29 January 2018

Rates Strategy: Taking stock after NZ CPI

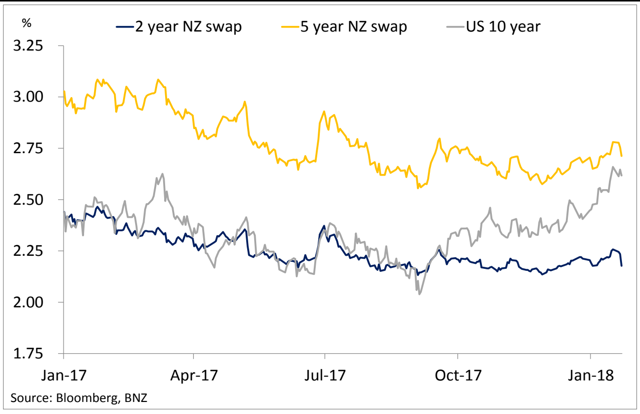
- **The NZ CPI last week was a material downside surprise and market expectations of rate hikes, along with ours, have been pushed back. We had been targeting 2.3% to receive 2 year swap, but post-CPI we now expect it to mostly trade in a lower 2.1% to 2.2% range for the coming few months.**
- **The case for receiving the front-end largely rests on carry and roll in what is likely to be a reasonably tight range-trading environment. We would see a move towards 2.25% as an opportunity to tactically receive the 2 year rate, or above 2.45% in 1y1y swap. The risk is that global rates continue to rise, dragging the NZ curve with it. But we expect the market to remain sceptical of RBNZ hikes in the next few months amid subdued inflation and a resilient NZD.**
- **An alternative is a NZ 2s10s swap curve steepener, which provides positive carry and should benefit from a further rise in global rates. We would look to set steepeners in 2s10s below 100bps. We will need global rates to go lower initially to reach our target.**

Strategy	Current level	Target Entry	Exit	Stop	Carry+roll(1m)
Receive 2 year	2.18%	~2.25%	2.10%	2.33%	3bp
Strategy	**Current level**	**Target Entry**	**Exit**	**Stop**	**Carry+roll(1m)**
2s10s steepener	107bps	<100bps	120bps	90bps	1bp

NZ rates caught between global and domestic forces

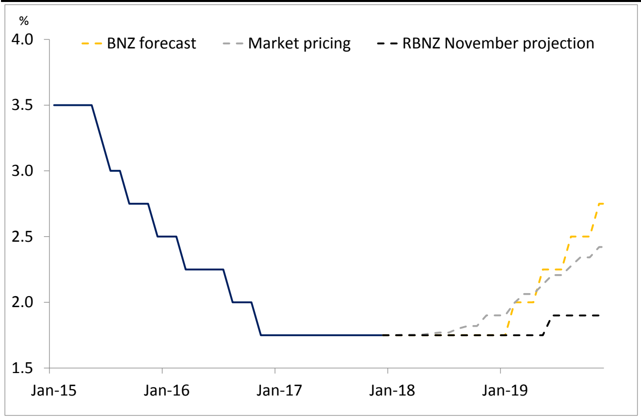
New Zealand rates have moved higher over the past few months, mainly driven by rising global rates. Before the CPI release, the 5 year swap rate had moved to 2.78% and at the front end, the 2 year rate had reached a 3 month high of 2.27%. While NZ rates have been dragged higher by global forces, they still significantly outperformed the US.

NZ Rates Have Lagged The Rise In US Yields



NZ rates saw a significant correction after the much weaker than expected CPI release. The 2 year swap rate is back to 2.18% and the 5 year at 2.71%. The market now prices a 30% chance of an August hike, with a February 2019 hike near fully-priced. The market prices close to 2 further hikes for 2019.

The Market Prices ~3 RBNZ Hikes By The End Of 2019



The CPI miss was material in our view (see *Seeing Through the CPI's New Clothes* for more details). We have pushed back our expected timing of the first RBNZ hike from August to February 2019 and we now don't expect the OCR to reach 3% until early 2020.

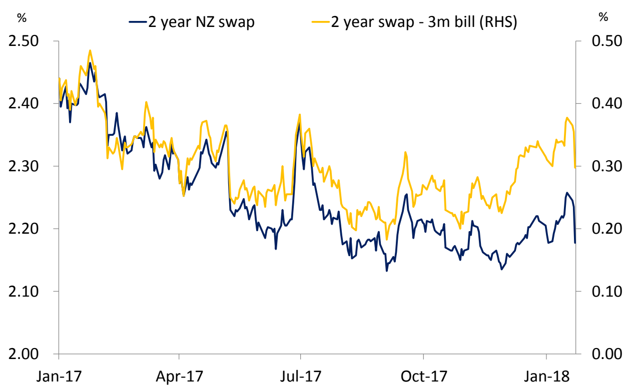
The RBNZ's most recent projections still forecast a much later rate rise (first 25bps hike in 2020). The Bank will release an updated set of projections with its MPS next week. Even before the CPI, we had thought the RBNZ would push back against expectations for hikes this year given the ongoing resilience in the NZD which is still ~2% above its forecasts. But the weaker CPI raises the risk that the RBNZ chooses to flatten its OCR track at next week's meeting, although we think this is still a low likelihood.

We had been targeting 2.3% as a level to receive the 2 year swap rate, but realistically the CPI downside surprise will now define a lower range. We still think there are upside risks to global rates, even after the moves seen year-to-date, and this could drag the kiwi front-end up a bit (especially if more central banks, and particularly the RBA, were to join the global tightening cycle). But in the absence of higher offshore rates actually leading to a lower NZD or much stronger evidence that domestic inflationary pressure is starting to surface, we would expect the market to remain sceptical of RBNZ hikes and for the front-end to be well anchored.

Lower 3 month bank bill rate supports the front-end

While the 2 year swap rate is almost 10bps lower than the start of last week, the difference between the 2 year swap rate and the 3 month bill (the yellow line below) is still reasonably elevated compared to its range over the past 12 months, even after the CPI miss. Effectively, the recent decline in the 3 month bank bill rate has meant the carry on the 2 year swap rate at current levels (~4.5bps/3mths) is comparable to mid last year.

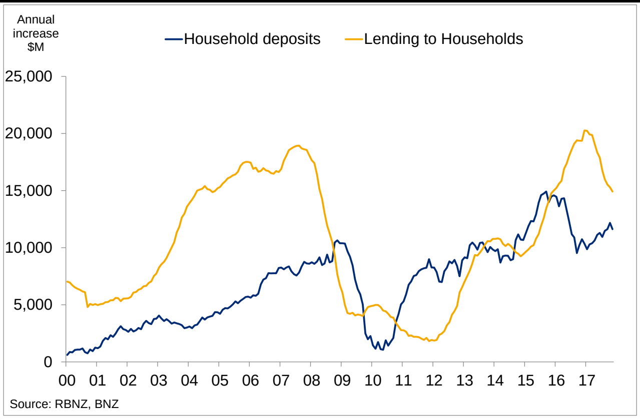
2 Year Swap – 3 Month Bill Still Reasonably Elevated



Source: Bloomberg, BNZ

The key driver behind the fall in the 3 month bank bill rate appears to be a surplus of liquidity in the domestic banking system. RBNZ data shows that lending to households has been slowing over the past 12 months while deposit growth has been rising. While the household sector is still a net borrower, the falling 3 month bank bill rate seems to imply that domestic banks anticipated greater net lending than has transpired and consequently have 'overfunded'. This surplus liquidity is being reflected in lower NZ money market rates including 3 month bank bill and NZ T-bill rates.

Lending To Households Has Slowed Recently



Source: RBNZ, BNZ

In time, banks' funding levels will normalise to levels consistent with their lending activity (i.e. deposit rates will fall and/or banks will adjust wholesale funding activity). A rise in the 3 month bank bill rate is a risk to received positions at the front-end, although there is no sign of the liquidity situation changing as yet.

New range in 2 year swap probably 2.10% – 2.20%

We now think 2 year swap will mostly settle in a 2.10% – 2.20% range, although it's possible, if global rates sell-off further, it could push back up to 2.30%. Similarly, in 1y1y we would expect a 2.30% - 2.45% range to hold in the near-term.

Given these reasonably tight expected ranges, the case for receiving fixed at the front-end would be based largely on carry and roll and the expectation that the market will gradually push back rate hikes until there is more concrete evidence of inflation (note: we expect annual headline CPI to move lower to 1.2% for the next two quarters, well below the RBNZ's current estimates).

Globally, NZ 2 year swap doesn't stand out as offering a significant carry/roll advantage to other major markets (2 year swap offers close to 10bps/3mths carry and roll). However, unlike many other countries, we don't expect the RBNZ to tighten rates this year and unless this perception changes we would expect moves higher in the kiwi front-end to be met with continued receiving interest.

Carry And Roll On NZ Swaps Vs. Other Markets

Carry and roll (bps/3mths)	2 year	5 year	10 year
NZ	9.5	8.6	5.9
AU	9.2	6.6	4.1
US	12.8	5.2	3.2
Canada	12.7	5.4	3.4
UK	9.5	5.7	3.5
Europe	5.9	7.9	6.0
Sweden	11.9	11.1	7.3

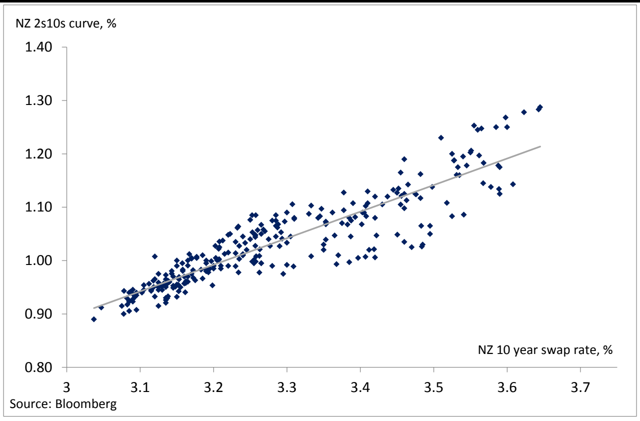
Source: Bloomberg. Roll interpolated from swap rates a year shorter.

In terms of trade targets, we would see a move in 2 year swap towards 2.25% (i.e. a short-term movement outside our expected range) as an attractive level to get long tactically and similarly above 2.45% in 1y1y. Volatility in global rates and the February 7th NZ labour market reports may provide near-term opportunities to set received positions.

NZ steepener effectively a positive-carry duration short

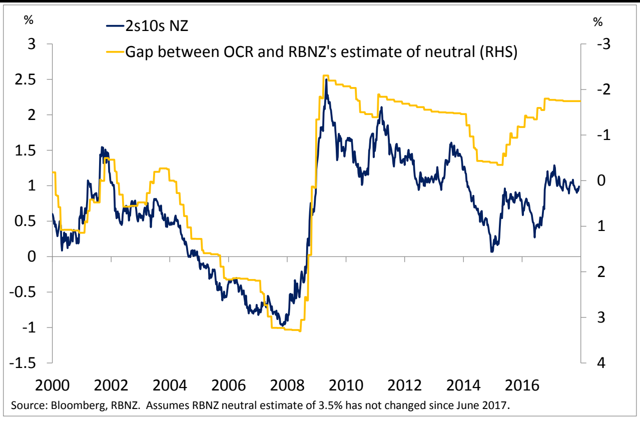
A NZ curve steepener is an alternative way to gain exposure to the carry and roll at the front-end while providing some protection against further rises in global rates. The NZ curve (2s10s swap curve shown below) has shown strong positive directionality with the level of rates this past year meaning a curve steepener is effectively trading as a positive carry duration short position.

NZ 2s10s Curve Vs. NZ 10 Year Swap Rate



Source: Bloomberg

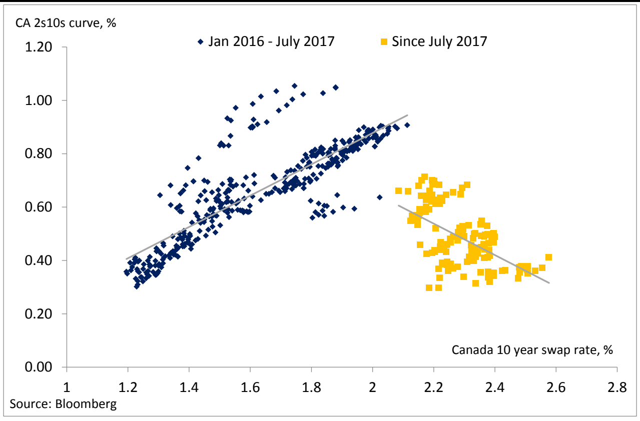
NZ 2s10s Curve vs. 'Gap' Between the OCR and Neutral



Source: Bloomberg, RBNZ. Assumes RBNZ neutral estimate of 3.5% has not changed since June 2017.

Of course, if the RBNZ makes clear that rate rises are on the agenda in the near-term, or if the market speculates that it might do so, the directionality can switch (the curve would bear flatten rather than bear steepen). In this regard, the Canadian curve would be a potential template to use. After the BoC indicated mid last year that it intended to hike rates, the Canadian curve switched to bear flattening mode – see chart below. However, given our expectation that the RBNZ will likely be side-lined this year, and the front end relatively anchored, we expect this positive directionality with global yields to remain.

Canada Swap Curve Has Changed Directionality



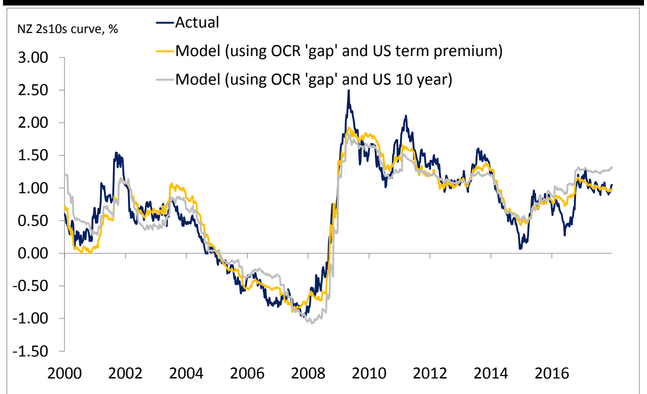
Source: Bloomberg

Global rates likely to be main driver of NZ curve in near-term

The two key drivers of the NZ curve are going to be the RBNZ policy outlook and global rates. The NZ 2s10s swap curve has historically been correlated with the 'gap' between the current level of the OCR and the RBNZ's estimate of neutral (i.e. how 'loose' or 'tight' monetary policy is). The RBNZ estimates the 'neutral' level of the OCR is around 3.5%[1] versus its current record low of 1.75%, a gap of 175bps.

Over recent years, the curve has been much flatter than implied by the pre-GFC relationship to the RBNZ monetary policy stance. This seems to be due to the low level of global rates since the GFC, which has weighed down on longer-dated NZ rates. If we model the NZ 2s10s curve on this OCR 'gap' and the US 10 year yield (the grey line shown below), the fit improves significantly. Interestingly, the relationship is even better when we incorporate the ACM model of the 10 year US term premium (shown in yellow), rather than the yield itself.[2]

NZ 2s10s Modelled on OCR Gap & (a) US10y (b) ACM



Source: Bloomberg, RBNZ, BNZ calculations.

A move below 100bps in 2s10s an opportunity to put on the steepener

Global rates have already risen this year, with the 10 year US Treasury yield up around 25bps and moving within range of our year-end target of 2.75%. We see upside risks to that 2.75% forecast, although it seems possible

[1] See *Looking at the Stars*, by RBNZ Assistant Governor John McDermott. The chart uses the mean of a number of alternative measures of the neutral rate. The range of estimates regarding the neutral rate is 2.5% to 4.5%.

[2] The term premium estimates come from NY Fed economists Tobias Adrian, Richard Crump, and Emanuel Moench (or "ACM"). See https://www.newyorkfed.org/research/data_indicators/term_premia.html.

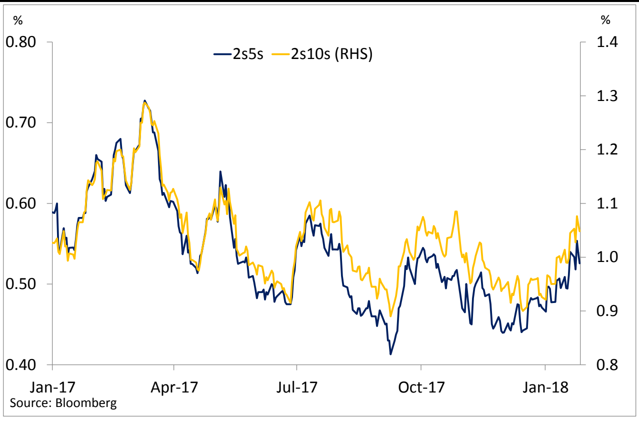
we might get a period of consolidation in the near-term. A NZ curve steepener is one way to position for higher global rates this year, while mitigating the negative carry involved in an outright short position.

The NZ curve has steepened up a few basis points since CPI. The 2s5s curve is now near 55bps while the 2s10s curve is close to 107bps. Given our view the RBNZ will be on hold this year and global rates move higher we expect this trend to continue.

We would favour a 2s10s steepener, given its more favourable carry profile than 2s5s (2s10s has 3.5bps carry and roll over 3 months) and given that we would expect 10s to lead the curve higher if driven by global factors.

Entry levels are clearly not as attractive as they were a few weeks back and we would wait for a correction below 100bps before initiating, which will likely require global rates to correct lower initially. We think ultimately the 2s10s and 2s5s curves will challenge the upper-ends of their trading ranges seen over the past 12 months if the 10 year US Treasury yield moves towards 3%.

NZ 2s10s and 2s5s Swap Curves



Source: Bloomberg

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