

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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CONTRIBUTOR

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ECONOMIC OUTLOOK

The 2011 Budget signalled a return to surplus by 2014/15, a year earlier than Budget 2010, but our high external debt looks set to maintain the interest of ratings agencies and is a reminder of our potential vulnerabilities. Global uncertainties continue to weigh on New Zealand's economic prospects. However, there remains a solid base of economic support, with loose financial conditions, rapidly recovering business confidence, the Rugby World Cup, and activity associated with Christchurch earthquake reconstruction suggesting better times ahead. We continue to expect a mild cyclical fillip in growth off a low base in H2 2011. Ongoing debt reduction remains the order of the day, but respectable income growth, strong commodity prices and healthier rural and household balance sheets suggest an improving climate for rural and urban spending. An improving economic outlook and concerns over the inflation outlook are set to see the RBNZ to start removing their March MPS insurance cut by the end of the year.

RATE VIEW

Although swap rates are barely changed relative to a fortnight ago (noting that rates have moved lower in that time, but have since retraced), developments on the domestic economic front point to greater upside risks ahead. Higher inflation expectations and Fonterra's announcement of a record payout are two notable developments that have caught our eye in the past week. We have long had an above-consensus view of the near term growth outlook (after being bearish for years!), and we will continue to monitor leading indicators, particularly given delays in official data releases following the February earthquake. They also add weight to our view that you don't have to scratch very deep to find a core of robustness to the economy, despite protestations of an austere Budget. Lower US bond yields and an explosion in demand for NZ bonds have helped keep a lid on NZ interest rates, and the swap market has ridden on the bond market's coat tails. But this can't last forever, and we are conscious that with the real OCR below zero, it is on borrowed time, and as it heads higher, so will the entire term structure of interest rates.

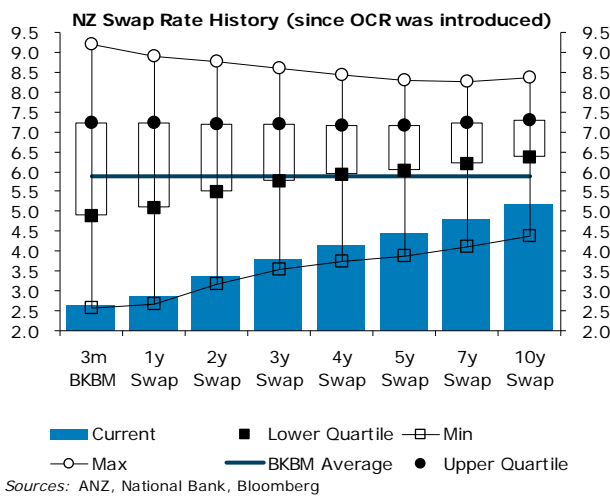
STRATEGY

Striking the right balance between achieving protection against rising rates and keeping overall interest expense down is always tricky when the yield curve is steeply upward sloping. Of course, the extra expense to fix is easier to swallow if you believe rates are headed higher, as we believe they are. Based on the differences between current swap rates and the long term BKBM average, we see the most value in the 4-5 year part of the curve, where we would be targeting to add to hedges. Shorter hedges (like the 2 year) are cheaper, but with the OCR likely to be on hold till December, a large proportion of the hedge will be dedicated to a period where rates are not likely to move by much. On the other hand, long term hedges like the 10 year are significantly more expensive, and given ever-present uncertainties, are probably too long in duration to consider seriously.

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VALUATION

Although medium and long term swap rates are slightly lower than where they were when we last published the *Borrower's Strategy*, the swap yield curve remains extremely steep. Fixing thus comes at a considerable premium. However, compared with historical ranges, all swap rates are low, in that they are all below their respective lower quartiles. Short end rates are not far from all-time lows, but offer little protection due to their short duration.



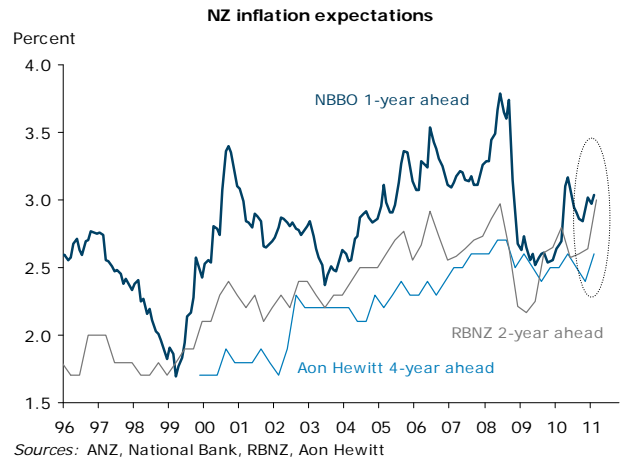
Current interest rate levels		
Maturity	2 weeks ago	Current
3-mth BKBM	2.67	2.65
2-year swap	3.35	3.38
3-year swap	3.83	3.81
4-year swap	4.19	4.15
5-year swap	4.46	4.42
7-year swap	4.86	4.80
10-year swap	5.22	5.15

Market expectations for RBNZ OCR (bps)		
OCR Dates	2 weeks ago	Current
Thu-9-Jun-11	0	0
Thu-28-Jul-11	+1	+1
Thu-15-Sep-11	+3	+3
Thu-27-Oct-11	+11	+8
Thu-8-Dec-11	+20	+19
Thu-26-Jan-12	+32	+29
Thu-8-Mar-12	+47	+49

SAME CHOICES, VERY DIFFERENT RISKS

Although the term structure of interest rates has changed very little over the past fortnight, offering the same broad choices for borrowers, the risks behind those choices have changed markedly. Indeed, despite a series of developments that in our view add substantially to upside risks to inflation, interest rates have barely changed. Is the market in denial? No, it is not – but it does seem to have been unduly influenced by offshore developments – most notably the European sovereign debt crisis and the slowing momentum of US data. Both are major developments – but we need to be careful about the assumptions we make about how they might impact on New Zealand.

However, before we look offshore, let's consider the three main developments that, as noted, add to upside inflation risks. The first and most obvious has been the recent spike higher in inflation expectations, as shown in the chart below.



We view this as a prickly development. While our research shows that one-offs such as petrol prices have an overtly strong impact on inflation expectations, and rising fuel costs act as a tax on consumption as well, we have some underlying concerns about the broader inflation outlook as well. We are particularly mindful that it has not just been a one or two "one-offs" that have driven CPI higher. Rather, it has been at least half a dozen factors driving prices higher, and when you take them together, they no longer qualify as "one-offs". Some factors – like the increase in GST – are true one-offs, but when you get to the point where people start pointing to it as a reason to put up wages, like they have been, all of a sudden what



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looks like a one-off becomes ingrained. This is, in a nutshell, the reason why so many central bankers see it as so critical to keep inflation expectations well-anchored. Moreover, while weak demand within the economy is helping to keep a lid on prices in some key sectors such as retailing (which is in deflation mode), a lower trend growth rate courtesy of deleveraging, structural changes across the economy, little business investment and weak productivity growth does not bode well for the economy being able to absorb a fillip on the demand side of the equation.

Of course, some people will point to the correlation between the prices of high-frequency purchases like petrol and inflation expectations as a reason to discount the recent jump. That may well be the case, but if petrol prices remain high in nominal terms – and they will unless oil prices fall or the NZD appreciates further – then the feeling that prices are high is unlikely to disappear in peoples' minds any time soon. In fact, that is strong evidence that New Zealanders confuse a high petrol price level with a high rate of inflation. Furthermore, if oil (and for that matter, commodity prices in general) are a function of strong global demand, then prices are set to remain high for a while. But no matter what you think, the thing that worries us is that it's not just the RBNZ survey that's pointing to raised expectations – the AON-Hewitt survey does too, as does the NBNZ survey. And whether the increase in expectation is driven by petrol prices or not may not be irrelevant when it comes to the question of whether they will influence future pricing behaviour. Until we see expectations moderate then, we will continue to harbour concerns about the inflation outlook. This does not mean we are turning to inflationary hawks. Far from it – rather, we view the inflationary dynamic is simply not consistent with the benign view being expressed by the RBNZ.

GET REAL

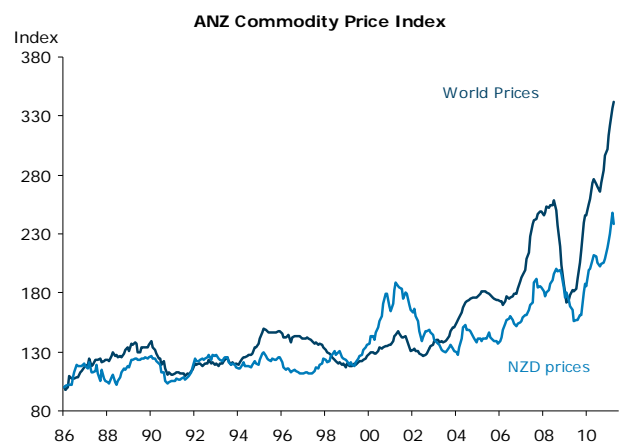
Talking of inflation, let's put the level of the OCR in perspective right here, right now. Not only is it at a record low, but it is well below both the current level of inflation (4.5%) and the RBNZ's own survey of expectations (3.0%). It is also below the 10 year average rate of inflation. More than anything else, the fact that the OCR is negative in real (i.e. inflation-adjusted) terms is the clearest signal that it is on borrowed time.

The question is, how soon will this happen, and what will the adjustment be? Our view has not changed – we believe the RBNZ will start raising rates in December, taking the OCR to 4.75% within 2 years. Even then, if inflation expectations stabilise at around 3%, that's a real rate of just 1.75%, which is about 1.5% below the long term average real OCR. The bottom line: the OCR is headed higher, and even if, like us, you see plenty of reasons (like the proliferation of floating rate debt and deleveraging) why it won't go as high as it has before – it still needs to go a lot higher.

MILK AND HONEY

High commodity prices not only add to inflation risks directly via higher food and fuel prices, they also add pressure indirectly through higher incomes. In that regard, this week's announcement by Fonterra that it has revised up its final payout by 10 cents to \$8.10 is an extremely positive development. Not only is that a new record payout, but production volumes are also at record levels, as is next year's starting forecast. The dairy sector is therefore doing extremely well, and the increased cashflow will percolate through the whole economy. Pessimists point to the fact that farmers are reducing debt, and of course, many are (which is a good thing). But not all of them are, and those that are doing so are simply freeing up capital for others.

Prices are not just high in the dairy sector – they're high for most of our commodity exports, and in fact, in world terms, the ANZ Commodity Price Index is at record levels, as the chart below demonstrates.



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Finally, let's get a few facts straight about the Budget. Many people believe that changes to Kiwisaver and Working for Families (among other things) in the Budget were a "downer". The media certainly seem to be portraying it that way, seemingly oblivious to the fact that there isn't an endless supply of free money available to the Government, which has had to contend with a rather cost blow-out courtesy of a couple of earthquakes. The Budget was "austere" in the sense that it wasn't a lolly scramble, and it did promise to keep net debt below 30% of GDP, and return to surplus a year earlier than the Government's HYEPU projections in December. But let's not forget that we now live in the age of austerity, and markets are nervous about countries that run up too much debt. Perhaps more importantly, the Treasury's projections show that fiscal policy is not set to be contractionary until 2012/13 (which means government spending will remain stimulatory throughout 2011/12). A tight fiscal stance will help the RBNZ greatly, although we view it as influencing where the OCR ends up as opposed to the trajectory and timing of the first hike.

GLOBAL DEVELOPMENTS

At the very beginning of this paper we noted how offshore developments were having an unduly large influence on the local market. Broadly speaking, this has come via two "themes". The first is the apparent slowing in momentum in the US. It is clear from recent data releases that the US economy is experiencing some sort of slowdown. But what is less clear is whether that slowing is cyclical (i.e. the "triple dip"), or whether it is just a temporary phenomenon, driven by the supply chain disruption following the Japan earthquake. What is clear is that US bond yields are at their lows for the year. Although the 10 year Treasury yield is not as low as it was during the depth of last year's "double dip", it is certainly giving plenty of credence to the idea that the US slowdown will be more than temporary. At this juncture it's difficult to say which way the US economy will go, and opinions are sharply divided. But if things do improve, US bond yields certainly have plenty of upside. If this happens, NZ interest rates will follow suit. Our US financial conditions measure suggests the easing in momentum at present is temporary.

The other global development is easier to make head or tail of – or at least the impact on New Zealand has been. What we are referring to here is

the European sovereign debt crisis, which is deepening by the day. At issue is the indebtedness of the so-called peripheral or Mediterranean European governments. None of this has any direct relevance to New Zealand. However, the indirect consequences are enormous.

The most obvious one is New Zealand's "points of differentiation", which are, thankfully, positive. We have done plenty of in-depth research into this, but the best way to summarise the situation as follows: New Zealand is smaller and less wealthy than our American and European counterparts. But even after the recent surge in government borrowing, our government debt levels are the envy of Europe and North America, as is even our 6.6% unemployment rate. We also have a free floating exchange rate, a complete lack of corruption, and complete monetary and fiscal policy transparency. Along with our AA+ credit rating (albeit on a negative outlook), these are things investors like.

New Zealand's private sector debt is very high, but for now, markets are prepared to overlook this, and government bonds are THE buzz word in global financial markets. This has been plain to see, even here in New Zealand, where thanks to significant participation by global investors, the Government has managed to raise over \$17bn of funding over the fiscal year to date. Borrowing that amount of money may not sound like a wise thing to do, but funding for the fiscal shortfall and the two earthquakes had to come from somewhere, and in the short term, the bond market is the only choice the Government has. But the really interesting thing about the past few months has been the fact that demand for NZ government bonds has outstripped supply (which is how the Government has managed to raise so much money relatively cheaply). This has been fortuitous – but it has also kept a lid on interest rates, especially at the long end of the yield curve. In our view, this is something borrowers should be very aware of.

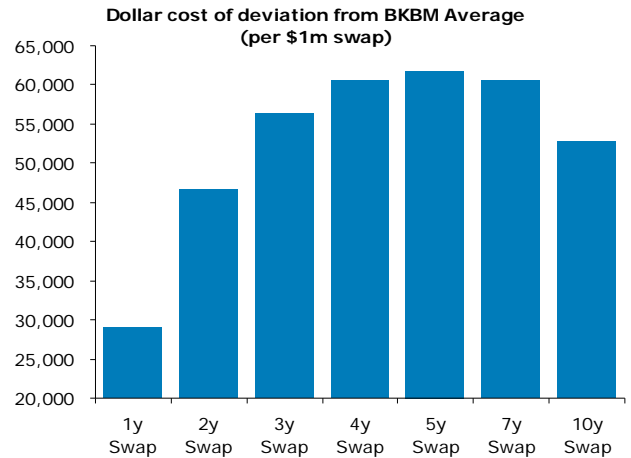
But that's not because we expect demand for NZ bonds to dry up all of a sudden – on the contrary, we expect demand to remain strong. But at some stage, overseas investors will have had their "fill" of NZ government bonds, or the Crown will have raised enough money that it no longer needs to issue bonds so vigorously. We are not there yet, and the time-frame for change will be measured in months, not days. But that time is slowly approaching – and in fact, net government bond issuance for the 2012/12 year is forecast to be "just" \$5.9bn, down from \$20bn this fiscal year.

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That's a big reduction. Indeed, having been the "dogs" of the market for around 2 years, NZ government bonds have now become the "darlings", and with that has come the normalisation of swap spreads. NZ government bonds no longer trade at yields above swap, and if demand remains strong, from here on in we are likely to see bond yields heading lower while swap rates stand still, as opposed to the two moving lower together. In fact, the more of a risk inflation becomes, and the brighter prospects for the future become, the more the market will start to factor in rate hikes, and that will have a much larger impact on swap rates than bond yields.

STRATEGY THOUGHTS

The level of foreign participation in our bond market has undoubtedly been a boon, and it has helped keep a lid on long term interest rates, as has the large rally in US bond yields. The RBNZ's relaxed stance has also helped – but when we look ahead, we are becoming increasingly uncomfortable with the idea that NZ rates are set to stay low, as forward rates imply. As noted, we expect the OCR to climb to 4.75% in 2 years time, yet the market is pricing in something closer to 4.1% by that time. This difference is large enough as it is, but it looks even worse when one considers that the forward curve has a habit of "over-pricing" future interest rates. In our view, the case for adding to hedges at current levels is strong, particularly in the 4-5 year part of the yield curve. These rates are both well below 4.5%, which used to be considered the bottom of the OCR range. They also strike the right balance between wanting to get a hedge on that will be effective from 2012, when we expect rates to moving up, and the overall cost of funds. As the chart below shows, if we adjust the degree to which each swap tenor is trading below the long term average 3mth BKBM rate (of 5.87%) by the basis point value of each swap, we find that swap rates are the most "opportune" in the middle part of the swap curve.



Sources: ANZ, National Bank, Bloomberg

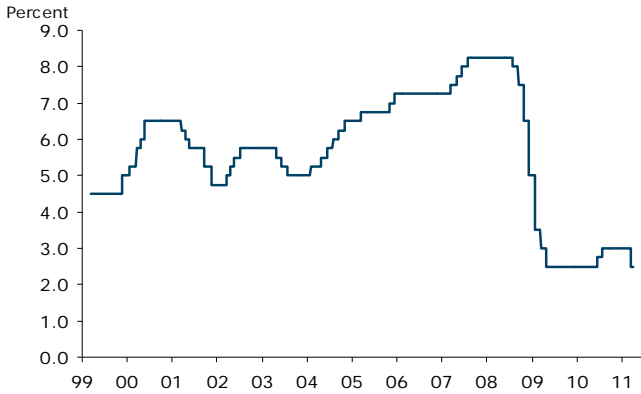
DEALING ROOM CONTACTS:

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

CHARTS (END OF MONTH)

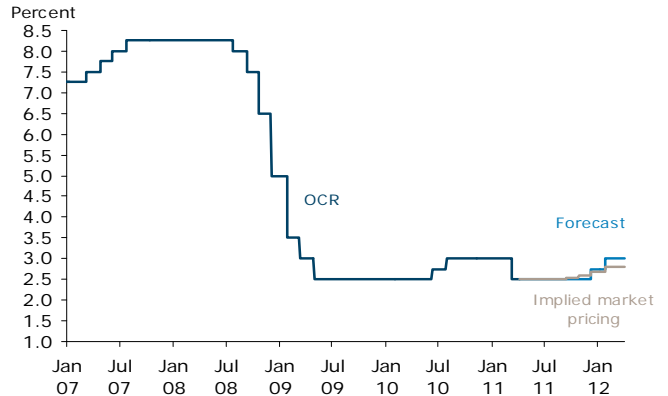
CHARTS

Official Cash Rate



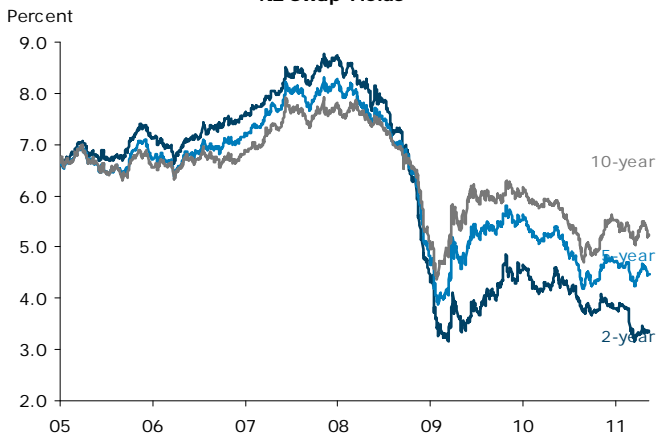
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



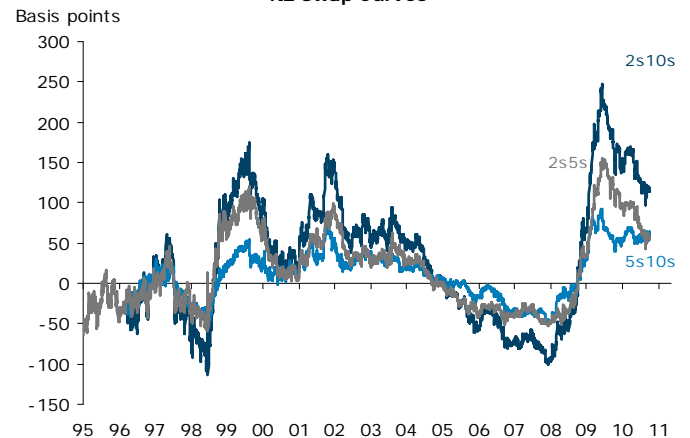
Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



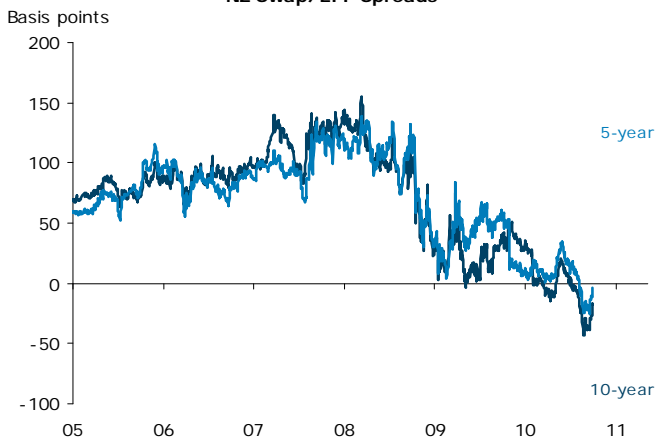
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



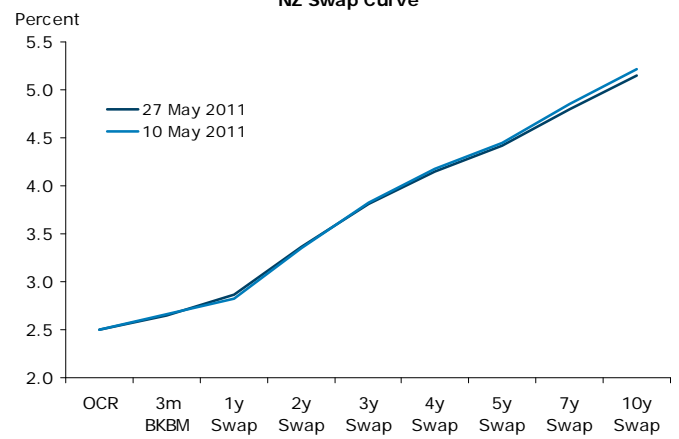
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

NZ Swap Curve



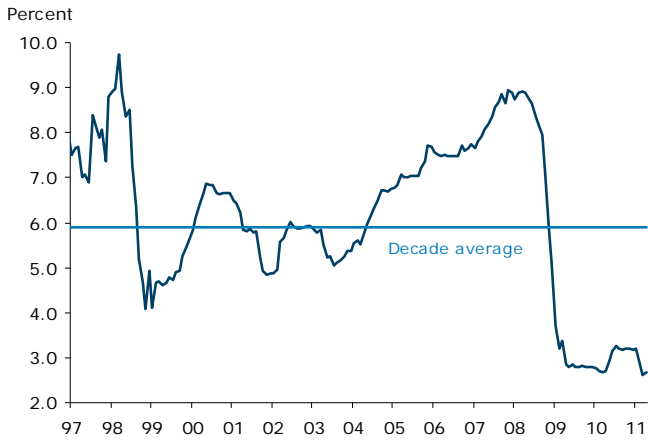
Sources: ANZ, National Bank, Bloomberg



CHARTS (END OF MONTH)

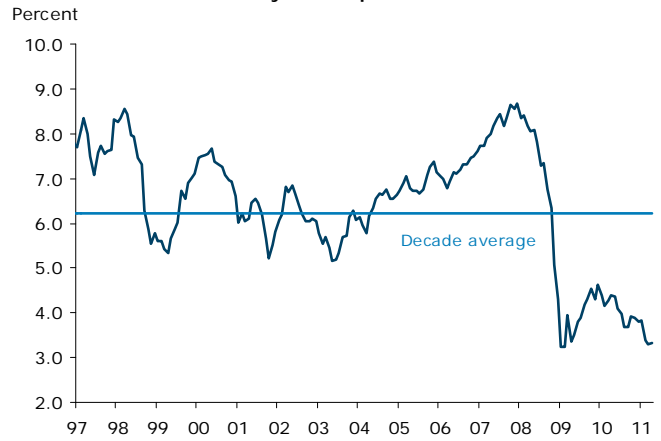
CHARTS (END OF MONTH)

3-month BKBM



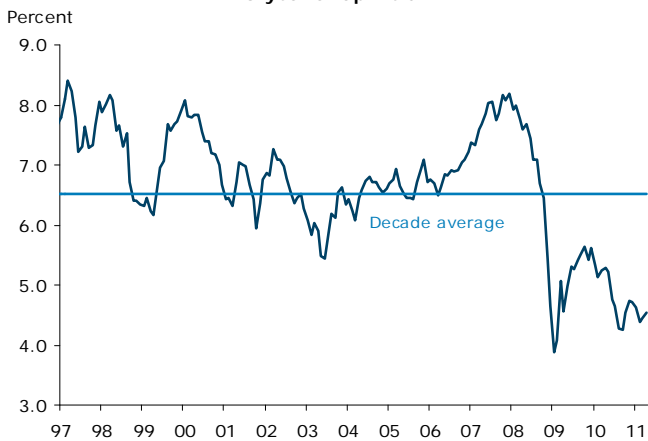
Sources: ANZ, National Bank, Bloomberg

2-year Swap Yield



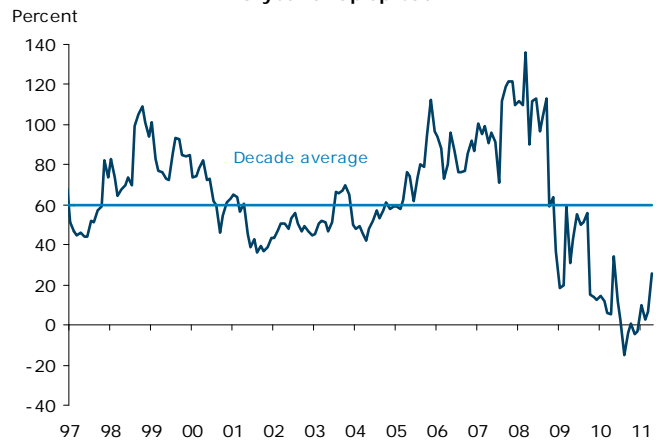
Sources: ANZ, National Bank, Bloomberg

5-year Swap Yield



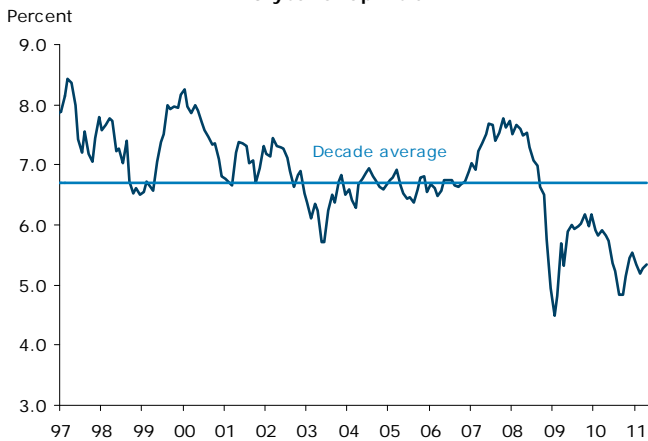
Sources: ANZ, National Bank, Bloomberg

5-year Swap Spread



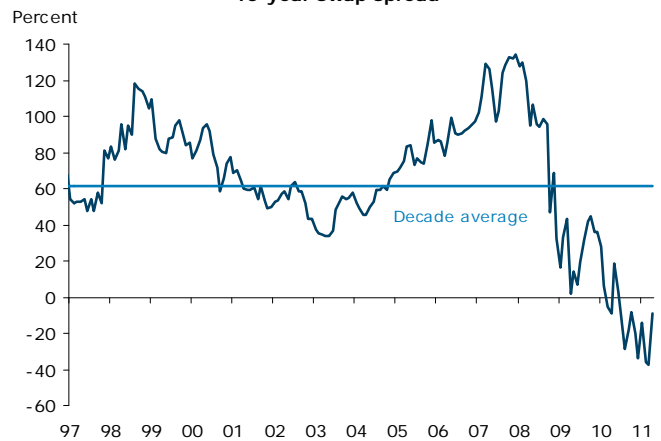
Sources: ANZ, National Bank, Bloomberg

10-year Swap Yield



Sources: ANZ, National Bank, Bloomberg

10-year Swap Spread



Sources: ANZ, National Bank, Bloomberg

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- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
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