2 November 2018

Making the (medium-term) case for paying NZ swaps

- **We make the case for scaling into paid positions in NZ swaps on a medium-term view.**
- **The first OCR hike is fully priced-in for 2021 and we are sceptical the market will push out the date of tightening even further unless there are renewed expectations of rate cuts (we continue to think rate cuts are highly unlikely over the next year).**
- **Longer-term NZ rate valuations look stretched to us on a cross-market basis. NZ has outperformed every major developed market in both 2017 and 2018, and the 5 year swap is barely 30bps from its all-time lows.**
- **Anecdotally, we perceive the market as being positioned long/received NZ rates and mortgage borrowing has been concentrated at very short tenors. This suggests to us that swap rates are vulnerable to a sharp move higher if the macro outlook improves or the RBNZ changes its tune.**
- **NZ FRA-OIS spreads have lagged recent moves higher in US spreads. There is the risk that NZ FRA-OIS spreads play catch-up to those moves offshore, adding to upward pressure to swaps at the margin.**
- **In the near term, it's hard to identify the domestic trigger that might cause NZ rates to sell-off significantly. We expect the RBNZ to maintain its recent messaging and range-trading to persist in the coming months. But investors with a medium-term outlook may want to consider using rallies to scale into paid positions.**

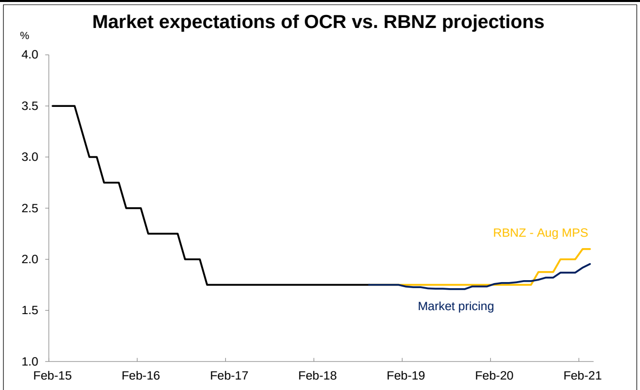
The NZ rates market has been the star performer in 2018. It is the only developed rates market with a lower 10 year swap rate (almost 30bps) than at the end of last year. Below, we outline the medium-term case for scaling into paid positions in NZ swaps.

1. The market prices very little RBNZ tightening

While the market has pared back its expectations of OCR cuts after the upside surprises to GDP and CPI over the past six weeks, the OIS curve remains very flat. The first RBNZ hike isn't priced-in until 2021 (see Chart 1). And there is only a very gradual pace of hikes priced-in thereafter (around one hike per year beyond 2021). Given this very flat rate profile, we think it will be difficult for the market to push out tightening even further unless there is renewed speculation about possible RBNZ rate cuts.

On that front, we think the likelihood of RBNZ rate cuts remains very low, at least over the coming twelve months or so. 'Hard' NZ data has remained at relatively strong

Chart 1: The market fully-prices the first RBNZ hike in 2021



Source: RBNZ, BNZ, Bloomberg

levels, in contrast to the weakness implied by the business surveys, while headline CPI inflation looks almost certain to exceed the 2% midpoint of the RBNZ's target from Q4 this year. Additionally, given the falls in NZ fixed mortgage rates over recent months, Governor Orr has effectively been able to deliver an easing of financial conditions, without needing to actually cut rates.

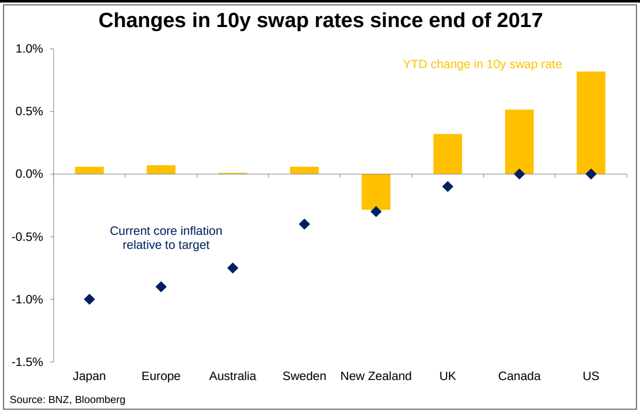
We expect the market to eventually shift its balance of risks assessment on the RBNZ towards hikes, and away from cuts. As a first step, if the market merely priced the same rate profile as it currently does for the RBA for instance (first hike in mid-2020), this would put the NZ 2 year swap at around 2.15% (vs. its current 2.05% level).

2. RBNZ not as far away from inflation target as some countries

As Chart 2 shows, NZ has outperformed all other developed rates markets this year (just like in 2017). The markets that have underperformed – the US, UK and Canada – have core inflation at, or close to, target and their central banks are currently raising rates.

While core inflation in NZ is below the 2% mid-point, the RBNZ is certainly closer to target than in several other countries that have not seen the same rates market performance as NZ. The Sectoral Factor Model of core inflation in NZ is 1.7%, 0.3% below the 2% mid-point. In Australia, core inflation is 0.75% below target; in Europe, core inflation is almost 1% below target and in Sweden, where the Riksbank has prepared the market for rate increases, core inflation is 0.4% below target. We don't think the level of NZ core inflation compared to other countries justifies the large NZ outperformance seen over the past two years.

Chart 2: NZ rates market has outperformed hugely in 2018

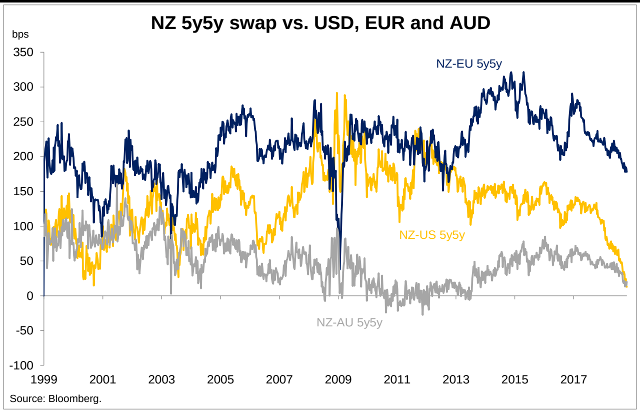


Source: BNZ, Bloomberg

3. Longer-term cross market valuations look stretched

We monitor cross-market 5y5y spreads as one indication of longer-term rates valuations. The NZ-US 5y5y spread is just 10bps,which is close to record low levels (see Chart 3). While the US is in a cyclically stronger position than NZ at present, which justifies the divergence in monetary policy, we continue to think NZ will have a higher cash rate in the *long-run* than the US. On this basis, we don't think the NZ-US 5y5y spread should trade sustainably below zero, and this suggests to us that NZ longer-term rates are stretched on a cross-market basis. We note also that NZ-EU and NZ-AU 5y5y spreads have reached multi-year lows.

Chart 3: NZ-US 5y5y spread near record low levels

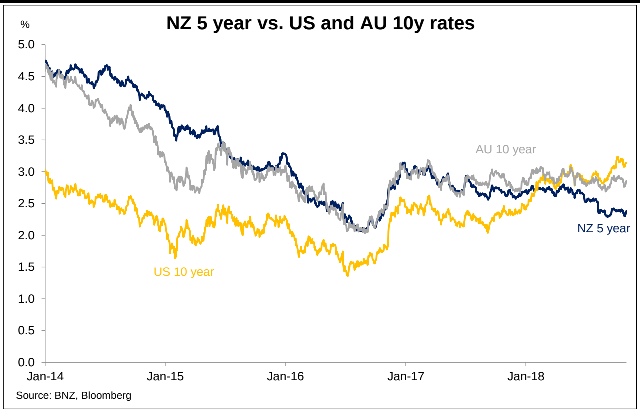


Source: Bloomberg.

4. Does it really make sense that NZ 5y swap is still within vicinity of the mid-2016 lows?

Notwithstanding the globally-driven rates sell-off over the past few days, the NZ 5 year swap rate remains within vicinity (around 30bps) of its all-time lows reached in mid-2016 (see Chart 4). That was a point in time when the 10 year US Treasury yield reached an all-time low of 1.35%, market participants were very sceptical about the prospect for higher inflation and the ability of central banks to raise rates, and oil prices were $40 per barrel. In NZ, the RBNZ was still cutting rates, headline inflation was barely above zero, and the NZ TWI was 7% higher than it is now. Since then, NZ inflationary pressures have risen, the NZD has fallen, and the Fed and the Bank of Canada

Chart 4: NZ 5 year swap not far from record lows in mid-16



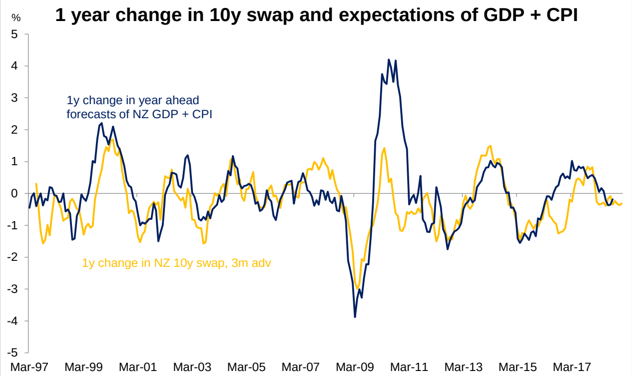
Source: BNZ, Bloomberg

(which, like NZ, has high levels of household debt) have shown it is possible to raise rates. The level of the 5 year NZ swap looks out of line with the change in the macro backdrop that has taken place since this point.

5. A lot of bad news has been priced-in to NZ

The decline in the NZ 10 year swap rate over the past 12 months broadly matches the reductions that have taken place to consensus forecasts of year-ahead NZ GDP and CPI (see chart 5). While this doesn't preclude further downgrades to forecasts of NZ growth and inflation, we infer from Chart 5 that NZ swap rates already incorporate a reasonable amount of 'bad news', in the form of now lower growth and inflation expectations.

Chart 5: Fall in 10y in-line with lower GDP/CPI forecasts



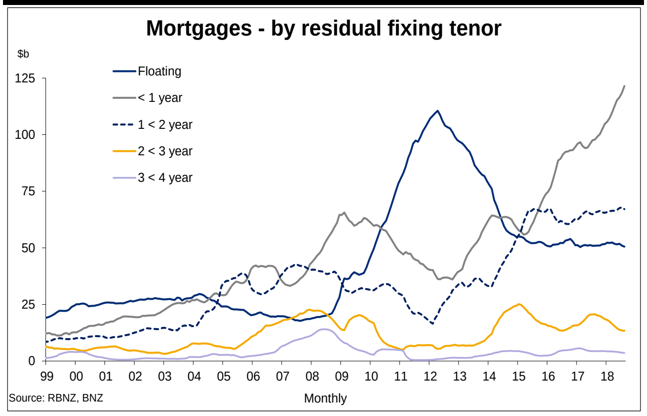
Source: Consensus Economics, RBNZ, Bloomberg.
Year-ahead NZ GDP forecast from Consensus Economics is added to year-ahead CPI forecast from RBNZ Survey of Expectations.

6. Market positioning is probably long/received

While there is no definitive source of positioning data for NZ rates, unlike the CFTC data on US rates positioning, our sense is that the offshore market is positioned long/received in NZ. On our recent trip to the UK and Europe, we inferred that investors generally saw NZ as an attractive cross-market duration hedge against favoured short positions in US and European rates. It was observed that the NZ curve was relatively steep by global standards, the RBNZ forward guidance – that it expects to keep the OCR on hold through 2020 – was perceived as anchoring the NZ curve, and if the global cycle really turned, the RBNZ had room to cut the OCR (unlike some central banks who were near the effective lower bound for rates). While we don't necessarily disagree with these sentiments, it leaves us with the sense that NZ swap rates are vulnerable to re-price sharply higher if the RBNZ rhetoric changes or the NZ macro outlook makes rate rises look a more likely prospect.

On the domestic front, we note that the vast majority of retail mortgage fixing has been concentrated in very short-term tenors. Chart 6 shows that almost all the growth in the stock of mortgages since 2016 has been concentrated in fixed-rate tenors with a maturity shorter than one year. The one-year mortgage rate is currently the lowest on offer among the major banks, and with little prospect of RBNZ rate increases in the near-term, it is natural that this tenor has attracted the bulk of recent fixing activity. While not an immediate concern, we would highlight that mortgage fixing tends to shift to two and three year tenors during RBNZ tightening cycles, which generates more pay-side flow for bank balance sheets and can exacerbate any move higher in NZ rates (especially if coming at the same time as investor positions are unwound).

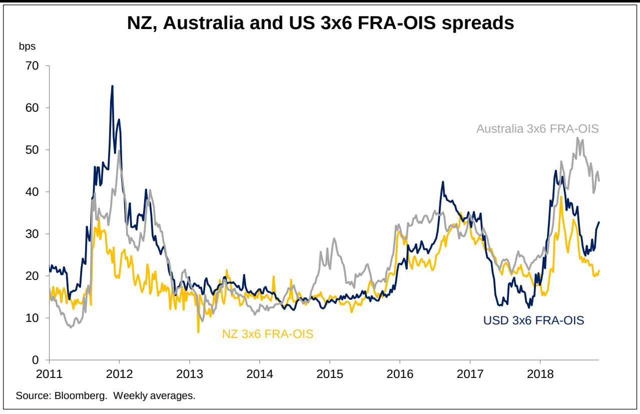
Chart 6: Most NZ mortgage fixing has been at short tenors



7. NZ FRA-OIS spreads have lagged offshore moves

As we head into year-end, there has been some upward pressure on US FRA-OIS spreads. The implied US Libor-OIS spread for the December IMM date is 37bps, around 12bps higher than spot Libor-OIS. In contrast, NZ FRA-OIS spreads have drifted lower over the past few months (notwithstanding some increase over the past few days), as shown in Chart 7. While NZ BKBM-OIS has been consistently lower than US Libor-OIS and Australian BBSW-OIS, there has been a more consistent correlation between FRA-OIS spreads between the three markets. We see the risk that NZ FRA-OIS spreads could play catch-up to offshore markets over the remainder of the year, adding some upward pressure on NZ swap rates at the margin.

Chart 7: NZ FRA-OIS spreads have lagged the US moves



8. But range trading likely near-term

While we think there is a strong medium-term case for scaling into short positions in NZ swaps, we struggle to see the near-term domestic triggers for such a move higher (with the exception of a possible intensification of funding pressures noted above). We expect the RBNZ to maintain its recent message that it expects to keep the OCR on hold through 2020, and we doubt the Governor would choose to take the option of rate cuts off the table at this stage – doing so would likely provoke a move higher in the NZD and, in any case, business confidence and the downside risks to growth haven't gone away. Consequently, we expect NZ rates to be reasonably range-bound over the coming few months. That said, we would look for opportunities to scale into paid positions in NZ 5y swap on a medium-term view if it rallies back to the bottom of its recent range (towards 2.3%). The negative carry and roll on a pay fixed 5 year NZ swap position is around -5bps over 3 months at present.

The clear risk to a paid swap position is that the RBNZ cuts rates in response to a potential slow-down in domestic activity. We think rising inflationary pressure and a sub-NARU unemployment rate would argue against such a move, but the market will likely remain wary of this risk whilst business confidence remains at depressed levels.

Finally, there is an argument that the US economy will have turned and the Fed will be cutting rates before the RBNZ gets around to tightening (say in 2020). In this scenario, the 'window' for RBNZ tightening would probably close and indeed the RBNZ may instead be cutting rates in line with other central banks. However, we see this as one of a range of possible scenarios (other scenarios include the global economic cycle extending even further), rather than our central case.

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