Trade Idea – NZ-AU 1y1y Spread Compression

- The NZ-AU 1y1y spread is near the top of its recent trading range.
- We think NZ rates can play catch-up with AUD rates and target a NZ-AU 1y1y compression trade at 40bp.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Entry</th>
<th>Exit</th>
<th>Stop</th>
<th>C&amp;R (1m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NZ-AU 1y1y tightener</td>
<td>40bps</td>
<td>&lt;25bps</td>
<td>47bps</td>
<td>-0.5bps</td>
</tr>
</tbody>
</table>

Risks to RBNZ pricing to the downside

We expect the RBNZ to cut the OCR next week to 1.25% and retain some form of easing bias. In the absence of a material turn-around in the data, we think market pricing of the RBNZ terminal OCR (currently around 0.9%) will be capped around 1% (i.e. with an easing bias, the market is likely to attribute at least as great a chance to a 0.75% or lower OCR than the risk that 1.25% represents the trough in the cash rate). In contrast, with domestic activity indicators at subdued levels and leading indicators of the labour market pointing to the risk of a turn in the unemployment rate, there is scope for RBNZ rate cut expectations to extend further in the event hard data weakens. Likewise, the RBNZ is cognisant of the potential upward pressure on the NZD if it doesn’t maintain cash rate relativities with other key central banks, suggesting more easing abroad may trigger deeper RBNZ cuts. In the current environment, we see the risks to the short-end of the NZ curve to the downside.

Relative to NZ, risks to AUD terminal rate pricing are becoming more balanced

The AUD OIS curve is priced for a terminal rate of just over 0.50% by mid next year. While NAB economists forecast a terminal rate of 0.75%, we have emphasized the risks are skewed to lower terminal rate pricing. There lacks a catalyst for a significant domestic-led sell-off in AUD rates in the immediate future. Indeed, we don’t rule out terminal rate pricing moving even lower and a catalyst could be a sub-0.4% core CPI print tomorrow. But broadly, we think scope for the AUD market to keep outperforming NZ has lessened. There is less clarity about the effective lower bound for the RBA cash rate and the willingness for other “extraordinary” policy measures to be enacted, which might constrain even lower RBA pricing. Meanwhile, there is further for RBNZ terminal rate pricing to fall before this becomes a pressing consideration for the NZ market.

NZD rates should catch-up to AUD rates if global rally extends

Aussie rates have outperformed NZ on the global move lower, with the NZ-AU 1y1y spread having been very directional since the start of the year. We think that the 1y1y spread is near a point of convexity where that directionality is at risk of shifting. While the starting point for NZ’s fundamentals is stronger (NZ core inflation is only 0.3% below the target midpoint and the
NZ unemployment rate is 1% lower than in Australia), if global events were to drive an extension of the broader rates rally, NZ has more room to cut on the cash rate side and more room for short-end rates to fall. We are less sure how a 1y1y NZ-AU tightener will trade in a global sell-off even though the recent correlation suggests AU should underperform.

NZ-AU 1y1y has recently been directional

AUD-NZD FRA-OIS likely neutral, but might help

AUD 1y1y BBSW-OIS spreads are 3bp above comparative NZD BKBM-OIS spreads. We expect this relativity to remain fairly stable. However, AUD funding spreads have historically being more prone to widening and are more sensitive to US developments. Recent USD FRA-OIS widening appears to reflect expectations for T-Bill issuance to rise, which had a modest widening impact on the AUD market. While not the base case, there is precedent (such as in 2018) for wider AUD-FRA-OIS via spillovers from the US CP market and AUD repo-OIS spreads (which have edged wider over the last few weeks to +35bp).

Target entry at 40bps

The NZ-AU 1y1y spread is currently around the top of the range of 21-37bp that has prevailed over the last 3 months. Conservatively, we think the spread will tighten back towards around 25bp and potentially towards zero in an extended global central bank easing scenario. We like current levels, but see some risk that Aussie CPI tomorrow sees the spread edge up to around 40bp or just over, so we set our target entry at that level. While our view for the core CPI measures are in line with consensus at +0.4% q/q, the last time Australian core CPI beat expectations was in mid-2016. We like being received NZD front end rates on back-ups heading into next week’s RBNZ meeting.

Risks

The main risks to the trade are significantly weaker Australian economic data relative to NZ or a statement from the RBNZ next week that suggests policy easing is near complete.

nick_smyth@bnz.co.nz and alex.stanley@nab.com.au
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

Analyst Disclaimer: The Information accurately reflects the personal views of the author(s) about the securities, issuers and other subject matters discussed, and is based upon sources reasonably believed to be reliable and accurate. The views of the author(s) do not necessarily reflect the views of the NAB Group. No part of the compensation of the author(s) was, is, or will be, directly or indirectly, related to any specific recommendations or views expressed. Research analysts responsible for this report receive compensation based upon, among other factors, the overall profitability of the Global Markets Division of NAB. NAB maintains an effective information barrier between the research analysts and its private side operations. Private side functions are physically segregated from the research analysts and have no control over their remuneration or budget. The research functions do not report directly or indirectly to any private side function. The Research analyst might have received help from the issuer subject in the research report.

New Zealand: This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. To the extent that any information or recommendations in this publication constitute financial advice, they do not take into account any person's particular financial situation or goals. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication. National Australia Bank Limited is not a registered bank in New Zealand.

USA: If this document is distributed in the United States, such distribution is by nabSecurities, LLC. This document is not intended as an offer or solicitation for the purchase or sale of any securities, financial instrument or product or to provide financial services. It is not the intention of nabSecurities to create legal relations on the basis of information provided herein.