

# NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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## CONTRIBUTORS

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

## ECONOMIC OUTLOOK

The February 22<sup>nd</sup> Christchurch earthquake has delayed the recovery by six months, with weak activity in the first half of the year. We see a springboard-style recovery emerging from the second half of 2011 and for this to continue well into 2012, underpinned by economic activity associated with repairing the \$15bn to \$20bn in earthquake damages. Hosting the Rugby World Cup will also benefit tourism and domestic spending. Financial conditions are supportive, commodity prices are at record highs and the global economy is recovering nicely. Considering the destruction to balance sheets and the weak starting position of the New Zealand economy, this is hardly growth to crow about, yet it is growth nonetheless. High headline CPI inflation and stronger growth will encourage the RBNZ to start removing the March insurance cut to the OCR, with the first 25bp hike in December.

## RATE VIEW

With the RBNZ on the sidelines until December, short end interest rates are likely to be reasonably stable over the next few months. Incoming data and shifting sentiment from offshore will generate some volatility, but the reality is that short term rates are, by and large, anchored in place by the OCR. Furthermore, it will take some time for earthquake related impacts to disappear from data, and as such, they will tend to be discounted. Long end interest rates are a different story, with offshore rates potentially set to rise dramatically as the year unfolds. US rates are particularly vulnerable. This is because the Fed will either move quickly to normalise policy, which will crimp excess liquidity, or take a more relaxed stance, and risk a loss of confidence on the inflation front. Either way, US rates are set to rise, and when they do, there will be a knock on impact here in New Zealand.

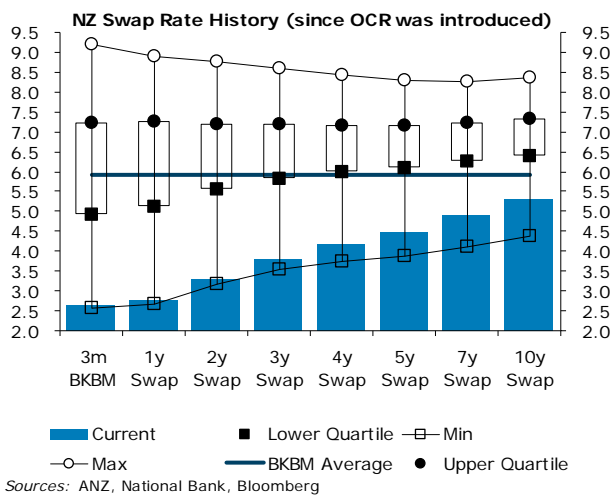
## STRATEGY

Although we continue to favour greater than normal exposure to floating rates (at least in relation to what one might expect with rates as low as they are), we see merit in making small additions to hedges at current levels. Short term rates are close to all-time lows, even if they have moved up mildly over the past fortnight. But they are not sufficiently low enough relative to our forecasts, or the RBNZ's, that they offer outstanding value, particularly given how low the floating rate is. The short end of the yield curve is very steep, and we favour structured hedges, such as cancellable swaps, over traditional fixed rate hedging. With global long term rates on the rise, we do see merit in adding to long term hedges. But the hurdle for doing so is high – although such a strategy may pay off in the long term should long end rates move higher, in the mean time, it means paying a substantially higher interest rate. If this is something your business can handle, and you have sufficient certainty with regard to the future, then it may be worth considering adding mildly to long term hedges.

# BORROWER'S STRATEGY

## VALUATION

Interest rates are higher across the board relative to where they were when we published our last *Borrower's Strategy* a fortnight ago. Whereas at that time markets were in a mild state of panic courtesy of the Japan nuclear situation (with rate cuts priced into the Australian market), cooler heads now prevail. And rates have moved higher as the nuclear risk has been priced out. The curve has steepened, taking the OCR-5yr spread to close to 2%, making any decision to fix expensive.



### Current interest rate levels

| Maturity     | 2 weeks ago | Current |
|--------------|-------------|---------|
| 3-mth BKBM   | 2.60        | 2.63    |
| 1-year swap  | 2.72        | 2.76    |
| 2-year swap  | 3.24        | 3.30    |
| 3-year swap  | 3.70        | 3.81    |
| 4-year swap  | 4.05        | 4.18    |
| 5-year swap  | 4.31        | 4.48    |
| 7-year swap  | 4.73        | 4.91    |
| 10-year swap | 5.15        | 5.31    |

### Market expectations for RBNZ OCR (bps)

| OCR Dates     | 2 weeks ago | Current |
|---------------|-------------|---------|
| Thu 28-Apr-11 | -1          | 0       |
| Thu-9-Jun-11  | -3          | 0       |
| Thu-28-Jul-11 | -7          | -1      |
| Thu-15-Sep-11 | -2          | +1      |
| Thu-27-Oct-11 | -1          | +5      |
| Thu-8-Dec-11  | +5          | +12     |
| Thu-26-Jan-12 | +12         | +28     |

## HOLDING PATTERN

We remain circumspect when it comes to making dramatic changes to overall hedge strategies, and continue to favour above-normal exposure to floating rates. This stems from three broad themes:

- 1) Broadly speaking, uncertainty remains high with regard to the state of the overall macroeconomic environment. Of course, one can never be certain about what the future holds, but if we were to plot the current environment against the experience of the past 5 years, even an optimist would put us at the uncertain end of the spectrum. The most obvious implication from this is that it strongly discourages against introducing fixed costs to the business.
- 2) The second is the degree to which traditional fixed rate hedges have been "undermined" by an ultra-low OCR. That is, outright swap rates may be low, but 3mth BKBM is even lower, tilting the playing field in favour of floating. This is the essence of what we have long referred to as the "borrower's dilemma".
- 3) The third theme is cashflow, although we probably have to concede that this is a by-product of (1) and (2) above. The difference is, whereas uncertainty and valuation are judgement calls, cashflow is a binding constraint. That is, even if you wanted to hedge right now, you might not be able to.

Taken together, these considerations are not persuasive arguments to add to hedges, at least not in the traditional sense. But that doesn't mean one should not consider adding to hedges. On the contrary – there are a number of strategies we do favour. But they either involve minor additions to long term hedges, or employ optionality, as we discuss in more detail in what follows.

## ANOTHER ANGLE

But with some swap rates within a few basis points of all-time lows, and others substantially lower than they were a few months ago, when the market was bracing itself for the recovery trade, by holding off now, do you run the risk of missing out on a salivating second bite of the cherry? Do lower rates not represent an opportunity? These are certainly questions that deserve to be pondered. As we step through the arguments, it certainly has us leaning more towards favouring adding some long term fixed cover than if we simply allow ourselves to be blinded by the eye-wateringly low floating rate.

## BORROWER'S STRATEGY

As a starting point, let's put the last few months in context, and see how far key borrowing rates have moved over the last few months. So as not to underestimate things, the table below shows the change from the day before the Christchurch quake (i.e. Feb 21<sup>st</sup>), the post quake trough. The dates that the respective lows occurred may be different for each swap. But with the obvious exception of the OCR, they all have two things in common – they are lower now than they were before the February 22<sup>nd</sup> earthquake, and they are all up off their lows.

| Key NZ rates before and after the Chch quake |                      |      |         |         |
|--|----------------------|------|---------|---------|
| Rate   | Feb 21 <sup>st</sup> | Low  | Change* | Current |
| OCR  | 3.00                 | 2.50 | -0.50   | 2.50    |
| 3m BKBM                                      | 3.19                 | 2.57 | -0.63   | 2.63    |
| 2y Swap                                      | 3.81                 | 3.16 | -0.64   | 3.30    |
| 3y Swap                                      | 4.15                 | 3.64 | -0.51   | 3.81    |
| 5y Swap                                      | 4.69                 | 4.23 | -0.46   | 4.48    |
| 10y Swap                                     | 5.43                 | 5.04 | -0.39   | 5.31    |

The question is: have we missed the boat? And should we look to rectify that by taking the opportunity to add to hedges now?

It is impossible to answer the first question – but what we do know is that at the time rates were plunging to new lows, we doubt many people would have had the fortitude to stand in the way of a rallying market. The old adage about catching a falling knife springs to mind. But even if you had been clever enough to hedge, aside from having a mark to market profit now, how would your decision look? Broadly speaking, they would have looked similar to how they would look if you hedged today. They'd be better trades than if they had been entered prior to the quake, but they'd all have you paying a much higher rate than the floating rate. Although the relativities have changed, you still won't have solved the borrower's dilemma.

Of course, as noted, you would be sitting on a mark to market profit, and having noted that earlier, we can't just leave that out there. For those prepared to "trade" the cycle, this can be a very lucrative way of adding value, or lowering interest expense. But it comes with risks, and for many borrowers, they are simply not worth taking. Large corporate borrowers may be in a position to do this, but smaller borrowers may not be able to. This leaves us broadly siding with the view that unless you can take profit, and trade your position around, you would need to be comfortable moving onto a higher

and less flexible rate to be happy having hedged at the lows.

The second question is, of course, the better question – and that's should we view the current set of interest rates as advantageous? At face value, this is questionable. To start with, market pricing is broadly consistent with the RBNZ's most recent projections for 90-day bank bill rates. These are only relevant out to 3 years (as the projections only go out 3 years), but against RBNZ implied "fair value" rates of around 2.95%; 3.40% and 3.80% for the 1 year, 2 year and 3 year respectively, current rates are not so cheap so as to be a screaming "must have", particularly when you factor in some of the objections and constraints described in the previous section.

To be sure, they are all lower, but are they low enough? We don't think so. These "savings" are all pretty marginal, and they won't protect you for long. And if rates stay stable over at least the next 3 months or so, there is a lot of money to be saved by being floating in the mean time, then paying fixed. In fact, 1 year, 2 year and 3 year swap rates can rise at the rate of around 7-8bps a month before you have to worry about having missed the boat, as this is what the "carry" cost of being paid is for these maturities. And in the absence of better information, we would prefer to take that risk, than take the risk of jumping in too soon.

Inflation also deserves a mention here, and as we briefly note later, this is shaping up to be a tricky issue for the major central banks. It is also set to be a minefield for the RBNZ too, and that's mainly because of where inflation is coming from. Higher food and fuel prices have and will continue to significantly add to inflation over coming quarters. Because these are core staples, it is easy to argue that they are like a tax on consumption, and thus something the RBNZ can ignore. But if it does so for too long, and peoples' real wealth starts getting eroded too much, the pressure will come to bear on wages, and before you know it you end up stuck in a wage/price spiral. This may sound like a remote outcome now, but the point is, it's not something you can ignore. Most importantly, it adds to the upside risks to the OCR, which incidentally, is negative in real terms.

The long end is a bit trickier – and if anything a little less one-sided. Of particular concern would be if we were to see a gratuitous rise in global interest rates, especially if that had an inflation concern at the root of it. If global rates were to rise, New Zealand rates will be sure to follow, and we have to

## BORROWER'S STRATEGY

admit to being nervous on this. We would be particularly concerned if the US Federal Reserve starts trading off the low inflation half of its dual mandate with the other half – full employment. The moment the Fed starts to tolerate more inflation in a bid to gin up the jobs market is the moment all bond holders fear. We don't think this is what the Fed is doing, but some committee members are certainly talking that way. If the Fed starts getting heavy handed on inflation, which will be a good thing for long end rates in the long term, the immediate knee-jerk reaction in the bond market is likely to be negative. Why is this? Because in signalling an end to zero interest rates, the Fed will, in effect, be shifting to end to the liquidity binge which has been partially responsible for lower long term interest rates. It is this that worries us more than the inflation threat, but either way, it is difficult not to be attracted to the view that global (read: US) long term interest rates could go a lot higher.

Finally, we should add that the GFC did not just spawn massive amounts of excess liquidity – it also heralded in unusually low policy interest rates, and these will not remain low forever. The upcoming global monetary policy normalisation process is slowly getting underway. While there are good reasons to expect it to be more muted and quite different to past cycles, the overall level of interest rates needs to rise, this is particularly the case in key trading partners like the US, UK and Europe, where real policy interest rates are negative and coming under increased stress from rising inflation. Central banks have a tough job on their hands, but one thing seems inescapable – policy rates must rise, and that will have a knock on effect on bond yields, and in turn, on NZ long term interest rates.

This gives intuitive appeal to the notion that now is a good time to add to long term hedges. But we must stress that the hurdle for action is still very high. Despite the prospect of rates moving higher, every day you pay a long term fixed rate is a day on a higher rate. Is this something you can afford? And are you confident enough to introduce not just more, but by definition higher fixed costs to your business? If you are, then you may wish to add to hedges. Indeed, we do favour mildly increasing long term hedge ratios for those that can overcome the objectives mentioned. But uncertainty remains high, and we certainly do not favour jumping in boots and all, so to speak.

### CANCELLABLE SWAPS

One strategy we favour at the moment is the cancellable swap. In return for a small premium above the normal swap rate, the borrower has the right to cancel the swap at some pre-determined date in the future. The advantage is that you are hedged for the full period. Should rates be lower in future, you can walk away from the swap, and revert back to floating without incurring any termination cost. This does not overcome the objection of having to pay a higher fixed rate in the mean time. But the yield curve is currently steep and if it turns out that the premium for additional term is too high, the structure gives you the ability to walk away.

As an example, consider this. As compared to paying fixed for 3 years using a vanilla swap with a market rate of 3.82%, you could pay an 8bp premium over the next 3 years, which would give you the right to walk away in 2 year's time. In our view, 8bps is a small price to pay for that optionality, which will become valuable should rates stay low for much longer than what's currently priced in (and assumed by most forecasters including ourselves and the RBNZ).

For those who want cashflow relief over the next 12 months, and wish to remain on floating, the whole structure can be priced starting in 1 year. For example, instead of paying 3 years fixed starting in 1 year at around 4.70%, you could enter a 1 year forward starting 3 year cancellable swap in return for a premium of 16bps over 3 years. This would leave you floating for the next year, fixed at 16bps above the standard 3 year/1 year forward rate for the following 2 years, with the right to walk away for the final year. Again, having the ability to walk away comes at a reasonably small premium, and once again, this may prove to be worthwhile should rates remain lower for longer.

Finally, we should add that such hedges are complex, and we must stress that anyone considering one should familiarise themselves with the product, and ensure that it is appropriate for your needs.

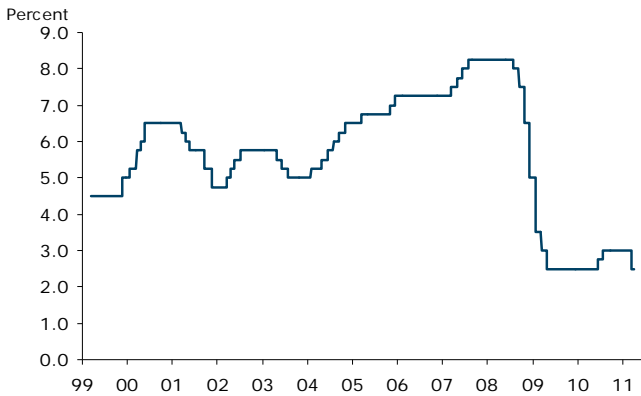
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| Christchurch | 03 364 5335 / 0800 269 261 |

# CHARTS

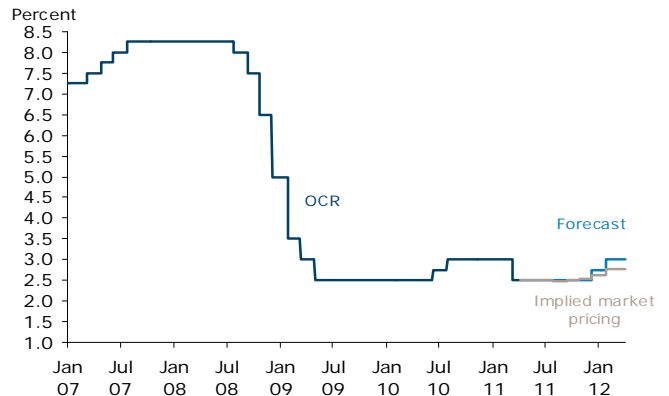
## CHARTS

**Official Cash Rate**



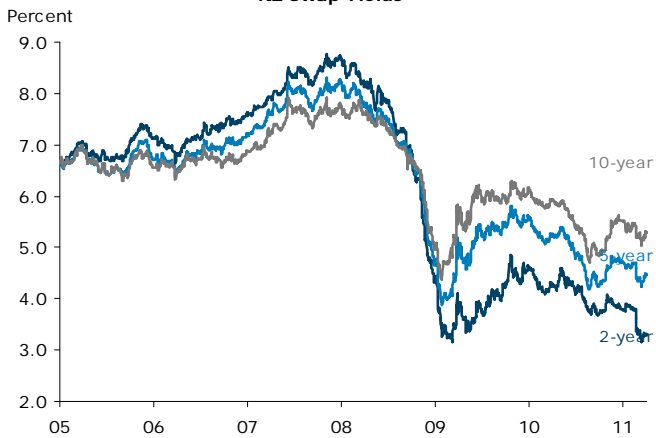
Sources: ANZ, National Bank, RBNZ

**OCR and market pricing**



Sources: ANZ, National Bank, RBNZ, Bloomberg

**NZ Swap Yields**



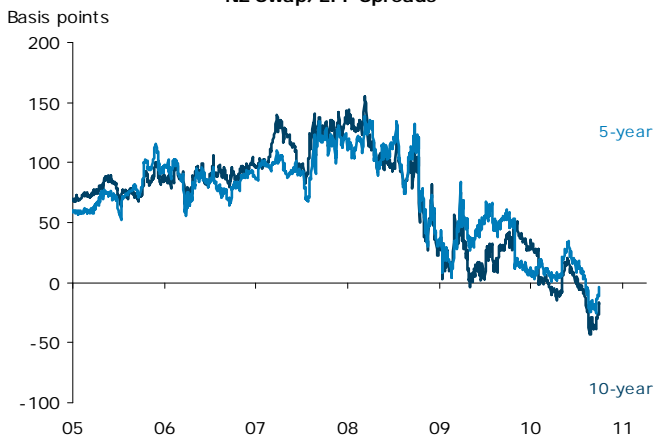
Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curves**



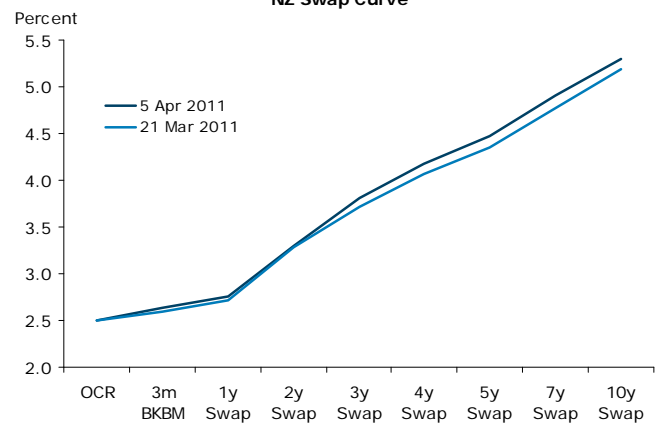
Sources: ANZ, National Bank, Bloomberg

**NZ Swap/EFP Spreads**



Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curve**

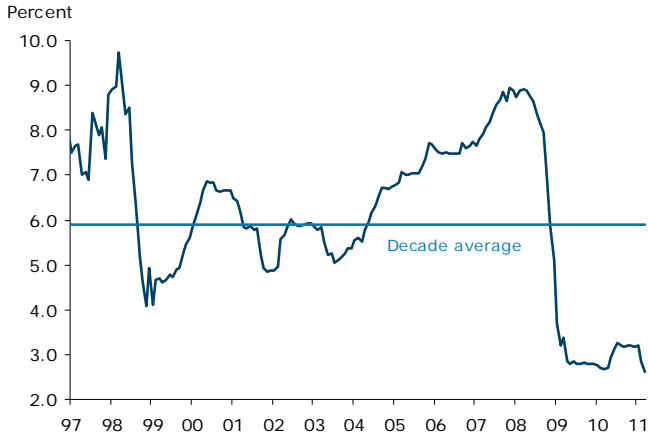


Sources: ANZ, National Bank, Bloomberg

# CHARTS (END OF MONTH)

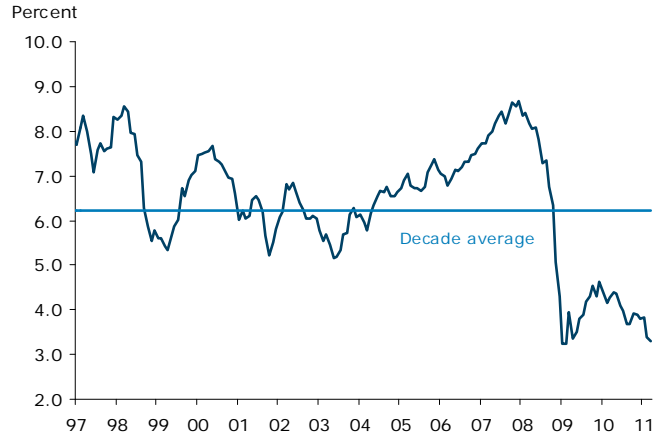
## CHARTS (END OF MONTH)

**3-month BKBM**



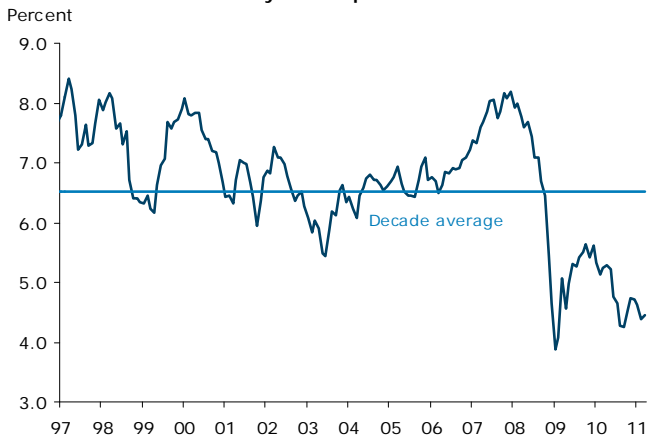
Sources: ANZ, National Bank, Bloomberg

**2-year Swap Yield**



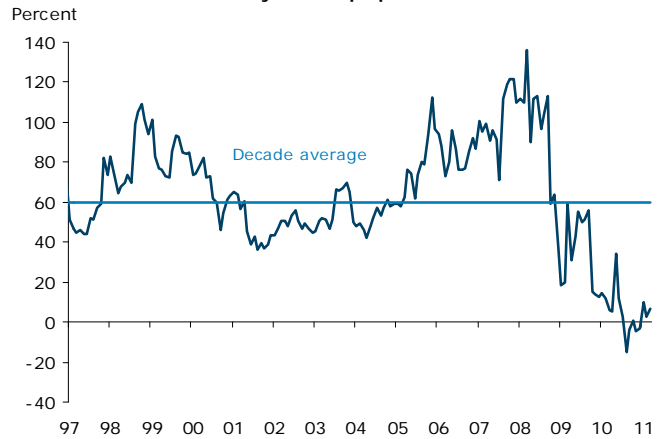
Sources: ANZ, National Bank, Bloomberg

**5-year Swap Yield**



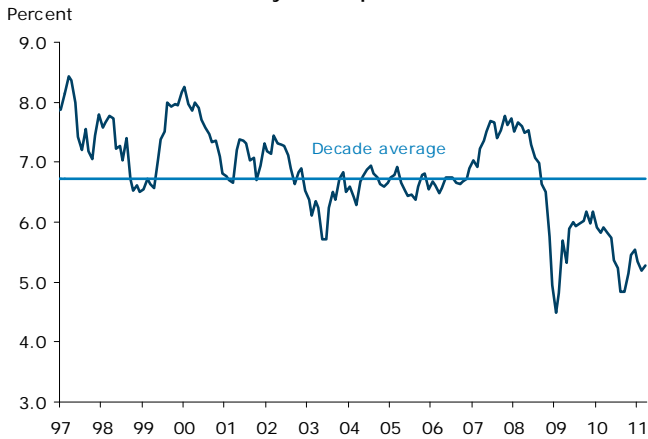
Sources: ANZ, National Bank, Bloomberg

**5-year Swap Spread**



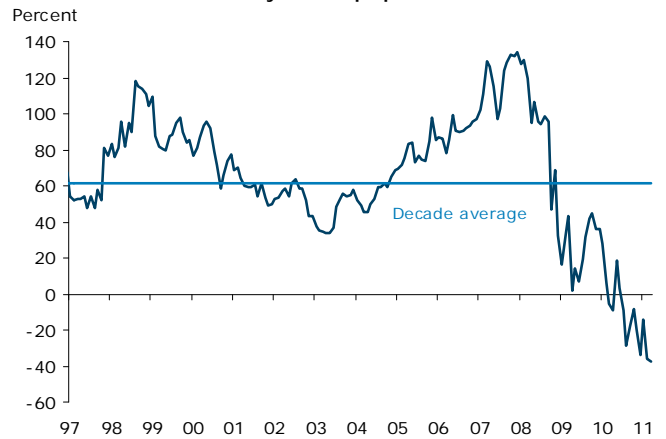
Sources: ANZ, National Bank, Bloomberg

**10-year Swap Yield**



Sources: ANZ, National Bank, Bloomberg

**10-year Swap Spread**



Sources: ANZ, National Bank, Bloomberg

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