NEW ZEALAND ECONOMICS
ANZ BORROWER'S STRATEGY

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CONTRIBUTOR

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ECONOMIC OUTLOOK

The Q3 GDP outturn confirmed a Rugby World Cup boost, but momentum in the New Zealand economy is now slowing as the Rugby World Cup boost dissipates. Business confidence data has lost some of its earlier resilience, and with the global outlook continuing to weaken, a potentially later start to earthquake reconstruction implies a more drawn out lull in activity. Although the housing market is strengthening from low levels, consumer spending remains modest, with signs the employment outlook is weakening. A slowing in activity and weaker than expected inflation data have diminished the possibility of an OCR hike in the near-term, with the OCR set to remain on hold for longer. Nevertheless, barring global meltdown, the next direction in the OCR will be up.

RATE VIEW

Broadly speaking, the risk is interest rates continue to edge lower. Of course, it's bordering on reckless to make such a sweeping generalisation, but when we consider the risk profile, that's where it firmly resides. But we need to appreciate the nuances, because the dynamics at play at the floating and so-called short end of the curve are quite different from those at the long end. Indeed, the short end is primarily driven by the near term monetary policy outlook (which has softened after the release of weak CPI data). The long end, by contrast tends to be driven by investment flows, which are in turn a function of things like real yield, monetary and fiscal credibility, the need for diversification and currency views. At the moment, New Zealand rates fairly well on these factors when compared with peers. What unites prospects for the short end and the long end is the outlook for Europe – for if things start to get ugly there, we may see OCR cuts here, and an eagerness to invest in NZ bonds. Of course, we can't be smug – although it is likely to be some time before the global scene settles, if the situation descends into complete chaos, even so-called "safe" markets like NZ might suffer too - as will funding markets. That being the case, for borrowers, the best scenario is one where things are just stressed enough to keep interest rates from rising, but not so stressed that funding dries up, or business prospects diminish further.

STRATEGY

On the face of it, with interest rates biased lower, and the global scene still somewhat precarious, it is understandable if borrowers feel like there is no hurry to hedge. We would further caution that if the outlook does sour, borrowers are likely to value flexibility over certainty, especially if revenue slows and funding costs rise. But by the same token, there is a lot of negativity priced in, and with rates approaching earlier cycle lows, and implied volatility falling, readers may want to consider hedging with swaptions. Swaptions are cheaper (but of course cover a shorter period), but more importantly, offer protection against the risk that all of a sudden rise in interest rates, and, you are left unhedged. Our feeling is that this is the risk most people are worried about.

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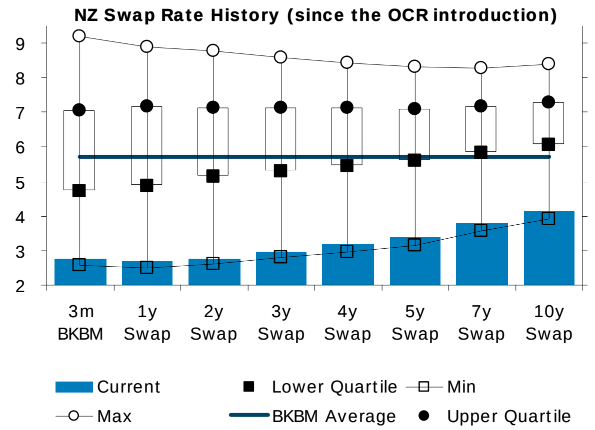
VALUATION

Interest rates are at similar levels to those prevailing when we last went to print before Christmas, although the curve has flattened a touch. This does make longer term hedging a touch more attractive, but as discussed in this document, we see no hurry to hedge, and prefer options over swaps. At this stage the market is pricing in around 50 percent odds of an OCR cut by June. Although we do not expect the RBNZ to cut rates, there are scenarios that might warrant one, and the market will continue to price this downside bias in. This will, in turn, tend to keep 3mth BKBM at or below current levels for the foreseeable future.



Sources: ANZ, National Bank, Bloomberg

Current interest rate levels		
Maturity	**Last edition**	**Current**
3-mth BKBM	2.68	2.75
1-year swap	2.65	2.69
2-year swap	2.77	2.78
3-year swap	2.97	2.96
4-year swap	3.20	3.17
5-year swap	3.43	3.40
7-year swap	3.85	3.79
10-year swap	4.21	4.16

Market expectations for RBNZ OCR (bps)		
OCR Dates	**Last edition**	**Current**
Thu-26-Jan-12	-4	-1
Thu-8-Mar-12	-6	-9
Thu-26-Apr-12	-8	-11
Thu-14-Jun-12	-8	-12
Thu-26-Jul-12	-8	-12
Thu-13-Sep-12	-8	-10
Thu-6-Dec-12	-8	-7

WEAKER INFLATION GIVES RBNZ SPACE

Q4 CPI data released yesterday was significantly weaker than both the market and the RBNZ expected, and has seen the market price in greater odds of a rate cut by mid year. In our view, the data does not in itself give the RBNZ the green light to cut the OCR, even if the weakness was broad-based. We're certainly going to need to see more signs of weakness in the economy before we can conclude that inflation is on a downward trajectory, especially with inflation expectations still elevated (albeit falling gently). We're also mindful of the lagged impact on "household monetary conditions" as borrowers roll off historic fixed rates that are substantially higher than current floating rates. Indeed Indeed, we estimate the average fixed mortgage rate rolling off at present is around 6.7 percent - a sizable gap from where current floating rates are at the moment (ANZ's carded variable rate is 5.74 percent). So policy is easing - by stealth, and the housing market is showing signs of responding.

Nevertheless, weaker CPI data certainly gives the RBNZ more "wiggle room" should some (likely offshore inspired) scenario emerge warranting further monetary policy support, and as noted earlier, we expect the market to continue trading with an easing bias.

DOWNSIDE RISKS DOMINATE, BUT DON'T COUNT ON IT

By now, we suspect most of our readers are reasonably familiar with what's happening in Europe – or are at least getting a whiff of the headlines about credit rating downgrades, bondholder haircuts, new ECB liquidity facilities and the like. The European sovereign debt crisis is certainly the issue of the day, and we would rate it at the top of our list insofar as event risk is concerned. Sadly, the longer things drag on, the more the crisis weighs on confidence, global growth, credit spreads and by implication, the global recovery. Worse still, it is not difficult to imagine an "accident" occurring, be it a default, a missed deadline, or more downgrades. All of this casts a dark shadow over the market.

That said, we need to be careful not to talk ourselves into a tailspin, and we need to acknowledge that there's a lot of negativity priced in. Indeed, witness the relative calm that followed S&P's announcement a week ago that it had downgraded 9 European sovereigns. Markets took fright, but they didn't fall out of bed like many feared they would, or like global markets did when the US was downgraded in August. When we look ahead, we fully expect bumps in the road in Europe, but the point is; they'll need to be fairly nasty bumps for markets to go completely awry. That being the case, we think it makes more sense to brace for uncertainty and a lack of progress, as opposed to a complete meltdown (although we wouldn't rule a meltdown out!). And in fact, while we know a serious shock in Europe has the potential to force the RBNZ's hand to the point where it cuts the OCR, this is something we ought not to wish for, because it is likely to be accompanied by weaker NZ growth prospects, and wider funding margins.

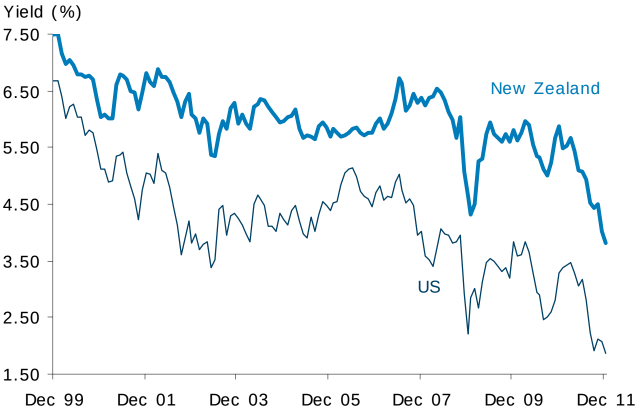
We must also recognise the political angle insofar as Europe is concerned. Indeed, as we highlighted in our Themes for 2012 article in this week's *Market Focus* (available on request) the fiscal economics ceased stacking up for some countries in Europe a long time ago, particularly for Greece. But this does not mean Greece is out for the count. Things are pretty dire, and it is reliant on the benevolence of its creditors and neighbours. However, the point is; it's the politics that will dictate the outcome, not the economics. That's both comforting and dangerous. It's comforting because politicians can influence outcomes. But it's dangerous because the market is counting on them succeeding, and they might fail, and if they do, the market could be in for a shock.

Ongoing uncertainty and a lack of concrete progress means that the local market is likely to go on carrying the "baggage" of European risk, and that's likely to weigh on interest rates, and monetary policy expectations. The end result is that floating interest rates are likely to remain low for at least the next 2 quarters. As we approach the end of the year, if Europe avoids an accident, and the US economy gains momentum (as recent data suggests it will), and commodity prices hold up, New Zealand will find itself on a reasonably sure footing, potentially necessitating higher interest rates. But there's plenty of water to flow under the bridge yet!

ARE INTEREST RATES TOO LOW?

As always, the answer is; it depends, and on a lot of things. The bears argue that interest rates need to rise because they are too low relative to benchmarks like historical experience and inflation, particularly in key markets like the US. Even the most basic analysis of the data bears this out. They show, for example, that US 10 year government bond yields are at their lowest level since Bloomberg records began in the early 1960s, as the next chart shows. Real yields are equally low, and in fact negative whether deflated by headline or core inflation. The doomsayers have correctly pointed out that this situation can't last forever – and it can't. The question is; will it last a little longer?

NZ & US 10yr Govt Bond Yields

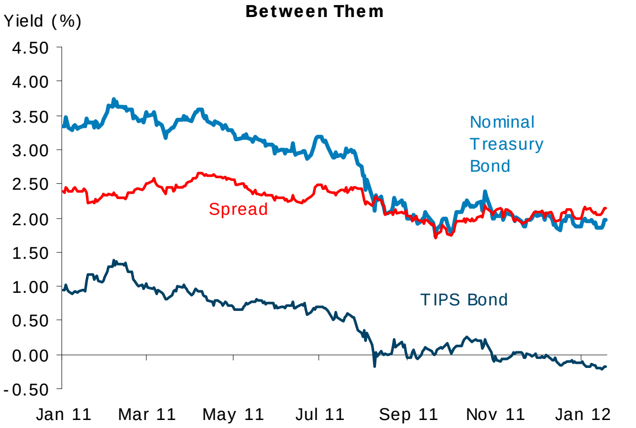


Sources: ANZ, Bloomberg

Well, it might. For one, there's more at play than plain economics at the moment. It can, for example, no longer be taken as a given that government bonds are risk free. This is especially true in Europe, where profligate governments have racked up enormous debts. As if that was bad enough, their individual central banks don't have the option to shift interest rates, nor do their economies have a flexible exchange rate as a safety valve. Perhaps worse still (for their governments), they don't even have the option of printing money to pay back debts. This has given rise to enormous investor distrust, with the end result being a massive flight to safety into the US bond market. Perhaps more than anything else, this is what is keeping bond yields lower. And until this situation changes, it may be a stretch to expect interest rates to rise in core markets.

An obvious question is; what impact has the so-called flight to safety had on yields? It is impossible to say, but a brief analysis of US inflation-linked bond yields (also called "TIPS", which compensate bondholders for rising inflation) is quite telling.

US 10yr Treasury and TIPS Yields, and the Spread Between Them



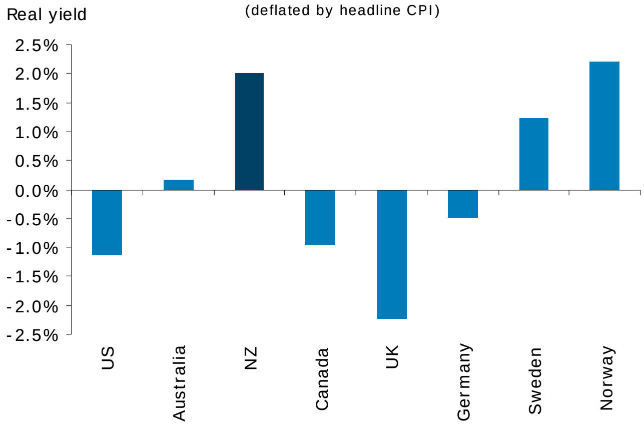
Sources: ANZ, Bloomberg

BORROWER'S STRATEGY

As the chart above shows, yields on 10yr TIPS have collapsed, and are now well into negative territory. Think about that – because it is akin to saying that the market is prepared to lend the US Treasury money at a loss. Why would anyone do that? One explanation might be that it is because they think they will be handsomely rewarded when inflation does start to rise (and many expect it will).

But if we look a little closer, we see that we have seen a similar trend with normal (i.e. non inflation adjusted) 10yr US Treasury bonds (or USTs). Yields on those have also fallen, and broadly speaking, have kept pace with TIPS yields, keeping the spread between nominal and inflation linked bonds fairly constant. Among other things, this tells us that it is not inflation expectations that have pushed bond yields lower, but something else. The tone of US data has improved, so it is not likely to be expectations of monetary policy being easier for longer. And it is not likely to be lower credit risk either – after all, the US had its credit rating downgraded in August. Our money is on flight to safety. Indeed, the irony is, the biggest move in US interest rates came days after the US's credit rating was downgraded, after which time, interest rates actually fell, presumably as the market priced in political gridlock, slow growth, and a yearning for safety. After all, Uncle Sam can (and has) been printing money to repay bonds, so it's not like you're not going to get your money back. Anyway, the point is, we suspect we are going to need to see a substantial change in risk appetite emerge before US interest rates rise in any meaningful way, pricing out the flight to safety premium. That will no doubt occur at some point, but is it realistic to expect such an outcome while the European debt crisis is ongoing? We doubt it.

What's the upshot of all this for New Zealand? For one, we need to be careful not to blindly assume that interest rates must surely rise simply because they are at historic lows. In fact, New Zealand continues to be considered a safe harbour on a storm, even if it is not seen as being so safe in a proverbial hurricane. As long as we don't see a hurricane, we would expect local bond yields to remain low. In fact, when we consider how attractive New Zealand bond yields are in comparison to global peers in both outright and real yield terms, as the next charts shows, given our distance from Europe (physically and metaphorically), we expect to see more investment in the local bond market. If we are right, it is hard to imagine local long term interest rates rising.



Sources: ANZ, Bloomberg

We already noted at the beginning of this note that the RBNZ was likely to be sitting on its hands until at least the end of the year, if not longer. With monetary policy on hold, and the yield opportunity plain to see, the bottom line is, it is simply not good enough to say that interest rates need to rise (just yet) simply because they low.

THE OPTION TO CHOOSE

At this juncture, we favour options over outright hedges. In our view, this is the best way to balance the desire to hedge that comes about when interest rates are low with the risk that rates stay lower for longer (recalling that if you do hedge for a term, even now, you will immediately start paying a higher rate). Caps are, as always, an effective way to hedge. However, they can be expensive, particularly when the yield curve is steep. They also offer protection right from the start. That is, your first few rolls are capped, even though the spread between the actual BKBM rate and the cap rate is so wide you are unlikely to need the protection early on – yet you are paying for it.

Indicative Cap and Swaption Pricing

Option	Strike	Premium per $1m face value
5 Year Quarterly Caps:		
Standard Cap	3.75%	$30,440
Standard Cap	4.00%	$27,170
5 Year Swaptions Expiring in 6 months:		
Payers Swaption	3.75%	$11,740
Payers Swaption	4.00%	$8,120

By contrast, swaptions offer the right to enter a swap at a future date, guaranteeing a maximum hedge rate in the future. As the comparison of examples in the table above shows, they are substantially cheaper, and in our mind are more closely aligned with the risks that lie ahead. Indeed, judging by feedback from customers received over the past 2 years, the real fear is that at some stage, interest rates will shoot higher, and those on floating will miss the boat. We suspect most borrowers are comfortable being floating for the next few quarters, but are somewhat nervous that swap rates may not stay low for that much longer, and swaptions are in our view the easiest way to hedge against this risk.

Moreover, should we get to the expiry date of the swaption, and interest rates are still below the strike rate, at that point a borrower can choose to enter another swaption (which may be the best course of action if uncertainty is still high), or simply to hedge at whatever the swap rate is on that date if by then there is more confidence that interest rates will rise.

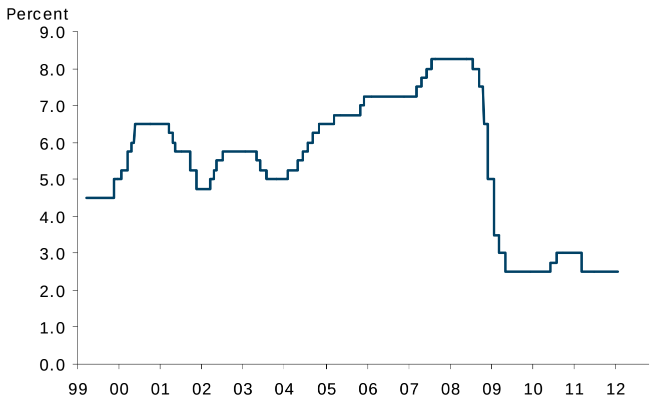
Like many others, we are pinning our hopes on 2012 as being a year of recovery, but we are mindful of the fact that we had similar feelings towards 2011 (and 2010 even!). Had a borrower had, for example, a 5yr cap for the past year, they'd only have 4 years left to run on it, having paid a reasonably large premium. Of course, they would have enjoyed low floating rats over that time, which has been a boon. But if they had bought a series of swaptions, they might have paid less premium in total, and been able to reset the strikes lower as swap rates fell, and maintained a 5 year duration. Of course, this is hindsight at play, but the point is, if you think borrowing rates are low, but are not sure when the big reversal will come, and think there is a risk they edge lower, swaptions may be the better choice.

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)

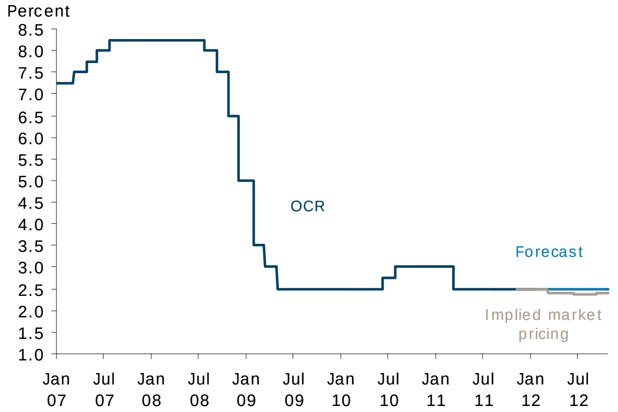
CHARTS

Official Cash Rate



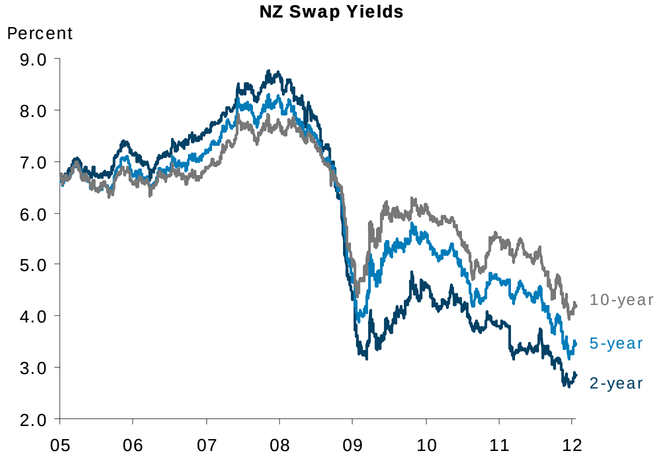
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



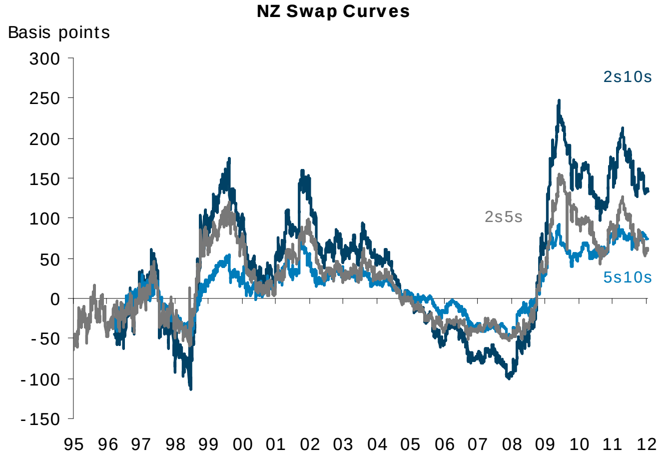
Sources: ANZ, National Bank , RBNZ, Bloomberg

NZ Swap Yields



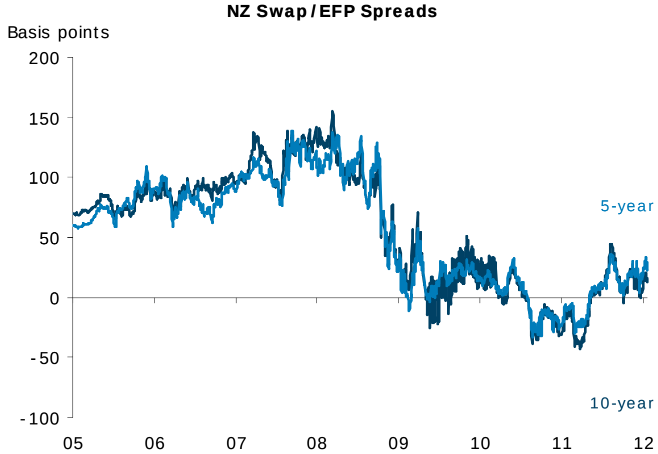
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



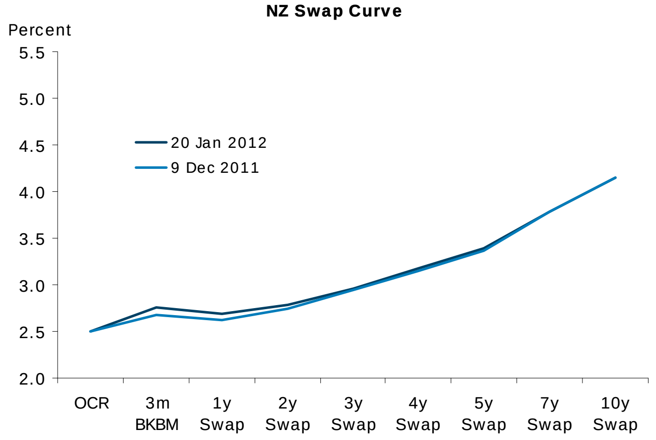
Sources: ANZ, National Bank, Bloomberg

NZ Swap / EFP Spreads



Sources: ANZ, National Bank, Bloomberg

NZ Swap Curve



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CHARTS (END OF MONTH)

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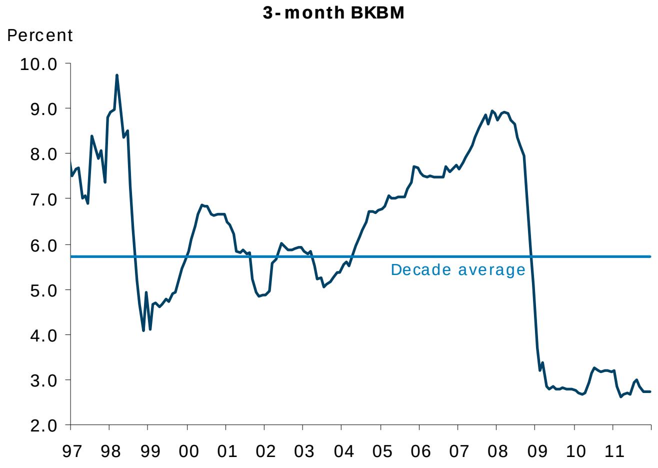

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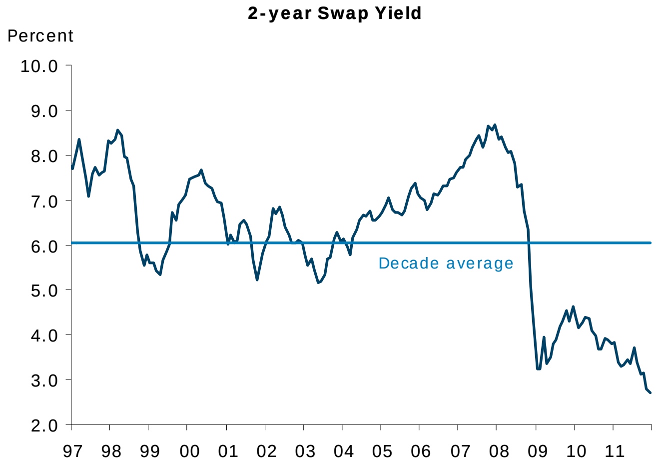

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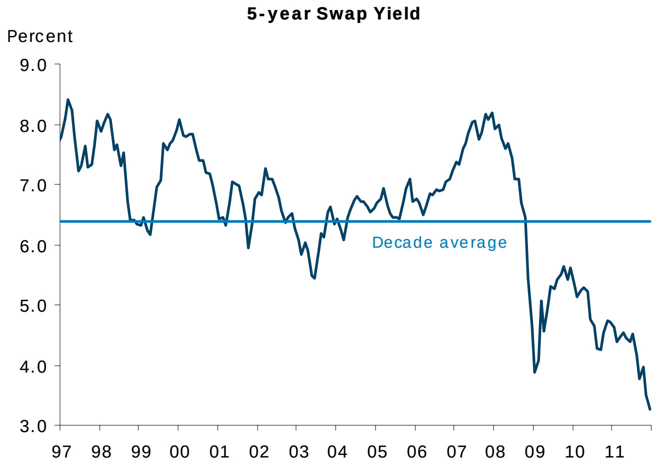

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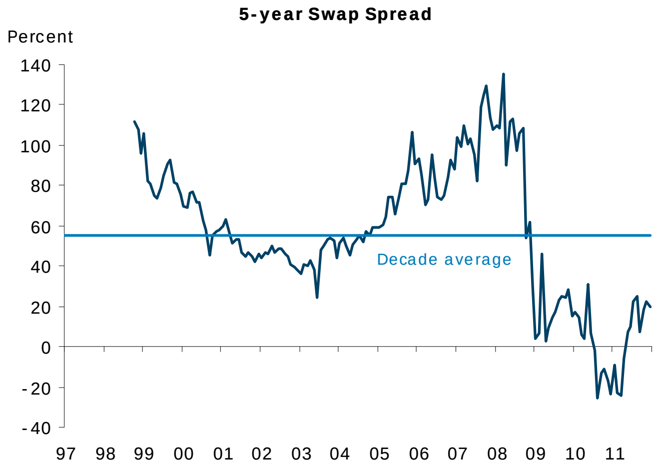

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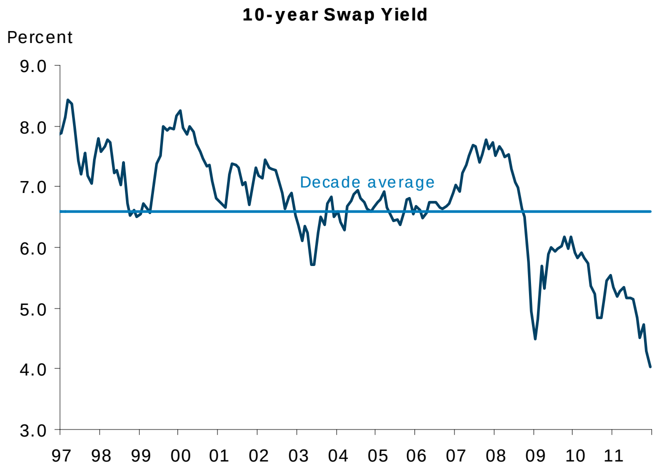

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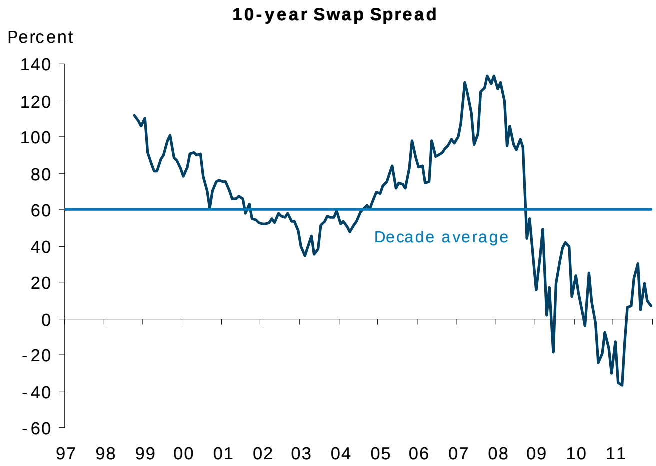

Sources: ANZ, National Bank, Bloomberg

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