Bond market implications from HYEFU – fiscal stimulus inbound?

- The HYEFU is next week. We think the bond programme will be increased given Finance Minister Robertson has signalled a “significant” fiscal package. Moreover, Treasury is almost certain to lower its short-term GDP forecasts.
- With scant details on the proposed fiscal package, it’s difficult to say how much the bond programme might be increased.
- On balance, we think it’s likely that NZDM announces a new bond syndication (probably a 2041). If the current 2019/20 bond programme is increased, we think a new bond syndication is almost certain.
- NZDM will also announce the bond tender schedule for the March quarter. We expect it to retain the 25s, 37s, linker 40s and introduce the 31s to the tender schedule.
- We expect nominals to bear the brunt of any increase in NZGB issuance. We expect linker issuance to be maintained at its current pace, at least over the remainder of the fiscal year.
- Long-end swap spreads have been little moved by the fiscal announcement; we think they should tighten. Fiscal stimulus also argues for wider NZ BEIs, a steeper curve and NZGB underperformance vs offshore markets.

HYEFU takes place next week
The Half-Year Economic and Fiscal Update (HYEFU) is next Wednesday, 11 December. Treasury will update its forecasts and economic assumptions and New Zealand Debt Management (NZDM) will provide an update on the NZGB bond programme. At the Budget in May, the bond programme was set at $10b for this fiscal year. Net issuance of nominal NZGBs was set to be positive in the current fiscal year for the first time since FY 2015/16.

Table 1: NZGB bond programme – from Budget 2019

<table>
<thead>
<tr>
<th>Year-ended 30 June</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross NZGB issuance ($b)</td>
<td>10</td>
<td>10</td>
<td>8</td>
<td>6</td>
</tr>
<tr>
<td>Net NZGB issuance ($b)</td>
<td>3.4</td>
<td>0.2</td>
<td>8</td>
<td>-2.9</td>
</tr>
<tr>
<td>NZGBs on issue ($b)</td>
<td>73.9</td>
<td>74.1</td>
<td>82.1</td>
<td>79.2</td>
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<tr>
<td>NZGBs on issue (%/GDP)</td>
<td>23.3%</td>
<td>22.2%</td>
<td>23.4%</td>
<td>21.6%</td>
</tr>
<tr>
<td>Forecast T-bills on issue ($b)</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: NZDM. Budget 2019

Robertson signals “significant” fiscal stimulus at HYEFU
Over the weekend NZ Finance Minister Grant Robertson signalled a major fiscal stimulus package, focused on infrastructure, in a speech to the Labour Party annual conference. Robertson said “we are currently finalising the specific projects that the package will fund but I can tell you this - it will be significant.” There aren’t many details to go on, although, coincidently, PM Ardern revealed that the government will provide $400m for state schools to upgrade their property, to be spent within two years. Robertson said the details of the fiscal package would be provided at HYEFU.

Some of the questions are:
- The size of the planned stimulus package.
- The extent to which the government will be able to deliver on its infrastructure wish list given tight capacity constraints, especially in construction.
- Whether it is funded on the Core Crown balance sheet (via NZGB issuance) or not. ¹

We had already thought that the risks were skewed towards NZDM increasing the bond programme if Treasury downgraded its GDP (and hence tax revenue) forecasts, just as the RBNZ did at the November MPS (see Chart 1 for a comparison of the RBNZ and Treasury’s nominal GDP projections). Indeed, yesterday Treasury said that GDP growth was likely to fall below its Budget forecasts. Based on Robertson’s comments, and the likelihood that Treasury lowers its short-term GDP forecasts, we think the bond programme will be increased.

With scant details to go on in terms of the fiscal package (besides Robertson’s comments that it would be “significant” and that it would be part of its “short and medium term programme”) and uncertainty around how much, if any, might be funded off the Core Crown balance

¹ For instance, investment in social housing is funded by Housing New Zealand Limited (a subsidiary of Kāinga Ora) in its own name. Housing New Zealand Limited is a Crown entity but its debt does not count towards Core Crown debt. Crown Infrastructure Partners is another example of a government agency that can take on debt without that counting towards Core Crown debt.
sheet, it’s difficult to come up with a precise estimate for the bond programme.

Given Robertson’s reference to the “short and medium term programme” and the lags in implementing infrastructure investment, it seems reasonable to expect an increase to at least the FY 20/21 bond programme and likely the 21/22 fiscal year as well. There have been changes of up to $10b in the forecast bond programme announced previously (Chart 2), with a $5b increase announced at the last Budget. The uncertainty is significant, but the direction of risks is clear.

It’s more difficult to say whether the current 19/20 fiscal year bond programme, which is almost six months through already, is increased or not. The risk is clearly that it is. Historically, there have been changes to the current year bond programme of $1-2b at HYEFU due to economic forecast revisions.

**On balance, we think a long-end syndication is likely to be announced**

If the bond programme for the current fiscal year is increased from the current $10b, we think it’s almost certain that NZDM will announce its intention to syndicate a new NZGB line, likely a 2041 maturity. While it’s not always the case that an increase to the bond programme is the trigger for a HYEFU syndication announcement (2015 being one exception), it certainly makes it more likely, in our view. The alternative would be to increase tender issuance, but with NZDM needing to tender more than $4b over the next six months as it is (which is a relatively high volume of tender issuance for the NZGB market), we see this option as unlikely.

Even if NZDM doesn’t increase the bond programme for the current fiscal year (instead increasing it in subsequent fiscal years), we still think it’s a close call whether NZDM might announce a new syndication. The main reason we see for announcing a new syndication would be to introduce another bond at the long-end of the curve, so that NZDM can soon stop issuing the 2037s. The 2037s already have over $6b outstanding, and at the current pace of issuance (i.e. assuming no increase to the bond programme) will have close to $7b by the end of June (see Chart 3). That would be pretty close to the $8-9b size that NZDM has tended to be cap recent bonds despite the 2037s having almost 18 years until maturity. NZDM will want to tender the bond again periodically in coming years, including when it rolls down to be the on-the-run 10 year.

On balance, we think its likely NZDM announces a new bond syndication at HYEFU. We think the choice of maturity for a new syndicated bond will be long-dated. We think a 2041 is most likely, in keeping with the four year gap between maturities (i.e. the 2037 is four years longer than the 2033). This allows NZDM to “fill in” the gap when it comes time to issue a new 10 year bond (i.e. issuing a 2039 bond in FY 2027/28 or 2028/29). But it’s also possible that NZDM could announce a 2043 or even, potentially, a 30 year maturity.

**We expect an unchanged tender schedule, except for the 31s replacing the 29s**

Separately, NZDM will also announce the bond tender schedule for the March quarter. At present, NZDM is tendering three nominal bonds (the 25s, 29s and 37s) and one inflation-indexed bond (the 40s).

NZDM will likely introduce the recently syndicated 31s into the tender schedule from January, probably at the pace of issuance (i.e. assuming no change to bond programme). NZDM is now targeting issue sizes closer to $10b than the $8-9b that recent issues have been capped at. As such, we expect NZDM to continue tapping the 2033s until the end of June, even though the amount outstanding is close to $8.5b. This would also explain why NZDM has run-up the amount outstanding of the 2037s to $6b when it still has such a long time until maturity. The risk is that NZDM switches from the 25s to the 27s for the March quarter.
At this stage, we don’t expect any adjustment in inflation-indexed issuance volumes (currently $50m per tender).

We expect overall issuance volumes during the quarter will be similar to the last two quarters, with any increase in the current year bond programme largely funded via the new bond syndication. Table 3 gives a sense of how we think the volumes could be split in the March quarter.

**Market implications**

- **Swap-bond spreads:** On the basis that the bond programme is increased, including for the current fiscal year, and NZDM announces a new long-end syndication, we expect NZGBs to cheapen vs swap. We expect the underperformance to be most marked at the long-end of the curve given the flat swap-bond curve and the recent richening in long-end NZGBs (see Chart 4 for the 2037s). In fact, there has been little movement in swap spreads since Robertson’s speech. See our previous note, which discusses why we think the long-end of the NZGB curve is particularly vulnerable at present to a fiscal stimulus.

To get a sense of magnitude, our low frequency ‘fair value’ model implies that each 1% rise in the stock of NZ government securities to GDP causes the 10 year swap-bond spread to tighten by around 8bps over the following 12 months (see Chart 5 for a hypothetical scenario where the stock of debt/GDP is 1% higher than the BEFU projections). The 10 year swap-bond spread is currently trading close to ‘fair value’ on this model, but that doesn’t take account of the prospect of greater issuance than that projected at the Budget.

**NZGB curve:** We expect the NZGB curve to steepen as the market will likely be highly resistant to pricing the risk of RBNZ rate hikes over the next 12-18 months. Any increase in NZGB supply is also likely to be concentrated at the long-end of the curve, which also argues for steepening, at least versus other markets.

**NZGB cross-market spreads:** We think NZGBs can underperform cross-market. We recently proposed a NZGB-UST 2037 spread widening position, in part due to the prospect of fiscal stimulus (see our five reasons why we think NZ-US spreads can widen [here]).

**Breakeven inflation:** We expect no change to linker issuance, with nominal bonds absorbing any increase in net supply, at least over the remainder of the fiscal year. Linkers comprise more than 20% of the stock of NZ government bonds, one of the largest proportions in developed markets, and we doubt NZDM would choose to increase linker issuance if it was going to increase this ratio, at a time when breakeven inflation is well below the RBNZ’s 2% target midpoint. The likely increase in nominal issuance should, all else equal, put some upward pressure on BEIs, although movements in global rates and global BEIs are likely to be the main near-term factors that determine how far NZ BEIs can bounce. At worst, the relative issuance dynamics between nominals and linkers should be less of a headwind for NZ BEIs going forward (see Chart 6).
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