Five reasons why NZ-US spreads can widen from here

• We think the multi-year NZ-US spread tightening is over. We outline five reasons why we think the risks are skewed towards wideners.
• Our base case is now that the RBNZ is on hold for the foreseeable future. But in the event that downside global events cause the RBNZ to resume its easing cycle, the Fed has more room to cut. This gives NZ-US wideners a positive skew in the medium-term.
• The RBNZ will announce its bank capital review on December 5th. We think the market is vulnerable to a possible softening of the proposals.
• NZ services and manufacturing PMIs suggest that NZ business confidence may have bottomed.
• We continue to see the risk of additional fiscal stimulus in NZ next year. This would reduce the risk of further OCR cuts and put supply-driven upward pressure on bond yields and NZ-US spreads.
• Longer-term NZ-US valuations are stretched on multiple measures we monitor.
• So our medium-term bias is for 10yr NZ-US wideners.

NZ-US spreads sideways in 2019, near all-time lows

NZ and US rates have experienced a major rally in 2019 but, through that all, the 10 year NZ-US spread has been relatively stable (Chart 1). The 10yr spread has broadly tracked expectations the OCR-Fed funds rate differential, which have mostly hovered between -50bps to -75bps.

The sideways price action in the NZ-US 10 year spread this year follows a multi-year tightening phase that started in 2014, as the market anticipated the end of the RBNZ tightening cycle and the commencement of its eventual easing cycle, and continued through the duration of the Fed’s tightening cycle from 2015-2018. We think this spread tightening phase has run its course. In this note we outline five reasons why we think the spread has seen has its lows and the risks are now skewed towards wideners.

1. Monetary policy outlook no longer favours tighteners and the Fed has more room to cut

The RBNZ surprised the market again at the November MPS by keeping the OCR on-hold at 1%. Importantly, the RBNZ significantly reduced its trend growth estimates. Previously, the RBNZ had forecast that growth would need to reach 3% in 2020 to get inflation to target. It has now lowered the hurdle rate for GDP growth to 2.2% - 2.5%. We view the RBNZ’s new growth forecasts as much more achievable and now see the RBNZ on-hold for the foreseeable future. The balance of risks around the next move by the RBNZ, at least over the next 12-18 months, is still heavily skewed towards cuts. But the hurdle for downside growth surprises to trigger OCR cuts appears to have been raised materially.

While the Fed has also signalled a pause, the risk of further spread tightening due to additional RBNZ rate cuts now looks much reduced.

The market prices only a modest amount of convergence between the RBNZ and Fed cash rates over the coming 18 months. The current spread between the OCR and the Fed’s IOER is 55bps. The market expects the cash rate differential to narrow to 35bps by the end of 2021 (see Chart 3), less than a single 25bp rate move.

We think the risks are towards the market pricing greater cash rate convergence. This can take place either of two ways – the market pricing in more rate hikes for the RBNZ than the Fed, or the market pricing-in more rate cuts for the Fed than the RBNZ.
The latter scenario is more obvious: the Fed has a higher policy rate and therefore more room to cut its cash rate. Were global growth to deteriorate or US recession risk to rise, the Fed has more room to cut (at least conventionally) and US rates have further to fall than NZ. Of course, a global central bank easing scenario looks less likely now, given the recent improvement in US-China trade relations. But over the medium-term, the fact remains that the US has more room to cut its cash rate and this suggests that NZ-US spreads should have a positive skew.

Would the market price more tightening for the RBNZ than the Fed? In general, we think the market is going to be reluctant to price hikes for either central bank anytime soon. Chair Powell made clear at the last press conference that the hurdle for Fed hikes is very high while the RBNZ has said that a “prolonged period” of low rates is likely. That said, the RBNZ is arguably further ‘ahead of the curve’ than the Fed, with the OCR seen to be further from neutral than the Fed funds rate (see Chart 4). So we don’t think it’s unreasonable to think the market might contemplate an earlier normalisation of rates by the RBNZ, especially if fiscal stimulus were to happen next year, the housing market to gain momentum and NZ business confidence to rebound, as suggested by the PMI and PSI surveys.

2. NZ services and manufacturing PMI surveys suggest that business confidence may have bottomed.

The NZ manufacturing PMI and services equivalent (the PSI) have improved notably over the past few months, suggesting that the activity indicators of the (more closely-followed) NZ business surveys are due for a rebound. The PMI/PSI differential between the NZ and US has increased significantly, to an above-average level based on the past seven years (see Chart 6). While the NZ PMI and PSI can be volatile month to month, they point to an improvement in the cyclical position of the NZ economy relative to the US. If NZ business surveys were to improve, as the PSI/PMI suggest might happen, it would weaken the case for further RBNZ rate cuts (at least for domestic reasons; it would be a different story if global concerns were to build, although in such an environment, we might expect the Fed to cut rates as well).

3. Maybe the bank capital review won’t be that bad?

The RBNZ releases the final outcome from its long-awaited review of bank capital requirements next week, on the 5th of December. The RBNZ’s initial proposal, outlined at the of 2018, was that the minimum Tier 1 capital requirements for the large (‘Big 4’) NZ banks would increase from 8.5% to 16% over a five year implementation period. Almost all of the increase in capital would need to be raised via common equity or retained earnings, the most costly form of capital (the RBNZ had previously made an in-principle decision not to recognise CoCos as eligible AT1 securities).

As proposed, this would increase the costs to banks to extend credit to the real economy. It would likely lead to higher lending rates for the real economy (independent of the OCR) and/or a lower supply of credit, especially to capital-intensive sectors of the economy such as agriculture and SMEs. As we outlined in our preliminary thoughts, if the proposed changes were to drive a bigger wedge between the OCR and real economy lending rates, the implication is that the neutral OCR would be lower. The RBNZ estimates that lending rates could be raised 20-40bps relative to the OCR as a result of the proposal.

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We see signs that the market has priced a lower medium- to-long run trajectory for the OCR as a result of the bank capital review. Chart 6 shows a scatter plot of the NZ-US 10 year spread in swaps and year-ahead RBNZ-Fed rate expectations. There appears to have been a level-shift in the relationship in December, which corresponds to the timing of the initial RBNZ proposal. i.e. for a given level of the expected RBNZ-Fed cash rate differential the 10 year spread is now lower than implied by the 2016-18 relationship (a similar downward shift is evident when looking at the 5y5s spread and versus other countries). Such a shift would be consistent with the market pricing a lower neutral rate for NZ relative to other countries.

Chart 6: The market prices modest RBNZ-Fed convergence

We don’t have a strong view as to the outcome of the bank capital review although the change in relationship above suggests to us that the market would be vulnerable to a material softening in the proposal. We note that BNZ’s CFO earlier this month said he anticipated changes to the proposal and was hopeful the implementation period could be extended to “anywhere from seven to 10 years” and there was “probably a softening on that stance” on AT1 eligibility. If such changes were realised, we think this would argue for NZ-US spread widening.

4. Potential for fiscal stimulus in NZ next year

In a recent note we highlighted the potential for fiscal stimulus in NZ next year. To be clear, the government hasn’t yet given any indication that it is considering additional stimulus and it remains publicly committed to its self-imposed target of reducing net debt to 20% of GDP within five years of taking office. However, with the opposition National party signalling that it would no longer target a reduction in net debt, we doubt next year’s general election will be fought on the basis of which major party is the most fiscally prudent. Arguably, National’s change in stance means Labour has less political capital to lose if it were to move away from its self-imposed 20% debt target and towards a more flexible approach to fiscal management.²

The possibility of additional fiscal stimulus is a medium-term risk for NZ rates as we think it would most likely be announced at the Budget in May next year (although market expectations may build in advance if the government were to foreshadow its plans beforehand). If it were to eventuate, we would see this as a catalyst for NZ-US spread widening:

- It would reduce the risk of further OCR cuts. The RBNZ’s current forecasts are based off official government policy to date, so any additional stimulus would need to be factored into the RBNZ’s economic outlook.
- The resulting increase in NZGB net supply should put upward pressure on longer-term rates on a cross-market basis. This would incentivise foreign investors to purchase more NZGBs and help absorb the increase in net issuance.³

While the US has the bigger fiscal deficit, the change in relative net issuance has been less favourable for NZ this year (see Chart 7). Fiscal stimulus, if it were to eventuate in NZ, would help even up the scales on relative net issuance between NZ and the US.

Chart 7: Increase in NZGB net supply FY 20, in contrast to US

5. Longer-term NZ-US valuations already stretched

We see longer-term NZ-US valuations as stretched. First, our long-run model of the NZ-US 10 year spread, based on the 2y3m and cash rate differentials, implies the spread is more than one standard deviation below ‘fair value’ (see Chart 8). In effect, expectations of the year-ahead RBNZ-Fed cash rate differential have increased around 80bps from the lows reached in October last year while there has been little movement in the 10yr spread (see Chart 9). The deviation from the model is one of the largest seen since 2000.

² The government has already made a move in this direction, changing its net core Crown debt target beyond FY21/22 to a range of 15%-25%.

³ See our previous note on the topic, Limits to falling NZGB yields – a supply and demand analysis, Foreign investors have been reducing NZGB holdings over the past three years as NZ yields have compressed to offshore. This would need to change if there was a large increase in net supply.
We also view the 5y5y spread as an indicator of market pricing of RBNZ-Fed neutral rate expectations (5y5y representing ‘beyond the current cycle’ interest rate expectations). We use this as another barometer of NZ-US long-end valuations. The 5y5y spread is currently just below zero, and within proximity of its record lows. Intuitively, we think the market should price a higher RBNZ neutral rate given NZ has, at least historically, maintained a higher nominal growth rate than the US (see Chart 10). And NZ also has significant fiscal capacity in reserve, which should be positive for longer-run neutral rate expectations. The fact the 5y5y NZ-US spread is negative, albeit only marginally, is another indication to us that long-end NZ-US valuations are stretched.

**So what could go wrong?**

Following the hawkish surprise from the RBNZ at the November MPS, NZ-US spreads are towards the top of their trading ranges for 2019 as the market has scaled back its OCR rate cut expectations significantly. While we think there are more reasons why the spread will widen ahead, with the announcement of the bank capital review and potential upside risks to NZ business surveys as possible near-term catalysts, we would ideally prefer an entry level of around -30bps on the 10 year spread in swaps (where we would set a stop below the all-time lows of -40bps).
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