The beginning of the end? NZ long-end rates outlook

- NZ long-end rates have moved higher this month, as global rates have sold off and the market has pared back OCR rate cut expectations.
- We recap recent moves and examine the outlook for the NZ long-end.
- Our working assumption is that the US 10y Treasury yield will face resistance at 2% and the RBNZ will cut the OCR in November, which should help contain the upside in the NZ long-end in the near-term.
- But November is a judgement call for the RBNZ and there is likely to be a sizeable reaction either way.
- Medium-term, we see limited value in the NZ long-end, outside some pessimistic economic scenarios.

The possibility of extra fiscal stimulus next year could be a catalyst for higher NZ long-end rates and would reduce the burden on the RBNZ.

- We think it might finally be time to consider using rallies to lighten long-end NZ duration exposures. We retain our medium-term bias for NZ curve steepeners and NZ-US long-end wideners.

NZ longer-term rates hit record lows at the start of last month, with the 10 year swap reaching 1.1% and the 10 year NZGB yield briefly traded below 1%, before recovering over 30bps over the remainder of October. The massive decline in rates this year has been more a global story than a NZ-specific one (notwithstanding the RBNZ’s 50bp OCR cut in August). 10y NZ-US and NZ-AU spreads have been broadly range-bound this year (see Chart 1). In this note we recap recent developments and set out our medium-term outlook for the NZ long-end.

The two key drivers of NZ long-end rates are global rates, especially the US and Australia, and the RBNZ outlook.

10yr US Treasury yield at 2% likely to provide resistance

In hindsight, the sharp rally in global rates in August following Trump’s announcement that he would put tariffs on ~$300b of Chinese imports looks like an overextension. Since then, rates have bounced strongly with Trump cancelling the planned tariffs for October, the US and China moving towards a “Phase-One” trade agreement and the risk of a no-deal Brexit now seemingly off the table. These developments have reduced downside tail risks to the global economy even though economic data hasn’t materially picked up yet (as illustrated by an equal-weighted composite of the ISM in Chart 2).

Chart 2: The 10yr UST yield has broadly tracked the ISM

The 10 year Treasury yield was trading just above 2% before Trump threatened China with tariffs on $300b of imports (Chart 3). If the December tariffs are suspended as part of this Phase-One agreement, this might argue for an extension of the 10 year yield move towards 2%.

Chart 3: If Dec tariffs are cancelled, US10y might get to 2%
We expect 2% to represent strong resistance for the 10 year yield. The 10 year yield has closely tracked two year ahead Fed rate expectations since 2016 (see Chart 4). Based on the correlation since August, we estimate that a yield just above 2% is broadly consistent with the market pricing-out the risk of future Fed cuts. To break above 2%, this relationship suggests the market would need to start pricing the risk of hikes.

Instead, we think the market will persist with pricing the balance of risks around the next Fed rate move towards an easing. Fed Chair Powell indicated at the last FOMC press conference that the hurdle for hikes is much higher than it is for cuts. While not precluding the market from pricing the risk of future hikes, it puts the onus on a material pick-up in global growth, something not seen in the data as yet. US (and NZ) rates have historically sold-off sharply after the last Fed rate cut in previous cycles (see Chart 5 for the NZ 10y swap rate), but we think the market will be slow to embrace the view that October was the last easing of this cycle. That means we’re cautious that we will see a "V-shaped" bounce in US, also NZ, long-end rates this time.

It’s possible the 2% level could be broken if the US cancels the previously implemented September tariffs, proving that there is a path to tariff reduction (and raising market hopes that previous tariffs could also be scrapped). Such a rise in yields might occur in conjunction with unwinds of long positions and an increase in the term premium (i.e. an increase in rates independent of the Fed outlook). But our working assumption is that 2% will represent the top of the range at this stage, and this will help contain the top-side in NZ long-end rates as well in the near-term.

Market conviction in a November RBNZ cut waning

There has been a major recalibration of OCR expectations over the past month. At the start of October, the market priced a 15% chance of a 50bp cut in November and even a week ago a November cut was 90% priced. That probability now stands at 50% (see Chart 7).

The retracement in OCR rate cut expectations has occurred against this improving global backdrop and reduced Fed and RBA easing expectations. Governor Orr has previously said that the market’s re-pricing of global central bank policy was the key, albeit not the only, driver behind its decision to cut 50bps in August. The market reasons that with Fed and RBA now priced to be on-hold over the remainder of the year, this puts less pressure on the RBNZ to follow suit in November. With the recent de-escalation in US-China trade tensions, there are also less downside tail risks to global growth so the risk management arguments for additional cuts also looks less pressing now.

RBA and RBNZ rate expectations continue to move in lock-step, emphasising that it is global factors that have been the key driver (see Chart 8) although position indigestion has likely exacerbated the recent move in NZ rates.
Our view is that the RBNZ will cut the OCR to 0.75% in November. Leading indicators suggest annual GDP growth could fall below 2%, well below the RBNZ’s forecasts of 3%+ which it sees as necessary to get inflation to target. We think the RBNZ will conclude, on balance, that the path of least regret is to cut the OCR. If inflation expectations pick up materially, or business surveys prove to have overstated the downside risks to the domestic economy, the RBNZ can always raise rates in the future.

That said, it is likely to be a finely balanced call and the market is still learning about the RBNZ’s reaction function under an MPC. It’s not difficult to conceive an on-hold decision either, especially with the market no longer fully-pricing a cut and the NZD trading towards the lower-end of the range over the past 12 months. The dovish RBNZ surprises in March and August both occurred when the NZ TWI was much higher than present – see Chart 9.

Our base case is that the RBNZ cuts the OCR and that this will keep NZ rates contained within their established trading ranges over the remainder of the year, but there is likely to be a sizeable reaction either way.

We still don’t see medium-term value in the NZ long end

Looking beyond the immediate November decision, our view remains that there is a lot of ‘bad news’ priced into the long-end of the NZ curve. First, the fall in the NZ 10 year swap rate over the past 12 months has been well in excess of the downward revisions to consensus forecasts of NZ growth and inflation (see Chart 10). The deviation is one of the largest on record. We see this as indicating that the market is pricing downside macro risk into the long-end. With global tail risks (i.e. US-China trade and Brexit) seemingly reduced, there is an argument that the market might start to price-out some of this pessimism.

Likewise, the Global PMI remains in contractionary territory, but it still broadly matches up with the 12-month change in the OCR (including forward expectations). This suggests the current (subdued) rate of global growth has already been priced by the NZ rates market already.

Even after the sell-off over the past month, the market still doesn’t price the OCR again reaching 1% until the end of 2023 and 1.5% until the end of 2026 (see Chart 12). While an extended period of low interest rates is definitely the central scenario, and central banks globally – including the RBNZ – are likely to be cautious with future tightening cycles, we would again argue that this largely incorporated into market pricing already. While it’s not inconceivable, we think it would be a very pessimistic state of the world where the RBNZ never raised rates again.

\[ ^4 \text{Consensus forecasts for year ahead GDP and inflation were 2.1% and 1.7% respectively, as of Q3.} \]
One of the arguments for lower-for-longer rates is the high level of household debt in NZ, which will constrain the ability of the RBNZ to normalise the OCR in the future. While we agree in principle that this will be a factor we observe that market pricing is consistent with the interest servicing ratio remaining near record low levels for years to come, even taking into account some upward pressure on spreads from the RBNZ’s bank capital review.2

Fiscal stimulus next year could be catalyst for higher long-end rates

One potential catalyst for higher long-end NZ rates is the possibility of additional fiscal stimulus from the government next year (the Budget is in May 2020, an election year). The last RBNZ statement observed that there was “scope for more fiscal and monetary stimulus, if necessary” implying fiscal policy could take some of the pressure off the RBNZ to support the economy. Indeed, were fiscal stimulus to be forthcoming, it’s possible the market could start to contemplate that we have seen the low in the OCR. Historically, the 10 year swap rate has bottomed in the three months preceding the final cut of the cycle (see Chart 14), although making that judgement in real-time is obviously difficult and there have been several false starts in the past.

The broader point is that we think the long-end of the NZ curve reflects a pessimistic future outlook, and the potential for fiscal stimulus is one reason to question that outlook and a possible catalyst for re-pricing.

If the RBNZ cuts the OCR at the November MPS, there’s likely to be a near-term relief rally in kiwi rates. But we still don’t think the medium-term case from owning/receiving the NZ long-end, both outright and cross-market, is convincing. In downside global scenarios there are now higher yielding markets to own, such as the US and Canada whose central banks have more room to cut rates (at least conventionally) than does the RBNZ.

Given the improved global backdrop, we think it’s unlikely that NZ 10 year swap will make new lows below 1.1%. Conversely, it’s not a stretch to think that 10 year swap can hit 2% over the next 6-12 months if the US 10yr yield can push towards 2% and the market starts to factor in a greater chance of fiscal policy in NZ, leading to NZ-US spread widening.

We think it might finally be time to consider using rallies to lighten long-end NZ duration exposures. We retain our medium-term bias for NZ curve steepeners and NZ-US long-end wideners.

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2 Assuming the household debt to income ratio and mortgage spreads are stable going forward.
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