

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

20 August 2010

CONTRIBUTORS

David Croy
Senior Interest Rate Strategist
E-mail: david.croy@anz.com

ECONOMIC OUTLOOK

Economic data has generally disappointed over the past month, and is consistent with a recovery that is losing some momentum. Key areas like the housing and jobs market remain subdued, though we suspect the latter is not as bad as what the official headline statistics portray. Retail sales surprised on the strong side and will make a positive contribution to GDP, but this has been achieved at the expense of heavy discounting. While few will admit it, we suspect many were expecting 2010 to be a classic V-shaped type recovery. After all, this was the message to be taken from sharp spikes higher in business and consumer confidence late last year and earlier this year. However, ongoing deleveraging and now, increased uncertainty surrounding the global outlook, are resulting in a more muted recovery compared to past economic cycles. This has seen confidence levels adjust to reflect reality. Although it won't help near term growth, the deleveraging process will ultimately result in a better platform from which the economy can bounce off from. So while we expect continued subdued and patchy growth for the rest of this year, we remain positive on the outlook for 2011.

RATE VIEW

Market expectations of RBNZ rate hikes have been pared back significantly, with market pricing now in favour of a pause as opposed to a hike in September. While we broadly concur with the spirit of this move, particularly in the short term (we still see the odds of a pause in September as being 50/50), what has surprised us has been the degree of tightening that has been "priced out" over the next 12 months. With only one 25bp hike priced in by January 2011 and another by June, markets look to have overreacted. The general level of interest rates has fallen to levels that we would regard as over-stretched relative to domestic fundamentals. But markets have been overwhelmed by talk of further quantitative easing in the US, and this is proving to be like having an elephant in the room for the local interest rate market. Rates may move lower yet, but the drivers will be global, not domestic.

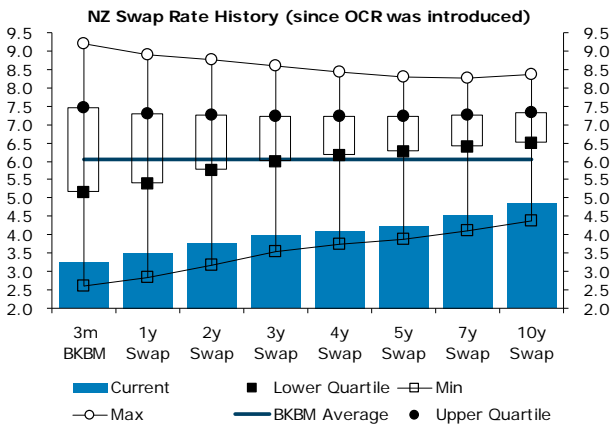
STRATEGY

Long term swap rates have fallen to levels that would have been unthinkable a month ago, and although they may go lower yet in the near term, they do offer outstanding value vis-à-vis the domestic economic outlook. We are not buying into the double-dip recession view, and as such we favour taking advantage of rates spikes lower like this. Our preferred strategy at the moment is to adopt "delta hedging". This involves putting a plan in place to add to incrementally at pre-determined yields. If rates move lower you'll be happy to do more, but if they rise, you'll be thankful you did some. While this is a fairly simple strategy, it is a valuation based one, and it is appropriate in an environment when uncertainty is high (and rates could go either way). The fact that we think domestic fundamentals are not consistent with the current level of longer term interest rates (and are being held down by global factors) only adds to the appeal of this strategy.

BORROWER'S STRATEGY

VALUATION

Swap rates have fallen significantly in the past fortnight, particularly beyond 5 years, taking 5 and 7yr rates within a few pips of 4.25% and 4.50% respectively. The 10yr is now well below 5%. Falling global rates have been particularly influential in the move, so much so that we believe rates have significantly under-shot what we would consider reasonable levels based purely on the domestic economic outlook. As a result, the swap yield curve has "flattened", closing the gap between the 2yr and 10yr by 18bps, the flattest since January 2009.



Sources: ANZ, National Bank, Bloomberg

Current interest rate levels		
Maturity	2 weeks ago	Current
3-mth BKBM	3.28	3.23
1-year swap	3.66	3.52
2-year swap	3.95	3.78
3-year swap	4.22	3.97
4-year swap	4.44	4.12
5-year swap	4.62	4.26
7-year swap	4.90	4.53
10-year swap	5.19	4.84

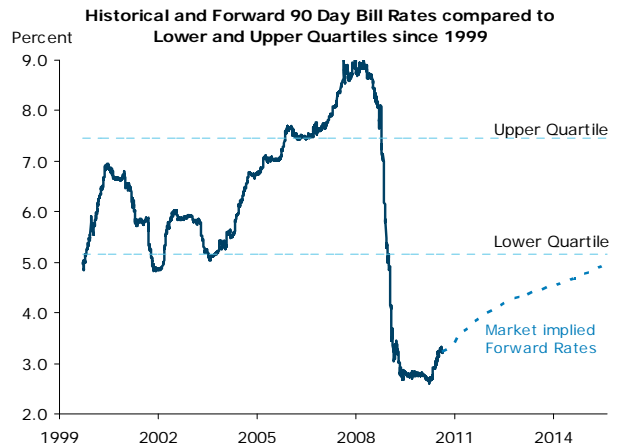
Market expectations for RBNZ OCR (bps)		
OCR Dates	2 weeks ago	Current
Thu 16-Sep-10	+16	+10
Thu 28-Oct-10	+28	+14
Thu 9-Dec-10	+36	+21
Thu 27-Jan-11	+41	+25
Thu 10-Mar-11	+47	+31
Thu 28-Apr-11	+57	+41
Thu-9-Jun-11	+68	+53

AN ELEPHANT IN THE ROOM

Did anyone see the elephant in the room? Look again. There he is, he comes from the United States and his name is quantitative easing (or QE for short). Although short term NZ interest rates have fallen primarily in response to weaker domestic data (which has added weight to the view that there is less urgency for the RBNZ to continue raising rates), market conjecture that the US Federal Reserve (the Fed) is inching closer to implementing another round of QE has had a major impact on global interest rates, and this is being felt in New Zealand. And that's precisely why we like the elephant analogy. It's always been important to keep an eye on US interest rates, but when the markets start to contemplate seismic shifts like QE, it's literally like an elephant coming into the room. And you can't ignore it.

In terms of the impact QE has had on domestic rates, it has been two-fold. The most intuitive impact has been at the long end, where there is a higher correlation between NZ and US interest rates. However the impact has also been felt at the short end, on the premise that if the Fed is contemplating QE, the odds of the RBNZ swimming against the tide are that much less. Whether or not events in the US will have a direct impact on RBNZ policy depends on how things unfold, but for now, markets are taking a cautious view, especially with the RBA content to sit on the sidelines for the time being.

To give an idea of how far the market has gone, consider this. As the chart below shows, market expectations now have the 90 day bill rate holding below the lower quartile for at least the next 5 years. This is remarkable, and while it is fair to say this recovery will be "different", we doubt it will be that different!



BORROWER'S STRATEGY

We explain QE in more detail later on, but what seems abundantly clear is that the effect of it is so powerful that NZ interest rates have divorced themselves from domestic fundamentals. Indeed, the 10yr swap rate is now below 5% again, something that has not occurred since early 2009. But whereas back then the RBNZ was slashing the OCR (in clips of 150bps!) and the NZ economy was already in deep recession with prospects for more to come, at the moment the economy is actually on the mend. To be sure, the recovery is proving to be somewhat less vigorous than at first assumed (and well short of the RBNZ's projections of growth of 1% per quarter through 2010 and into 2011). But make no mistake, it is recovering, and the implication that the 3mth Bank Bill "BKBM" rate will average below 5% for the next 10 years (as implied by swap yield) is a stretch. That is, of course, unless you expect the economy to start going backwards again or remain in an anaemic state for quite a few years. It's also worth adding that forward rates implied by the term structure have historically tended to overstate future interest rates. In other words, although over the life of a swap the two parties to it will exchange interest payments which are assumed at the outset to be of equal value, it would be a mistake to assume that because the 10yr swap is trading at, say, 5% that this is somehow akin to saying that the market "thinks" BKBM will average 5% over the next 10 years. When adjusted for the term premium, the 10yr swap rate is actually implying an even lower average for BKBM.

OPPORTUNITY KNOCKS

Two weeks ago we noted that although long end rates could go lower yet, it was worth using what we considered to be over-stretched levels to add to hedges at the long end, leaving some powder dry to do more if rates did indeed move lower. Rates are now at an even deeper extreme, and while they may move lower still, the fact that rates have become so overwhelmed by global events and disconnected from domestic developments suggests there are opportunities for borrowers. This stems wholly from our view that the interest rate environment is not as benign as the term structure of interest rates assumes.

The economy may not be booming, but it is still recovering and we do expect positive growth (albeit patchy and slow) over the next few years. However it would be foolish not to ignore the elephant in the room that is QE. While not specific to New Zealand,

it has had a significant impact on bringing rates lower here and it may well yet have more impact going forward. But interest rates are already stretched, and at some point we expect a rebound. This could be mild if, for example the Fed makes small concessions that are seen to take effect. Or it could be sharp if the Fed rules out QE and data start to recover. But the point is, valuations look stretched. And while it's always difficult to make a decision in an environment where opposing forces exist, or to go against the trend for fear of missing out on better levels, you'll never know till after the fact whether the decision you made was the most cost effective. But that's not a reason to shy away from making a decision.

Our preferred strategy from here could be likened to "delta hedging". While we are mindful of the reasons why interest rates are falling (namely fears of a deteriorating global outlook), falling rates do favour borrowers. Furthermore, we believe they are well below where they would be if it weren't for global influences. As noted earlier, rates could keep moving lower yet, but equally, they may start rising again. As such we favour a strategy of adding to hedges incrementally as rates move lower, with an intention to add more at regular intervals should they ratchet lower yet. In some ways it's like having a dollar each way – if rates rise, you're pleased to have done some hedging – but if rates fall, you're happy to do more. It's a simple strategy, but it's a good one if you like the level of rates, but don't know what might happen. And let's face it, what's driving NZ rates now are not NZ fundamentals, with recent moves mostly dictated by offshore events.

WHAT IS QE?

Given all the talk (in this paper and in the market) we thought it might be useful to elaborate on exactly what QE is, especially as it is having an outsized impact on US interest rate. Some describe QE as printing money, and in its crudest form this is true. However in the modern monetary economic context it's slightly different. What actually happens is the Fed buys bonds with money that is "created" by simply crediting the seller's account. This leaves sellers cashed up, forcing them to contemplate other investment or spending decisions, and as this spending and investment filters through the economy, it typically produces growth. In reality it is far more complex, and the Fed will target specific bonds of specific maturities in specific sectors to force what it sees as a

BORROWER'S STRATEGY

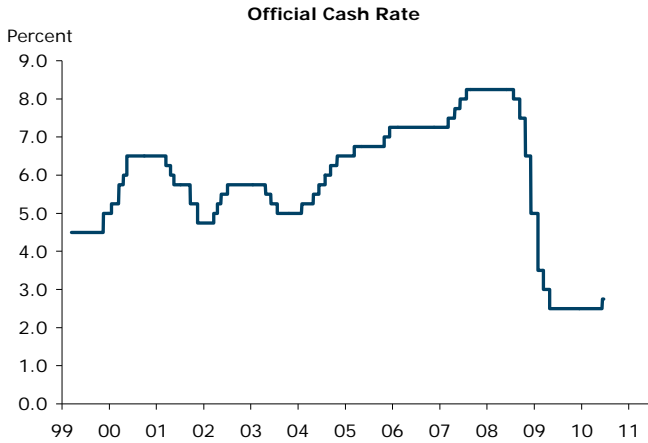
desirable outcome. But the one inescapable fact is the downward pressure QE will have on benchmark interest rates – after all, that's the whole point of QE. Indeed, central banks prefer to implement monetary policy by adjusting the cash rate (and in many cases giving guidance around likely future decisions), but when the cash rate is at zero already (as it is in the US), this leaves the Fed with few alternatives. Among these, getting long term rates lower via QE is seen as a viable alternative.

DEALING ROOM CONTACTS:

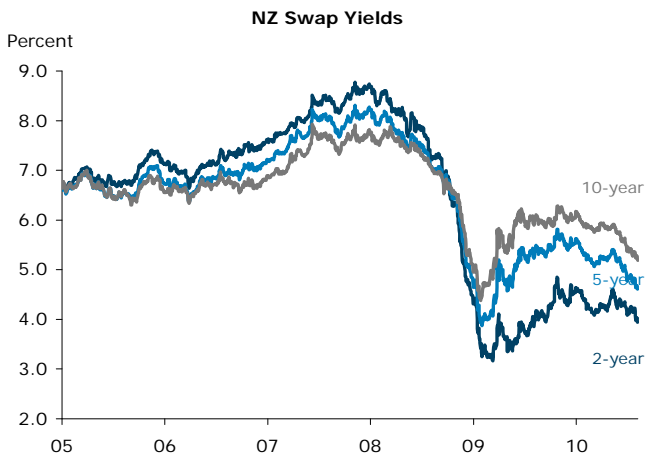
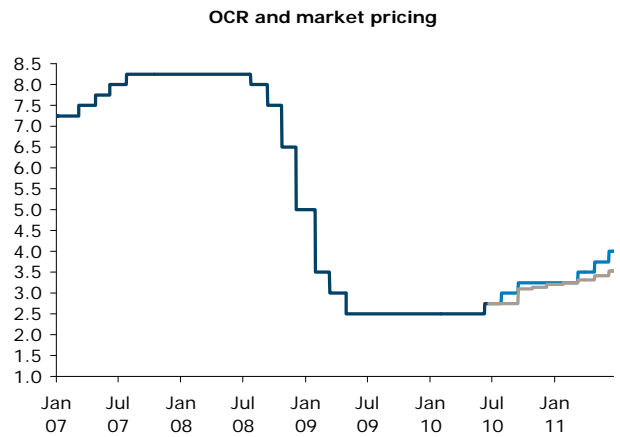
Auckland	09 377 9450 / 0800 730 100
Wellington	04 471 0030 / 0800 445 088
Christchurch	03 364 5335 / 0800 269 261

CHARTS

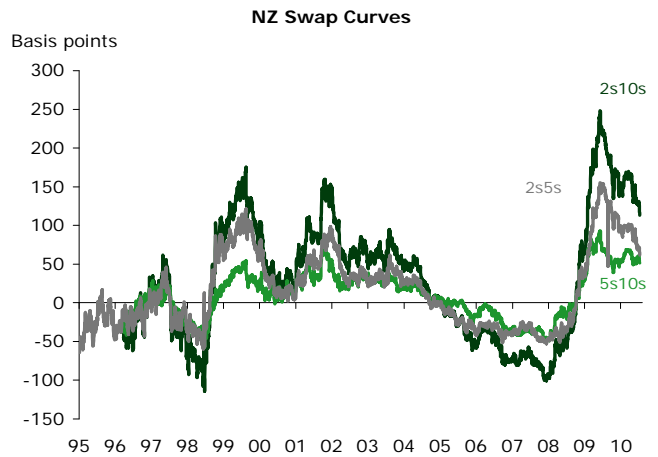
CHARTS



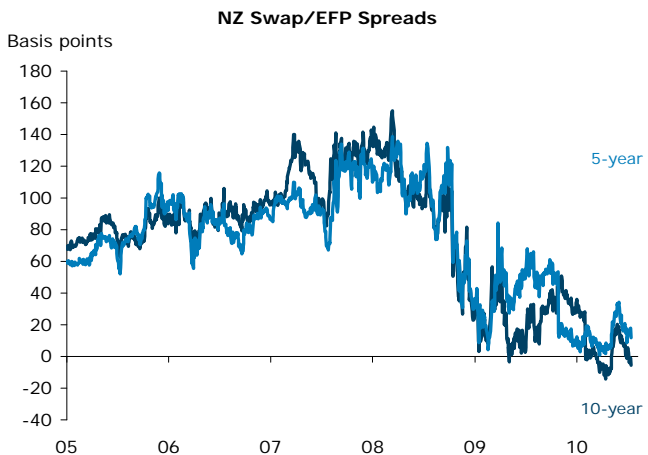
Sources: ANZ, National Bank, RBNZ



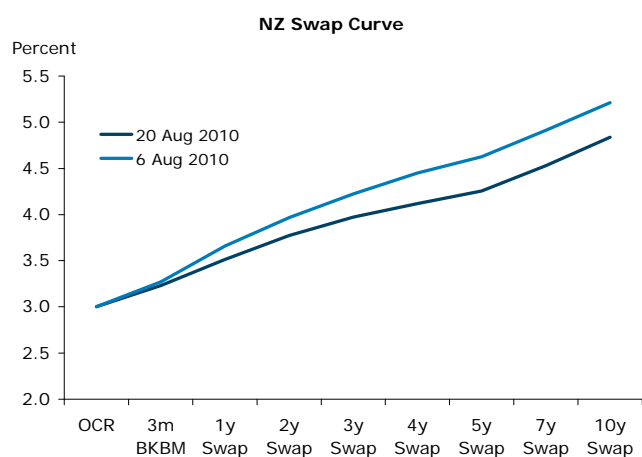
Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg



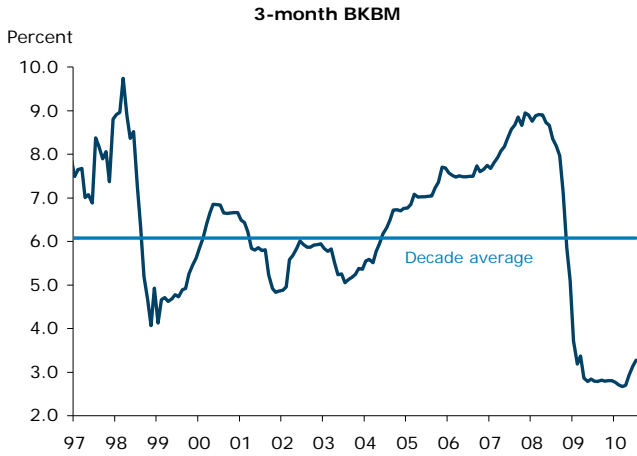
Sources: ANZ, National Bank, Bloomberg



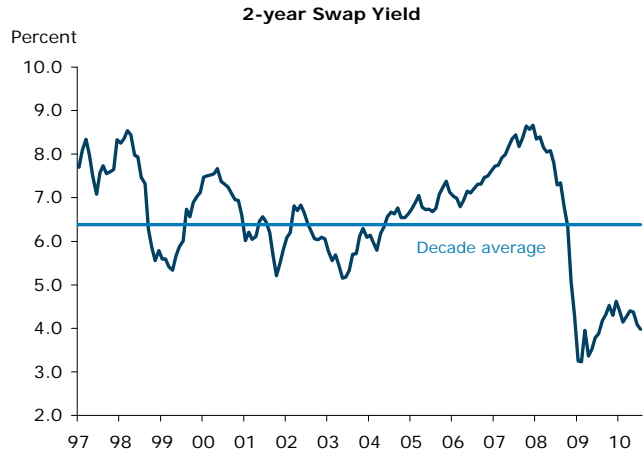
Sources: ANZ, National Bank, Bloomberg

CHARTS (END OF MONTH)

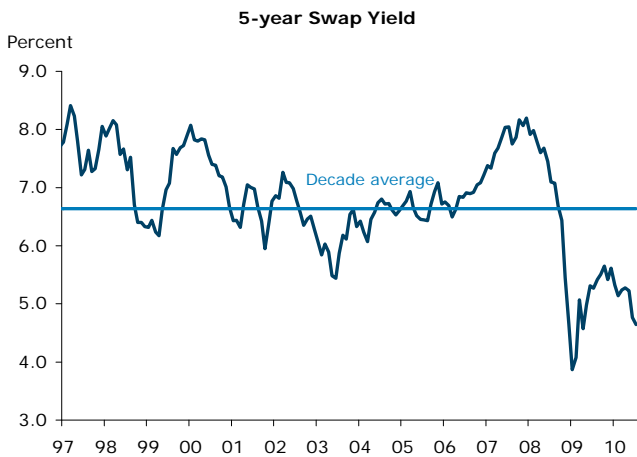
CHARTS (END OF MONTH)



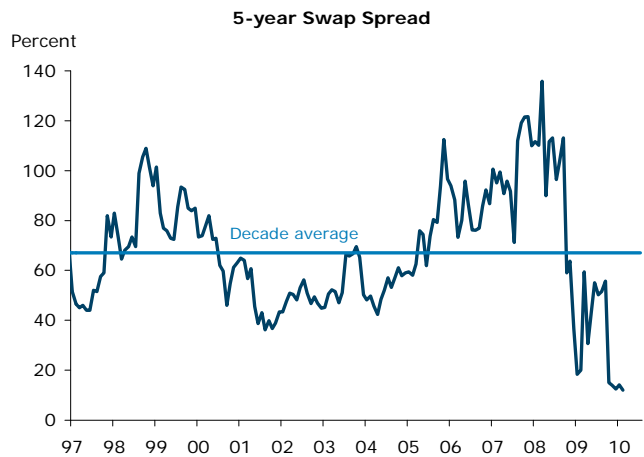
Sources: ANZ, National Bank, Bloomberg



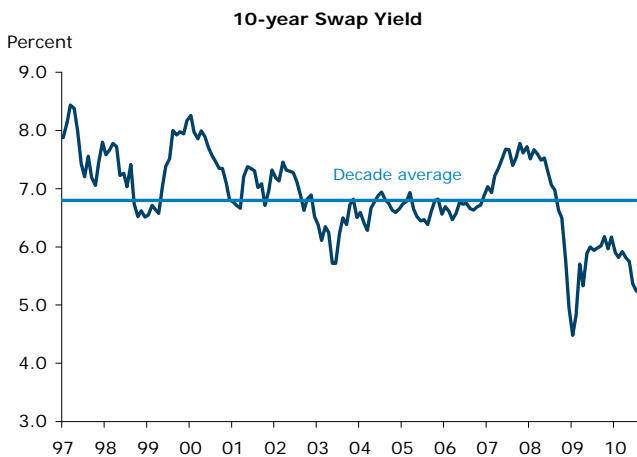
Sources: ANZ, National Bank, Bloomberg



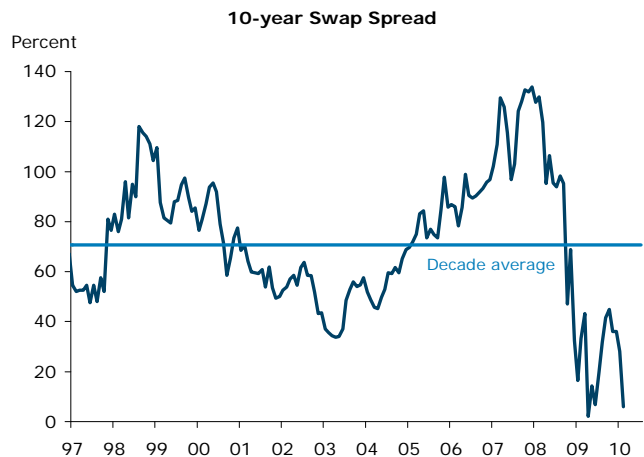
Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg



IMPORTANT NOTICE

NEW ZEALAND DISCLOSURE INFORMATION

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

Qualifications, experience and professional standing

Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

Professional indemnity insurance

The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

Other interests and relationships

When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

- ANZ Investment Services (New Zealand) Limited (ANZIS), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ANZIS may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- ING (NZ) Holdings Limited (ING), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ING and its related companies, including ING (NZ) Limited, may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- Direct Broking Limited (DBL), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. DBL may receive remuneration from a third party relating to a security sold by the Investment Adviser.

Securities about which investment advice is given

The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

PROCEDURES FOR DEALING WITH INVESTMENT MONEY OR INVESTMENT PROPERTY

If you wish to pay investment money to the Bank you can do this in several ways such as by:



IMPORTANT NOTICE

- Providing cash;
- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

Use of Money and Property

Money or property held by the Bank for a specific purpose communicated to the Bank (e.g. the purchase of an interest in a security) may not be used by the Bank for its own purposes and will be applied for your stated purpose. No member of the Bank's staff may use any money or property deposited with the Bank, for their own purposes or for the benefit of any other person. In the absence of such instructions, money deposited with the Bank may be used by the Bank for its own purposes, provided it repays the money to you upon demand (or where applicable, on maturity), together with interest, where payable.

NEW ZEALAND DISCLAIMER

The Bank does not provide investment advice tailored to an investor's personal circumstances. It is the investor's responsibility to understand the nature of the security subscribed for, and the risks associated with that security. To the maximum extent permitted by law, the Bank excludes liability for, and shall not be responsible for, any loss suffered by the investor resulting from the Bank's investment advice.

Each security (including the principal, interest or other returns of any security) the subject of investment advice given to the investor by the Bank or otherwise, is not guaranteed, secured or underwritten in any way by the Bank or any associated or related party except to the extent expressly agreed in the terms of the relevant security.

This document is provided for informational purposes only and does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this document can be reproduced, altered, transmitted to, copied to or

distributed to any other person without the prior express permission of the Bank.

This document is a necessarily brief and general summary of the subjects covered and does not constitute advice. You should obtain professional advice before acting on the basis of any opinions or information contained in it. The information contained in this document 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 document. Neither the Bank nor any other person involved in the preparation of this document accepts any liability for any opinions or information (including the accuracy or completeness thereof) contained in it, or for any consequences flowing from its use.

UNITED STATES DISCLAIMER

This document 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 document 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 document is issued on the basis that it is only for the information of the particular person to whom it is provided. This document may not be reproduced, distributed or published by any recipient for any purpose. This document does not take into account your personal needs and financial circumstances. Under no circumstances is this document 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 document (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 document. 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 document 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 document 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 document. 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.