

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

14 October 2011

CONTRIBUTOR

David Croy
Senior Interest Rate Strategist
Phone: +64 4 576 1022
E-mail: david.croy@anz.com

ECONOMIC OUTLOOK

Economic headwinds are intensifying. The pending rebuild in Christchurch continues to face delays and the global scene is deteriorating. Restoring stability to the global scene requires decisive action and leadership by politicians, yet many are being caught in the rip of populism. This combination presents clear downside risks to the outlook, although to date, there is minimal evidence of actual flow-through to New Zealand. We continue to watch the "five C's" – namely, commodity prices, confidence, the cost of funds, China and the currency. We have downgraded our year-ahead assessment for the New Zealand economy. Momentum in early 2012 is expected to be particularly soft. Within our economic assessment we continue to emphasize a heightened period of economic volatility, around a lower secular trend growth rate. An uncertain global backdrop is expected to keep the Reserve Bank on the sidelines for some time, with the OCR set to remain at 2.5%.

RATE VIEW

New Zealand swap rates have lifted but this should be considered in the context of significant volatility, with the lift off all-time lows seen a week ago. Sentiment has improved vastly over the past few days, but there is little in the way of substance behind it. Indeed, debt problems in Europe run deep, and US politicians remain divided on President Obama's jobs package. If the politicking around the debt ceiling debate is any guide, the road to bipartisan agreement on budget cuts that were a condition of the ceiling being lifted is set to be long and messy. If there is anything the last two years has taught us, it is that the global economy is fragile and vulnerable, and unusually susceptible to shocks that might have been more easily coped with in better times. Events that might have barely caused a ripple pre-GFC are having pronounced effects now. What's more, policy makers across the globe have their backs against the wall, and simply don't have as many options available to them any more. Time is what is needed. So, pleasing as it is to see sentiment rebound, unless it is accompanied by concrete action plans in Europe and the US, we tend to view it as just another wild swing in markets. Just as rates overshot to the downside at the peak of the panic last week, they risk an overshoot to the topside over the coming weeks. Our overall macro view is cautious and with downside risks building both here and abroad, we expect rates to remain low well into 2012.

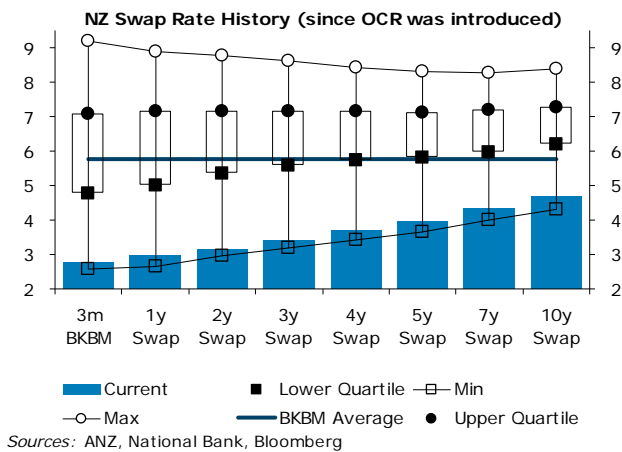
STRATEGY

We continue to take a guarded view and prefer to keep a high degree of exposure to floating rates. Fixed rates are low (even after the move higher in the past week), but with the OCR on hold until mid-2012, and the global scene at centre stage and still challenging, we see no urgency to add to fixed cover. In this edition we also update earlier analysis that shows that the ex-post average term premium for paying fixed is very high – even for New Zealand, which has often had an inverse yield curve. Although one could argue that the normal checklist of conditions needed to be comfortable fixing is met (e.g. low fixed rates, the tightening cycle about to begin), this is well countered by structural effects (OCR lower for longer, OCR likely to peak at a lower rate) and the slope of the curve. Our preference is to watch and wait.

BORROWER'S STRATEGY

VALUATION

Interest rates are low, and the curve is reasonably flat by recent standards. However, the slope of the curve is steep relative to long term averages, and in our view, long term interest rates remain too high relative to the likely path of the OCR over coming years. For those looking to minimise cost of funds in outright terms (or against a floating benchmark), we see little reason to fix at this stage. On the other hand, for those borrowers who need to fix (or are benchmarked against fixed rates) there may be some attraction in adding to hedges simply because swap rates are low, even though we see the floating rate averaging lower over time.



Current interest rate levels

Maturity	Last edition	Current
3-mth BKBM	2.82	2.76
1-year swap	2.88	2.94
2-year swap	3.06	3.16
3-year swap	3.26	3.41
4-year swap	3.46	3.69
5-year swap	3.67	3.96
7-year swap	4.03	4.35
10-year swap	4.34	4.69

Market expectations for RBNZ OCR (bps)

OCR Dates	Last edition	Current
Thu-27-Oct-11	-2	0
Thu-8-Dec-11	-1	+2
Thu-26-Jan-12	0	+4
Thu-8-Mar-12	+2	+10
Thu-26-Apr-12	+6	+17
Thu-14-Jun-12	+7	+20
Thu-26-Jul-12	Not forecast	+26

GLOBAL VOLATILITY

Global uncertainty remains high and the amplitude of swings in sentiment has shifted up a gear, resulting in enormous volatility, which has inevitably spilled over into local markets. However, as we noted on page 1, the overall picture has not changed, and there are still major challenges ahead. Indeed, if we think back to a week or so ago (when all but the most optimistic commentators thought we were standing at the edge of an abyss) the major issues in Europe were:

- the need to recapitalise European banks;
- indecision over the 6th tranche of bailout funds;
- ratification by all EU member states of the expanded EFSF;
- the ECB's apparent reluctance to relax monetary policy; and
- long-term sovereign insolvency concerns.

We won't go through each issue in detail, but suffice to say there has been no *concrete* resolution on any one of the issues. However there has been progress in some areas. For example, while the ECB hasn't cut rates, they have offered up new liquidity facilities. Slovakia has now ratified the EFSF, and as it was the last country to do so, this issue has been dealt with. But markets are increasingly nervous that even an expanded EFSF won't be enough to stop the rot.

But the first and last issues are the big ones – and at this stage there is no plan to recapitalise the banks, and the need for such a plan will only increase if the so-called Greek haircut is increased. And as we have long argued, it will take years for sovereign debt to get down to more manageable levels across the European periphery. In short then, we are sceptical as to whether any real progress has been made.

We are also mindful of problems in the US. Although the US is in better shape than Europe, particularly now that activity data is showing signs of stabilising, it is not out of the woods. The big issues in the US are:

- political disagreement over Obama's American Jobs Act stimulus package;
- the lack of common ground between the main political parties with respect to Budget cuts that need to be agreed to under the debt ceiling increase;
- the pace of deterioration in the fiscal position;
- an excessive reliance on global as opposed to local savings; and

BORROWER'S STRATEGY

- the inability of mortgagees who are underwater on their mortgages to refinance at the new record-low interest rates.

As things stand now, no concrete progress has been made on any of these issues except the last, where US Treasury Secretary Geithner is understood to be close to announcing a plan to unlock the re-fi freeze. This could give confidence a decent boost, but as with Europe, it is just one issue, and there are others. Our fear is that the market has gotten so bulled up and the hurdle has been raised so high that nothing short of substantial progress on all issues will keep sentiment aloft. All of this is of course subjective – but the point is, the market looks like it is setting itself up for disappointment. Whatever the case, what happens offshore is crucial for New Zealand. As the RBNZ have made clear – future monetary policy decisions depend crucially on how global developments unfold.

Of concern to New Zealand in particular is what all of this means for the US dollar. Unless the US economy makes meaningful progress in rebalancing its economy, the USD could remain under pressure for a lot longer. In many ways, the US is in the same boat as New Zealand – but for them the debt issue is broader, with high levels of both government AND household debt. They also have a current account deficit problem. However the issue is resolved (via hard graft and saving or via inflation eroding the real value of debt) it is likely that we will see a structural weakening of the USD. This will only make it more difficult for New Zealand to adjust.

SETBACKS

The global scene is certainly challenging – but so too are things back home. And we're not talking about injuries in the All Blacks' camp – although that is unwelcome news. The two events that have worried us the most over the past fortnight have been Fletcher Building's Trading Update and the grounding of the MV Rena on Astrolabe Reef.

We're not normally in the habit of commenting on individual companies. However, Fletcher Building is one of New Zealand's largest listed companies and a key bellwether for the Christchurch rebuild. What worries us was the comment they made on the matter in their trading update. They noted that "The pace of reconstruction efforts in Canterbury was expected to accelerate in the second half of the 2012 financial year, assuming a continuing reduction in seismic activity. However, the region experienced a further magnitude 5.5 earthquake on Sunday 9 October which the government believes could further delay rebuilding efforts. New Zealand Treasury

expectations are that the rebuilding in Canterbury will not "begin in earnest" until the second half of the 2012 calendar year". Fletcher's are at the coal face, and this comment confirms anecdotes we have been picking up. This raises the question – once the Rugby World Cup is over, with the global slowdown likely to have an adverse impact on Q4 and Q1 growth, and the Christchurch rebuild not likely to begin in earnest till H2 2012, what will propel the economy through the summer?

The grounding of the MV Rena is also cause for concern. We estimate that the direct cost of the oil spill cleanup could cost anywhere between \$15m and \$55m. Getting an estimate of the cost is difficult, to say the least, but this is the range we arrive at when we examine estimates from spills elsewhere, and academic literature on the matter. We are no experts, but the point is, the damage bill is not trivial, and for those in the Bay of Plenty, it comes on top of the devastation of the PSA virus. Central government can of course fairly easily absorb such a cost. Moreover it may be covered by insurance. But it is yet another niggly factor, and these are becoming far too regular. Whatever the cleanup costs are, they are likely to be minor when compared to the impact the spill will have on confidence, coastal property values, and tourism.

HOW EXPENSIVE IS IT TO FIX

In an environment where fixed rate are higher than floating rates, this is a good question. However, we won't look to address it directly now; rather our analysis focuses on the 15 years from 1996 to today.

In what follows we examine the historic performance of 2 year and 5 year swaps going back to March 1996. We obviously can't see how well today's swap rates might perform, as we don't know what future floating rates might be. But we can back-test swaps. In terms of dates, the 2yr swaps that we back-tested were those instigated between October 1996 and October 2009 (noting that a 2 yr swap that instigated in October 2009 will have just matured). Similarly, the 5yr swaps we back-tested were those instigated between October 1996 and October 2006. This gives us at least 10 years of history. Note that we did not test 10 year swaps as very few clients hedge for that long, and we'd only have a short history considering that a 10 year swap that has just matured was instigated way back in October 2001.

In terms of methodology, we examined swaps on every day during the study period, and simply looked at the difference between the fixed rate and the floating rate. As an example, if you paid fixed for 2 years on 10 January 2000, you would have paid a

BORROWER'S STRATEGY

fixed rate of 7.31%. With the benefit of hindsight, we know that the average of the 8 quarterly rate sets on the floating leg was 6.14%. As such, the payer of this swap paid 1.17% more than he or she would have had they just stayed floating. We repeat this analysis on every day of the study period, for both the 2yr and the 5yr swap. We also did the same for the Australian and US markets as a cross check. Of course, the economic cycle will influence the results – but with such a long history, and with the analysis being spread over 3 countries, the results are reasonably “robust” in our view.

What we found was not surprising. As the tables below show, on average, between 1996 and 2009, 2year swaps ended up costing 0.55% more than staying floating. Moreover, the simple probability that an individual swap dealt on any given day outperformed staying floating was just 38%. The results for the 5 year were even worse – 5yr swaps ended up costing 0.60% more on average, and the probability of any swap beating floating was just 27%. This is pretty sobering stuff – as it suggests that your basic odds of outperforming floating have been well less than even in the past 10-13 years for 5 year and 2 year swaps respectively. Of course, there is more to fixing than saving money – reducing volatility has value. The question is whether it's worth such a stiff fee.

Long term average performance of swaps (cost of fixed leg less cost of floating leg)		
Strategy	2 year	5 year
New Zealand	0.55%	0.60%
Australia	0.37%	0.57%
United States	0.82%	1.75%

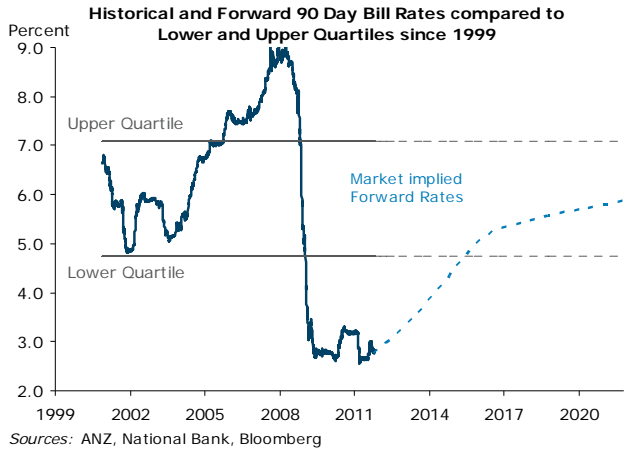
What is interesting (if not obvious) is that these “odds” of beating floating (which we will call “success”) can be improved markedly by applying some common sense and judgement. For example, if, say, you simply chose never to fix if the 2yr was, say, above 6.5%, then your odds of beating floating almost double to 77%. Similarly, if you simply choose not to hedge when the 5 year was above 7%, your odds of success improve to 65%. It's no surprise that the odds of success improve the lower you place your “no hedge” limit, as the table below shows.

Odds of success for various “no hedge” limits (New Zealand market only)		
Strategy	2 year	5 year
Always hedge no matter what rate	38%	27%
Don't hedge above 8%	53%	33%
Don't hedge above 7.5%	61%	50%
Don't hedge above 7%	69%	65%
Don't hedge above 6.5%	77%	91%
Don't hedge above 6%	87%	100%

The question is: do you have the fortitude to stand back and do nothing when rates are rising. It's easy to say you do now, but will that change in the face of rising rates? The point is, don't be sucked into thinking that simply not hedging at high rates is a winning strategy in all circumstances. It will probably work (and history has shown it to be the right thing to do), but common sense is also required. Just as we think rates are moving into a structurally lower range in future, making us less enthusiastic about fixing, if things started to change, so would the strategy. For example, say the RBNZ decided to let inflation rise (and to be sure – we see almost no chance of this!), the average level of interest rates would also rise markedly.

Some may argue that rates are precisely at the point of the cycle where the odds of “beating” floating are the most favourable. However, one also has to acknowledge that the OCR cycle has shifted structurally lower owing to deleveraging, debt levels and slower growth. As the chart overleaf shows, market implied forward rates track all the way up to 5.9%, well above where both the RBNZ and our forecasts see the 90 day bill rate peaking (around 4.25% to 4.5%). Even though swap rates are close to all-time lows now, that does not necessarily make them good value – as floating is also likely to be unusually low relative to the pre-GFC experience.

BORROWER'S STRATEGY



STRATEGY

Our preference is to remain on floating, and avoid the temptation of introducing fixed costs to the business via hedges just because swap rates are low. As we have argued at length in earlier editions, there are significant structural issues that New Zealand.Inc has to deal with, and with that comes structurally lower policy rates.

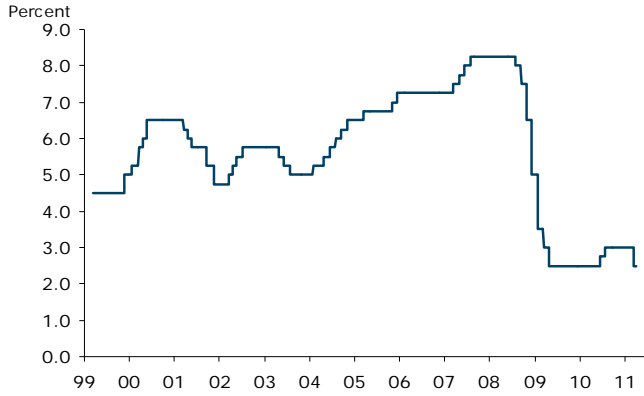
Looking at the offshore scene, we'd go so far as to say that we need to see European politicians come up with a credible and timely plan, that substantively solves the issues we pointed to, as a minimum requirement for us to be satisfied that the global concerns that RBNZ Governor Bollard is worried about have been satisfactorily dealt with. In the meantime, keep a close eye on developments, but don't panic.

Dealing room contacts		
Location	Local	Toll free
Auckland	09 377 9450	0800 730 100
Wellington	04 471 0030	0800 445 088
Christchurch	03 364 5335	0800 269 261

CHARTS (END OF MONTH)

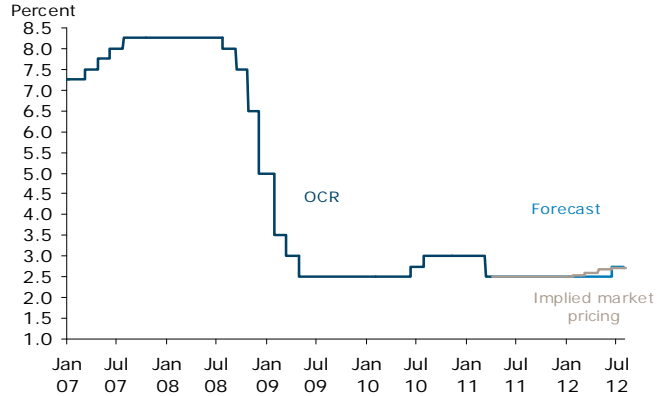
CHARTS

Official Cash Rate



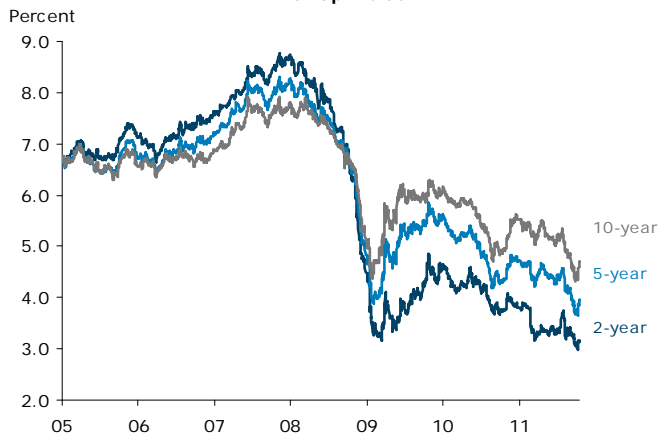
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



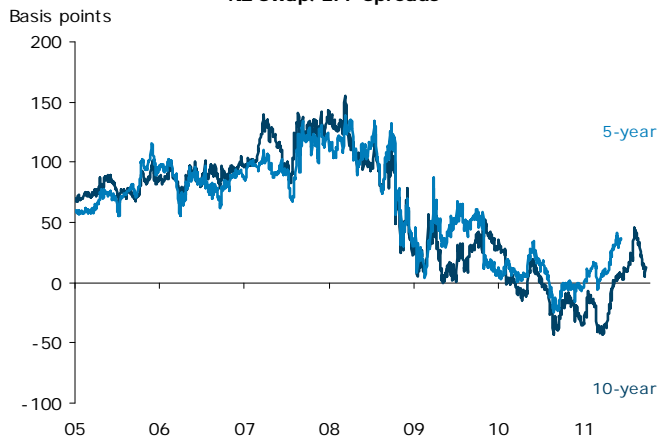
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



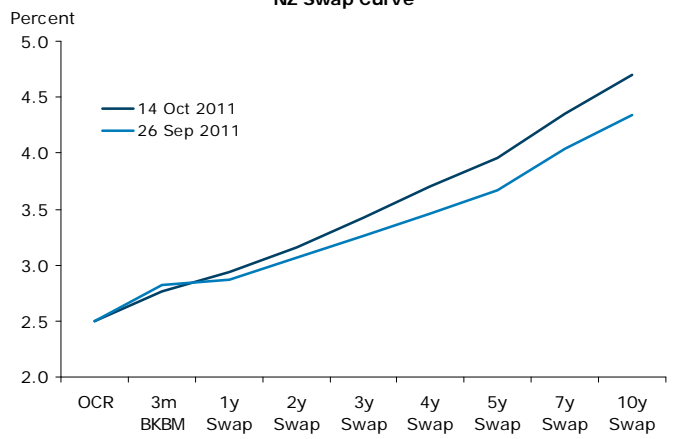
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

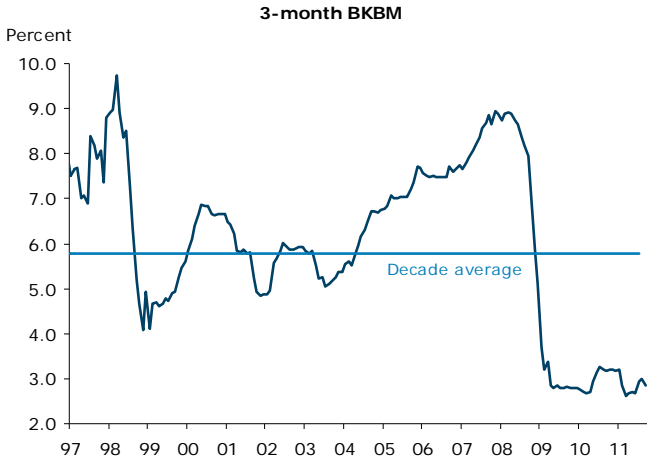
NZ Swap Curve



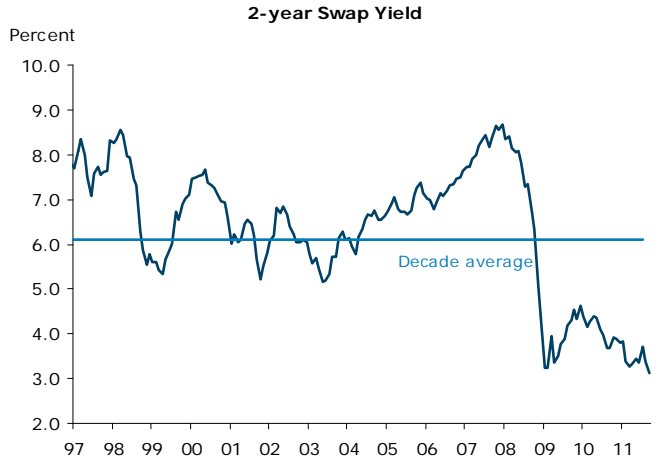
Sources: ANZ, National Bank, Bloomberg

BORROWER'S STRATEGY

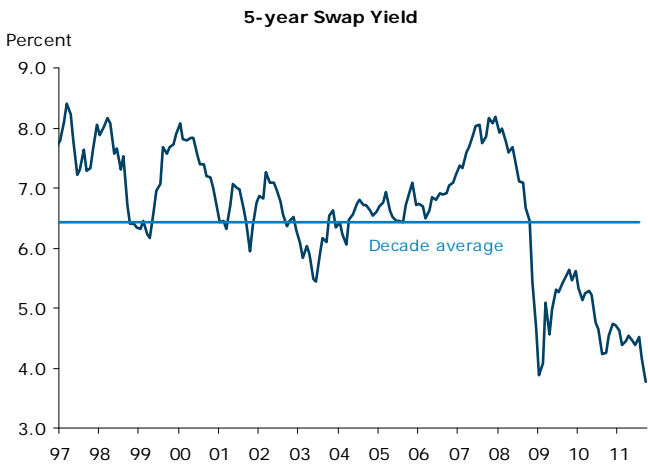
CHARTS (END OF MONTH)



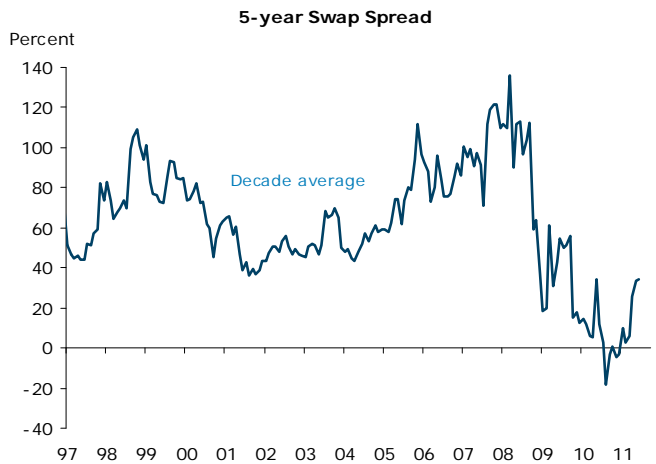
Sources: ANZ, National Bank, Bloomberg



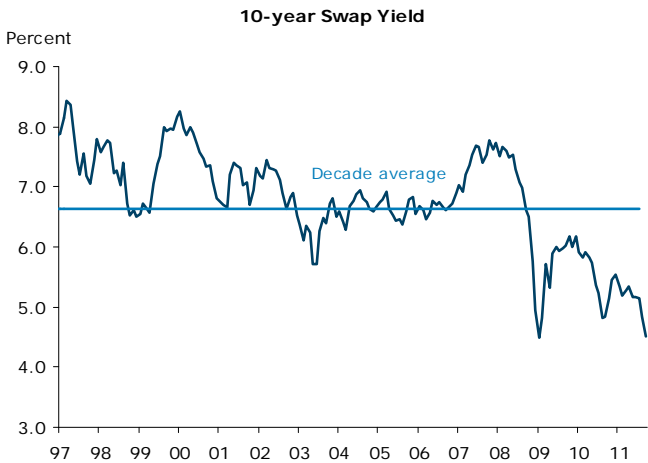
Sources: ANZ, National Bank, Bloomberg



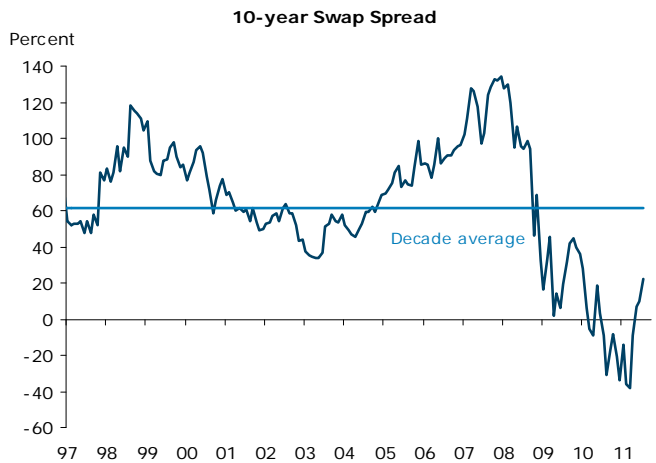
Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg

IMPORTANT NOTICE

NEW ZEALAND DISCLAIMER

This publication is for information purposes only. Its content is intended to be of general nature, does not take into account your financial situation or goals, and is not a personalised adviser service under the Financial Advisers Act 2008. It is recommended you seek advice from a financial adviser which takes into account your individual circumstances before you acquire a financial product. This publication does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this publication can be reproduced, altered, transmitted to, copied to or distributed to any other person without the prior express permission of ANZ National Bank Limited (the "Bank").

This publication is a necessarily brief and general summary of the subjects covered. The information contained in this publication is given in good faith, has been derived from sources perceived by it to be reliable and accurate and the Bank shall not be obliged to update any such information after the date of this publication. To the extent permitted by law, neither the Bank nor any other person involved in the preparation of this publication accepts any liability for the content of this publication (including the accuracy or completeness thereof) or for any consequences flowing from its use.

UNITED STATES DISCLAIMER

This publication is being distributed in the United States by ANZ Securities, Inc. (Member of FINRA [www.finra.org] and registered with the SEC) ("ANZ S") (an affiliated company of Australia and New Zealand Banking Group Limited ("ANZBG") and the Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this publication and wishing to effect transactions in any fixed income securities referred to herein should contact ANZ S 277 Park Avenue, 31st Floor, New York, NY 10172 USA, Tel: 1-212-801-9160, Fax: 1-212-801-9163, not its affiliates.

This publication is issued on the basis that it is only for the information of the particular person to whom it is provided.

This publication may not be reproduced, distributed or published by any recipient for any purpose. This publication does not take into account your personal needs and financial circumstances. Under no circumstances is this publication to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZBG, the Bank, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this publication (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this publication. If you have been referred to ANZBG, the Bank, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this publication accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this publication and are subject to change without notice. No part of the author's compensation was, is or will be directly or indirectly related to specific recommendations or views expressed in this publication. ANZBG, the Bank, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

This document has been prepared by ANZ National Bank Limited. ANZ (part of ANZ National Bank Limited), Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2000 Fax 64-4-496 8639 <http://www.anz.co.nz> e-mail nzeconomics@anz.com