Domestic search for yield driving long-end LGFA tighter

- Long-end LGFA-NZGB spreads have tightened sharply this year.
- The tightening in spreads has accompanied the sharp falls in outright rates and increase in domestic holdings, a sign of search for yield activity.
- If the low rate environment becomes entrenched, domestic investor demand is likely to remain strong and spreads can compress further over time.
- We expect more long-end supply from LGFA and Housing NZ in the year ahead to provide a headwind to spread tightening and would wait for a back-up before initiating spread compression trades.
- We target LGFA-NZGB 2033 tighteners around +90bps.

Sharp move tighter in long-end LGFA spreads

Long-end LGFA-NZGB spreads have compressed sharply this year. The 2033 spread has moved from 124bps at the end of December to just 82bps now, the tightest spread since the bond was issued over two years’ ago. Shorter-dated LGFA has also tightened, but by notably less than the long-end (see Chart 1). We outline some of the drivers and our view on the outlook for spreads in this note.

1. NZGB underperformance on higher supply

Part of the LGFA-NZGB spread tightening story, especially at the longer-end of the curve, reflects underperformance of NZGBs. The NZGB underperformance has been particularly notable since NZDM announced a surprise $2b increase to its bond programme at the Budget in May. Breaking down the interpolated 10 year LGFA-NZGB spread into its two components (the LGFA-to-swap spread and the swap-NZGB spread) shows that swap spread narrowing has been responsible for around 2/3 of the tightening move this year (see Chart 2).

2. Evidence of domestic search for yield activity

The spread tightening in long-end LGFA has been mirrored by similar moves in other high-grade issuers, including SSAs and Housing New Zealand, and has accompanied the broader rally in rates this year (see Chart 3).

Furthermore, the spread tightening has coincided with a sharp increase in domestic holdings of the two longest-dated LGFA bonds, the 2027s and the 2033s (see Chart 4). We think this is a sign that search for yield activity from domestic investors has been, at least partially, responsible for the spread tightening, with the low-for-long narrative becoming further entrenched in the market.
Investors can increase their running yield more than 50% switching out of NZGB 2033s into the LGFA equivalents which, in a low yield environment, should be expected to attract increased demand, at least from domestic investors. There is also relatively little competition at the long-end of the NZ spread curve from issuers besides Housing NZ, meaning that demand for long-end spreads is funnelled into a relatively small subset of names. While the low outright level of rates persists, we expect domestic demand for long-end LGFA to remain strong and help contain the top-side in spreads. We are encouraged that offshore holdings of long-end LGFA (the 27s and 33s) have continued to increase, albeit modestly, despite the falls in NZ rates (both outright and relative to other markets).

**3. Broader strength in credit markets**

This year has been a strong one for credit markets, with credit spreads tightening globally amid the shift towards monetary policy easing among central banks and the sharp fall in government bond yields, to record low levels in some cases (including NZ). While LGFA, being towards the stronger-end of the credit spectrum, has shown an inconsistent relationship with global credit market moves in the past, the broader backdrop this year has certainly helped reinforce the spread tightening domestically. Other NZ spreads sectors have also performed well, especially NZ senior bank debt, which has tightened aggressively.

4. **Modest Kauri issuance year-to-date**

SSA issuance has been very modest this year, with only $2.45b issued year-to-date, near the lowest run-rate since 2013, and well below average levels (see Chart 7). Issuance from Housing New Zealand, a relatively recent entrant to the high grade market, has helped fill the void somewhat. Even so, the lower-than-average level of high-grade (non-government) supply has allowed LGFA to issue $1.6b in the six months to June—a record pace for the issuer—while spreads have moved tighter.

Looking ahead, there is the potential for a pick-up in Kauri supply, with NZO issuance now looking relatively more cost-effective to issuers than it has done for much of the year (indeed, IFC printed a $600m new issue last month). Additionally, Housing NZ, which has already syndicated a $500m bond this year, has said it expects to issue around $1.5b per year, with some of that issuance likely to be long-dated. So the broader high-grade supply outlook is probably going to be less supportive of further LGFA tightening than the past six months.

**Long-end LGFA supply to keep coming**

LGFA issued a record $2.4b of bonds in the year-ended June 2019, including its inaugural syndication of the 2024 maturity bond. LGFA forecasts lower supply this year, at $1.64b gross and $660m net (see Chart 8), although there...
is the risk that the funding requirement is ultimately revised higher, as was the case last year, if council borrowing demands exceeds forecasts.

With most of LGFA’s existing bond lines close to the $1.5b ‘soft cap’, there are only three bonds at present with significant capacity to tender into: the 2022s, 2024s and 2033s (see Chart 9). Until LGFA introduces a new bond, regular tender supply of the LGFA 2033s will continue (recent tenders have seen $50m of the 2033s offered). Moreover, with only ‘gap’ remaining on the LGFA curve until the 2027 maturity, the next bond is probably going to be a longer-maturity, rather than a mid-curve issue.

We think this regular supply of long-end LGFA should provide a headwind for further long-end spread tightening, although if the search for yield remains strong it seems more likely to slow, rather than prevent, tightening. The current rate of 2033 LGFA tender issuance, if maintained over the coming months, will be close to its fastest pace since the bond was first introduced in 2017 (see Chart 10).

Still value in long-end LGFA, but waiting for a back-up

We highlighted our constructive medium-term view on long-end LGFA back in March. While spreads have tightened aggressively since then, we think the value case still holds. LGFA-NZGB spreads are still wide relatively wide compared to SSA and other high-grade domestic issuers in other major markets.

While the carry and roll isn’t as high as for shorter-dated LGFA-NZGB spreads (0.9bps per month on the 2033s vs. 1.5bps on the 2024s), the advantage of long-end LGFA-NZGB spread tighteners is that they allow investors to lock in those spreads for an extended period. Our bias is still to target spread compression on the 2033s although, given the pace of the recent moves and the consistent supply on the horizon, we look for a move towards 90bps before initiating the position.

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