Limits to falling NZGB yields – a supply and demand analysis

- Foreign investors have been net sellers of NZGBs for the past three years. Based on the current level of NZGB yields and spreads to offshore bond markets, we would expect this trend to continue.
- This fiscal year is the first in which there is positive net supply of NZGBs while NZ yields are below US.
- If foreign investors reduce holdings at the same pace they have done over the past 12 months, it will require a large net increase in domestic holdings.
- More likely, we think market prices will adjust to incentivise foreign investors to buy NZGBs / reduce holdings more slowly.
- This implies the NZGB curve should be resistant to further flattening, NZ-cross market spreads should widen and/or the NZD should weaken. We think swap-bond spreads are biased narrower.
- There have been calls for fiscal stimulus. Higher net supply of NZGBs, were it to eventuate, would reinforce these market dynamics.

Constrained supply of NZ government securities...

The NZ government is in a very strong fiscal position by international standards, with net core Crown debt of around 20% of GDP. The strength of the government’s finances is illustrated by the fact that the stock of total NZ government securities was lower in June 2019 than what it was three years earlier. The decline in nominal securities (bonds and bills) has been even more marked than the total, with the amount outstanding of inflation-indexed bonds having increased over that time (Chart 1).

...And net selling by foreign investors

The reduction in the amounts outstanding of NZ government securities has been largely accommodated by net selling from foreign investors. The total stock of NZ nominal securities fell by $7b between August 2016 and July 2019. Over that time, foreign investors reduced their exposure by around $12b (see Chart 2 for all NZGS). The Central government category increased its holdings by $3.5b and domestic financial institutions (e.g. fund managers) by $1b.1 Bank holdings were slightly higher.

Chart 2: Foreigners have been reducing NZGS for 3yrs

Breaking down bond holdings since August 2016 shows foreign investors have reduced exposure to short-dated NZGBs significantly (Chart 3). Foreign investors net sold, or let mature, $21b of nominals maturing 2023 or earlier. They net bought $9b of nominals maturing 2025 or later. The same pattern is evident over the past 12 months.

Chart 3: Foreigners have sold short-dates, bought long-end

1 The RBNZ notes “Central Government” holdings include securities held by the Accident Compensation Corporation (ACC), Earthquake Commission (EQC), New Zealand Superannuation Fund (NZSF), and Southern Response Earthquake Services Limited (SRESL). We have excluded EQC.
Positive NZGB net supply and tight cross-market spreads

The reduction in foreign holdings, both outright and as a proportion of the total stock of NZGBs, has occurred against a backdrop of narrowing yield spreads between NZ and other key markets (see Chart 4). The 10 year NZGB now yields around 40bps less than the US, 10bps less than Canada and 15bps more than Australia (down from 40bps in mid-2016).

The environment over the coming 12 months may present a bit more of a challenge for the NZGB market than the past three years. This will be the first time that there will be positive net supply of NZGBs while NZ-US spreads are negative and NZ yields versus an equally weighted basket of US, Australia, Germany, Canada, UK and Japan is at its tightest level on record (see Chart 5).

Foreign selling will increase the burden on domestics

The net supply forecast for NZGBs is hardly huge ($3b for nominals). However, if foreign investors continue to reduce holdings at the same pace as they have done recently, it will require domestic investors to boost their holdings materially. As things stand, we’re not convinced that there will be any let-up in foreign selling. As we set out in a recent note, FX-hedged yields on NZGBs are lower than most major markets and, for unhedged investors, NZ’s historic yield advantage has been substantially diminished and the NZD is not obviously ‘cheap’ on a long-term basis vs. most major currencies.

In the last fiscal year, foreign investors reduced existing (non-maturing) nominal NZGB holdings by $1.5b. Foreign investors also hold $2.8b of the Apr-20 NZGB which will mature this fiscal year. Assuming the same pattern as last fiscal year implies foreign holdings of nominal NZGBs will fall by $4.3b this fiscal year. Combined with NZDM’s net issuance forecast, this implies domestic investors will need to buy $7.2b of nominals. That would be close to a record-setting pace of domestic NZGB buying (see Chart 6 for all NZ government securities).

Domestic capacity has its limits

While domestic investors have increased their holdings of NZGBs over the past few years, there are still limits to the capacity of the domestic market to absorb significant net supply. A lot has been made of rising inflows into Kiwisaver – NZ’s voluntary pension scheme. But, in terms of fixed income, all of these Kiwisaver inflows over the past three years have been invested into spread sectors rather than government bonds (Chart 7). With outright NZGB yields at record low levels, it’s hard to see that trend reversing.
Demand from the broader funds management sector will ultimately be determined by inflows into funds and any potential asset allocation out of other sectors. But it seems hard to argue for an influx of net new money into the sector when the 10 year NZGB yield is barely 1% and, at a retail level at least, term deposits still offer almost 3%. The life insurance sector has been responsible for almost all the NZGB buying since June 2016 (see Chart 8).

Banks are one domestic investor grouping that has greater ability to scale up purchases quickly if required. After the GFC, bank buying helped absorb the initial wave of NZGB and T-bill issuance from NZDM. Banks have the ability to leverage, if the potential return is attractive.

But with swap-bond spreads not trading too far below BKBM-OIS (implying there is little carry advantage to holding NZGBs on asset swap, not taking into account the cost of balance sheet), it’s not clear there is a compelling investment opportunity in NZGBs for banks. Historically, the periods when banks have tended to ramp up buying of NZ government securities are those when swap spreads are trading well below BKBM-OIS (see Chart 8).

Banks’ holdings of high grade bonds (including NZGBs) have gone broadly sideways over the past few years consistent with the flat trend in market debt outstanding (see Chart 9). Looking ahead, the RBNZ’s proposed increased in bank capital may result in banks attempting to limit growth in risk-weighted assets (as well as re-price lending and borrowing rates). If balance sheets aren’t going to be growing materially, then demand for HQLA probably isn’t going to either. Over time, the phasing out of internal RMBS, which account for a significant portion of banks’ liquid asset holdings, and the introduction of Residential Mortgage Obligations (RMOs) may see some HQLA rotation into other high grade product, such as NZGBs.² But that is a theme that will likely take a long time to play out.

It seems a reasonable expectation that banks holdings will be flat to modestly higher over the coming twelve months, unless swap spreads narrow materially.

Market implications

We are not arguing that NZDM will have any difficulty selling NZGBs or that there will be a demand short-fall. However, recent demand trends and the positive net issuance profile for the coming year suggests to us that one or several segments of the investor base need to be incentivised to buy more NZGBs than they have been doing. Market prices can adjust in any combination of the following ways:

- NZGBs could cheapen to swap, making it more attractive for banks to buy NZGBs on asset swap;
- NZ spreads against other key global markets could widen, making it more attractive for foreign investors to buy NZGBs unhedged;
- The NZD could depreciate, also making it more attractive for foreign investors to buy NZGBs unhedged;
- The NZGB curve could steepen, making it more attractive for foreign investors to buy bonds on a FX-hedged basis, or banks to buy bonds on a leveraged basis.

² The RBNZ’s November 2018 draft proposal on RMOs said that 15% of the senior notes should be initially placed with non-regulated entities / investors. As of August 2017, banks held $23bn of internal RMBS as primary liquid assets. Assuming the internal RMBS were replaced like-for-like by RMOs, this implies that banks would need to purchase (at least initially) around $3.5bn of alternative liquid assets. However, over a proposed transitional period of 5 years, this works out at around $700m per year, which we don’t think changes the broader calculus of our argument. Additionally, to the extent that real money investors buy RMOs instead of NZGBs, it will reduce demand from other domestic investors for NZGBs, all else equal.
The most obvious implication, we think, is that NZGBs will cheapen to swaps. While swap-bond spreads have narrowed over the past few months, we’re not convinced they are yet at a level that will catalyse a large increase in bank balance sheet demand. The 2037 maturity NZGB traded above swap when it was first issued, and it’s not difficult to imagine the same occurring over the next twelve months. Our expectation that NZDM will announce a new long-bond NZGB syndication (probably a 2041 maturity) at the HYEFU in December reinforces our view that long-end swap-bond spreads are biased tighter.

The call on the NZGB curve depends on how low the RBNZ cuts the OCR (we currently forecast a 0.75% trough in the cash rate but with clear downside risks) and what global bond yields do. Our bias is that the NZGB curve will steepen, or at least be resistant to further flattening, unless global bonds rally materially further. If the RBNZ were to cut the OCR to zero, or even below, it’s not clear that long-dated NZGBs would necessarily rally that far, unless the rest of the world was going in that direction too. In this scenario, there would doubtless be some domestic investors who stretch down the yield curve to avoid near zero, or negative yields, at the front-end. But unless the NZD also depreciated sharply, we would expect an exodus of foreign investors to outweigh that domestic long-end demand (in turn keeping the curve steep). NZ is a current account deficit country, unlike Germany and Japan, and the bond market has greater than 50% foreign ownership.

Our bias is that long-dated NZGBs will underperform USTs on an extension of the global rates rally. Indeed, in the most recent move down in UST yields, NZ-US spreads have widened (although they remain within established ranges, see Chart 11). NZGB yields are already significantly below USTs across the curve. The Fed has more room to cut than the RBNZ does (at least, to 0%). The US Treasury market is more a safe haven than the NZGB market. And recent demand trends in NZ show that foreign investors have not been increasing exposure to NZGBs despite the growing universe of negative yielding debt, unlike the US market.

More expansionary NZ fiscal policy would reinforce these market dynamics

There have been growing calls domestically for the government to adopt a more expansionary fiscal policy. RBNZ Governor Orr recently commented that monetary policy “needs friends”, which some interpreted as a call for more active fiscal policy.

The NZ government is in a very strong fiscal position by global standards, and the costs of further monetary policy easing are likely to grow as the RBNZ approaches 0% (see our recent note on the RBNZ’s unconventional policy options). In that environment, it seems reasonable to expect the government might consider additional spending at some point.

In a way, one could argue the government has already made a move in this direction, changing its net core Crown debt target beyond FY21/22 to a range of 15%-25%. The government retained its target of 20% of GDP within five years of taking office, but the first move towards loosening that restriction has been made. Ahead of the general election next year, it seems a question of what, if any, political capital the government thinks it might lose by moving away from the 20% target for FY21/22 versus the support it could provide to the economy by bringing forward a more flexible approach to fiscal management.

Additionally, we would note that the Treasury’s growth forecasts still look too optimistic for us, and if they were to be revised down at the HYEFU in December, the natural consequence would likely be greater NZGB and/or Treasury bill issuance.

We think the risks around future NZGB issuance are tilted all one way – primarily from a shift towards more expansionary fiscal policy but also from Treasury’s existing growth forecasts proving too optimistic, in our view. If those risks materialise, we would expect swap-bond spreads to narrow sharply and our conviction in long-dated NZGB cross-market underperformance and NZGB curve steepening will grow.

nick_smyth@bnz.co.nz
Contact Details

BNZ Research

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Phone</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stephen Toplis</td>
<td>Head of Research</td>
<td>+64 4 474 6905</td>
</tr>
<tr>
<td>Craig Ebert</td>
<td>Senior Economist</td>
<td>+64 4 474 6799</td>
</tr>
<tr>
<td>Doug Steel</td>
<td>Senior Economist</td>
<td>+64 4 474 6923</td>
</tr>
<tr>
<td>Jason Wong</td>
<td>Senior Markets Strategist</td>
<td>+64 4 924 7652</td>
</tr>
<tr>
<td>Nick Smyth</td>
<td>Interest Rates Strategist</td>
<td>+64 4 924 7653</td>
</tr>
</tbody>
</table>

Main Offices

<table>
<thead>
<tr>
<th>Location</th>
<th>Address</th>
<th>Phone</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wellington</td>
<td>Level 4, Spark Central</td>
<td>+64 4 474 6905</td>
</tr>
<tr>
<td></td>
<td>42-52 Willis Street</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Private Bag 39806</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Wellington Mail Centre</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lower Hutt 5045</td>
<td></td>
</tr>
<tr>
<td></td>
<td>New Zealand</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Toll Free: 0800 283 269</td>
<td></td>
</tr>
</tbody>
</table>

Wellington: 80 Queen Street Private Bag 92208 Auckland 1142 New Zealand Toll Free: 0800 283 269

Auckland: 111 Cashel Street Christchurch 8011 New Zealand Toll Free: 0800 854 854

National Australia Bank

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Phone</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ivan Colhoun</td>
<td>Global Head of Research</td>
<td>+61 2 9237 1836</td>
</tr>
<tr>
<td>Alan Oster</td>
<td>Group Chief Economist</td>
<td>+61 3 8634 2927</td>
</tr>
<tr>
<td>Ray Attrill</td>
<td>Head of FX Strategy</td>
<td>+61 2 9237 1848</td>
</tr>
<tr>
<td>Skye Masters</td>
<td>Head of Fixed Income Research</td>
<td>+61 2 9295 1196</td>
</tr>
</tbody>
</table>

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

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. 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.

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.