

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

18 February 2011

CONTRIBUTORS

David Croy
Senior Interest Rate Strategist
Phone: +64 4 576 1022
E-mail: david.croy@anz.com

ECONOMIC OUTLOOK

The New Zealand economy continues to be weighed down by deleveraging. There remain pockets of weakness, with published Q4 data showing declining retail volumes and construction sector indicators suggesting ongoing weakness. However, the picture in early 2011 – though largely anecdotal and circumstantial to date – looks more positive. Prospects for the income generating part of the economy are improving. Recent rainfall, record high export commodity prices and a strong likelihood of an upward revision of the dairy payout are expected to boost export incomes. Deleveraging will remain a substantive headwind on momentum but we suspect the economy is setting itself up for a strong springboard boost to growth in the coming months, and particularly as various one-offs come to the fore.

RATE VIEW

Last year's data and mixed messages to date is keeping the market and RBNZ attuned to a "lower for longer" rates view. We are cautiously optimistic that the economy is at an inflexion point, though lags in reporting mean that it will be some time before it shows up in the hard data. This wouldn't normally be an issue – after all – monetary policy should be forward looking. But with the signs of recovery still very tentative (read: circumstantial) and wariness that we've been here before (with last year's rate hikes), the hurdle for action is high. Thankfully the room for regret is also a little lower than it otherwise be, courtesy of the large proportion of borrowers on floating rates, and the steep yield curve, which will reinforce that behaviour. As such, we expect the RBNZ to proceed cautiously (read: remain on hold until September), at which time we expect the Bank to embark on a path of moderate tightening.

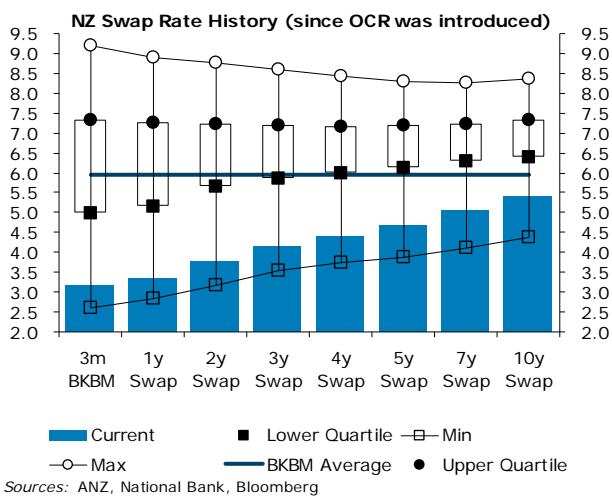
STRATEGY

With the RBNZ on the sidelines until September, and the eventual rate hikes to be fairly muted when they come, the hurdle for fixing remains high. Long term hedging is only likely to appeal to the most risk averse, or those contemplating long term stable investment (such as infrastructure projects). Indeed, with the margin between BKBM and the 5yr at 1.5%, the cashflow implications of hedging are significant. Given the high degree of uncertainty surrounding other aspects of the outlook (Middle East tensions, European sovereign debt concerns) we prefer the flexibility that options offer. The flattening of the FRA strip makes caps less expensive, and floors more valuable, which in turn makes collars more attractive. With rates set to rise rather than fall, giving up some downside in order to protect against upside certainly appeals. We would however note one area of caution: the market is pricing in a very demure economic picture with just 38bps of hikes priced over the coming year. This seems light despite obvious risks surrounding the outlook and a cautious RBNZ. Once we see some consistency in NZ data outturns, the market has the potential to reprice quickly. We believe such consistency is six weeks off and this is a dynamic we remain wary of.

BORROWER'S STRATEGY

VALUATION

The yield curve has pivoted about the 3 year swap, with 1yr and 2yr rates lower, and 4yr+ rates higher, relative to a fortnight ago. This steepening of the curve not only increases the overall cost of long term fixing, it also makes the relative choice (between, say, 2yr and 5yr) even trickier. We believe this is something we're just going to get used to, as we expect the cash rate to be unusually low even when rates start to rise, and for term premiums to remain unusually large.



FAIR VALUE

If you were to explain the purpose to hedging to a newcomer on the corporate treasury team, chances are you'd characterise it as a smoothing exercise. Chances are words like planning, certainty, avoiding surprises and things would come up to. In bookie parlance then, it's literally all about hedging your bets. But how can you do that without knowing what the bet is – i.e. what's at stake. The cost of being wrong and the likely cost if things pan out as you expect? In our view, that's where fair value analysis comes in. You may be bound by treasury policy and hedge limits, but to the extent that there's some discretion, value ought to play a part in decision making.

With the RBNZ set to raise rates this year – subject to no more global surprises, borrowers are justified in worrying about rising interest expense. But with the curve as steep as it is, is it worth it? We use fair value to help inform our thinking.

So, where does fair value lie for each swap maturity, and how does that compare to the historic record? And what difference do margins make?

One way to get a feel for value is to look at where swap rates should be given a set of scenarios for where the OCR might go. A swap is, after all, an agreement to swap fixed for floating. Of course, this kind of analysis is really only useful for short end swaps. Indeed, while it's reasonably easy to form a view on how perhaps the next 2 years will pan out, it's not credible to make detailed forecasts of the next 10 years or so, which may encompass several business cycles. But we'll come back to that later.

A useful starting point is the RBNZ's forecasts. Admittedly, they are a touch out of date, in that they come from the December *Monetary Policy Statement*, and are due to be updated next month. However we doubt the bank's overall view has changed much since December. Indeed, key data like the unemployment rate, GDP and retail sales have all disappointed. We also thought it would be useful to test 3 other scenarios – our forecast, a more hawkish RBNZ and a more dovish RBNZ.

Under our forecasts, we assume the RBNZ re-starts the rate hike cycle in September, with another hike in December, with a further 5 hikes in 2012 taking the OCR to a terminal rate of 4.75%.

By contrast, our hawkish (inflation emerge quicker) scenario sees the RBNZ lifting the OCR by 25bps in June, September and December, with 1 rate hike

Current interest rate levels

Maturity	2 weeks ago	Current
3-mth BKBM	3.19	3.17
1-year swap	3.37	3.33
2-year swap	3.80	3.78
3-year swap	4.13	4.13
4-year swap	4.38	4.42
5-year swap	4.60	4.67
7-year swap	4.97	5.05
10-year swap	5.35	5.43

Market expectations for RBNZ OCR (bps)

OCR Dates	2 weeks ago	Current
Thu 10-Mar-11	0	0
Thu 28-Apr-11	0	0
Thu-9-Jun-11	+5	+2
Thu-28-Jul-11	+15	+9
Thu-15-Sep-11	+21	+16
Thu-27-Oct-11	+33	+25
Thu-8-Dec-11	+43	+38

BORROWER'S STRATEGY

per quarter till the OCR reaches 5.5%. Our dovish scenario sees the RBNZ leave rates on hold until December, gradually taking the OCR to 4.5% by the end of 2013. We could present more extreme scenarios as well, such as the OCR on hold all the way through 2011, but this is contingent on some sort of global accident scenario, which while possible, doesn't enter the realms of being probable. But the mere chance of this certainly needs to be taken into account when decisions are made as the probability is not zero.

Fair value swap rate projections					
Term	Current Market	RBNZ Projection	ANZ Forecast	Hawkish	Dovish
1 yr	3.33%	3.46%	3.32%	3.46%	3.19%
2 yr	3.78%	3.77%	3.92%	3.95%	3.57%
3 yr	4.13%	4.01%	4.25%	4.43%	3.92%

So, how do the numbers stack up? What stands out to us is that the 2 year and 3 year are trading well below where they ought to given our new forecasts (recall we were calling for a June start to the tightening cycle). Does that make them good value? Taken at face value it does, particularly when you consider that they are both trading much closer to the RBNZ's downbeat forecasts. The only problem is, they cost more, and they may not be sufficiently below fair value to be of interest. That is, they may not be trading at enough of a discount. And that's pretty well how we'd characterise the market right now – cheap, but perhaps not cheap enough. This is particularly so when you consider that there is still a lot of uncertainty out there, and fixing now means parting with more money now in order to reap rewards later. It's a classic problem.

COLLARS

One way to avoid having to worry about whether you're right or wrong is to use options. As we have highlighted in our past few editions of the *Borrower's Strategy*, they allow you to have your cake and eat it too, as the saying goes. But like paying fixed, optionality comes at a cost, even though we believe that cost is reasonably low in relation to the cost of paying fixed. For example, a 5 year ATM cap costs 75bps. By comparison, the spread between 3mth BKBM and the 5yr fixed rate is 150bps, or twice the cap premium. Of course, the 75 basis points is payable against a variable

floating rate, so being capped may end up costing more if the floating rate moves up more quickly. But of course, being capped does offer more flexibility, and that has some value.

That may be all well and good – but the one objection we encounter time and time again from customers is the cost of option premium. Even if, as we noted, this needs to be put in the context of the cost of other decisions (or worse still, the cost of being wrong), it is nonetheless an objection. That being the case, how can premium expense be reduced? We have written about this before, most recently in our papers titled *Managing the Cost of Caps, Parts 1 and 2* (which are available on request). What won't surprise is that the two main ways to reduce the cost of caps is to either move the strike (so it offers less protection), or sell a floor against it (thereby giving up some participation, should rates move lower). Both have validity. Indeed, if one is keen to avoid adverse outcomes, setting the strike at a level above which things start to hurt may make more sense than setting the strike at the money. Similarly, just as fixing is trading certainty against cost, selling a floor (to create a collar) is trading off participation in downside for cost reduction.

One reason why collars appeal a little more at the moment for shorter maturities (like the 2 year) is because the short end of the curve has flattened. That is, the spreads between BKBM and the 2yr has declined. This has the effect of lowering the rate at which forward interest rates step up, which in turn reduces the relative "expensiveness" of the longer term caplets that make up the cap. The converse is true for the floors that make up the other leg of the collar, and when combined, they make collar pricing more attractive.

One strategy that looks particularly attractive at the moment is the step up collar. This is similar to a standard collar, except that the upper and lower bounds are not fixed. Rather, they step up over time, either in a single increment, or gradually. By rising with forward rates, the collar becomes substantially cheaper.

Consider the following zero cost example:

Term:	3 years
Lower Bound (first year):	3.20%
Upper Bound (first year):	3.82%
Lower Bound (last 2 years):	4.35%
Upper Bound (last 2 years):	5.02%

BORROWER'S STRATEGY

By stepping up the collar during the latter part of the arrangement, this substantially reduces the cost of the longer dated caplets. As the structure is zero cost, this can be used (amongst other things) to reduce the strike on the floors during the first year, enabling more participation now (when participation is more certain).

As a comparison, if we were to set the upper cap at the same level as the 2nd year throughout the structure (5.02%), which would in effect be a standard cap, the floor strike would come in at 3.74%. In our view this is substantially less attractive, as relative to the step up collar, there is very little participation up front, and that's when we are confident BKBM will be lower.

WHAT ABOUT LONG TERM RATES

We mentioned earlier than thinking about the next business cycle may not that useful when it comes to fair value for longer term rates. But that doesn't mean it's not worth analysing longer term rates – it's just that they are affected by much more than the next business cycle. In that regard, charts like the on page 2 are useful. By comparing the current set of long term rates against the long term average floating rate, one can get an idea of how "cheap" term swap rates are. Taken at face value, our first chart in the Valuation section tends to suggest that term swap rates are exceptional value (being that they are well below the long term average 3mth BKBM rate; and between their respective lower quartiles and lows). However, this has been the case for some time, so it's not exactly new. Why then are we not advocating mass long term fixing?

The main reason is because margins have changed, and substantially. For example, the "Big Four" banks were able to raise 5 or 7 year debt at margins of around 0.1% above swap prior to the GFC. However, in the current market, comparable margins are much higher. Indeed, ANZ issued \$150m of 5 year bonds this week at a margin of 1.65% along with \$100m of 7 year bonds at a margin of 1.8%. If we add that to the current 5 and 7 year swap rates (4.67% and 5.05% respectively), we get 6.32% and 6.85% respectively. By contrast to swap rates, actual bank funding rates are well above the long term 3mth BKBM rate (of 5.94%), even if you add the commensurate short term funding margin. And because most corporate borrowers pay a margin above what banks pay, that makes the curve even

steeper, which in turn discourages hedging, and goes a long way to explaining why we are confident that the RBNZ will be a little less "trigger happy" as to when they begin raising rates.

DEALING ROOM CONTACTS:

Auckland 09 377 9450 / 0800 730 100

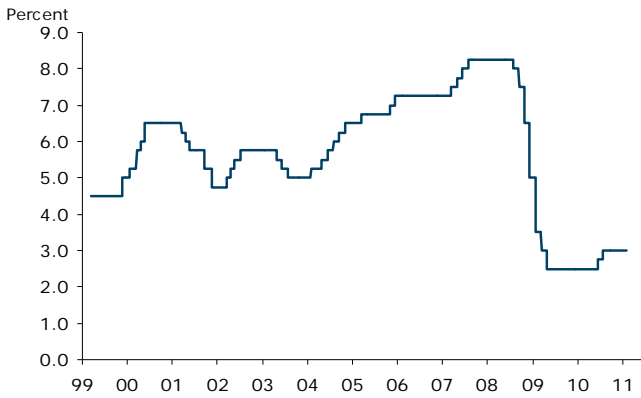
Wellington 04 471 0030 / 0800 445 088

Christchurch 03 364 5335 / 0800 269 261

CHARTS

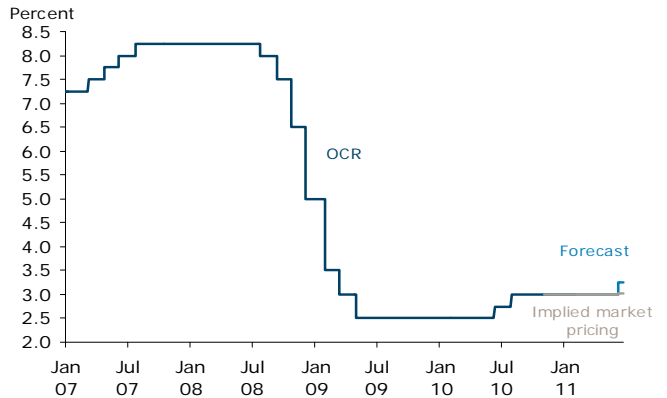
CHARTS

Official Cash Rate



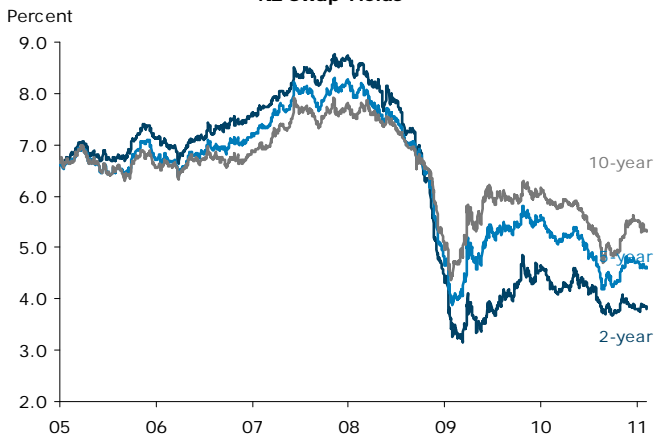
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



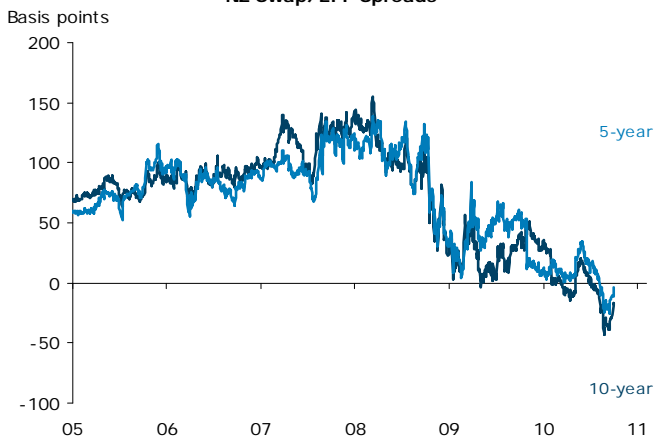
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



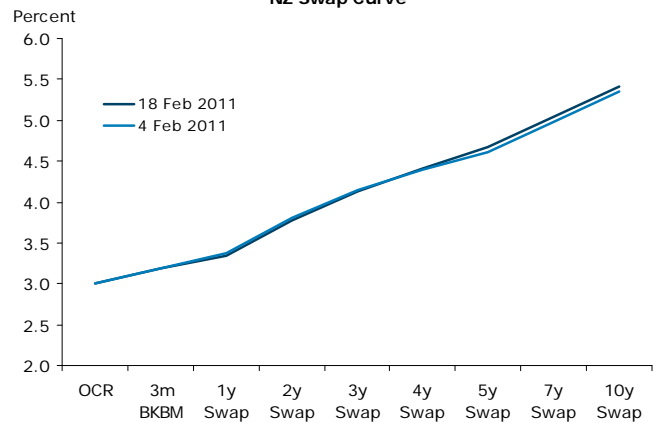
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

NZ Swap Curve

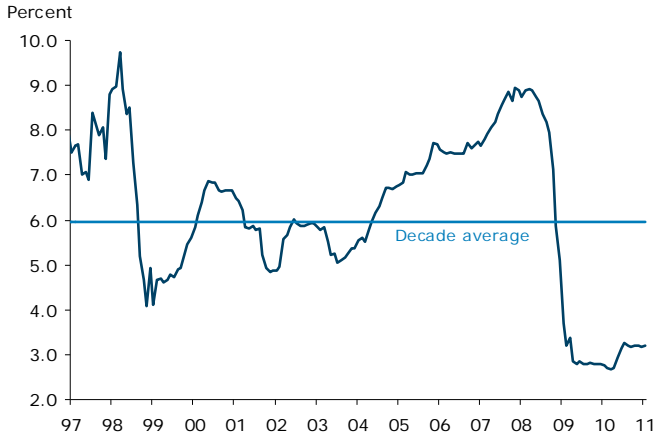


Sources: ANZ, National Bank, Bloomberg

CHARTS (END OF MONTH)

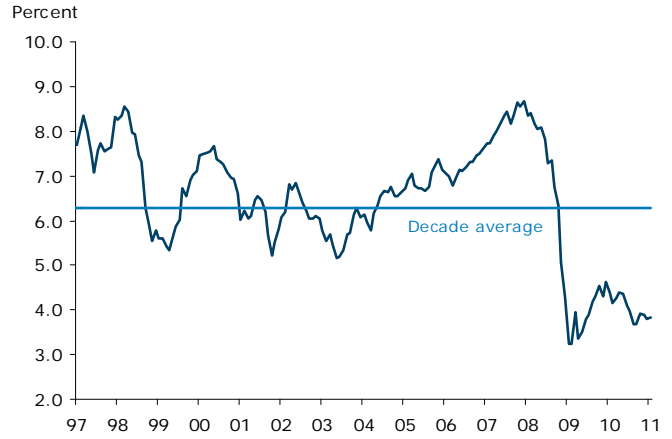
CHARTS (END OF MONTH)

3-month BKBM



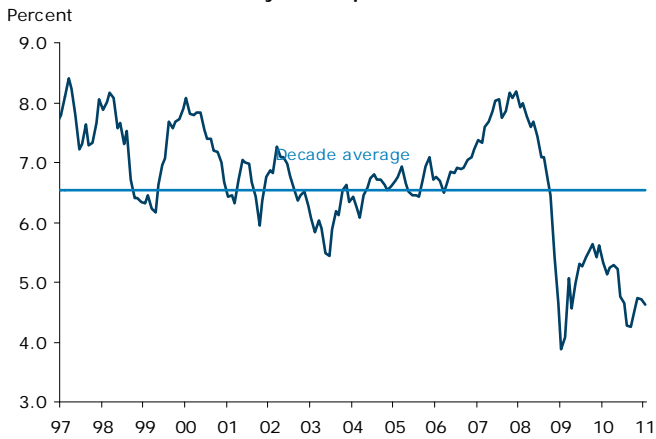
Sources: ANZ, National Bank, Bloomberg

2-year Swap Yield



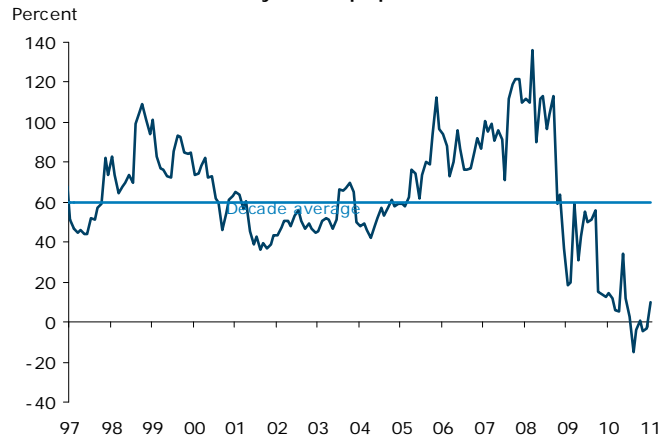
Sources: ANZ, National Bank, Bloomberg

5-year Swap Yield



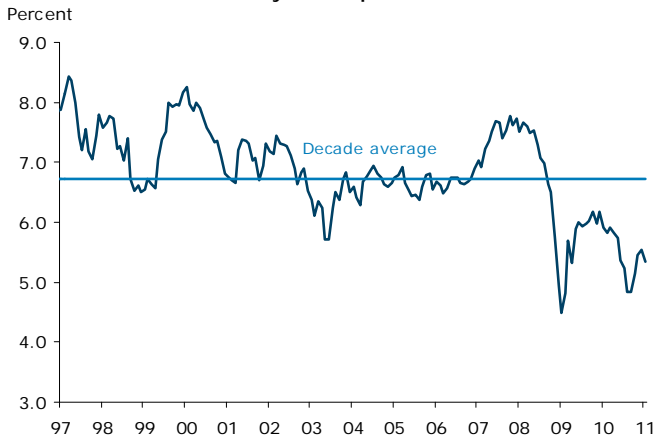
Sources: ANZ, National Bank, Bloomberg

5-year Swap Spread



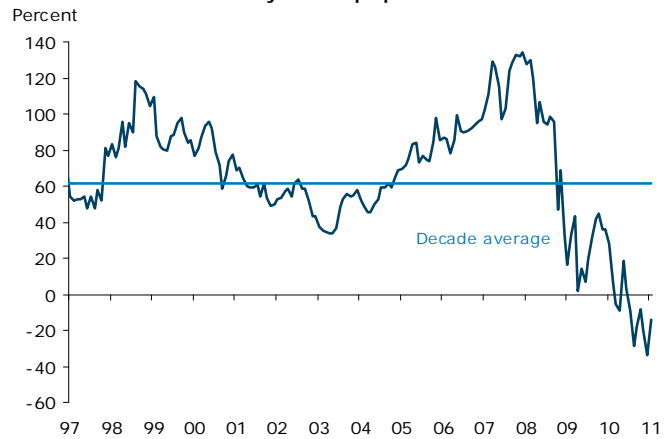
Sources: ANZ, National Bank, Bloomberg

10-year Swap Yield



Sources: ANZ, National Bank, Bloomberg

10-year Swap Spread



Sources: ANZ, National Bank, Bloomberg

IMPORTANT NOTICE

NEW ZEALAND DISCLOSURE INFORMATION

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

Qualifications, experience and professional standing

Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

Professional indemnity insurance

The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

Other interests and relationships

When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

- ANZ Investment Services (New Zealand) Limited (ANZIS), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ANZIS may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- OnePath (NZ) Limited, as a wholly owned subsidiary of the Bank, is an associated person of the Bank. OnePath and its related companies may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- Direct Broking Limited (DBL), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. DBL may receive remuneration from a third party relating to a security sold by the Investment Adviser.

Securities about which investment advice is given

The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

PROCEDURES FOR DEALING WITH INVESTMENT MONEY OR INVESTMENT PROPERTY

If you wish to pay investment money to the Bank you can do this in several ways such as by:

- Providing cash;



IMPORTANT NOTICE

- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

Use of Money and Property

Money or property held by the Bank for a specific purpose communicated to the Bank (e.g. the purchase of an interest in a security) may not be used by the Bank for its own purposes and will be applied for your stated purpose. No member of the Bank's staff may use any money or property deposited with the Bank, for their own purposes or for the benefit of any other person. In the absence of such instructions, money deposited with the Bank may be used by the Bank for its own purposes, provided it repays the money to you upon demand (or where applicable, on maturity), together with interest, where payable.

NEW ZEALAND DISCLAIMER

The Bank does not provide investment advice tailored to an investor's personal circumstances. It is the investor's responsibility to understand the nature of the security subscribed for, and the risks associated with that security. To the maximum extent permitted by law, the Bank excludes liability for, and shall not be responsible for, any loss suffered by the investor resulting from the Bank's investment advice.

Each security (including the principal, interest or other returns of any security) the subject of investment advice given to the investor by the Bank or otherwise, is not guaranteed, secured or underwritten in any way by the Bank or any associated or related party except to the extent expressly agreed in the terms of the relevant security.

This document is provided for informational purposes only and does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this document can be reproduced, altered, transmitted to, copied to or

distributed to any other person without the prior express permission of the Bank.

This document is a necessarily brief and general summary of the subjects covered and does not constitute advice. You should obtain professional advice before acting on the basis of any opinions or information contained in it. The information contained in this document is given in good faith, has been derived from sources perceived by it to be reliable and accurate and the Bank shall not be obliged to update any such information after the date of this document. Neither the Bank nor any other person involved in the preparation of this document accepts any liability for any opinions or information (including the accuracy or completeness thereof) contained in it, or for any consequences flowing from its use.

UNITED STATES DISCLAIMER

This document is being distributed in the United States by ANZ Securities, Inc. (Member of FINRA [www.finra.org] and registered with the SEC) ("ANZ S") (an affiliated company of Australia and New Zealand Banking Group Limited ("ANZBG") and the Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this document and wishing to effect transactions in any fixed income securities referred to herein should contact ANZ S 277 Park Avenue, 31st Floor, New York, NY 10172 USA, Tel: 1-212-801-9160, Fax: 1-212-801-9163, not its affiliates.

This document is issued on the basis that it is only for the information of the particular person to whom it is provided. This document may not be reproduced, distributed or published by any recipient for any purpose. This document does not take into account your personal needs and financial circumstances. Under no circumstances is this document to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZBG, the Bank, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this document (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this document. If you have been referred to ANZBG, the Bank, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this document accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this document and are subject to change without notice. No part of the author's compensation was, is or will be directly or indirectly related to specific recommendations or views expressed in this document. ANZBG, the Bank, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.