

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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ECONOMIC OUTLOOK

Domestic economic data released over the last few weeks has echoed a familiar theme, generally coming in on the low side of expectations. Yesterday's HLFS employment data was just one example of this. In addition, housing market data has been particularly soft, casting a shadow over households, which remain cautious in their spending decisions. Net migration has slowed significantly and commodity prices and business and consumer confidence have pulled back (but remain positive). We read the recent retreat in confidence as the reality of a more subdued recovery starting to dawn, as opposed to the recovery itself coming under threat. Indeed, it is entirely consistent with our long held view that the economic recovery will be more muted compared to past cycles, with bumps along the way. Deleveraging remains a dominant theme, and this will hold growth back in the near term. However, somewhat ironically, a more subdued growth outcome in 2010 means we will be more optimistic about prospects for 2011, for it shows that the NZ economy's imbalances are being addressed, which will set the stage for a more sustainable rebound further down the track.

RATE VIEW

The OCR is still headed higher, but given what have been very real signs of slowing momentum, and increased financial market volatility, we doubt the economy can withstand increases every six weeks. As we've been saying for months, rather than being quick and decisive, the policy normalisation path will be an elongated one with pauses along the way. At this stage we ascribe 50/50 odds to a September hike, with a long pause likely in Q4 and into Q1 before policy normalisation continues. At present the market is placing a bob each way, looking for a pause in the tightening cycle, but not keen to push rates too far into 2011. In fact we'd consider the market has now done a full circle, from overpricing the endgame for the OCR six weeks ago to now under-pricing it despite prospects for obvious pauses in the hiking cycle along the way. Rates have moved a long way now, and it will take a significant re-rating of the policy outlook for short end rates to move much lower. While long end rates could fall further if the US Federal Reserve may opt to re-engage in quantitative easing (QE), we think this outcome is far from a central scenario.

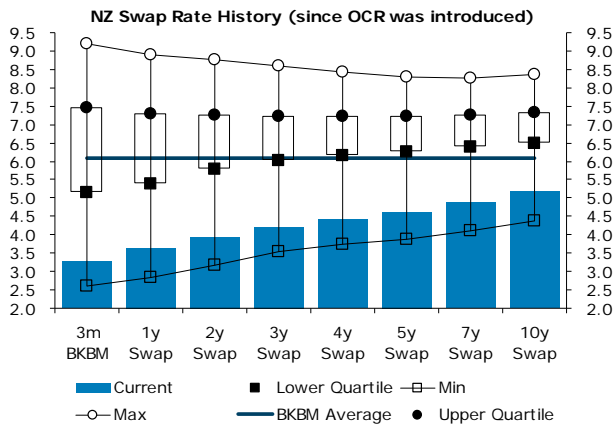
STRATEGY

The market is now pricing in a much more gradual series of rate hikes in the wake of the RBNZ OCR Review and yesterday's data, which seems appropriate. Short rates could edge lower, but there is a limit to how much further they can go without pricing in a "no change" scenario, which seems extreme. This may suggest there is value in short term hedging – but we don't believe there is, as the risk of policy being more aggressive than what's priced in seems low. Long end rates offer exceptional value relative to historic norms. They could go lower yet if the Fed re-starts QE, but this already looks at least partially priced into the market. With long end rates well below what we would regard as reasonable given the long term outlook (the 7yr swap is below 5%) we think there is merit in doing some long term hedging, with a mind to doing more if the Fed actually do engage in QE again.

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VALUATION

Swap rates are lower across the board, led by the short end. The 2yr swap fell below 4% in the days following *the OCR Review*, but the rally did not last, and it wasn't until yesterday's soft HLFs employment report that the 2yr moved convincingly below 4%. The 7yr rate is below the key 5% level, and the 10yr is now at 5.19%. Long end rates in particular are extremely low by historical standards. The recovery is losing momentum, but we doubt the economy is in as bad a shape as the term structure of interest rates implies – but we are mindful of the impact that global rates are having on NZ rates.



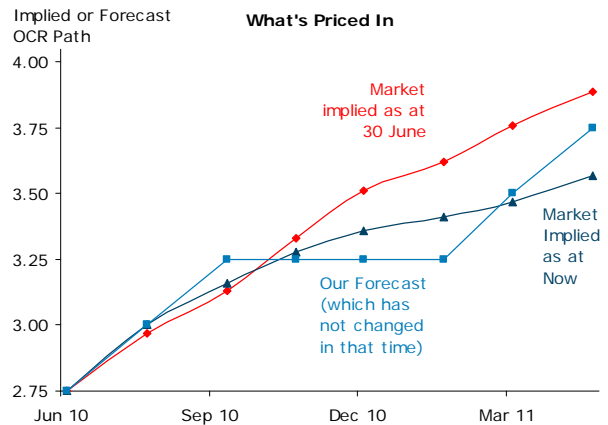
Sources: ANZ, National Bank, Bloomberg

Current interest rate levels		
Maturity	2 weeks ago	Current
3-mth BKBM	3.24	3.28
1-year swap	3.80	3.66
2-year swap	4.21	3.95
3-year swap	4.46	4.22
4-year swap	4.65	4.44
5-year swap	4.80	4.62
7-year swap	5.06	4.90
10-year swap	5.33	5.19

Market expectations for RBNZ OCR (bps)		
OCR Dates	2 weeks ago	Current
Thu 16-Sep-10	+16	+16
Thu 28-Oct-10	+35	+28
Thu 9-Dec-10	+43	+36
Thu 27-Jan-11	+56	+41
Thu 10-Mar-11	+64	+47
Thu 28-Apr-11	+88	+57
Thu-9-Jun-11	Not forecast	+68

MASSIVE SWING

The past six weeks has seen a massive swing in sentiment. Six weeks ago the trajectory for rates was up, and in a quick fashion with the cash rate expected to be at close to 4% within a year, and at 5% by the end of the cycle. By contrast, current market pricing in the near-term is less aggressive, and the endgame has been lowered, as the chart below shows. This full-circle swing looks a little extreme to us. We certainly concur with the spirit of a market that is unwilling to price in an overly aggressive tightening profile given the fragile nature of the global economy. But equivalently, we are mindful that the rubber band is taut, and the RBNZ rather belligerently reminded us not once but twice in their *OCR Review* last week about how supportive policy settings were. In central bank speak this is a reminder that the trend for rates is still up – something that shouldn't be forgotten.



Sources: ANZ, National Bank, RBNZ, Bloomberg

RISKS BOTH WAYS

Domestic economic data releases over the last six weeks have been almost universally soft, with few exceptions. This is troubling for two reasons. The first and most obvious is that it is now clear that the fledgling recovery has lost some momentum. And while it would be an exaggeration to say that the recovery has been threatened or has "petered out", the fact that it has less potency makes us more cautious. After all, we always warned that the recovery would be patchy and gradual, so we'll refrain from throwing the baby out with the bathwater just yet. However, recent developments do suggest that there is less urgency for the RBNZ to get the OCR back towards more neutral (or less stimulatory) monetary policy settings. That is, as we look to the future, increased uncertainty about



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how quickly the economy is recovering suggests that the pace of rate rises is likely to be slower.

The second troubling aspect about recent data is that it raises questions about the starting point. Yesterday's HLFS employment data is a case in point. While few people (including us) really believed that the unemployment rate actually fell as sharply as the Q1 survey suggested it did (the official data showed that it fell from 7.1% to 6.0%), it did seem credible that the unemployment rate fell. However, yesterday's data (showing a rise in the unemployment rate to 6.8%) suggests that the underlying state of the labour market was probably weaker than initially assumed. When we consider this in light of the growing list of weaker than expected data releases of late, and signs that the economy is facing stronger headwinds than we originally thought, we have to question our starting point assumptions. Indeed, both business and consumer confidence have fallen from their highs, commodity prices are lower, net inward migration is down, the housing market seems stuck in the doldrums, and financial markets have been maligned by risk aversion. This suggests that the pace of tightening will be more gradual than previously thought, and goes some way to validate the market's view that this rate hike cycle will be much more muted than past cycles.

But while increased headwinds may sap some of the economy's potential, and suggest the peak in the OCR may be lower, it is difficult to imagine that the rates cycle will peak below neutral (unless we do enter another recession, but that's not the central scenario). If we put aside global financial market considerations for the moment, erratic domestic data should be viewed as a sign that the recovery will take longer, as opposed to being written off. As such, we need to be mindful of the permanence of the market reactions. Or put another way, while it may be appropriate for the market to push out the rate hike cycle, this should have more of an impact on the short end than the long end. So far it has – but we note that the long end of the curve has gone a long way too. And with the 10yr rate now below 5.20%, there is an air of permanence about how long the economy will be in the doldrums. We don't subscribe to this notion, and as we have long pointed out, if slower growth in 2010 is being driven by much-needed structural adjustments, this makes us even more upbeat about 2011 and 2012. Based purely on domestic considerations, it is tempting to conclude that the long end of the curve has well undershot the market, and has been plagued by

pessimism. This suggests there is a case for rates to move higher.

That being said, there have been some significant changes to the global financial environment. Chief among these is growing speculation that the US Federal Reserve is mulling over the possibility of reengaging in quantitative easing (QE). Sometimes known as "printing money", the express intention of such a policy is to get long term interest rates down in an effort to kick start the economy. It is completely understandable that the Fed may be mulling this over – after all, the Fed has a so-called "dual mandate" – low inflation and full employment. The problem is, the US unemployment rate has been above 9% for 15 months now and shows no signs of moving convincingly lower. At the same time, core inflation is falling, pushing real interest rates up. Whether the Fed adopt this policy is uncertain – but the market is eager to entertain the debate, and this is having a significant impact on US and Japanese interest rates. Should these key rates fall further, they will take NZ rates with them, to an extent at least. As such, there is a risk that the term structure of rates moves lower yet still. But at present we suspect a fair portion of this risk is already reflected in yields and hence if the Fed decides to stick to their script there seems an equivalent chance of a mild pull-back.

SOME VALUE AT THE LONG END

If valuation measures suggest that NZ term rates are too low, but the possibility of QE suggests they may move lower, what to you do? The fact that there are two fairly powerful opposing forces makes the decision tough. On the one hand, long rates look way too low relative to where the domestic economy is headed. Things may feel difficult now, but it would be a stretch to say the economy will be in the doldrums for the next 7 years as the current 5% 7yr swap rate implies. In a sense then, long end rates are like a beach-ball under water. The problem is, it is global considerations that are holding them down, and these are powerful forces. But while QE would have a significant impact, the hurdle for the Fed adopting it is high. Given that a fair probability of it is already priced in (which is what helped drive NZ rates lower), there's an argument for using this as an opportunity to do a little more long term hedging, keeping some powder dry to do more should the Fed actually go down the path of QE. Increased uncertainty certainly suggests some caution – but on pure valuation basis, it is worth getting involved in some

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way. Indeed, as we pointed out in our last issue, markets have a habit of "undershooting", and while the market may go lower yet, what's going on now has all the characteristics of a classic undershoot.

But if the long end has some appeal, what does the short end offer, especially now that the market is "only" pricing in 47bps of OCR hikes by March? Technically speaking this is less than our forecasts, but bear in mind we see the odds of a Sep hike as being 50/50. This suggests there less value in hedging at the short end. Doing so will protect you against rising rates, but with a one-hike-every-two meetings profile prices in, it's debatable how much faster the RBNZ will move given the loss of momentum in the recovery. The onus is certainly now on the data to prove that the RBNZ should stick to the "game plan" outlined in the June MPS (which had the 90 day bill rate projected to be at 3.7% by December, consistent with 4 rate hikes by then). As such we see little reason to rush in to fix.

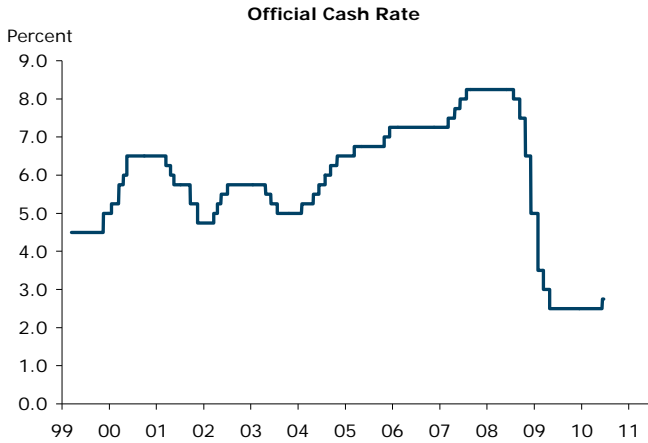
But you guessed it – there is a caveat. While we think the chances of it are fairly slim, it is possible that the 35% of the populous that are on a floating mortgage flock to a fixed rate following recently announced rises in floating rates (which have coincided with cuts in fixed rates). The margin between floating and long term fixed rate is almost prohibitively expensive. However the margin between floating and the 2yr rate has fallen to 60bps at one bank, and no doubt this will be matched by others. This spread has fallen substantially in the past two months and may prove to be attractive to some. If borrowers fix en masse, we may see an outsize reaction to 2yr swap rates as the market digests the flow, as we saw in March last year. However, the differences between now and then are aplenty. Back then both the rate and the step-up were much lower. Now the overall rate is about 1.8% higher, and the step up is positive, making it less appealing. But it is worth highlighting the risk, adding that the mania we saw last year was short-lived. Indeed, rates eventually reverted back to "normal" fairly quickly following the mortgage paying. If it happens again, it may be wise to sit it out.

DEALING ROOM CONTACTS:

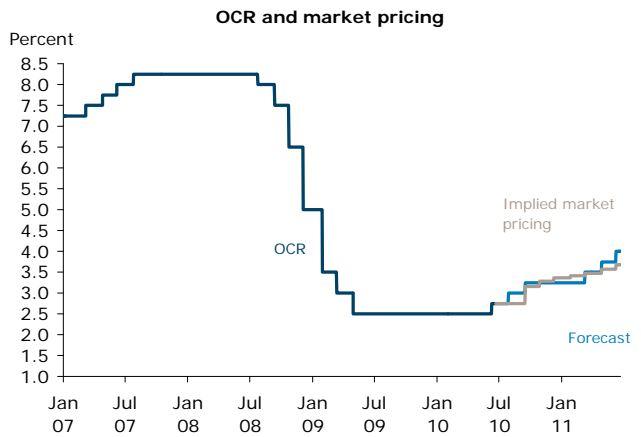
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CHARTS

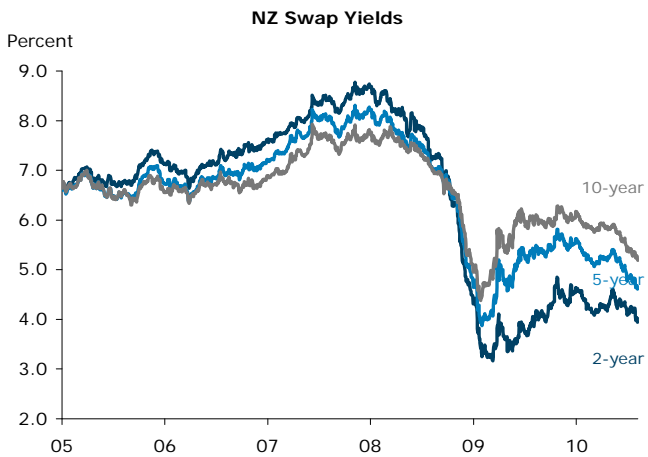
CHARTS



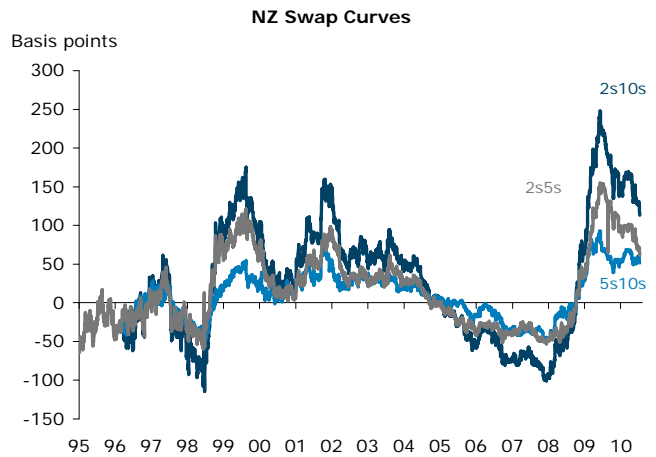
Sources: ANZ, National Bank, RBNZ



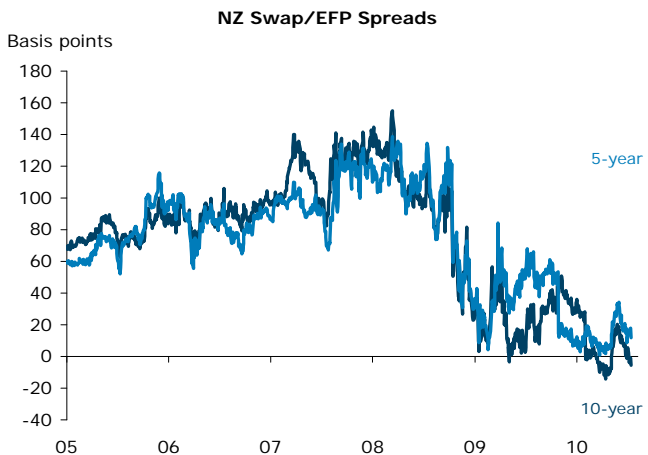
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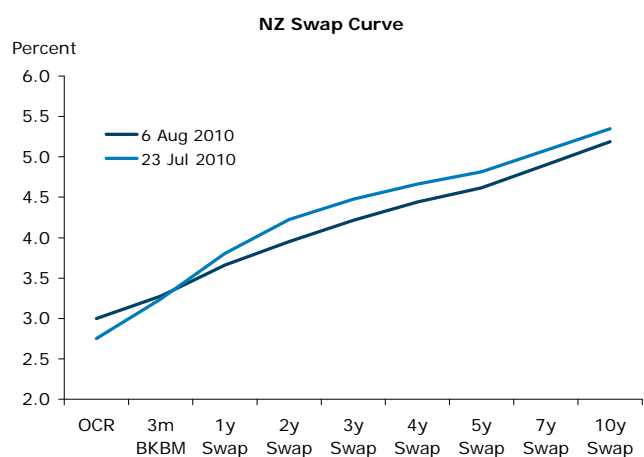
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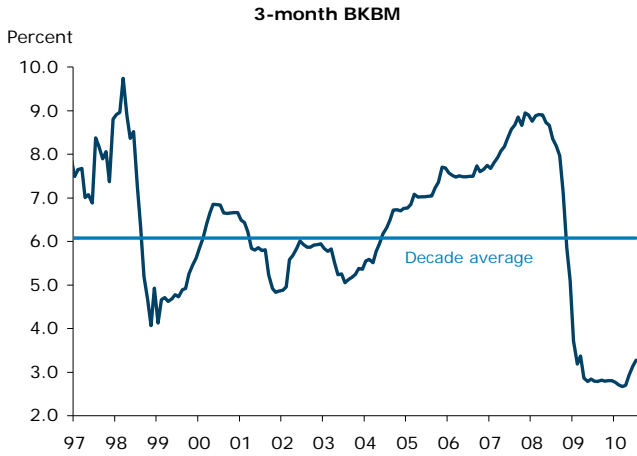
Sources: ANZ, National Bank, Bloomberg



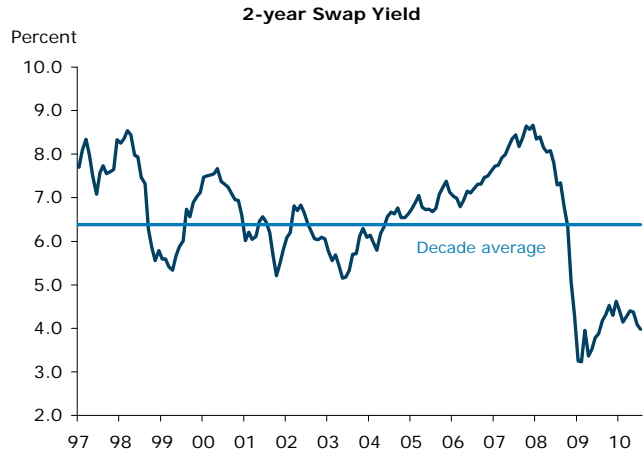
Sources: ANZ, National Bank, Bloomberg

CHARTS (END OF MONTH)

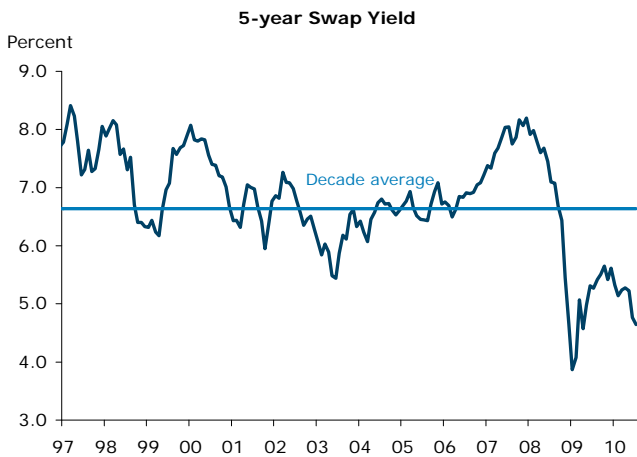
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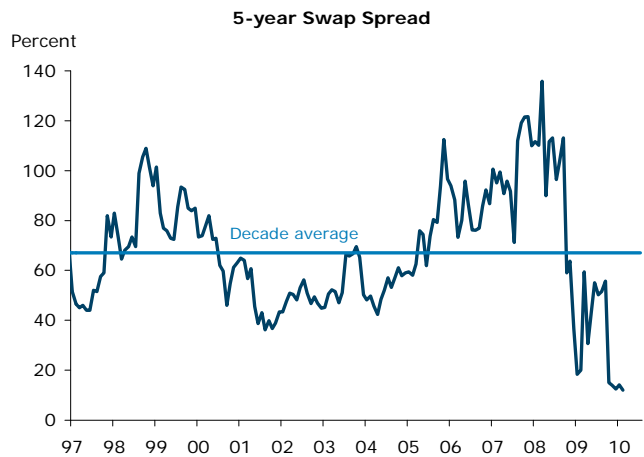
Sources: ANZ, National Bank, Bloomberg



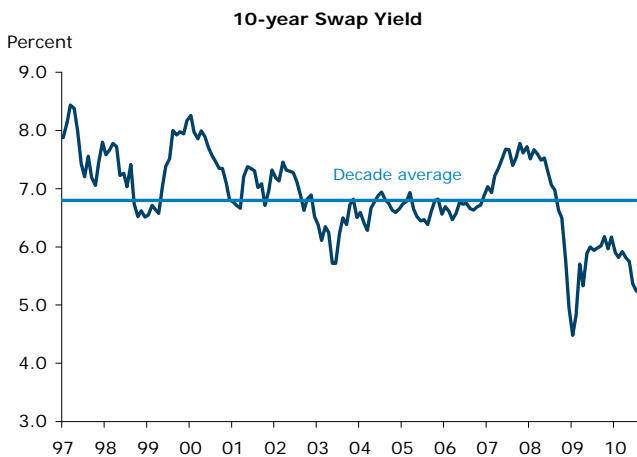
Sources: ANZ, National Bank, Bloomberg



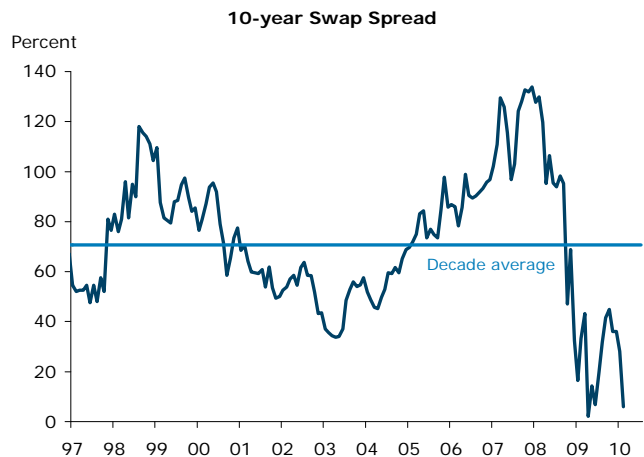
Sources: ANZ, National Bank, Bloomberg



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