

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

1 October 2010

CONTRIBUTORS

David Croy
Senior Interest Rate Strategist
E-mail: david.croy@anz.com

ECONOMIC OUTLOOK

The outlook for the economy remains subdued in the short term, with growth likely to be below par for the remainder of the year. Although partly due to the negative impact of one-offs like the Canterbury earthquakes, the real story is one of continued deleveraging, domestic demand not taking the baton from the inventory rebuild early in the year or businesses yet having the confidence to invest. Traditional post-recession drivers like hiring, investment and deferred consumption look to be compromised in the short term by poor asset performance (read: housing), a lack of certainty, and tax changes. However we are more bullish on 2011 economic prospects, with growth likely to be supported by the recent easing in financial conditions, earthquake rebuilding, Rugby World Cup related activity, and a better tone to the US economy. Deleveraging in 2010 also paves the way for a stronger 2011.

RATE VIEW

Soft Q2 GDP data has gone a long way to validate the RBNZ's change of heart, and is suggestive of significantly more slack in the economy than first assumed. This leaves the RBNZ very much on hold for the time being – which for now means until March 2011 at the earliest. However, we believe this is now very much priced in to the yield curve. Not only are swap rates much lower than they were a fortnight ago, approaching the year's lows again, but as we discuss in more detail in this edition, rates are starting to get stretched relative to historic measures as well as our and the RBNZ's forecast. We would be in a mild state of shock had this been occurring solely for domestic reasons. However it is not – rather it is occurring in an environment where global long term interest rates are being held down by expectations of further quantitative easing (QE) in the US. The threat of QE is like an "elephant in the room" for the local interest rate market, and while it's likely to keep downward pressure on term rates, caution is required. Strengthening equities are being supported by expectations of further QE and are playing a key role in driving lead indicators (in somewhat of a blind leading the blind mantra). Lead indicators are now starting to turn and if this persists the upshot will be that no further QE will be required, with the market giving up some of its recent gains. We appear set for a collision course.

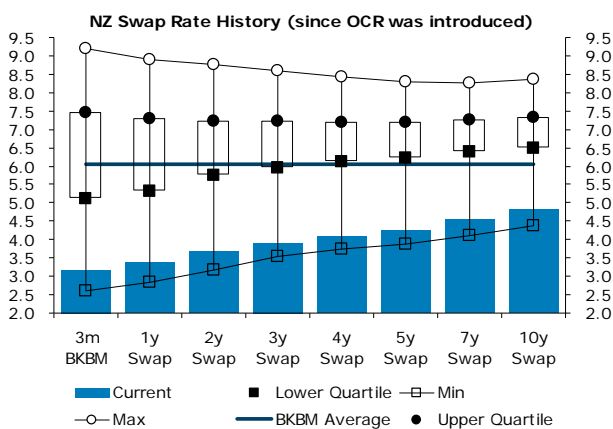
STRATEGY

Strategic calls at this juncture are extremely difficult, courtesy of the unusual interest rate environment we are in. Indeed, although we believe interest rates are too low relative to traditional fundamentals, there are good reasons for it. This potentially opens up opportunities for borrowers, but as always, hedging is about risk management. That is, although unusually low rates may appear to be attractive and potentially argues for higher hedge ratios; don't lose sight of other uncertainties and the value of flexibility. Indeed, the fact that the Fed is contemplating QE suggests there are grave concerns for the US economy, and this has implications for NZ. Our preferred strategy is to add progressively to hedges as rates ratchet lower, leaving a good amount of powder dry in anticipation of a formal announcement from the Fed. Although US rates have fallen substantially already in anticipation of an announcement, confirmation will see them move even lower.

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VALUATION

Although the 3mth BKBM rate is slightly higher, swap rates have fallen across the board over the past fortnight, reversing the move higher over the prior fortnight. The curve has flattened mildly, with the long end rates leading the way lower. The move lower in rates largely reflects global moves, and as we discuss later, although the domestic economic environment is benign, rates would not be at current levels had US rates not been this low.



Sources: ANZ, National Bank, Bloomberg

Current interest rate levels

Maturity	2 weeks ago	Current
3-mth BKBM	3.15	3.17
1-year swap	3.48	3.39
2-year swap	3.79	3.66
3-year swap	4.04	3.91
4-year swap	4.13	4.08
5-year swap	4.41	4.25
7-year swap	4.69	4.53
10-year swap	5.00	4.83

Market expectations for RBNZ OCR (bps)

OCR Dates	2 weeks ago	Current
Thu 28-Oct-10	+2	Flat
Thu 9-Dec-10	+6	+1
Thu 27 Jan-11	+15	+6
Thu 10-Mar-11	+26	+17
Thu 28-Apr-11	+35	+27
Thu-9-Jun-11	+46	+34
Thu-28-Jul-11	+55	+41

THE ELEPHANT IN THE ROOM

Regular readers will recall that we first coined the term “elephant in the room” in relation to QE about 6 weeks ago, recognising the extreme impact it was having on global interest rate markets. And although the US Federal Reserve has yet to explicitly engage in further QE, Fed Chairman Bernanke has done little to dissuade the market that he is not about to do something more substantial. If anything, the Fed appears to be setting the scene for its next move, having noted in the September 21st FOMC statement that it “is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate”. This is a subtle yet significant change from the prior statement, where the Fed simply said that it would “employ its policy tools as necessary to promote economic recovery and price stability”.

Given these developments, it makes sense to prepare for the possibility of further QE. Two other considerations deserve attention – form and timing. With regard to form, what matters most will be the impact and longevity of any announcements. For example, the Fed’s most recent QE programme was a one-off announcement, designed to “shock and awe” the market. The initial impact was significant, but bond yields started rising within a matter of weeks. Neither markets nor the Fed knew how much of an impact a given volume of QE would have. By contrast, if the Fed announces rate targets or takes a more measured approach, altering the size of its QE programme at each FOMC statement in response to how the economy and interest rates evolve, they have a better chance of getting bond yields to their desired level. As such, the way any additional stimulus is delivered is critical.

Timing is also important – and while it would seem like there is some urgency, the reality is that one voting member of the FOMC remains a dissenter, preferring not to express the need for rates to remain low, or for the Fed to maintain the size of its balance sheet. Although one can not rule out an inter-meeting announcement, the fact that there is a dissenter would seem like a high hurdle to overcome. This suggests any announcement will be left to the regular FOMC meeting, where any dissent can be dealt with, and at a time when the market is expecting an announcement. And with the next meeting on November 3rd, market attention has naturally turned to that date as a contender for the next major move.

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All of this may seem esoteric, but given the impact US rates are having on our market, nothing could be further from the truth. Indeed, the better we understand what's going on in the US, the more informed we will be on the domestic rates outlook. Figuring out how changes in US rates will impact our interest rates isn't easy.

Broadly speaking we'd add two comments. First, as we highlighted in our September 1st edition, the correlation between US 10yr bond yields and NZ 10yr swap yields is high (79% levels correlation since 1999), and higher than correlations with domestic factors. This suggests we are set to see changes. The second point is that, as we delve into in more detail next, we also need to be mindful of domestic considerations, as these are acting in the opposite direction of offshore considerations. That will not only dilute the impact of offshore developments, but it is also strongly suggestive of more volatility.

COLLISION COURSE

The past month has seen an 8.6% rise in the US S&P 500 Index. Anticipated QE and lower yields have played a key role supporting risk appetites. While we are dubious of equities as a lead barometer in terms of the economic cycle, we've still noticed a strong correlation between equities and lead indicators of late. Weakness in equities over mid year was one factor accentuating weakness in lead indicators, which in turn exacerbated weakness in global bourses – a dynamic we refer to as the blind leading the blind. With equities now finding their feet, lead indicators (like the latest Chicago PMI, released overnight) now look to be firming again. If lead indicators continue to turn, QE will not be required and hence the market could give up some of its recent gains. But of course the recovery itself is strongly conditioned on such supportive financial conditions remaining in place. We appear set for a collision course.

FAIR ENOUGH

To give an idea of how stretched interest rates are relative to domestic "fundamentals" at the moment, you only need to look at how they compare to historic rates, and other measures of fair value. We consider a number of measures, as follows.

- **Historic averages.** Swap rates for every maturity are below the long term average

3mth BKBM rate. What's more, every swap rate is at least 2% below its own long term average. So even if you take the RBNZ's estimate that bank funding costs have driven a circa 1.5% "wedge" between the OCR and ordinary interest rates, this has more than adequately been captured.

- **Cyclicality.** Somewhat related to the point above, in the past 4.5% was considered the "low point" in the OCR cycle. Yet that's where the 7 year swap is today!
- **Real interest rates.** Two-year-ahead inflation expectations stand at around 2.6% (according to the RBNZ survey). This sits fairly well with the post OCR regime average CPI rate of 2.2%. If we average the two and assume inflation will average around 2.4% over the long term, then that puts the real OCR at 0.6% (having been at about zero for a year when the OCR was 2.5%). It also puts the real 2yr rate at 1.2% and the real 10yr rate at 2.4%.
- **Fair value vis-à-vis the RBNZ's projections.** The RBNZ's 90-day bank bill projections only go out to March 2013. However if we add a couple of points to their projections at a trend pace, which seems reasonable, we can derive "fair value" swap rates. And they stand at around 3.5% for the 1yr, 3.85% for the 2yr and 4.1% for the 3yr. These compare to current market rates of around 3.4%, 3.7% and 3.9% respectively.
- **Fair value vis-à-vis our projections.** We see the OCR rising to 5.25% by late 2012. Like the RBNZ's projections, if we use this to calculate fair values, we find that *our* fair values for the 1yr, 2yr and 3yr swap rates are 3.2%, 3.8% and 4.3% respectively. Again, that's well above the market

None of this is meant to spook you, or even to suggest that rates are *too* low. Indeed we think it is possible, likely even, that rates move lower yet. But at the same time we have to acknowledge that it's something other than the domestic outlook that is responsible for this situation.

STRATEGY

QE seems more likely than not, and while we need to acknowledge that there is a risk it does not eventuate (with the result being that rates would be

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much higher in the US) it makes sense to prepare for it. The outlook is this binary, and the stakes are high. Given the influence that speculation of further QE has had on NZ rates to date, and how stretched rates are relative to the "fundamentals", if one concedes that there is a possibility (no matter now slim) that QE is not forthcoming, then there is an argument for adding to hedges at current levels.

But with the balance of probability in favour of QE, it makes sense to factor it into the decision too. In that regard it pays to think about how the market is likely to trade in the lead up to the next FOMC meeting. In our view US rates are not likely to simply gradually grind lower to the point where there is no impact by the time an announcement is made. Rather we'd expect to see rates spike lower on confirmation of QE. The first stop is likely to be the prior low of around 2% for the US 10yr Treasury bond, or close to it. That's around 50 basis points below current yields. It's impossible to say what the impact of a move there would be on NZ rates, but we think it's safe to say that it will be less, and the local market will struggle to break through prior lows (of around 4.25% for the 5 year and 4.4% for the 10yr). Indeed, recall that those lows were made at the height of the hysteria, in the thick of an easing environment when the RBNZ was cutting rates in chunks of 150bps. Things are quite different now – while the RBNZ is on the sidelines for the time being, the OCR is still headed gradually higher, not lower. As such, we'd view the next 20-40 basis points as the "opportunity zone" for those looking to get some heavily discounted long term hedges in place.

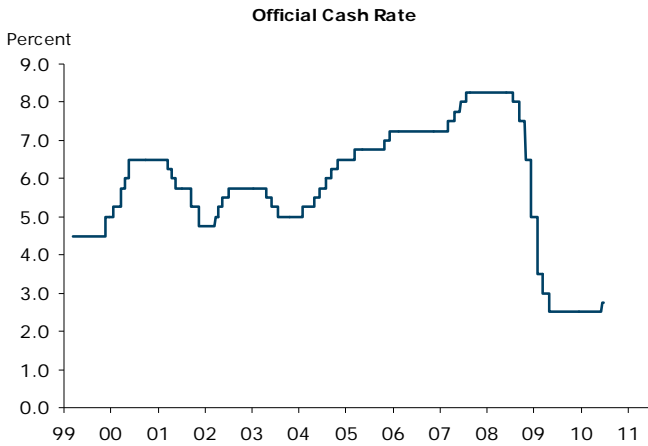
Bearing in mind the possibility that rates snap higher on a "no-QE" outcome, we think there's value in doing some hedging around current levels, adding more every 10bps or so as we head lower. Of course, while we can't rule it out, we would be fairly surprised if NZ swap rates made new lows this year. Indeed, we believe the domestic economy would need to take a significant turn for the worse for such an outcome to eventuate.

DEALING ROOM CONTACTS:

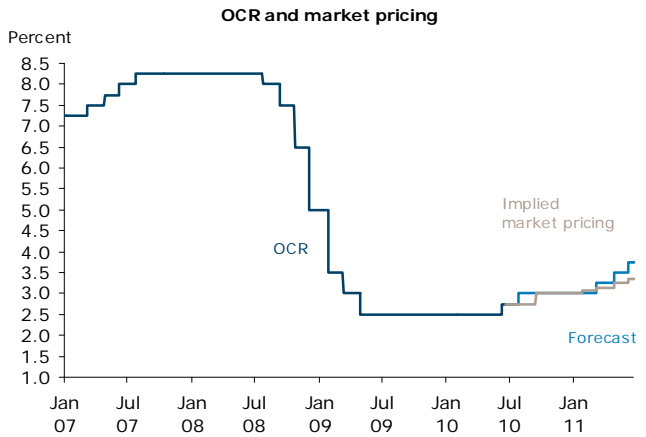
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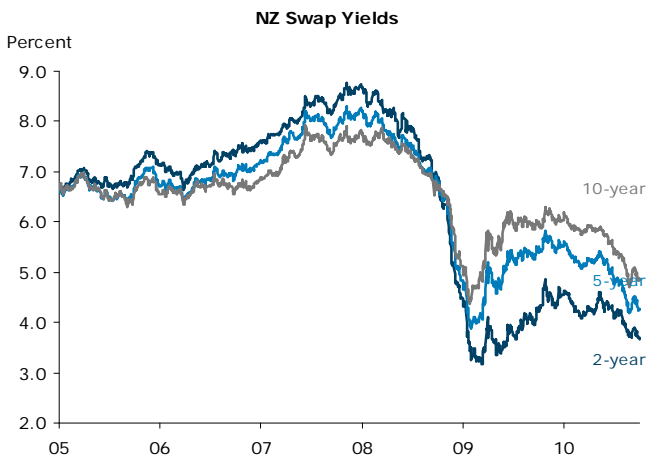
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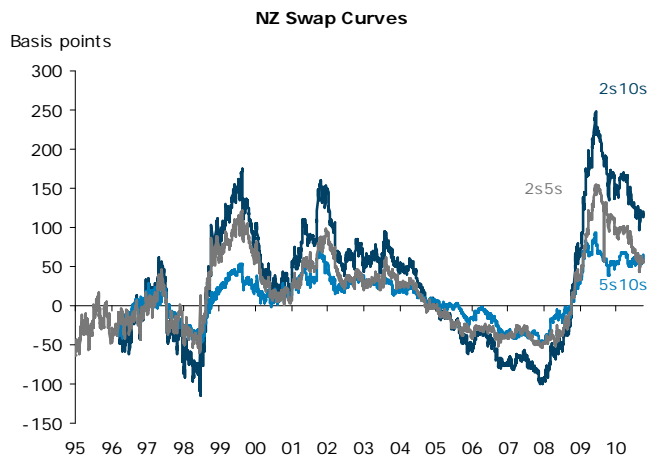
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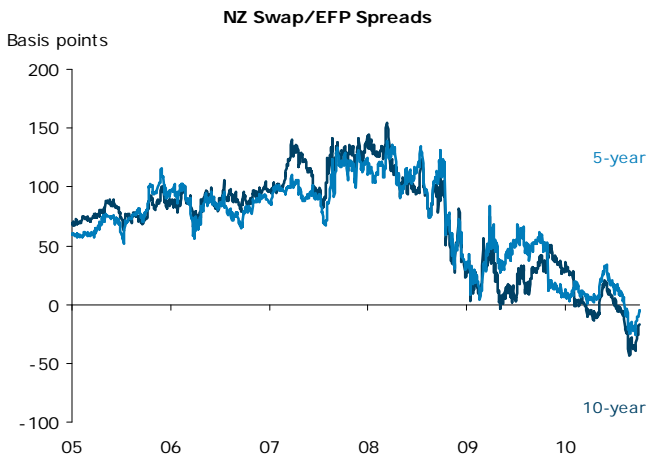
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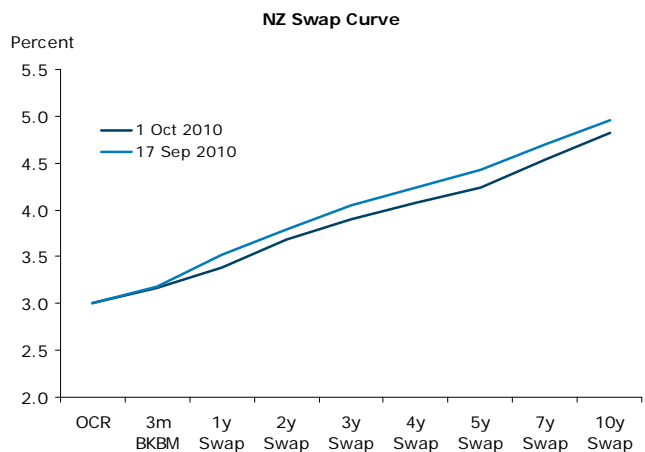
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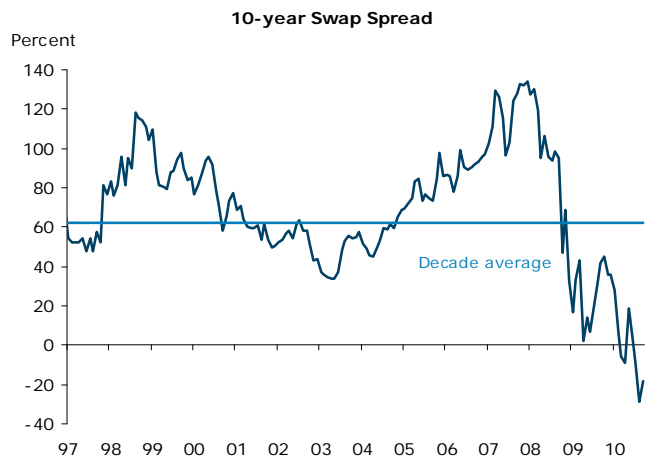
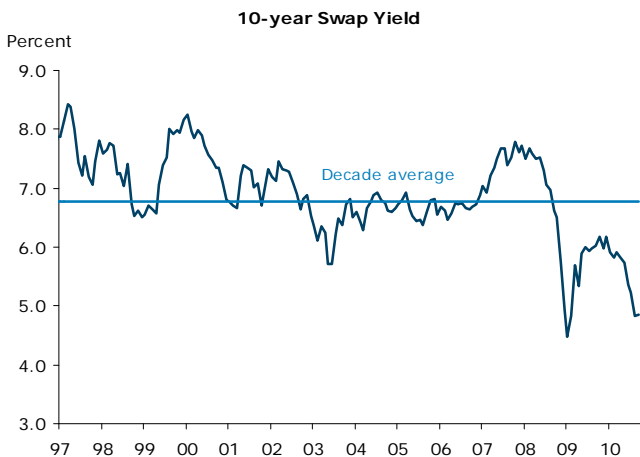
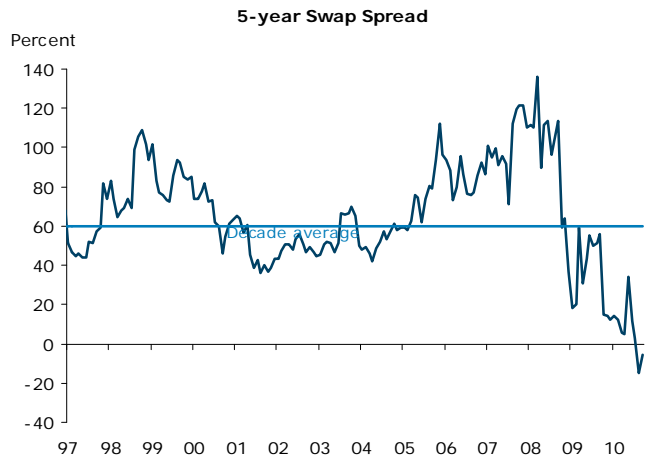
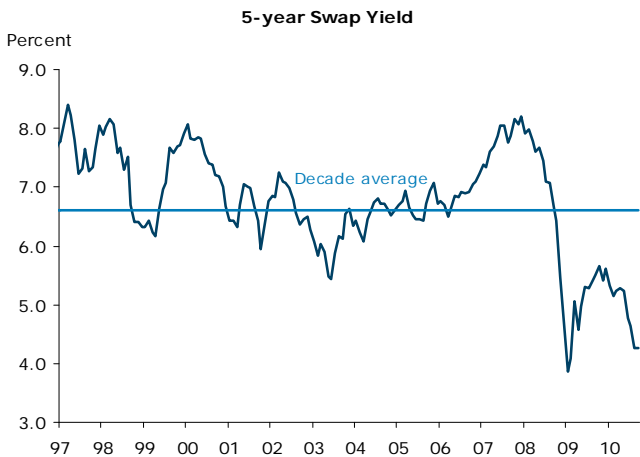
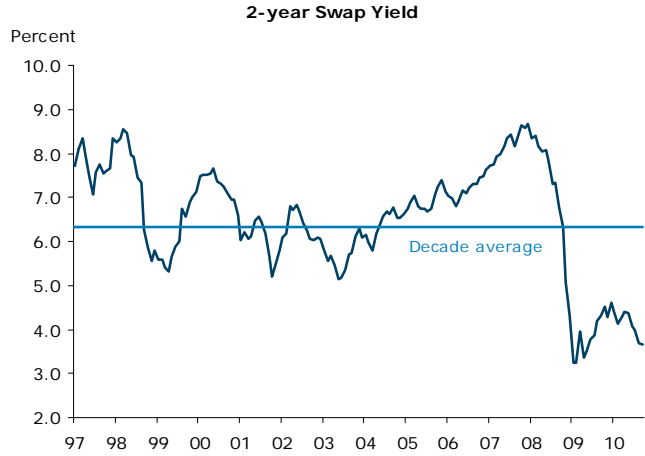
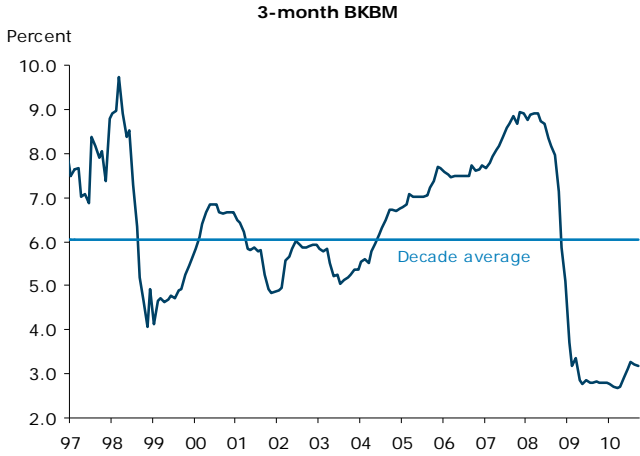
Sources: ANZ, National Bank, Bloomberg



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CHARTS (END OF MONTH)

CHARTS (END OF MONTH)



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