

# NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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## CONTRIBUTORS

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## ECONOMIC OUTLOOK

The economic outlook for the remainder of 2010 remains subdued, with household sector data continuing to disappoint as deleveraging and balance sheet repair weighs on domestic demand. However, the recent dataflow has not been one-way traffic, with improving domestic business sentiment and improving leading global indicators positive signs. Stronger labour cost figures combined with today's better unemployment figures are a reminder that capacity pressures could emerge quickly. Conditions for a more robust upswing for 2011 are moving into place, as the boost to incomes from high export commodity prices and the continued recovery in the labour market gradually filters through the economy. Growth will also be supported by supportive financial conditions, earthquake rebuilding, RWC related activity, and a broadening in the global recovery.

## RATE VIEW

It seems clear from the subdued market reaction to the US Federal Reserve's second instalment of quantitative easing (QE II) that it was fully priced in. Indeed, the bond market failed to rally despite getting what it wanted. This leaves us wondering what it will take to drive rates substantially lower, and highlights the scale of anticipation. We have not changed our RBNZ forecasts or view of NZ interest rates on the back of QE II, and we are not likely to. A market that had pushed too far is always going to be vulnerable to recoil. We need to be mindful that QE II is a positive development in so far as global growth goes, and it adds to inflation risks, which are already elevated among key emerging market trading partners. As such, we remain of the view that interest rates remain biased upward over the medium term. However, prepare for more volatility. Indeed, bonds are now the primary monetary policy instrument, and the large scale purchase of them prevents them from being able to respond to the threat of inflation down the track. Event risk will be considerable as we look to future FOMC meetings. US labour market statistics will be crucial over the coming months and particularly into the first quarter of 2011.

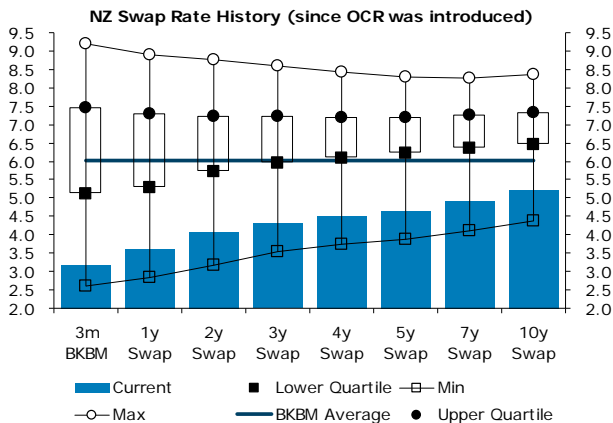
## STRATEGY

Readers will ideally already be well hedged if they have shared our views in relation to the opportunities that QE thrust on the local market. Indeed, our NZ growth forecasts are above-consensus for 2011 and we believe the market has mildly underestimated the degree of RBNZ tightening that's in store. Given this, and the unusual impact expectations of QE was having on local rates, we felt it was appropriate to be well hedged. We remain of this view, and favour having at least some cover on at the moment in case the recent run up in rates is sustained. However we do not advocate chasing the market too far – as with past episodes, the market has a tendency to come back after violent spikes higher.

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## VALUATION

Swap rates have moved up substantially since the last edition of the *Borrower's Strategy* a fortnight ago. Although the 3mth rate has held steady, both the 2 year and 3 year swap are now above 4%, and the 10 year is above 5%. The resultant "bear steepening" of the yield curve is an unwelcome development for borrowers – not only does it make fixed rate hedging more expensive in outright terms, but with the floating –fixed spread increasing, it makes the conundrum of whether to fix or not that more difficult to resolve.



Sources: ANZ, National Bank, Bloomberg

### Current interest rate levels

Maturity	2 weeks ago	Current
3-mth BKBM	3.18	3.18
1-year swap	3.43	3.60
2-year swap	3.77	4.06
3-year swap	3.98	4.32
4-year swap	4.16	4.51
5-year swap	4.32	4.65
7-year swap	4.63	4.92
10-year swap	4.92	5.21

### Market expectations for RBNZ OCR (bps)

OCR Dates	2 weeks ago	Current
Thu 9-Dec-10	+1	+2
Thu 27 Jan-11	+4	+5
Thu 10-Mar-11	+9	+14
Thu 28-Apr-11	+23	+28
Thu-9-Jun-11	+30	+46
Thu-28-Jul-11	+47	+61
Thu-15-Sep-11	Not projected	+77

## QE II PASSES LIKE A SHIP IN THE NIGHT

Market anticipation of the US Federal Reserve's announcement of its second quantitative easing programme (QE II) had reached fever pitch over the last few weeks. However, in the event, the Fed's announcement earlier today came and went like a ship passing in the night, with very little immediate reaction in the market. This is probably the key take-out for most borrowers in that it is something of a relief that the event has not added to volatility. In our view, this largely stems from the fact that the Fed delivered on market expectations. Indeed, at \$600bn, the size of the programme was at least as large as what the market was expecting (the consensus was for something around US\$500bn). The Fed also announced that bond purchases under the programme would be spread out over the next 8 months, and would target Treasury bonds with maturities right across the yield curve. Perhaps more importantly, the Fed has stated that it intends to regularly review the size of the programme as information comes to hand. In other words, the programme is up for review at each upcoming FOMC meeting. Labour market development will be key and take on special importance going forward.

We don't intend getting bogged down on the detail of the Fed's announcement – we'll leave that to the experts on the ground. But we will make four observations:

- The size of the QE II programme is open ended, in that the size of it is up for review at each upcoming FOMC meeting. Purchases will also be spread out over a number of months. This gives the Fed massive flexibility, and dramatically increases its chances of success, the implication being that if it doesn't succeed, the FOMC will just "upsize" the programme until it does. Similarly, if inflation does pick up, the Fed might downsize the programme – then where would bond yields be?
- Don't lose sight of one half of the reason why the Fed has adopted QE again – and that's to ensure that inflation rises. The Fed has a dual mandate – maximum employment and price stability, and the last time we looked, pursuit of better levels of both tend to be something the bond market dislikes with a passion.
- Having had its expectations satisfied, US bond yields have failed to rally further. In fact, some bond yields (like 30 year Treasuries) rose. This strongly suggests that QE II was fully priced in. Given the Fed's commitment to do what it takes, we wonder what it would take to drive yields lower. We think that broadly speaking, we have seen the lows.

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- Finally, the more successful the Fed is, the more quickly global growth recovers, the greater the impact will be on New Zealand.

That said, the near term outlooks for US interest rates remains benign, but that's mainly because long term interest rates are now the monetary policy instrument. But things are far less rosy as we look further down the track. Indeed, as we have maintained for weeks now, we urge readers not to lose sight of the bigger picture – which is one of a faster than otherwise recovery in US growth and increased inflation risks. We have not changed our forecasts for the RBNZ on the back of QE II, and we have no plans to do so any time soon. But we would concede that at the margin, it will add more pressure on the RBNZ to raise rates. This is not only a global growth story, but also an inflation one. This is hardly a benign environment for bond yields. However, in the near term, the picture is "corrupted" by the fact that there's a big buyer of bonds in the market- in the form of the Fed on behalf of Uncle Sam. But once this is over, where would bond yields be? A lot higher, we suspect. Indeed, as we noted last week, real 10 year government bond yields are negative in a number of key Asian trading partners. Similarly, US 5 year inflation protected Treasury yields are also negative. As an Irishman once said, Achtung baby!

### COMPLACENCY

Few would have expected it, but today's NZ HLFS employment data had a much larger impact on the market than the Fed announcement did. We won't go into detail about the jobs data here (see our *Review* for an in-depth analysis), other than to say that the 1.0% rise in employment and fall in the unemployment rate to 6.4% was stronger than what the market was expecting. But it wasn't *that* strong to foster a fundamental rethink from the RBNZ, and the circa 9bps jump in the 2yr swap rate certainly seems like an over-reaction. Or was it? As a reaction to the data alone, we do think it was a bit extreme. But when you consider how complacent market expectations for monetary policy had become, it's easy to understand why things moved so far. Indeed, our analysis prior to the data shows that the market was pricing in just 14bps of tightening by March, and a further 14bps by April. Or put another way, the market had just one RBNZ rate hike priced in by April, and was hedging its bets as to whether it would be in March or April. We have always felt these odds were a bit light – not only do we see March as the likely date

of the next rate hike, but we also see a higher end point than what the market is pricing in. Just as the market got overly "beared up" on interest rates after the June rate hike, it had gotten overly "bulled up" after the September pause. We now look set for some reciprocal recoil from extended valuations.

Indeed, the latest run up in swap rates looks like it may have a little further to go yet. Flow and positioning can play havoc in the New Zealand market when liquidity is absent. This raises the risk that rising yields become self-sustaining in the near term. At this stage it's not something to panic about, and in fact we suspect upside momentum will fade into Christmas and after the dust settles, the likelihood of further patchy data will still provide a reality check. Indeed, we suspect that the very fact that swap rates have risen so sharply (2yr swap rates are up around 30bps in the past week) will spur some hedgers into action. We'd expect to see a similar dynamic if we see higher swap rates spill over into mortgage rates, adding further pressure on the swap market.

But while we would not panic about the recent rise in rates, equally, we are struggling to imagine what sort of news might drive NZ rates materially lower again. As regular readers will be aware of, we have long held the view that this current episode (i.e. the low rates environment of the last two months) was something of an opportunity for borrowers. We're still of that view, and we hope some of our readers took advantage of the low rates that have been available lately. If you haven't, our preference is to at least get some cover on board, in case this run up becomes self sustained. But we wouldn't go chasing things too far, particularly given how far the market has moved in the past week or so.

### STRATEGY

QE II has come and gone with very little reaction. We view this as a positive, and at the risk of speaking too soon, given the massive move lower in bond yields in anticipation of it, we always thought another big push lower was a bit far-fetched. As such we can be thankful the Fed didn't disappoint, which would have seen yields skyrocket. It's also worth reiterating that despite getting what it wanted, the bond market failed to kick on after QE II, when one would have expected a relief rally.

The near term global rates environment looks subdued, particularly as the Fed is using long term rates as its new policy lever, and has implied that it will do whatever it takes to get the US economy on

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track. But when we look to the future, we see upside risks everywhere – particularly in relation to inflation. The RBNZ may be on hold for now, but as we look to 2011, we expect above consensus NZ growth, continued strong demand for our exports, and an uptick in inflation. Traditional demand pull inflation is nowhere to be seen, and it's hard to see it emerging any time soon given the deleveraging that's going on. But we are less sanguine about inflation pressures that are emerging from Asia, and from non competitive sectors. Given how sanguine the RBNZ's forecasts are, this spells only one thing, upside risks, and this is only further supported by QE II. As such, we favour being reasonably well hedged at this point – ideally having done some hedging prior to the run up in rates that has occurred since our last edition of the *Borrower's Strategy*.

If you were waiting for that last dip lower in rates to hedge, and stood by the sidelines waiting for QE II, chances are you'll be disappointed. Although we're reluctant to go chasing the market, and can't help but feel that the horse has bolted in the short term, we do believe it is appropriate to at least have some cover in place. But as we have seen just about every other time rates have snapped higher this cycle, it's equally likely we see a respite once near term pressure subsides. Provided the big picture remains the same, we favour using any such dip to get hedge ratios up to fairly high levels.

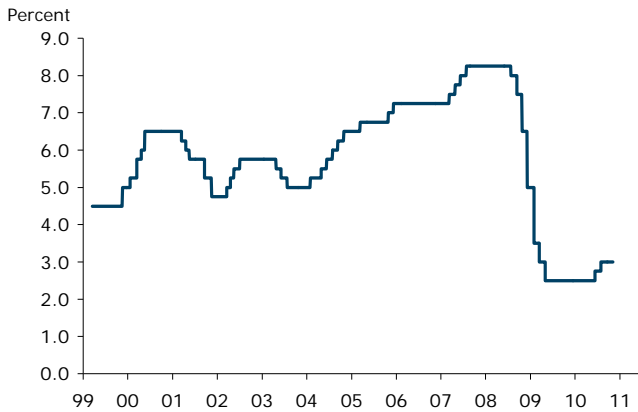
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Wellington	04 471 0030 / 0800 445 088
Christchurch	03 364 5335 / 0800 269 261

# CHARTS

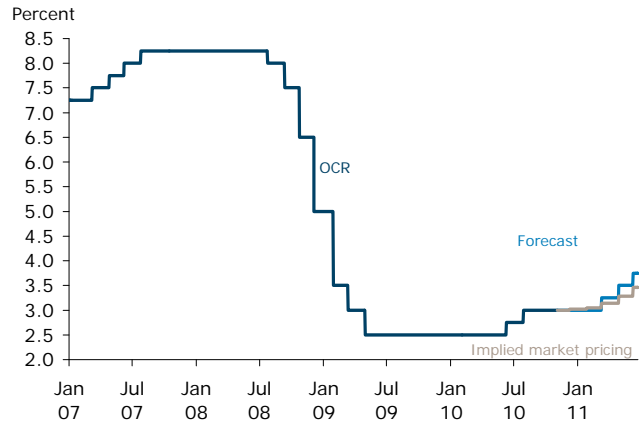
## CHARTS CHARTS

**Official Cash Rate**



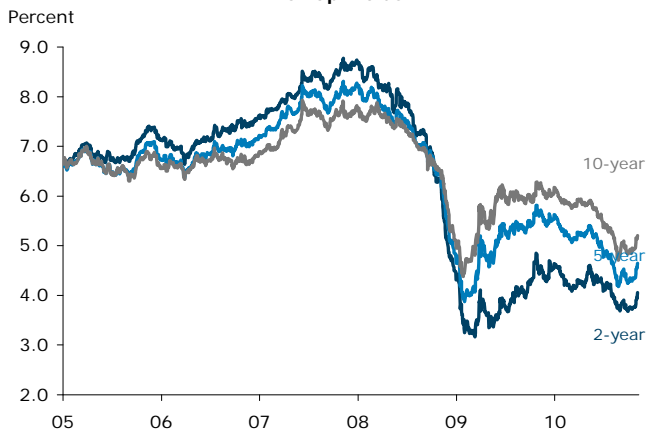
Sources: ANZ, National Bank, RBNZ

**OCR and market pricing**



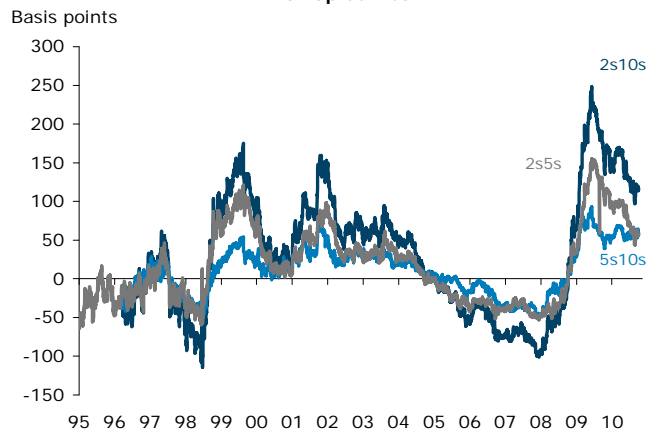
Sources: ANZ, National Bank, RBNZ, Bloomberg

**NZ Swap Yields**



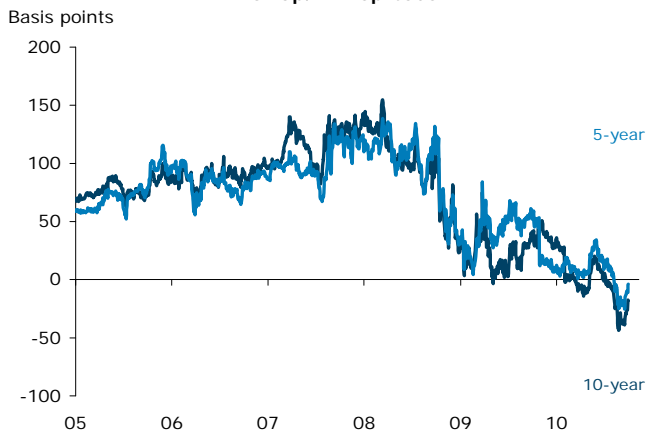
Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curves**



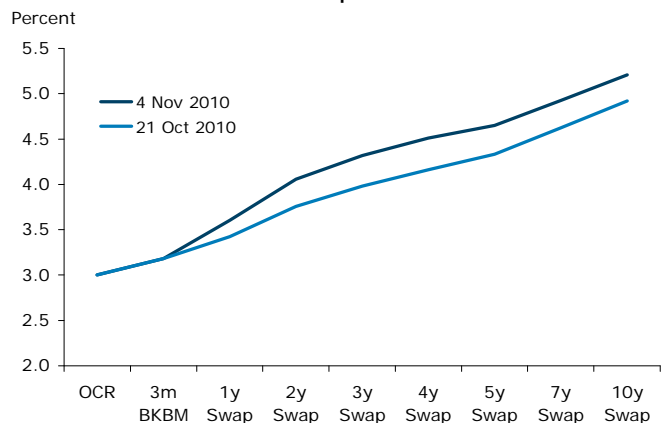
Sources: ANZ, National Bank, Bloomberg

**NZ Swap/EFP Spreads**



Sources: ANZ, National Bank, Bloomberg

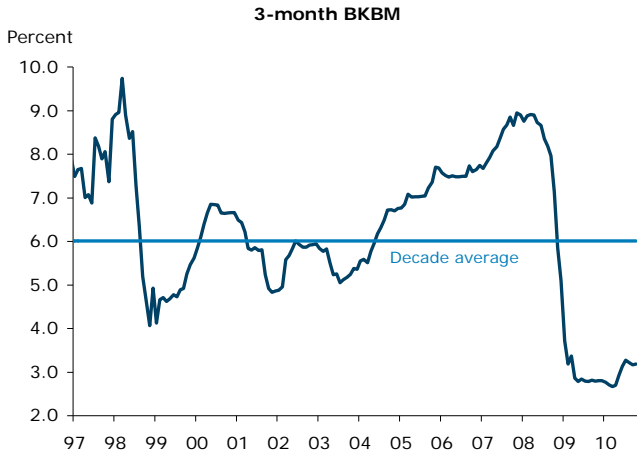
**NZ Swap Curve**



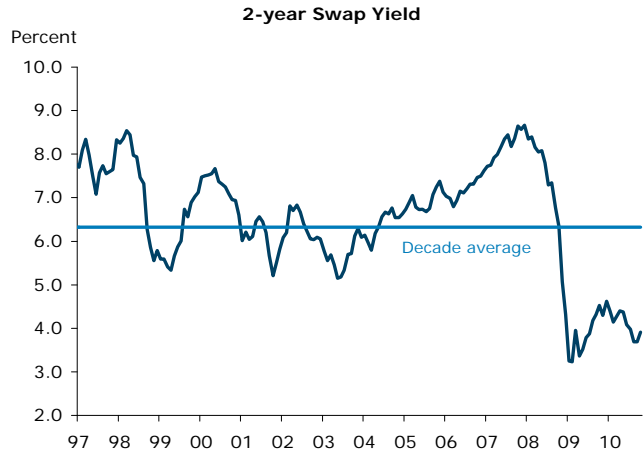
Sources: ANZ, National Bank, Bloomberg

# CHARTS (END OF MONTH)

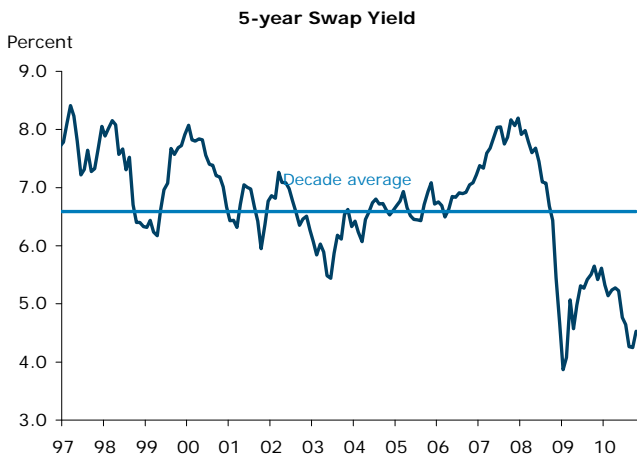
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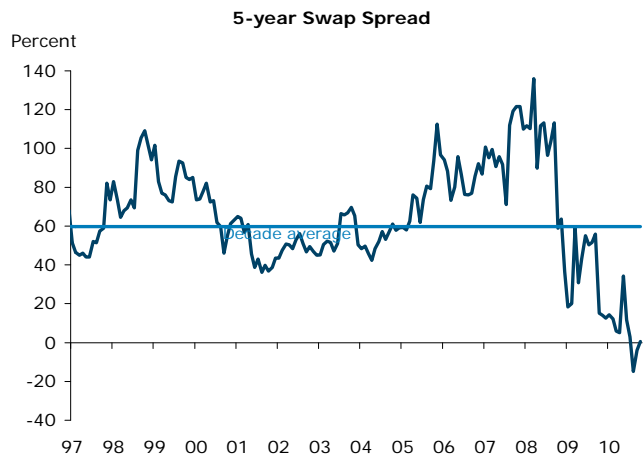
Sources: ANZ, National Bank, Bloomberg



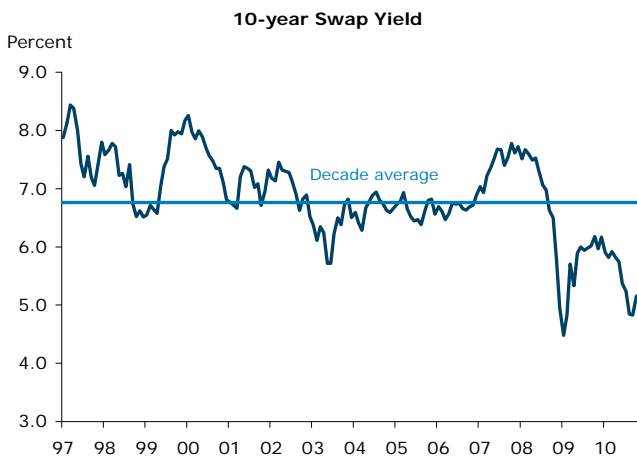
Sources: ANZ, National Bank, Bloomberg



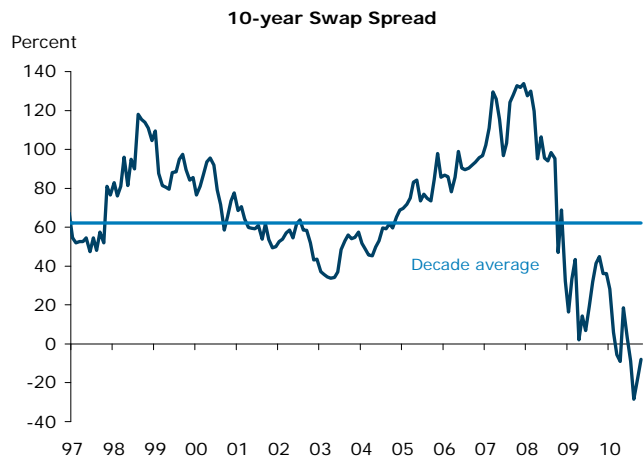
Sources: ANZ, National Bank, Bloomberg



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