

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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CONTRIBUTOR

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ECONOMIC OUTLOOK

The economy has moved from recovery to expansion, with GDP growth, business investment and employment all expanding with some solidity. Timely anecdotes we are picking up around the nation portend of more of the same. Challenges remain. Within a cyclical fillip prognosis (i.e. upbeat assessment) for the coming year, we continue to take a secularly guarded view towards prospects given deleveraging requirements and a volatile global environment. Moreover, tightening financial conditions via a stronger NZDUSD in particular (against the grain of receding soft commodity prices) risk crimping momentum. However, with a building base forming in Christchurch (residential wise) and the Rugby World Cup approaching, such dynamics portend of a solid base to growth extending. In this environment, emerging signs of core inflation (which is running just above the middle of the 1-3 percent policy band) are set to continue.

RATE VIEW

With the economy moving into expansion, the OCR needs to move higher sooner rather than later. Global events pose clear and significant risks, and may yet spell trouble. However, with inflation elevated, the RBNZ has much room for regret, and little room to manoeuvre, and we would not rule out a rate hike before December, which remains our core view. In fact we are increasingly erring towards a September move. Put simply, the 50 basis points of "insurance" delivered in March needs to be reversed, and we can put it a strong case for it being now. However, some perspective is required. Even though the risk is that the OCR heads higher sooner or more rapidly in the near term, we need to be cautious about extrapolating this into a more prolonged cycle. As history (and the most recent Australian experience has taught us) we are still only looking at a trough to peak move of around 200bps. Despite the low starting point, we remain mindful of near record levels of leverage, high exposure to floating rates, the growing importance of prudential policy and an uncertain global credit environment.

STRATEGY

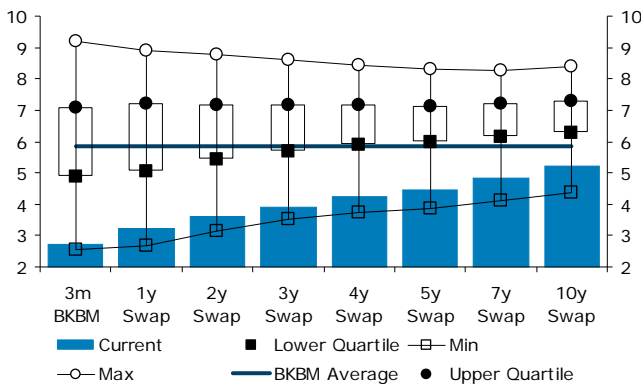
Although there is considerable global uncertainty, the domestic picture is shaping up well, and we believe it is now time to take action. At this juncture our preference is to avoid the temptation of rushing to fix for long terms. This is the "new normal", and it is simply not credible to suggest that the OCR is headed back to historic norms. While market sentiment has clearly shifted towards rate hikes occurring *earlier*, we would urge readers not to confuse this with a call for *more* rate hikes. As such, our preference is to add to hedges in the 2-3 year part of the curve, which are in our view under-priced scope for rate rises. But we would urge against jumping in "boots and all". This is largely because the global liquidity situation is very fluid (no pun intended). More than anything else, this is the one global risk that could delay rate hikes, and render traditional swap hedges ineffective. This must be acknowledged.

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VALUATION

Interest rates are much higher at the short end, but only mildly higher at the long end, which has led to a "flattening" of the yield curve since our last edition. But while short end rates have moved up, they still offer reasonable value relative to where we see the OCR heading. That is, even after the move, the forward bill rates remain below our forecasts. By contrast, the long end is pricing in something of a return to pre-GFC normality, with long term 90-day bill projections back towards 6.5% in 10 years. We believe this is too optimistic.

NZ Swap Rate History (since OCR was introduced)



Sources: ANZ, National Bank, Bloomberg

Current interest rate levels

Maturity	Last edition	Current
3-mth BKBM	2.67	2.70
1-year swap	2.91	3.15
2-year swap	3.38	3.58
3-year swap	3.79	3.92
4-year swap	4.13	4.22
5-year swap	4.42	4.46
7-year swap	4.82	4.86
10-year swap	5.18	5.22

Market expectations for RBNZ OCR (bps)

OCR Dates	Last edition	Current
Thu-28-Jul-11	0	+3
Thu-15-Sep-11	+2	+11
Thu-27-Oct-11	+6	+27
Thu-8-Dec-11	+15	+40
Thu-26-Jan-12	+22	+62
Thu-8-Mar-12	+39	+71
Thu-26-Apr-12	+60	+79

SAIL RIGHT ON THROUGH

Recent domestic data releases have not only been strong, they have been consistent. Commentators like us have alluded to this for a while now, but for a long time, the market was in a mind to ignore domestic data, fearful of ill winds blowing in from offshore. To be fair, those ill winds haven't really moderated, but it is increasingly looking like New Zealand is set to navigate choppy waters, sailing right through global turmoil. That's a brave call, but we have seen this sort of thing before – witness the Australian experience in the immediate post-GFC era. Sure, the stakes are high, and the pessimists will say that the debt meltdown in Europe and the debt ceiling in the US have the potential to drag NZ into the mire. But New Zealand has a lot going for it at the moment in terms of the level of commodity prices, the regions we trade with, with a few special factors (like earthquake rebuilding and the Rugby World Cup) thrown in to boot. Moreover, one reason we look healthier now is due to the extent of weakness seen in 2009 and 2010. Such weakness has firmed up the economic base and fundamentals.

Of course, it's not all plain sailing – and there are signs that Australia – our largest trading partner is slowing. New Zealand is also somewhat exposed to global debt markets, insofar as our external debt position sits. But for now, New Zealand stands out as being a safe place to park cash relative to traditional markets like the US (negotiating a debt ceiling, having been put on notice by credit rating agencies) and Europe (struggling to contain a sovereign debt crisis). Investor attitudes to New Zealand remain constructive – as is plainly obvious by the performance of the NZD. But what matters for borrowers is that interest rates are also on the move.

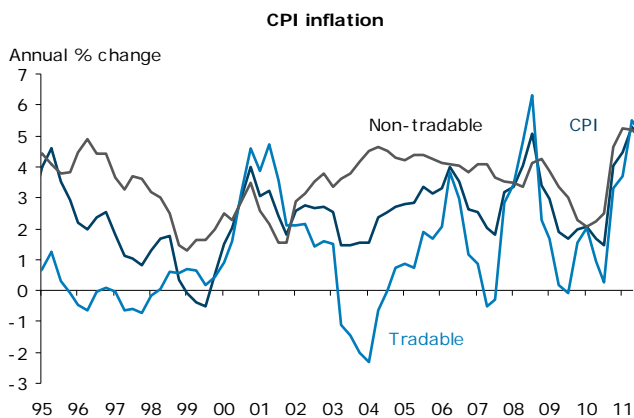
BORROWED TIME

When we look at what has driven interest rates higher, it was less the cumulative effect of a string of better than expected local data releases that caught the market off guard. Rather it was the double barrel "hit" offered by GDP data, and then CPI data that really caught the market off guard. Interest rates have spiralled higher in the wake of this data. Such outturns have been catalysts but of course the reality is that the tenor of prior data had been consistently pointing the same way.

Of course, the GDP data is very dated now. However, it has confirmed what we have suspected for a long time now – that the economy was on much more solid footing when the 22 February earthquake

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hit than was widely assumed. Moreover, recent gains in confidence and accommodative financial conditions point to strong growth in the quarters ahead. Until now, markets have ignored the so-called soft signs of recovery. However, when matched with the historical experience, combined with the impact of one-offs like earthquake reconstruction and the Rugby World Cup, New Zealand is starting to differentiate itself as one of the few developed economies set to expand at an above-trend pace in 2012, rapidly absorbing spare capacity.



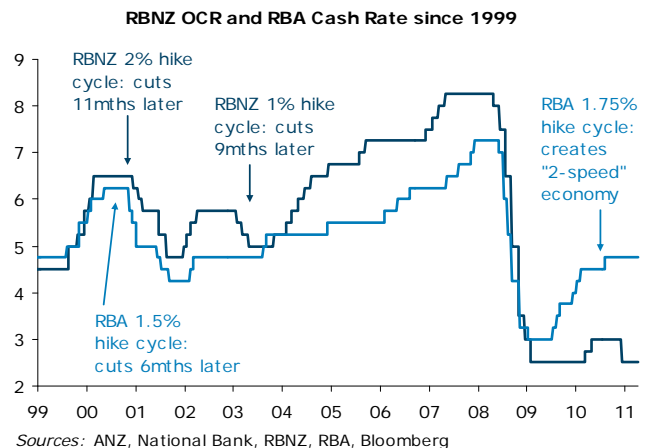
Sources: ANZ, National Bank, Statistics NZ

As uplifting as the GDP data was, recent Q2 CPI data are even more "troubling" with regards to what it implies for monetary policy, as the chart above demonstrates. Headline CPI rose by +1.0% in Q2, taking the annual rate to 5.3% for the year, the fastest pace in more than 20 years. A large part of this can of course be explained by the increase in GST on 1 October. However, Statistics New Zealand note that even when GST is stripped out, CPI rose by 3.3% y/y – well above the top end of the RBNZ's target band. This leaves the RBNZ with very little "wiggle room" and, in our view the OCR is on borrowed time here at 2.50%. With the data has come a shift in the debate, which has moved away from whether the RBNZ will start raising rates in December to how far the OCR needs to rise by December. Indeed, as the table on page 2 shows, the market now expects the RBNZ to lift rates by 11bps by September, up 9bps since our last edition of the *Borrower's Strategy*. In other words, the market is now roughly 50/50 priced for a hike by September.

EARLIER OBJECTIONS

With interest rates on the move higher, it's easy to get caught up in the frenzy, and easier still to reach for the panic button. Rising interest rates are always an unwelcome development (on their own at least)

for borrowers. Of course, if they are accompanied by an improving economic outlook, there is less reason to be downbeat – and to be fair, that's how things look right now. But we should also not lose sight of the factors long cited by ourselves and others that argue for less a less aggressive policy reaction this time around. This is less about saying that "this time will be different", rather it's a reflection of the change of scene. In fact, when you look at past cycles, our forecasts for the amount of monetary policy tightening in store are pretty similar to the past, with the obvious exception of the mid-2000s mega tightening cycle. This is shown in the chart below. Note too that even Australia, oft-hailed as the lucky country has seen its economy slow substantially after "just" 175bps of rate hikes in the past two years. What's different now is that starting point – with the OCR at 2.5% at the start of the cycle, as opposed to 4.5% or thereabouts. Of course, long term bank margins are nearly 1.5% higher now, as we note later, and that is clearly having an impact. This is because higher margins will reduce the extent to which the RBNZ may need to raise the OCR in order to achieve a given level of ordinary interest rates (such as mortgage rates).

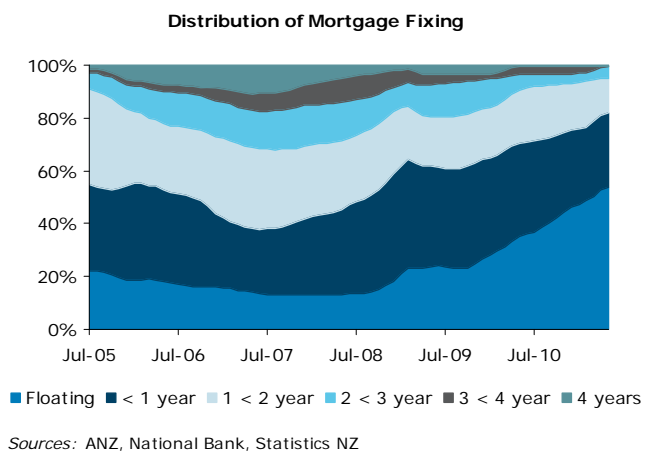
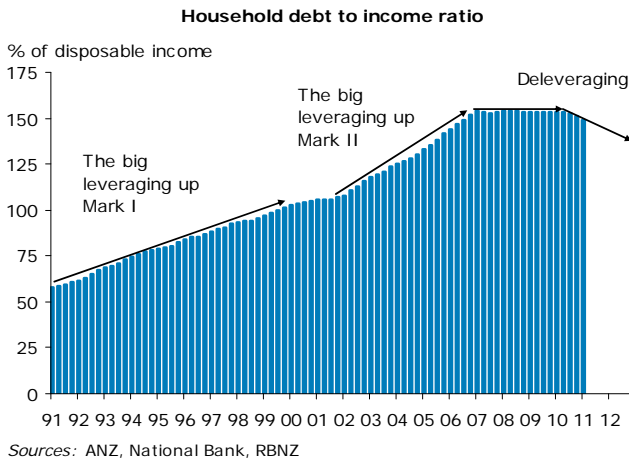


But it's not just margins that have changed, and to be fair, they should eventually fall as the economy rebalances. But that will be some years away, and in fact, they have actually risen lately. Nonetheless, what matters more is the economy's ability to withstand higher interest rates, and in the simplest terms, this is a function of leverage (as measured by household debt to income) and mortgage borrower exposure to floating rates. As the charts overleaf show, both are at extremes at the moment.

The degree of leverage is more structural (because it will take years to deleverage). By contrast, the degree of exposure to floating rates is simply a current condition, but to the extent that the steep

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yield curve (which encourages borrowers to stay floating, and savers to fix) is likely to remain in place as deleveraging continues, it may also be structural. Similarly, to the extent that the RBNZ don't wish to lose effective control of monetary policy (which they will if borrowers flock to fixed again, like they did prior to the GFC), then they have a vested interest in acting in a more considered fashion.



GLOBAL INFLUENCES

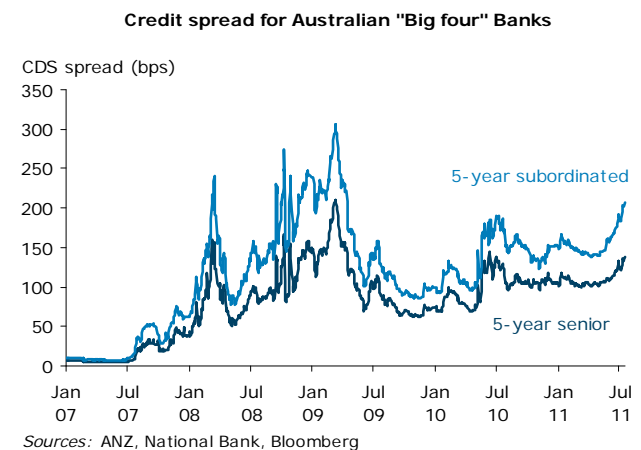
It's not just structural factors that are likely to keep a lid on how high the OCR will go over the cycle (which is obviously important for longer term rates). Global developments also tend to be very influential. In that regard, market attitudes have shifted markedly, and markets are now taking a macroeconomic view on what fiscal largesse means for interest rates, as opposed to a credit view. That is, markets are buying into the slow growth implied by fiscal consolidation, as opposed to selling the credit risk of excess debt. Judging by market moves of late, it is almost as though the reality of fiscal consolidation across virtually the entire developed world has dawned on the market. Greece has long been viewed

as the poster-child, but similar problems run deep in the US and in core Europe too.

Indeed, consider the way the US market has reacted to the possibility of a credit rating downgrade. Such an outcome would typically be regarded as negative for the bond market. However, it is plausible that Uncle Sam may be granted an exception of sorts. Such news is likely to be taken negatively by the currency market, keeping the USD on the skids. However, if the threat of (or actual) downgrade leads to real fiscal consolidation, fiscal policy is set to do all the heavy lifting, leaving monetary policy on hold for much longer. In turn, this increases the appeal of the carry trade (particularly given the attractiveness of US roll+carry stats), keeping a lid on US bond yields. This is the logic the "smart money" is running with, and it's difficult to fault.

BEING EFFECTIVE

If there is one aspect about the global outlook that does trouble us somewhat at the moment, it is the potential for credit nervousness to create tensions in the local market. At this stage, the spillover has been limited and nowhere near as severe as it was following the collapse of Lehman Brothers. However, some spillover has clearly been evident, as the chart of local bank credit spreads below shows. As such, it would be foolhardy not to acknowledge the possibility that the situation may intensify.



Furthermore, if it does, and the situation does get sufficiently "critical", it could have an impact on monetary policy. That is, so long as credit remains freely available, and it's only a matter of the price of it (i.e. the credit margin) that's changing, then upcoming rate hikes may be offset by wider margins. Although this is a bit theoretical (in the sense that it's hard to imagine it's only the price that changes), the point is, wider margins could displace rate hikes.

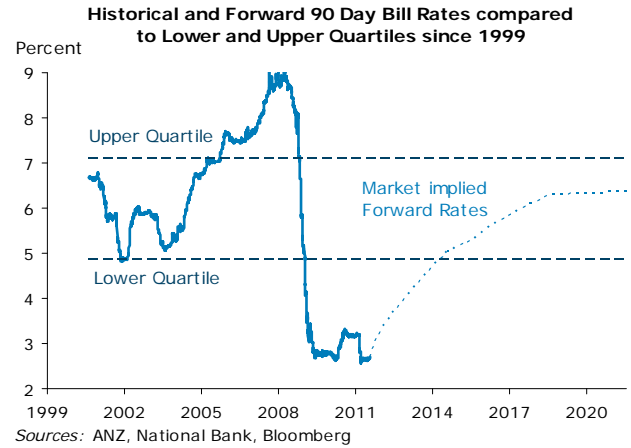
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Such changes will not change the all-up rate a borrower pays, but if that borrower is counting on a swap to hedge against rising interest rates, and it's the margin that goes up, then the hedge will be somewhat ineffective. As such, some caution is required, although in our view such dynamics should not be a blank objection to hedging.

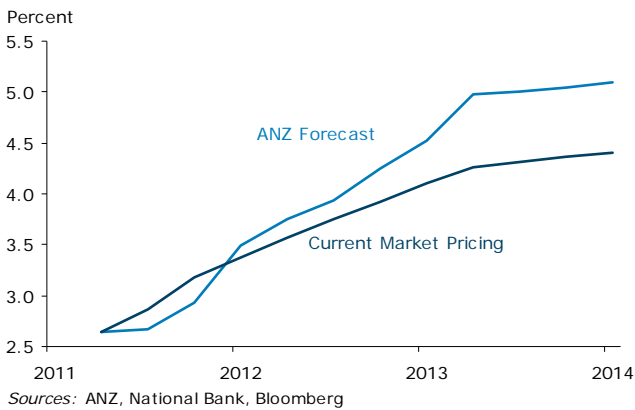
CONCLUSIONS

Although the market has flexed its muscles in terms of how much more tightening has been priced in over the remainder of the year, the pace of tightening priced in over 2012 and 2013 still looks light relative to our forecast. Indeed, as the chart below shows, it's almost like the very short end has over-reacted, but this has not rippled further along the curve. As noted earlier, the RBNZ is on borrowed time, and while we don't see a need to the OCR to go back to pre-GFC levels, we do believe the OCR is on borrowed time here, and will prompt the RBNZ to start raising rates by December at the latest. As such, we believe there is merit in hedging for 2-3 years.

historical standards, but they are still very high relative to the level of the OCR, and remain higher than where we see the OCR topping out. From a valuation perspective, they are simply too expensive in our view.



ANZ 90 Day Bill Forecast vs Market



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Auckland	09 377 9450	0800 730 100
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Of course there's plenty of uncertainty out there – so some caution is required, and we certainly don't favour jumping in "boots and all". But the case for adding to hedges here is stronger than it was a few weeks ago. Granted, we could have made the call earlier, and instead chose to stand on the sidelines. But we always flagged the risk rates would move higher when the news flow improved, and we believe there was merit in seeing how things unfolded, as opposed to taking a punt.

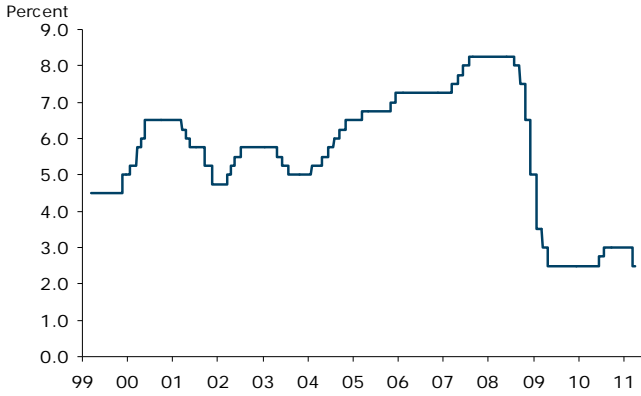
However, we would caution against longer term hedging. In our view, we are not headed back to pre-GFC normality, not in the next 2 years, and possibly not even in the next decade. Yet in some ways, this is what the market is pricing in, as the chart below shows. 10 year swap rates are low by



CHARTS (END OF MONTH)

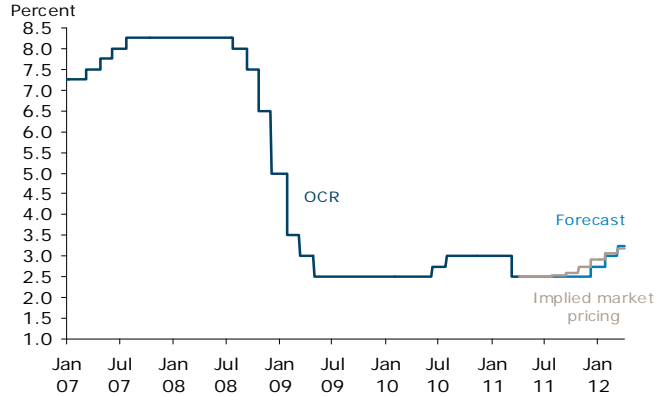
CHARTS

Official Cash Rate



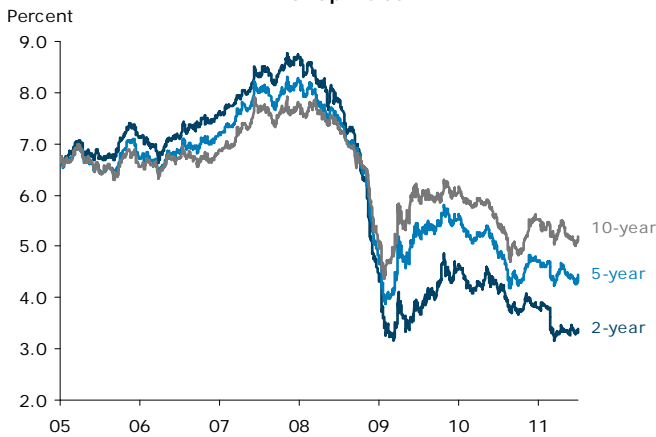
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



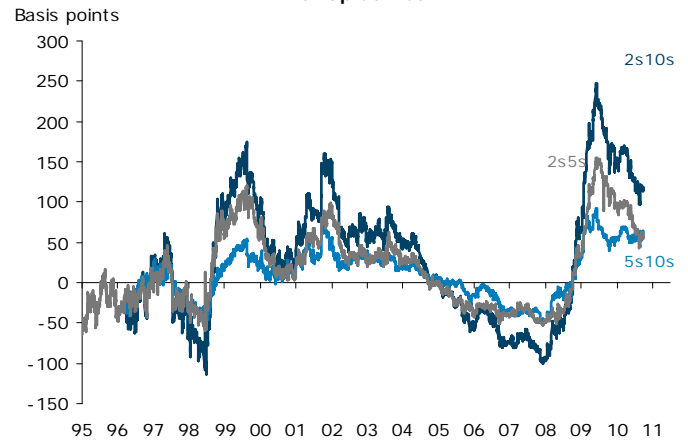
Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



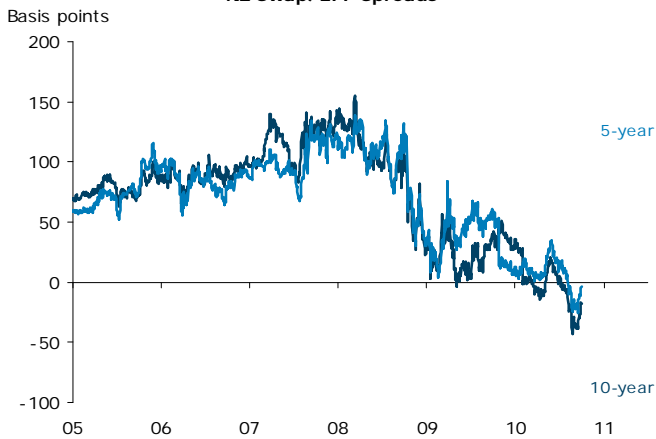
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



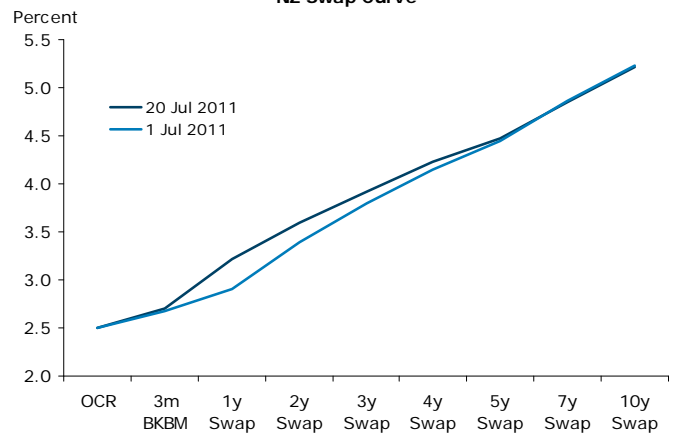
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

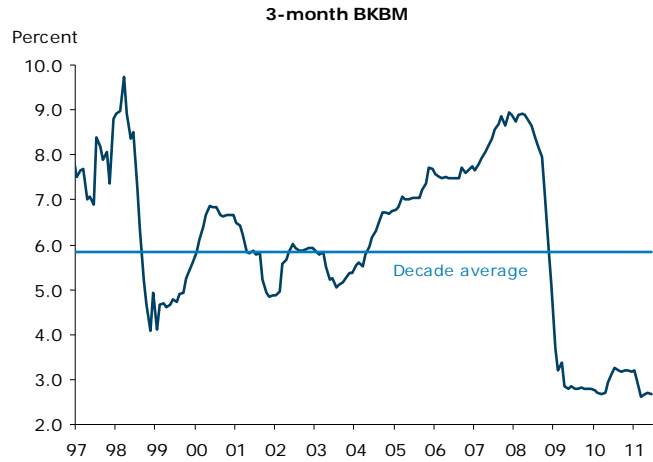
NZ Swap Curve



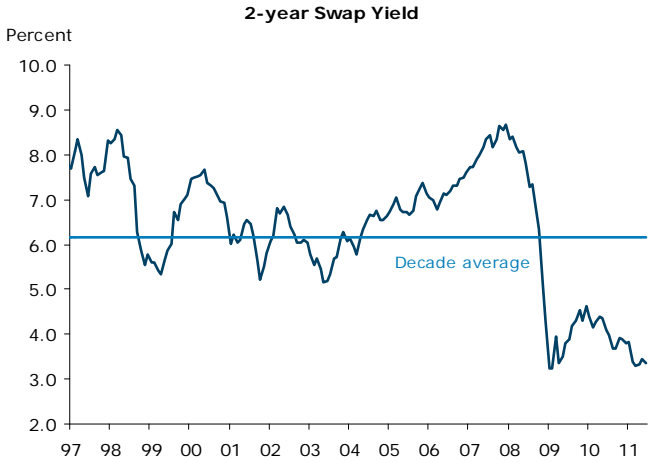
Sources: ANZ, National Bank, Bloomberg

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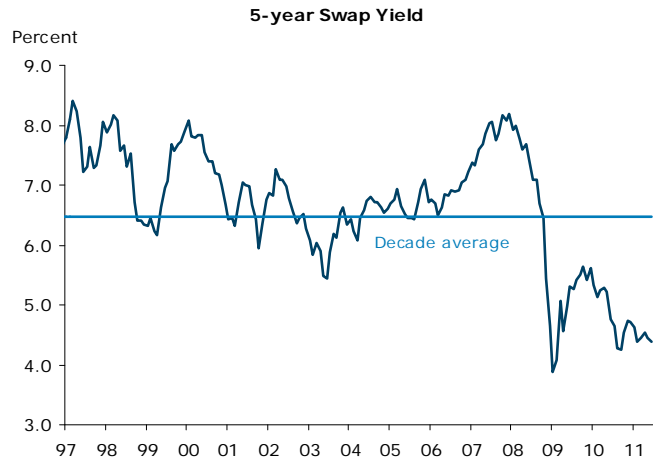
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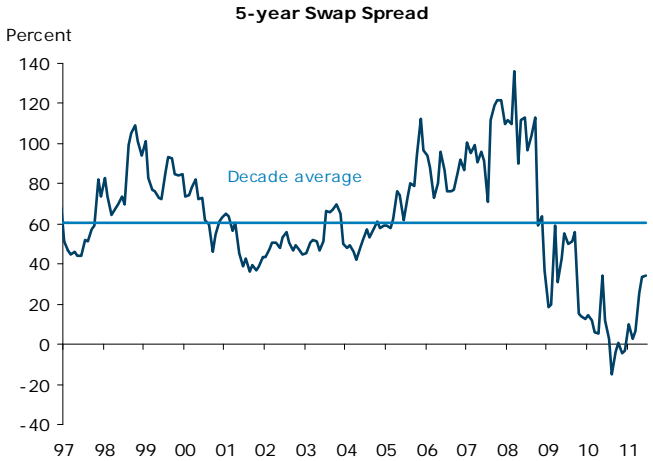
Sources: ANZ, National Bank, Bloomberg



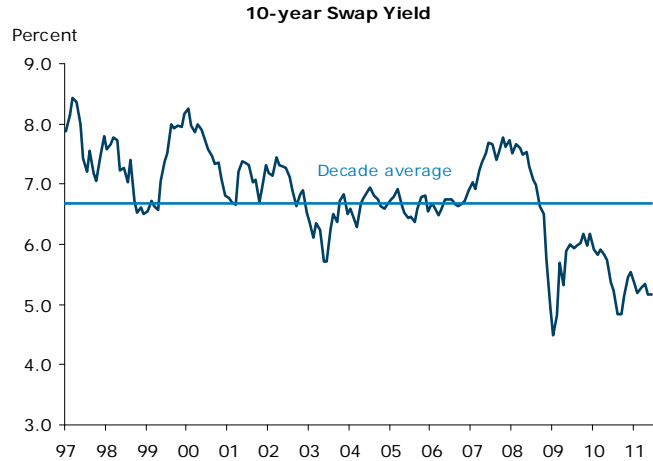
Sources: ANZ, National Bank, Bloomberg



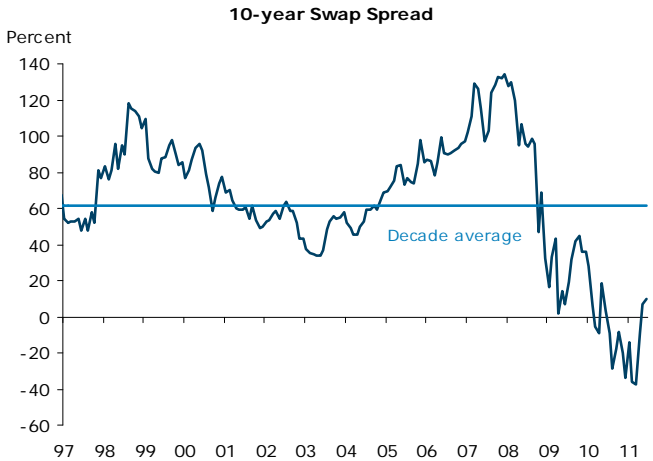
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