Global Markets Research

Interest Rates: Strategy

7 December 2015

Great Rate Expectations: a monumental moment in markets

***Gradualism**: "the policy of approaching a desired end by gradual stages".*

Unthought known – lift-off and the great gradualism debate.

"Feel the path of every day. Which road you taking?"

Now is Janet Yellen's moment. The moment to lift the heads of corporate America, by telling them the economy is strong enough. A moment monumental in markets. And ground-breaking action in a world of low inflation.

The economic data is good enough to justify lift-off. The stronger USD has been a key driver behind the lowering of the Fed's GDP forecasts. The large appreciation in the USD and its impact on the US economy is already largely factored into the FOMC's outlook. Despite the higher USD assumption and slower growth, the Fed has continued to signal higher rates. The Fed's Broad USD index is now only 1-2% above where it was ahead of the Sep '15 forecasts, and oil is lower. The higher USD, compounded by a lower price of oil, is disinflationary (chart 1). But the fall in the price of oil will support the US growth outlook. **December is a go** and 70% priced in the market.

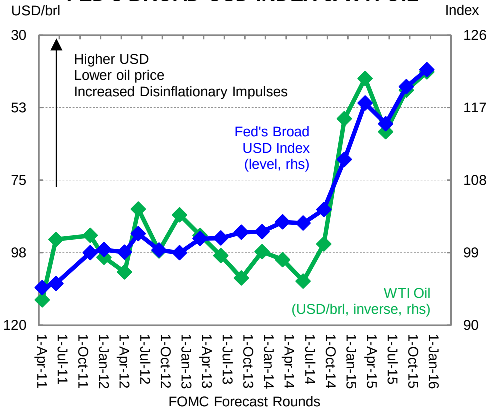
<u>The pace of gradualism is the great debate.</u> We offer some thoughts on the likely pace of Fed tightening in what will be a year of debate on the subject.

We chart the current "gradual" pace of tightening outlined in the FOMC's "dot plot" projections in September (chart 2). The current projected path is half as gradual as previous cycles. And relative to the past, because of the near-zero starting point, it will peak at a much lower level (Mar '88 9.75%, Feb '94 6%, June '99 6.5%, June '04 5.25%). The implied path in Fed funds market pricing, is half as gradual as the FOMC's predicted path. The CBA expected trajectory is split roughly down the middle. We agree with the Fed's initial lift-off towards 1% (chart 3). Although we believe the FOMC will ultimately under deliver on their longer term trajectory. We expect the FOMC to use the dot plots to arrest any sharp sell-off in US rates (particularly long-end rates). **The FOMC will most likely give with one hand (hike the funds rate), and take with the other hand (lower the dot plots).**

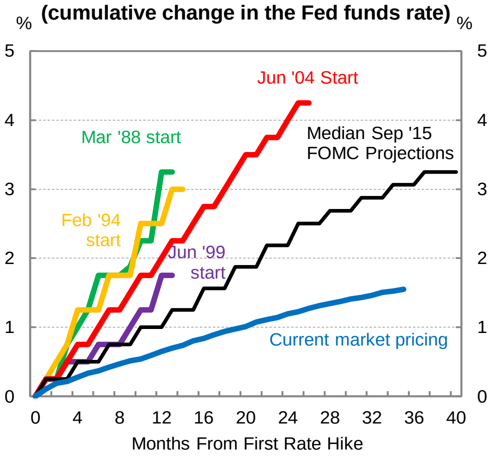
The market is likely to be shocked regardless. We believe the Fed will trim the dot plots by as much as 25 to 50bps, but not by more. The FOMC have trimmed their long-run median plot from 4.25% to 3.5% over 2015. We expect a move to 3% in 2016, but not in one meeting. **The FOMC is highly unlikely to slash the dot plots enough to justify current market pricing**. We believe most of the market's disbelieve in the FOMC's trajectory is around "lift off", with so many false starts, rather than the pace thereafter. We continue to expect a sharp sell-off in short to mid-curve US rates from December. A Fed funds rate hike in December and an FOMC dot plot projected path slightly lower to that in September, should see the market pricing adjust significantly higher. And the month of December is historically (or notoriously) more frustrating for liquidity.

Into the Fed decision, we hold a **paid position in April OIS** (established at +30bps), currently ~47bps, and we target a pop higher towards 75bps. We see the Fed tightening in December, and again in Q1 and Q2. We also hold a **2s10s swap curve flattener** (established at 130bps), currently ~110bps, and we target a drop to 90bps. Tightening cycles flatten curves.

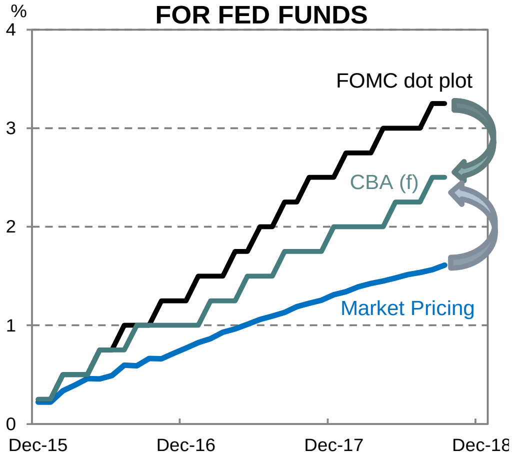
1. **FED's BROAD USD INDEX & WTI OIL**



2. **FED RATE HIKE CYCLES**
(cumulative change in the Fed funds rate)



3. **RISKS TO MARKET PRICING FOR FED FUNDS**



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Porch: the Wheels are turning down the downside.

"All the bills go by and, initiatives are taken up, by the middle. There ain't gonna be any middle any more..."

At polar opposites of the Fed, we await the mighty RBNZ. In the September Monetary Policy Statement the central, or middle, scenario was a cut to 2.5%. There ain't going to be any middle any more. We expect the RBNZ to deliver on its central scenario, and possibly better outline a path to 2%. The current "*downside*" scenario to 2% is likely to move a step closer to a central scenario, if not this week, then in 2016 (chart 4).

The central scenario of 2.5% has been signalled. And we believe the central scenario will be delivered this Thursday. In every decision there are pros and cons, risks and rewards. The risks of remaining on hold outweigh any rewards. The Antipodean transition from goods exports, to service exports requires a weaker currency. The drop in New Zealand's terms of trade requires a softer currency to alleviate the blow to domestic incomes. A weaker currency also stimulates key exports in tourism, education and other manufactures (and the same can be said for Australia).

Should the RBNZ decide to hold the cash rate above their central scenario at 2.75% Thursday, then all hell will break loose. The currency would spike at least 1-2 cents higher, and the rates market would be unforgiving in a 15 to 25bps move higher. The strength of the NZD TWI is deflationary, and currently 7-to-10% *ABOVE* the RBNZ's forecast track (chart 5). Most of the RBNZ's forecast return to 2% inflation is based on a bounce in tradables inflation (chart 6). We believe the strength of the currency has significantly reduced the likely bounce in tradables inflation. It is time for the RBNZ to use its main policy tool.

The path of least resistance is a rate cut to the telegraphed 2.5%. The rates market would move ~10-15bps lower is a controlled (front-loaded) move, and the currency could lose as much a cent. Job done. The only risk into 2016, is a move towards 2%. We recently lowered our forecast track for Kiwi rates; see "*Kiwi swap forecasts revised lower, as a 2% OCR is now our base case*". We now forecast a 2% cash rate by mid-2016 (no longer a *risk* scenario). We now forecast the 2-year swap rate trading towards 2.2% (more than 30bps below our previous estimate). The OIS strip offers significant value above 2.4%, and OIS flatteners can reduce directional risk (chart 7).

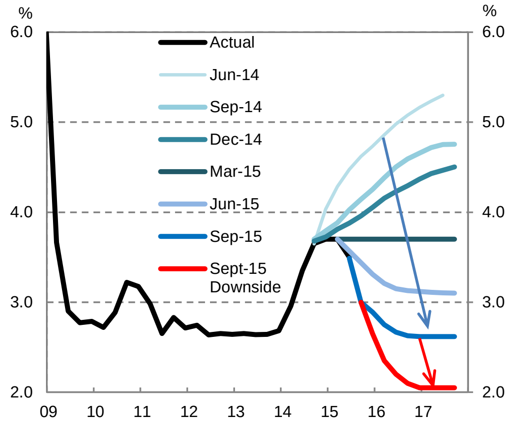
We recommend an OIS flattener in Kiwi. We recommend paying March OIS at 2.48%, versus receiving September OIS at 2.41%. The spread of -7bps offers good risk/reward. We believe the trade risks just ~4bps for a potential +27bp gain. If the RBNZ cut in December and hold for longer, the March OIS leg will gain a few points, while the September OIS leg will lose a few more. The spread may steepen to -3bps. Alternatively, if the RBNZ cuts to 2.5% and then moves down the downside scenario to 2% (our forecast), the paid position in March may gain (if the second move is delayed), or will lose far less than the received position in September OIS. Two cuts to 2% by mid-year could see a gain of over 40bps on the September OIS leg alone (chart 7).

Dissident: Draghi decides to under deliver

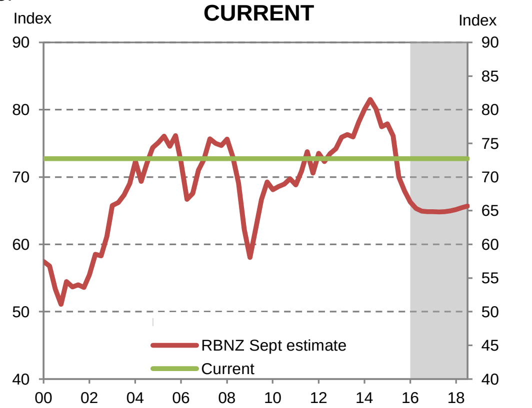
"Escape is never, the safest path. A dissident…"

The market was "Draghi-nated" at the December ECB meeting after more policy easing was announced. But it was not enough to match, never mind exceed, the high hurdle set by the market. The ECB cut the deposit rate by 10bpts to a new record low -0.3%, and increased the duration of its €60bn per month asset purchase program by 6 months to "*March 2017, or beyond, if necessary*". Added to that, the ECB announced that it would "*reinvest the principal payments*" on assets purchased during the QE program beyond March 2017 and for "*as long as necessary*".

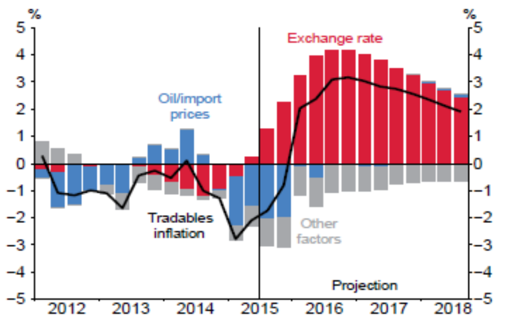
4. RBNZ FORECAST OF 90-DAY RATES



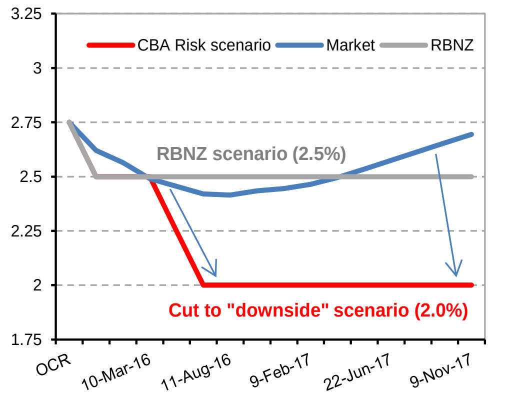
5. RBNZ FORECAST OF NZ TWI VERSUS CURRENT



6. DRIVERS OF INFLATION



7. CBA FORECAST VERSUS MARKET PRICING FOR RBNZ



The market was clearly caught off guard, ourselves included. However the fact remains, the ECB eased policy further, with the risks skewed towards more action in 2016. The large Eurozone output gap, ongoing but historically tepid domestic Eurozone recovery, slowing emerging market growth, and lower commodity prices should keep inflation pressures muted. The ECB is already operating on a low margin of error, with the deviation in its inflation forecasts two-year ahead relative to its target (0.3%pts) still quite large (chart 8). It would not take much for policy to be adjusted further.

Overall, the ongoing and extended ECB balance sheet expansion, the decision to reinvest principal payments, a lower deposit rate and the ECB's forward guidance should see excess liquidity in the Eurozone financial system continue to rise (chart 9). This will continue to push Eurozone money market rates down towards the new lower deposit rate. Front-end Eurozone swap rates should remain pegged in negative territory for the foreseeable future.

We continue to favour long duration positions in European rates. We hold a received position in 2-year EONIA (established at -10bps), currently -23bps, and we target a move to -35bps. **Monetary policy divergence between the Eurozone and US is ongoing**, and will widen as the Fed starts its tightening cycle in December. Given our expectations for Eurozone rates and our view that more of a cycle will be priced in for the US Fed, we look for a further widening in the US-Eurozone two-year swap spread (currently 103.5bps). We target 150bps, and hold the stop at 90bps.

Rearviewmirror: the BoE wants the Fed to go first

"I'm not about to give thanks, or apologize… I hardly believe, finally the shades are raised."

The domestically orientated parts of the UK economy remain on solid ground. The UK composite PMI has rebounded over the past couple of months, dragged up by the services sector which comprise close to 80% of the UK economy. The drivers of solid domestic demand, such as real wage growth, buoyant consumer and business confidence, and a robust labour market remain in place. From the external sector, the additional ECB measures, designed to reinforce the Eurozone recovery, should indirectly support the UK via the trade channel. The Eurozone is the UK's largest export destination.

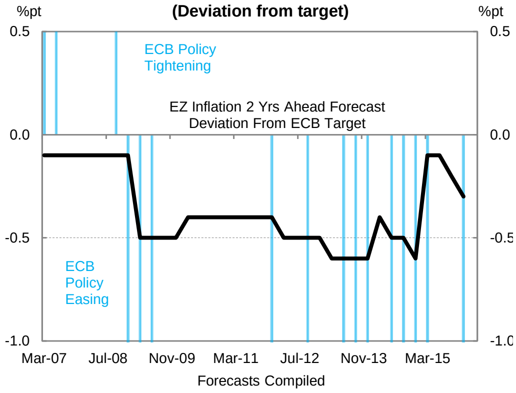
Slack in the UK economy is close to being eroded. Annual wage growth finally looks to be on an upward trend (chart 10). This, combined with the rolling off of base-effects from lower energy prices should trigger the start of the turn higher in UK CPI in coming months. This turn higher would give comfort to the BoE. Furthermore, we remain of the view, that a somewhat orderly market reaction to a Fed rate hike in December will also give confidence to the BoE about the global backdrop. And once the Fed kicks off its cycle, the broader market will refocus its attention on which central bank could be next. The BoE is the only other major central bank with a longer-dated tightening bias. We continue to look for a BoE rate hike in May 2016, with a risk it is delayed to August. Our expectations on the BoE led us to **pay the July 2016 OIS**. We hold the position on the risk of a BoE move in May.

Release: Stevens to say goodbye, but at what rate?

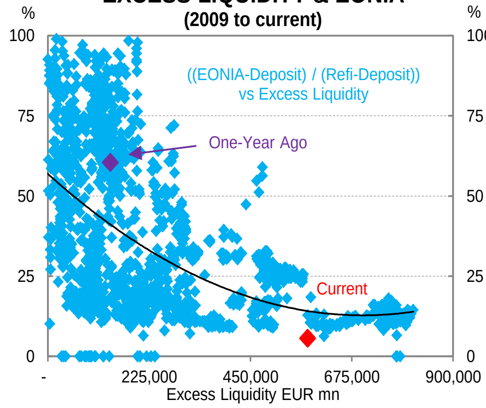
"For you to speak to me, I'll open up, Release me"

2016 marks the last year in office for RBA Governor Glenn Stevens. Of course he'd like to hand over a healthy economy to the Governor in waiting (Phil Lowe?). A policy mistake in the form of tighter policy is an unlikely legacy. Getting any necessary rate cuts out of the way to give the incoming Governor a cleaner slate, must be a consideration. The Governor has made it crystal clear that if the economy looks in need of an injection, he'll deliver the medicine. And one simple dose won't do, the prescription will be two. But we are some way away from any action, however. The Governor told us at the ABE dinner to "chill out" over the Christmas break. Or more importantly, chill out over the

8. **ECB STAFF INFLATION FORECASTS**

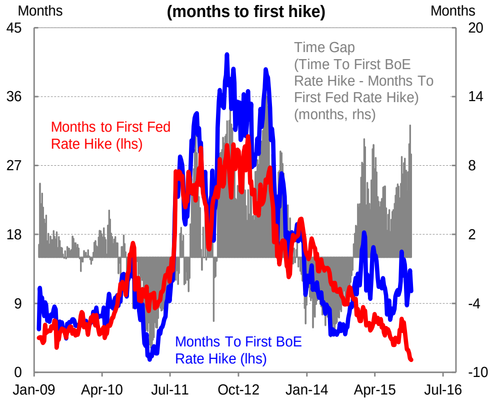


9. **EXCESS LIQUIDITY & EONIA**



10. **UK PHILLIPS CURVE**

11. **FED & BoE RATE EXPECTATIONS**



FOMC decision. There is no doubt in our minds that **Fed lift-off is beneficial to Antipodean central bankers. It is all about the currency after all.**

In the lead up to the FOMC meeting, and with the RBA sidelined until at least February, the Aussie rates market has sold off. **We believe the rates market has sold off too much, however.** In the Aussie OIS, OIS, OIS! market we have gone from an arguably stretched implied terminal rate of 1.52%, to 1.85%, in just a few weeks. See chart 12.

Against our paid positions in US (and UK) short-end rates, we hold received positions in Australia. We have recommended a received position in June OIS, a March-June OIS flattener, and a 6m1y swaption receiver spread. We entered these trades too early, and they have moved slightly against us. We remain steadfast in our conviction and hold long-duration positions in the Aussie short-end. Because we believe the recent move higher has gone too far.

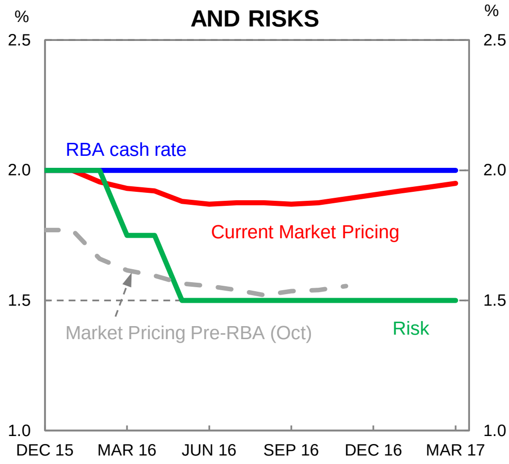
The trade we believe will work well into 2016, is the March-June OIS flattener (chart 13). If the RBA remains chilled out for longer, the March OIS will gravitate to 2%. The risk of a rate cut to 1.5% is ever-present, and should keep the June OIS reflecting the risk of -50bps.

Current OIS market pricing is presented below on page 4, along with our current trade recommendations on page 5.

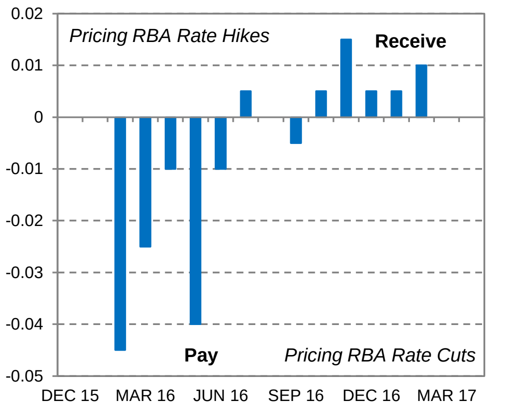
As we move into 2016, we would appreciate any feedback on the “Great Rates Expectations” publication. Any thoughts on how we can improve the publication would be greatly appreciated.

Thank you for reading.

12. **MARKET PRICING FOR RBA AND RISKS**



13. **MARKET PRICING FOR RBA**
(30-day Interbank Futures)



Current OIS market pricing

US	Implied	Cum. BP	Cum. %
07-Dec-15	0.13		
16-Dec-15	0.31	0.18	70%
27-Jan-16	0.35	0.22	86%
16-Mar-16	0.45	0.32	126%
27-Apr-16	0.51	0.38	153%
15-Jun-16	0.59	0.46	183%
27-Jul-16	0.65	0.52	210%
21-Sep-16	0.75	0.62	246%
02-Nov-16	0.81	0.68	274%
14-Dec-16	0.90	0.77	307%

Australia	Implied	Cum. BP	Cum. %
07-Dec-15	2.00		
02-Feb-16	1.96	-0.04	-17%
01-Mar-16	1.93	-0.07	-26%
05-Apr-16	1.88	-0.12	-48%
03-May-16	1.88	-0.12	-47%
07-Jun-16	1.90	-0.10	-40%
05-Jul-16	1.90	-0.10	-40%
02-Aug-16	1.87	-0.13	-53%
06-Sep-16	1.87	-0.13	-53%
04-Oct-16	1.87	-0.13	-53%
01-Nov-16	1.87	-0.14	-57%
06-Dec-16	1.88	-0.12	-49%

New Zealand	Implied	Cum. BP	Cum. %
07-Dec-15	2.75		
10-Dec-15	2.65	-0.10	-41%
28-Jan-16	2.57	-0.18	-74%
10-Mar-16	2.51	-0.24	-96%
28-Apr-16	2.47	-0.28	-114%
09-Jun-16	2.44	-0.31	-125%
11-Aug-16	2.41	-0.34	-138%
22-Sep-16	2.40	-0.35	-140%
10-Nov-16	2.41	-0.34	-137%
22-Dec-16	2.42	-0.33	-131%

Euro	Implied	Cum. BP	Cum. %
07-Dec-15	-0.13		
21-Jan-16	-0.24	-0.11	-43%
10-Mar-16	-0.24	-0.11	-44%
21-Apr-16	-0.24	-0.11	-43%
02-Jun-16	-0.24	-0.11	-45%
21-Jul-16	-0.25	-0.12	-49%
08-Sep-16	-0.27	-0.14	-57%
20-Oct-16	-0.28	-0.15	-60%
08-Dec-16	-0.27	-0.14	-56%

UK	Implied	Cum. BP	Cum. %
07-Dec-15	0.46		
10-Dec-15	0.46	0.00	1%
14-Jan-16	0.45	-0.01	-2%
04-Feb-16	0.46	0.00	0%
17-Mar-16	0.50	0.04	14%
14-Apr-16	0.51	0.05	22%
12-May-16	0.54	0.08	31%
16-Jun-16	0.56	0.10	42%
14-Jul-16	0.59	0.13	51%
04-Aug-16	0.61	0.15	60%
15-Sep-16	0.66	0.20	79%
13-Oct-16	0.68	0.22	89%

*A 25bp hike should see the Fed Fund rate to 0.375, inside the Fed's target band of 0.25-0.50

Trade tracker table for 2015

Trade recommendation	Start Date	Entry	Target	Stop	Current P&L (bps)	Target P&L (bps)	Action
Receive EUR 2Y versus paid USD 2Y swap spread	7-Dec-15	103	150	90	-	47	ESTABLISH
Receive AUD June'16 OIS	10-Nov-15	1.82	1.5	1.92	-5.00	32	Hold
Receive NZD Mar'16 OIS	10-Nov-15	2.56	2.25	2.65	7.00	31	Hold
Receive NZD 1y1y swap rate *	10-Nov-15	2.87	2.25	3	8.76	62	Hold
Receive AUD 6m3y swap rate	5-Nov-15	2.18	1.6	2.3	-11.00	58	Hold
AUD 6m1y swaption 1.8%/1.55% 1x2 receiver spread	5-Nov-15	1.88	1.55	1.3	-	22.5	Hold
Receive NZ 2y3y versus paid US 2y3y *	4-Nov-15	131	80	145	3.07	51	Hold
Pay US April'16 OIS *	19-Oct-15	30	75	39	17.00	45	Hold
Pay UK July'16 OIS	19-Oct-15	57	75	52	3.00	18	Hold
Receive Aus 5-year 1m /1m BOB	16-Oct-15	9.75	5.75	12	2.75	4	Hold
Pay Aus 10y10y 6s3s basis	16-Oct-15	0	10	-3	1.00	10	Hold
Pay Aus Mar'16 OIS versus receive Jun'16 OIS	26-Aug-15	-3	-20	4	3.00	17	Hold
US 2s10s swap curve flattener	10-Aug-15	130	90	140	15.62	40	Hold
Receive EU 2-year EONIA *	9-Jul-15	-10	-35	-20	-9.77	25	Hold
Receive NZ 5y5y versus paid US 5y5y	11-May-15	140	75	165	-11.50	65	Hold
NZ 2s10s swap curve steepener (re-enter) *	11-May-15	50	150	30	37.25	100	Hold
Outstanding P&L					**61.17**	*627.5*	

** targets revised*

Trades closed year-to-date	Start Date	Entry	Target	Exit	Booked P&L (bps)	Target P&L (bps)	Action
Pay AUD/USD 10y10y xccy basis	7-Oct-15	-9.5	5	-15	-5.50	14.5	STOPPED OUT
Receive NZ 2y1y swap rate * revised stop hit	11-Jun-15	3.55%	2.75%	3.05%	50	80	PROFIT
Receive NZ 1y1y swap rate * revised stop hit	11-Jun-15	3.05%	2.60%	2.85%	20	45	PROFIT
Pay Aus 10y EFP	25-Sep-15	27	40	20	-7	13	STOPPED OUT
Receive CAD 2y1y swap rate	9-Jul-15	1.16%	0.92%	1.20%	-4	24	STOPPED OUT
Receive CAD 2y swap rate	9-Jul-15	0.84%	0.78%	0.78%	6	6	TARGET HIT
Pay Aus Nov OIS versus receive Mar OIS	21-Jul-15	-1.5	-20	-16	15	18	PROFIT
Aus 2s10s swap curve steepener	20-Apr-15	60	120	120	60	60	TARGET HIT
Receive NZ 1y1y swap rate	11-May-15	3.40%	3.00%	3.00%	40	40	TARGET HIT
NZ 2s10s swap curve steepener	1-Mar-15	10	50	50	40	40	TARGET HIT
Aus 6m2y versus 6m4y swap steepener	5-Feb-15	10	35	35	25	25	TARGET HIT
Receive NZ June'15 OIS	30-Jan-15	3.39%	3.00%	3.25%	13.75	13.75	TARGET HIT
Receive NZ 3m1y versus paid US 3m1y	23-Jan-15	309	280	280	29	29	TARGET HIT
Receive NZ 1y1y swap rate	22-Jan-15	3.67%	3.40%	3.40%	27	27	TARGET HIT
Pay Aus Oct '15 OIS	22-Dec-14	2.17%	2.50%	2.00%	-17	33	STOPPED OUT
Receive NZ 5y5y versus paid Aus 5y5y	26-Nov-14	65	40	40	25	25	TARGET HIT
Pay Aus 3y 6s3s BBSW-BBSW basis	18-Aug-14	6.375	13	13	6.625	6.625	TARGET HIT
Pay Aus 3y 3s1s BBSW-BBSW basis	18-Aug-14	6.75	13	13	6.25	6.25	TARGET HIT
P&L booked year-to-date					**330.13**		
Profit/Loss Ratio					*3.10*		

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