

5 March 2018



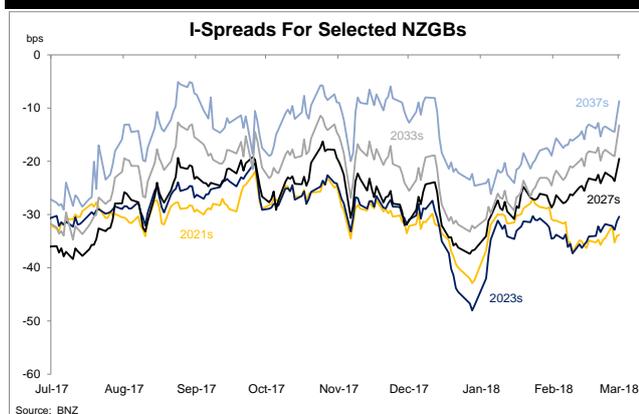
## Interest Rate Strategy: 2029 NZGB Syndication RV

- **The NZDMO is scheduled to syndicate a new 2029 maturity NZGB before the end of June. Longer-dated NZGB swap spreads have narrowed over recent weeks, potentially indicating the market is building-in a concession for the syndication (the exact timing and volume of which is uncertain).**
- **We use several methods to estimate 'fair value' for the new 2029 bond, with a range between +15.5bps to +18.5bps over the existing 2027 bond. Our preferred method points to a yield of 3.14% and a spread of +18.5bps to the 2027 bond.**
- **A risk is that the recent compression between NZGBs and UST yields limits offshore investor participation in the syndication. That said, NZGB yields remain far higher than in most developed bond markets and the NZGB curve has steepened, which should encourage switch activity from shorter-dated bonds. In addition, long-dated NZGBs are trading 'special' in repo, implying the dealer community is short.**

### Background

The NZDMO is scheduled to syndicate a new 2029 maturity bond before the end of June. The exact timing of the syndication is unknown, but long-dated swap spreads have narrowed over recent weeks which may indicate the market is building-in some concession ahead of a potential announcement. 2027 and 2033 NZGB swap spreads are near their narrowest levels over the past 9 months.

### Longer-Dated NZGB I-Spreads Have Narrowed



### Fair Value Estimates

We use several methods to estimate 'fair value' for a hypothetical new 3% 2029 NZGB, assuming it was issued today. The range of estimates is between +15.5bps to +18.5bps over the existing 2027 bond (the NZ-AU interpolated method is a little lower, at +12.5bps). Yields and spreads can obviously change significantly between now and whenever the bond is syndicated. We assume the NZDMO would look to issue \$2b, based on previous syndicated issues, although the exact volume is uncertain.

### Summary of 'fair value' and alternative estimates

	Yield	Spread to Apr-27	ASW (S/Q)
NSS fair value	3.14	18.5	-13.7
Swap Model	3.11	15.5	-16.6
MDur Interpolated	3.12	16.5	-15.6
NZ-AU Interpolated	3.08	12.5	-19.5

As regular readers will know, our preferred method for pricing bonds on a liquid curve is generally the Nelson Siegel Svensson (NSS) curve estimate procedure, which breaks down the zero coupon curve into level, slope, and curvature components. The NSS method takes account of coupon differences between bonds. In this instance, the NSS method generates the highest yield estimate, 3.14%, a spread of +18.5bps to the 2027 bond.

Other methods are similar but suggest a slightly lower yield:

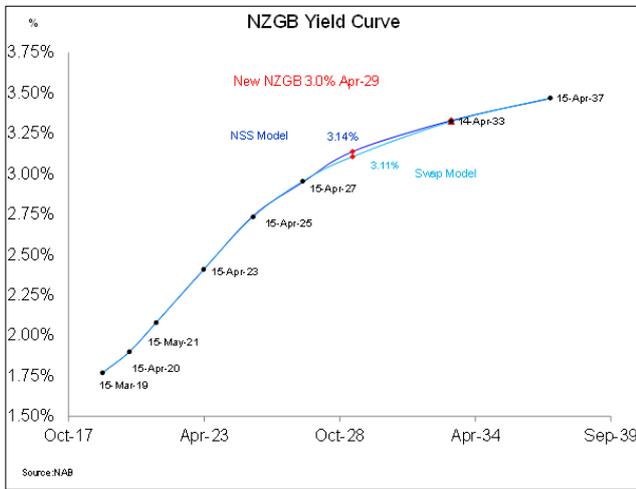
- **Swap Model:** We linearly interpolate the I-spread curve for a hypothetical 2029 NZGB, which generates a yield on the 2029 of 3.11%, and a spread of +15.5bps to the 2027 bond.

- **Modified Duration Interpolated:** We linearly interpolate the NZ yield curve based on the modified duration of the bonds, rather than maturity. This generates a yield on the 2029 of 3.12%, and a spread of +16.5bps to the 2027 bond.

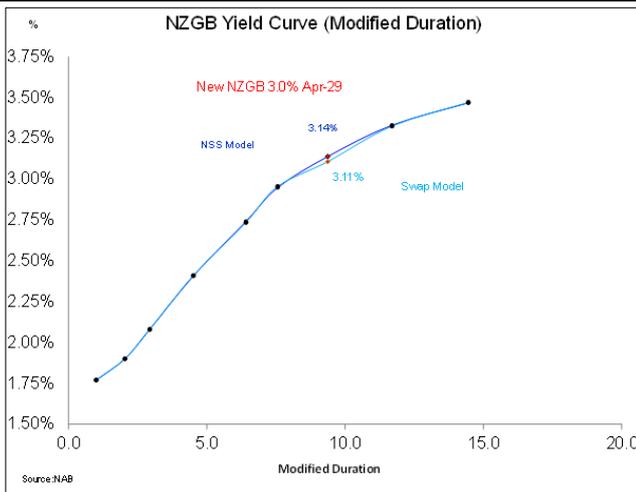
- **NZ-AU Interpolated:** A linear interpolation of the NZGB-ACGB spread curve points to a spread of 30.5bps at the 2029 maturity. This translates to a yield on the NZGB 2029 of 3.08% and a spread of +12.5bps to the 2027 bond. The NZ-AU interpolation does not take into account coupon and duration differences between the two curves and so is

arguably a less accurate way of estimating fair value than the NSS or modified duration interpolation approaches.

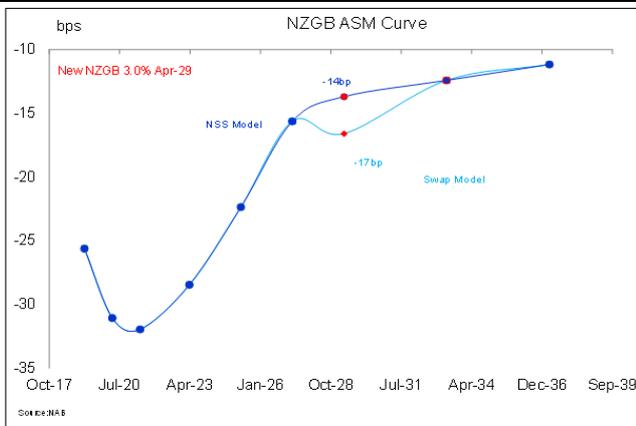
**NZGB Yield Curve With New Apr-2029**



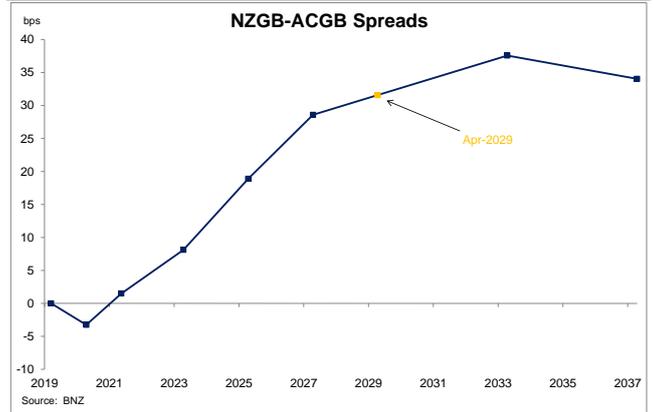
**NZGB Curve With Modified Duration Axis**



**NZGB ASW (S/Q) Curve**



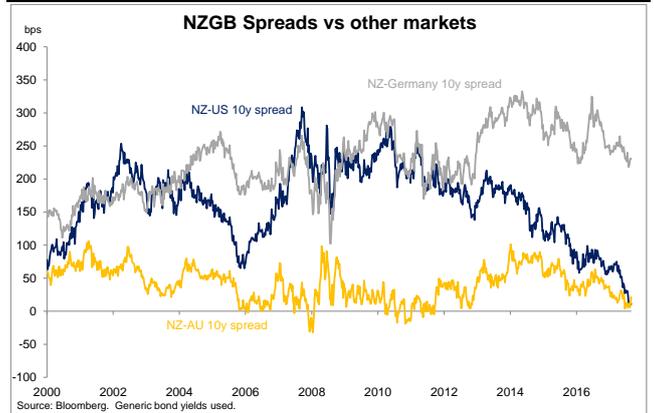
**NZGB-ACGB Spread Curve**



**Offshore demand a key question**

NZGB spreads have tightened significantly against other markets the last few years. The spread between 2027 NZGBs and equivalent maturity US Treasuries is now just 10bps. Short to intermediate maturity NZGBs are already trading through USTs. NZGB spreads to ACGBs have also declined the last year although they too have rebounded over recent weeks.

**NZGB Spreads To USTs And ACGBs At Multi-Year Tights**

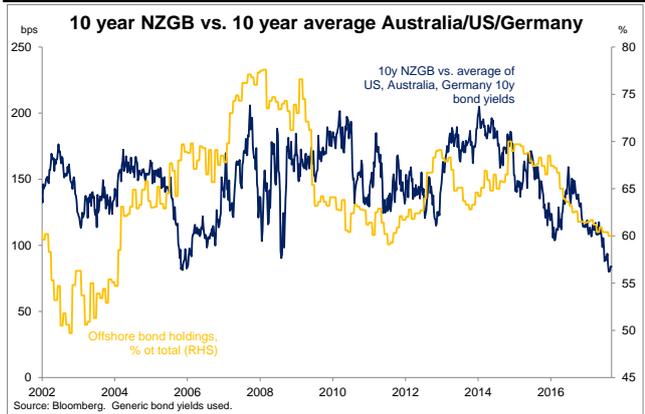


To date, there has been a gradual reduction in offshore holdings of NZGBs over the past two years. The share of NZGBs held by offshore investors is now 60%, near its lowest since 2004. A risk is that there may be less foreign investor demand for the new 2029 bond given the compression in spreads with major offshore markets (although NZGB yields remain much higher than most developed country markets, including Europe and Japan).

From the perspective of an FX-hedged Japanese investor, the 2029 NZGB looks comparable to Australian, US and Canadian bonds of similar maturity, assuming a yield of 3.14%.<sup>1</sup>

<sup>1</sup> The table shown here assumes a hypothetical Japanese investor hedges the FX risk with rolling 3 month FX swaps. The FX-hedged yield depends on the local currency

**NZ Offshore Holdings Of NZGBs Have Declined**



**FX-Hedged Yields From Perspective Of Japanese Investor**

FX hedged yield (%)	5 year	2029	20 year
Japan	-0.10	0.10	0.51
Sweden	0.50	1.11	1.78
France	0.40	1.18	1.67
Germany	0.27	0.98	1.31
UK	0.28	0.69	1.03
Australia	0.01	0.44	0.81
US	0.22	0.45	0.45
Canada	0.27	0.50	0.61
<b>New Zealand</b>	<b>-0.21</b>	<b>0.50</b>	<b>0.84</b>

\* Source Bloomberg, BNZ calculations. Assumes the 2029 NZGB YTM is 3.14%

**Other considerations**

- The Apr-29 tenor will replace the Apr-27 maturity as the new 10y bond over the next year and the 10y part of the curve typically has wide participation amongst investors.
- The NZ government remains in a very strong fiscal position by international standards, and in December the NZDMO forecast that NZGB net issuance would be negative over the coming few fiscal years.<sup>2</sup> We will receive an update on the NZGB issuance programme at the Budget on May 17<sup>th</sup>.
- The NZGB curve has steepened, which may encourage switch activity from shorter-dated bonds. The spread between 2021s and 2027s reached its steepest levels in several years last month.
- The Apr-29 will lengthen the duration of the NZ bond index modestly, which could add to support from passive investors.
- Longer-dated NZGBs (i.e. 2023s and longer) are trading special in repo, implying the dealer community is short. Dealers may use the syndication as an opportunity to cover short positions.

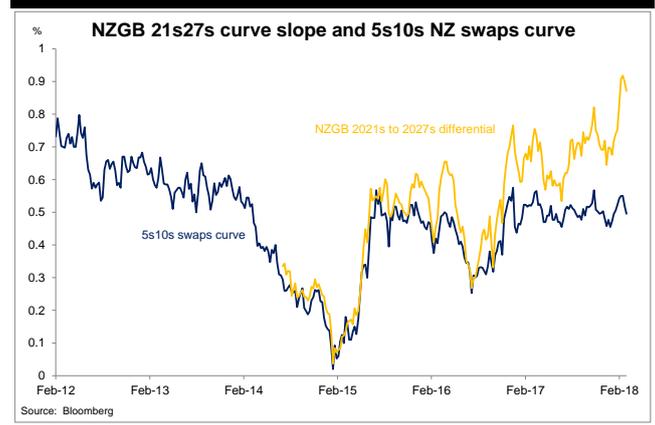
bond yield, the respective 3 month rates, and the 3 month FX basis. This is a static analysis, as any of these components can change.

<sup>2</sup> In 2017, the NZ government announced its intention to maintaining the amount of NZGBs on issue at a level not less than 20% of GDP over time. Although this threshold is not binding at present, it will ensure that the NZDMO maintains a minimum level of gross issuance of NZGBs.

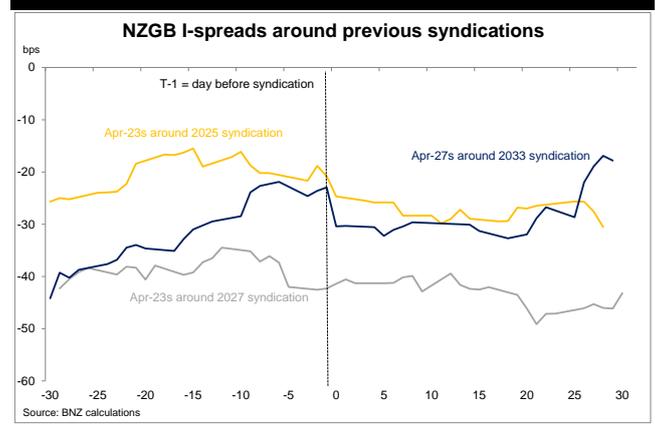
**Previous syndications**

NZGB I-spreads narrowed heading into the 2033 syndication. However, NZGB I-spreads were more stable in the month leading up to the 2025 and 2027 syndications, which were closer to 10 year maturity at time of issue, as the 2029 would be. Post-deal performance, in the month that followed, was also better for the 2025s and 2027s than it was for the 2033s.

**NZGB Curve Has Steepened Recently**



**NZGB I-spreads Around Previous Syndications**



[nick.smyth@bnz.co.nz](mailto:nick.smyth@bnz.co.nz)

## Contact Details

### 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

### Peter Jolly

Global Head of Research  
+61 2 9237 1406

### 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

### 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

### New York

Foreign Exchange +1 212 916 9631  
Fixed Income/Derivatives +1 212 916 9677

### Hong Kong

Foreign Exchange +85 2 2526 5891  
Fixed Income/Derivatives +85 2 2526 5891

**ANALYST DISCLAIMER:** The person or persons named as the author(s) of this report hereby certify that the views expressed in the research report accurately reflect their personal views about the subject securities and issuers and other subject matters discussed. No part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in the research report. Research analysts responsible for this report receive compensation based upon, among other factors, the overall profitability of the Markets Division of National Australia Bank Limited, a member of the National Australia Bank Group ("NAB"). The views of the author(s) do not necessarily reflect the views of NAB and are subject to change without notice. NAB may receive fees for banking services provided to an issuer of securities mentioned in this report. NAB, its affiliates and their respective officers, and employees, including persons involved in the preparation or issuance of this report (subject to the policies of NAB), may also from time to time maintain a long or short position in, or purchase or sell a position in, hold or act as advisors, brokers or commercial bankers in relation to the securities (or related securities and financial instruments), of companies mentioned in this report. NAB or its affiliates may engage in these transactions in a manner that is inconsistent with or contrary to any recommendations made in this report.

**NEW ZEALAND DISCLAIMER:** 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. 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.

**US DISCLAIMER:** 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.

**National Australia Bank Limited is not a registered bank in New Zealand.**