NZ BEIs – still cheap, still waiting

- NZ BEIs have traded a very narrow range this year.
- We think this represents a relatively positive outcome given the large rally in rates and decline in global BEIs.
- The attractive starting point for valuations and NZDM’s decision to reduce linker supply has helped support NZ BEIs.
- Compared to core inflation, NZ BEIs are the cheapest on record. But it’s likely take a sell-off in nominal rates for this valuation gap to correct.
- We think owning Kiwi linkers outright is a relatively attractive way of achieving duration exposure at present. Importantly, linkers provide protection against the very scenario which could trigger a meaningful re-pricing in rates, namely higher inflation.

1. Stability in NZ BEIs - a respectable performance

NZ breakevens (BEIs) have traded a very narrow range so far this year (just 15bps for the interpolated 10 year BEI). While not terribly exciting, we think this represents a relatively positive result over what has been a challenging environment for inflation markets globally. The stability in NZ BEIs stands in contrast to the decline in Australian BEIs to all-time lows (Chart 1).

NZ linkers have also outperformed their historic beta significantly so far this year. The 10 year NZGB yield has fallen 80bps which, based on a historic beta of about 0.5, might have been expected to lower BEIs by around 40bps. In fact, NZ BEIs have actually widened this year, at least for the 2030 linkers and longer, with linkers more than keeping pace with the aggressive rally in nominals.

2. The value case for NZ BEIs is still compelling but a slow-burn story

One of the reasons we think BEIs have held up relatively well this year is that the starting point for valuations was already incredibly cheap. We compare BEIs to core inflation as a means of judging valuations1. Last week’s NZ CPI release showed a pick-up in core inflation, with the lowest of the six measures (the Sectoral Factor Model and CPI ex-food and energy) sitting at 1.7%, more than 60bps higher than the level of the 10 year BEI. That’s the biggest gap – and on our framework, the most attractive valuations – since linkers were reintroduced in 2012.

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1 The simple assumption is that food and energy price movements will be zero in coming years
And with the exception of Canada, NZ BEIs are trading at the largest discount to core inflation among developed markets (see Chart 4). While that will reflect, to some extent, the illiquidity of Kiwi linkers, it still highlights the relative cheapness of NZ BEIs and the additional ‘buffer’ that a NZ BEI position offers relative to most global peers.

Compared to Australia specifically, the outperformance of NZ BEIs looks justified, at least based on recent inflationary developments. The NZ 10 year BEI is trading at its highest level relative to Australia since late 2013, with the gap now around -30bps (see Chart 5). Based on our NAB colleagues’ forecasts for Q2 Australian CPI, NZ will have higher year-on-year inflation than Australia on both a headline (1.7% v 1.4%) and core basis (1.7% v 1.5%). And the respective trends in rental inflation are likely to remain supportive of NZ going forward.\(^2\)

But the global environment provides a more challenging backdrop for inflation markets, including NZ. Bond yields are trading near multi-year (or all-time) lows, global inflation has been subdued and there are increased concerns about the effectiveness of monetary policy in generating inflation at very low levels of policy rates. The lack of response in inflation markets globally to the dovish shifts by central banks suggests a growing scepticism in the market about the ability of central banks to reflate using monetary policy alone. As long as this environment persists, NZ BEIs will likely continue to trade cheap to core inflation and could possibly fall further if the global rates rally extends.

While we think the medium-term case for BEI wideners is compelling (given current levels imply a significant fall in underlying inflation pressures), a more meaningful re-pricing of BEIs is likely to require a nominal sell-off (with linkers lagging the move), like in late-2016. In the absence of a nominal bond sell-off, it’s more likely to be a slow grind, with investors gradually accruing the positive carry between realised inflation prints and the low levels of BEIs.

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2. Rents contribute 7% to Australian CPI and 9% for NZ. NZ rental inflation grew 1% in the June quarter following a change to Stats NZ’s methodology, with the series running at an annual rate of around 3.5%. In contrast, our NAB colleagues expect Australian rental inflation of 0.1% in the June quarter with rising vacancy rates in Sydney pointing to ongoing weakness ahead.

3. But NZ BEIs likely to stay cheap until nominals sell-off

The value case for holding Kiwi linkers has been evident for some time and yet NZ BEIs continue to trade close to 1%. We think that’s related to two factors. First, there has been consistent supply of linkers into a concentrated buyer-base and the total stock of linkers is now large, as a proportion of the NZGB market (around 24%). Second, inflation has been subdued globally and the market is focused on downside risks to global growth and inflation.

On the supply-side, in late May, New Zealand Debt Management announced a reduction to linker issuance for this fiscal year, from $1b previously to $500m, and an increase in nominal issuance from $7b to $9.5b (see Chart 5). We estimate that nominal duration supply could be close to a record this fiscal year, based on our assumptions around the distribution of issuance, and we expect that to put some upward pressure on long-end nominal NZGBs relative to swaps and linkers. Of course, this doesn’t change the fact that there is a large stock of linkers outstanding but, going forward, we think supply will certainly be less of a headwind for BEIs than it has been.
4. Owning NZ linkers outright is an attractive way of taking positive duration exposure

In a world of low, and in some case negative, interest rates, it has become increasingly difficult for investors to find value in global bond markets. On that front, we see NZ linkers as having some appealing characteristics for investors looking for a positive duration exposure:

a. Valuations are not unreasonable: The 10 year forward 5 year real yield is around 1% (see Chart 7). While that’s significantly lower than it was even a year ago, it’s not far from the RBNZ’s estimate of the neutral real rate, which stood at around 1.25% as at the end of December, and our analysis which points to a possible 0.5% - 1% range. Linker yields are also well above the real OCR, which is currently -0.2% (using year-on-year headline CPI) and is projected to fall further based on market pricing (see Chart 8).

Chart 7: NZ 10y5y real yield not too far from RBNZ neutral

Chart 8: NZGBi yields vs real OCR (deflated by headline CPI)

b. The RBNZ has more room than most to cut rates: In a scenario where central banks are heading towards zero or the effective lower bound (which, to be clear, is not our base case), the RBNZ stands out as having one of the highest cash rates in the developed world and more room to cut rates than most. NZ already has some of the highest nominal yields in the developed world and, based on the most recent two quarters’ CPI prints, the 2030 NZ linker will offer an all-in yield close to 2% from late September (Chart 9). NZ linkers offer both a relatively high yield and the potential for capital appreciation in a global race to the bottom, especially compared to countries like the UK and Germany (see Chart 10).

Chart 9: NZ towards the upper-end of global DM yield table

Chart 10: NZ real yields still much higher than UK, Germany

c. Linkers provide protection against the scenario where duration sells off: The scenario where duration globally, including in NZ, gets hammered is one in which there is an unexpected increase in inflation, or perhaps a material lift in fiscal stimulus, triggering a reassessment of the future monetary policy outlook. Given the very flat forward curves (the market barely prices the OCR to exceed 2% in 10 years’ time), the rates market would experience a sizeable reaction. In this scenario, longer-term real yields would probably increase, although likely by much less than nominal yields. We’re not claiming this scenario looks particularly likely in the near future, but the cost of owning that insurance via NZ linkers – where the BEIs are not much higher than 1% - looks very low. That makes owning NZ linkers look a much better risk-reward proposition to us from a duration perspective than nominals.

3 The annualised inflation rate is 0.4% for the 20th September coupon and 1.36% for the 20th December coupon. Assuming CPI inflation stabilises around the level of core going forward implies around a 1.7% pick-up to the real yield.

nick_smyth@bnz.co.nz
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

New York  
Foreign Exchange  
+1 212 916 9631

Fixed Income/Derivatives  
+1 212 916 9677

Sydney  
Foreign Exchange  
+61 2 9295 1100

Fixed Income/Derivatives  
+61 2 9295 1166

Hong Kong  
Foreign Exchange  
+85 2 2526 5891

Fixed Income/Derivatives  
+85 2 2526 5891

London  
Foreign Exchange  
+44 20 7796 3091

Fixed Income/Derivatives  
+44 20 7796 4761

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