24 January 2019

NZ Breakevens – Reiterating The Value Case After NZ CPI

- **NZ breakevens reached multi-year lows earlier this year. The 10 year breakeven reached 1%.**
- **In contrast to the move in breakevens, NZ core inflation measures are trending higher amidst an extremely tight labour market and broader upward pressure on costs.**
- **On our valuation framework, NZ breakevens are the cheapest they have been over the past seven years.**
- **The RBNZ has suggested that core inflation needs to be at least 2% before considering rate hikes. But breakevens don't reflect the RBNZ ever meeting its inflation target, let alone exceeding it.**
- **A breakeven widener is a way of opposing the recent rally in rates, but one that has positive carry.**
- **If the global growth outlook deteriorates significantly, then NZ breakevens will probably fall further. But there is already a lot of bad news priced.**
- **Continued supply of NZ linkers is a headwind to performance. Even so, at current valuations, NZ BEIs are approaching levels that are extremely difficult to justify on a fundamental basis, in our view. Breakeven wideners present an outstanding risk-reward opportunity for investors with a medium-term outlook.**

NZ breakevens make multi-year lows

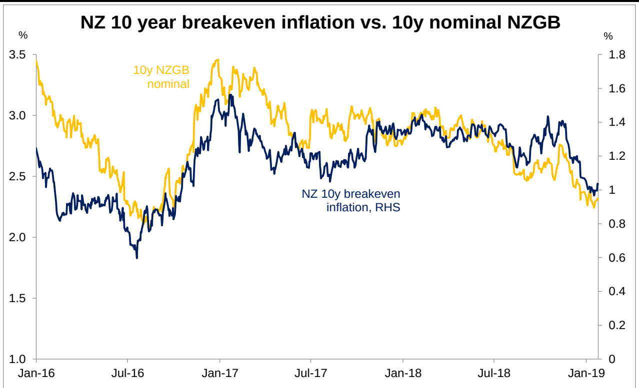
NZ breakevens (BEIs) reached multi-year lows earlier this year, with the 10 year NZ BEI hitting 1%. The narrowing in NZ BEIs has occurred amidst the rally in nominal bond yields over the past few months. BEIs remain highly directional with broader moves in rates (see Chart 1).

Global forces have been the main driver of the moves in NZ BEIs. Similar moves have been seen offshore, with US and Australian BEIs moving sharply lower over recent months (see chart). The deterioration in the global growth outlook (including increased speculation of a US recession), heightened risk aversion in global markets, the rally in global rates and fall in oil prices have all contributed to breakevens falling.

NZ domestic inflationary pressures rising

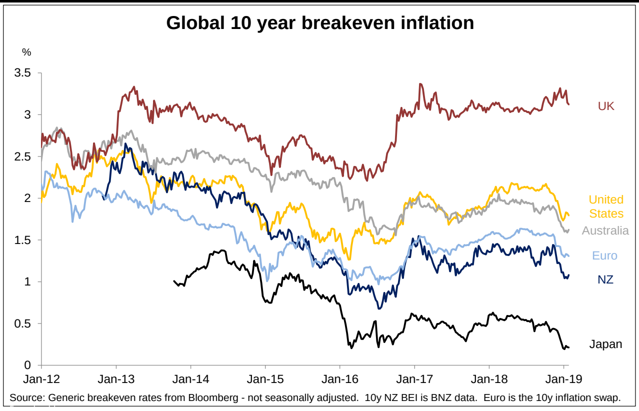
In contrast to the moves in NZ BEIs, domestic inflationary pressures have continued to rise amidst extreme tightness in the labour market and broader cost pressures facing NZ businesses. Yesterday's NZ CPI release showed that non-tradables (i.e. domestic) inflation rose to 2.7% year-on-year, its highest level since 2014. Non-tradables inflation tends to be a more persistent component of headline CPI than tradables inflation.

Chart 1: NZ BEIs reach lowest levels since 2016



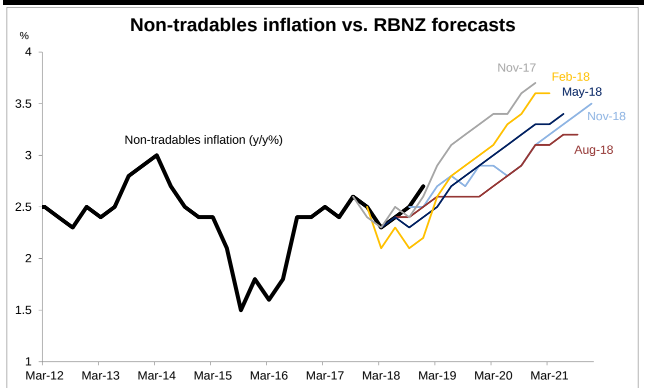
Source: BNZ, Bloomberg. Bond yield and breakeven linearly interpolated.

Chart 2: Global BEIs have fallen over the last few months



Source: Generic breakeven rates from Bloomberg - not seasonally adjusted. 10y NZ BEI is BNZ data. Euro is the 10y inflation swap.

Chart 3: Non-tradables CPI has exceeded RBNZ forecasts



Source: RBNZ, Bloomberg

Chart 3 shows that non-tradables inflation has surprised the RBNZ to the upside over the past five quarters (after years of the reverse), underlining that domestic inflation pressures are finally increasing faster than expected.

The various core measures of inflation mostly moved higher as well. CPI ex-food and energy increased to 1.5% while the trimmed mean and weighted median measures are now at or above 2% (see Chart 4). The RBNZ's Sectoral Factor Model of core inflation was unchanged at 1.7%, but it has been gradually trending higher over the past 18 months. The broader picture is one in which underlying inflation pressures in NZ appear to be rising, and we think this is likely to continue given the stretched labour market and the forthcoming increases to the NZ minimum wage (which increases another 7% in April).

NZ BEI valuations look even more compelling post CPI

Our valuation framework for BEIs is to compare them to core inflation. The logic being that the current level of core inflation provides a conservative estimate of what headline inflation might be in the future. It assumes that all the various transitory influences on inflation (like oil prices and FX-related moves) will net to zero in the future and that there is no increase in underlying inflation pressures (unlike the models of economists and central banks that build in a gravitational pull to the inflation target). We think this is a reasonably conservative framework.

At present, NZ BEIs are significantly below all measures of NZ core inflation (see Chart 5). In fact, the gap between core inflation and BEIs is the most negative it has been since linkers were reintroduced in NZ in 2012 (see Chart 6, which shows the difference between the 10y BEI and various core inflation measures). On this framework, NZ BEIs are not just cheap, but they are the cheapest they have been over the past seven years.

On a cross-country comparison, NZ BEIs stand-out as relatively cheap on this valuation framework (see Table 1). The 10y NZ BEI is around 45bps below CPI ex-food and energy and around 90bps below the average of the Stats NZ measures of core inflation. NZ BEIs are far more favourable on this basis than Australian, Swedish, European or Japanese BEIs. The only countries that come close are the US and Canada (depending on which core CPI metric one focuses on), although the Fed and BoC have been raising rates over the past few years, in contrast to the RBNZ.

Dovish RBNZ should be supportive of NZ BEIs

Despite the tightening labour market and increase in underlying inflation pressures, the RBNZ has retained a resolutely dovish stance over the past year. In fact, at the last MPS in November, the RBNZ forecast that CPI would *exceed* the mid-point of the 1-3% target range at the end of its forecast horizon, in 2021 (see Chart 7). Typically, central banks would adjust the policy rate track such that inflation would be at target at the end of its forecast period. That the RBNZ chose not to do so suggests that it may have tolerance for inflation to spend some time in the upper-half of the target inflation band. But NZ BEIs don't price anywhere close to the RBNZ even reaching the 2% mid-point, let alone exceeding it. And if NZ inflation really did average 1% over the next 10 years, as implied by BEIs, the RBNZ would almost certainly be cutting rates.

Chart 4: NZ core inflation measures trending higher

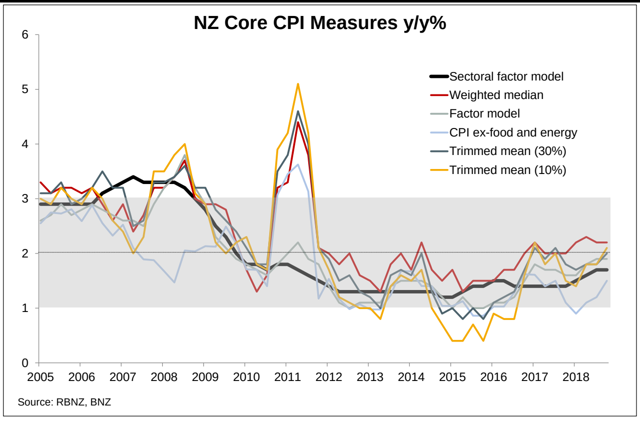


Chart 5: NZ breakevens vs. NZ core inflation measures

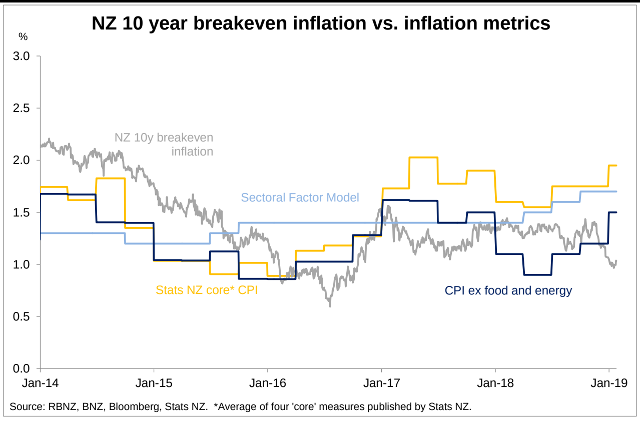


Chart 6: NZ BEIs are significantly below all core measures

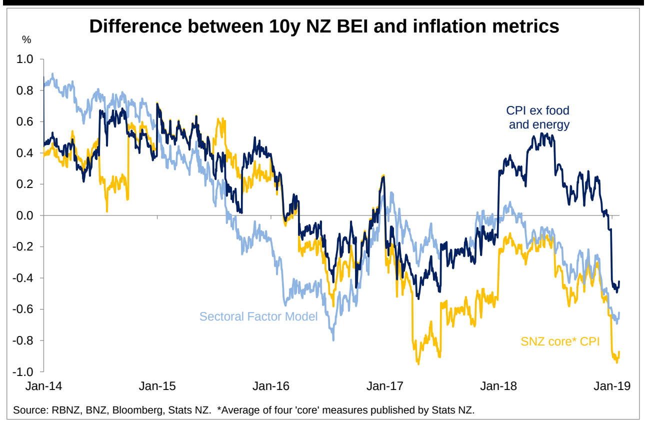


Table 1: Cross country comparison of BEIs vs. core metrics

Global BEIs vs. inflation metrics

	10y BEI rate***	CPI ex-food and energy	Alternative core**	Headline CPI	CB target
New Zealand	1.04	1.5	1.95	1.9	2.0
Australia	1.67	1.3	1.75	1.9	2.5
Canada	1.42	2.3	1.87	2.0	2.0
Sweden	1.85	1.3	1.50	2.0	2.0
USA	1.79	2.2	2.48	1.9	2.2
Eurozone*	1.31	1.0		1.6	1.9
Japan	0.23	0.1		0.3	2.0

* the euro 10y inflation swap rate is shown. CPI ex food, energy, alcohol and tobacco shown.
** Average of 4 Stats NZ measures for NZ. Average of WM and TM for Australia. Average of 3 BoC measures for Canada. CPIF-ex energy for Sweden. Cleveland Fed 16% trimmed mean, median CPI and Atlanta Fed sticky CPI for the US.
*** Not seasonally adjusted

Linker supply is the headwind to performance

One of the reasons that NZ BEIs are so far below core inflation and the RBNZ's target mid-point is the continued net supply of the product. Net supply of linkers by New Zealand Debt Management (NZDM) this fiscal year (i.e. by the end of June) is forecast to be around $1b. In contrast, the net supply of nominals this fiscal year is forecast to be around -$4.2b.

Linkers make up over 20% of the total government bond market in NZ, which is very high by international standards (see Chart 8). The only country with a comparable proportion of linkers outstanding is the UK, which has a large pool of defined benefit pension fund buyers. In addition, the proportion of linkers in the NZ government bond market is set to grow further in coming years, unless NZDM reduces linker issuance in the future.

On that front, we think it is possible that NZDM might decide to reduce linker issuance at some point. NZDM has said it is committed to linkers being around 20% of its total portfolio over time, but without this being a strict target. The Budget in May would be a natural window when NZDM could announce any change to linker issuance, although that is still some time away and, even then, there is no guarantee that it happens.

Conclusion

The continued net supply of linkers is a headwind for BEI performance. It explains why NZ BEIs are below the 2% target mid-point. Even so, valuations now are so stretched that we think the risk-reward is extremely attractive for investors with a medium-term horizon.

Carry is positive on BEI wideners (by between ~2bps per month on the 2025s to ~0.5bps on the 2040s until the March linker coupons). Given the positive correlation with broader rate market moves, a BEI widener is one way to express a higher rates view in the NZ market without the negative carry that an outright paid position in swaps or short position in bonds would entail.

The main risk is that the global outlook deteriorates further, and the market prices a high chance of a US recession. In such an environment, rates will rally globally, oil prices will likely fall, and market expectations of inflation globally are likely to fall significantly. That said, we think there is already a significant amount of 'bad news' in the price already, with NZ BEIs not far from 1%. We also note that the NZD has tended to fall during prior US recessions (see Chart 9), and consequently NZ tradables inflation has actually tended to increase, at least in the short-term, due to the falling currency. While we'd still expect NZ BEIs to fall in such a scenario, this might provide at least some offset for NZ inflation.

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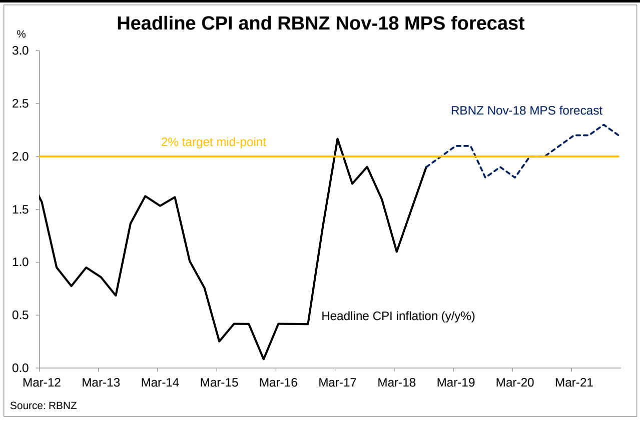
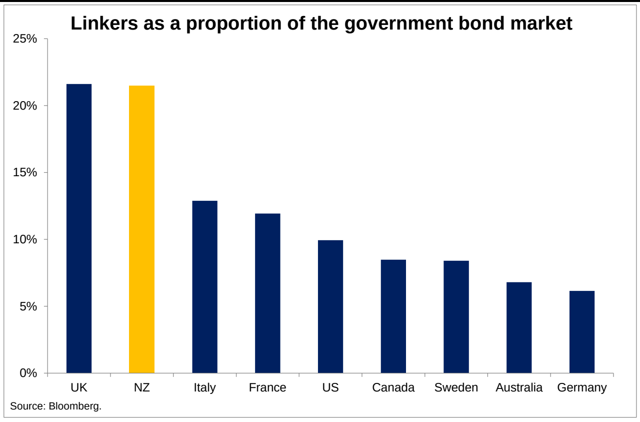
Chart 7: The RBNZ forecast a CPI overshoot in November



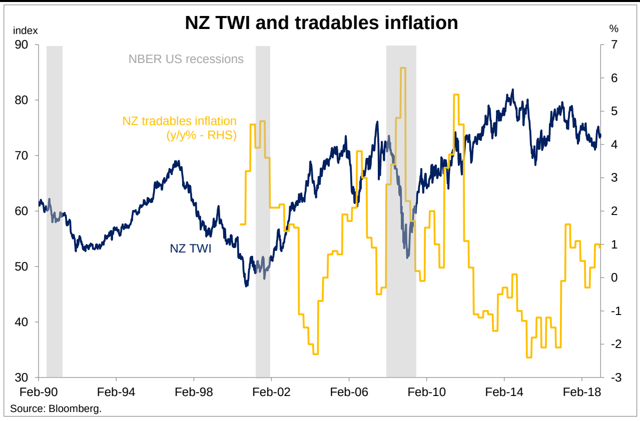
Source: RBNZ

Chart 8: Linkers are a relatively high share of NZGB market



Source: Bloomberg.

Chart 9: The NZD has fallen during prior US recessions



Source: Bloomberg.

Table 2: NZ linker real yields, BEIs and BEI carry

Linker	Real yield	Maturity-matched BEI	Carry on BEI (bps/month)
20-Sep-25	1.045%	0.97%	2.1
20-Sep-30	1.335%	1.07%	1.2
20-Sep-35	1.500%	1.12%	0.8
20-Sep-40	1.625%	1.22%	0.6

* Carry is until the March 20th coupon date, assumes 1.75% repo on NZGB short

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