

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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CONTRIBUTOR

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ECONOMIC OUTLOOK

Global developments continue to take precedence over local considerations. While we've been surprised by the intensity of market movements in some instances, the developments fit within the key theme of our economic prognosis: healing in the post-GFC world will be a long, drawn-out process. Recent global data has been weak (not dire), but the next month or so will be critical. The European situation remains troubling with markets seeking a circuit breaker. By contrast, the local dataflow has shown resilience and with the pending boost provided by the Rugby World Cup and earthquake reconstruction we expect New Zealand to remain an economic out-performer, in a solid as opposed to spectacular growth sense. Nevertheless, the New Zealand economy is not immune from global weakness, with the OCR expected to remain at low levels until the global scene stabilises.

RATE VIEW

Markets are schizophrenic and uncertainty is at an extreme at the moment. In fact, the situation is so extreme that even if one was blessed with the perfect foresight on how the macro and policy outlook might evolve, there is no guarantee that one could accurately predict how markets might react. As an example, it is not clear how markets will react to more Fed stimulus, should they deliver it. Will bond yields rise on jubilation that the economy has a fighting chance at recovery, or fall on the idea that a big buyer is about to enter the market. Much depends on other markets, and how they react. We do think markets are priced more for "Armageddon" than is warranted. By the same token, there is no obvious circuit breaker in sight. Perhaps worse still (depending on your view), the one thing markets are gunning for is quantitative easing, and not just in the US, but also in Europe and Japan too. And history tells us that QE is generally associated with lower interest rates. For our part, we see volatility as the key feature of markets in coming weeks. Although we think the local outlook demands a higher OCR, this is completely swamped by global risks.

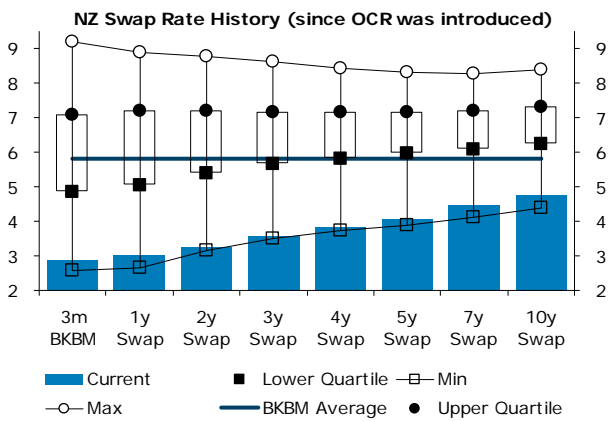
STRATEGY

This fortnight's edition is deliberately short and to the point. The reason is this: markets are on the move, and uncertainty is high. We wouldn't normally allow market volatility dictate a strategy. However, in the current environment, when the market is trading at a premium and out of line with global peers, it is not clear to us that borrowers should be in a rush to fix. Pricing has changed since our last edition, but the market turmoil is ever-present, and our preference is to stay on floating, and take advantage of the low rates on offer. Time remains on the borrower's side.

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VALUATION

The main feature of the past fortnight has been the mild widening of the yield curve, with the 5yr swap being the pivot point. To be fair, markets were stressed when we last went to print, and the short end was reacting to the fact that the Australian market was pricing in 6 rate cuts by Christmas. But the Fed had not yet made its commitment to keep the Fed Funds rate on hold for 2 years, and now that it has, long end yields have fallen. Term rates do offer better value, but as they trade at a premium to floating, some caution is required given the lack of certainty with regard to the outlook.



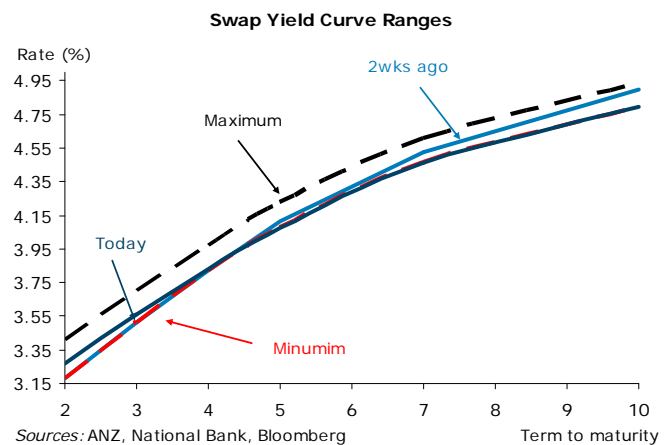
Sources: ANZ, National Bank, Bloomberg

| Current interest rate levels | | |
|------------------------------|--------------|---------|
| Maturity | Last edition | Current |
| 3-mth BKBM | 2.74 | 2.88 |
| 1-year swap | 2.86 | 3.03 |
| 2-year swap | 3.15 | 3.27 |
| 3-year swap | 3.47 | 3.56 |
| 4-year swap | 3.78 | 3.84 |
| 5-year swap | 4.07 | 4.08 |
| 7-year swap | 4.49 | 4.47 |
| 10-year swap | 4.87 | 4.79 |

| Market expectations for RBNZ OCR (bps) | | |
|--|--------------|---------|
| OCR Dates | Last edition | Current |
| Thu-15-Sep-11 | +3 | +4 |
| Thu-27-Oct-11 | +7 | +10 |
| Thu-8-Dec-11 | +11 | +18 |
| Thu-26-Jan-12 | +15 | +25 |
| Thu-8-Mar-12 | +17 | +29 |
| Thu-26-Apr-12 | +19 | +38 |
| Thu-14-Jun-12 | +25 | +41 |

SAME, SAME ...

Although a quick glance of the table below reveals some reasonably large changes in interest rates between the snapshot taken a fortnight ago and today, in spirit, the overall interest rate environment hasn't changed. Day to day volatility makes it look like interest rates have moved markedly, with interest rates moving down one day on panic, only to rise the next day on optimism. What matters more is when you take your snapshot. Indeed, it was just a fluke that when we published the last edition of the *Borrower's Strategy*, short end rates were at their lows. Had we published the next day, our table would have shown that all interest rates had actually fallen, in some cases quite substantially. As the chart below shows, the basic shape and level of the yield curve has not changed much, and the choices and tradeoffs borrowers face are basically the same as they have been for a few weeks now, ever since global interest rates collapsed.



The point is, we would urge readers not to be drawn in to day to day or week to week changes, and instead focus on the general level of interest rates, which remain very depressed. That's the real constant out there, and as we alluded to in our introduction, interest rates are trading as though some sort of Armageddon or meltdown is around the corner.

... BUT DIFFERENT

Although the overall interest rate environment hasn't changed, the global scene certainly has. We wrote at length in our last edition about global market turmoil. At that stage the US has just had its credit rating downgraded, and markets were in panic mode, not yet convinced that the European Central Bank's decision to buy Spanish and Italian bonds would do the trick, so to speak. Such was the level of panic and the spillover to our part of the world that readers

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may recall that at the time, the Australian market was pricing in 6 policy interest rate cuts by Christmas.

If we wind the clock forward today, the mood has improved somewhat. The most pronounced change over the past fortnight has been the shift in focus away from Europe and towards the US. That said, markets are deeply suspicious of how things will pan out in Europe, and the sovereign debt crisis remains a major issue. Politicians continue to go down the "muddle through" road, and the whole debacle is notable for its lack of decisive decision making. However, the Fed's decision to keep Fed Funds on hold for the next 2 years has had a profound impact on US interest rates, taking the bellwether 10yr bond yield to within touching distance of the previous all-time low reached in 1941. The mood has only been exacerbated further by another slew of soft data out of the US (most notably the Philly Fed survey), which has many convinced that the US is headed for a recession if it is not already in one. We won't make judgement here on that – after all it's not an area we have a comparative advantage in. But it is worth highlighting the fear that has gripped markets.

Equally noteworthy has been the enormous burden markets have now placed on Federal Reserve chairman Ben Bernanke's shoulders. As many readers will be aware, the Fed's Jackson Hole symposium kicks off later this week, and all eyes are on Bernanke's speech on Friday, and many are hoping he will hint at QE3. It's not clear that such a course of action would be effective, and nor are the conditions necessarily ripe for it. Furthermore, there is division among the voting members of the Fed. But markets are anxious, and 3 days out from the speech, the mood on the street seems to be that interest rates will fall regardless. That is, bond yields will fall if the Fed does hint at further QE, on the idea that a big buyer is about to enter the market. But they may also fall if they don't, on the view that a lack of action will plunge the economy into recession, denting confidence in equities, leading to safe haven buying of bonds.

FOR YOU, SPECIAL DEAL

The question before markets now then is, what will it take to restore confidence in global markets? Many think further QE is the only answer, and while we have our reservations, we have some sympathy for the view. But that's less a judgement on whether it is appropriate or will be effective, and more a reflection of the likelihood that those in the decision making seats see it as the easiest way out. Indeed, the US may engage in further QE (somewhat

honestly) in order to bolster growth. By contrast, Europe may do it (somewhat dishonestly) to monetise its bad debts, and the resultant flood of liquidity may leave the Japanese with very little choice but to pursue QE themselves in a bid to weaken the yen. Is this the new deal? It could be.

Whatever happens, we need to be careful about how we assume global events may impact on New Zealand. If, for example, we do see a flood of liquidity, some of that money will come New Zealand's way, helping to avoid one of the most detrimental impacts of the GFC – which was a dearth of liquidity and a surge in funding margins. Caution in interpreting what we're in or is certainly warranted. As we have noted several times, markets are priced for a meltdown, and have given little credence to the notion that (a) policy makers won't stand idly by, and (b) that the domestic outlook is experiencing something of a purple patch. Both of these factors leave us optimistic that New Zealand will fare reasonably well over the next few quarters.

CONCLUSION

Despite our optimism with regard to the domestic economy, we must equally acknowledge the substantial downside risks to the global outlook, and that markets are moving quickly. The most concerning possibility would be a deep or "proper" double dip recession in the US. Europe has long faced the prospect of a downturn, but we would rather be clear that the US will in fact avoid a recession (and China a hard landing) before adding to hedges.

The other objections we have are (a) timing; and (b) whether expectations already priced into the market. With regard to the former, time is on the borrower's side. With uncertainty as high as it is at the moment, we can expect the RBNZ to stay in hold for a little longer – hence we deferred our forecast for the first hike from September to December. On the latter – it is not clear to us that the gap between our forecasts and market pricing is enough value to go adding to hedges here, particularly as the New Zealand market is the only market pricing in OCR hikes. As such, our preference is to hold for now, and await clarity before making bold decisions.

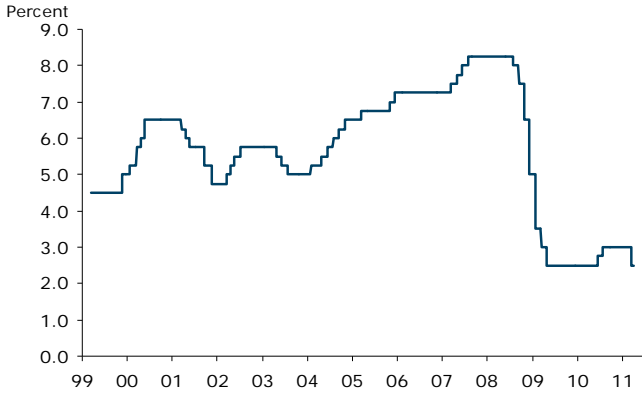
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CHARTS (END OF MONTH)

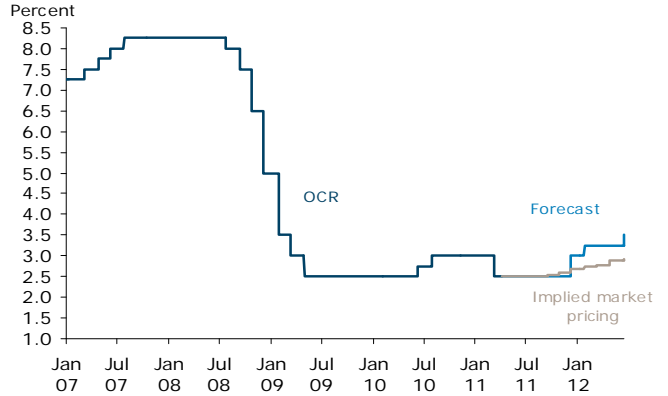
CHARTS

Official Cash Rate



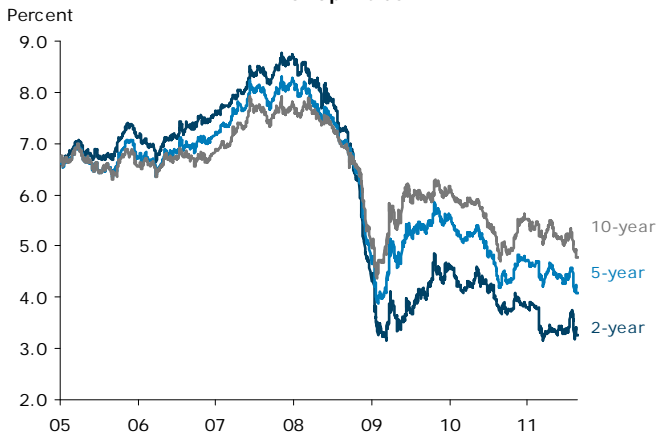
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



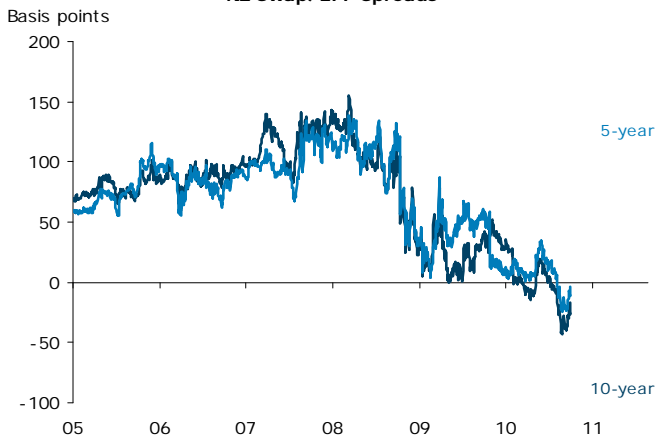
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



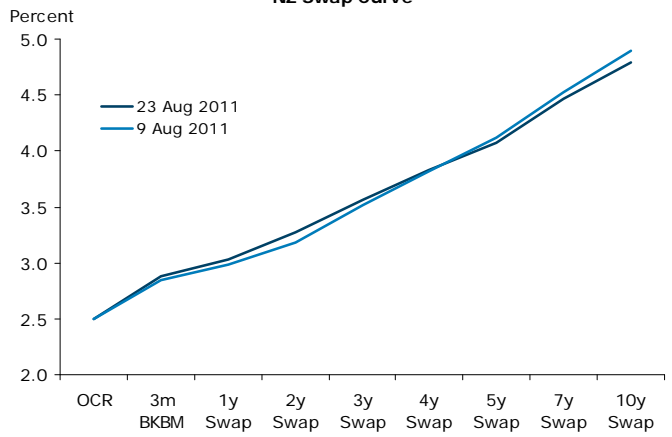
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

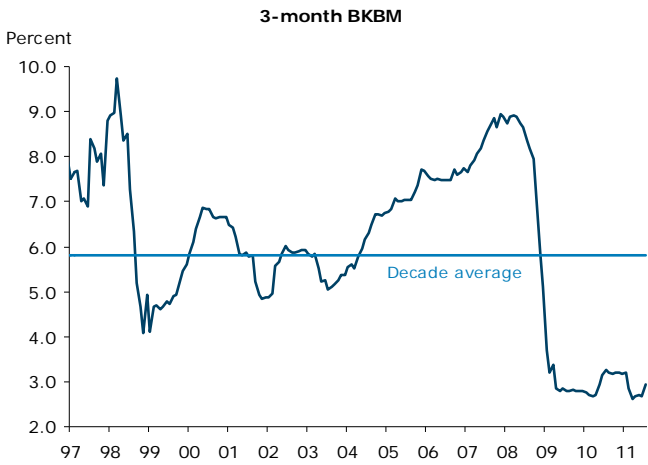
NZ Swap Curve



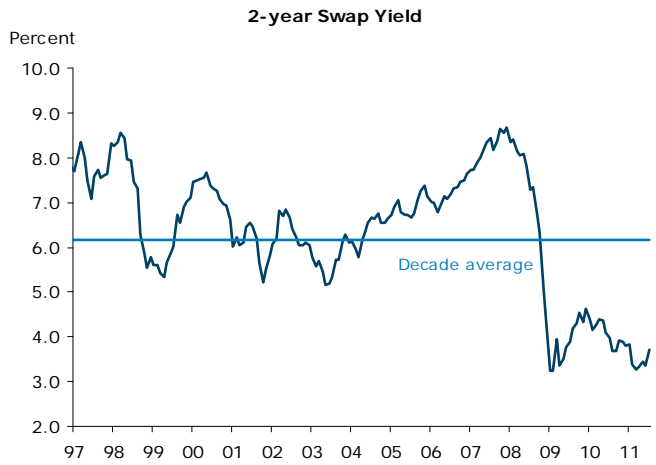
Sources: ANZ, National Bank, Bloomberg

CHARTS (END OF MONTH)

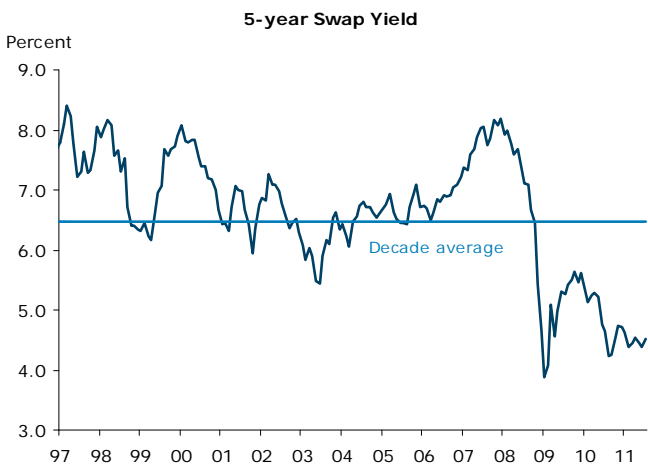
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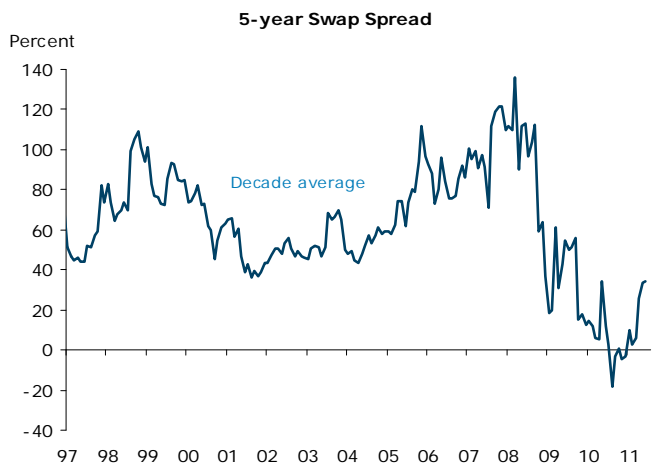
Sources: ANZ, National Bank, Bloomberg



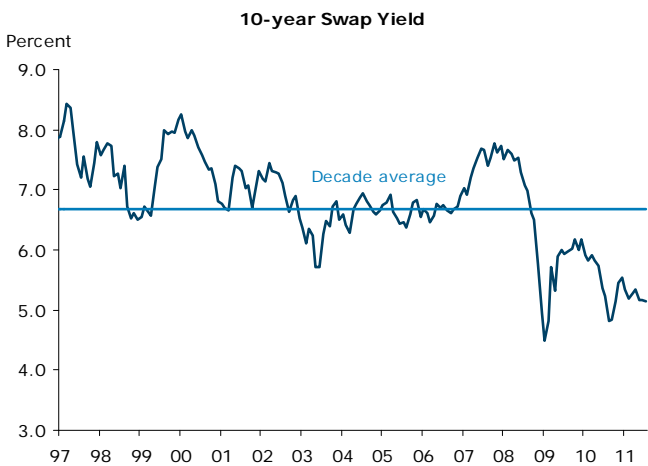
Sources: ANZ, National Bank, Bloomberg



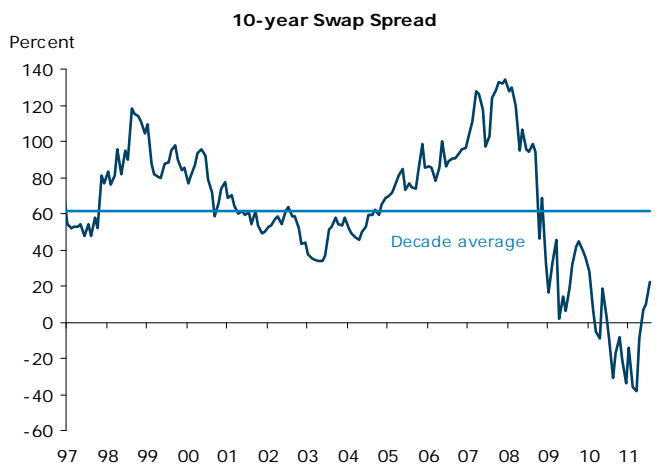
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