Global Markets Research

Fixed Income & Rates: Kiwi Trade Note

21 March 2016

Adding to long Kiwi positions, as the RBNZ takes on the RBA.

Kiwi rates now have more value, much more value.

We recommend clients:

1. Receive August OIS at 1.98%. Risk 2bps to gain 48bps.
2. Receive 2y3y at 2.77%. Risk 13bps to gain 57bps.
3. Long NZGB 27s versus Short ACGB 27s. Risk 15bps to gain 50bps.

Wheeler the reluctant, well no more.

We now see a very good chance that the RBNZ cuts the cash rate to 1.5%. The risk is the RBNZ tries to stay ahead of currency markets and cuts consecutively to 1.5% by August. **We upgrade our weighting in Kiwi rates from "raging bulls", to "break the limits long".** We have heightened our conviction on Kiwi rates following an extensive marketing trip to middle earth. Governor Wheeler has proven himself responsive, not reluctant, but a little remiss.

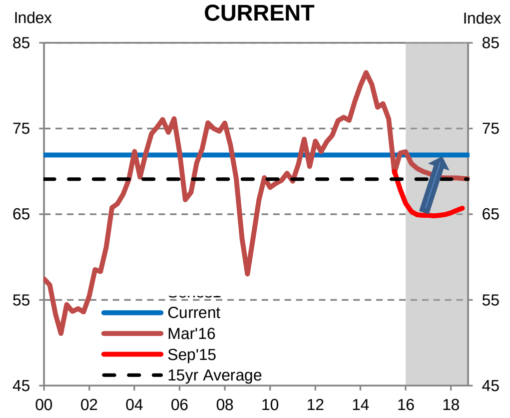
There are three themes resonating with RBNZ officials, and Kiwi corporates:

1. **The Kiwi dollar is too high.** The big dollar is largely to blame. The sharp turnaround in Fed rhetoric reflects a high sensitivity to the USD and global developments. The Kiwi dollar is also too high against the AUD. The RBNZ can at least attack the Aussie. And like an All Black front row, the RBNZ must be the favourite here.
2. **Inflation expectations are too low.** Tradables inflation is largely to blame. The currency is not helping with the reversal. Inflation expectations are falling. And expectations have become more backward looking. Mechanically, 2-year ahead inflation expectations will continue to fall with the last CPI print. The auto-regressive nature of expectations is frustrating for a central bank using forward guidance.
3. **Negative rates mean lower lower bounds all round.** The BoC's recently published "*Prudent Preparation: The Evolution of Unconventional Monetary Policies*" delivered a revised lower bound of -50bps for Canada's policy rate. The BoC operate an effectively identical OCR to the RBNZ (and RBA). The BoC's work strongly suggests a theoretically negative lower bound down under. Whatever we thought the lower bound was for the RBNZ's OCR, it is much lower, and theoretically negative. We are all merely a spread to each other after all.

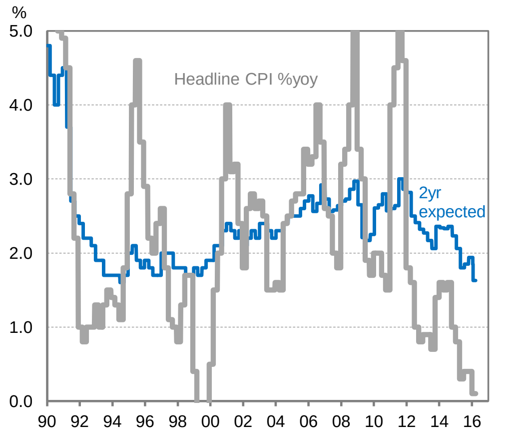
The risks facing the New Zealand economy are heavily tilted to the downside. We expect the RBNZ to cut in April to 2.0%. And then use the June MPS to explain a change in tack to 1.5%. The RBNZ's two downside scenarios, outlined in the March MPS, show a move to 1.5%. The RBNZ's previous downside surprise scenarios have become central scenarios for the past 18 months. We expect no different this time around.

We recommend three trades to benefit from the likely move lower in Kiwi rates. And we overview our current recommended trades, most of which have benefitted from the RBNZ cuts to date.

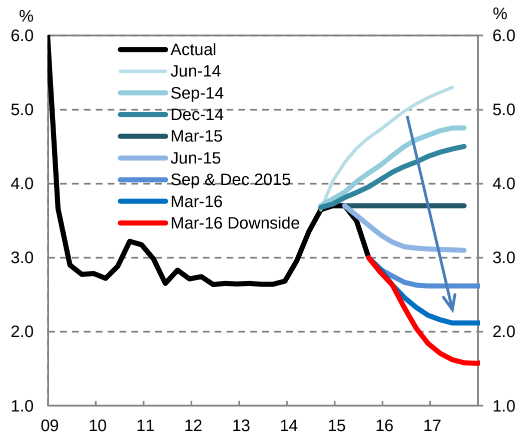
RBNZ FORECAST OF NZ TWI VERSUS CURRENT



KIWI INFLATION EXPECTATIONS



RBNZ FORECAST OF 90-DAY RATES



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We also preview our lower Kiwi forecasts, on page 6, to reflect the extra 50bps of cuts forecast from 2% to 1.5%. See indicative table on page 6. Our global bond and swap forecasts are currently under review and will be lowered in a forthcoming note.

The risks remain asymmetric, to the downside.

New Zealand is a small open economy. And global growth has disappointed. Nominal growth across the world is sub-trend. Inflation expectations are falling everywhere - except in those few nations with collapsing currencies. Bank funding costs are being driven higher by regulation, and reduced risk appetite. Negative interest rates in large parts of the world are reducing bank profitability and widening rate differentials. The Kiwi currency is an attractive high yielder.

The US Fed was more dovish than expected. The Fed's March statement and projections show in no uncertain terms that rate hikes are not imminent, and maybe a 2H'16 story. Despite a rise in core inflation and a calming of fears in financial markets, the FOMC showed fear in the face of turbulence. The balance of risks statement vanished and international risks shone. The terminal, or neutral rate was lowered again. It won't be long before 3% becomes the central estimate. This time last year not one FOMC member predicted the neutral rate to be 3%. Now 5 FOMC members (almost 1/3 of the board) see 3% as neutral. The risk is some members move below 3%, and they start to highlight that is a long-run estimate, rather than any 'target' to be achieved in this cycle. Long-end yields are lower and we are convinced that upside is minimal.

The weaker global backdrop has heightened downside risks to inflation. The RBNZ have noted that inflation expectations have become more backward looking. Mechanically, the sharp decline in headline inflation will continue to alter perceptions of medium term inflation. The currency is no help.

The RBNZ estimated neutral rate in New Zealand is now 4%, down from 4.5%. By definition, the current policy stance is less accommodative. And there are asymmetric risks to the outlook.

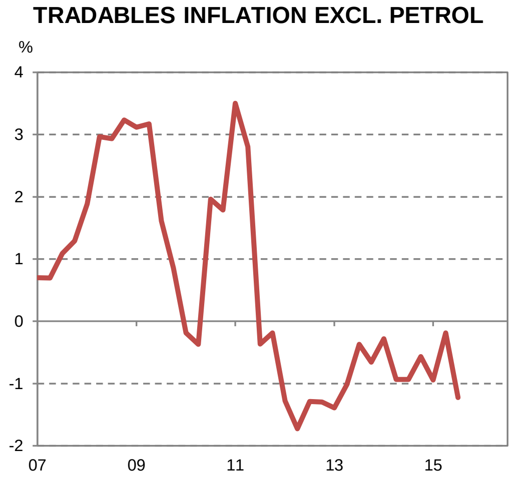
The RBNZ outlined three risks, each with a bp impact on the 90-day trajectory:

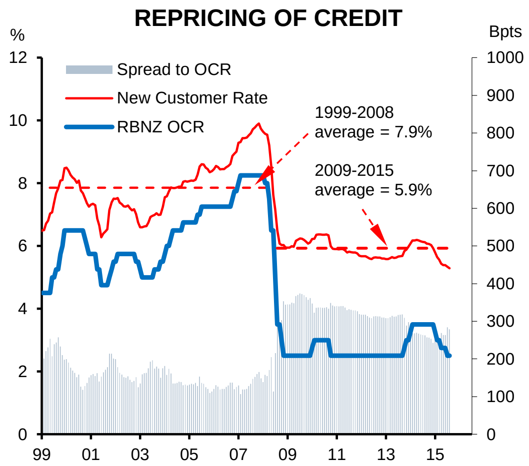
1. Lower imported inflationary pressure (-40bps);
2. Reduced risk appetite in financial markets, or bank funding (-50bps);
3. Higher house price inflation and domestic demand (+40bps).

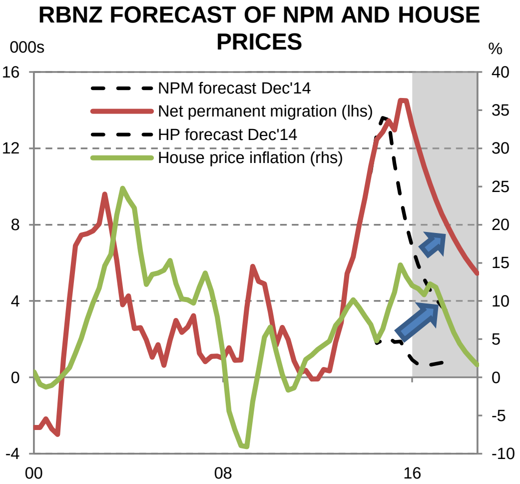
The RBNZ has expressed 2:1 downside risks. We believe the RBNZ sees at least a 30% chance of a move to 1.5%. The 1 in 3 chance of 1.5% will be tested across these 3 main risks.

The first risk is purely currency. The RBNZ's TWI forecasts have been reluctantly rebased and revised higher (chart 1). The current TWI is 6% higher than the RBNZ's March quarter forecast from the September MPS. The RBNZ's entire forecast trajectory is now ~7% higher from the September MPS trajectory. The softening USD was reinforced by last week's FOMC statement. The threat to inflation from weaker imported prices remains. **The RBNZ is one step down the first "lower imported inflation" downside scenario.** To offset lower imported costs the RBNZ have an additional 40bps of easing in the 90-day to 1.7% (so 1.5% OCR).

The second risk is bank funding. Bank funding costs are inhibiting pass-through. We believe the RBNZ is factoring in ~40bps of pass-through to variable mortgage rates from 50bps of cuts. The pass-through from the first 25bp rate cut is just ~15bps. The majority of Kiwi mortgages are on fixed rates. And the pass-through to fixed rates has been less. **The RBNZ is already one step down the second "higher funding costs" downside scenario.**

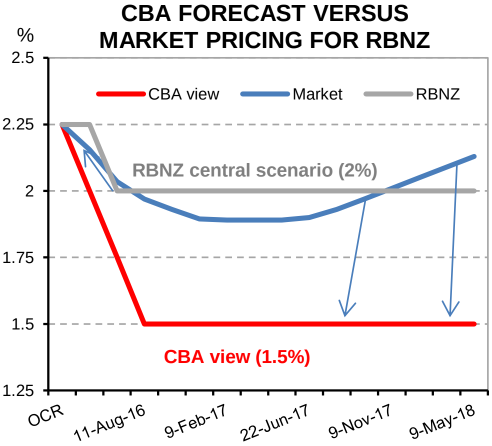






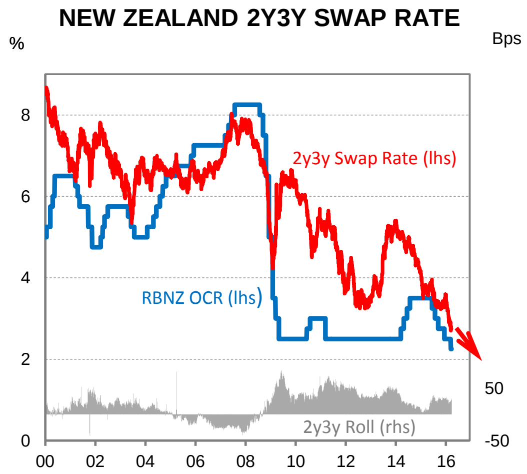
To offset mortgage spreads the RBNZ have an additional 50bps of easing in the 90-day to 1.6% (flirting with 1.25%).

The third risk is translation from housing to spending. The only upside risk. *"If stronger house price inflation translated into additional growth in residential construction activity and consumption expenditure, domestic demand could be stronger than in the central projection" (RBNZ MPS).* The lonely upside scenario has been tempered by the recent cooling in Auckland house prices. And inflation has been restrained despite the surge in housing. Financial stability concerns have been approached with macro-prudential measures. And much of Auckland's housing "shock" can be attributed to migration, rather than speculation. To tackle higher house prices and non-tradables inflation, the RBNZ have a 90-day track of 2.5% (unchanged OCR at 2.25%)



We add to our Long Kiwi bond position and add two received positions in Kiwi rates.

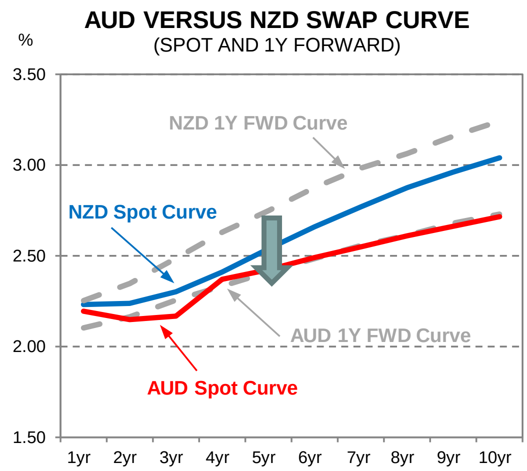
In terms of reward for received trades, the potential payoff is large. We believe there is a 75% chance of a cut to 1.75%, and over 50% chance of a rate cut to 1.5%. And there is at least a 10-to-20% chance of a cut to 1.0%. In terms of risk, we believe there is a <5% chance of the RBNZ remaining on hold at 2.25% and/or contemplating hikes this year (so 95% chance the RBNZ cuts to 2% or below).



We recommend an outright received position in August OIS. The August meeting is an MPS date, so contains the ability for the RBNZ to change direction. The August OIS captures 3 meeting dates and 2 MPS releases. There is a significant probability that the RBNZ cuts at all 3 meetings.

We recommend receiving August OIS at 1.98%. We hold a stop at 2.0% to risk 2bps. We target a move to 1.5%, but would settle for a move to 1.75%. **The trade therefore risks 2bps to gain 23bps to 48bps.** The risk/reward in being received August OIS is remarkable given the bearish RBNZ commentary.

We also recommend receiving 2y3y swap rate at 2.77%. The curve has steepened into the belly and offers attractive carry. The carry and roll on the 2y3y is ~30bps per annum. We target an ambitious to 2.20% (70bps above our expected OCR rate). We hold a stop of 2.90%. **We risk 13bps to gain 57bps.** The risk reward in being received the belly of the Kiwi curve is adequate given the risks offshore, and continued hunt for yield.



In 2010, the Kiwi 10-year bond yield traded nearly 100bps below the Australian 10-year bond rate. The RBA was tightening at the time, but a recent precedent was set. If the RBNZ are serious about influencing the currency lower, and targeting the Aussie is the obvious choice, they may well attempt to take Kiwi rates well below Aussie rates. RBA rate cuts (given their own currency dilemmas) may prevent that, but it provides good reason to think the RBNZ is going to end up well below 2.0% (the current RBA cash rate).

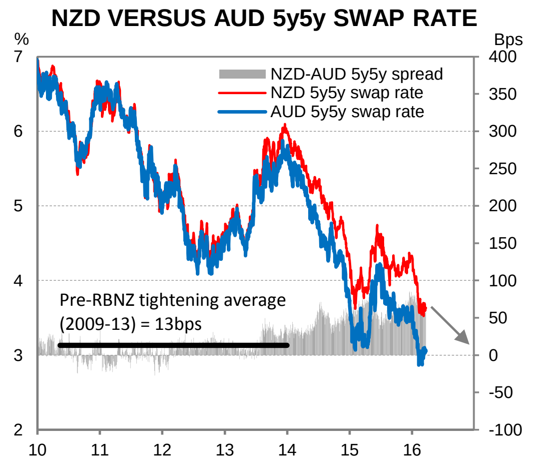
Our long duration bias in Kiwi is strengthened by adding **a long position in NZGB April 2027s.** We are somewhat concerned with an unexpected bounce in US Treasury yields. FOMC members may actually deliver on their forecasts, maybe. We look to partially offset the FOMC risk with a short position in ACGB April 2025s. **The NZCG 27s to ACGB 27s spread is currently 34bps.** We target a move to -20bps. We establish a stop at +55bps.

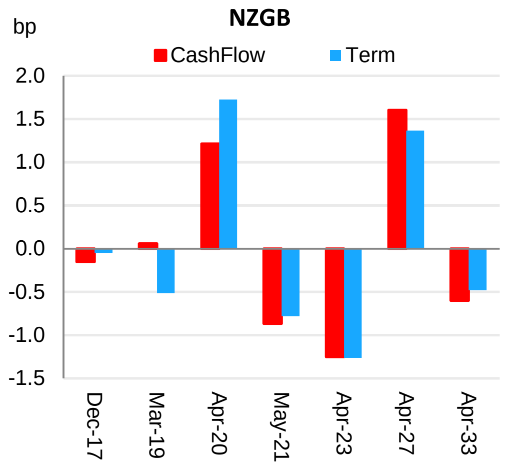
From a relative value perspective the ACGB 27s are slightly "rich" on the curve. The NZGB 27s have softened recently and look very "cheap" on the curve. In a sharp US led sell-off we expect the ACGB 27s to underperform the NZGB 27s. The Kiwi outperformance should be reinforced by the relative stance of the central banks. RBNZ cutting and RBA holding (for now) implies a sharp contraction in NZ-AU rate spreads.

We have hit target on our Kiwi OIS flattener. We paid March OIS versus received September OIS at -7bps. We lost on the March leg, but gained on the September leg. **The spread hit our target of -34bps, for a 27bps gain.** The March-September flattener is a prime example of the effectiveness of OIS flatteners, even when we are surprised by earlier-than-expected rate cuts.

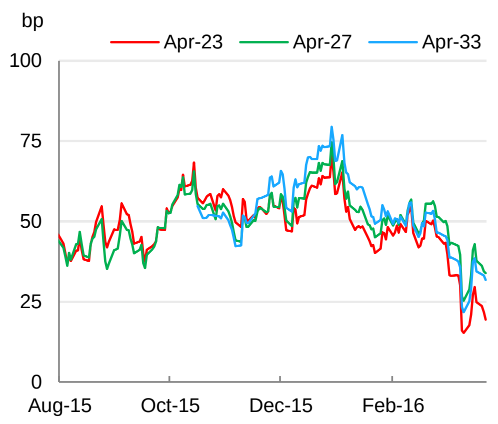
Unfortunately, our mistimed paid April OIS position stopped out. And is a prime example of over-thinking an already great portfolio position. We lost 7bps on the paid April OIS. We risked 7 to gain 18bps.

We hold our outright received Kiwi 1y1y (from 2.87%), Kiwi 2s10s steepener (from 50bps), and our NZ-US 5y5y spread compression trade (from 140bps).





NZGB Spreads to matched ACGBs:



Trade tables

Trade recommendation	Start Date	Entry	Target	Stop	Current P&L (bps)	Target P&L (bps)	Action
Receive NZ Aug'16 OIS	**23-Mar-16**	**1.98**	**1.5**	**2.0**	**-**	**48**	**LOCK AND LOAD**
Receive NZ 2Y3Y swap rate	**23-Mar-16**	**2.77**	**2.20**	**2.90**	**-**	**57**	**LOCK AND LOAD**
Receive UK Aug'16 OIS versus pay Dec '16 OIS	26-Feb-16	-9	20	-17	3	*29*	Hold
Receive US Jun'16 OIS versus pay Jun'17 OIS	26-Feb-16	7	50	0	26	*43*	Hold
Pay Aus July'16 OIS	26-Feb-16	1.78	2.00	1.70	14.5	*22*	Hold
Aus 1y1y versus 1y5y swap curve steepener	15-Feb-16	30	70	10	-1.5	*40*	Hold
Pay Aus Sep'16 OIS versus receive Mar'17 OIS	21-Jan-16	-4	-20	2	3	*16*	Hold
Receive EUR 2Y versus paid USD 2Y swap spread *	7-Dec-15	103	150	113	34.8	*47*	Hold
Receive NZD 1y1y swap rate *	10-Nov-15	2.87	2.25	2.7	62	*62*	Hold
Receive AUD 6m3y swap rate *	5-Nov-15	2.18	1.6	2.1	-7.0	*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 Aus 5-year 1m /1m BOB	16-Oct-15	9.75	5.75	12	1.3	*4*	Hold
Pay Aus 10y10y 6s3s basis	16-Oct-15	0	10	-3	4.0	*10*	Hold
Receive NZ 5y5y versus paid US 5y5y	11-May-15	140	75	165	1.7	*65*	Hold
NZ 2s10s swap curve steepener (re-enter) *	11-May-15	50	150	30	25.5	*100*	Hold
P&L outstanding					**167.29**	*518.5*	

** targets revised*

Trades closed year-to-date	Start Date	Entry	Target	Exit	Booked P&L (bps)	Target P&L (bps)	Action
Pay Kiwi Mar'16 OIS versus receive Sep'16 OIS *	7-Dec-15	-7	-34	-20	-7	*#VALUE!*	TARGET HIT
Pay Kiwi April'16 OIS	26-Feb-16	2.32	2.50	2.25	-7	*18*	STOPPED OUT
US 2s10s swap curve flattener	10-Aug-15	130	90	140	40	*40*	TARGET HIT
Pay US April'16 OIS *	19-Oct-15	30	75	39	9	*45*	PROFIT
Pay US 1y1y swap rate	21-Jan-16	1.05	1.55	0.95	*-10*	*50*	STOPPED OUT
Pay UK 1y1y swap rate	21-Jan-16	0.585	0.75	0.52	-6.5	*16.5*	STOPPED OUT
Pay Aus Mar'16 OIS versus receive Jun'16 OIS	26-Aug-15	-3	-20	-16	13	*17*	PROFIT
Receive AUD June'16 OIS	10-Nov-15	1.82	1.5	1.73	9	*32*	PROFIT
Receive NZD Mar'16 OIS	10-Nov-15	2.56	2.25	2.33	23	*31*	PROFIT
Receive EU 2-year EONIA *	9-Jul-15	-10	-35	-35	25	*25*	TARGET HIT
Pay UK July'16 OIS	19-Oct-15	57	75	52	-5	*18*	STOPPED OUT
Receive NZ 2y3y versus paid US 2y3y *	4-Nov-15	131	80	145	-14	*51*	STOPPED OUT
P&L booked year-to-date					**69.50**		
Profit/Loss Ratio					*1.88*		

Trades closed in 2015	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	*39*	PROFIT
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 in 2015					**330.13**		
Profit/Loss Ratio					*3.10*		

Current OIS pricing across markets

	Implied	Cum. BP	Cum. %
23-Mar-16	0.36		
27-Apr-16	0.39	0.03	13%
15-Jun-16	0.44	0.08	32%
27-Jul-16	0.54	0.18	70%
21-Sep-16	0.58	0.22	87%
02-Nov-16	0.62	0.26	103%
14-Dec-16	0.66	0.30	119%
01-Feb-17	0.70	0.34	136%
22-Mar-17	0.74	0.38	154%
03-May-17	0.82	0.46	184%

	Implied	Cum. BP	Cum. %
23-Mar-16	2.00		
05-Apr-16	1.98	-0.02	-7%
03-May-16	1.95	-0.05	-19%
07-Jun-16	1.92	-0.08	-33%
05-Jul-16	1.89	-0.11	-45%
02-Aug-16	1.85	-0.15	-60%
06-Sep-16	1.84	-0.16	-65%
04-Oct-16	1.83	-0.17	-69%
01-Nov-16	1.81	-0.19	-75%
06-Dec-16	1.79	-0.21	-85%
07-Feb-17	1.75	-0.25	-99%
07-Mar-17	1.78	-0.22	-87%

	Implied	Cum. BP	Cum. %
23-Mar-16	2.25		
28-Apr-16	2.16	-0.09	-37%
09-Jun-16	2.05	-0.20	-79%
11-Aug-16	1.98	-0.27	-109%
22-Sep-16	1.93	-0.32	-128%
10-Nov-16	1.90	-0.35	-141%
22-Dec-16	1.90	-0.35	-139%
02-Feb-17	1.92	-0.33	-133%
23-Mar-17	1.93	-0.32	-128%
04-May-17	1.91	-0.34	-138%

	Implied	Cum. BP	Cum. %
23-Mar-16	-0.33		
21-Apr-16	-0.34	-0.01	-5%
02-Jun-16	-0.36	-0.03	-13%
21-Jul-16	-0.39	-0.06	-24%
08-Sep-16	-0.41	-0.08	-30%
20-Oct-16	-0.41	-0.08	-34%
08-Dec-16	-0.41	-0.08	-33%
19-Jan-17	-0.43	-0.10	-40%
02-Mar-17	-0.44	-0.11	-46%

	Implied	Cum. BP	Cum. %
23-Mar-16	0.46		
14-Apr-16	0.46	0.00	-0%
12-May-16	0.45	-0.01	-3%
16-Jun-16	0.45	-0.01	-6%
14-Jul-16	0.44	-0.02	-8%
04-Aug-16	0.44	-0.02	-10%
15-Sep-16	0.43	-0.03	-12%
13-Oct-16	0.43	-0.03	-12%
03-Nov-16	0.43	-0.03	-12%
15-Dec-16	0.43	-0.03	-13%
26-Jan-17	0.43	-0.03	-13%
16-Mar-17	0.43	-0.03	-14%

***A 25bp hike should see the Fed Fund rate to 0.625, inside the Fed's target band of 0.50-0.75**

Updated Kiwi Swap Forecasts

	Current	End of Period							
	%	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
New Zealand									
Two-Year Swap	2.24	1.90	1.70	1.70	1.75	1.80	1.85	1.90	2.15
Five-Year Swap	2.55	2.30	2.10	2.15	2.25	2.35	2.50	2.70	3.00
Ten-Year Swap	3.06	2.90	2.75	2.80	2.95	3.10	3.25	3.40	3.60
2-10 Year Curve	82	100	105	110	120	130	140	150	145

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