15 May 2018

Post-RBNZ Update: Steepeners And Linkers Look Even Better

- **The RBNZ statement and post-MPS comments from Governor Orr were dovish and likely reset the range at the front of the curve lower.**
- **The market may start to price some chance of rate cuts later this year if key domestic data disappoints.**
- **That said, we think the RBNZ has set itself a low hurdle for being positively surprised by inflation, unemployment and the NZD.**
- **Two simple Taylor rules we derive put monetary policy nearly as accommodative as it has been since 2002.**
- **Curve steepeners look better risk-reward to us than outright duration at these levels. Likewise, NZ linkers look very attractive if the RBNZ won't tighten pre-emptively and monetary policy will be behind the curve this cycle. The MPS has increased our conviction in both NZ curve steepeners and breakeven inflation wideners.**

Some RBNZ takeaways

The headlines from the RBNZ were centred around the opening paragraph of the MPS, which stated the OCR "will" be on hold at 1.75% for "some time" – decisive language that reinforces the sense that rates likely aren't going anywhere this year – and the explicit statement that the risk of the next move being a cut or a hike is equally balanced. See Clarity Defines Orr Debut for the team's initial reaction to the MPS.

The dovish message was reinforced in Governor Orr's post-MPS interview with Bloomberg in which he acknowledged he wanted core inflation to start rising towards 2% before raising rates.[1] In the RBNZ MPS, the chart of CPI inflation refers specifically to one measure of "core inflation" – the RBNZ's sectoral factor model (SFM) – which is currently 1.5%. The SFM has historically been very slow moving; outside the GFC, it's very rare for it to move more than 0.1% each quarter.

While the SFM can be revised and the question put to Orr by Bloomberg only asked whether it needs to be "rising towards" 2% before hiking, as a likely best case (rising 0.1% per quarter) core inflation wouldn't hit 2% until Q2 next year (Q2 CPI released late July 2019).

We think the likelihood of rate cuts is low…

The RBNZ's characterisation of an equal balance between rate cuts and hikes will probably increase chatter about the possibility the next move in the OCR could be down. We noted the argument against rate cuts was framed in the MPS in terms of 'overheating' the labour market, rather than financial stability risks. With the labour market seen to be near its maximum sustainable level, any cuts would probably need to be quickly reversed if the economy strengthens like the RBNZ expects.

From our perspective, we would be very surprised if the RBNZ cut rates, partly because we think it has set itself a low hurdle for being positively surprised by the data (let alone the data being weak enough to justify a cut). The RBNZ forecasts headline CPI at 1.6% through to Q3 2019, despite the fact core inflation is currently 1.5%, implying next to no increase in inflation pressures over the coming year and a half. Our initial forecast is for headline CPI inflation to get to 2% in Q3 this year. The 1 April increase in the minimum wage, recent increases in petrol prices and fall in the NZ TWI (already 1.5% lower than the RBNZ's assumed level for Q3 2019) are all supportive of headline CPI coming in higher than the RBNZ's current forecasts. Additionally, the unemployment rate is forecast to fall only 0.2% over the coming three years to 4.2%, which seems very achievable based on the pace of decline over recent years.

Does any of this mean the RBNZ might actually hike sooner than markets expect? Possibly, although on the basis of Orr's comments to Bloomberg, we suspect core inflation will need to be more like 1.7 – 1.8% for hikes to even to come into the conversation and that doesn't look likely to be a story for this year, even if headline CPI is 2% in Q3. We note that there was no uplift in core inflation during the last spike to 2% in headline CPI last year.

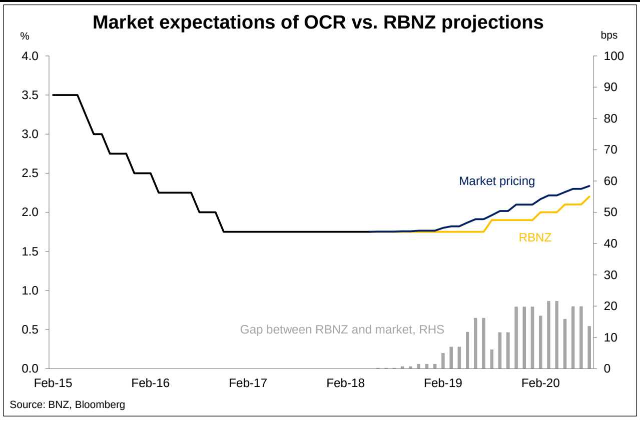
…but that doesn't mean the market won't price it in

While it's certainly not our expectation, we can see the logic in the market pricing in the *balance of risks* towards cuts for this year in the OIS curve. The RBNZ has two sides to its mandate – employment and inflation. The RBNZ see employment being near enough to target but core inflation is below target (1.5% v 2% target). There is an asymmetry.

[1] See "RBNZ's Orr Wants Core Inflation to Pick Up Before Tightening", Bloomberg, 10th May 2018.

Given the RBNZ's preferred core measure is slow moving and will almost certainly be below 2% by year end, this suggests there is close to a zero chance of a rate rise this year. But if there is a big global "risk-off" move or if NZ data turns, the chance of a rate cut is arguably non-zero. The very fact that the RBNZ Statement is explicit in that the next move could be either a cut or a hike means that the market will likely start to price in some chance of rate cuts if important domestic data (GDP, labour market, CPI) disappoints, in our view.

Market OCR expectations have moved closer to the RBNZ



Source: BNZ, Bloomberg

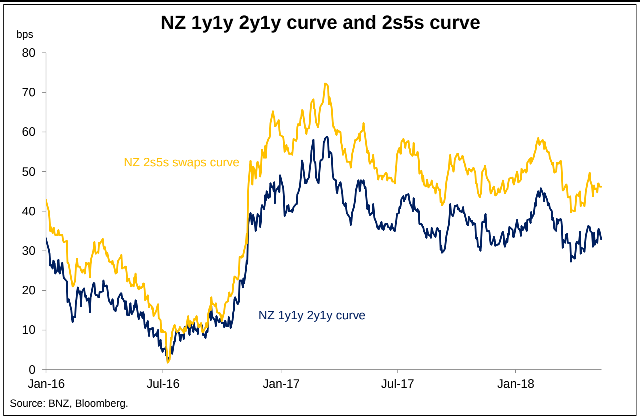
Implications for markets – curve steepeners better risk reward than outright duration…

Outright duration at the short-end of the curve is a difficult call at present. There is now a very modest tightening profile priced in by the market, and we think headline CPI could get to 2% quite soon, which may feel quite a different backdrop for the market, especially if the NZD continues to fall.

But by the same token we don't think now is the time to position short at the NZ front-end. It's hard to identify the near-term catalyst for the NZ curve to re-price higher given the RBNZ rhetoric (it's hardly going to change any time soon), short positions are negative carry, and the market may react asymmetrically to weaker data in the coming months and toy with pricing rate cuts. For reference, if the market were to price the RBNZ rate track (assuming 30bp BKBM-OIS) that puts the 2y swap around 2.13% and 1y1y a bit above 2.20%, levels we think should define the bottom of the range in the first instance.

Instead, short-end forward steepeners and 2s5s steepeners look much better risk-reward. Steepeners give some protection against the tail risk of a rate cut, they mitigate the negative carry, and if the data does surprise positively (and the NZD continues to fall) the market should back-load the tightening. The 2s5s swap curve has flattened marginally post RBNZ and the 1y1y 2y1y steepener we previously recommended is around 34bps, close to our entry. The RBNZ increases our conviction in that position. There is little more than one hike priced between mid-2020 and mid-2021 – which looks reasonably skinny to us – and the gap between the RBNZ and the market has crunched in (see chart to the left).

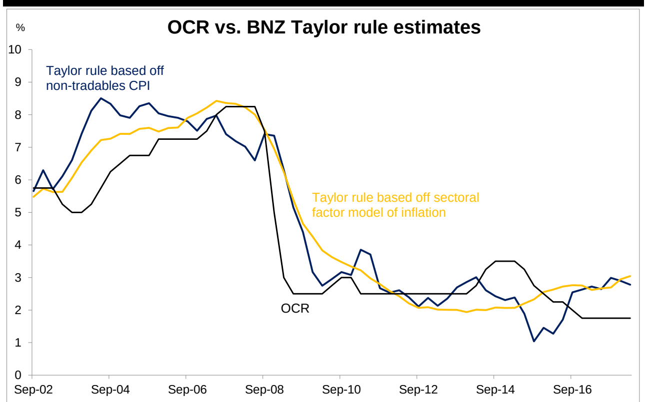
2s5s and 1y1y 2y1y have not steepened post-RBNZ



Source: BNZ, Bloomberg.

A Taylor rule analysis of the OCR reinforces our sense that monetary policy will be behind the curve this cycle, and supports the case for steepeners and linkers (see below). We derived two simple Taylor rules based off, firstly, the gap between the SFM and 2% and, secondly, the gap between non-tradables inflation and 3% (near to its average post 2002, when the CPI target range shifted to 1-3%). We used the difference between the current unemployment rate and the RBNZ's recent estimates of NAIRU (with a coefficient of 1) and the RBNZ's estimate of the time-varying neutral real rate (r*).[2] While there is a great degree of uncertainty around the estimates of r* and NAIRU, the Taylor rules put the current stance of monetary policy as nearly as accommodative as it has been post-2002. The simple message for us is that delayed rate rises now should mean faster tightening in the future, and a steeper curve.

The OCR is below two simple Taylor rule estimates



Source: RBNZ. BNZ estimates. Using Taylor('93) equation with a coefficient of 1 on the unemployment gap.

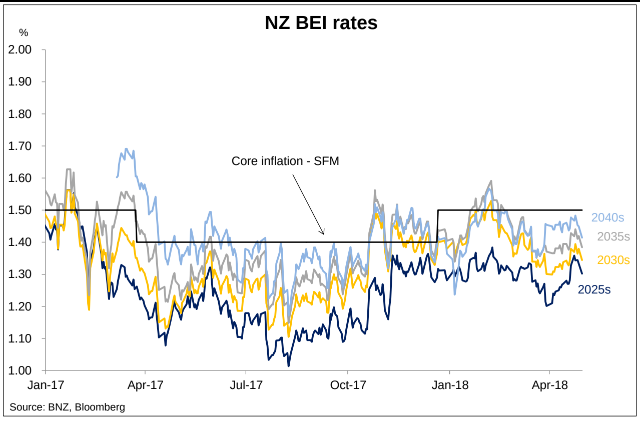
2 We used the RBNZ's estimates of NAIRU from a recent Analytical Note and the estimate of r* from Assistant Governor McDermott's speech from July last year. We assumed both NAIRU and r* were unchanged from the most recent RBNZ estimates (Sep-17 for NAIRU and Jun-17 for r*).

…and linkers look very attractive if the RBNZ won't tighten pre-emptively

We inferred from the MPS that the Bank won't tighten pre-emptively, unlike in 2014. The MPS stated a preference to wait until there was more convincing evidence that inflation was heading to target before tightening: "*While employment and inflation are expected to increase, responding to such expectations without more evidence that they are emerging could stifle the recovery. A longer period of low inflation risks inflation expectations falling and this becoming embedded in price-setting behaviour.*"

A central bank that won't tighten pre-emptively, especially in an environment where there is good reason to expect headline inflation to be closer to 2% this year, should be an excellent environment for linkers to perform. Strangely, breakevens have narrowed slightly post the MPS, which makes no sense at all to us; the 2035 breakeven widener position we recommended earlier this month looks even more compelling to us now. Governor Orr has implied the RBNZ will only hike if core inflation is higher than it is now (probably closer to 2%) and its hard seeing NZ breakevens remaining in the 1.30-1.40% range in that scenario.

NZ breakevens remain under core inflation



Source: BNZ, Bloomberg

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