

17 July 2018



Trade Idea: Buy LGFA 2023 vs. NZGB 2023

- **Intermediate maturity LGFA bonds have underperformed NZGBs the past two months. The constant maturity 5y spread is towards the upper end of its trading range for the past 12 months.**
- **Notwithstanding some growing headwinds to spread markets offshore, we remain constructive on LGFA given the relatively attractive yield pick-up to NZGBs, modest net supply requirements and what we expect will be continued strong investor demand.**
- **Last Friday, S&P reaffirmed LGFA's AA+ local currency, long-term credit rating. The removes a potential source of uncertainty for the product.**
- **Mid-curve LGFA bonds have underperformed the short-end notably, and the 3s5s LGFA-NZGB box and LGFA ASW curve are historically steep. The 2022s and 2023s offer the highest carry and roll down on the curve and we expect some investors to extend out of shorter-dated LGFA bonds in time.**
- **We enter a spread tightener between LGFA 2023s and NZGB 2023s targeting 20bps all-in profit (including carry) with a stop-loss at 80bps. Were the stop to be reached it would represent new wides for the constant maturity 5 year LGFA-NZGB spread.**

Strategy	Entry	Target	Stop	Carry and roll (1m)
2023 LGFA-NZGB tightener	68bps	20bps all-in profit	80bps	2.3bps

Mid-curve LGFA-NZGB spread widening

Intermediate maturity LGFA-NZGB spreads have widened over the past two months. The constant maturity 5 year LGFA-NZGB spread reached the widest levels since early 2017 last week, although it has since retraced some of that move – see chart 1.

The recent move wider in 5y LGFA-NZGB spreads has been partly due to some mild widening in LGFA asset swap spreads, as shown by the grey area in Chart 2, as well as some widening of mid-curve swap spreads recently (the 2023s are now the richest bond on the NZGB ASW curve).

We remain positive on LGFA bonds in light of the relatively wide yield pick-up to NZGBs, modest net issuance requirement (\$80m for FY19), and what we expect to be continued strong investor demand for the product. While there are some growing headwinds to spread markets offshore (Fed tightening and balance sheet reduction, the risk of trade war escalation and corresponding weakness in risk assets, reduced demand for US corporate bonds from large multi-nationals after the recent US tax reform), we

Chart 1: 5y LGFA-NZGB spreads near 12 month wides

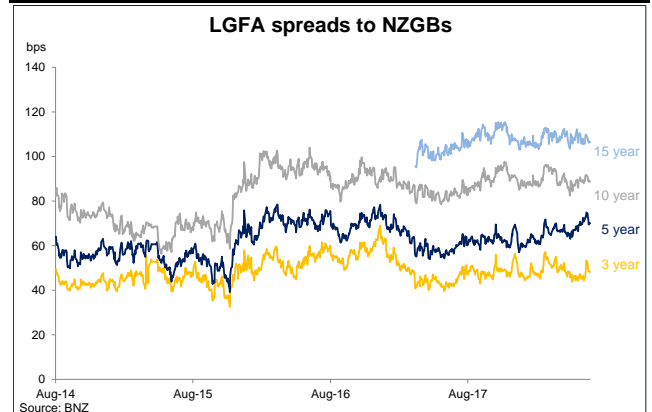


Chart 2: 5y LGFA-NZGB spread breakdown

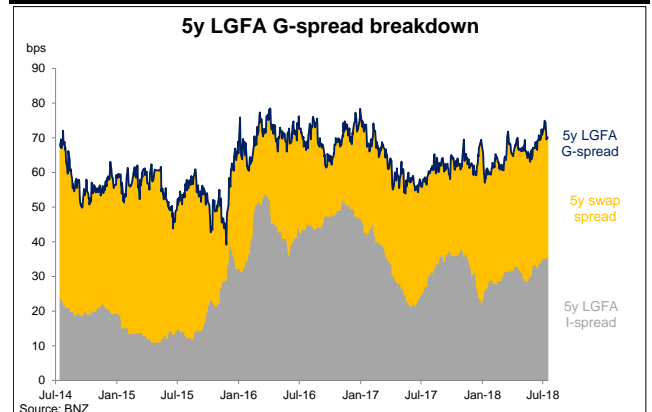
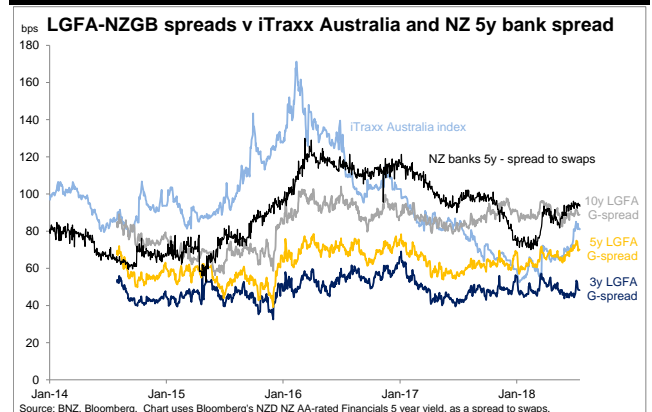


Chart 3: LGFA-NZGB spreads vs. iTraxx Australia



expect LGFA, which is towards the top tier of the credit spectrum, to be reasonably well insulated from any prospective global market volatility. We note that there was next to no impact on spreads from volatility around Italian politics or from the stock market sell-off earlier this year.

On Friday, S&P reaffirmed LGFA's AA+ local currency, long-term credit rating (which is equalised to that of the NZ government). S&P's decision removes a source of uncertainty over the issuer and is supportive of the product, in our view, although there has been little market reaction to the announcement.

LGFA 2022s and 2023s look cheap on the curve to us

Mid-curve LGFA-NZGB spreads have widened over the past month, as shown in Chart 4 on the right, and this part of the curve stands out as cheap to us on a number of metrics. For instance, the 2021-2023 LGFA-NZGB box is at extreme levels, as shown in Chart 5, while the 2021-2023 LGFA ASW box is also near record wides. The 2023s are also cheap relative to the IBRD curve (see Annex). Similarly, the 2022s have cheapened up recently against shorter-dated bonds.

Supply may be one possible explanation for the cheapness of mid curve bonds, given LGFA has been tendering 22s and 25s over the past three months. But given the steep slopes of the ASW and G-spread curves we expect some investors to eventually extend from shorter maturities into mid curve bonds (the 2022s and 2023s offer the highest carry and roll-down on the LGFA curve). We also note that, unlike NZGBs, 5 year LGFA looks relatively more attractive on a hedged basis to foreign investors (see Table 1 in the Annex) which should help support demand from offshore.

With the constant maturity 5 year LGFA-NZGB still within proximity to multi-year wides and the uncertainty around LGFA's rating having been resolved, we choose to enter a spread tightening trade in the 2023s at current levels. We expect the '23s to roll down the curve and see the carry as attractive, particularly in light of the relatively low volatility of the product (the 2023 LGFA-NZGB spread offers close to 2.5bps carry and roll per month versus a 15bp trading range over the past 12 months). A good alternative would be to buy the 2022s, which we also view as cheap, in the tender tomorrow (\$30m is being offered by LGFA).

The 2023s LGFA-NZGB spread is around 69bps (mid-market) and we enter the position at 68bps. We see 10-15bps spread tightening potential and, combined with carry, we target a total return of 20bps. We set a stop-loss at 80bps, which would represent new wides (post 2014) for the constant maturity 5 year LGFA-NZGB spread.

One risk to the position is that weakness in global risk assets, potentially related to an escalation in US-China trade tensions, leads to wider LGFA ASW spreads while NZGBs

Chart 4: 2023 LGFA-NZGB spread has widened recently

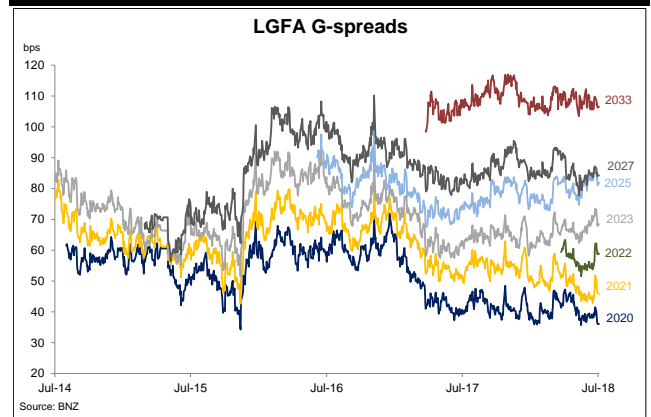


Chart 5: The 21s23s LGFA-NZGB box is stretched

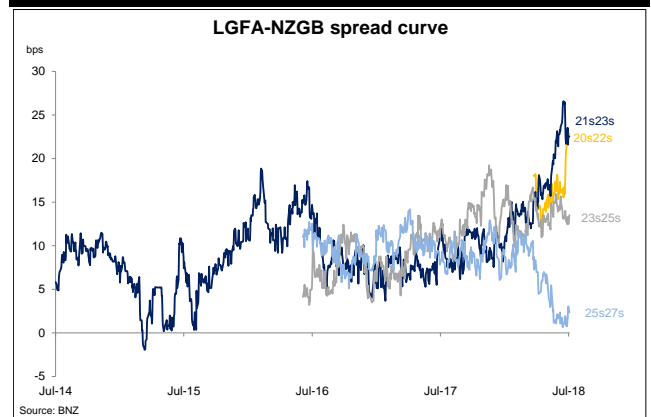
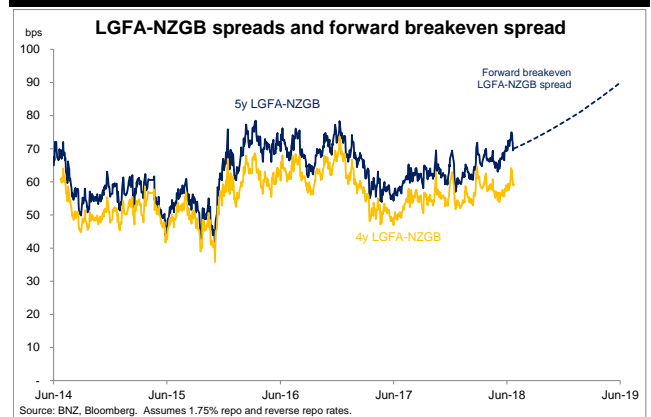


Chart 6: Forward breakeven 5y LGFA-NZGB spread



remain rich to swaps amidst negative net issuance of NZGBs and T-bills. We can't rule out spreads widening further from here, but we see mid-curve LGFA as notably cheap and hope that provides at least some protection against such a scenario. At present, we think the risk-reward favours tighteners.

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Chart Annex:

Chart 1: LGFA historical ASW spreads



Chart 4: LGFA and IBRD ASW curves – 2023s are cheap

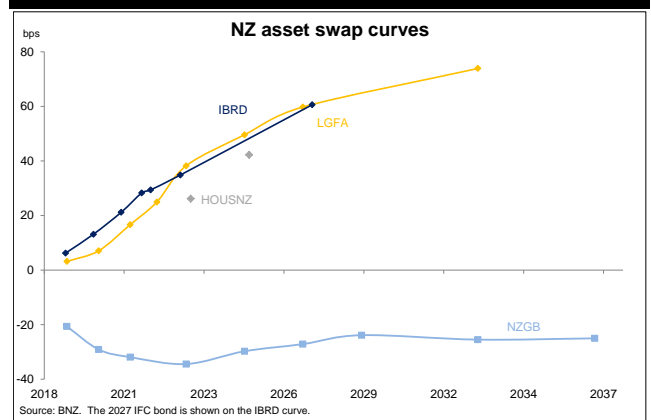


Chart 2: 21s23s LGFA ASW box is stretched

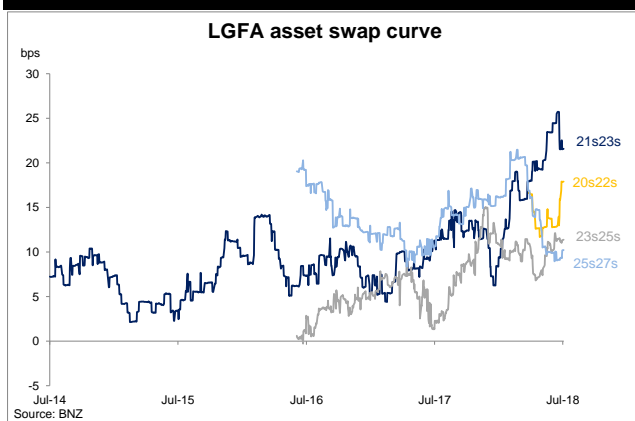


Chart 5: LGFA holdings by bond and investor type

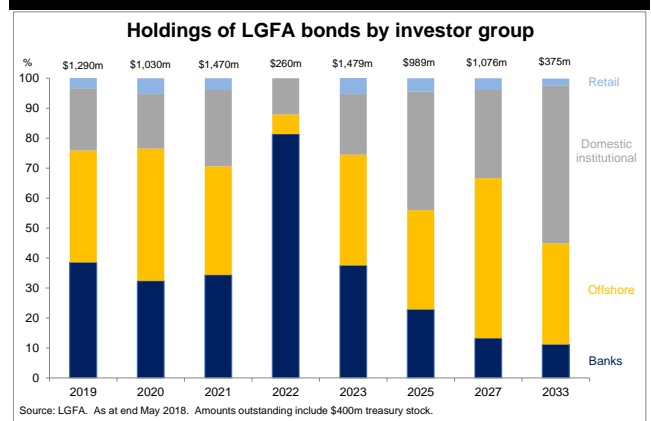


Chart 3: Carry and roll highest on mid-curve LGFA bonds

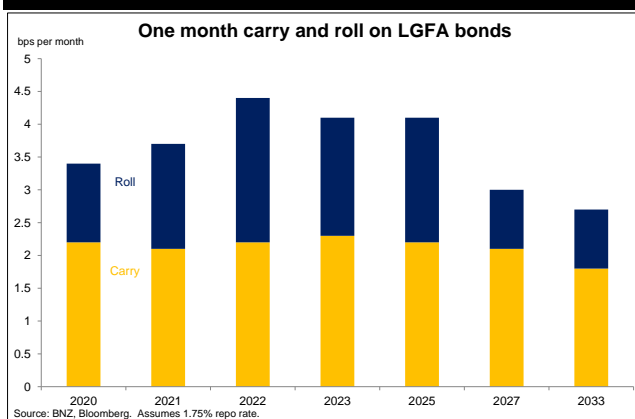


Table 1: Hedged yields for Japanese investors

5 year maturity	Local currency yield	Synthetic Japanese yield
Japan Govt bond	-0.11	-0.11
CAD BRCOL	2.38	0.46
USD ASIA	2.92	0.44
NZD ASIA	2.85	0.34
NZLGFA 2023	2.84	0.34
GBP EIB	1.25	0.31
US Treasury	2.75	0.28
Sweden govt bond	-0.11	0.15
Canada govt bond	2.05	0.14
AUD ASIA	2.67	0.13
UKT	1.03	0.09
EUR EIB	-0.13	0.08
France govt bond	-0.16	0.06
Germany govt bond	-0.31	-0.09
Australia govt bond	2.28	-0.27
NZGB	2.15	-0.35
10 year France	0.45	0.67

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