rates

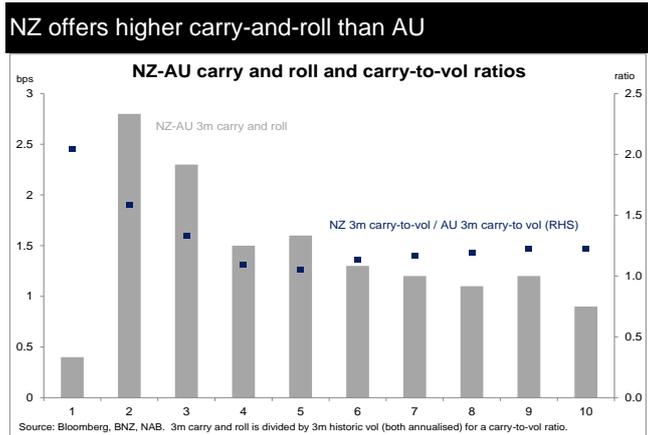


Positioning – target shallow pull-back in spread for widener

We think the NZ positioning has been longer than AU since RBNZ Governor Orr openly considered cutting rates a few months back. That has added to significant momentum in the NZ sell-off this week and for a market with relatively less liquidity than AU, we see some consolidation as likely in the next few weeks, particularly so given there is no major NZ data until GDP shortly before Christmas. The NZ-AU 5y spread has moved from -14bp to +5bp in one week. We would look to enter wideners on a pull-back to flat, targeting +15bp.

Strategy	Entry	Exit	Stop	C&R (1m)
NZ-AU 5y widener	≤0bps	+15bps	-7bps	-0.6bps

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