

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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CONTRIBUTOR

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ECONOMIC OUTLOOK

The New Zealand economy is performing okay, challenges considered, though the risk profile is skewed towards the downside. Q3 GDP is looking reasonable, though not spectacular, and the Rugby World Cup alongside the General Election is making it more difficult than usual to get an accurate read on underlying momentum in the economy. Confidence is still holding up at present, though the real test is how economic activity fares in the early part of next year. The global outlook continues to deteriorate, and even if the EU leaders summit make progress towards fiscal union, the Eurozone faces a huge growth challenge. With Chinese growth also slowing, the economic outlook is still littered with downside risks. The only bright spot is that the US dataflow looks to be improving, though whether this can carry on into early next year remains to be seen. There will be growth in the New Zealand economy, but it will be modest.

RATE VIEW

The local market has flip-flopped over the course of the past several weeks, driven by offshore developments. In our last edition, markets were fully priced for a 25bp cut by March 2012. Pricing has since backed off, and following the RBNZ *Monetary Policy Statement* yesterday, is pricing in a flat OCR until late next year. Markets can and do get carried away at times. And given that markets don't tend to have a flat rates profile for long (they tend to want to gravitate towards pricing in hikes or cuts), we can expect to see another shift in market pricing. Looking beyond the near-term volatility though, our core view is that the RBNZ is on hold for quite a while. Resolution in Europe is going to take time, and even if that occurs, we still need to deal with a slowdown in global growth – including recession in the Eurozone. Earthquake reconstruction won't kick in until late 2012 and fiscal policy is in a straitjacket, which means it is up to monetary policy to remain stimulatory for longer. The RBNZ may have dropped their tightening bias and shifted towards neutral, but the hurdle to rate cuts is very high, in our view. It will require a severe global recession akin to the 2008 crisis to get the RBNZ to cut the OCR from current levels.

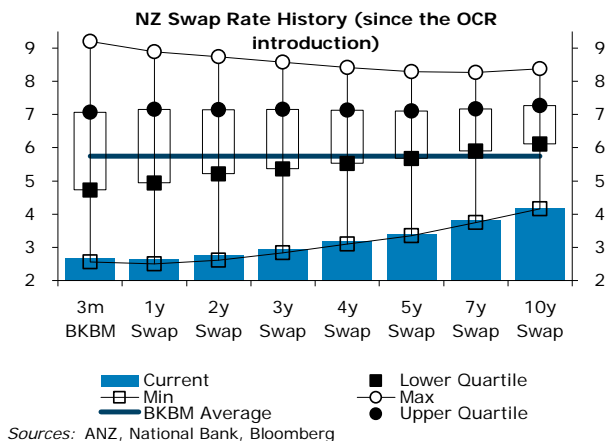
STRATEGY

Swap rates may have risen off their record low levels, and the move higher in yields looked almost as aggressive as the earlier fall. But do not be spooked and fret that you have missed the boat. With the RBNZ on the sidelines for a while and the outlook still very uncertain, there is no need to rush in to hedge. There is still a possibility that swap yields could fall again, especially if the EU leaders summit fails to deliver on market expectations of progress towards fiscal union, and/or the ECB does not provide sufficient liquidity to ease stresses in the European banking system. We continue to favour remaining on the sidelines to take advantage of lower floating rates. If hedging using swaps, just bear in mind the risk of rising margins due to higher funding costs.

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VALUATION

Since hitting record lows a couple of weeks ago, domestic swap yields have risen across the curve by as much as 16bps. At one stage, the move higher in yields was almost as aggressive as the earlier move lower. The RBNZ was certainly more cautious, but rate cuts were not on offer. However, a long period of an unchanged OCR is in prospect. So while the back-up in yields might suggest that we have missed the bottom, this is not to say that those lows won't be revisited. The global situation is still uncertain, and the domestic interest rate market is reacting more to offshore developments than it is to domestic ones. The RBNZ may be on hold, but markets could be back pricing in cuts if the European situation remains dicey.



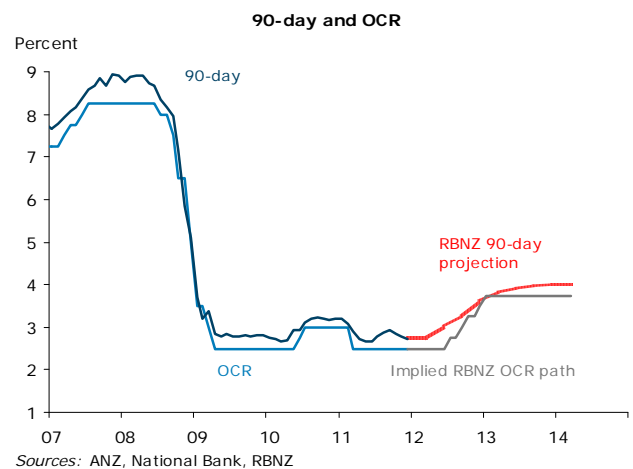
Current interest rate levels		
Maturity	Last edition	Current
3-mth BKBM	2.67	2.68
1-year swap	2.53	2.65
2-year swap	2.68	2.77
3-year swap	2.90	2.97
4-year swap	3.15	3.20
5-year swap	3.40	3.43
7-year swap	3.84	3.85
10-year swap	4.21	4.21

Market expectations for RBNZ OCR (bps)		
OCR Dates	Last edition	Current
Thu-26-Jan-12	-22	-4
Thu-8-Mar-12	-26	-6
Thu-26-Apr-12	-28	-8
Thu-14-Jun-12	-30	-8
Thu-26-Jul-12	-33	-8
Thu-13-Sep-12	-30	-8
Thu-6-Dec-12	#N/A	-8

STAYING ON THE SIDELINES FOR LONGER

The RBNZ's decision yesterday to leave the OCR unchanged at 2.5% was not unexpected. Neither was the more downbeat tone compared to October. In a clear change in tone, the RBNZ made no reference to the OCR moving up this time. So clearly, the RBNZ has now shifted from a soft conditional tightening bias in October into neutral gear. However, this is not the same as signalling that it is preparing to cut rates. Far from it. The RBNZ's 90-day interest rate projections may have been revised down considerably, with a later and less steep increase compared to the September MPS (4% endpoint now compared with 4.3% previously), but it still shows rates moving up, eventually.

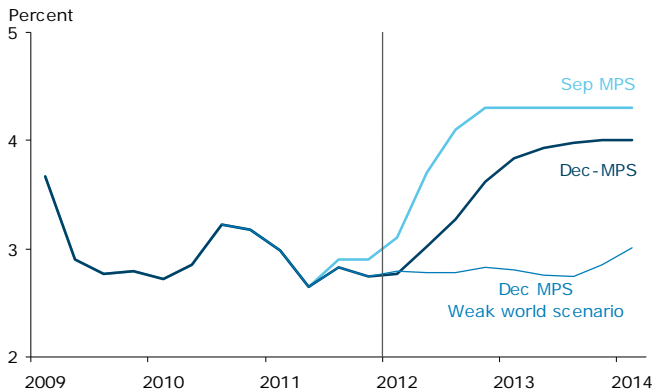
Technically, the RBNZ's 90-day track look to have the OCR moving up from around the middle of 2012. However, this looks nothing more than the passive workings of their economic model, and is based on a pretty benign central view of global developments. The spirit of the RBNZ's view is simple: the odds are that the next movement in the OCR is up, but not for a very long time. This fits with our core view also.



For those looking for rate cuts from the RBNZ, the alternative scenario produced by the RBNZ provides a useful guide on how bad things need to get for the RBNZ to ease. Under a scenario where trading partner growth slumps to around two thirds as deep as 2008 in output gap terms, but which bounces back only half as fast (given that there is less scope for fiscal and monetary policy stimulus this time around), the implied 90-day track is completely flat. Reading between the lines, this implies that the hurdle for OCR cuts is very high. Things need to get really bad for the RBNZ to provide more stimulus.

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Published MPS 90-day track



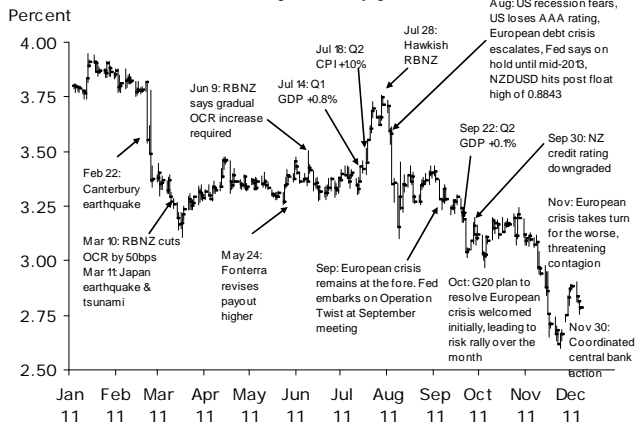
Sources: ANZ, National Bank, RBNZ

A YEAR TO FORGET

Of course, this is not to say that rate cuts won't happen. It is just that something untoward and totally unexpected would need to happen – something far worse than a global recession. Looking at the year to date, there have certainly been plenty of unexpected events that have come our way that have changed the outlook materially.

The chart below shows the 2-year swap yield and significant local and global events. The list is not exhaustive, but illustrates the impact that unexpected developments can have on interest rates, and how many of them are completely out of our control. From the 2-year swap yield starting out at around a 3.75% to 3.9% range, the February 22 Christchurch earthquake led to a collapse in swap yields, as the devastating impact caused markets to price in cuts from the RBNZ. The Bank duly delivered a 50bp insurance cut at the March MPS, and the day after, an even more devastating earthquake hit Japan, sending local yields even lower.

NZ 2-year swap yield



Sources: ANZ, National Bank, Bloomberg

The resilience of the New Zealand economy in bouncing back for the earthquake led to yields rising sharply mid-year, as the RBNZ signalled a preparedness to remove the insurance rate cut. But global events started to come to the fore from August, with US recession fears and an escalation in the European debt crisis leading to lower global and domestic yields.

The key lesson in looking back at the year that almost was, is to understand the value of being flexible. If you had rushed in to fix at the start of the year when things were looking stable, you would have been ruing that move. No matter how promising local developments may look, global themes ultimately swamp local considerations. Therefore, paying attention to what is happening offshore is equally, if not more, important than what is happening in your own backyard.

What will 2012 bring? More uncertainty and volatility is about all you can say with absolute certainty. A lot rests on European policymakers coming up with something of substance and more than the usual kicking the can down the road. The coordinated global central bank action to ease liquidity pressures last week may have bought some time, but it does not address the fundamental fiscal problems facing Europe. And the US needs to face up to its fiscal mess at some point as well.

Even if progress is made towards fiscal union in Europe, the region still faces a huge growth challenge. We're in a deleveraging world and that means weak growth. The best policymakers can do is limit the downside risks and foster a semi-orderly adjustment. Easing solvency pressures manifesting in market dislocation requires credibility, confidence and competence from the political hierarchy. Connecting politics to those three C's is somewhat of an oxymoron.

At present, the New Zealand economy has stayed resilient in a relative sense, though the actual performance has been somewhat scratchy. With the Rugby World Cup boost now over, and earthquake reconstruction still some time away, the real test for the economy will come early next year.

There are some positives we can point to. The New Zealand dollar is playing an important buffering role, and there is still more passive stimulus in the pipeline from borrowers who are coming off fixed rate mortgages and renewing at mortgage rates of up to 1% lower. The housing market is showing more pep, and with the RBNZ staying on the sidelines for a while, this is helping to provide accommodative financial conditions.



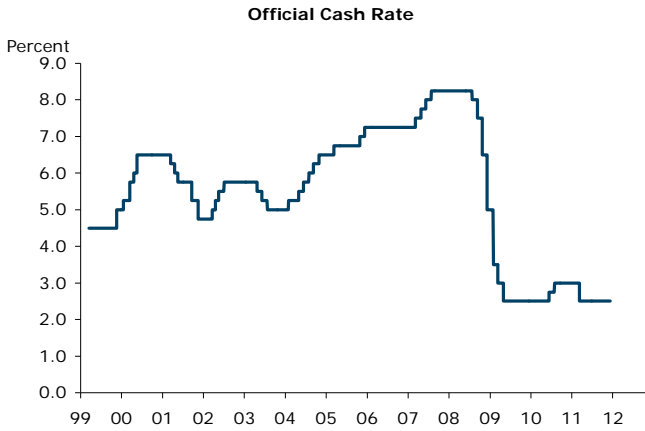
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However, the risks to the outlook are clearly to the downside. As such, it pays to follow the RBNZ's lead, and simply watch, wait and worry. Swap yields look very attractive now, but they looked similarly attractive at the start of this year too. Look where we ended up.

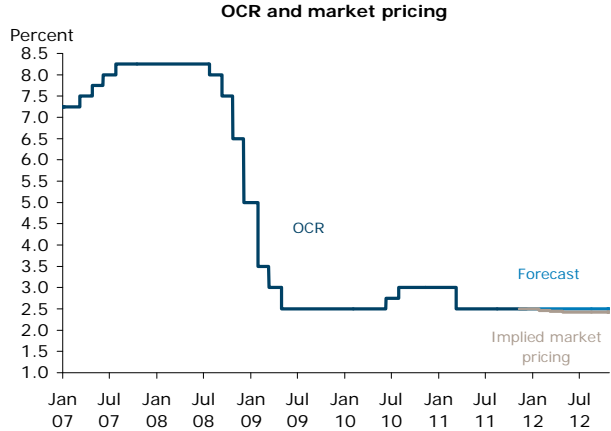
Dealing room contacts		
Location	Local	Toll free
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Wellington	04 471 0030	0800 445 088
Christchurch	03 364 5335	0800 269 261

CHARTS (END OF MONTH)

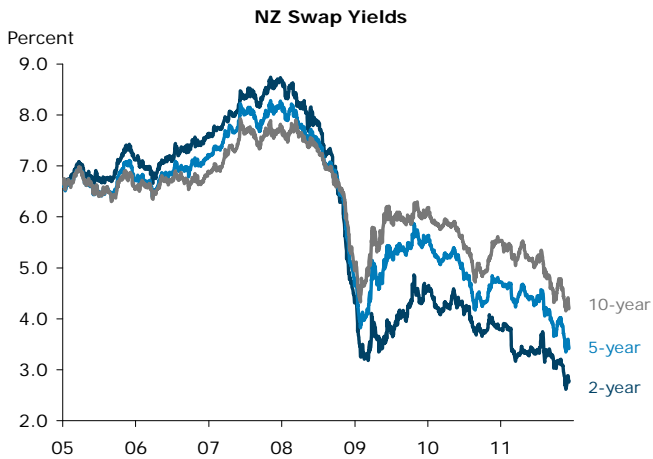
CHARTS



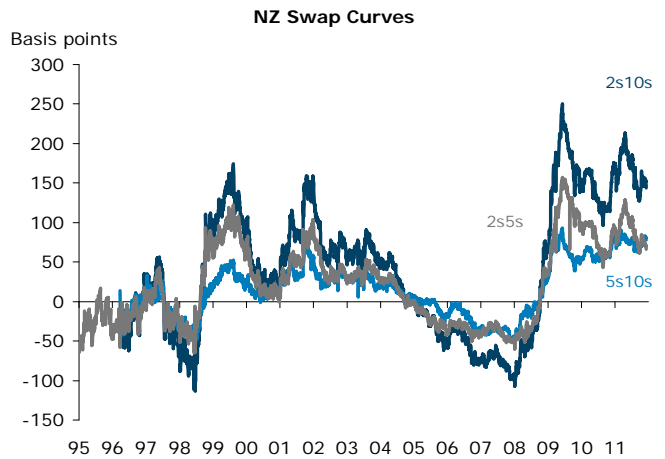
Sources: ANZ, National Bank, RBNZ



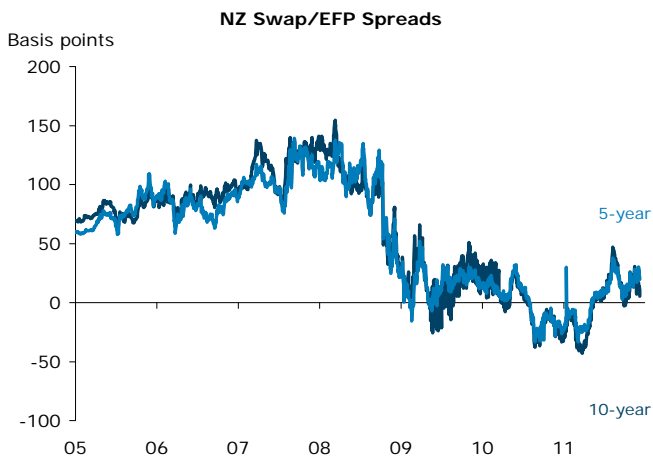
Sources: ANZ, National Bank, RBNZ, Bloomberg



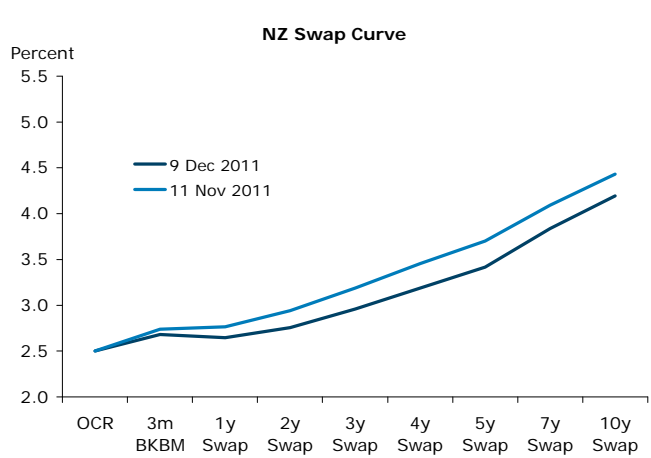
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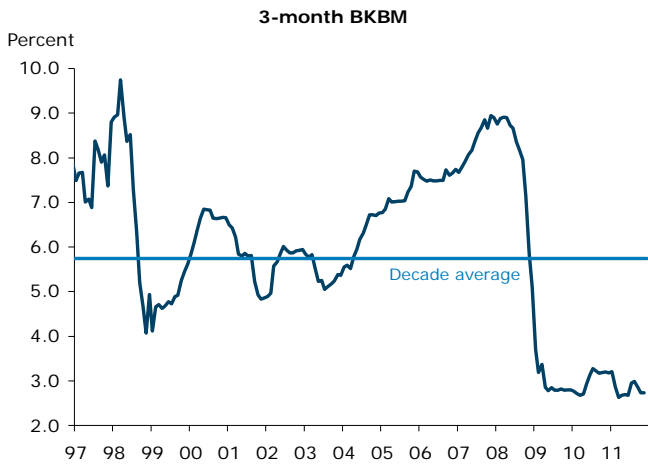


Sources: ANZ, National Bank, Bloomberg

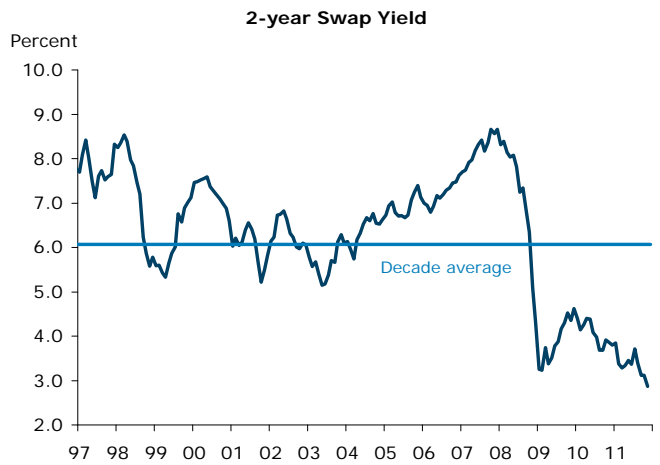


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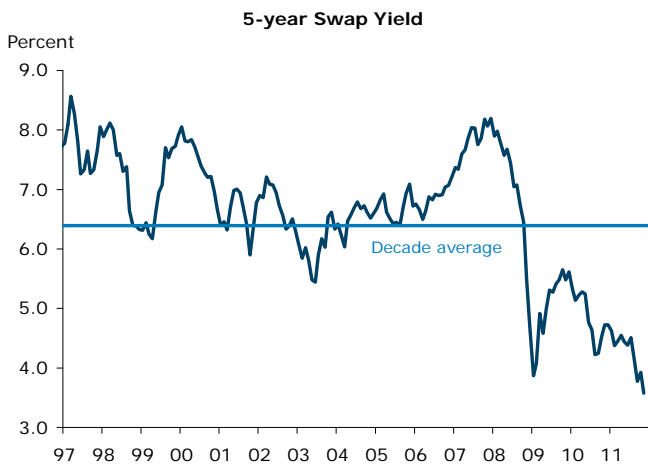
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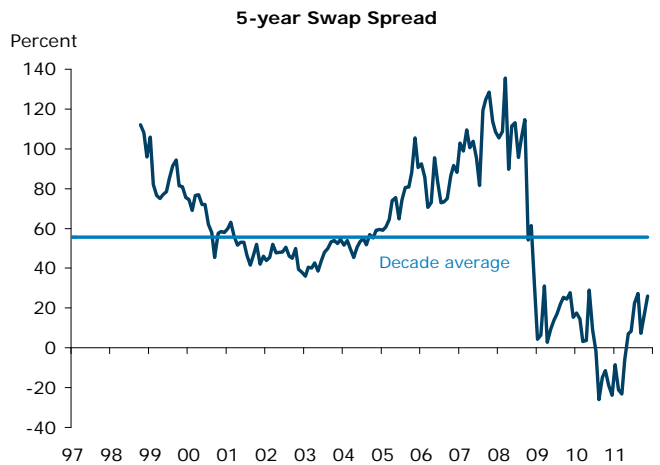
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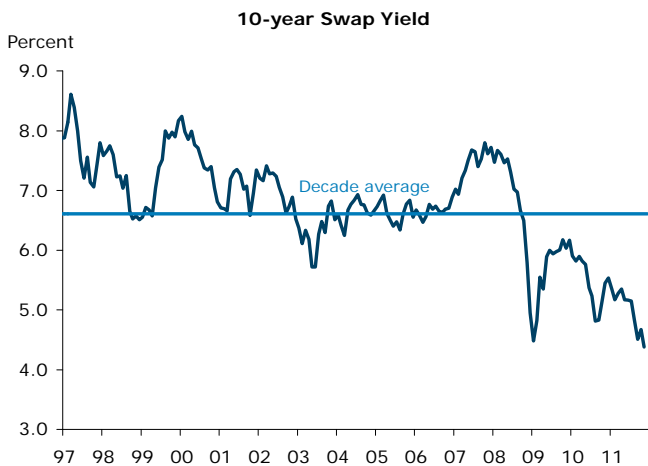
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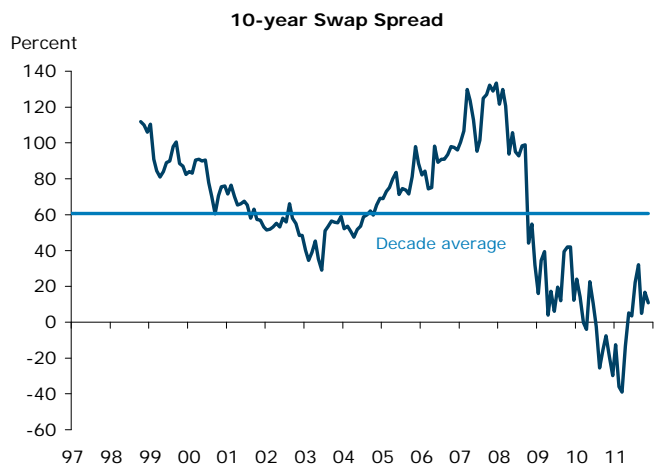
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