

# NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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## CONTRIBUTORS

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## ECONOMIC OUTLOOK

Near-term economic performance continues to be hampered by structural imbalances within the economy. Household sector activity is still weighed down by ongoing deleveraging, with weak retail and housing sector activity illustrating the high degree of caution evident. At the same time the outbreak of PSA and a weaker lamb kill are weighing on export sector prospects, with the high NZD/USD a headwind for exporters, notwithstanding the boost provided by the low NZD/AUD and high commodity prices. Conditions for a more robust upswing for 2011 are moving into place, as the boost to incomes from high export commodity prices and the continued recovery in the labour market gradually filters through the economy. Financial conditions remain extremely supportive, with booming commodity prices assisting in the rebalancing process for the economy. Earthquake related reconstruction will also provide a modest boost, as will activity associated with the 2011 Rugby World Cup.

## RATE VIEW

Reserve Bank Governor Bollard has made it clear that he is comfortable with the Bank's September MPS assessment, labelling recent market reaction to stronger data like the Q3 HLFIS employment report a "*misinterpretation*". He went further than that, adding that "*we'd look for the market to correct that and we'll be talking further about that when we put out the monetary policy statement*". He also said that the high NZD would have a bearing on future OCR decisions, adding weight to the idea that policy will be benign for some time. We also expect upcoming data to support the RBNZ's dovish view, keeping a lid on short end swap rates. However, the long end is a different story, and if ever there was a "buy the rumour, sell the fact" event, QE II fits the bill perfectly. US rates have failed to rally since QE II, with markets running scared of the inflationary consequences down the track. US interest rates remain volatile, and importantly, we doubt the global rates environment will be as benign as it was in the lead-up to QE. That said, New Zealand interest rates are likely to benefit from what we expect to be more sanguine local data in the run up to Christmas, potentially offering borrowers one last bite at the cherry, so to speak.

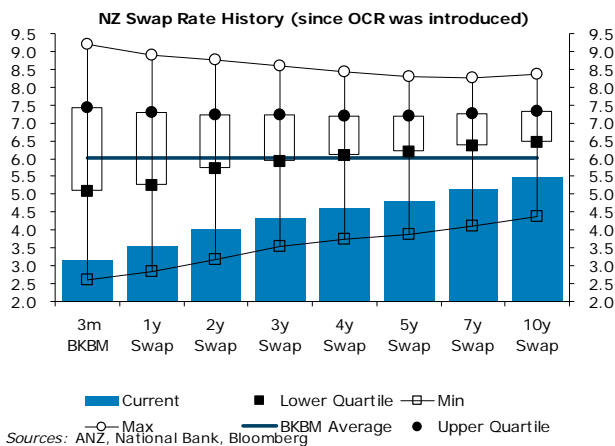
## STRATEGY

Regular readers will be aware of our long-held view that NZ rates were being held artificially low by the prospect of QE, particularly given supply side inflation pressures emerging in Asia, and our expectations of above-consensus GDP growth in 2011. Ideally, readers will have increased their levels of term cover prior to QE, as we favoured. However, if cover levels remain light, we do not advocate "chasing" the market, particularly at the short end, where rates seem way too high given RBNZ comments and the tone of upcoming data. Aggressive risk managers may even use the steepening of the curve as an opportunity to shorten the duration of cover, with a view to adding more cover later should rates move lower and/or the curve flattens.

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## VALUATION

The yield curve has steepened substantially over the past week, with the short end rallying on dovish RBNZ comments, and the long end moving higher on in line with global yields. Indeed, since our last edition, the curve has steepened a staggering 29bps, with the 2yr swap down 3bps, the 10yr swap up 26bps, and the 3yr swap acting as the "pivot" point. Relatively speaking, it is now more expensive to fix, further deepening the borrower's conundrum. Forward starting swaps have moved even further, and no longer offer the value they did.



## "MISINTERPRETATION"

Although short end rates have been dragged higher by global influences over the last few weeks, which is understandable, in our view there's a limit to how much higher key bellwethers like the 2 year swap can go. Strictly speaking, the 2 year is a few basis points lower than it was at the time we published the *Borrower's Strategy*, as the table below left shows. However that masks the fact that it reached 3.92% at one point last week. Perhaps worse still, at 4.03%, the 2 year is still around 25-30 basis points higher than it was over most of October, during which time the market had settled into a comfortable 3.72/3.78% trading range. We don't think this is realistic – for two reasons.

First, it contrasts starkly with comments by RBNZ Governor Bollard at the news conference following the release of the *Financial Stability Report* just a week ago which suggest rates ought to be lower. Although it was the strength of the NZD that got most of the attention, the Governor did make some pointed comments about interest rates as well. Indeed, he noted that:

*"financial markets have taken it into their head to interpret some New Zealand data more strongly than we might otherwise do. We would also note that, of course, if the New Zealand dollar stays at relatively high levels that does reduce pressure on monetary policy and the markets will presumably reach the conclusion that there would be likely less of an increased track in interest rates in New Zealand".*

So, not only is the high NZD not helping the much-needed rebalancing of the economy, but it is likely to lead to less aggressive rate hikes if sustained. This seems to be lost on the market, which continues to focus on rising global rates. Bollard also added that his view was that the outlook for the economy had not changed in light of recent data, which contrasts significantly with recent changes in market pricing. That said, we suspect recent data has evolved broadly in line with what the RBNZ were expecting, and it is possible that the Governor's comments were more tactical in nature, and were designed to weaken the currency, so perhaps we should not take him too literally. But the fact that he linked currency strength to the interpretation of recent data and to future OCR decisions is nonetheless interesting. Specifically, we note that the Governor also noted that:

Current interest rate levels		
Maturity	2 weeks ago	Current
3-mth BKBM	3.18	3.16
1-year swap	3.60	3.55
2-year swap	4.06	4.03
3-year swap	4.32	4.35
4-year swap	4.51	4.62
5-year swap	4.65	4.83
7-year swap	4.92	5.15
10-year swap	5.21	5.47

Market expectations for RBNZ OCR (bps)		
OCR Dates	2 weeks ago	Current
Thu 9-Dec-10	+2	+0
Thu 27 Jan-11	+5	+4
Thu 10-Mar-11	+14	+13
Thu 28-Apr-11	+28	+27
Thu-9-Jun-11	+46	+40
Thu-28-Jul-11	+61	+53
Thu-15-Sep-11	+77	+69

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*"we're not seeing any fundamental change in our understanding of the New Zealand economy out of that data, some of the market seem to think there was"*

As if that wasn't crystal clear, his final comment on the matter was:

*"if there's some misinterpretation of New Zealand data, as we feel there might have been over the last couple of weeks, then we'd look for the market to correct that and we'll be talking further about that when we put out the monetary policy statement in a month's time"*

The second reason why we question the level of short term rates stems from our reading of the data. Interpreting (or misinterpreting) recent data is one thing, but looking to the future is another entirely, and when we look to the next few weeks, it's hard to see where the upside risks for rates lies. Between now and Christmas there are about half a dozen domestic events that have scope to move the market, as follows. We're not trying to forecast the data – after all – some of it is for November, and we're only half way through the month. But when we think of the tone surrounding upcoming events, as noted below, we don't exactly get the feeling of elation.

Upcoming events		
Date	Event	Comment
29 Nov	NBNZ Business Outlook Survey – Nov	It's our data and we couldn't possibly comment.
9 Dec	RBNZ MPS – Dec	Will be dovish if Bollard comments at the FSR are anything to go by.
14 Dec	REINZ Housing data – Nov	Oct 2010 was the worst October on record. What's changed this month?
14 Dec	Retail Sales – Oct	Some retailers saying the post GST slump was the worst they've seen.
16 Dec	NBNZ Business Outlook Survey – Dec	Will depend on the pre-Christmas mood.
23 Dec	GDP – Q3	National Bank Regional Trends and NZIER QSBO surveys suggest GDP may have contracted in Q3.
25 Dec	Christmas	Retailers still offering huge (20-60%) discounts, yet X'mas is only 5wks away!

Given this outlook, we wonder what the market is reacting to. Of course, there's more to market moves than just reacting to and anticipating data – flow and positioning matter too. But that's just it – the recent rise in short end yields has all the hallmarks of a squeeze, and once the panic subsides, we expect the 2 year to head back below 4%, and to settle closer to levels prevailing over October.

### A DIFFERENT STORY

The long end looks to be a different story, but that's mainly because US rates have risen aggressively. US Treasury bond yields remain volatile (having traded up, then down, then up again in 15bp waves over each of the past 3 nights). While we expect this to continue as the mood in the market swings between a deep seated fear of inflation and delight at the prospect of Fed buying, it's hard to ignore the fact that US bond yields have not fallen since QE 2 was announced. As noted last week, if the market can't rally having been given all it wanted plus some, we wonder what it would take for yields to fall. That being the case, we're not holding our breath waiting for global yields to fall, and instead, we're getting ready for what looks set to be a gradual grind higher in global yields over the course of 2011. NZ rates will inevitably move higher in this environment, although with less vigour, mainly because unlike the Fed, who may be forced to accept a little more inflation in return for a lower unemployment rate, the RBNZ is singular in its focus (on inflation). Similarly, NZ rates did not fall as aggressively as US rates during this year's rally, so are less likely to rebound by as much.

### STRATEGY

We don't favour chasing the market, particularly at the short end, which is ripe for a correction. But while we see scope for long end yields to move higher over 2011, equally we see no point in chasing the market there, particularly given the significant volatility of the past few days, and ahead of what we expect to be some pretty subdued domestic data.

Of course, no strategy is without risks, and there is no guarantee that rates will drift lower in the weeks ahead. This is less likely to be an issue for borrowers who took advantage of the pre-QE rally to put additional cover in place. However, those who have less than ideal cover on board will now no

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doubt be wondering with the curve as steep as it is (making the choice to fix that much more difficult) what the best course of action is. As always, it depends on your circumstances, but when the curve is steep, optionality can be beneficial. Instead of "paying away" points to go further out on the curve to be fixed, you may consider paying premium instead – at least that way you can still enjoy low rates for a while, and save more money in the long term if floating rates don't rise as much as swap rates imply. As noted, we do expect global long end rates to move higher, but remember, caps roll at the 3mth BKBM rate, and that's likely to rise less rapidly, held back by sub par near term growth and de-leveraging.

Consider the table below, which has indicative pricing for caps with strikes at the money (ATM), at the money plus 25bps (ATM+25bps), and at the money plus 50bps (ATM+50bps). Those premiums may look high, but when you consider them in relation to the spread between the fixed rates for each period against the current BKBM rate, they look considerably more attractive. For example, instead of paying 116bps above BKBM at the moment to be fixed for 3 years, you may wish to spend 39bps on a 3 year option with a strike at 4.82% (4.32% + 50bps). You don't have as much upside protection (the strike kicks in 50bps higher), but you do get to participate in the downside, and that's significant at the moment. We know, for instance, that the rate on the option for the first quarter will be 3.16% (the current BKBM rate). Assuming, say, BKBM rises by 25bps per quarter (broadly analogous with 25bps rate hikes per quarter) then the next 3 rolls will be 3.41%, 3.66% and 3.91%. That's an average of 3.54% for the first four rolls, or a saving of 78bps versus the fixed rate. Having saved 78bps for the first year, that's "paid for" 2 years worth of premium at 39bps per annum (the premium cost), making the breakevens on the options look very attractive over the remaining two years.

**Selected cap premiums (basis points per annum)**

Term	Fixed Rate	Spread to BKBM	ATM	ATM+ 25bps	ATM+ 50bps
3 yr	4.32%	116bps	56bps	47bps	39bps
5 yr	4.83%	166bps	70bps	61bps	53bps

Finally, it's worth adding that the significant steepening of the yield curve we have seen over the

last month does present opportunities for more aggressive risk managers to shorten the duration of existing hedges, with a view to re-extending later should rates rally into Christmas. For example, had you paid fixed for 7 years at the time of our issue a month ago (the October 22<sup>nd</sup> edition) you may have done so at around 4.63%. Now that the curve has steepened, the 2 year swap starting in 5 years has sold off aggressively, rising from around 5.51% to 6.14% today. If you wished to shorten the original swap by 2 years, you could do so, and shave close to 50 basis points off the original swap (which would now be a 4 year 11 month swap). In other words, you'd be left with a swap with a little less than 5 years to run at a rate of around 4.13%. This kind of active management can be beneficial, but we must stress that it's not for the faint-hearted, and should only be engaged in within comfortable hedge ratios. That is, it would be foolish to shorten if you're already short on cover, but if you're well above prudent minimum cover ratios, and want to lighten up and take some profit, that's another thing altogether.

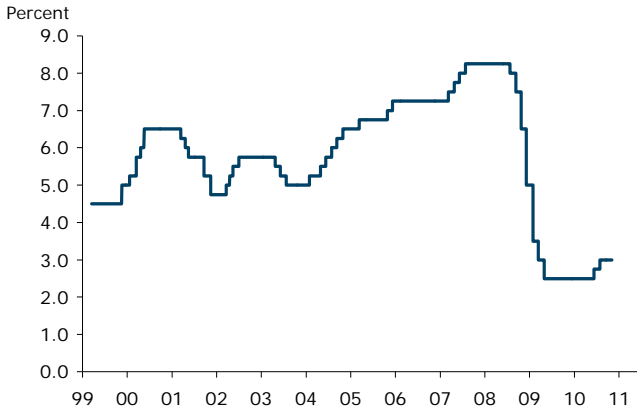
### DEALING ROOM CONTACTS:

Auckland	09 377 9450 / 0800 730 100
Wellington	04 471 0030 / 0800 445 088
Christchurch	03 364 5335 / 0800 269 261

# CHARTS

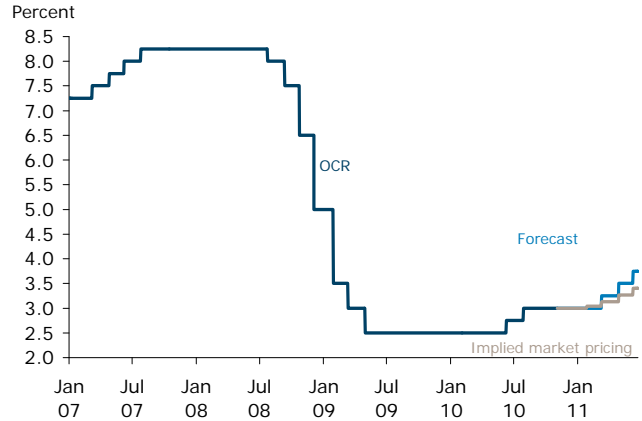
## CHARTS CHARTS

**Official Cash Rate**



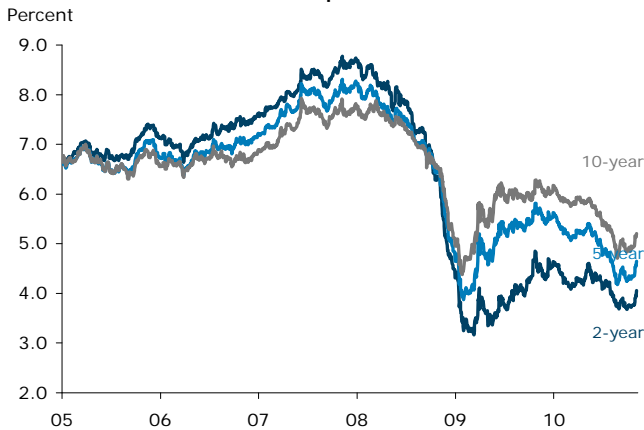
Sources: ANZ, National Bank, RBNZ

**OCR and market pricing**



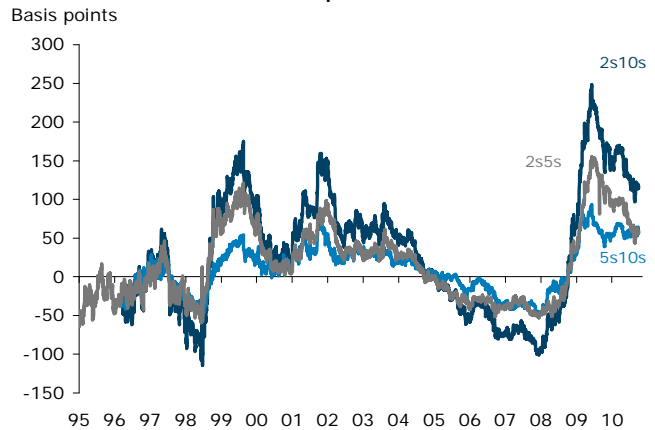
Sources: ANZ, National Bank, RBNZ, Bloomberg

**NZ Swap Yields**



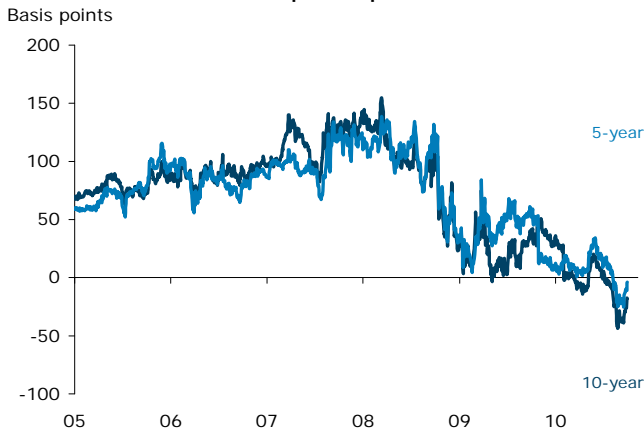
Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curves**



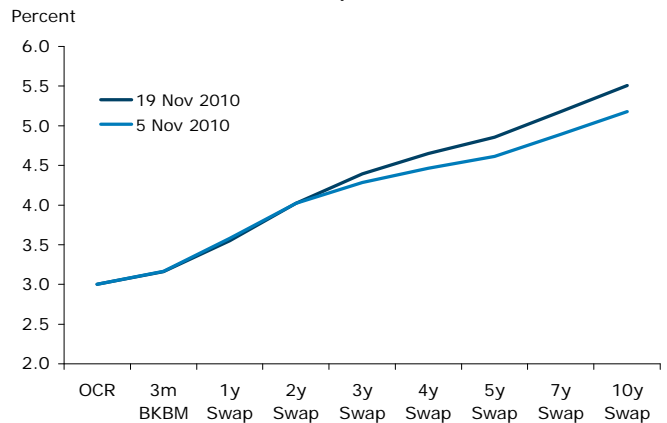
Sources: ANZ, National Bank, Bloomberg

**NZ Swap/EFP Spreads**



Sources: ANZ, National Bank, Bloomberg

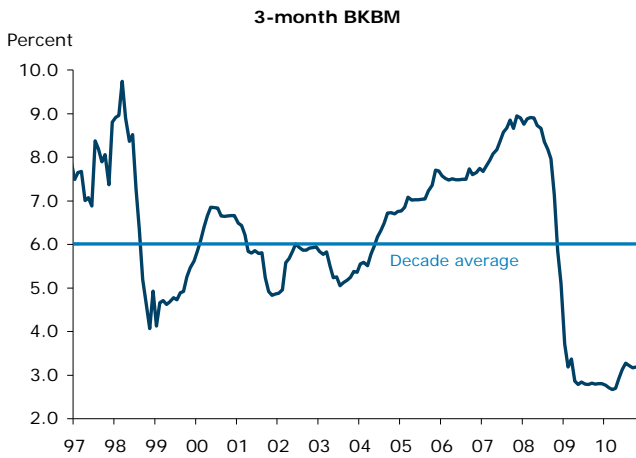
**NZ Swap Curve**



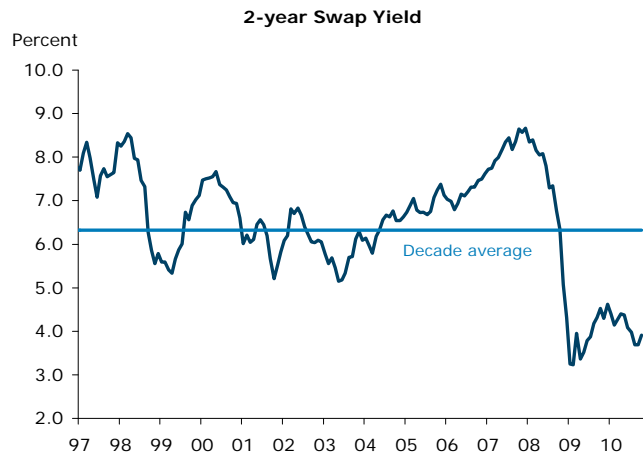
Sources: ANZ, National Bank, Bloomberg

# CHARTS (END OF MONTH)

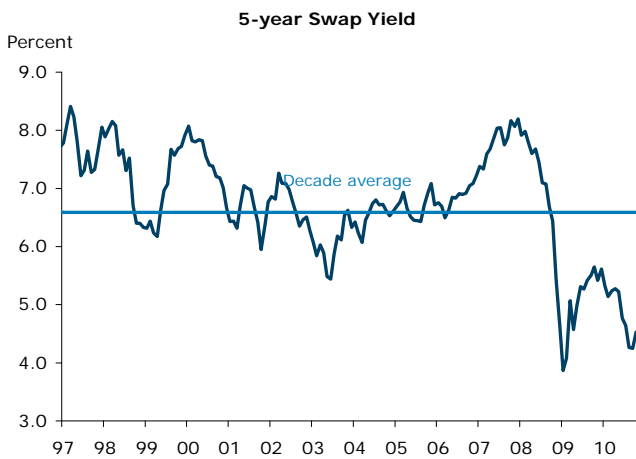
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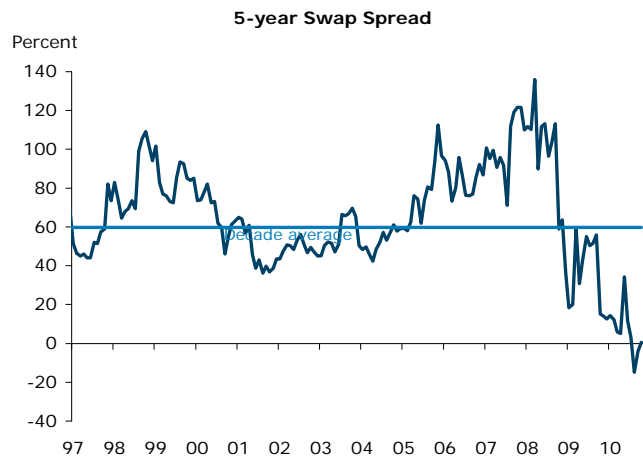
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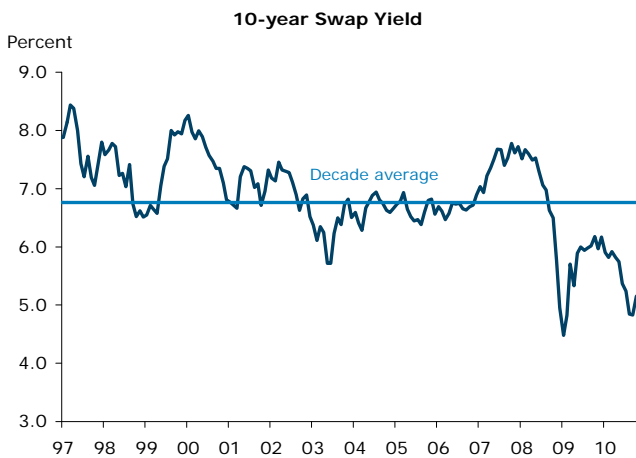
Sources: ANZ, National Bank, Bloomberg



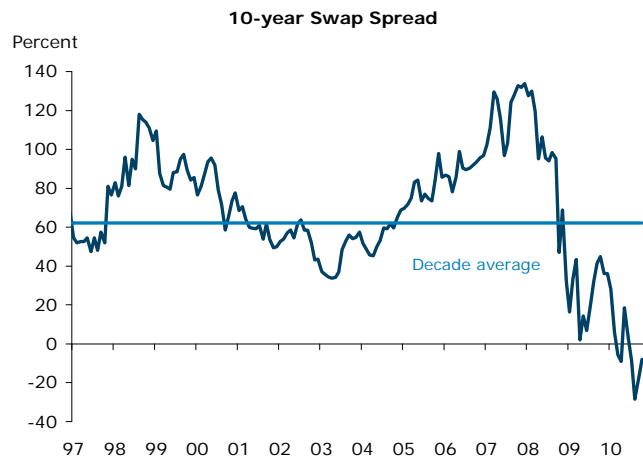
Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg



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