

# NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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## CONTRIBUTORS

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## ECONOMIC OUTLOOK

The outlook for the domestic economy has undoubtedly softened. Deleveraging remains pervasive as households, farms and other businesses concentrate on improving balance sheets. On top of this, the Canterbury earthquake is likely to weigh on economic activity in the short-term. This is not up for debate. However, we take the view that softness and ongoing deleveraging sets the scene for a more robust expansion in 2011. After finding ourselves more bearish on economic prospects (more bullish interest rates) in the first half of 2010, we now find ourselves in the reciprocal position and talking the economy up relative to the RBNZ and market! High commodity export prices and demand from emerging economies continue to provide economic support and are assisting a better mix to growth. Similarly, although the earthquake was clearly a negative, rebuilding will see activity recover at a faster pace, adding to prospects for a 2011 recovery. We've always taken the view that 2010 was going to be a tough year and 2011 much better. We see little reason to alter this prognosis.

## RATE VIEW

Last week's *Monetary Policy Statement* was a clear game-changer; with the RBNZ swinging from what we felt was an overly optimistic stance in June to an equally pessimistic stance this month. Some moderation to their view was always on the cards, as was the decision to leave the OCR on hold. But we wonder whether the RBNZ have swung too far, and for the first time in a long time, our forecasts for growth, and our long term interest rate projections are higher than the Bank's. We think the OCR will remain in hold until 2011, and although we're comfortable with the Bank's view that the tightening cycle will be punctuated by pauses, we expect the path towards neutral will be more rapid than what's priced in. That being said, there are several uncertainties, chief among them the US Federal Reserve's next move. What the Fed does will undoubtedly influence the direction of NZ interest rates, and as it stands now, it looks like that direction is down. But with the OCR still on a gradual upward path, lower global rates will have their work cut out for them to push NZ rates lower. The proverbial rubber band is stretching.

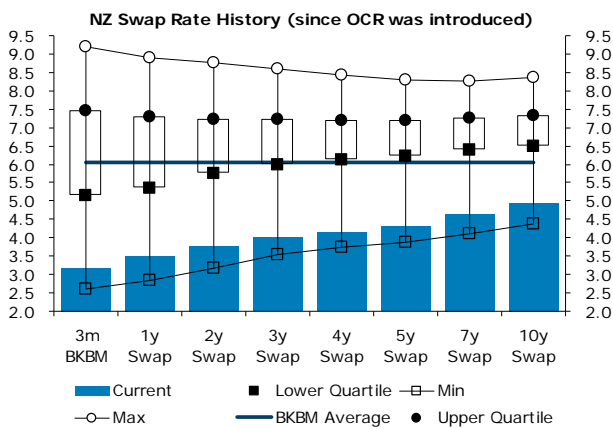
## STRATEGY

Interest rates are moving back into the "value" or "opportunity" zone, having been quick to embrace the RBNZ's lower 90-day bill track. We're less complacent, and although we see US rates remaining low (and potentially going lower yet), we doubt the economic outlook is as benign as the term structure of interest rates implies. From a valuation perspective, we therefore see value in adding to hedges over the next 25 basis points or so to the downside at the long end. Strategically though, we need to acknowledge that it's not good enough just for rates to appear cheap to fix – such a strategy must be aligned with business objectives. We also need to acknowledge that the more exposed businesses can be to floating rates, the less heavy handed the RBNZ needs to be. This argues for less hedging than one may have been accustomed to, strengthening the trust between the RBNZ and business.

# BORROWER'S STRATEGY

## VALUATION

Swap rates have moved higher across the board over the past 2 weeks, following global moves. The RBNZ's decision to leave the OCR on hold last week helped stem the rise, but as the decision was expected, the market had already factored it in, and as a consequence, market reaction was minor. Despite the move higher, swap rates remain low in absolute terms. They may move lower again, but with so much downbeat news already priced in, the hurdle for significant downside is high.



Sources: ANZ, National Bank, Bloomberg

Current interest rate levels		
Maturity	2 weeks ago	Current
3-mth BKBM	3.21	3.15
1-year swap	3.41	3.48
2-year swap	3.68	3.79
3-year swap	3.89	4.04
4-year swap	4.06	4.13
5-year swap	4.23	4.41
7-year swap	4.51	4.69
10-year swap	4.82	5.00

Market expectations for RBNZ OCR (bps)		
OCR Dates	2 weeks ago	Current
Thu 28-Oct-10	+6	+2
Thu 9-Dec-10	+11	+6
Thu 27 Jan-11	+18	+15
Thu 10-Mar-11	+20	+26
Thu 28-Apr-11	+27	+35
Thu-9-Jun-11	+40	+46
Thu-28-Jul-11	Not forecast	+55

## RESERVE BANK ADOPTS DOVISH TONE

Last week's RBNZ *Monetary Policy Statement (MPS)* was significantly more dovish than we and the market expected. Some moderation was always on the cards, particularly given how upbeat the Bank was in June. We've always been at the more conservative end of the growth spectrum for 2010 but even we were surprised with how vigorously the RBNZ seems to be encapsulating economic softness.

The Bank did hint at a change of tack, noting at the July OCR Review that the outlook had "softened". However, the tone of the *MPS* was extremely circumspect, to the point where we wonder whether it was a little too downbeat. Indeed, we believe the RBNZ (along with other commentators talking a 6% plus OCR endgame) were too bullish in June, but are now coming in too bearish on 2011 prospects, and hence low on their assessment of where rates will end up. But we firmly acknowledge that this may take a while to play out with data likely to look particularly patchy into calendar year end.

Looking more specifically at the *MPS*, several things have changed. The first is the outlook for the household sector. In June the Bank talked of an improving labour market, and expected to see a rebound in residential investment and business investment. However, they now characterise growth in employment as "subdued" and "likely contributing to the reduced consumer optimism of late". And with net migration well down and the housing market having "weakened considerably" the Bank now sees much weaker consumption and residential investment, with no pre-GST spend up likely. Business investment is also forecast to remain fairly subdued, constrained by "a tighter credit environment and elevated risk aversion". Furthermore, the output gap is projected to remain negative right through the projection period (as opposed to closing in mid 2011 in the June *MPS*), maintaining downward pressure (albeit fading over time) on inflation. Finally, it's also worth noting that the RBNZ explicitly noted that "several on-hold decisions are implied" by the new 90-day bill track. It doesn't get much clearer than that.

## OCR LOWER FOR LONGER

In terms of the RBNZ's 90-day bill projection, broadly speaking they have come down to meet the market, as the top chart below shows. One factor at play was the assumption that bank funding costs (second chart below) will remain elevated for the

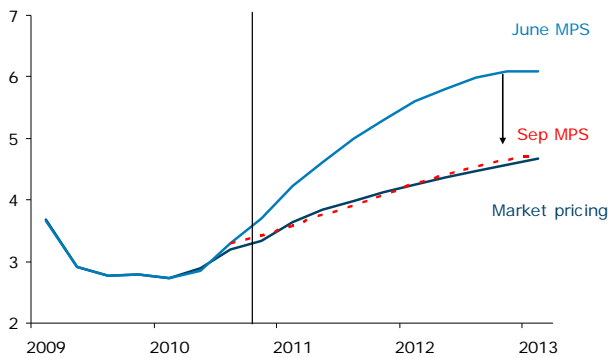


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projection period. Although the Bank has said in the past that they expected these conditions to "persist", in their modelling they had assumed some normalisation. As such, some of the rationale behind a lower track reflects this re-calibration. The Bank has also assumed the TWI will be a bit higher, acting as a bit of a drag on growth.

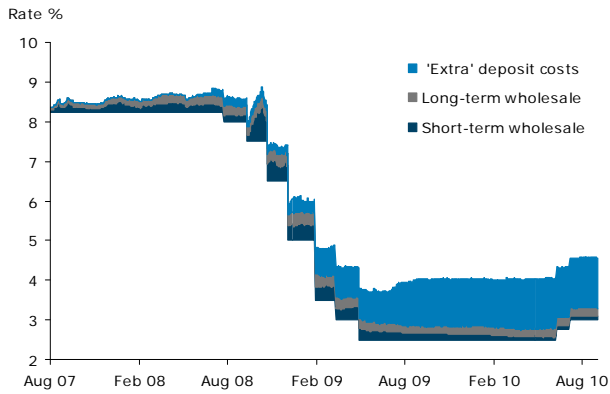
around 120 basis points of OCR hikes over the next 2 years. That's just 15 basis points per quarter, and although it's consistent with the RBNZ's latest projections, we need to be mindful that those projections incorporate a pretty subdued outlook. As such, we feel there isn't much more room for downside. Indeed, with the OCR at just 3 percent, it would take some pretty negative news to get the market thinking it needed to stay there for an extended period (or even head lower). Yet that's what it would take to get significant traction to the downside on short rates. To give an idea of how relaxed market pricing is, you don't have to look too far past an old favourite chart of ours. As the chart below shows, the market doesn't have the 90 day bill rate reaching 5% until well after 2014. When you compare that to past cycles, that's not just an extremely low end-point, it's also a very gradual trajectory.

**RBNZ 90-day Bank Bill Projections**



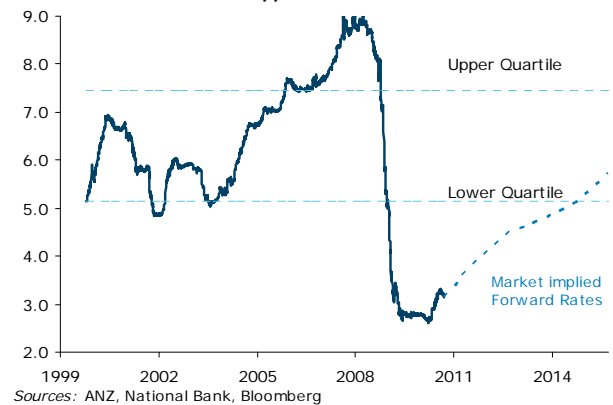
Sources: ANZ, National Bank, RBNZ, Bloomberg

**Indicative marginal funding costs relative to the OCR**



Sources: ANZ, National Bank, RBNZ

**Historical and Forward 90 Day Bill Rates compared to Lower and Upper Quartiles since 1999**



Sources: ANZ, National Bank, Bloomberg

## STRATEGY

In our view, the bulk of the move lower in interest rates has now occurred. Further downside is possible, and indeed even likely, particularly at the long end. But when we look at what it might take for us to see a repeat of the sorts of moves we've seen of late, the hurdle is high.

Let's consider the short end first. The bellwether 2 year swap has backed up off its late August lows, but it is around 40 basis points off its July average. Perhaps more importantly, it is now just 60 basis points above the 3 month BKBM rate, implying

What about the long end of the curve? Is that any different? In some ways it is, but in some ways it isn't. It's different to the extent that there are other drivers. However it's similar to the extent that it's getting stretched. As we highlighted in our last edition, offshore interest rates tend to be the dominant force here – and they have been falling (in a trend sense at least). But there's a limit to how disconnected the long end can become from domestic monetary policy. So unless you expect the RBNZ to sound an even more cautious tone in the months ahead, even if US rates do fall further, domestic long end rates will be doing battle with an upward trajectory for the OCR every step of the way. Incidentally, that's exactly how we expect things to pan out. While we're not explicitly forecasting further quantitative easing (QE) in the



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US, with inflation still trending lower and unemployment still stubbornly high, unless we see a rapid improvement, it's reasonable to expect some kind of response. And with the Fed Funds rate at zero, it will be non-traditional. There are few legitimate choices left, and QE would seem to be the obvious choice. Whatever they choose to do, we are confident it will be designed to hold long term rates down. We therefore struggle to see US rates rising any time soon, rather we suspect they will hold steady or fall gradually, at best adding downward pressure to NZ rates, at worst keeping a lid on them.

In our mind these considerations lend themselves to two broad conclusions. The first is that the broad structure of rates is biased lower, at least in the near term, and especially at the long end. But the second is that things will get progressively more stretched as this process unfolds. Based purely on our economic view, we think the next 25 basis points or so (lower) represents an opportunity for borrowers keen to lock in cover at historically cheap levels, particularly at the long end. It's not that we're trying to be clever, or trying to pick the low. After all, we do believe current interest rates are too low given the economic outlook. But with the RBNZ firmly on the sidelines and the Fed potentially poised to be more accommodative, we do need to acknowledge that rates could edge lower yet, especially in the near term, and especially at the back end of the curve. As such, any execution strategy ought to recognise this.

Of course, there are caveats. However, they're probably not the ones that first spring to mind. For example, we might be wrong – the economy may be bound for a recession, and rates may move much lower. Even though we believe there's a slim possibility that may be the case (after all, we obviously don't set out to be wrong), the one caveat we do want to stress is that things really will be different this time – or at least different in a different way. With more borrowers than ever on floating rates, and the RBNZ seriously acknowledging the role that increased funding costs, tighter regulation, and the slope of the curve have on monetary policy, the rationale for "filling your boots" on swaps at low levels is diluted somewhat. In some ways it's a bit of a trust thing. The more exposure the economy has to floating rates, the less they have to move. Hopefully the end result is less volatility in the business cycle too – which is good for everyone. We'd therefore encourage borrowers to view hedging as an effective means of delivering certainty, making

planning easier, and smoothing out interest expense, rather than as a means of beating the market, or beating the RBNZ at its own game.

Clearly, the ability to hedge depends on how healthy cashflow is, and how your business is performing. Remaining floating is cheaper, and as such it's a legitimate choice, especially with the RBNZ set to raise rates by less in acknowledgement of the fact that so many borrowers are. However, if things are picking up, and you can afford or need certainty, given our economic view, now would seem a good time to be adding to hedges.

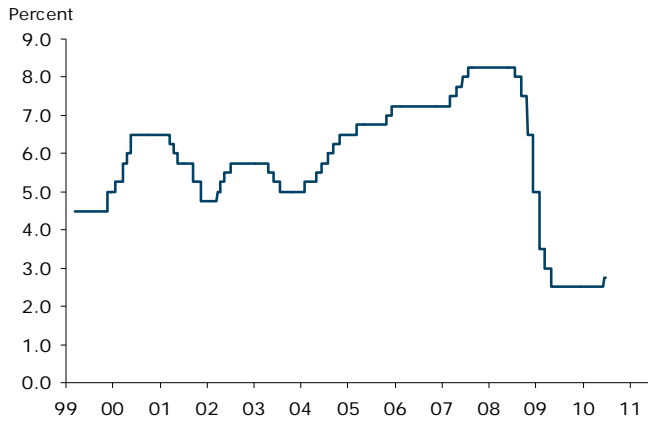
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# CHARTS

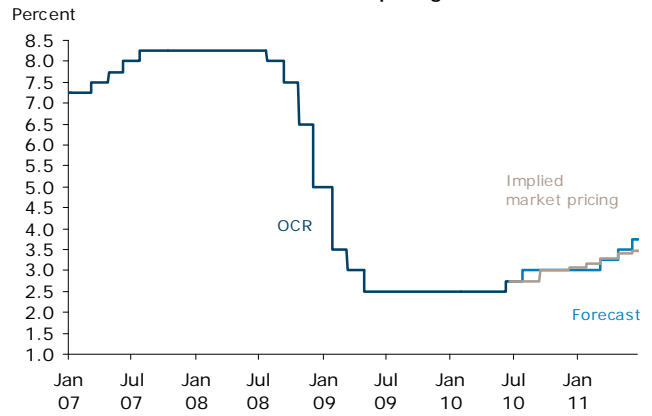
## CHARTS

**Official Cash Rate**



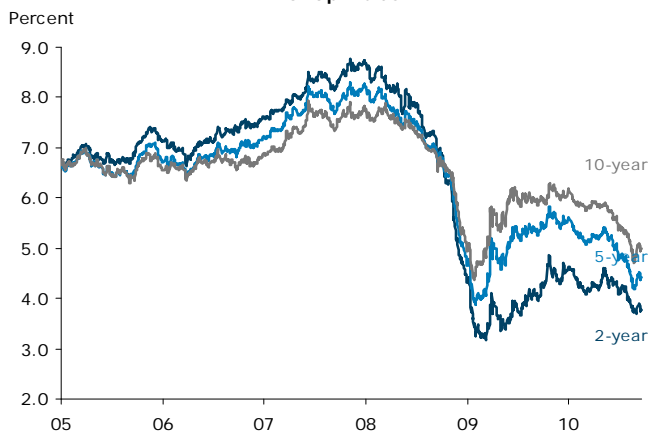
Sources: ANZ, National Bank, RBNZ

**OCR and market pricing**



Sources: ANZ, National Bank, RBNZ, Bloomberg

**NZ Swap Yields**



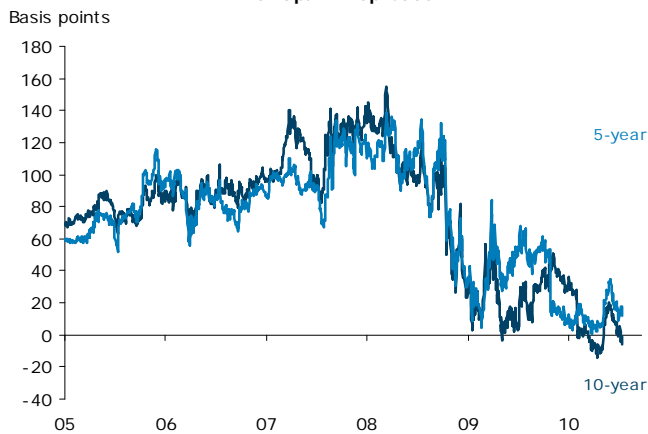
Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curves**



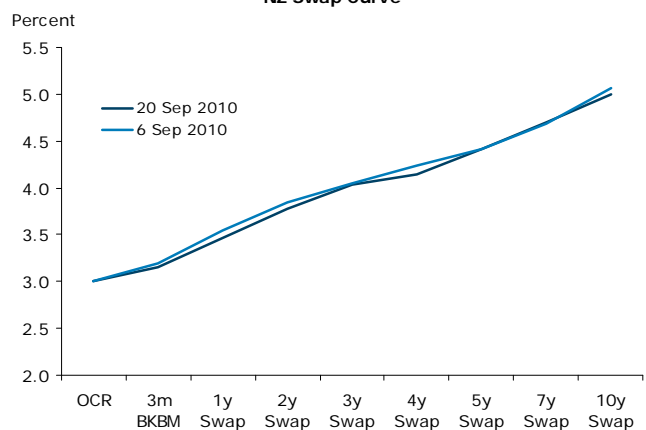
Sources: ANZ, National Bank, Bloomberg

**NZ Swap/EFP Spreads**



Sources: ANZ, National Bank, Bloomberg

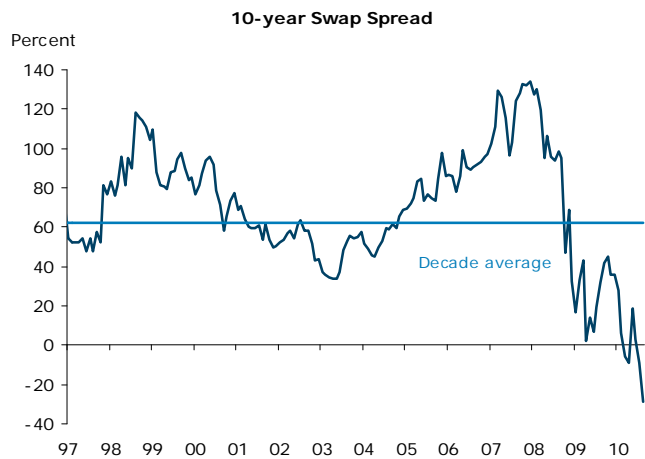
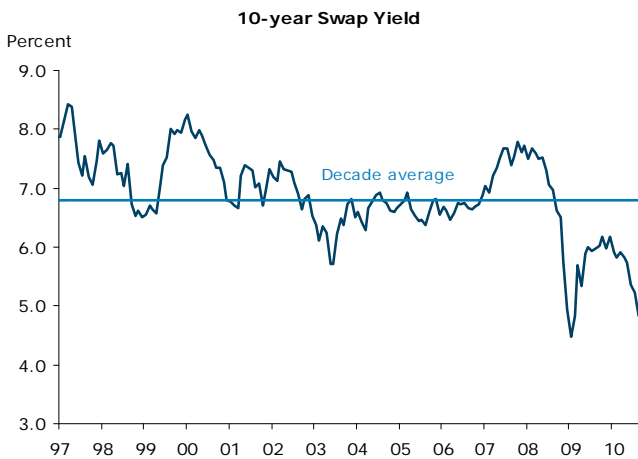
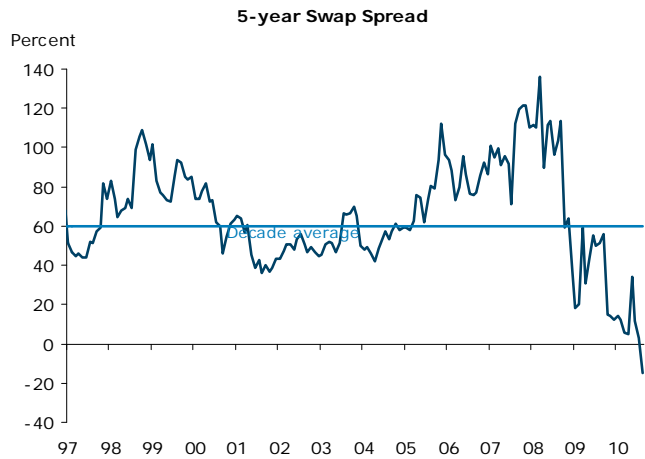
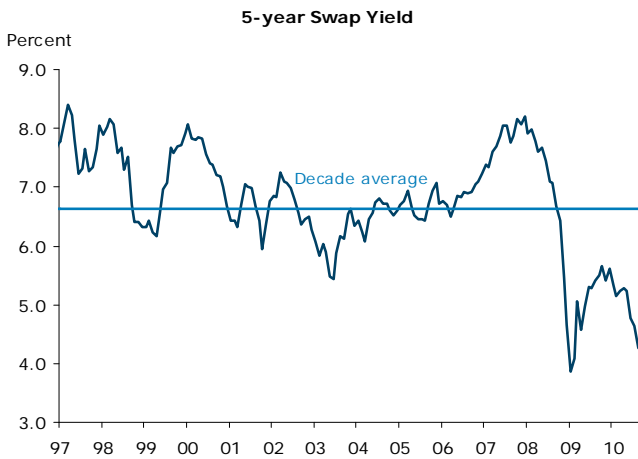
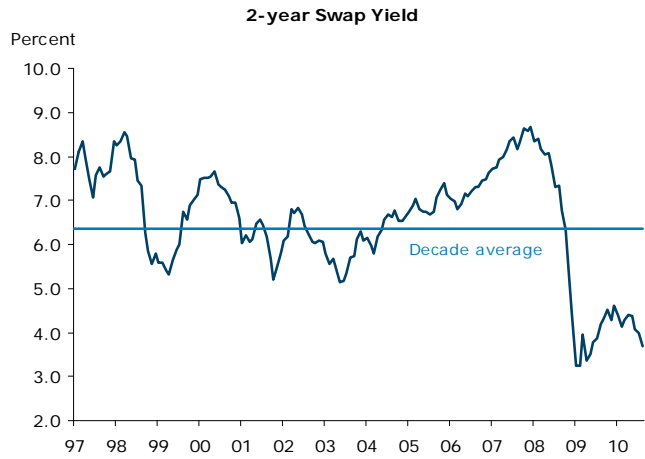
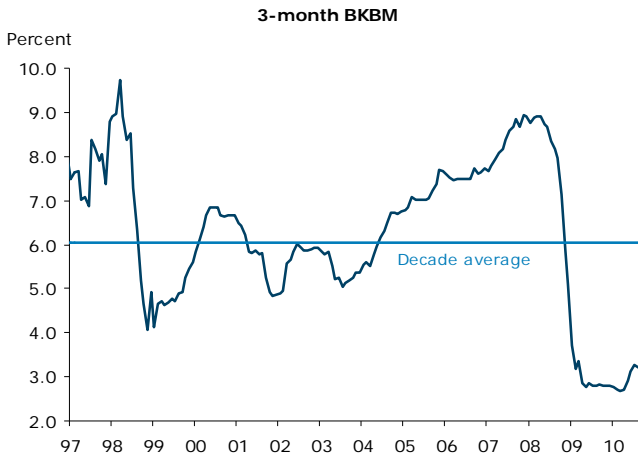
**NZ Swap Curve**



Sources: ANZ, National Bank, Bloomberg

# CHARTS (END OF MONTH)

## CHARTS (END OF MONTH)



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