

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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CONTRIBUTOR

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ECONOMIC OUTLOOK

The February 22nd Christchurch earthquake has delayed the recovery by six months, offsetting earlier signs of improvement. Beyond the \$10-15b in damages and initial hit to activity, the rebuild effort will be a 5-10 year programme, adding 1.5 percent to GDP each year. We are detecting a base of resilience within the economy, with interest rate sensitive sectors showing signs of improvement from depressed levels. We have pencilled in a sharp upturn in momentum from the second half of this year. A lower level of activity provides a larger springboard from which recovery can occur. Financial conditions remain highly supportive: the OCR has been cut and commodity prices remain strong. The Rugby World Cup will provide a further boost. While contained current inflation fits with a patient RBNZ, the inflation outlook remains somewhat troubling and the Bank should be casting nervous glances at the housing market. A stronger cyclical upswing and higher inflation is expected to see the RBNZ lift the OCR by year end.

RATE VIEW

Inflation data earlier this week has highlighted the need for the RBNZ to be stern and patient. Indeed, while measures of core inflation were muted, and may give the RBNZ comfort that inflation remains under control, as with past quarters (urging patience), there were several large one-offs. This in itself is not an issue, rather the repetitiveness and composition of them. Indeed, our research suggests that large price rises in core staples and frequently purchased goods (like food, fuel and cigarettes) tend to have an outsized impact on inflation expectations. However, lower than expected headline figures give the market breathing space, and the market is likely to gravitate around the December / early 2012 rate hike view, as opposed to toying with an earlier hike than that. Still, with around 135bps of rate hikes priced into calendar 2012 and very little before or after, there is limited further upside in the key 2 year swap yield, but plenty of upside in medium to long term rates. The latter could rise markedly if global rates start to rise. That said, global markets are starting to get concerned about sovereign credit risks, and that may keep a lid on risk appetite, and see money flow into New Zealand out of traditional markets like the US.

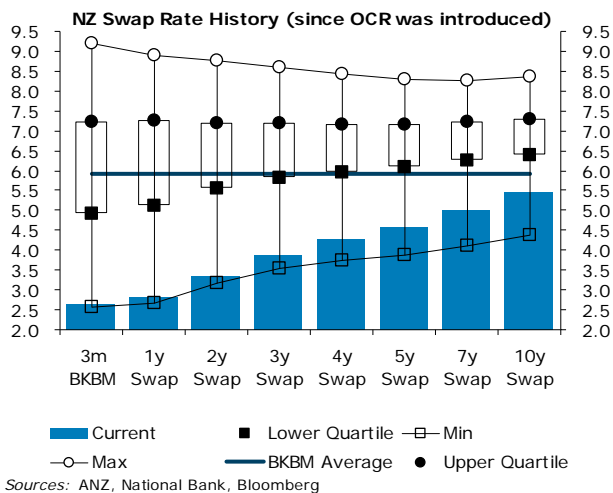
STRATEGY

The broad thrust of our thinking has not changed – we continue to favour a greater than normal exposure to floating rates while taking opportunities to add to medium term hedges on dips. Broadly speaking, we favour a balance of low cost funding as well as protection against rates rising in future. Given the point of the business cycle (i.e. the pre-recovery stage) and the level of long term rates relative to historical ranges, it is tempting to think that now would be a good time to add to long term hedges. We have a great deal of sympathy for that view, but we are also mindful of how low floating rates are, and expect the upcoming rate hike cycle to be long and drawn out, as opposed to swift and abrupt. This leaves us less eager to embrace long term hedging. Vanilla option strategies look reasonably attractive, even if only because premiums are low in relation to the slope of the curve.

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VALUATION

Interest rates continue to edge higher, and are up across the board for the second fortnight in a row. But a glance at the tables below masks some volatility – for example the bellwether 2 year swap traded as high as 3.46% last week, which is up around 30bps from the mid-March low. The key feature of the past fortnight has been the steepening of the yield curve, which only serves to make fixed rate paying that much less appealing.



STANDING BY

As we noted in our summary page, the broad thrust of our thinking has not changed – while we remain concerned that in the medium term rates will rise over the next two years, we are also mindful that when the time comes for the RBNZ to raise rates, it will do so only gradually. If we are right, this raises the “hurdle” to fixing, as it means that floating rates are likely to remain more competitive for longer. The RBNZ has only current prudential policy changes to help here (i.e. the core funding ratio) but also those that are pending (i.e. new changes to rural lending capital requirements). As a result, we favour a mix of floating rate exposure and medium term hedges, with more of an emphasis on the former.

If we were expecting a “normal” business cycle we would probably look to favour the latter – particularly when we think back to how aggressive the RBNZ has been in the past, and how resilient the economy has been to rate hikes. However, at the risk of being laughed out of the party by uttering the phrase “this time is different”, we do have to acknowledge that this time around, there are a lot more business and mortgage borrowers on floating. Moreover, many businesses and households are “donkey deep” in debt that the credit creation process is less likely to propel the economy forward with the same gusto as it has in the past when debt levels were low and asset prices were more reasonable.

INFLATION AND THE HIGHER KIWI

Recent inflation data also leaves us somewhat circumspect – but not for the reasons one might expect. Indeed, while we were of course pleased to see that Q1 inflation was lower than what we thought it might have been, we still harbour reservations about the inflation outlook, as regular readers of our research and commentaries will be aware of. The thing is, even if we are spot on in our view that the RBNZ has potentially underplayed the inflation risks, the simple fact that Q1 CPI data released earlier this week came in below expectations means that the market is likely to defer the debate for a few months, or at least until/unless we see another round of high visibility price rises (for items like petrol). This is precisely why swap rates have retreated in recent days, having gotten mildly uncomfortable ahead of the data. So while it is too soon to close the book on inflation, the market has put the issue to bed for

Current interest rate levels		
Maturity	2 weeks ago	Current
3-mth BKBM	2.63	2.65
1-year swap	2.76	2.83
2-year swap	3.30	3.38
3-year swap	3.81	3.91
4-year swap	4.18	4.34
5-year swap	4.48	4.67
7-year swap	4.91	5.12
10-year swap	5.31	5.52

Market expectations for RBNZ OCR (bps)		
OCR Dates	2 weeks ago	Current
Thu 28-Apr-11	0	0
Thu-9-Jun-11	0	+1
Thu-28-Jul-11	-1	+1
Thu-15-Sep-11	+1	+5
Thu-27-Oct-11	+5	+11
Thu-8-Dec-11	+12	+16
Thu-26-Jan-12	+28	+32

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now. That said, that doesn't mean we should be complacent. The NZ market is notorious for how quickly it chops and changes, overshooting on the top and bottom side as it re-prices.

We are also mindful of the exchange rate, and as we have long argued would inevitably occur (simply because any other position would simply have not been tenable), it was interesting to note that the RBNZ have now essentially moved to embrace the higher NZD. Indeed, in a speech last week, Governor Bollard noted that he expects "higher terms of trade to continue to be reflected in the exchange rate", adding that this "would deliver the benefits of the rising terms of trade to the community at large – through higher wealth and cheaper imports". In other words, the high exchange rate is here to stay, and it will help keep a lid on inflation. In fact we would put it more bluntly: the RBNZ needs a higher currency to keep a lid on inflation.

Does this sound familiar? Yes it does, for this is exactly the conclusion the Reserve Bank of Australia arrived about a year ago. Like the RBNZ, the RBA used to get a bit nervous about a high exchange rate, intervening at times to skim the froth off it. But amidst the commodity boom, it now embraces it, and so it should. That may be all well and good, but what does it mean for interest rates? It's simple – all other things equal, the higher the NZD is, the more scope there is for interest rates to remain low. That's not to say that we explicitly forecast the NZD to go higher, and to be high enough to stop interest rates rising. And it's certainly not a suggestion that the MCI is back. Indeed, financial conditions are very easy at the moment, and interest rates do need to move higher at some stage. But we also need to acknowledge that if the NZD does remain lofty, it does take pressure off interest rates, giving the RBNZ more "wriggle room". And this is something hedgers need to be aware of.

GLOBAL RUCTIONS

There is one other recent development worthy of note, as it is likely to be a key influencer of New Zealand long term interest rates in the months and years to come. Yes, it's that old chestnut – sovereign debt concerns. This has become the hot topic in global bond markets following news that Standard & Poor's has placed the US government's AAA credit rating on negative outlook, and on speculation that Finnish elections may return a

government reluctant to support future European bailouts. In addition to confounding markets, which have been accustomed to buying US dollars and US Treasury bonds at times of stress (the classic "safe haven" trade), we suspect these developments will lead to greater differentiation among global investors, particularly in relation to sovereign bonds.

The obvious question most investors will ask is how safe is their US Treasury portfolio? And if it is judged to be more risky, what are the alternatives? Thankfully, New Zealand stands out among the alternatives. We have our fiscal challenges - there is no doubt about that. But when you compare New Zealand's significantly better starting point, lower overall government debt profile, and Finance Minister Bill English's commitment to returning to surpluses; against other countries, we look good. Indeed, New Zealand was one of a handful of governments that were running surpluses before the GFC, and while the deficit will blow out this fiscal year courtesy of a natural disaster (which is quite distinct to fiscal largesse), there is a plan in place to return to surplus by 2015/16. This requires some tough political choices but when you eye policies (or sacred cows) that are now being looked at (i.e. student loans, legal aid. Working for families, the family court), the Government looks prepared to make some hard choices, and has the mandate (polling) to do it. By contrast, the US has no stated intention to ever return to surplus, and many European governments are focussing on getting deficits back within the 3% Maastricht limit. Similarly, whereas Europe is focussing on getting government debt back to 60% of GDP, New Zealand is already well below that level. Moreover, all these nations face far greater populist sentiment which makes the process of austerity all the more difficult.

The point is, it's easy to get carried away and to over-emphasise the impact of the earthquake and the Crown's fiscal challenges, but just about every country has fiscal challenges. The difference here is that we are doing something about it, and our better starting point and our world best practice arrangements (things like an independent central bank, fiscal transparency, zero corruption) and floating exchange rate mean we have more flexibility in relation to others. By comparison then, we are extremely well placed. With roughly twice as many New Zealand government bonds in the market than there were 2 years ago, the irony is that this has led to an increase in liquidity, making New Zealand a ripe market for international investors, particularly those that buy into the terms

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of trade boom that has the potential to deliver Australian style income growth over the next few years. If this occurs, as confidence in the US fiscal position is eroded, New Zealand may find itself a quasi safe-haven market, and if it does, that will help keep a lid on New Zealand longer term interest rates. Sound far fetched? Well, it might be if you're used to trading New Zealand as a risky peripheral market. But if you step back, throw away all your pre-conceived notions and look at the hard facts, on paper, markets like New Zealand (and Australia) compare extremely well. Especially if you think the commodity price boom still has some way to run yet.

BREAKEVENS AND FAIR VALUE

Interesting as it is to ponder where New Zealand stands in an international line-up for investors, the task at hand for many borrowers is to get a handle on where value lies on the yield curve – after all, borrowers need to choose some point on the curve to borrow off. In what follows we use two different types of analysis. The first are a simple set of breakevens (analogous to forward rates) that show where future interest rates need to be in future in order to justify a decision to hedge today. We present the results of this analysis in the first table below. They illustrate the trade-off between wanting to hedge ahead of rate rises and the slope of the curve. For example, the term structure of interest rates assumes the 3 year swap will rise from its current level of 3.91% to 4.88% in 1 year, then up again to 5.63% in 2 years, and then on to 6.10% in 3 years. Those are hefty increases, yet that's what you'd be endorsing if you paid fixed at these levels. Because all tenors step up steeply for all forward periods, you need to be very confident that rates will rise quickly before you go hedging. This is why we are somewhat less enthusiastic about adding to hedges, despite our view that the overall level of rates will rise in time to come.

Swap breakevens (forward rates)						
Swap	Now	In 1yr	In 2yrs	In 3yrs	In 4yrs	In 5yrs
1yr	2.83	3.95	5.06	5.69	6.17	6.40
2yr	3.38	4.49	5.38	5.93	6.28	
3yr	3.91	4.88	5.63	6.10		
4yr	4.34	5.18	5.80			
5yr	4.67	5.40				
6yr	4.90					

Sources: ANZ, Bloomberg

The second table presents what are probably best described as "floating rate fair value" estimates. That is, we use our forecasts for floating interest rates to compute a set of fair values, assuming our forecasts eventuate. The problem, of course, with this approach is that most people, including ourselves, only forecast out to around 3 years, which makes it impossible to generate fair values for longer tenors. Nonetheless, it is useful to do the analysis to get an "anchor" for short end rates. And what it shows at the moment is that market rates are pretty close to where they ought to be given our forecasts, suggesting an absence of "value" at the short end of the curve. It is interesting to note that 2 and 3 year swap rates are above where they should be given RBNZ projections – but as the Governor hinted at the time the projections were released, they were a technical assumption, and given how quickly the situation was changing in March, you certainly wouldn't want to hang your hat on them, so to speak.

Current rates and fair values			
Rate	Current Market Rate	Fair Value with Our Forecasts	Fair Value with RBNZ Forecasts
6mth BKBM	2.64	2.62	2.71
1y Swap	2.83	2.82	2.81
2y Swap	3.38	3.41	3.33
3y Swap	3.91	3.92	3.72

Sources: ANZ, Bloomberg

CAP PRICING

Interest cap pricing remains reasonable, particularly when compared to the cost of "climbing" up the yield curve to fix. Indeed, the 5 year swap is over 200bps higher than the floating rate. Instead of paying away the slope of the curve to fix, it makes more sense to pay option premium in favour of some upside protection, while continuing to enjoy low floating rates. Of course, this comes at a cost (the premium), but if rates stay low, you will recoup some (or all) of your premium, but if they rise, you'll still be protected.

Consider the table below, which has indicative pricing for caps for various maturities with strikes at the money (ATM) for each swap, 25bps above the market (ATM+25), and 50ps above the market (ATM+50). As the table shows, premiums remain competitive relative to the slope of the curve.

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Selected Cap premiums (basis points per annum)			
Term/Strike	ATM	ATM+25	ATM+50
2 yr	46bps	32bps	22bps
3 yr	66bps	49bps	37bps
4 yr	79bps	61bps	47bps
5 yr	88bps	69bps	54bps

Sources: ANZ

For example, instead of paying 127bps above BKBM at the moment to be fixed for 3 years, you could spend 49bps on a 3 year option with a strike at 25bps above the current market (i.e. at 4.16%). This doesn't offer as much protection as a classic hedge (the strike is 25bps higher, and the premium is 49bps), but the flip side is, you continue to pay BKBM whenever it's below 4.16%, and right now, that will save you 127bps compared to being fixed.

DEALING ROOM CONTACTS:

Auckland 09 377 9450 / 0800 730 100

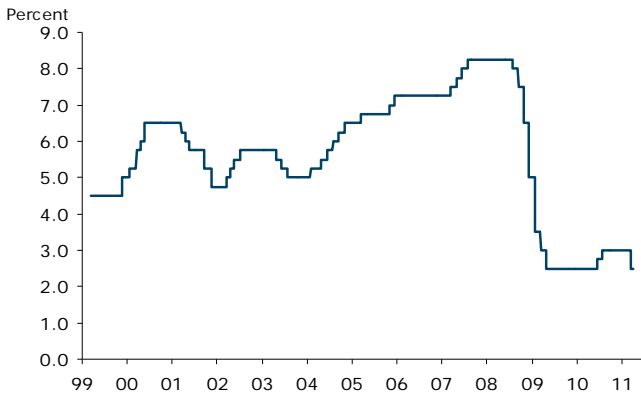
Wellington 04 471 0030 / 0800 445 088

Christchurch 03 364 5335 / 0800 269 261

CHARTS

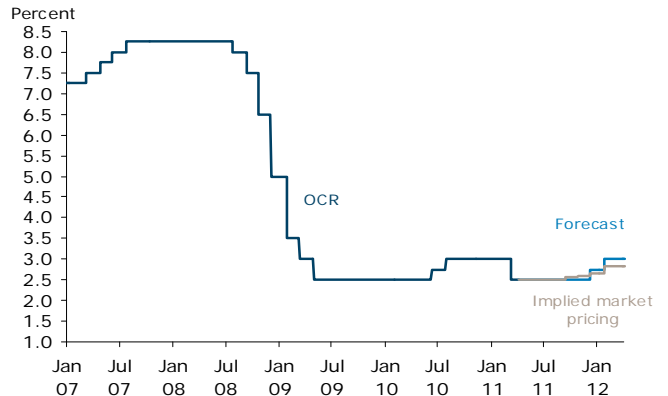
CHARTS

Official Cash Rate



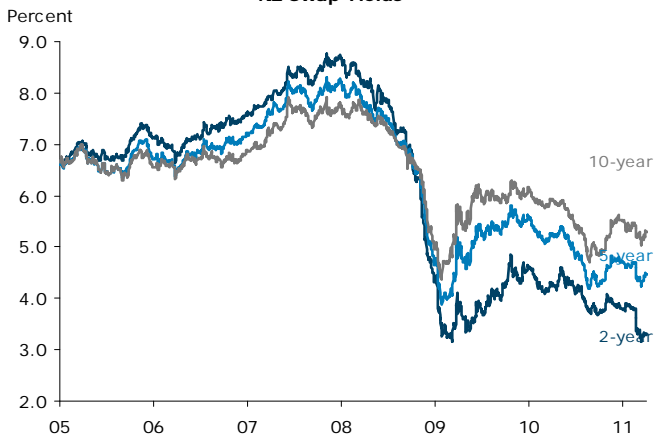
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



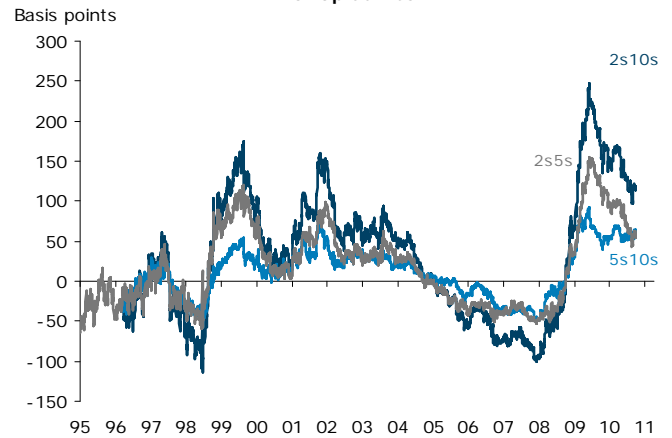
Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



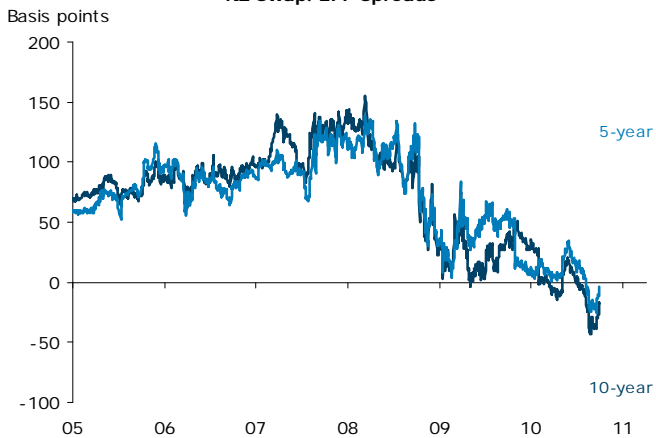
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



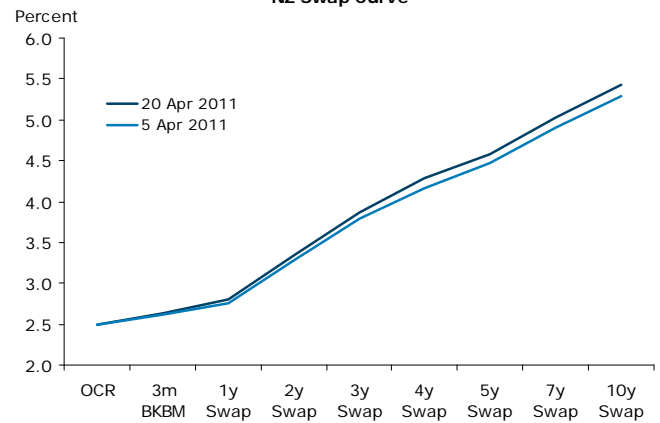
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

NZ Swap Curve

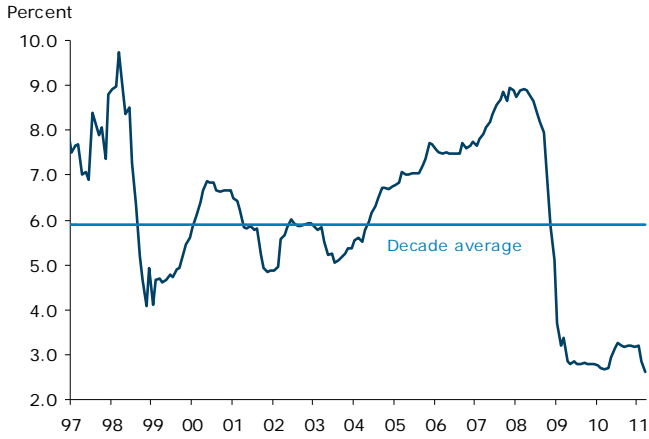


Sources: ANZ, National Bank, Bloomberg

CHARTS (END OF MONTH)

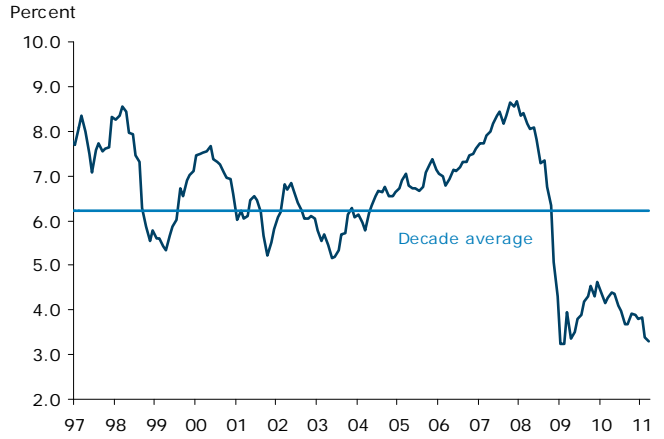
CHARTS (END OF MONTH)

3-month BKBM



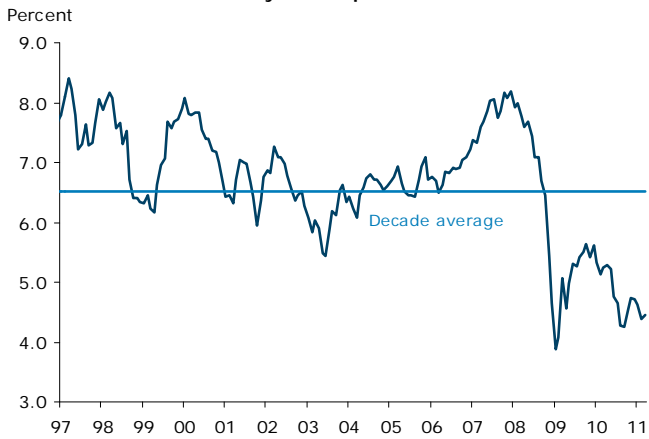
Sources: ANZ, National Bank, Bloomberg

2-year Swap Yield



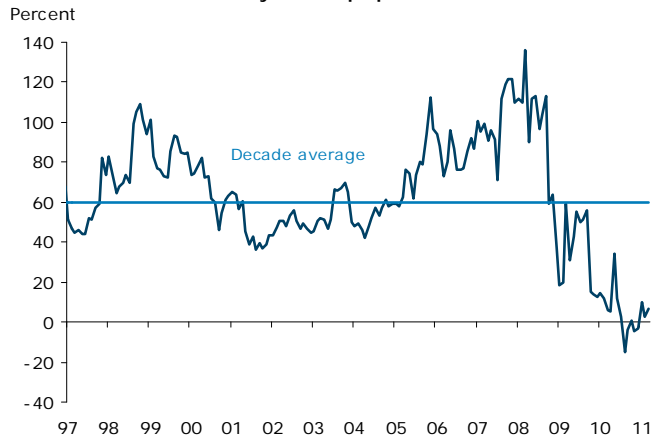
Sources: ANZ, National Bank, Bloomberg

5-year Swap Yield



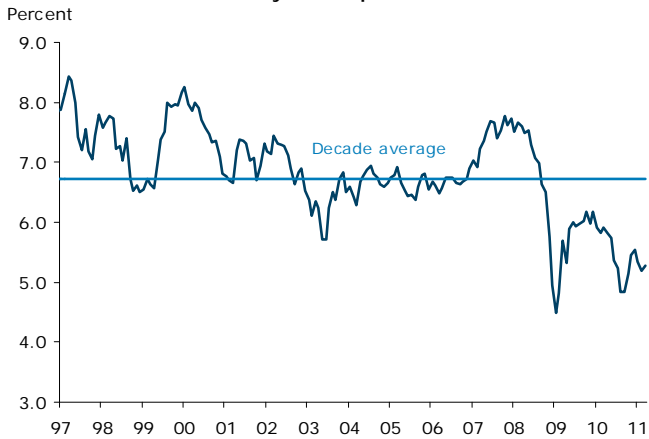
Sources: ANZ, National Bank, Bloomberg

5-year Swap Spread



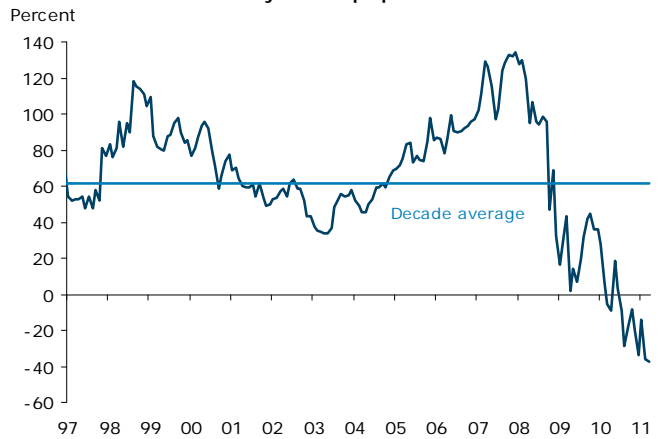
Sources: ANZ, National Bank, Bloomberg

10-year Swap Yield



Sources: ANZ, National Bank, Bloomberg

10-year Swap Spread



Sources: ANZ, National Bank, Bloomberg

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