

# NEW ZEALAND ECONOMICS

## ANZ BORROWER'S STRATEGY

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### CONTRIBUTOR

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### ECONOMIC OUTLOOK

We remain cautiously optimistic New Zealand is set for a brief fillip to growth, though this remains within the spirit of a subdued trend rate of growth for a number of years as the economy rebalances. Structural headwinds remain but cyclical tailwinds (i.e. record commodity prices and the rural chequebook) are stronger. We also have a less benign view on inflation than the RBNZ does, and see signs of inflation pressure emerging sooner as the recovery unfolds. However, this week's aftershocks in Christchurch (the latter of which was a magnitude 6.3, the same as the devastating February 22nd quake) has increased the level of uncertainty. At this early stage we are viewing this week's aftershocks as a risk factor, as opposed to a catalyst for markedly changing our forecasts. The same applies to the growing sovereign frictions we are seeing across Europe, slower Australian economy and weakening US data. Such risks temper prospects somewhat, though we are of the view the economy is in much better shape now than it was in 2009/10 and post either September or February.

### RATE VIEW

Had it not been for this week's aftershocks in Christchurch, the market would be focussing squarely on the more upbeat tone of the RBNZ's June *Monetary Policy Statement* and the recent solid run of local data. Instead, markets are in a sort of limbo, unsure of how much weight to place on the impact of the aftershocks and global scene. We certainly believe interest rates would be a lot higher had it not been for seismic activity, and we would urge hedge managers not to lose sight of that fact. Global factors like the deepening European sovereign debt crisis and the US slowdown do pose additional risks. However, we prefer to be guided by our core view, as opposed to risk factors.

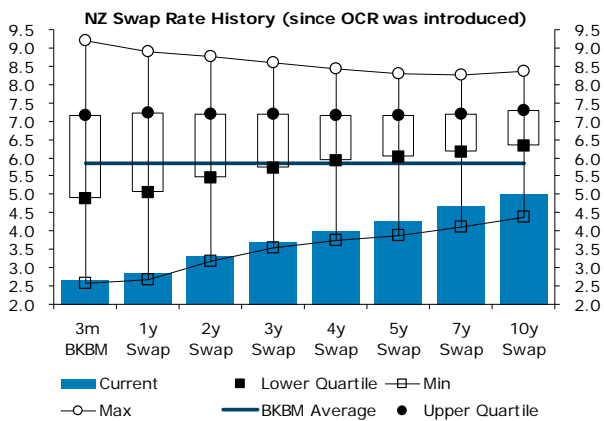
### STRATEGY

Only time will tell whether the current low level of interest rates will be viewed as an opportunity missed or the beginning of a sustained period of uncertainty. We tend to think it will be more the former than the latter, largely based on our assessment of domestic economic conditions outside of Canterbury. Greater than normal uncertainty argues for caution though. Ironically, we see international risks as being more a cause for concern than local risks. Interest rates are at competitive levels, but there are risks, and global markets are nervous. As such, we prefer to use vanilla caps to add to hedge cover at these levels, with one eye on value, but another on the possibility that the downside move extends further. This does mean paying a premium. However, that premium just got cheaper, thanks to the fact that 2 year to 10 year swaps are about 10-15 basis points lower than they were last week, before Monday's aftershocks. Option premiums are also low relative to the premium between floating rates and fixed rates.

# BORROWER'S STRATEGY

## VALUATION

Swap rates are lower across the board compared with where they were when we last published the Borrower's Strategy two weeks ago. This has led to a "flattening" of the swap curve, reducing the additional cost of fixing. It also means the curve is now "pricing in" substantially less in the way of OCR hikes than the RBNZ's own projections, and our forecasts. However, despite the move, the curve remains very steep by historic standards, so some fortitude is required if one chooses to fix.



Sources: ANZ, National Bank, Bloomberg

Current interest rate levels		
Maturity	2 weeks ago	Current
3-mth BKBM	2.65	2.66
2-year swap	3.38	3.30
3-year swap	3.81	3.70
4-year swap	4.15	4.02
5-year swap	4.42	4.28
7-year swap	4.80	4.67
10-year swap	5.15	5.01

Market expectations for RBNZ OCR (bps)		
OCR Dates	2 weeks ago	Current
Thu-28-Jul-11	+1	0
Thu-15-Sep-11	+3	0
Thu-27-Oct-11	+8	+1
Thu-8-Dec-11	+19	+11
Thu-26-Jan-12	+29	+18
Thu-8-Mar-12	+49	+33
Thu-26-Apr-12	Not forecast	+43

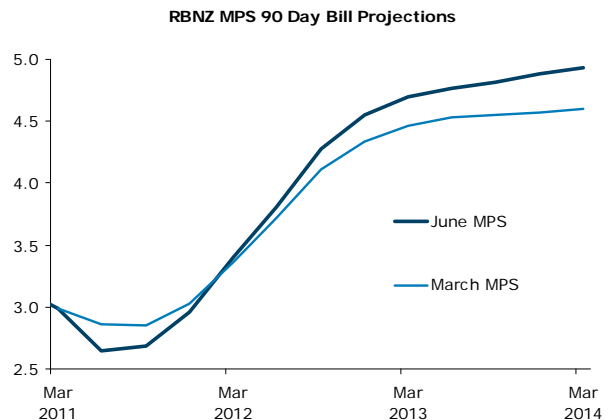
## RBNZ FORECASTS POINT TO A RATE HIKE BEFORE YEAR-END

Although last week's *Monetary Policy Statement* seems like a distant memory in light of Monday's aftershocks, we ought not to lose sight of it. It is, after all, an up to date assessment of the economy, and at a minimum, remains "current" with regard to all parts of the economy outside of Canterbury. So, what did the RBNZ say in the *MPS*?

Broadly speaking, we took 3 main points from the *MPS*. The first was what we would describe as a mildly hawkish tone. Although the RBNZ seems to have a mixed view on inflation, they are more upbeat on growth. Indeed, the Bank has acknowledged that CPI is elevated, and inflation expectations have risen, but they believe that "indicators of capacity usage and core inflation suggest underlying inflation remains constrained". However, whereas the Bank was uncertain on the policy outlook in March and April, noting that policy will be "guided by emerging economic data", they now note that "the pace and timing of increases will be guided by the speed of the recovery". This is a clear sign that the next move is a hike.

The second was a trio of what we would describe as assumptions that have asymmetric risks. The Bank have specifically noted that its projections rely on 3 key judgements – that construction cost inflation will be subdued; that household deleveraging will continue; and that the rise in surveyed inflation expectations will be short-lived. We hope they are right – but the point is, all three are "downside" assumptions. If these assumptions are not "realised", inflation pressures are likely to be higher, perhaps substantially so.

The last was the substantial upward revision to the Bank's 90 day bank bill projections, as the chart below shows.



Sources: ANZ, Bloomberg

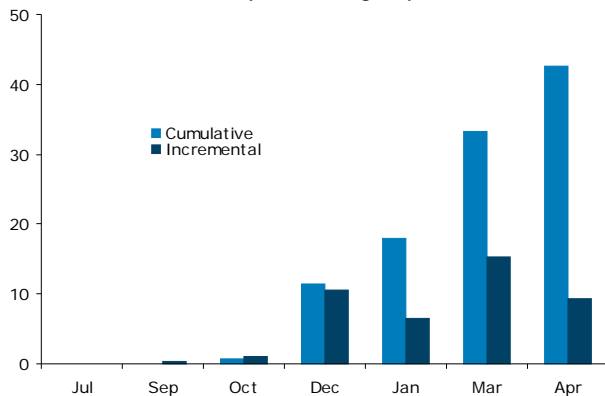


## BORROWER'S STRATEGY

Furthermore, the Bank's new 90 day bill projections were substantially higher than what the market had priced in prior to the MPS (and of course, today). Although there was much confusion about the Governor's subsequent quip that the market had overreacted, this comment was likely directed at the NZD, and not interest rates. Indeed, if one assumed the RBNZ's bill track come to fruition, the 2yr swap would be nearer 3.6% and the 3 year would be nearer 4%. Yet both never got near that level.

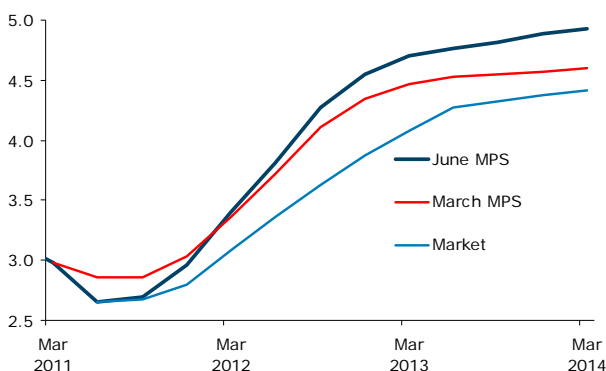
As the first chart below shows, the market is pricing in just 11bps of tightening by December, and just 43bps by April 2012. Yet as the second chart shows, the RBNZ is flagging the 90 day bill rate to rise by 27bps between Q3 and Q4 this year, and by a further 85bps between Q4 this year and Q2 next year. By comparison, the market is pricing the 90 day bill rate to rise by just 13bps between Q3 and Q4, and only 56bps between Q4 and Q2 2012. This is a slower rate of increase than the Bank flagged even in March, when they cut the OCR! There are times when we disagree with the RBNZ's assessment (such as mid 2010 when they were optimistic on prospects and we weren't) but at present we broadly concur.

RBNZ: Expected Change (bps)



Sources: ANZ, Bloomberg

RBNZ MPS 90 Day Bill Projections and market expectations



Sources: ANZ, Bloomberg

It is clear that the market has deeply discounted the RBNZ's view. This is understandable given this week's aftershocks and global risks. But even so, we are struggling to reconcile the difference between the market's post-aftershock expectations and the Bank's projections. Indeed, if we quantify it in terms of timing, whereas the RBNZ sees the bill rate averaging 4.3% over Q3 2012, the market doesn't have it getting there till about 9 months later, in Q2 2013. In terms of the magnitude of the differences, whereas the RBNZ assumes the bill rate will average 3.40% in Q1 2012, the market is pricing in a rate of 3.08%. The gap widens further later in 2012 – indeed, whereas the RBNZ see the bill rate averaging 4.55% in Q4 2012, the market has the rate over 65bps lower at just 3.87%. This has placed an enormous wedge between the market and the Bank, and the question has to be asked, are this week's events sufficient to justify it? This does not mean the market should slavishly follow the RBNZ and such forecasts can have a limited shelf life. However, we should still remain wary of significant disconnections opening up, despite local and global developments.

### UNCERTAINTY

While we are very comfortable with the spirit of our localised economic assessment, two emerging uncertainties are potential game-changers, namely seismic events in Christchurch and the deteriorating global scene.

At this early stage it is difficult to quantify the impact of the aftershocks in terms of damage, the hit to confidence, and the potential hit to economic activity. On the face of it, recovery prospects have clearly been pushed back though we are not overreacting here: we never expected it to start until 2012 anyway! One worry factor for us is the psychological aspect that could encourage massive intra-regional migration flows: more depopulation pressure on Christchurch but population growth elsewhere. This has the potential to be very inflationary in the short-term and something we are monitoring.

Turning back to market pricing, market implied rates for 2012 are on average 52bps lower than the RBNZ's forecasts. That's the equivalent of two 25bp moves. But remember, the RBNZ saw it fit to cut the OCR by "only" 50bps following the devastating February quake, and even then it did so with some caution. It would seem to us then that the market has given uncertainty the full benefit of

## BORROWER'S STRATEGY

the doubt, and ignored the data. Remember too, that the RBNZ's projections are conditional on three fairly "hopeful" scenarios – and in that regard, we would view their projections as baseline estimates. Not that the market is in a mood to entertain it, but not surprisingly, our forecasts have the OCR rising even faster.

### RECENT DATA

So why are we more upbeat (or probably better described as less downbeat!) than the market? The answer can, in short, be explained in two ways, as follows. First, we remain focussed on the data, particularly leading indicators. These remain very relevant. As important as Canterbury is, it accounts for 10-15% of the economy, depending on how you measure it. If forward looking leading indicators like business confidence, consumer confidence, financial conditions indices and the Business NZ Manufacturing PMI are anything to go by, New Zealand is set to experience a robust rebound. The aftershocks will have an impact, but the dislocation of people from Christchurch to other parts of the country will provide something of an offset, especially if we don't lose too many Cantabrians to Australia.

Second, we are philosophical. It's as simple as this: we remain focussed on the core issues, not the risk factors. If we get compelling evidence pointing to widespread disruption and a delay to the rebuild, which in turn would delay the recovery, we will change our view. But we don't have enough information to make that call yet, and in fact, anecdotes are mixed, and are not all negative. We have already highlighted leading indicators. Let's also not lose sight of things like New Zealand's spectacular jump in the terms of trade, our orientation to Asia, long term supporting structural factors like our water resources and access to free trade zones and the like. Let's also not lose sight of one-offs like the Rugby World Cup.

This does not mean we're becoming disconnected with wider issues. We still view the journey rebalancing the NZ economy as being a long one. The trend rate of growth is will be lower for years to come. We expect bumps along the way (our bathtub with waves!). Yet, there is growing economic critical mass supporting a brief cyclical fillip to growth. It's off a low base but we'll take it!

### GLOBAL DEVELOPMENTS

Of course, it's not all plain sailing – there are global issues to deal with too, and they are significant. We spoke about this at some length in our last edition, noting that there were two major risks. The first is the apparent slowing in momentum in the US. Recent data suggests that the US economy is experiencing some sort of slowdown. But it is not clear whether that slowing is cyclical (i.e. the "triple dip") or whether it is just a temporary phenomenon, driven by the supply chain disruption following the Japan earthquake. The jury remains "out" on this. Yet the "verdict" is critical, for if the US does slow further, it will undoubtedly have a knock-on effect, particularly with Japan and much of Europe experiencing difficulties. Equally, if it is a temporary slowdown, then US interest rates have a lot of (upward) adjusting to do, and as they do, they will take NZ long term interest rates up with them.

The other global development is the European sovereign debt crisis. Long-term readers will be aware that we've been downbeat on the endgame here for some time, so in a sense the recent escalation is not really surprising. The situation has certainly intensified significantly over the quarter. If Greek 10 year Government bond yields are anything to go by, the market expects the recovery rate on a debt restructure to be about 51%. Indeed, Greek bond yields are now at around 17.4%, having climbed from 12.7% at the end of March to 15.3% at the end of April, and 15.8% at the end of May. This is a "powder keg" and risks destabilising the financial system further. For now, New Zealand seems well isolated, and bank asset quality in New Zealand is high relative to other countries. But equally, it would be foolhardy not to expect some sort of knock-on effect here if credit markets start getting nervous again, and liquidity becomes an issue. Ironically this may actually be the catalyst to a lower NZDUSD (on the assumption a flight to USD quality continues and the Euro weakens) and we wonder where inflation pressure could be in the NZD even mildly corrects.

### OPTIONALITY

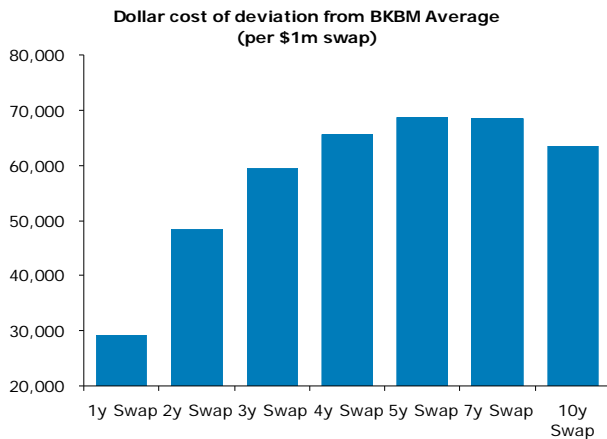
We have no doubt interest rate would be higher had it no been for this week's aftershocks and the escalation of global risk aversion. At face value, interest rates look attractive at current levels. But we must also concede that the level of uncertainty has risen, and as such, we prefer optionality over

## BORROWER'S STRATEGY

fixing. Vanilla caps make sense in the current environment, and are a reasonably low risk way to add to hedge cover at current levels. Premiums are not low, but they are low in comparison with the slope of the curve. As an example, whereas a 5yr ATM cap costs 77bps, this is only about half the "premium" payable when switching from floating (currently 2.67% to 5yrs fixed (currently 4.28%).

Selected Cap premiums (basis points per annum)			
Term/Strike	ATM	ATM+ 25	ATM+ 50
2 yr	44bps	35bps	29bps
3 yr	59bps	50bps	42bps
4 yr	70bps	60bps	51bps
5 yr	77bps	66bps	58bps

In terms of where on the curve to hedge, as has been the case for some time, the 4-7 year part of the curve is farthest from the long term 3mth BKBM rate, when adjusted for duration, as the chart below shows. 7 year options are significantly more expensive, and as such, we favour 4-5 year caps.



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Auckland 09 377 9450 / 0800 730 100

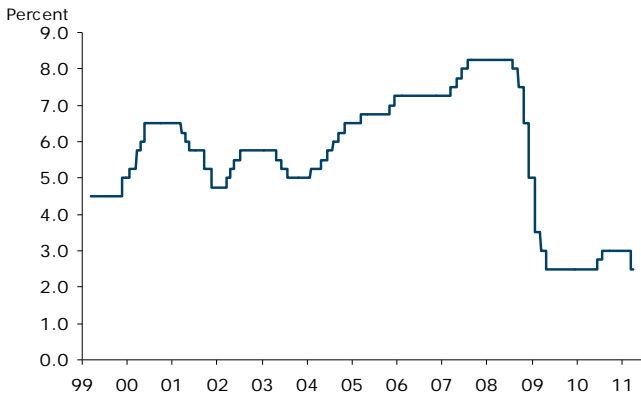
Wellington 04 471 0030 / 0800 445 088

Christchurch 03 364 5335 / 0800 269 261

# CHARTS (END OF MONTH)

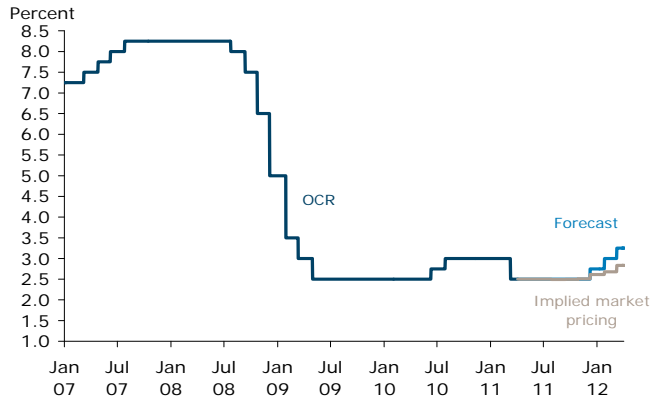
## CHARTS

**Official Cash Rate**



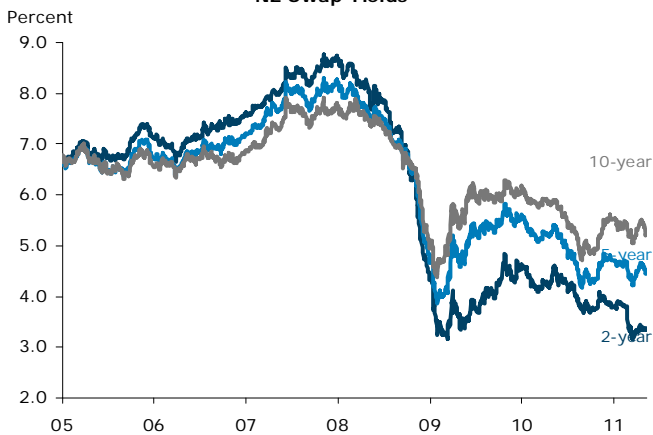
Sources: ANZ, National Bank, RBNZ

**OCR and market pricing**



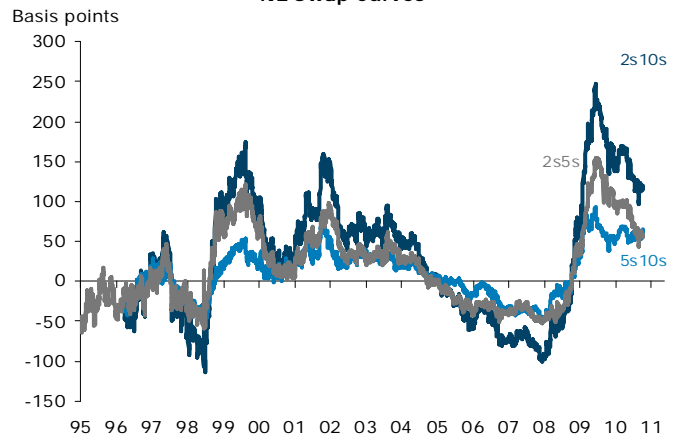
Sources: ANZ, National Bank, RBNZ, Bloomberg

**NZ Swap Yields**



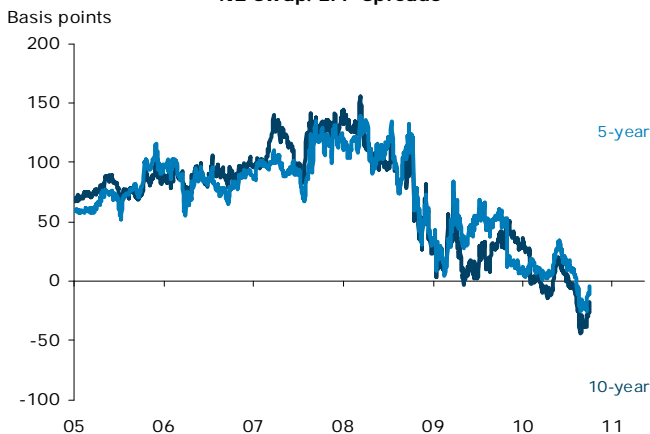
Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curves**



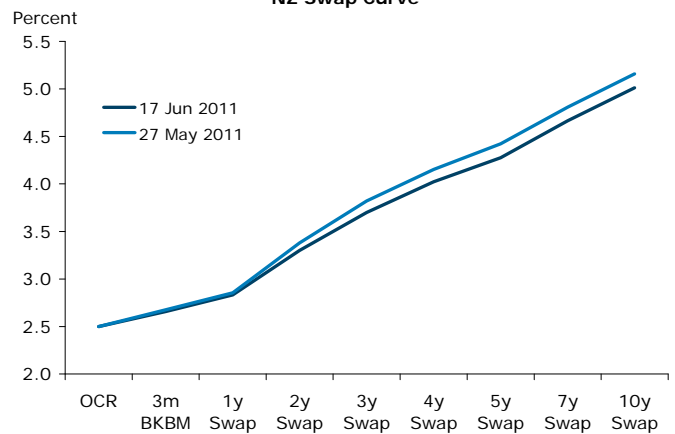
Sources: ANZ, National Bank, Bloomberg

**NZ Swap/EFP Spreads**



Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curve**

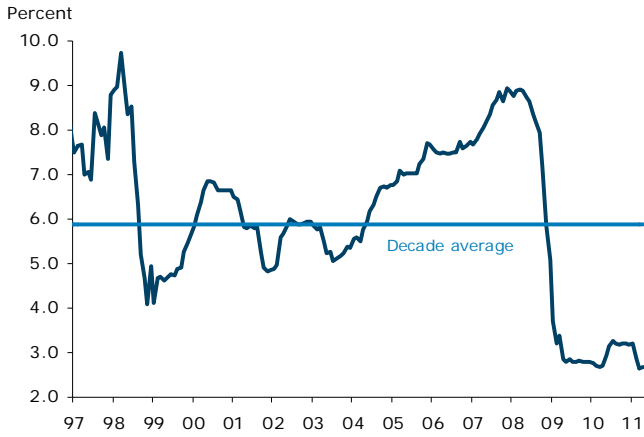


Sources: ANZ, National Bank, Bloomberg

# CHARTS (END OF MONTH)

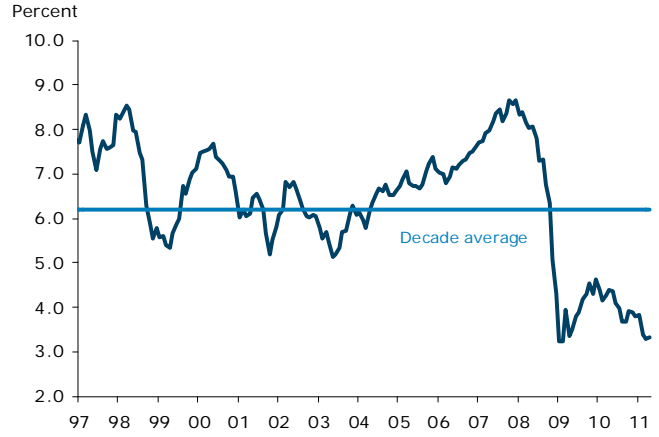
## CHARTS (END OF MONTH)

**3-month BKBM**



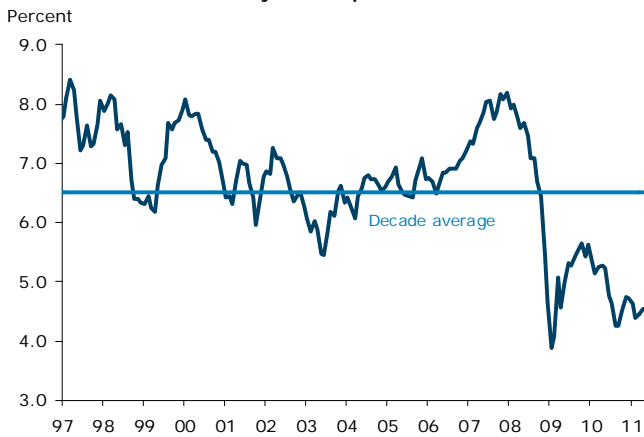
Sources: ANZ, National Bank, Bloomberg

**2-year Swap Yield**



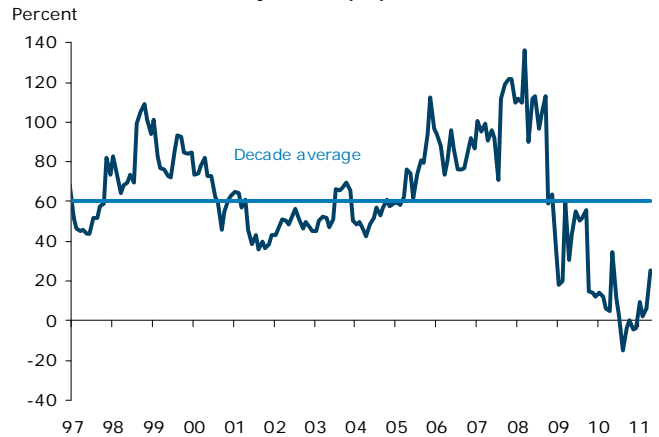
Sources: ANZ, National Bank, Bloomberg

**5-year Swap Yield**



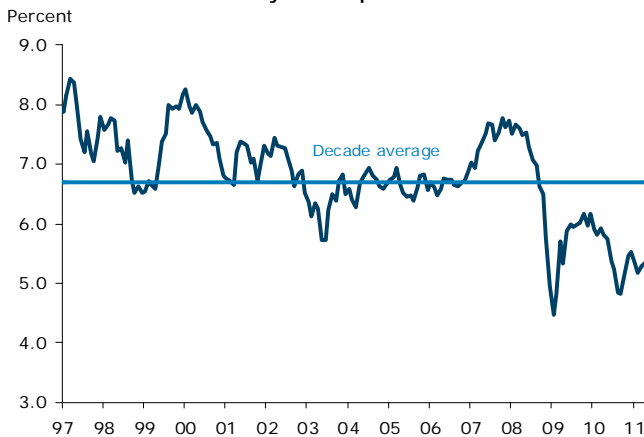
Sources: ANZ, National Bank, Bloomberg

**5-year Swap Spread**



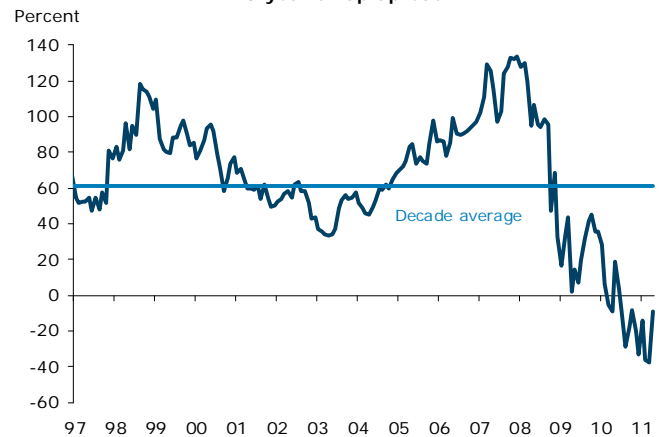
Sources: ANZ, National Bank, Bloomberg

**10-year Swap Yield**



Sources: ANZ, National Bank, Bloomberg

**10-year Swap Spread**



Sources: ANZ, National Bank, Bloomberg

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