

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

3 March 2011

CONTRIBUTORS

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

ECONOMIC OUTLOOK

Early indications for the New Zealand economy in 2011 had looked relatively promising, but the Christchurch earthquake has fundamentally changed the economic picture. We expect at least a 1% hit to Q1 GDP from disruption effects, with more likely in Q2, depending partly on how long confidence is impacted. Beyond that, the rebuild effort will be massive, but significantly delayed by assessment bottlenecks and big-picture planning requirements. Consumers are set to struggle, with the earthquake coming on top of high food and energy prices and still-high levels of household debt. Meanwhile, the income-generating part of the economy continues to be underpinned by record-high commodity prices. The two-speed economy theme just got turbo-charged, something the RBNZ will be mindful of.

RATE VIEW

Our view has changed completely. We now expect the RBNZ to cut the OCR by at least 25bps next week, and to leave the door open for another cut in April. Although we are not ruling out the possibility of a 50bp cut next week, a smaller 25bp cut has more intuitive appeal. Although it is abundantly clear that the economy will be materially affected by the earthquake, fiscal policy needs to do much of the heavy lifting and respond accordingly, which takes some pressure off monetary policy. We also need to recognise that the NZD has fallen materially, particularly against the AUD, our largest trading partner. This has occurred despite record high commodity prices. Nonetheless, it's difficult to envisage the RBNZ not cutting rates given the magnitude of the shock to the economy. The Governor's words of 2008 following the GFC apply: *"everyone needs to play their part."* With the OCR set to fall this year, and remain on hold for some time, short end swap rates are biased to head lower yet. But with the long end held back by global interest rates, which threaten to rise, the yield curve is set to steepen dramatically in the weeks ahead. Indeed, long end rates would be a lot higher had it not been for flight-to-safety buying of US bonds on Middle East concerns.

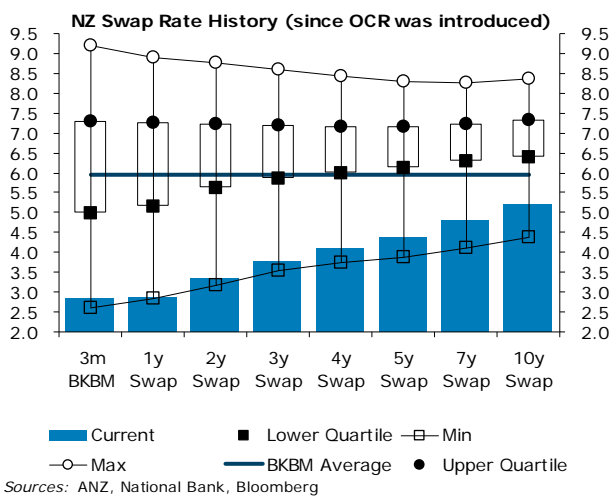
STRATEGY

From the outset we want to make it clear that we believe this is not the time to jump to conclusions. Major question marks remain, and now is the time for patience. As we noted in Monday's *Market Focus*, we see little point in adding to hedge cover using swaps until we get a clearer idea of the scale of the devastation of the Christchurch quake, and the impact it will have on monetary and fiscal policy. It is early days, and the quake was such a game-changer that we'd urge borrowers (particularly small businesses) to consider the impact it will have on their business before making hedge decisions. However, larger borrowers with a portfolio of hedges may view the recent fall in rates as an opportunity, and given how far rates have fallen, there is an argument to do so. But we would not be inclined to rush into anything, particularly if like us, you believe the RBNZ will cut rates, and the market will move to price in rates on hold for the remainder of 2011. Until things settle, it will be difficult to assess the relative merits of short or long term hedging, or for that matter, remaining floating.

BORROWER'S STRATEGY

VALUATION

Short term swap rates have plummeted over the past ten days, which has led to a substantial steepening of the yield curve. The 1 year rate is now within 5bps of an all time low; and the 2 year is within 20bps. But this does not necessarily make them good value. Indeed, we are bemused by the market's assumption that June will be the low point in the cycle, with the OCR back at 2.75% by December. In our view, this means short end rates have scope to move lower.



PATIENCE

There is significant uncertainty ahead, and anyone who tells you that they have an accurate handle on what's going on is simply misguided. As such, right from the outset we believe it is important to inform our readers that the best thing to do is to be patient, and avoid the temptation to jump to conclusions. Instead, we urge our readers to keep themselves informed of what's going on, keep an eye on markets, and watch monetary and fiscal policy developments closely. Indeed, markets are moving quickly, and over the past ten days we have seen the bellwether 2 year swap rate drop from around 3.83% to 3.33%, only to then rise to 3.45% before dropping again to 3.30% at one stage in the past 24 hours. Low rates like this may look attractive, and there is some chance that the market has overshot. But we'd rate the probability as low. The earthquake is not only a massive hit to the national balance sheet, it will also detract from economic activity for some time to come, and even the PM is endorsing a rate cut.

FUNDAMENTALLY DIFFERENT

As we noted in our introduction, last week's Christchurch earthquake has fundamentally altered the economic outlook. And nobody will be immune. Obviously those on the ground will be affected the most – and our thoughts are with the residents of Christchurch and their friends and family. But equally, events of this magnitude will have ripple effects throughout the economy – be it a re-prioritisation of government spending, higher insurance premiums, pressure on asset values (watch section values), lower tourism arrivals, and massive and sudden shifts in internal migration. These effects will be profound and long-lasting. They will interact with the initial hit to GDP and consequential rebuild thereafter.

There's no such thing as a normal earthquake, and gauging the economic impact would have been difficult no matter how events transpired. But the recent quake probably had more complications than most. In terms of the timing of the earthquake, from an economic standpoint it probably couldn't have been worse. Not only was it large and centred almost directly under our second largest city, but it resulted in significant loss of life. It has also occurred in the middle of a commodity boom, just as the Government was looking to tighten the purse strings, and just as the economy was looking like the recovery was taking hold, and the RBNZ was

Current interest rate levels

Maturity	2 weeks ago	Current
3-mth BKBM	3.17	2.83
1-year swap	3.33	2.87
2-year swap	3.78	3.35
3-year swap	4.13	3.78
4-year swap	4.42	4.10
5-year swap	4.67	4.38
7-year swap	5.05	4.81
10-year swap	5.43	5.22

Market expectations for RBNZ OCR (bps)

OCR Dates	2 weeks ago	Current
Thu 10-Mar-11	+0	-31
Thu 28-Apr-11	+0	-35
Thu-9-Jun-11	+2	-43
Thu-28-Jul-11	+9	-40
Thu-15-Sep-11	+16	-35
Thu-27-Oct-11	+25	-35
Thu-8-Dec-11	+38	-25

BORROWER'S STRATEGY

poised to start raising rates this year. Indeed, as regular readers will recall, we were starting to receive some very powerful anecdotes, and 2011 was shaping up to be a year of recovery.

But the quake has put paid to all that, and getting an accurate understanding of how the quake will alter the economic outlook is no mean feat. As we have noted several times over the past few years, as economists and analysts we understand the business cycle reasonably well. By contrast, structural changes are difficult to get a handle on, and even before the quake we were only just starting to get a decent feel for how major structural issues like deleveraging were having on the economy. We now have a one in who knows how many year event (80 years if you go back to the Napier earthquake) to deal with. This will take some working through.

WHERE MIGHT RATES GO?

This is of course the question on everybody's lips, and while we would be the first to acknowledge that there is still considerable uncertainty over the long term interest rate outlook (more on that later), there does seem to be one inconsistency in terms of where market pricing sits. We hinted at this in the valuation section. Indeed, if there is one thing we find odd about market pricing, it's that the OCR is assumed to be cut by at least 25bps next week, reach a low point by June, and then start rising thereafter. This just seems nonsensical. If the RBNZ are going to cut the OCR next week, they won't go taking it back shortly after June. As with the post GFC era, we would expect the OCR to be on hold for some time, until the end of the year at least. If markets move to price this type of scenario in, the 2 year swap can fall much further (even if policy is set to be normalised in 2012 as we discuss in the next two paragraphs).

What about the long term outlook? Can rates keep falling, or will we reach a point where things are simply overstretched? We think the latter is more likely – and as always, timing is critical. Notwithstanding the potential for significant negative surprises, there are two ideas that we just can't seem to be able to shake off. The first is that we can take the earthquake in our stride, and there will inevitably be a springboard dynamic at play. Activity will be slow for a while, and things will get deferred. But as the rebuild starts (and remember, some things like sewer and water systems need to be rebuilt very quickly), activity will start to

recover. Remember too that foreign reinsurance companies carry a significant loss burden, as will the Crown, and by borrowing in global markets, they are able to spread the loss over a much longer period, giving growth a much greater chance.

The second idea is that of normalisation. Technically this is probably a sub idea of the first idea, but the point is, when the economy does start to show signs of stabilising, monetary policy is set to normalise. And to the extent that global inflation pressures continue to percolate in the background, this may happen with more urgency than originally envisaged. In fact, we'd go so far as to say that the lower rates go in 2011, the more they need to go up in 2012, or whenever the time comes to normalise policy. This is why we have rate hikes in our forecasts for 2012. It's not that we think we are geniuses and can pick turning points with accuracy that far out, but an acknowledgement that the economy won't be in a hole forever.

As such, the entire term structure of interest rates can't converge on the OCR, wherever it settles over the next few months. As noted, we believe short end rates can go lower yet, but long end interest rates will be limited by fears of the normalisation dynamic. They will also be influenced by global yields, and it is simply a coincidence that global rates were falling aggressively during February. We note that US 10 year Treasury bond yields have fallen by around 40 basis points in the past 3 weeks. Safe-haven buying has undoubtedly played a role in holding US interest rates down – and while it does seem that tensions in the Middle East in particular are a long way from being resolved (if anything, things are mushrooming), we are mindful of the solid improvement in the tone of US data. This could propel US yields higher over the next few months if high oil prices don't threaten the US recovery.

BACK WITH A VENGEANCE

Despite the risk of a globally-inspired push higher in long term rates, we are still not inclined to seriously consider adding to longer term hedges at current levels. Our rationale is simple. For one, the relative value of fixing has changed, courtesy of plummeting short end rates. For instance, the 2 year swap is around 50bps lower than where it was prior to the earthquake. A change of this magnitude fundamentally changes the economics of fixing, and until we get an idea where short end

BORROWER'S STRATEGY

rates may settle, we can't make an informed decision.

Similarly, with the renewed threat of a downturn comes the real possibility of tighter cashflow, potentially constraining choices. You may well feel that now is the time to add to long term hedges, but can your business cope with higher interest bills? As an example, the 7 year swap is almost 200bps higher than the 3mth BKBM rate, and that's a stiff premium. Or perhaps put another way, and to borrow a term we have used a lot in the past few years that regular readers will be familiar with, the borrower's dilemma is back, and with a vengeance.

WHAT TO DO?

By now it should be clear that we favour doing nothing. Not literally doing nothing, but holding off making substantial changes to hedges. It's early days yet – but we feel strongly that the earthquake is still a developing story, and one that needs to be monitored closely. Shivers, we are full time analysts, and we still don't know what it all means. But if there is one common thread to the news flow over the past ten days, it is probably that each new piece of information seems to be worse than the last. There have been exceptions – for instance – we are very encouraged that some Cantabrians have been able to return to work this week. But we are equally worried about some of the other anecdotes we have received, particularly in relation to how long the Christchurch CBD may be out of action, and the impact the quake has had on tourism. With floating rates falling quickly, there is no harm in holding off.

Finally, a word on interest rate caps, which regular readers will recall we have had a preference for over the last few months. Recent events bring these into their own. Indeed, as much as one dislikes paying premium, when things go wrong, the ability to participate in the downside can make all the difference.

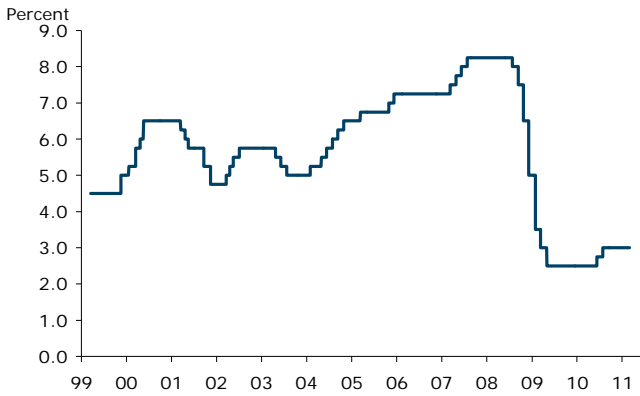
DEALING ROOM CONTACTS:

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

CHARTS

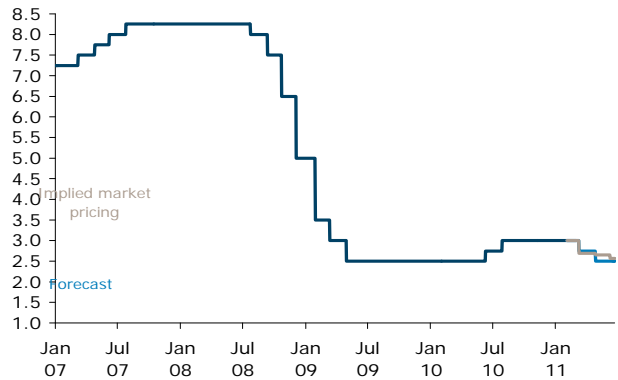
CHARTS

Official Cash Rate

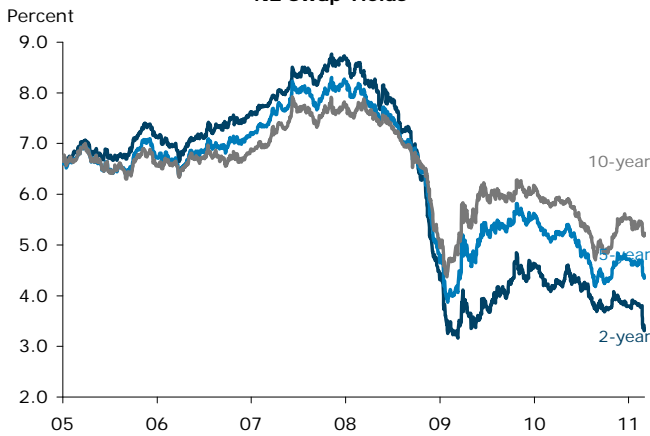


Sources: ANZ, National Bank, RBNZ

OCR and market pricing

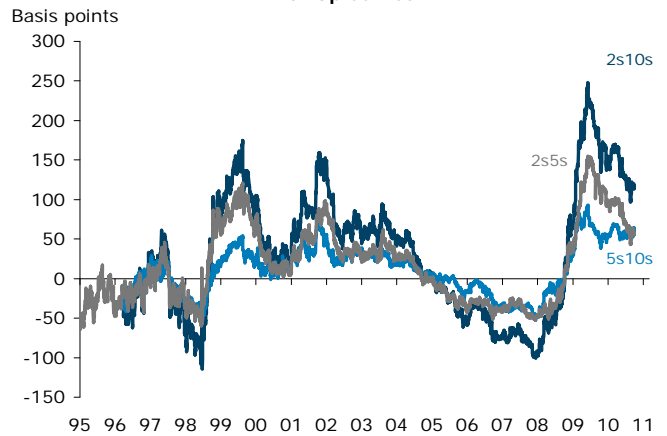


NZ Swap Yields



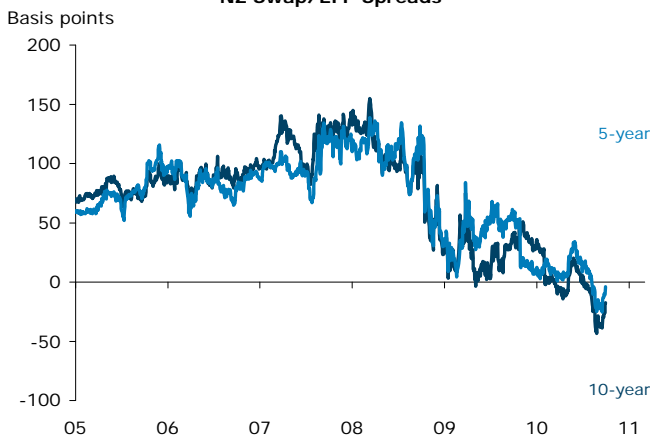
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



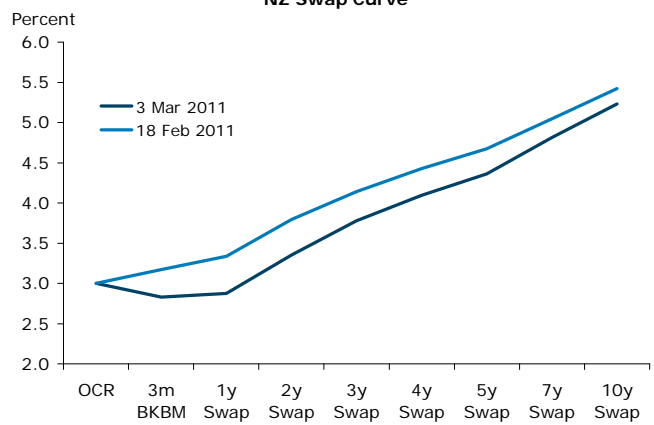
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

NZ Swap Curve



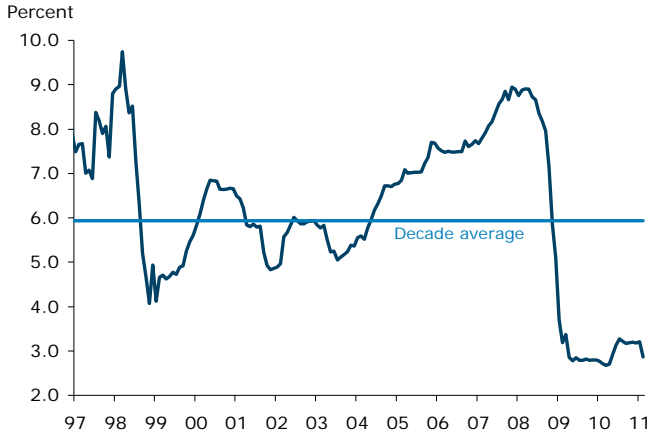
Sources: ANZ, National Bank, Bloomberg



CHARTS (END OF MONTH)

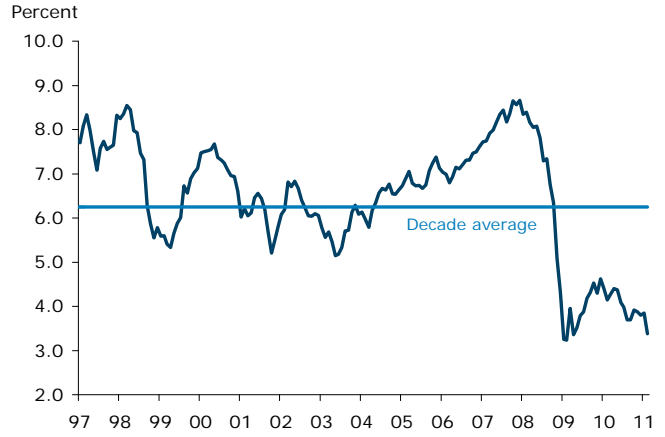
CHARTS (END OF MONTH)

3-month BKBM



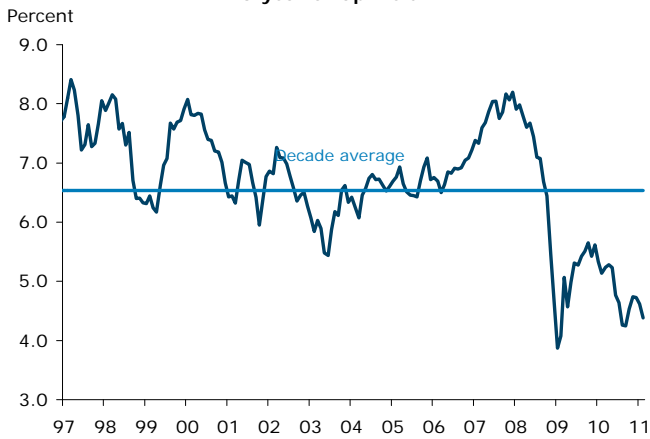
Sources: ANZ, National Bank, Bloomberg

2-year Swap Yield



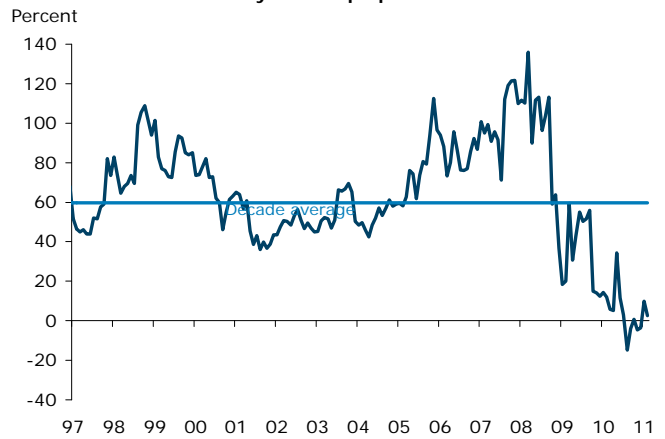
Sources: ANZ, National Bank, Bloomberg

5-year Swap Yield



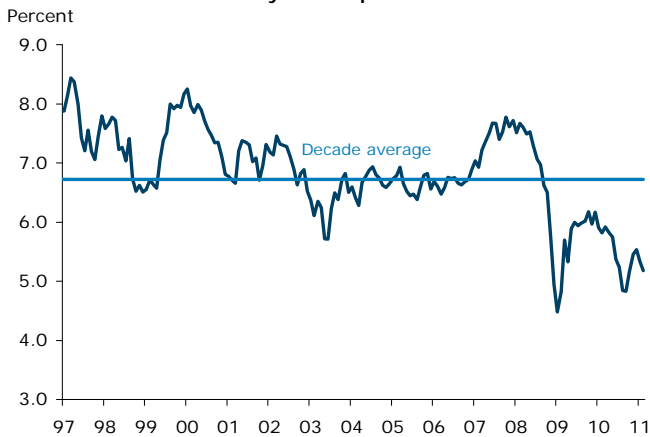
Sources: ANZ, National Bank, Bloomberg

5-year Swap Spread



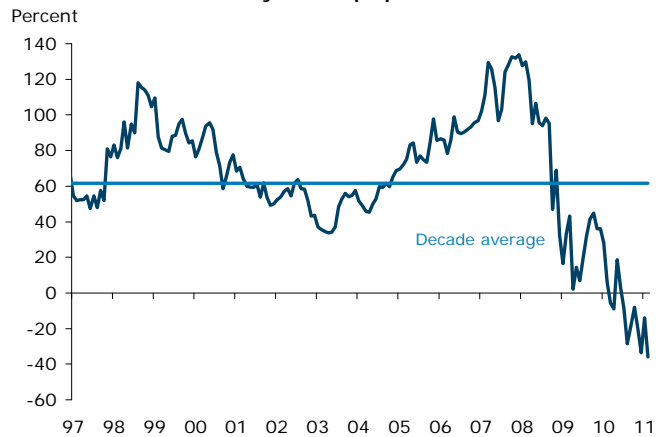
Sources: ANZ, National Bank, Bloomberg

10-year Swap Yield



Sources: ANZ, National Bank, Bloomberg

10-year Swap Spread



Sources: ANZ, National Bank, Bloomberg

IMPORTANT NOTICE

NEW ZEALAND DISCLOSURE INFORMATION

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

Qualifications, experience and professional standing

Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

Professional indemnity insurance

The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

Other interests and relationships

When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

- ANZ Investment Services (New Zealand) Limited (ANZIS), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ANZIS may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- OnePath (NZ) Limited, as a wholly owned subsidiary of the Bank, is an associated person of the Bank. OnePath and its related companies may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- Direct Broking Limited (DBL), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. DBL may receive remuneration from a third party relating to a security sold by the Investment Adviser.

Securities about which investment advice is given

The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

PROCEDURES FOR DEALING WITH INVESTMENT MONEY OR INVESTMENT PROPERTY

If you wish to pay investment money to the Bank you can do this in several ways such as by:

- Providing cash;



IMPORTANT NOTICE

- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

Use of Money and Property

Money or property held by the Bank for a specific purpose communicated to the Bank (e.g. the purchase of an interest in a security) may not be used by the Bank for its own purposes and will be applied for your stated purpose. No member of the Bank's staff may use any money or property deposited with the Bank, for their own purposes or for the benefit of any other person. In the absence of such instructions, money deposited with the Bank may be used by the Bank for its own purposes, provided it repays the money to you upon demand (or where applicable, on maturity), together with interest, where payable.

NEW ZEALAND DISCLAIMER

The Bank does not provide investment advice tailored to an investor's personal circumstances. It is the investor's responsibility to understand the nature of the security subscribed for, and the risks associated with that security. To the maximum extent permitted by law, the Bank excludes liability for, and shall not be responsible for, any loss suffered by the investor resulting from the Bank's investment advice.

Each security (including the principal, interest or other returns of any security) the subject of investment advice given to the investor by the Bank or otherwise, is not guaranteed, secured or underwritten in any way by the Bank or any associated or related party except to the extent expressly agreed in the terms of the relevant security.

This document is provided for informational purposes only and does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this document can be reproduced, altered, transmitted to, copied to or

distributed to any other person without the prior express permission of the Bank.

This document is a necessarily brief and general summary of the subjects covered and does not constitute advice. You should obtain professional advice before acting on the basis of any opinions or information contained in it. The information contained in this document is given in good faith, has been derived from sources perceived by it to be reliable and accurate and the Bank shall not be obliged to update any such information after the date of this document. Neither the Bank nor any other person involved in the preparation of this document accepts any liability for any opinions or information (including the accuracy or completeness thereof) contained in it, or for any consequences flowing from its use.

UNITED STATES DISCLAIMER

This document is being distributed in the United States by ANZ Securities, Inc. (Member of FINRA [www.finra.org] and registered with the SEC) ("ANZ S") (an affiliated company of Australia and New Zealand Banking Group Limited ("ANZBG") and the Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this document and wishing to effect transactions in any fixed income securities referred to herein should contact ANZ S 277 Park Avenue, 31st Floor, New York, NY 10172 USA, Tel: 1-212-801-9160, Fax: 1-212-801-9163, not its affiliates.

This document is issued on the basis that it is only for the information of the particular person to whom it is provided. This document may not be reproduced, distributed or published by any recipient for any purpose. This document does not take into account your personal needs and financial circumstances. Under no circumstances is this document to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZBG, the Bank, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this document (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this document. If you have been referred to ANZBG, the Bank, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this document accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this document and are subject to change without notice. No part of the author's compensation was, is or will be directly or indirectly related to specific recommendations or views expressed in this document. ANZBG, the Bank, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.