11 July 2018

An Update On NZ Funding Pressures (Or Lack Thereof)

- **The Australian bank bill-OIS spread has de-coupled from US Libor-OIS recently and remains at very elevated levels.**
- **In contrast to Australia, the NZ bank bill-OIS spread has declined to almost 20bps.**
- **The NZ banking system looks very well-funded and there are no signs of pressures in the domestic cash market. NZ repo trades very close to the OCR, in contrast to Australia. Given there is no apparent concern about bank credit risk, we don't see any automatic links between the NZ and Australian funding markets.**
- **Despite this, NZ and Australian bill futures remain directionally correlated. Upward pressure on BBSW has pushed up NZ bill futures yields in spite of the difference in relative cash market pressures.**
- **We can see value in buying the Sep-18 bank bill futures, which implies BKBM will increase 8bps over the coming two months. The position offers positive roll and would also benefit if the market puts more weight on the chance of an RBNZ cut.**

NZ BKBM-OIS below Australian BBSW-OIS

NZ BKBM-OIS has retraced from a peak of 31bps in late April to almost 20bps currently. In contrast, Australian 3m BBSW-OIS is 54bps and remains at historically elevated levels. The divergence between NZ and Australian bills-OIS has raised some questions among market participants around the respective drivers of the two markets.

Our NAB colleagues recently discussed a number of possible reasons for the rise in BBSW-OIS, independent of Libor-OIS.[1] In this note we discuss the state of the NZ funding market and highlight a number of differences to the situation in Australia.

NZ not experiencing the same repo market pressures

In Australia, GC repo remains significantly higher than OIS, which has contributed to resetting the entire cash money market term structure (including BBSW) at higher levels. The intuition is that repo is secured funding, and so unsecured rates such as BBSW, should in theory trade at higher rates. Banks borrowed cash from the RBA in its last OMO at 56bps over OIS – see Chart 2.

Chart 1: NZ BKBM-OIS is well below Australian BBSW-OIS

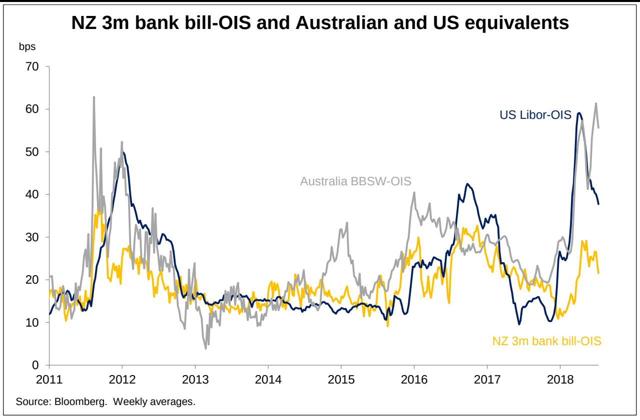
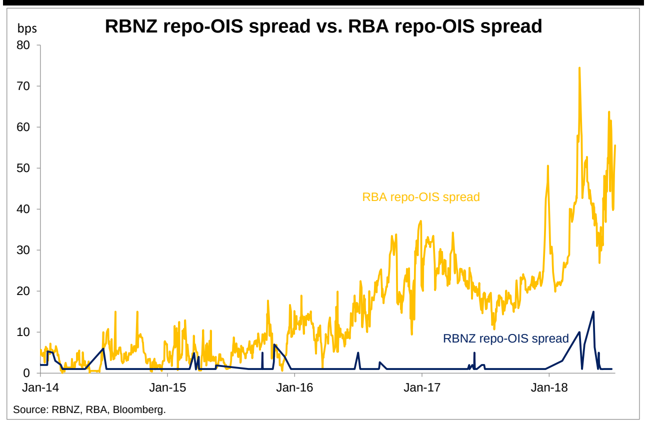


Chart 2: Australian repo remains elevated compared to NZ

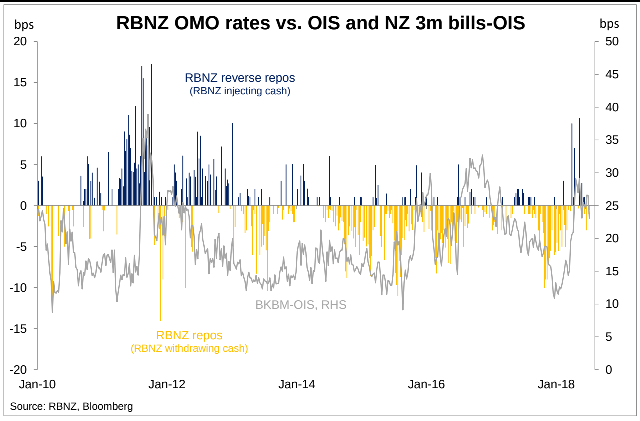


In contrast to Australia, there are no obvious pressures in the NZ repo market, with GC continuing to trade very close to OIS and helping to anchor unsecured rates like BKBM.[2] Likewise, the RBNZ has been transacting its OMOs (both reverse repos and repos) at rates similar to the OCR over the past month. There were some modest signs of funding pressures in May, when banks were willing to pay around 10bps over the OCR for repo funding from the RBNZ on a few occasions (as shown by the spikes in the blue bars in Chart 3) but these pressures appear to have dissipated.

[1] See *NAB Rates Strategy: Australia – an island of money market pressure*, 20 June.

[2] There does not appear to be the same demand from non-residents to fund NZGB positions via repo compared to Australia. Non-resident's aggregate repo position in NZGBs has increased this year, but remains quite low in absolute terms ($3b in non-resident repo vs. $75b NZGBs outstanding). The lack of a liquid government bond futures contract in NZ also means there is not the same pressure to fund bond positions in repo for bond-futures basis positions like in Australia.

Chart 3: RBNZ OMOs have been transacted close to OCR

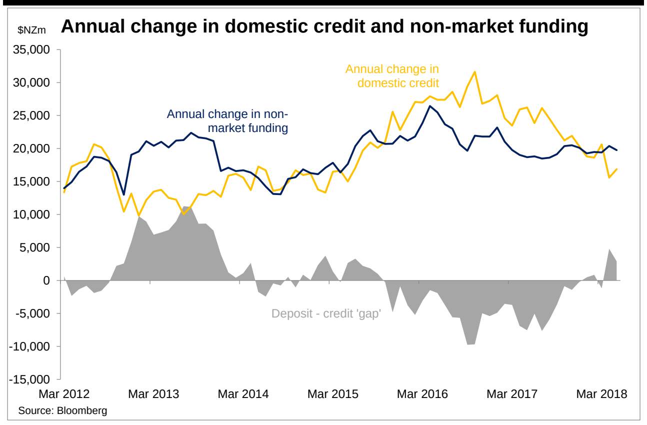


NZ credit growth remains muted, deposit growth holding up

Domestic credit growth has softened over the past year, reflective of the slow-down in the NZ housing market. In contrast, deposit growth (proxied by the annual change in 'non-market funding') has been reasonably steady. The difference between domestic credit growth and deposit growth provides a measure of the incremental funding 'gap' that needs to be sourced from the market.

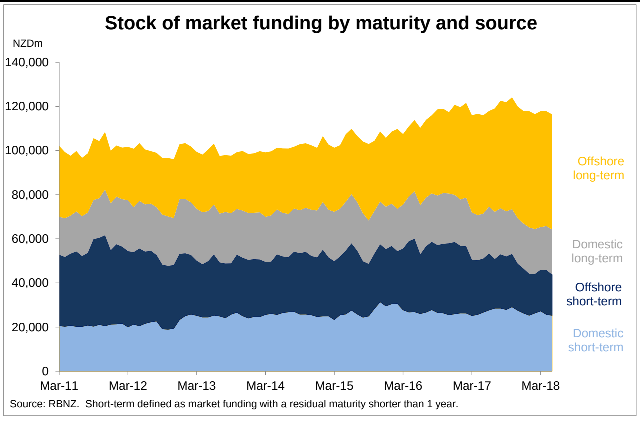
Compared to late 2016 / early 2017, when credit growth was sharply outstripping deposit growth, the funding deficit in NZ now appears to be shrinking (see Chart 4). This reduces the need for local banks to tap short-term funding markets and intuitively should put less upward pressure on BKBM.

Chart 4: Credit growth has slowed more than deposits



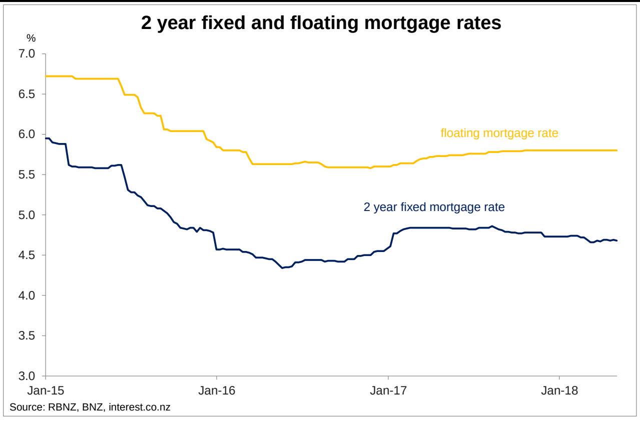
Additionally, as we pointed out earlier this year, banks increased their stock of offshore term debt last year by a net $10b (possibly extrapolating the prior growth in credit). Given the slowing in credit growth that has since taken place, we think this has left NZ banks very well-funded. We note that market-based funding has been reasonably flat so far this year, which would be consistent with banks' reduced market funding needs.

Chart 5: Market-based funding has been flat this year



Finally, NZ mortgage rates have been stable to lower this year (including domestic banks offering a number of 'specials' recently on 2 year fixed mortgage rates). We think this corroborates the view that NZ banks are in a strong liquidity position and, at least at the margin, trying to encourage more net lending.

Chart 6: NZ mortgage rates have been stable to lower

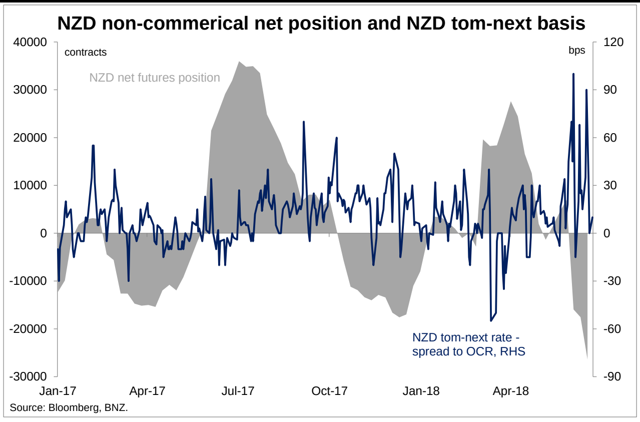


The NZ position seems in some contrast to Australia, where deposit growth has been slowing more sharply than credit growth and likely contributing to the elevated level of BBSW in our NAB colleagues' view.

Sporadic pressure via FX forwards but not affecting the domestic cash market

There have been several instances over the past month when funding pressures have emerged through the NZD FX forwards market. At one point earlier this month, the implied funding cost via tom-next FX forwards traded at 200bps over the OCR – an extremely stretched level. We attribute those funding pressures via FX forwards to an increase in speculative short positioning in the NZD, as suggested by CFTC data (see Chart 7). Similar pressures have been seen at times in AUD FX forwards

Chart 7: Speculative short positioning in the NZD has risen



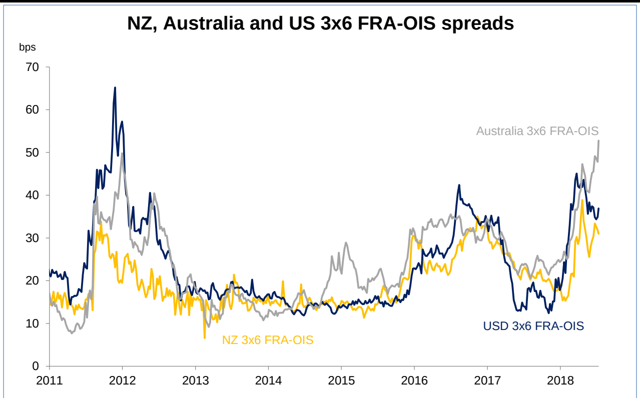
Source: Bloomberg, BNZ.

There was next to no impact on the domestic cash market through this time, with no pressures evident in either repo or unsecured cash markets. The pressure in FX forwards did not appear to be a shortage of NZD liquidity, but rather domestic banks' constraints on offlaying US dollars, which meant they were constrained from taking the other side of these FX forward flows.[3] These pressures in tom-next FX forwards have since dissipated, with the RBNZ injecting significant amounts via FX swaps.

NZ and Australia bill futures market remain highly correlated – value in Sep-18 bill futures

Despite the differences in the NZ and Australian cash markets, the NZ and Australian bank bill futures have been highly correlated over the past few months. For instance, the NZ 3x6 FRA-OIS spread has widened since late May, coincident with the widening in Australian FRA-OIS spreads – see Chart 8. The widening in NZ FRA-OIS spreads occurred despite BKBM-OIS tightening to near 20bps.

Chart 8: NZ FRA-OIS spreads have widened recently

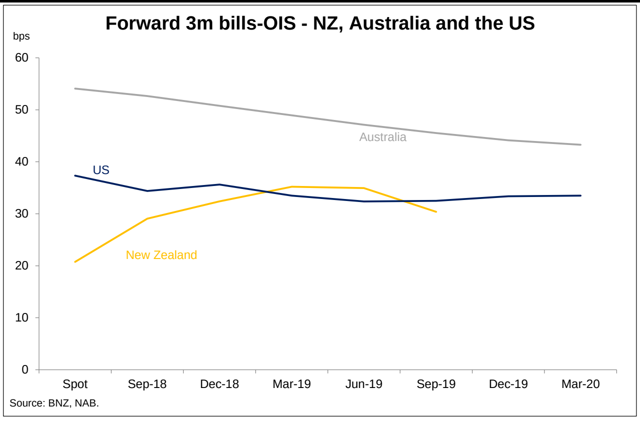


Source: Bloomberg. Weekly averages.

We suspect some of the widening pressure in NZ FRA-OIS spreads has been due to a perception among some market participants that Australian funding pressures will ultimately show up in NZ.[4] While we can understand that funding pressures in the US can and do affect the NZ market, as it is a primary source of offshore funding for domestic banks, we don't see any automatic link between the NZ and Australian funding markets given NZ banks' limited borrowing in Australia.[5]

The NZ September bank bill futures yield (ZBU8) is 2.035%, implying an 8bp increase in BKBM over the coming two months, a reasonably steep increase. The Sep-18 futures yield implies the BKBM-OIS spread will be around 29bps at this time – see Chart 9. If it were realised, it would see the NZ BKBM-OIS spread towards the upper end of where it has traded post-GFC.

Chart 9: NZ bills-OIS is priced to widen this year



Source: BNZ, NAB.

We can see value in buying ZBU8 as we don't think the underlying fundamentals of the NZ cash market point to an 8bp rise in BKBM over the coming two months. A long position in ZBU8 also gives investors some exposure to a scenario where domestic data is weaker than expected and the market attributes a greater chance to the possibility of an RBNZ easing later this year (we think the chances of a hike are next to zero). Calibrating stop-loss and take profit levels on the position are tricky, but we think the probability that BKBM will realise lower than what the ZBU8 futures contract implies is reasonably high.

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3 When market participants borrow NZD through the FX forwards and lend USD (to fund the short NZD FX position), it leaves the FX forward counterparty with USD Domestic banks were also likely receiving USD cash collateral from cross-currency basis swap counterparties due to the fall in the NZD, using up existing credit lines and leaving them less able to intermediate the FX forward flows.

4 Some profit-taking on received NZ swap and bill futures positions in the wake of the RBNZ OCR Review has also likely put some upward pressure on NZ bank bill futures yields.

5 If there were concerns about the perceived creditworthiness of Australian banks, there would be an obvious link to NZ banks' domestic funding spreads, but this does not appear to be the case. The elevated level of Australian BBSW appears to be a funding issue.

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