

28 June 2018



Trade Idea: Receive November 2018 OIS

- **The RBNZ OCR Review signalled a less firm commitment to keep rates on hold.**
- **We think the risk of a rate cut over the remainder of the year is greater than the risk of a hike. We think the market should price the balance of probabilities into the OIS curve more towards cuts.**
- **While we think the likelihood of a cut is still low, an escalation in global trade tensions (and associated financial market volatility) or further softness in domestic activity data could see the market shift to pricing rate cuts into the very short end of the curve.**
- **We choose to receive the November 2018 meeting date OIS, which we think offers an asymmetric risk-reward profile.**

Strategy	Entry	Target	Stop	Carry and roll (1m)
Receive Nov meeting OIS	1.73%	1.67% initially	1.76%	-1bp

A less firm commitment to keep rates on hold

The RBNZ OCR Review contained a less firm commitment to keeping rates on hold. The Statement said that the RBNZ sees the OCR on hold “for now”; in the May MPS the wording used was “for some time”. Additionally, the RBNZ removed the reference to an equal balance between the risk of a rate cut and rate hike.

As the team [outlined](#) earlier today, the House view is that the Statement was reasonably balanced with no clear directional bias. However, we think the market will place more emphasis on several dovish references:

- Trade tensions had tempered global optimism;
- Weaker than expected GDP implied marginally more spare capacity;
- The fiscal impulse is now expected to be slightly lower and later than previously expected.

Taken in conjunction with the changes in language mentioned above, we think the market will conclude that the RBNZ has moved to a subtle easing bias.

Risk of a cut this year greater than risk of a hike

While we expect headline inflation to pick up over the remainder of this year (above what the RBNZ forecasts) the Governor has previously intimated that he wants to see

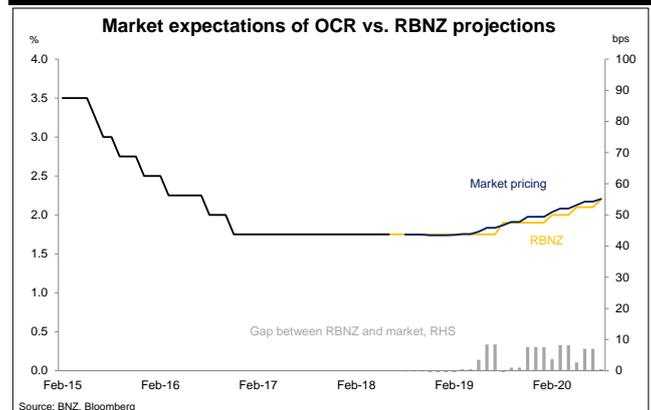
core inflation moving towards 2% before raising rates.¹ The RBNZ’s preferred measure of core inflation is the Sectoral Factor Model, which is currently 1.5% and has historically been very slow moving; core inflation is almost certain to be below target come the end of the year. We see the chance of a rate rise by the end of the year as close to zero.

In contrast, there are several scenarios we can envisage where the market might start to price-in the risk of rate cuts:

- An escalation in trade tensions and corresponding tightening in financial conditions. We note that the rate cut scenario outlined in the May MPS revolved around tighter financial conditions (which feeds through to lower export prices and higher mortgage rates);
- Weaker than expected GDP growth and labour market indicators, implying greater spare capacity in the economy. We note that Assistant Governor John McDermott referred to this risk in February.²

To be clear, the BNZ House view is that the RBNZ doesn’t cut rates and the next move is a tightening mid-next year. But we think the asymmetry in risks over the coming months means the OIS curve should price the balance of risks more towards rate cuts.

Market only pricing a marginal chance of RBNZ rate cut



¹ See “RBNZ’s Orr Wants Core Inflation to Pick Up Before Tightening”, Bloomberg, 10th May 2018.

² <https://www.stuff.co.nz/business/101325338/reserve-bank-chief-economist-if-growth-lags-were-cutting-the-banks-dont-get-that>

There has been a modest rally in the OIS curve since this morning's RBNZ Statement with the November OIS meeting around 1.74%, mid-market. Despite the rally, we think there is value in receiving this contract given its "option-like" characteristics. We would set a tight stop-loss at 1.76% and would re-evaluate our profit target if the contract traded to 1.67%, implying a one-third chance of a rate cut. The trade rolls slightly negatively by around 1bp over 6 weeks.

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