5 April 2018

bnz

Trade Idea: NZ 1y1y 2y1y Steepener

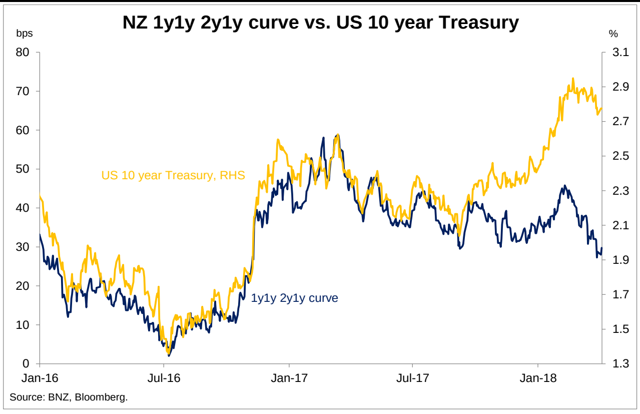
- **The NZ curve has flattened recently, in line with the rally in long-end global rates and funding pressures pushing up the front-end.**
- **We recently stopped out of our 2s10s curve steepener, but see an opportunity to replace it with a 1y1y 2y1y steepener. The 1y1y 2y1y curve is around 30bps, with the market pricing little more than one RBNZ hike between early-2020 and early-2021.**
- **At current levels, we think the risks are asymmetric and a steepener can work in a range of scenarios. The trade rolls around flat and should benefit were global rates to reverse their recent declines.**
- **We think the RBNZ will ultimately hike by more than the forwards are discounting over the coming few years, but getting the timing right on an outright short position is tricky, given the negative carry and lack of obvious catalysts for re-pricing. In the next few quarters, headline CPI is set to fall to around 1%, and there is even a scenario where the market starts to contemplate OCR cuts this year.**
- **Looking beyond the near-term dip in headline CPI, there are more reasons to expect a pick-up in inflationary pressures next year, with the minimum wage set to rise again and the fiscal stimulus boosting the economy later this year. With so little priced into the curve in the 1y1y 2y1y horizon, we see little scope for much flattening from here.**

Strategy	Entry	Exit	Stop	Roll (1m)
1y1y 2y1y steepener	31bps	50bps	20bps	flat

Global curves have flattened significantly over the past month and a half, with NZ being no exception. We highlighted two main risks when we recommended a 2s10s steepener in early March, namely a further rally in global rates and an intensification in funding pressures (FRA-OIS spreads) pushing up short-end swaps. As it transpired, both risks materialised, stopping us out of the position.

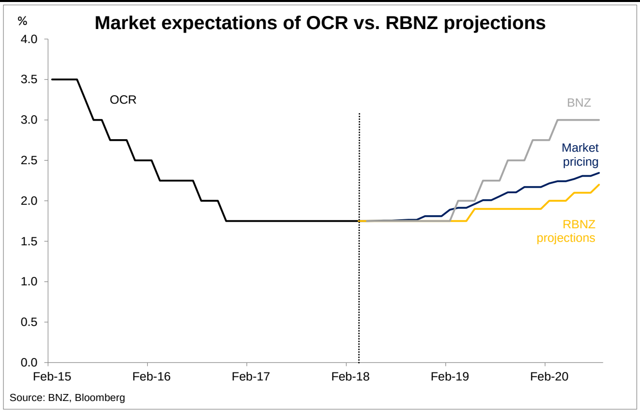
The NZ curve flattening has extended to the front-end of the swaps curve, with the spread between the 1y1y rate and the 2y1y rate (i.e. the one year rate in two years' time) declining to around 30bps, its flattest level since the end of 2016 (see chart). Although the correlation has broken down somewhat of late, the last time the 1y1y 2y1y curve was at these levels, the 10 year Treasury was around 2%.

1y1y 2y1y curve near flattest levels since end-2016



The OIS curve now prices a very gradual OCR tightening cycle in coming years. The first hike is fully priced for June 2019, with a second hike in March 2020 and a third hike around a year later. At present levels, we think there is limited room for the forward curve between 2020 and 2021 to flatten significantly further from here and we favour a 1y1y 2y1y swaps curve steepener.

The market prices a very gradual OCR tightening path



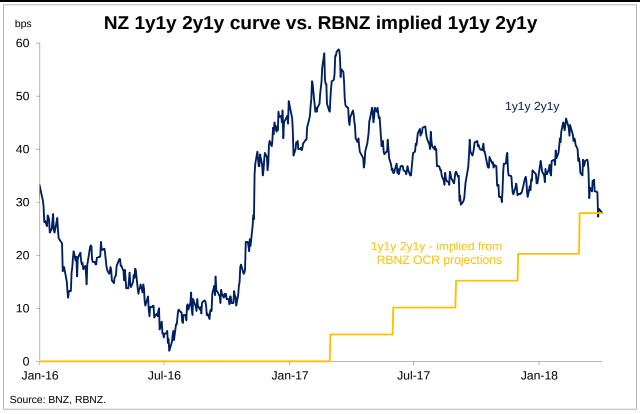
Our view is less based on a specific upcoming event or catalyst, but rather that we think the risks are asymmetric at current levels and a steepener could work in a range of scenarios.

- Were global rates to reverse their recent declines, we would expect the NZ swaps curve (including 1y1y 2y1y to steepen up) from here.

- Were new RBNZ Governor Adrian Orr to give a dovish steer at his first MPS on May 10th (not something we are necessarily forecasting), the market could well start to price the risk of OCR cuts this year.[1] In such an environment, we would expect 1y1y 2y1y to bull steepen.

- In all likelihood, the next move in the OCR is likely to be up and the market should continue to price policy normalisation in future years. While headline CPI is set to fall to around 1% in the coming few quarters, there is a stronger case to be made for higher medium-term inflationary pressures (and RBNZ tightening). The minimum wage will increase in bigger increments in the next 3 years, the fiscal stimulus should boost growth later this year, and the unemployment rate looks set to fall further. In an environment where lift-off is expected next year, we don't think there is much scope for the market to price substantially less than it does already into 1y1y 2y1y. As an aside, we note that the RBNZ's February OCR projections were consistent with a 1y1y 2y1y curve around current levels.

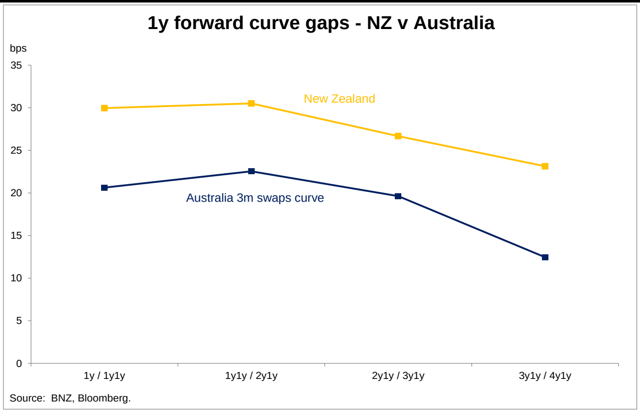
1y1y 2y1y is now consistent with RBNZ OCR projections



We prefer the steepener to a directional paid position in short-end NZ swaps. Besides the risk that the market could price the chance of rate cuts this year, the steepener avoids the negative carry a short position involves.

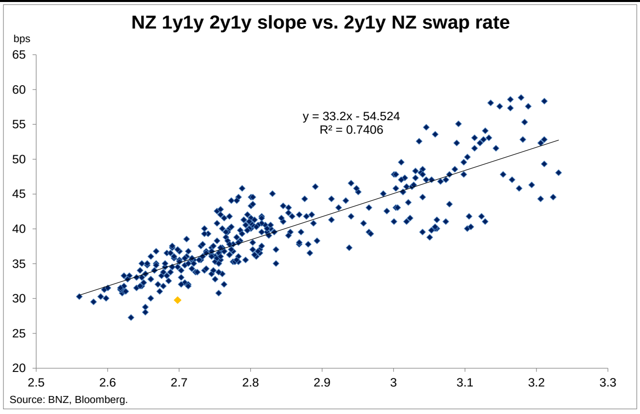
In terms of a global comparison, the NZ 1y1y 2y1y curve is steeper than US, Canada and the UK, which is unsurprising given these central banks are already actively engaged in tightening cycles (and hence the market has front-loaded more tightening). The NZ curve is steeper than Australia (30bps v 25bps), but not materially so in our view, and the roll-down on the two curves is similar. Given NZ's lower unemployment rate, impending fiscal stimulus and stronger growth, we would prefer to position for steepening in this part of the curve in NZ.

NZ forward curve is steeper than Australia



The obvious risk is that the recent global rates rally extends further, with NZ long-end rates following suit and 1y1y 2y1y flattening further. That's certainly something we can't rule out given market positioning in US Treasuries seemingly remains very short. We would note though that 1y1y 2y1y is already quite flat relative to the level of 2y1y (see chart below, which shows data since the start of 2017) which we hope may provide some protection against a further rally.

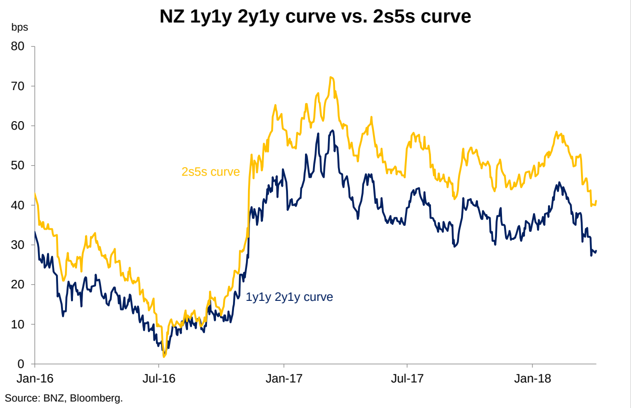
1y1y 2y1y is quite flat relative to the level of 2y1y swap



Some investors may prefer to express the trade as a straight 2s5s swap curve steepener, which is correlated to the forward position we propose (see chart below). At the margin, we prefer the 1y1y 2y1y expression which we think should be less impacted from any intensification of funding pressures than 2s5s. i.e. we expect further increases in FRA-OIS spreads should impact the 1 year tenor more so than 1y1y.

[1] We had previously recommended a receive August OIS position on this basis.

2s5s is highly correlated to 1y1y 2y1y



Source: BNZ, Bloomberg.

We would set a target of 50bps on the 1y1y 2y1y position, and a stop loss at 20ps. Were the stop-loss to be reached, the curve would be back to levels before the US Presidential election, which is hard to reconcile with the improvement in global data (including US inflation) since then.

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