12 January 2018

NZGB Yields To Go Higher This Year – Lighten Up On Duration

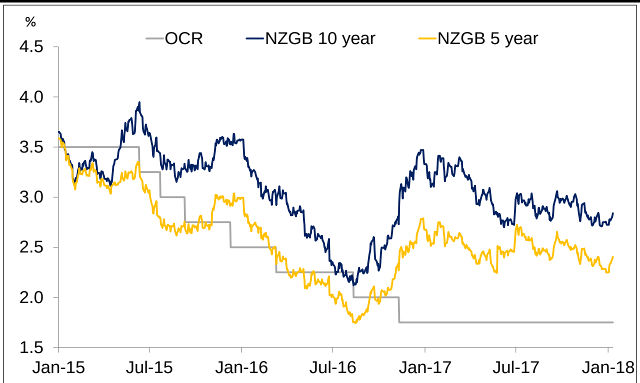
- In an environment of further Fed hikes and rises in USTs, we expect NZGB yields to head higher.
- The days of NZGBs being a major beneficiary of the global search for yield look numbered. The 10 year NZGB-UST spread is around 30bps, its tightest level since the 1990s, while the spread is inverted in short-to-intermediate maturities already. We see the risk that foreign demand for NZGBs will be affected if yields do not rise with USTs. NZGBs also look relatively unattractive on an FX-hedged basis compared to other developed country bond markets.
- In the near-term, the market is likely to remain sceptical of the RBNZ raising the OCR. But this shouldn't stop longer-term NZ rates rising in sympathy with the US. The upcoming syndication of a new 2029 NZGB may put long-dated NZGBs under some upward pressure locally.

We expect NZGB yields to be pushed higher by USTs

New Zealand yields fell over the course of 2017 as the RBNZ kept the OCR at a record low of 1.75% and the initial sell-off after the US Presidential election in November 2016 unwound. NZ yields remain well off the levels seen in mid-2016 in the aftermath of Brexit, but are still reasonably near to their range lows. We expect NZGB yields to move higher, mainly driven by moves offshore in the first half of the year.

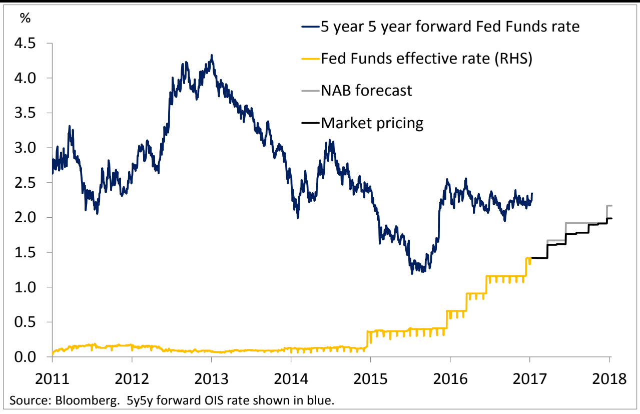
We expect US Treasury yields to rise this year as the Fed tightens monetary policy and inflation moves to target.

NZGB Yields Fell Last Year After Post-Trump Sell-Off



Source: Bloomberg. Generic bonds.

The Market Prices Little Fed Tightening Beyond 2018



Source: Bloomberg. 5y5y forward OIS rate shown in blue.

We expect the Fed to raise the Fed Funds rate three times this year versus market expectations of around two hikes.

The Fed has also started to reduce the size of its balance sheet by not fully reinvesting the proceeds of maturing US Treasuries and MBS. Its balance sheet reduction will pick-up pace this year and should put some additional upward pressure on longer-maturity Treasury yields. The US Treasury was expected to increase bond issuance anyway this year to finance the recently agreed tax plan, and the Fed's reduced reinvestment will further increase the amount of bonds the market needs to absorb.

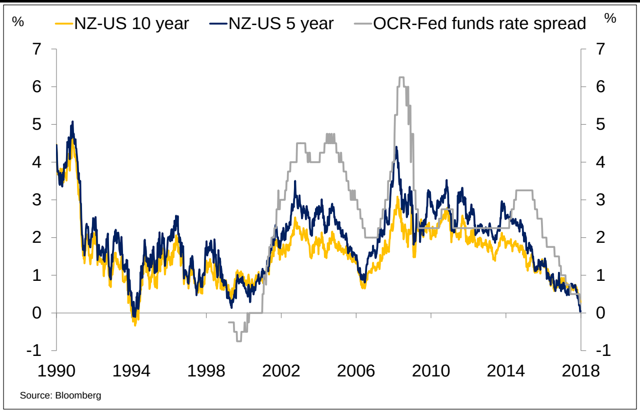
10 year Treasury yields were range-bound in 2017 despite the Fed hiking rates three times. But we expect longer-dated US yields to come under upward pressure this year as the market revises up its view of the terminal Fed Funds rate. We don't think longer-run expectations of the Fed Funds rate will stay at current levels if the Fed raises rates to 2.25% as we expect and the US economy doesn't show signs of slowing materially.

Foreign demand for NZGBs may be affected if yields don't rise

NZ has been a beneficiary of the global search for yield over recent years. Amid zero or negative rates in large parts of the developed world, NZGB yields stood out as offering attractive returns to foreign investors.

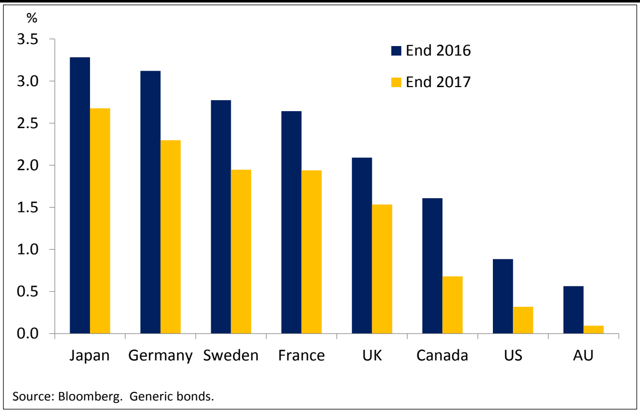
But NZ's relative yield advantage fell significantly versus other global bond markets in 2017. The spread between 10 year NZGBs and USTs fell to its tightest level since

Multi-Decade Tights in NZ-US Bond Spreads



Source: Bloomberg

NZ's Global Yield Advantage Has Fallen – 10 yr Spreads



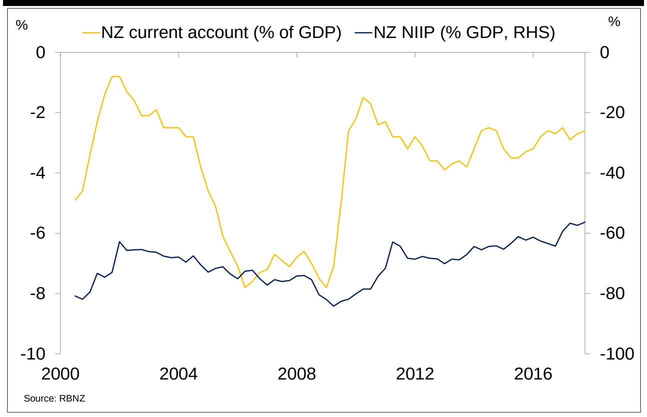
Source: Bloomberg. Generic bonds.

1994 by the end of last year. The NZGB-UST 2027 spread is around 30bps at present while the spreads are already inverted at the short-end.

Historically, NZGBs have tended to provide a yield advantage to other developed country bond markets. For one, the OCR has historically been higher than in other countries. But NZGBs should arguably also provide some risk premia to foreign investors. NZ runs a current account deficit and has a negative Net International Investment Position; that is, NZ is a net borrower in global capital markets and needs to attract funding. And despite its growth in recent years, NZ remains a small market in a global sense and unlikely to represent a 'core' holding for most foreign investors, so it probably needs to offer some liquidity premia.

Foreigners own around 60% of the NZGB market. Looking ahead, we see the risk that some foreign investors who own NZGBs unhedged as part of their NZD currency allocation, such a central banks, may limit further purchases and even choose to switch some holdings back into other markets should NZGB spreads compress further. Given our forecast of rising UST yields, this implies NZGB yields should come under upward pressure as well to retain international demand.

NZ is a Net Borrower in Global Capital Markets



Source: RBNZ

Of course, NZ still has much higher yields than in Europe and Japan, but there is now more competition for yield-seeking investors from the US, Australia and even Canada.

NZGBs look unattractive on an FX-hedged basis

While NZGBs still offer relatively high yields optically, on an FX-hedged basis they look relatively less attractive than most developed market peers. At the short-end, the NZGB 2021 yields around the same level as the FX-implied cost of funding, as shown in the table below[1]. In contrast, even short-dated JGBs and bunds offer better carry on an FX-hedged basis at the short end, even though these bonds have negative yields.

Short-Dated NZGBs Look Unattractive When FX-Hedged

3 year maturity	Local currency yield	3m FX-implied funding cost	Difference	Carry (bps/3mth)
US	2.15			
Canada	1.85	1.33	0.51	4.6
Australia	2.16	1.87	0.29	2.6
France	-0.30	-0.58	0.28	2.2
Sweden	-0.40	-0.67	0.27	2.6
Japan	-0.09	-0.28	0.18	1.6
UK	0.62	0.44	0.18	1.6
Germany	-0.45	-0.58	0.13	1.1
New Zealand	2.15	2.17	-0.02	-0.1

Source: Bloomberg. Specific bonds used. FX implied funding cost adjusts 3m Libor rate for FX basis

In the 10 year maturity, only JGBs look less attractive on this basis than do NZGBs (when hedged to a base currency of USD), albeit the difference is more marginal. For global asset managers taking active positions in NZGBs to express a view on NZ interest rates (as opposed to the NZD), the carry is nowhere near as attractive as implied by the outright level of yields.

10 yr NZGBs Also Less Attractive on This Basis

10 year maturity	Local currency yield	3m FX-implied funding cost	Difference	Carry (bps/3mth)
US	2.54			
France	0.66	-0.58	1.24	3.6
Sweden	0.60	-0.67	1.26	3.9
Germany	0.47	-0.58	1.05	2.9
UK	1.32	0.44	0.89	2.5
Canada	2.16	1.33	0.82	2.4
Australia	2.68	1.87	0.81	2.8
New Zealand	2.87	2.17	0.70	2.4
Japan	0.06	-0.28	0.33	0.9

Source: Bloomberg. Specific bonds used. FX implied funding cost adjusts 3m Libor rate for FX basis

[1] The table assumes the bonds are hedged back to a base currency of USD using 3m FX forwards. This is a static analysis and doesn't assume any change in future funding costs, which would happen if the central bank moved rates and/or the FX basis shifted.

Risks to higher NZGB gross bond supply in future years

Net issuance of NZGBs is projected to be negative over the coming few years based on the Treasury's most recent forecasts, which should, at face value, provide some support to the market. These bond forecasts incorporate the Labour coalition government's '100 day plan', although they do not incorporate other proposed policies. We will need to wait until the budget in May to get a better steer on the government's fiscal plans, but we see clear risks that bond issuance is ultimately revised higher than these forecasts even if the government remains in a very strong fiscal position by global standards.

NZGB Net Bond Supply Forecast to be Negative This Year

NZDMO Issuance Projections						
NZD billion (face value)	17/18	18/19	19/20	20/21	21/22	**Total**
Gross bond issuance	7.0	7.0	7.0	7.0	7.0	**35.0**
Repayment of market bonds	9.1	7.9	7.3	11.1	0.0	**35.4**
Net bond issuance	-2.1	-0.9	-0.3	-4.1	7.0	**-0.4**

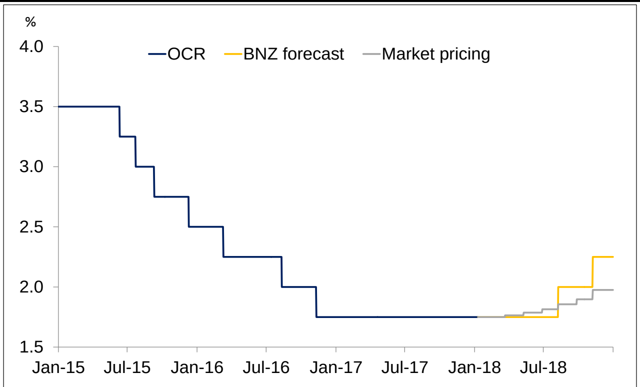
Source: NZ DMO, Dec HYEFU 2017

RBNZ hikes unlikely until August at the earliest

The other key driver of NZGB yields this year will be the outlook for RBNZ policy. BNZ Economics expects greater evidence of NZ pricing pressures to emerge by August, creating the conditions for the RBNZ to commence a gradual hiking cycle, albeit with risks skewed to a later rather than an earlier start date. BNZ Economics expects a second hike in November.

While NZGB yields would undoubtedly come under upward pressure under BNZ Economics' forecast, we suspect the market will remain sceptical of RBNZ hikes in the near-term. Having been consistently disappointed by NZ (as well as global) inflation over the past few years, the market will likely wait until there is clear evidence of a build-up in domestic inflationary pressures, a weakening in the NZD or a clear signal from the RBNZ itself before re-pricing the NZ short-end.

BNZ Expects RBNZ Rate Rises to Commence in August



Source: Bloomberg

The question of what happens to the NZD if the Fed raises rates above the OCR is an open question. However, as a current account deficit country and with the real effective exchange rate above its long-term average, the risks to the NZD seem skewed to the downside in such a scenario. Moving into the second half of the year, we may see expectations for RBNZ hikes start to grow.

The monetary policy outlook for NZ this year is also complicated by the impending change in leadership at the RBNZ and prospective changes to the Policy Targets Agreement and RBNZ Act. We don't foresee a major change in policy direction based on the RBNZ shifting to a dual mandate[2]. And it seems too soon to speculate on any policy leanings of the new Governor. However, to the extent that former RBNZ Governor Wheeler was reluctant to contemplate raising the OCR pre-emptively for fear of repeating the 'mistake' of the 2014 tightening cycle, a new Governor without this history may be less inclined to run a policy of being behind the curve.

But Scope for Longer-Term NZ Rates to Rise

Even if the market is reluctant to re-price the NZ short end in the near-term, there seems scope for long-dated rates to rise. Rising US rate expectations should transmit to higher NZ longer-term rates. And any rise in risk premia, either related to NZ country premia or a rise in global term premia, should cause upward pressure on NZ yields too. Over the past few years, NZ long term rates have been well correlated with estimates of the US term premium.

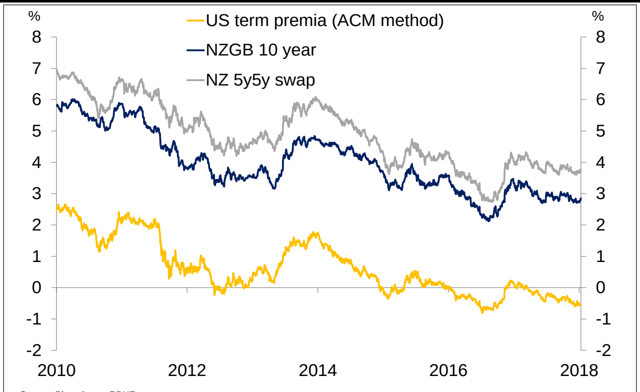
NZGBs are currently trading tight in repo, implying the market is short. However, NZGB tenders are set to resume again next week for the first time in a month, with $200m 2025s to be issued. The DMO is scheduled to tender $350m of nominal bonds a month (split between $100m 2025s and $150m 2033s) and $100m 2040 maturity inflation-linked bonds until the end of the quarter.

The DMO is also planning to syndicate a new 2029 maturity bond before the end of June. We see the risk that the syndication comes as soon as the start of February which could put some upward pressure on NZGB yields locally and help alleviate the market's short base.

While we do not subscribe to the view that we will see a major bear-market sell-off in bonds (absent a significant pick-up in inflation), we think NZGB yields can track higher alongside USTs, and the NZGB curve can steepen in that environment. Implicit in our view on NZ rates is that the major spread compression between NZ and the US is largely behind us.

[2] The Labour-led coalition government is planning to add employment to the RBNZ's mandate, alongside its inflation target. Many central banks have dual mandates (such as the Fed and RBA) and have arguably conducted policy in a similar manner to the RBNZ.

10 yr NZGB Rates Correlated with US Term Premia



Source: Bloomberg. RBNZ.

We Expect Higher Long End NZGB Yields This Year

Source: Bloomberg.

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