RBNZ cuts 50bps – Initial thoughts and possible trade ideas

- The RBNZ unexpectedly cut the OCR by 50bps, citing sluggish domestic growth and global risks.
- The market prices the terminal OCR at around 0.65%, implying close to a 50% chance of a move to 0.5%.
- The RBNZ has shown it is willing to be pre-emptive, aggressive and wants to get ahead of the curve. Past form suggests negative news in NZ or globally may result in more cuts as the “path of least regret”.
- The RBNZ reaction function argues for receiving short-end NZ rates outright and vs. Australia. Steepeners and BEI wideners should benefit, subject to global markets not worsening further. A NZ steepener boxed with an AU flattener helps neutralise that global risk.

RBNZ springs massive surprise
Against consensus expectations and market pricing for a 25bp rate cut, the RBNZ sprung a massive surprise by cutting 50bps at the August MPS. The RBNZ cited the slowing domestic economy and global growth, recently exacerbated by deteriorating trade tensions between the US and China, as the reasons behind the OCR cut. In the press conference, Governor Orr said the committee had weighed up cutting 25bps now and signalling another cut in the future versus an immediate 50bp move at this meeting, and said the “path of least regret” was “more, sooner” rather than the risk of “doing too little and too late.” In the event the aggressive OCR cut delivers higher inflation expectations in a year’s time, this was seen as a “quality problem” to deal with.

The RBNZ didn’t signal a policy bias in the statement wording, but the forward OCR track—which indicates a terminal cash rate of 0.9% by Q3 2020 - and the Governor’s comments in the press conference, in which he said “nothing is ruled out in the future”, suggests the Bank retains a soft easing bias. The Bank has not signalled any near-term policy action, and our interpretation would be that the 50bp move was intended to get ahead of the curve. The Bank’s central scenario would be for no change to the OCR in September. However, its revealed behaviour suggests the Bank will act aggressively and pre-emptively if global conditions or domestic data worsen further. We expect a follow-up OCR rate cut in November.

Market reaction
There has been a huge, front-end led rally in kiwi rates, with 2 year swap 20bps lower to 0.89%, 5 year swap 16bps lower to 1.02% and 10 year swap 15bps lower to 1.31% - all record lows (see Chart 1). The terminal OCR is priced at 0.65%, with most of that easing front-loaded into the next three meetings (see Chart 2 and 3).
**Implications and possible trade expressions:**

Receive short-end kiwi rates tactically

Despite the rally, we still see the risks to the short-end of the kiwi curve to the downside. While the RBNZ hasn’t given an overly strong signal that it will cut again, the market is likely to keep rate cut risk premia priced into the short-end of the curve given the RBNZ’s proactive stance and downside risks to global growth. That should keep the upside to the short-end rates capped—we would be surprised if the market priced the terminal OCR above 0.75% unless there is a material change in global conditions, even if the RBNZ stays on hold in September, as seems likely. That suggests 1y1y shouldn’t trade much above 1.05%. Downside surprises in NZ or global data, another market meltdown, or more aggressive easing from major central banks (in particular the Fed and RBA) can see the rally extend and the market probe terminal cash rate pricing sub-0.5%. We think there is an asymmetric skew lower to short-end pricing and would look to set tactical received positions in 1y1y on a back-up towards 1%. 1y1y rolls positively again, by around 0.5bps per month.

![Chart 4: Look to receive 1y1y tactically towards 1%](image)

Long NZ cross-market and 1y1y NZ-AU specifically

The RBNZ has shown itself to be more proactive than other central banks to date. While the RBNZ is arguably ahead of the curve compared to global peers, if global growth were to slow further or there was to be a significant tightening in financial conditions, recent form would suggest the (initial) RBNZ response would be at least as aggressive as those actions taken by other central banks. NZ is closer to its mandated targets than many central banks, yet this hasn’t stopped the RBNZ cutting more aggressively to this point.

The scope for NZ outperformance against the ‘high yielders’ such as Canada and the US in an extended global easing scenario is likely to be limited, given those two central banks have higher cash rates and greater scope to cut further than the RBNZ. However, we think the risk-reward on NZ-AU compression trades is favourable, despite RBNZ being closer to its inflation and employment targets than the RBA. We entered a receive NZD /pay AUD 1y1y trade at 40bps post the upside surprise to NZ employment data earlier in the week and we think the position can compress further.

RBA Governor Lowe has previously referred to the UK, Canada and US experience as suggesting a possible 0.25%-0.5% lower bound for the Australian cash rate. The market prices the terminal RBA cash rate at 0.35%, suggesting a reasonably high likelihood that the RBA will cut to the lower-end of that range. In contrast, the market prices the terminal OCR at 0.65%, despite the RBNZ seemingly being more open to the idea of negative interest rates as part of its policy toolkit, were unconventional policy to be required (indeed, Governor Orr mentioned the RBNZ’s work on the suite of unconventional policy options was well-advanced, and that it was easily in the realms of possibility that “we may have to use negative interest rates in the future”). An NZ-AU 1y1y compression trade gives exposure to a scenario where the RBA halts rate cuts at 0.25% or 0.5% and the RBNZ at least matches that level. We revise our target on the 1y1y compression trade to 15bps initially and lower the stop to our entry level of 40bps.

The other cross-market trade on our radar is long NZ /short UK. NZ has a higher cash rate than the UK, and BoE Governor Carney recently said the BoE saw the effective lower bound at “close to, but a little above, 0%.” While the UK rate outlook is clouded by Brexit and the end of Carney’s term in January next year, at face value this suggests scope for RBNZ-BoE cash rate convergence in a global easing cycle.

![Chart 5: Market prices RBA terminal cash 30bps over OCR](image)

The outlook for gilt yields is also ambiguous with respect to Brexit. It’s not certain that a no-deal scenario would necessarily trigger lower gilt yields, given the inflationary impact, possibility of capital flight, and prospect of higher future gilt issuance to support the economy (albeit with more QE a possibility). We observe than when the GBP had its flash crash on 7th October 2016, that the 10 year gilt yield rose 10bps.
NZ curve should steepen and BEIs should widen, subject to global forces:

A more proactive RBNZ and a Governor that has articulated a preference for being ahead of the curve should argue for more steepening, especially given 2s5s and 5s10s are still trading near multi-year lows (2s5s briefly inverted for the first time since 2008 in the days leading up to the MPS). The flattening in the curve to date largely reflects the large rally in global rates this year (see Chart 7), and the main risk to a steepening position is that this extends further, notwithstanding the chance of more aggressive RBNZ easing. In addition, were the RBNZ to adopt a doctored forward guidance in the future – one of its stated unconventional policy tools and arguably the easiest to implement – this has the potential to restrain steepening, at least in 2s5s. Our 2s5s trade position is under review.

While the value case for holding NZ linkers on a BEI basis is compelling in our view, and the position will provide positive carry over time if CPI inflation can exceed 1%, the global backdrop for BEIs is challenging, as shown by the sharp falls in recent weeks in Australian and US BEIs (see Chart 8).

NZ 2s10s steepeners boxed with Australian flatteners:

One way to neutralise the inherent bearish bias in a NZ curve steeper would be to box it with a flattener in AUD. Given the RBNZ appears to be proactive and willing to cut more aggressively than the RBA and has suggested a greater openness to negative rates, this implies more scope for front-end led NZ curve steepening. Despite the sharp move yesterday, the NZ-AU 2s10s box is still within proximity of multi-year lows. On a consistent semi-quarterly basis, the AUD and NZD curves are at similar levels, and we would argue that there are more reasons for steepening pressure in NZ than Australia. The NZ-AU box has been highly correlated with the NZ-AU 1y-1y spread over the past twelve months.

Likewise, NZ BEIs should widen from their current depressed levels, given the RBNZ’s apparent determination to achieve inflation at the midpoint of its target range. However, as we argued in a recent note, a re-pricing of NZ BEIs in the near-term is likely to require a long-end led nominal roll-off.
Contact Details

BNZ Research

Stephen Toplis
Head of Research
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Jason Wong
Senior Markets Strategist
+64 4 924 7652

Nick Smyth
Interest Rates Strategist
+64 4 924 7653

Main Offices

Wellington
Level 4, Spark Central
42-52 Willis Street
Private Bag 39006
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Toll Free: 0800 854 854

National Australia Bank

Ivan Colhoun
Global Head of Research
+61 2 9237 1836

Alan Oster
Group Chief Economist
+61 3 8634 2927

Ray Attrill
Head of FX Strategy
+61 2 9237 1848

Skye Masters
Head of Fixed Income Research
+61 2 9295 1196

Wellington
Foreign Exchange
+800 642 222
Fixed Income/Derivatives
+800 283 269

New York
Foreign Exchange
+1 212 916 9631
Fixed Income/Derivatives
+1 212 916 9677

Sydney
Foreign Exchange
+61 2 9295 1100
Fixed Income/Derivatives
+61 2 9295 1166

London
Foreign Exchange
+44 20 7796 3091
Fixed Income/Derivatives
+44 20 7796 4761

Hong Kong
Foreign Exchange
+85 2 2526 5891
Fixed Income/Derivatives
+85 2 2526 5891

Analyst Disclaimer: The information accurately reflects the personal views of the author(s) about the securities, issuers and other subject matters discussed, and is based upon sources reasonably believed to be reliable and accurate. The views of the author(s) do not necessarily reflect the views of the NAB Group. No part of the compensation of the author(s) was, is, or will be, directly or indirectly, related to any specific recommendations or views expressed. Research analysts responsible for this report receive compensation based upon, among other factors, the overall profitability of the Global Markets Division of NAB.

NAB maintains an effective information barrier between the research analysts and its private side operations. Private side functions are physically segregated from the research analysts and have no control over their remuneration or budget. The research functions do not report directly or indirectly to any private side function. The Research analyst might have received help from the issuer subject in the research report.

New Zealand: This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. To the extent that any information or recommendations in this publication constitute financial advice, they do not take into account any person's particular financial situation or goals. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication. National Australia Bank Limited is not a registered bank in New Zealand.

USA: If this document is distributed in the United States, such distribution is by nabSecurities, LLC. This document is not intended as an offer or solicitation for the purchase or sale of any securities, financial instrument or product or to provide financial services. It is not the intention of nabSecurities to create legal relations on the basis of information provided herein.

www.bnz.co.nz/research