

16 August 2018



NZ Linkers Post-RBNZ: Better Fundamentals And Very Cheap

- **NZ linkers have significantly underperformed nominal bonds over the past month, resulting in a sharp narrowing in NZ breakevens.**
- **In our view, the fundamental case for owning NZ linkers, either on breakeven or outright, has improved over this time. NZ core and headline CPI inflation have increased, the NZD has fallen and the RBNZ has signalled that it may tolerate above-target inflation.**
- **We think the recent tightening of NZ breakevens reflects both the broader NZ rates rally, in which linkers have lagged, and idiosyncratic factors in both nominal NZGBs and linkers.**
- **The recent cheapening has created an excellent opportunity to buy NZ linkers, in our opinion. We expect the idiosyncratic factors to eventually normalise and for the market to ultimately re-price to the fundamentals. We have lowered the stop-loss on our NZGBi35/NZGB37 trade to 100bps.**
- **We highlight the large fall in NZ breakevens compared to other major markets.**

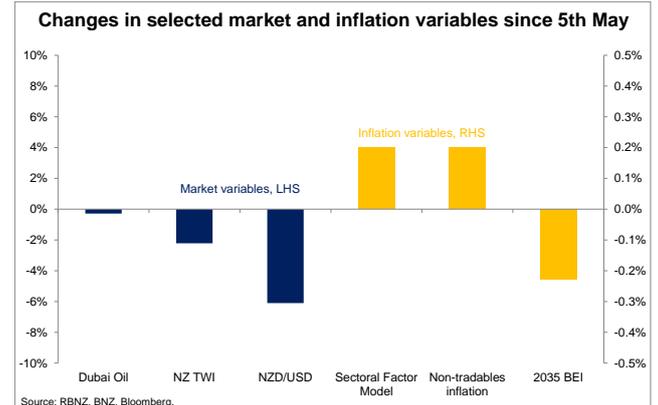
Lower NZ breakevens despite improving fundamentals

In early May, we entered a NZ breakeven inflation (BEI) widener [position](#), buying the 2035 NZ linker and selling the 2037 nominal NZGB at 146bps. Our rationale for the trade was based on our expectation that annual NZ CPI inflation would move to 2% this year and this should ultimately be reflected in wider breakevens. Furthermore, with breakeven inflation below most measures of core inflation, we believed the position provided a 'buffer', or margin of error, in case our inflation forecasts were too high.

NZ Breakevens have fallen sharply over the past month. Our NZGBi35/NZGB37 position has narrowed 25bps over this time to 119bps currently, below our initial stop-loss level. On a fundamental basis, however, we think the thesis for owning linkers, both outright and on breakeven, has become even more compelling since we entered the position. We note that since May:

- All measures of NZ core inflation increased at the last CPI report, including the RBNZ's Sectoral Factor Model which moved up to 1.7% (see Chart 2). Non-tradables inflation (which tends to be the most persistent component of CPI) was also higher than expected at 2.5%. This suggests NZ underlying inflation is picking up, consistent with building capacity constraints. Headline inflation also increased to a 1.5% annual rate.

Chart 1: NZ BEIs fall despite rising inflationary pressures



- The NZD has fallen by over 6% against the USD and almost 2% on a TWI basis. As a rough rule of thumb, the fall in the TWI should add around 0.2% to headline inflation in 12-18 months' time.
- Dubai oil prices are unchanged from early May. Oil prices in NZD terms have actually risen given the currency fall. In addition, the government implemented a fuel levy in Auckland that took effect on July 1st and should add 0.1% to Q3 headline CPI. A nationwide fuel levy will add a similar amount to Q4 CPI.

With the 10 year NZ breakeven now significantly below most measures of NZ core inflation, the market is effectively pricing a softening of underlying inflation in the future. We think this indicates that NZ breakevens offer significant value, even in a steady inflationary scenario.

Chart 2: NZ BEIs are lower than headline and core CPI



RBNZ a dovish surprise and another supportive factor

Despite the firming in the inflation outlook – both on a core and headline basis – the RBNZ outlined a dovish stance at the August MPS, and pushed back the first forecast OCR tightening to late 2020. In general, we detected a greater tolerance to above-target inflation than we previously thought:

- In the press conference, Governor Orr expressed an openness to using the full width of the 1-3% inflation target range and said the RBNZ would look through inflation coming through from the currency, oil and regulated prices (like the fuel levy).
- In a subsequent interview with Bloomberg, Assistant Governor McDermott reiterated that the RBNZ was prepared to look through headline inflation above 2% and added that the RBNZ would need to see *core* inflation above 2% to consider rate rises in the current circumstances.

While it remains to be seen how the RBNZ would react if growth did firm and core inflation did move to 2%, the message from McDermott was that a rate rise was “off the table for the foreseeable future”. Furthermore, he stated the RBNZ had moved closer to the “trigger point” for rate cuts in light of downside risks to growth. That points to an asymmetric outlook for the OCR over the coming year: skewed towards rate cuts.

Taken at face value, this all should be very bullish for linkers, especially coming at a time when inflation pressures appear to be on the rise. Counterintuitively, NZ linkers have significantly lagged the move in nominals since the MPS with the 10 year BEI narrowing 7bps.

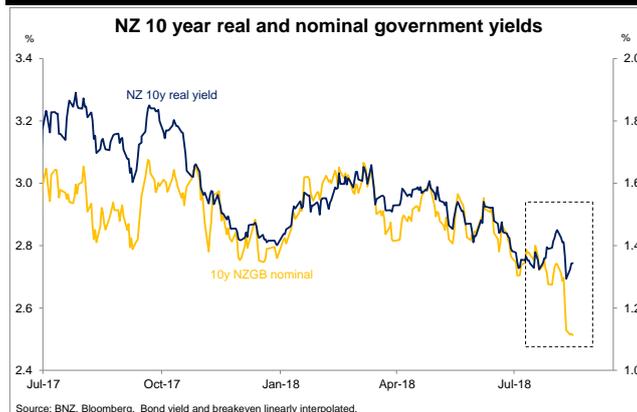
So what is going on? Large nominal NZGB outperformance

We think part of the reason for the BEI tightening has simply been the large rally in long-end nominal NZGBs. Since mid-July, the on-the-run 10y nominal NZGB (the ‘29s) has rallied 30bps. This has outpaced the 17bp rally in the 10 year swap and the meagre 2bp rally in the 10 year NZ real yield (see Chart 3). The sharp widening in long-end swap spreads implies there are idiosyncratic factors, probably flow-related, at play with nominal NZGBs. Long-end NZGB swap spreads are at their widest levels over the past 12 months.

Historically, linkers have tended to have a lower beta than nominals, implying that breakevens tend to narrow when the market rallies.¹ For the 2035 linkers for instance, the beta has averaged around 0.5. Even so, the fact that NZ real yields are close to unchanged over the past month reflects a large underperformance relative to the historic beta, and probably suggests that there has been selling pressure in linkers in the market.

¹ One reason for the lower beta of linkers is probably due to their relative illiquidity compared to nominals. Average monthly turnover in nominals in 2018 has been around \$10b vs. close to \$1b for linkers, using RBNZ data based on trades settled in NZClear.

Chart 3: NZ real yields significantly lag the nominal move

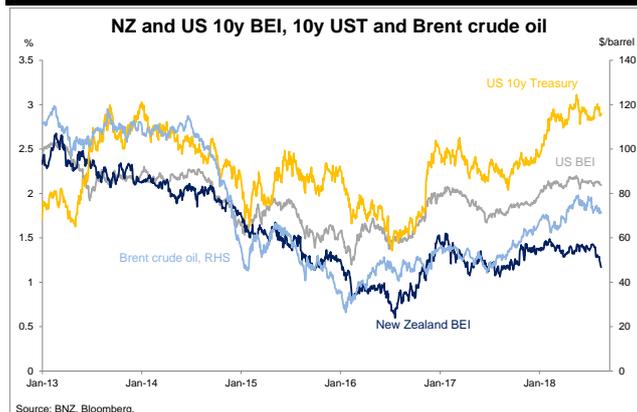


Stress-testing the breakeven position

While we think NZ linkers offer excellent value and we are very confident that investors who hold the position on a medium-to-long term basis will ultimately realise that value (either through the inflation accrual/carry or market repricing), there is still the short-term market risk to contend with. The question is: just how cheap can NZ linkers get and how low can BEI go?

The historic low in the 10 year NZ BEI is around 60bps, much lower than here. We would observe, however, that the environment in mid-2016 was one in which both oil prices and global rates were near their lows, and BEI rates around the world were at depressed levels. Headline CPI in NZ, at the time, was barely above zero and most measures of NZ core inflation were close to 1%.

Chart 4: A completely different backdrop for BEI vs. 2016



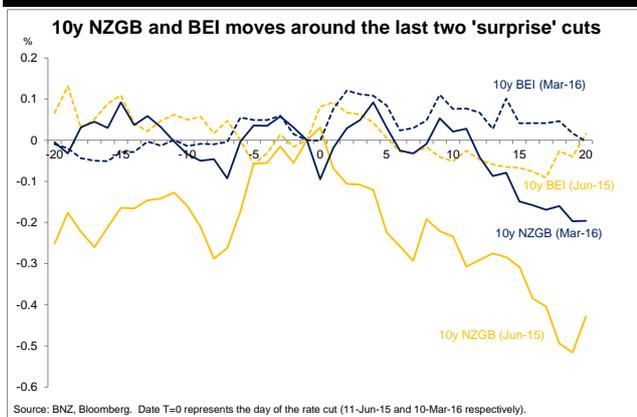
Our assessment is that unless there is a significant and sustained correction in risk assets, a large decline in global rates or a significant fall in oil prices, it's hard to see NZ breakevens challenging those levels any time soon. That would be a scenario we think where the market was starting to contemplate a US or global recession.

What if the RBNZ actually delivered on rate cuts, and lowered the OCR to 0.75% as outlined in Scenario 2 of the August MPS? In such an environment, the NZ curve, including the 10 year point, would likely rally sharply, and given linkers' historic tendency to lag nominals, this has the potential to cause a further tightening of breakevens.

To test this, we ran a simple regression of the NZ 10y swap on the US 10y Treasury and the NZ 2y swap since 2000. Over this time, the beta of the 10y NZ swap to the 2y was around 0.5. Working on the extreme case that the 100bps in cuts resulted in an equivalent rally in the 2 year rate, this would translate into a 50bp fall in the 10y NZ swap. And assuming NZ linkers have a beta of 0.5 to the nominal 10y, this would therefore imply a 25bp tightening of BEI rates.

In our opinion, we think BEIs would perform noticeably better in such a scenario, provided the global backdrop remains benign. Looking at the two rate cuts in the most recent cycle that weren't near-fully-priced in advance (the first one in Jun-15 and then again in Mar-16), linkers outperformed their beta significantly in the month that followed. 10y BEI rates were close to unchanged on both occasions a month after the respective cuts, despite a 20 to 50bp rally in the 10y government bond over that same period. This makes intuitive sense to us: if the central bank proactively surprises the market by easing, linkers should perform relatively well given the greater likelihood that inflation will increase in the future.

Chart 5: BEIs performed ok around the Jun15 & Mar16 cuts



Conclusion

In light of what we see as an improved fundamental backdrop for NZ BEI and what appear to be idiosyncratic factors affecting both the linkers and the nominals, we are reluctant to stop-out of the position at this point. We think the medium-term risk-reward is very attractive.

Consequently, we choose to lower the stop on the position to 1%, from 1.2% (where the NZGBi35/NZGB37 spread sits currently). Adding a 20bp buffer is broadly consistent with the rate cut scenario we highlight above. Were the revised stop-loss to be hit, it would also imply NZ breakevens 20bp to 75bps below the various core

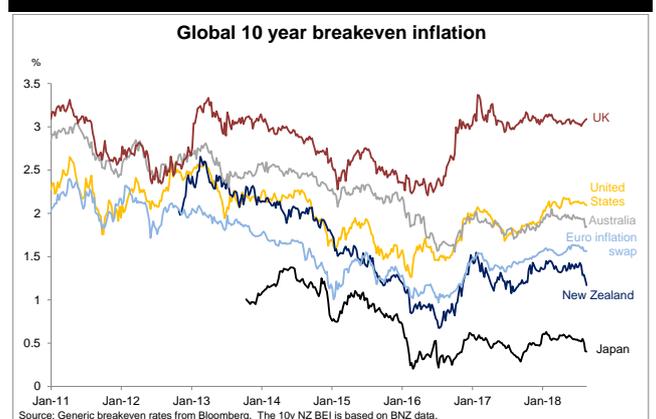
inflation metrics. With the exception of CPI ex-food and energy, these deviations would be near historic extremes.²

Can NZ linkers cheapen further, even in an environment of steady-to-improved fundamentals? The short answer is they almost certainly can. Given their relative illiquidity, flows can have a pronounced effect on the linker market at times. But while we can't rule out further NZ BEI narrowing, our expectation is that the idiosyncratic factors holding back linkers will normalise and the market will ultimately catch-up to the fundamental backdrop.

Annex: Cross-country comparison

While breakeven inflation has fallen in several other markets recently, the NZ BEI move stands out – see Chart 3.

Chart 7: NZ BEIs have fallen faster than other markets



In Table 1, we compare global BEIs to core inflation metrics in several major markets. NZ 10y BEI is around 50bps below the average of Stats NZ core CPI measures. Only in the US, where CPI ex-food and energy is 2.4% (and other core measures average around 2.5%) is there such a significant deviation. NZ 10y BEI is also 0.35% below the current headline rate of CPI, although this deviation is more comparable to most other countries. While NZ linkers are relatively illiquid, and some of the "cheapness" undoubtedly reflects an illiquidity premium, our assessment is that they compare favourably to other global markets.

Table 1: NZ BEIs relatively low compared to other mkt

	10y BEI rate***	CPI ex-food and energy	Alternative core**	Headline CPI	CB target
New Zealand	1.16	1.1	1.75	1.5	2.0
Australia	1.88	1.6	1.90	2.1	2.5
Canada	1.74	1.8	1.97	2.5	2.0
Sweden	1.96	0.9	1.30	2.1	2.0
USA	2.09	2.4	2.53	2.9	2.2
Eurozone*	1.56	1.1		2.1	1.9
Japan	0.41	0		0.7	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

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² CPI ex-food and energy was depressed by the fees-free tertiary education policy introduced by the government at the start of the year. We estimate this policy has subtracted around 0.2% of the annual CPI ex-food and energy inflation rate.

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