5 March 2018

bnz

Trade Idea: 2s10s NZ Steepener

- **The NZ swaps curve has flattened the past few weeks, in line with the rally in US Treasuries and flattening in the US curve. The recent rise in the 3 month bank bill rate has also pushed up short-dated NZ swaps to near the top of recent trading ranges.**
- **We recommend entering a 2s10s steepener at 98bps, in line with our target entry levels set out earlier this year. The steepener carries and rolls positively and, with the RBNZ likely on hold in 2018, it should trade directionally with long-end global rates; we see upside to UST yields.**
- **The steepener should also work in a scenario where the market starts to price-in a chance of RBNZ cuts this year (something we still think unlikely) or one in which global term premia re-prices higher.**
- **The main risks are (a) a deeper pullback in UST yields and (b) a faster rise in the 3 month bank bill rate, which could potentially trigger position unwinding at the front end of the NZ curve.**

Strategy	Entry	Exit	Stop	Carry & Roll (1m)
2s10s swap steepener	98bps	120bps	87bps	0.7bps

Recent curve flattening due to global factors and rises in the 3-month bank bill rate

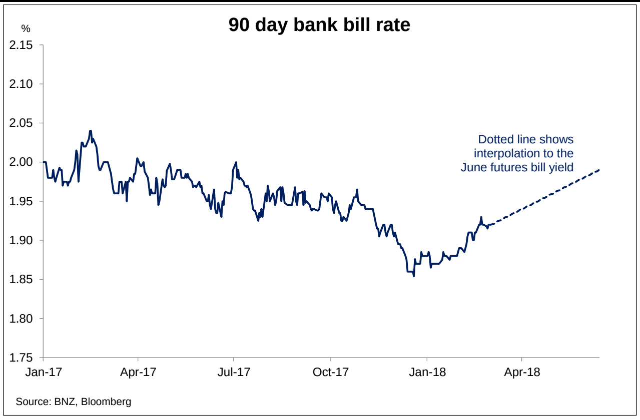
As we outlined earlier this year (see *Taking Stock After NZ CPI*), our bias is for a steeper NZ swaps curve in 2018. The primary rationale is that we see upside to UST yields from here and we expect the front-end of the NZ curve to remain anchored amid an unchanged OCR.

After steepening to 115bps in mid-February the NZ 2s10s curve has flattened back below 100bps, our target entry level from earlier this year. The flattening in the NZ curve has been driven mainly by the rally in US Treasuries and flattening in the US curve. The rise in the 3 month bank bill rate (and expectation that bills-OIS will continue to widen) has pushed short-dated NZ swaps towards the top of their recent, narrow trading ranges, adding to the flattening pressure on the NZ curve at the margin.

Rationale for NZ curve steepener

We view the recent pull-back in Treasury yields as mainly driven by short-covering by investors ahead of 3% rather than being fundamentally driven. Notwithstanding recent stock market volatility and the risk that trade tensions might

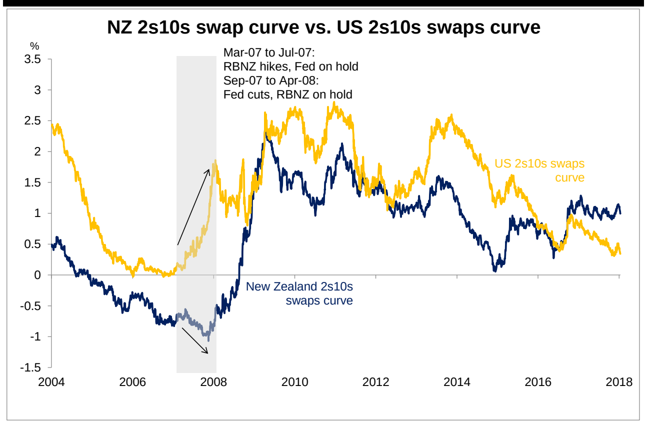
The Market Prices Further Rises In 3 Month Bank Bill Rate



escalate further, we continue to see upside to UST yields from here. The incremental news-flow since our earlier note has been directionally in favour of higher US yields, with the recently agreed US budget to add ~$300bn to Treasury supply over the next 2 years, core CPI and wage data surprising to the upside, and some Fed officials, including Chair Powell, raising the prospect the Fed might lift the 2018 'dots' at the upcoming March meeting.

We expect further rises in US yields will push up NZ long-dated rates and steepen the NZ curve, provided the RBNZ remains side-lined. Our prior is the NZ curve will steepen even if the rise in US yields is accompanied by a bear flattening in the US curve – i.e. the NZ curve will be more sensitive to the level of US rates rather than the curve. We

NZ 2s10s Curve Can De-Couple From US 2s10s At Times



National Australia Bank

highlight a previous period of monetary policy divergence between NZ and the US between early 2007 and mid 2008 where the NZ and US curves moved in opposite directions.

A steepener should also benefit from a scenario where the market starts to price-in a chance of rate cuts this year from the RBNZ, although – as we outlined in *Receive August RBNZ OIS* – we think the hurdle for action is very high. Another scenario where the NZ curve should steepen is one in which global term premia re-prices higher, perhaps due to Fed balance sheet reduction or if the market starts to price a higher inflation risk premium into the US curve. We're not forecasting a large rise in the term premium, but given it is starting from a historically low level, we think directionally the risks are higher.

We see current levels as attractive to enter a 2s10s steepener. We target a move to 120bps, just below the highs reached in early 2017 and would place a stop-loss at 88bps, below the lows reached mid last year. The major risk is that USTs experience a deeper correction from here, and continued weakness in stock markets or a turn-around in US data triggers further liquidation of short positions. Another risk is that the NZ 3 month bank bill rate rises faster and this leads to an unwinding of received positons in short-end NZ swaps, causing a flattening of the curve. For now though, the domestic system still appears to be in a healthy liquidity position given muted domestic credit growth.

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