23 February 2018

Trade Recommendation: Receive August RBNZ OIS

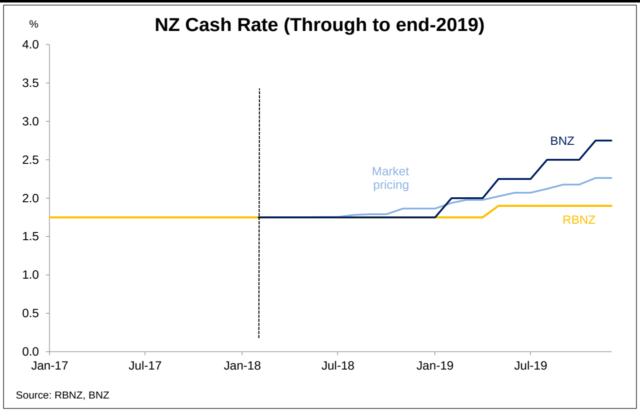
- Our base case is that the RBNZ will be on hold this year with the first hike coming in February 2019. But the balance of risks over the coming 6 months seems more tilted towards a cut than a hike, although both seem low probability. The new RBNZ Governor takes charge after the March OCR meeting, which adds an additional layer of uncertainty.
- The hurdles for the RBNZ cutting rates seem very high. That said, in an environment where headline CPI is very low (and the RBNZ projects will remain below the midpoint for several years) and the NZD relatively strong, we suspect the market will be more sensitive to downside data surprises. We see downside risks to the RBNZ's CPI and GDP forecasts over the next 2 quarters (GDP is released 15 March).
- We think the cleanest expression is to receive the August RBNZ meeting OIS, currently at 1.775%. While we don't expect an RBNZ rate cut, that doesn't mean the market might not price-in some chance.

Strategy	Entry	Exit	Stop
Receive Aug RBNZ OIS	1.775%	1.70%	1.815%

RBNZ market pricing – some chance of hikes in 2018

The market prices 2.5bps into the August RBNZ meeting (10% implied probability) and 11bps into the November RBNZ meeting (44% implied probability). Our base case, along with that of the RBNZ, is that the OCR will be on hold this year. We see the next move being a hike, in February 2019.

BNZ and RBNZ expect the OCR on hold this year



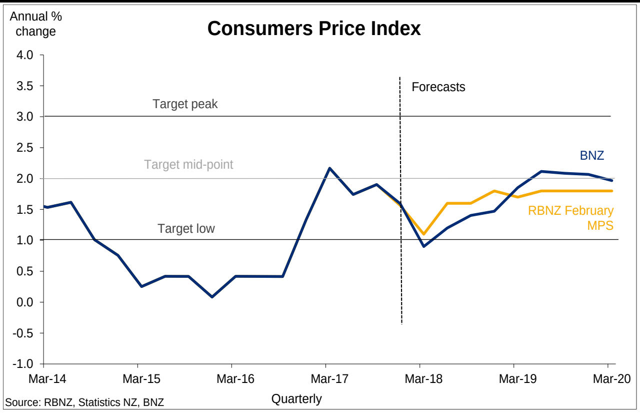
Downside risks to RBNZ GDP and CPI projections near-term – asymmetric market risks

In the February MPS, the RBNZ forecast quarterly headline CPI outturns of 0.6% and 0.5% for Q1 (released 19 April) and Q2. Our latest forecasts suggest downside risk to these estimates. We have pencilled in 0.4% and 0.3% respectively, which would lower the annual headline rate to 0.9% in Q1 and then 1.2% in Q2. Even putting aside our own expectations for these releases, the RBNZ doesn't expect CPI to reach the 2% midpoint until Q3 2020, some two and a half years away[1].

While the low headline inflation rate is partly due to base effects and policy-induced factors (e.g. the start of the fees-free tertiary education), non-tradables inflation remains below its historical average and the RBNZ's sectoral factor model of core inflation has been unchanged at 1.4% for three quarters. The relatively strong NZD, for as long as it persists, is an additional headwind for NZ inflation.

On the growth side, the RBNZ forecast 0.7% and 0.8% for Q4 and Q1 GDP respectively before it starts to pick up later in the year as the fiscal stimulus kicks in. We again see downside risks to these near-term GDP estimates, and our current forecast is 0.5% for both Q1 and Q2 GDP.

We expect lower headline CPI than the RBNZ in 2018



[1] One could argue that the RBNZ forecasts headline CPI to be 1.8% at the end of the year and that is near the 2% target midpoint.

Against a muted inflationary backdrop and one in which headline CPI is probably going to fall to close to 1%, we suspect the market will react asymmetrically to upcoming data releases. For instance, a weaker than expected GDP release on 15 March could see the market start to contemplate the risk of rate cuts. In contrast, a strong GDP result might push up rates a little but it doesn't really alter the low inflationary picture in the next few quarters, which we think creates a very high hurdle for rate hikes. i.e. we expect the front-end of the rates curve to react more strongly to weaker data than stronger data.

New RBNZ Governor adds to uncertainty

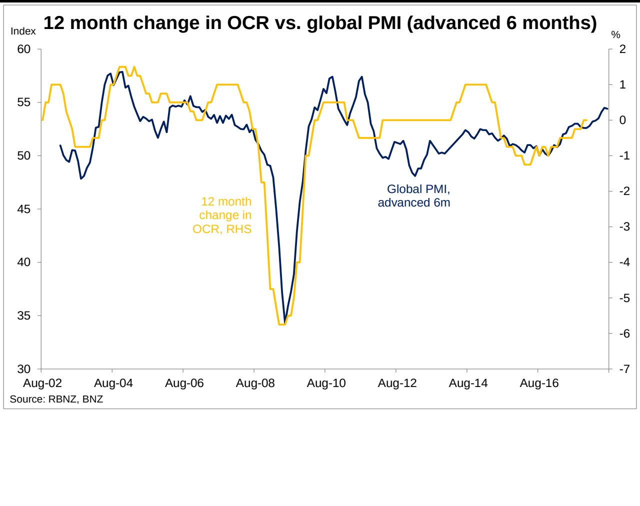
The added layer of uncertainty is that the RBNZ will have a new Governor, Adrian Orr, for the May MPS. Before that, the Governor will need to sign a new Policy Targets Agreement (PTA) with the Minister of Finance. The current PTA makes specific reference to the 2% target midpoint (the midpoint was added to the PTA when Graeme Wheeler became Governor). There is a good chance the reference to the 2% target midpoint will be retained, as eliminating it might affect inflation expectations and, in the current environment, create the perception that the RBNZ is comfortable with CPI persistently towards the lower end of the target range.

We don't pretend to know how the new Governor might see the outlook, nor for how long he would be comfortable with CPI below the midpoint. But if CPI and GDP are in line with our expectations, there has to be some risk that the RBNZ extends the timeframe for reaching 2% CPI even further, absent an offsetting policy action, NZD depreciation, or other material development. The May MPS, although some time away, shapes up as a major risk event, as we will receive the CPI and OCR projections from the RBNZ for the first time under Orr's leadership.

Hurdles for cutting still very high

We acknowledge the hurdles for both rate cuts and hikes in the next 6 months are very high. The major hurdle for a rate hike is the low level of inflation, following many years

Global growth backdrop argues against OCR cuts



of CPI being below the midpoint. We also doubt the RBNZ would want to encourage further NZD strength at a time when inflation remains relatively low.

The hurdles for rate cuts include:

- The global growth backdrop continues to improve. Historically, there has been a relationship between the global PMI and changes in the OCR, although the correlation has broken down at times (see chart below);
- While we see downside risks to near-term GDP, we expect the fiscal stimulus will start to filter through into growth later this year. As monetary policy impacts the economy with a lag, this implies a rate cut would start taking effect at the same time NZ growth may be strengthening.
- Survey-based measures of inflation expectations remain well anchored at 2%;
- The RBNZ may weigh the risk of having to 'flip-flop' and start raising rates shortly after any rate cut, if growth and inflationary pressure strengthen later this year or early next;
- While the NZD is strong at the moment and acting as a disinflationary impulse (the TWI is above the RBNZ's projections), FX market sentiment can change quickly;
- The RBNZ is cognisant of the longer-term financial stability risks associated with low interest rates and may be wary that rate cuts could reignite the NZ housing market. That said, they may see the current environment (house price growth has slowed significantly) as a more favourable environment for rate cuts than when the housing market was booming.

Receive August 2018 meeting OIS

While this is a long list of reasons why the hurdle for cutting is high, that doesn't mean the market won't price the balance of risks in favour of cuts rather than hikes. The schedule for potentially material market-moving NZ events in the next month is:

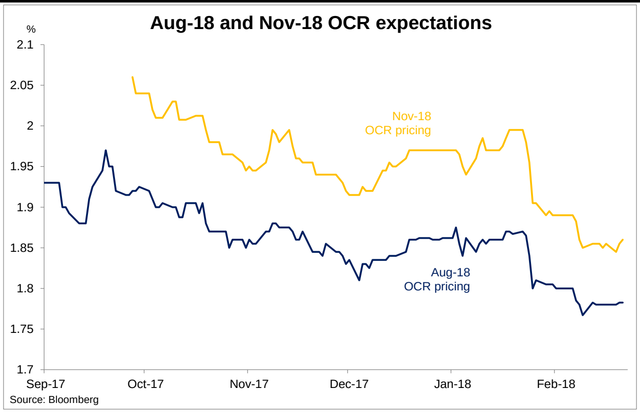
February 28 – ANZ Business Survey

March 15 – GDP

March 22 – RBNZ OCR Review

Our preferred trade expression is to receive the August 2018 meeting OIS, at current levels of 1.775%. The market prices 2.5bps of rate hikes by August, and in our base case of rates on hold the trade would earn this roll-down. In the scenario where the market starts to contemplate a rate cut at the August meeting, the new Governor's second MPS, the trade would make more. In the tail risk scenario of an actual rate cut, the trade would

OCR expectations for 2018 have been drifting lower



make 27.5bps. We think there is a very low probability of a rate hike by August, thus creating quite an attractive risk reward profile, and an 'option-like' payoff.

One could make the case for receiving the November 2018 meeting OIS, which has more upside as it has 11bps priced-in, or in swaps, like the 2 year rate. If the market starts pricing some chance of OCR cuts into the August meeting, these trade expressions would almost certainly work as well. But these are also riskier positions as the chance of rate hikes later this year is likely to be higher, especially if the global economy maintains its momentum and NZ growth starts to pick-up. The short-end of the swaps curve will also be influenced by the 3 month bank bill rate, which has started moving higher, in sympathy with moves in US Libor-OIS.

On balance, we prefer the August 2018 meeting as we have higher conviction in the RBNZ not hiking the OCR by that time. We also suspect that if the new Governor is minded to cut rates, it's more likely to be reasonably soon in his tenure or not at all. At the margin, the August 2018 meeting should also be less influenced by offshore developments, including any further rise in foreign central bank rate hike expectations.

We would set a stop-loss at 1.815%, the level reached after the CPI release. If the market were pricing more than a 25% chance of an August rate rise, we would accept that macro developments had moved against our thesis. We would set an initial profit target of 1.70%, but would review this if it were reached.

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