

# NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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## CONTRIBUTORS

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## ECONOMIC OUTLOOK

The outlook for the economy remains subdued, with growth likely to be well below par for the remainder of 2010, before recovering somewhat in 2011. One-offs like earthquake rebuilding and the Rugby World Cup will be influential, as will be buoyant global growth, particularly in Asia. However, the domestic economic outlook remains constrained by deleveraging, the likelihood of further mild falls in house prices, and a lack of investment and hiring. Standard & Poor's recent decision to put NZ's AA+ credit rating on negative outlook is a timely reminder that the Government's choices are constrained, and that has implications for growth and the monetary policy response (read: fewer rate hikes). We're not out of the woods yet.

## RATE VIEW

The RBNZ remains on the sidelines, with the next rate hike at least 6 months away. Furthermore, the RBNZ has reiterated that "low interest rates are having a less stimulatory effect than in the past", which is their way of saying that the OCR will rise more gradually, ultimately reaching a lower end point. With near term economic data likely to be soft (particularly Q3 GDP, which will be a small positive, or possibly even negative) and investors looking to put their money to work over the holiday period, we expect short end rates to be under continued downward pressure. However, the long end is a different story, and is being held up by rising global rates. US interest rates have been particularly influential, having snapped higher recently following the news that the Obama administration had agreed to extend the Bush era tax cuts. This not only places more pressure on the US's already massive fiscal deficit, but raises US growth prospects, which are both a negative for bonds, and by implication, long end NZ interest rates.

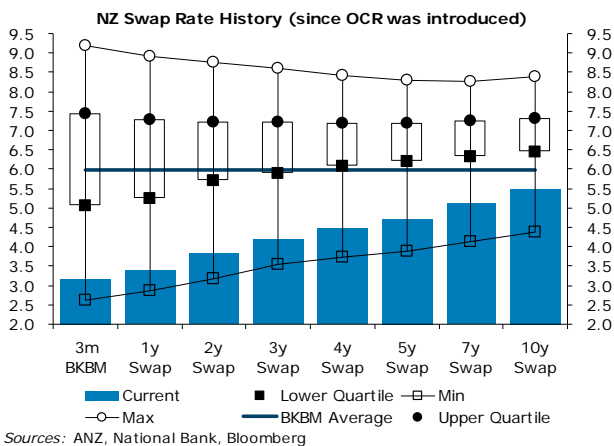
## STRATEGY

The economic and monetary policy outlook is strongly suggestive of remaining on floating, and maintaining exposure to what must be regarded as stimulatory interest rates. However, no matter how cautious the outlook looks now, we need to be mindful of how quickly positive surprises (look back a year) and negative surprises (look back the last 6 months) can grip markets. As such, it is prudent to have some protection in place, and caps are the most sensible option. The slope of the curve does make caps more expensive than they would be if the curve was flat, but it also makes paying fixed very expensive. Instead of paying a premium to fix, we favour paying a premium to have cap protection. We also reiterate comments made in our previous edition about using the changing slope of the yield curve as a way to reduce interest expense by shortening the duration of existing hedges, and incorporating any mark to market gain in the remaining term of the swap. However, this is only suitable for active risk managers, and within sensible overall hedge ratios.

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## VALUATION

The steepening of the yield curve that started in November has gathered momentum over the past week. This has occurred as a result of the short end being held down by expectations of a cautious RBNZ MPS (which have been validated) and the long end moving higher in line with global yields, which have been thumped by the so-called bond vigilantes (who have little tolerance for fiscal largesse). The steeper curve just deepens the borrower's conundrum, as it makes term fixing even more expensive. But there's more to it than that ...



## HOW DO INTEREST RATES COMPARE TO RBNZ PROJECTIONS?

Today's RBNZ MPS was more dovish than the market expected. Indeed, they expect house prices to fall a little more, and jobs growth to be muted, which will have a knock on effect on demand. This is, in a nutshell, exactly what's driving the massive consumer deleveraging we have observed this year, and when you combine that with the possibility of a drought this summer, and an ongoing lack of investment, the outlook is hardly a bright one. There are positives though, most obviously, strong rise in commodity prices. But as the RBNZ points out, this is not without its risks. Indeed, global economic growth may start to deteriorate. We may also see house prices fall by a little more than the RBNZ has forecast, producing what they have termed "asymmetric" risks, which "cannot be ignored".

Not surprisingly, the RBNZ lowered its 90-day bill rate projections. The market has yet to fully embrace these, with short end yields a little higher than the RBNZ's bill track implies, as the table below shows. We suspect it will only be a matter of time before rates adjust lower, particularly if next week's Half Year Economic and Fiscal Update is "tight". Indeed, fiscal policy is in a credit rating constrained virtual straight jacket, and that puts more pressure on monetary policy. But the thing that could really see rates fall is if investor demand for running yield (or "carry" as it is known in the trade) over the holiday period picks up. This could have a significant downward impact on short end yields, particularly if Q3 GDP (due December 23) is soft.

Current interest rate levels		
Maturity	3 weeks ago	Current
3-mth BKBM	3.16	3.16
1-year swap	3.55	3.40
2-year swap	4.03	3.81
3-year swap	4.35	4.19
4-year swap	4.62	4.48
5-year swap	4.83	4.73
7-year swap	5.15	5.10
10-year swap	5.47	5.48

Market expectations for RBNZ OCR (bps)		
OCR Dates	2 weeks ago	Current
Thu 9-Dec-10	+0	+0 (actual)
Thu 27-Jan-11	+4	+1
Thu 10-Mar-11	+13	+3
Thu 28-Apr-11	+27	+4
Thu-9-Jun-11	+40	+20
Thu-28-Jul-11	+53	+40
Thu-15-Sep-11	+69	+48

Rate and Period	90-day Bill	1yr Swap	2yr Swap
Current Market Rate	3.16%	3.40%	3.81%
Rate for Dec 2010 implied by RBNZ MPS	3.20%	3.39%	3.70%
Rate for Mar 2011 implied by RBNZ MPS	3.25%	3.53%	3.84%
Rate for Jun 2011 implied by RBNZ MPS	3.43%	3.69%	3.98%

## THE CONUNDRUM

At its most basic level, hedging is a choice between fixed and floating. Being fixed affords certainty, whereas being floating leaves one exposed to fluctuations in rates (and more recently, margins too). When the curve is inverted, hedging is pretty easy, and as many borrowers discovered over the

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pre-GFC period, term hedging often saved money and increased certainty, in what many borrowers might regard as a perfect match. Things get slightly more strategic when the curve is slightly positive, but for many borrowers, this is fairly manageable, and many are happy to pay a small premium to fix for a term. In fact, this is so intuitive that academics have even attempted to use this logic to explain the "normal" term structure of interest rates.

However, things start to get really tricky when the curve has a steep upward slope to it, as it does at the moment. As the curve steepens, the trade-off between certainty and cost becomes increasingly skewed in favour of remaining floating. This would be bearable if the floating rate was perceived to be near the top of the rates cycle, but when it's perceived to be near the bottom (as it is now), it might not stay low. In other words, the more attractive the floating rate, the more likely it is to rise. In a nutshell, this is the current conundrum facing borrowers.

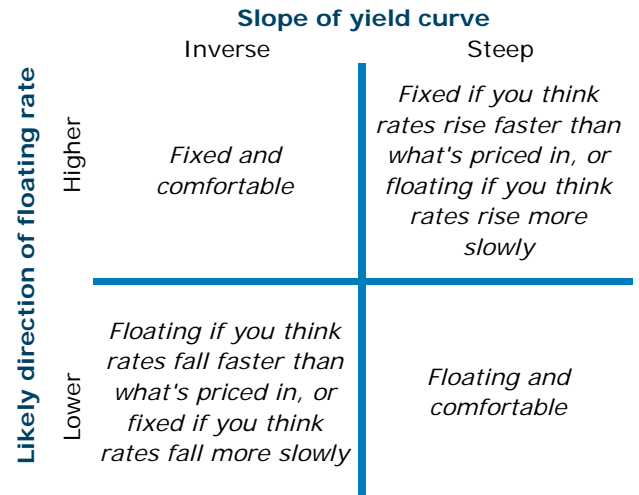
But is the conundrum something we can live with? Maybe it is, particularly if everyone comes to the same conclusion, and stays on (or rolls into) a floating rate, which is pretty well what's going on. RBNZ data shows that the proportion of mortgage borrowers on floating is now as high as it has ever been (since the OCR was introduced). The more this happens, the more sensitive borrowers are to rate rises, the less the RBNZ needs to raise rates, and over time, a sense of trust begins to form. In fact, this notion has been at the core of RBNZ communications all year, and the Bank again reiterated it today, noting that "interest rates are now projected to rise to a more limited extent", and "household and business caution suggests current low interest rates are having a less stimulatory effect than in the past".

With floating rates less likely to rise (or rise by as much), this effectively softens one stress factor in the conundrum. That said, not everyone has the ability to stay floating, and there is still something to be said for certainty. But we think caps make more sense than being fixed.

### FORECASTING AND JUDGEMENT

The thing is, borrowers face different conundrums at different times, and although the real world is infinitely more complex than a quadrant, it is useful to distil the basic issues down, and present them in a diagram, as we have done below. It's certainly a

useful way of presenting the different issues and choices that arise at different points in time.



Looking at the quadrant, what becomes immediately obvious is that forecasting matters. Observing the slope of the curve (i.e. if you're on the left or the right of the quadrant) is easy and a matter of fact. But if we don't forecast, then we don't know whether we're on the top or bottom half of the quadrant.

The next thing that stands out is that sometimes the decision is obvious, like when you think rates will fall and the curve is steep, or you think rates will rise and the curve is inverted. However, an element of judgement is required if the curve is inverted and you think rates will fall, or when the curve is steep and you think rates will rise. And that latter situation is exactly where we are now. Right now we need to be good at forecasting, and have good judgement.

Having pointed all that out, where's this going? In short, the current form of conundrum is one that is strongly supportive of caps. Indeed, at the moment, you not only need to be able to forecast direction, but magnitude too. We think we're reasonably good at forecasting direction, and not bad at forecasting magnitude. Without inviting a fight, we certainly don't think we're worse than anyone else, and at the risk of pumping our own tyres, we think we've called the rates outlook pretty well this year.

But it doesn't matter who you are, the further out a forecast, the larger the scope for error. And if you want to get an idea of how badly "the market" was forecasting the outlook a year ago, consider the

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table below (taken from the last issue of the *Borrower's Strategy* in 2009 – a year ago). Check it out. As the top table shows, the OCR was forecast to be 199bps higher by October this year, yet the RBNZ actually only raised rate by just 50bps (and that looks like it was too much!). That's a massive error, overstating rate hikes by a factor of 4.

The bottom table below shows a similar tendency. For example, if you paid fixed for 3 years last December, you would have paid 5.06%. Right now, that swap has 2 years left to run, and the current 2 year rate is just 3.80%. Again, that's a staggering difference. Had you been capped or floating, you'd have paid an average rate of around 2.95% over the past year (instead of 5.06%), and if you take the RBNZ's 90 day rate forecast from today's Monetary Policy Statement as a guide, you can expect to pay an average floating rate of around 3.7% for the next year. These kinds of errors can put businesses at risk, hence our preference for caps.

Market expectations for RBNZ OCR (bps) (from the 16 December 2009 <i>Borrower's Strategy</i> )		
OCR Dates	Expectations in Dec 2009	What actually happened
Thu 28-Jan-10	+4	+0
Thu 11-Mar-10	+23	+0
Thu 29-Apr-10	+42	+0
Thu 10-Jun-10	+89	+0
Thu-29-Jul-10	+119	+25
Thu-16-Sep-10	+164	+50
Thu-28-Oct-10	+199	+50

Interest rate levels (from the 16 December 2009 <i>Borrower's Strategy</i> )		
Maturity	Market in Dec 2009	Where that rate* is now
2-year swap	4.54	3.40
3-year swap	5.06	3.81
4-year swap	5.34	4.19
5-year swap	5.51	4.48
7-year swap	5.75	4.93
10-year swap	6.00	4.36

\*After 1 year has elapsed. (i.e. if you entered a 5 year swap a year ago, it would now be a 4 year swap)

### STICK WITH CAPS

If it was purely a decision between fixed and floating at the moment, you'd only need to read the first few paragraphs of today's RBNZ Monetary Policy Statement to realise that floating is the obvious choice for now. In fact, although they didn't explicitly state it, we suspect that's precisely the message they want to get out to the public at large, building on that growing trust we mentioned earlier.

However, hedging is all about risk management, not punting, and our analysis of how wrong the market was a year ago is testament to what can happen when forecasts go wrong. As such, we think it makes much more sense to consider caps. 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. 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), and at 4.50%, 5.00%, 5.50% and 6.00%. The premiums may look high, but when you consider them in relation to the spread between the fixed rates for each period against the current BKBM rate, they look considerably more attractive.

Selected cap premiums (basis points per annum)					
Term/Strike	ATM	4.50%	5.00%	5.50%	6.00%
2 yr	44bps	24bps	16bps	11bps	7bps
3 yr	59bps	47bps	34bps	24bps	17bps
4 yr	69bps	66bps	49bps	36bps	26bps
5 yr	76bps	83bps	63bps	48bps	35bps

For example, instead of paying 102bps above BKBM at the moment to be fixed for 3 years, you may wish to spend 34bps on a 3 year option with a strike at 5.00%. As we noted in our last edition, caps don't offer as much upside protection as paying fixed (the strike kicks in 81bps higher than the market), but you do get to participate in the downside, and that's significant at the moment. We know, for instance, that the rate on the option for the first quarter will be 3.16% (today's BKBM rate). Assuming the 90-day bill rate rises in line with the RBNZ's projections over the next 3 quarters, the

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next 3 rolls will be 3.26%, 3.43% and 3.60%. That's an average of 3.37% for the first year, or a saving of 82bps versus the fixed rate. Having saved 82bps for the first year, that's "paid for" 2 years worth of premium at 34bps per annum, making the breakevens on the options look very attractive over the remaining two years. For a full discussion of caps, see our publication titled *Managing the Cost of Caps, Part 1* (available on request).

### SHORTEN AND REDUCE

It is also worth reiterating comments made in our last edition about using the significant steepening of the curve as a potential opportunity to shorten cover and take profit on some longer term hedges. This kind of strategy can add some real value, but it is only suited to active risk managers, and we must stress that it's not for the faint-hearted, and should only be engaged in within comfortable hedge ratios. We'd also add that given the rates outlook, we'd only advocate doing so with a view to adding to cover following what we expect to be a rally into Christmas.

To give an idea of what's possible, if for example, you paid fixed for 7 years a month ago, you would have paid a rate of around 4.88%. Now that the curve has steepened, the 2 year swap starting in 5 years has risen to around 6.23%. If you wished to shorten the original swap by 2 years, you could do so, and shave a little over 50 basis points off the original swap (which would now be a 4 year 11 month swap). This would leave you with a swap with a little less than 5 years to run at a rate of around 4.3%.

### LAST EDITION FOR 2010

This is the last edition of the *Borrower's Strategy* for 2010. We would like to thank our clients for their readership over the year, and we look forward to resuming production in mid January. We hope you have a safe, enjoyable and relaxing festive season!

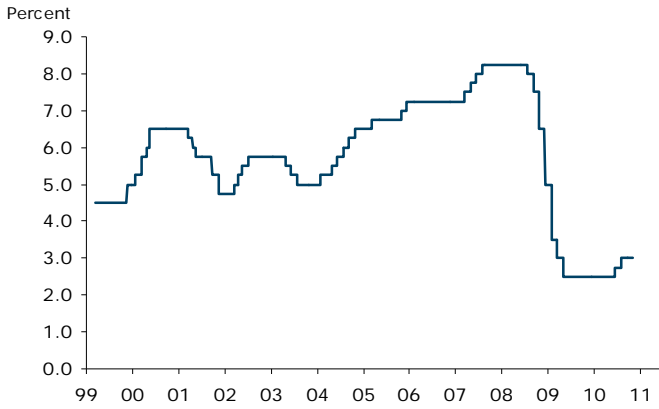
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# CHARTS

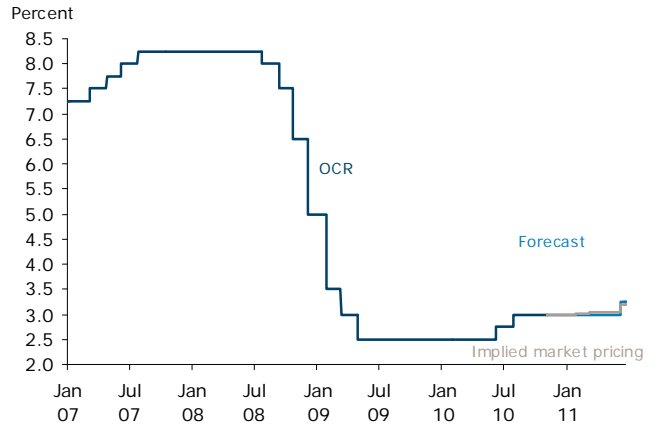
## CHARTS

**Official Cash Rate**



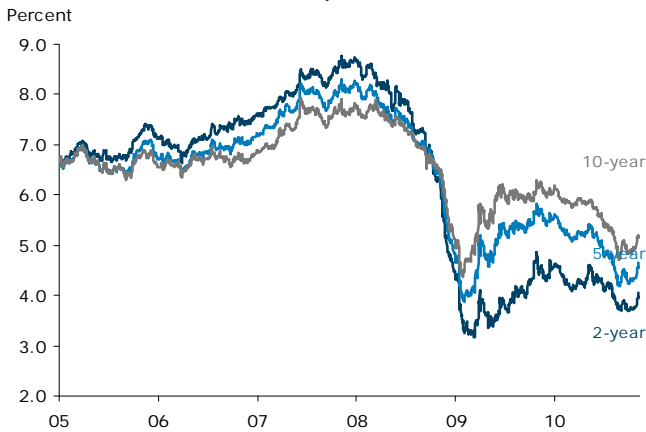
Sources: ANZ, National Bank, RBNZ

**OCR and market pricing**



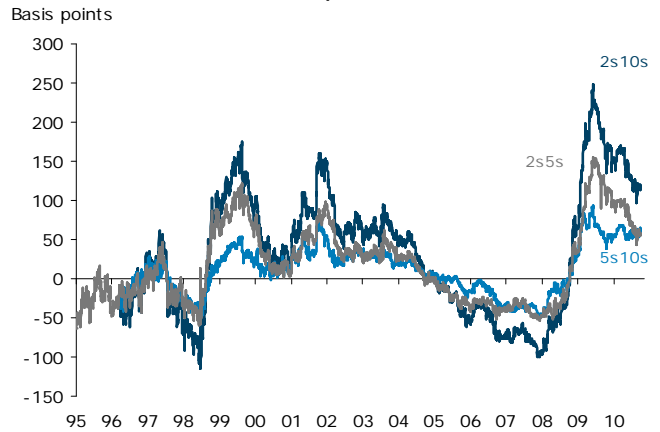
Sources: ANZ, National Bank, RBNZ, Bloomberg

**NZ Swap Yields**



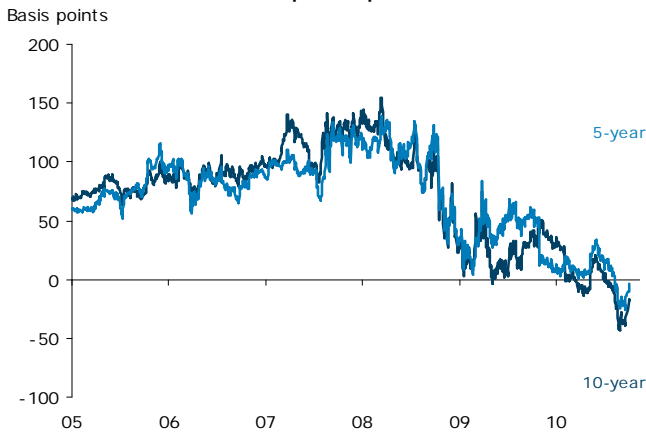
Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curves**



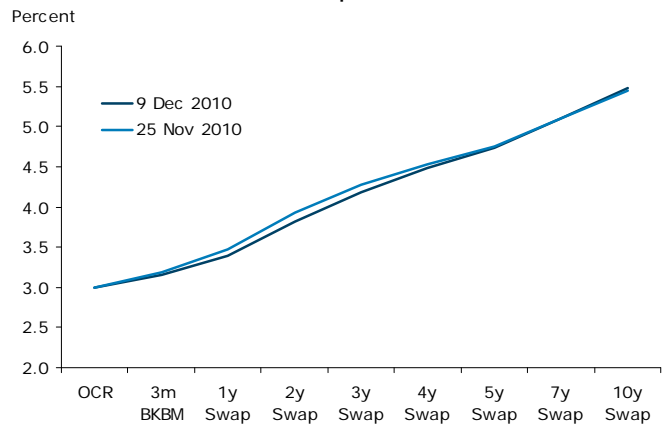
Sources: ANZ, National Bank, Bloomberg

**NZ Swap/EFP Spreads**



Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curve**

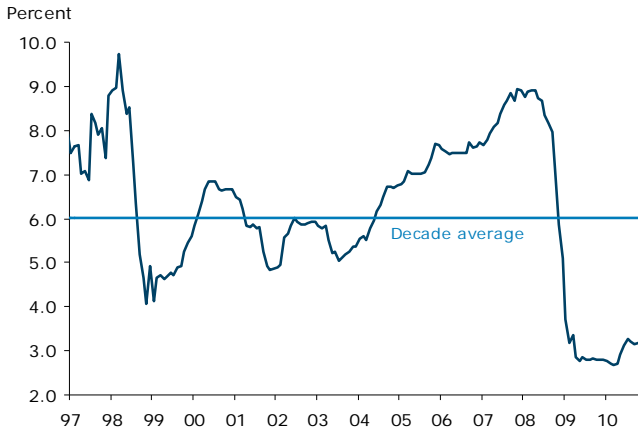


Sources: ANZ, National Bank, Bloomberg

# CHARTS (END OF MONTH)

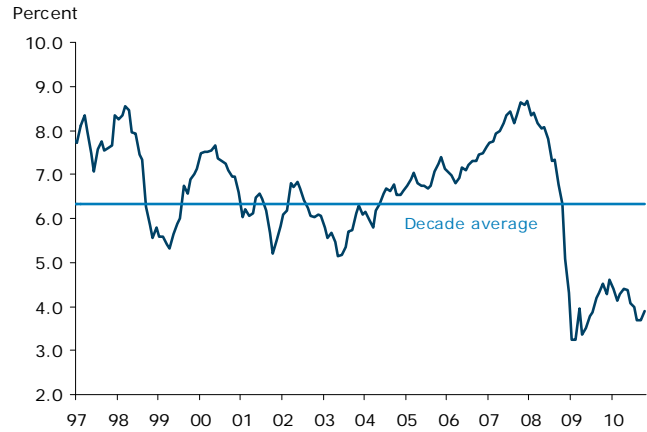
## CHARTS (END OF MONTH)

**3-month BKBM**



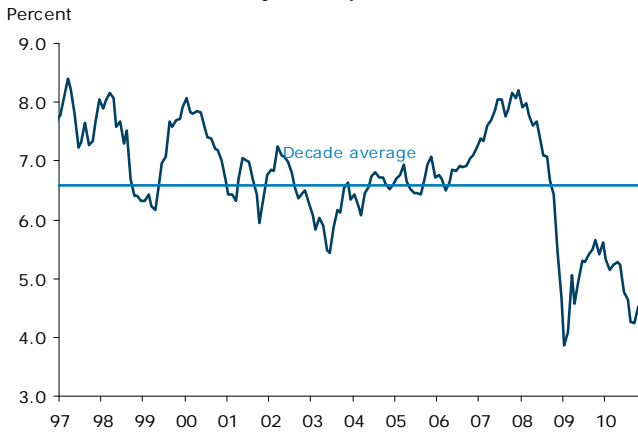
Sources: ANZ, National Bank, Bloomberg

**2-year Swap Yield**



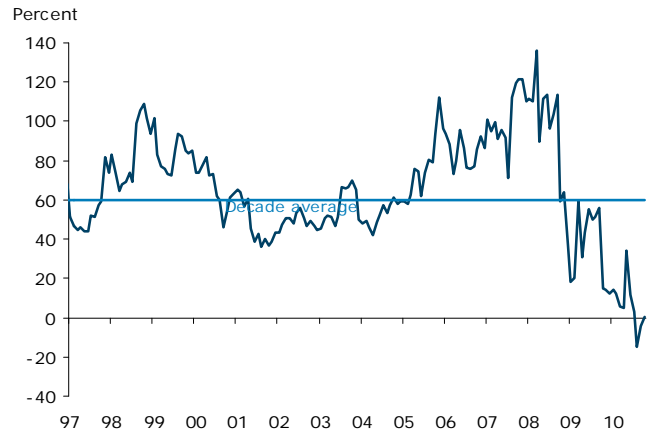
Sources: ANZ, National Bank, Bloomberg

**5-year Swap Yield**



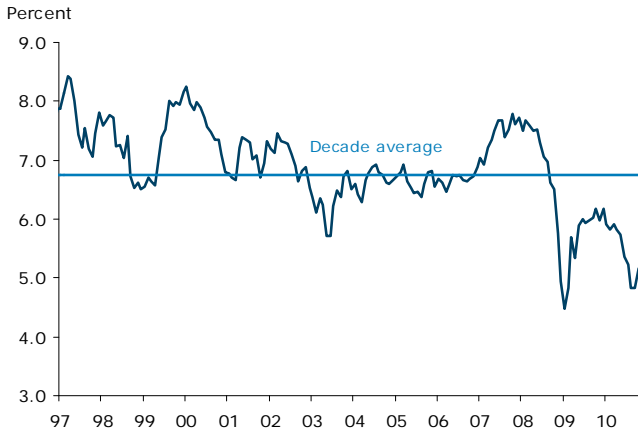
Sources: ANZ, National Bank, Bloomberg

**5-year Swap Spread**



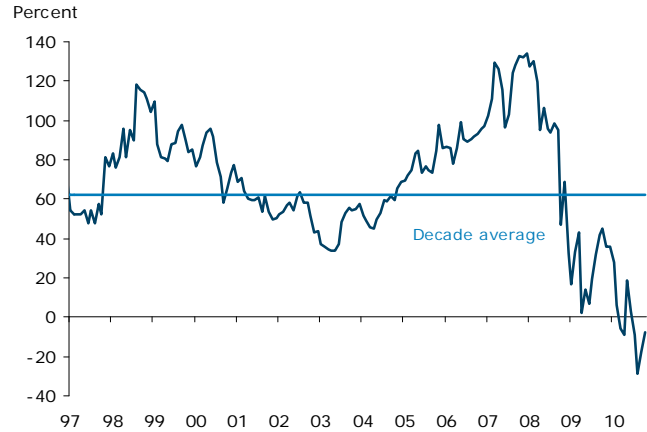
Sources: ANZ, National Bank, Bloomberg

**10-year Swap Yield**



Sources: ANZ, National Bank, Bloomberg

**10-year Swap Spread**



Sources: ANZ, National Bank, Bloomberg

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## IMPORTANT NOTICE

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