22 May 2018

The End Of The NZ Yield Premium Over AU?

- NZ-AU rate differentials have tightened notably of late.
- Policy rate forecasts point to a fairly flat NZ-AU spread outlook over the next year. NAB's updated RBA cash rate view puts policy on a similar path to BNZ's forecast for the RBNZ, with no move expected by either central bank until May 2019.
- Strategically, we see NZ-AU spreads as slightly too tight. However, a lack of inflation catalysts and relative funding spread differences are a barrier to spread widening in the near term.
- The stand-out move is in NZGB-ACGB spreads, which reached negative out to 9 years - a move that more reflects relative richness is in NZGBs, than cheapness in Aussie bonds. We see limited room for this move to extend.
- The NZGB-ACGB 2027 spread reached a low of -4bp last week (current+2bp) and we think it will track a range of -10bp to +20bp.
- The NZ-AU 5y5y swap spread looks broadly consistent with RBNZ and RBA neutral rate expectations.

RBNZ and RBA priced for a similar outlook

RBNZ-RBA policy rate spreads and expectations of policy action are a key driver of NZ-AU swap and bond spreads. Current market pricing is for both the RBA and RBNZ to remain on-hold for an extended period of time before slowly tightening. The AUD OIS curve is not fully priced for the first 25bp hike until August 2019, while the equivalent move isn't priced into the NZD curve until September 2019. The RBNZ-RBA year-ahead rate spread (proxied by 4th bill rate spread) is around +6bp and 2y to 5y swap rate spreads are between +9bp and 20bp. These spreads are at the low end of trading ranges that have prevailed since the RBNZ-RBA policy rate spread hit 25bp in 2016.

Chart 1: RBNZ vs RBA OIS Pricing

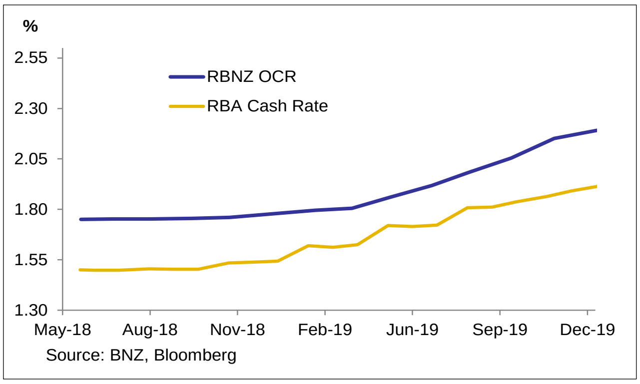
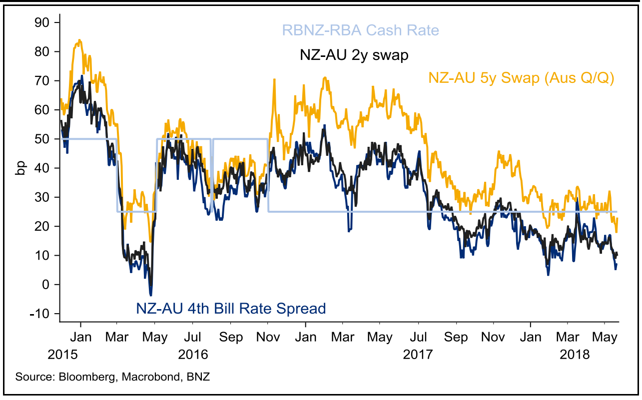


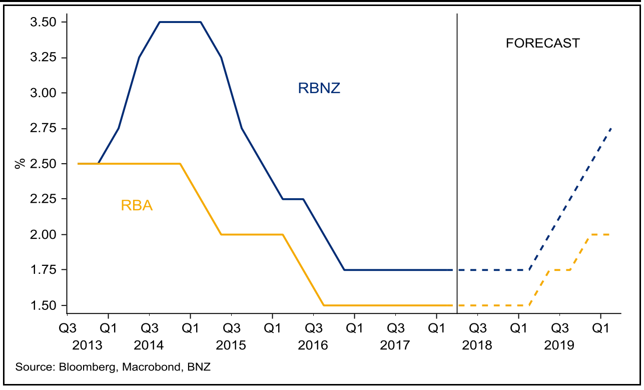
Chart 2: NZ-AU Rate Spreads



NZ and AU cash rate forecasts are flat for the next 12 months

Today, NAB economics pushed back their forecast for the start of the RBA tightening from November 2018 to May 2019. This is close to current market pricing and in-line with BNZ economists call for the first RBNZ hike. The trajectory for the RBNZ cash rate is higher over the next several years than for the RBA.

Chart 3: RBNZ and RBA Cash Rate Forecasts



Our forecasts are for a relatively steady outlook for NZ-AU swap and bond differentials over the next 6-12 months. A more aggressive RBNZ than RBA tightening cycle is expected to take spreads wider in late 2019 and into 2020.

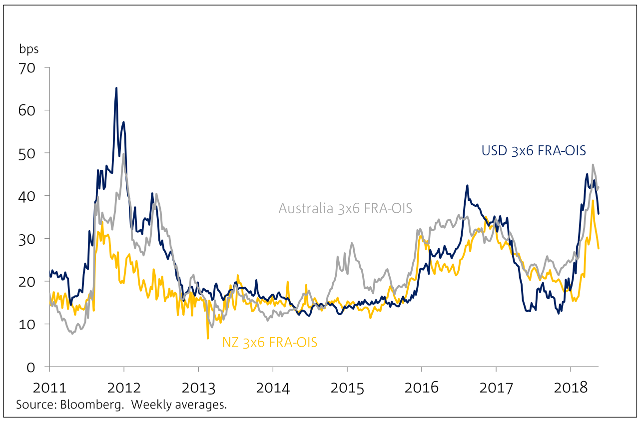
Strategic bias for NZ underperformance, but in swap funding spread differences are a constraint

At present, we don't see a strong catalyst for the market to re-price either the RBA cash rate or RBNZ OCR higher. Both central banks are awaiting evidence of a pickup in core inflation and that looks increasingly like a story for next year and neither bank needs to be in a rush to tighten. However, unemployment is more clearly trending down in NZ than AU and the NZ labour market arguably has less slack.

That latter point suggests risks are for more upside in NZ rates than AU rates, leading to wider NZ-AU rate spreads. However, relative funding spread differences complicate the outlook somewhat. The 3m BKBM rate is just 5bp above the 3m BBSW rate, reflecting a relatively wider 3m BBSW-OIS (43bp) than BKBM-OIS (24bp) spread. In forwards, we note NZ FRA-OIS has actually tightened by more than AU FRA-OIS over the last month, as US Libor led a compression in funding spreads (Chart 5). Looking ahead, it's possible that a further fall in US Libor could add downward pressure in NZ-AU spreads. However, NZ FRA-OIS spreads are closer to longer run averages, so at some point we think AU spreads will play catch-up if US Libor continues to compress.

This means the 2y NZ-AU swap differential may struggle to push out towards the cash spread of 25bp until Aussie funding costs ease further, although at 9bp it's likely near the low end of its range. We see some risks to funding spreads widening over the next month, as has been the experience ahead of recent quarter-ends.

Chart 4: FRA-OIS Spreads

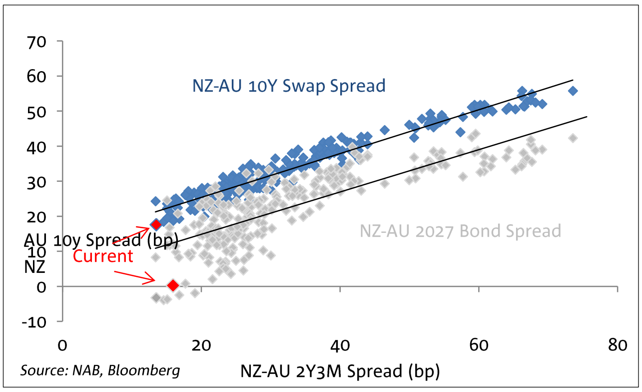


10y NZ-AU rate spreads – swap close to fair vs front end, but NZGB-ACGB spread relatively tight

For most parts of the curve we think the NZ-AU policy rate spreads will re-assert as the main driver of spread compression. To gauge longer term spread value, we look to NZ-AU rate pricing for the next cycle (proxied by 2y3m rate) and 5y5y spreads against neutral expectations.

We estimate a similar rates cycle outlook should push the 2y ahead 3m rate from 15bp to around 25bp (our longer term RBNZ profile is above the RBA, but this isn't likely to be priced in the near term). For the NZ-AU 10y swap differential, we estimate this is worth only a small move in long term rates - about a 5-7bp widening in spreads. That's based on a long term beta between with 10y and 2y3m spread of around 0.5-0.6. As the charts show, the 10y (2027) bond spread is more out of line with short end pricing than the swap spread.

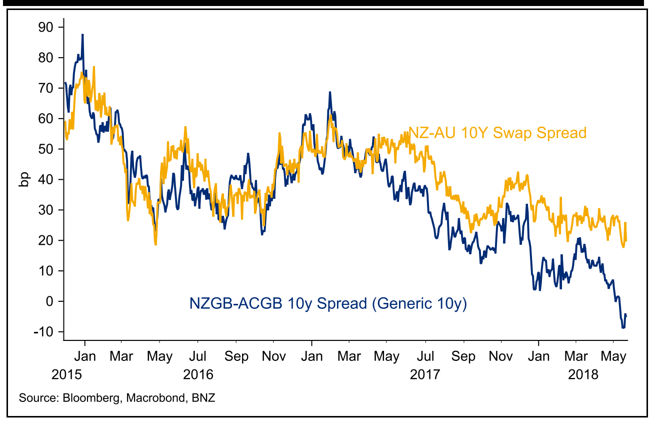
Chart 5: NZ-AU Swap & Bond Vs Short End Pricing



Multi-year lows in NZ-AU bond spread partly due to richness in NZGBs

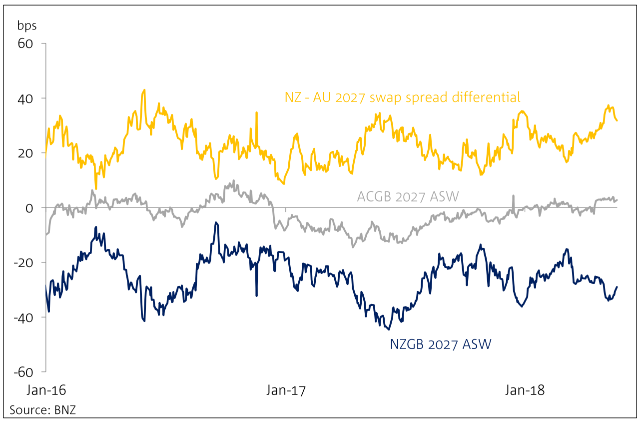
As noted above, the NZ-AU 10y bond spread has moved further than the spread in swaps and is at its narrowest level since 2012 (when the RBA cash rate was 175bps higher than the OCR).

Chart 6: NZ-AU 10y spreads



The recent extension in the NZ-AU bond spread is partly explained by richening in NZGBs and one way to see this is through ASW spreads. The 10 year NZGB-swap spread has widened 15bps since late February and is approaching the wider end of the range seen over the past two years. With Australian swap spreads having been largely range-bound over that time, this has mechanically tightened the NZ-AU 10 year bond spread, pushing it to new lows.

Chart 7: NZGB vs ACGB Apr-27 ASW Spread



Source: BNZ

The broader backdrop is one in which net issuance of NZGBs has been constrained in recent years, keeping NZ swap spreads relatively wide compared to those in Australia. The NZDMO projects net supply of NZGBs will be negative over the coming fiscal year. Nonetheless, with NZGB-swap spreads near the wider end of the range, and the NZDMO having announced a $1b increase to the bond programme last week, there may be a case for a short-term correction in NZGB-swap spreads. A correction in NZGB-swap spreads back to the middle of the recent range would see the NZ-AU 2027 spread back further into positive territory, absent a compression in cash rate expectations between the two countries. Such a move would see the NZ-AU 2027 spread back near to the trend line shown in Chart 5.

NZGB-ACGB 10y spread is too tight, but not yet time to fade

All up, we see front end NZ-AU differentials as slightly too tight. However, we're not expecting significant widening any time soon, consistent with the fact NAB and BNZ see a very flat outlook for relative policy rate spreads over the next year. A flat policy rate outlook suggests swap rate spreads across the curve shouldn't invert significantly.

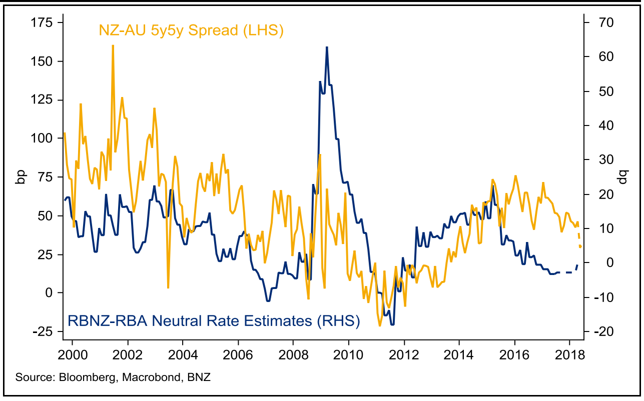
The tightness of the NZGB-ACGB 10yr spread stands out the most. We don't see an especially bullish case for 10y ACGBs at current levels. ACGB spreads to US 10yrs, swap, the limited RBA policy tightening outlook and still elevated repo rates are all barriers to significant ACGB outperformance.

We think the NZGB-ACGB spread will largely be a function of relative NZGB richness, which in turn reflects the low supply outlook. The 2027 spread, currently around +2bp, has scope to trade to around -10bp, but our analysis also shows a potential range high of 20bp. We would consider spread trades around these levels.

NZ-AU 5y5y spreads not out of line with longer term neutral rate

Another way to assess value in longer term rate expectations is to look at 5y5y spreads compared to respective neutral rate expectations, derived from RBNZ and RBA forecasts. As the chart shows, excluding the 2008-09 period, the nominal neutral spread has mostly oscillated between -15bp and +20bp. The 5y5y spread is correlated with neutral spreads, but has typically traded in a wider range, which we would attribute to the fact the cash rate spread has mostly been higher in NZ and liquidity premiums wider. The last few years has seen the correlation break down, but broadly we don't see 5y5y spread of 39bp as fundamentally too high or low, in our view. All up, we think the 10yr NZ-AU swap rate spreads will continue to be driven more by expectations for the next cycle.

Chart 8: NZ-AU 5y5y Vs Neutral Rate Spread



Source: Bloomberg, Macrobond, BNZ

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