

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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CONTRIBUTOR

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ECONOMIC OUTLOOK

We remain cautiously optimistic. Broad based commodity price strength has pushed the terms of trade to a 37-year high. Deleveraging is ongoing, but solid income growth does mean that the impact on spending has been reduced. While the June 13 aftershocks are a reminder that the situation in Canterbury remains fluid, the willingness of the Government to use its balance sheet has provided more certainty. Growth looks set to springboard from low levels from the second half of this year, underpinned by supportive financial conditions, quake reconstruction and the Rugby World Cup. This will be taking place against a backdrop of lower trend growth as the economy rebalances away from spending towards production. We have a less benign view on inflation than the RBNZ, and expect signs of emerging inflation pressure to result in the RBNZ unwinding the March MPS insurance cut from December. While we are seeing signs of slower global growth momentum and more fragility in the global economy, we are of the view that the New Zealand economy is resilient and in better shape now than it was in February.

RATE VIEW

Domestic swap rates would almost certainly be higher had it not been for aftershocks and rising global uncertainty. However, while the aftershocks were the catalyst for the initial shrugging off of the RBNZ's projections, last week's government announcement on the plan for Christchurch has placated the pessimists. More recently though, global uncertainties have stepped into the breach, so to speak, and this has had a much more significant impact on interest rates here and abroad. Indeed, Australian rates are now pricing in high odds of a RBA rate cut by year end! Market reaction in NZ has been less spectacular – but it has been significant and the market remains wary of global risks. In this environment, despite New Zealand's improving domestic fundamentals, it is difficult to imagine rates moving substantially higher any time soon though we believe the coming months may flag rising inflationary pressure (inflation expectations, core measures, jobs growth). The RBNZ is flagging more prudential measures, which should act as a semi substitute for the OCR (in so far as how high it goes). We respect global challenges (though view recent US data weakness as temporary). Yet, a 2.5 percent OCR simply looks out-of-sorts with the growth and inflation profile.

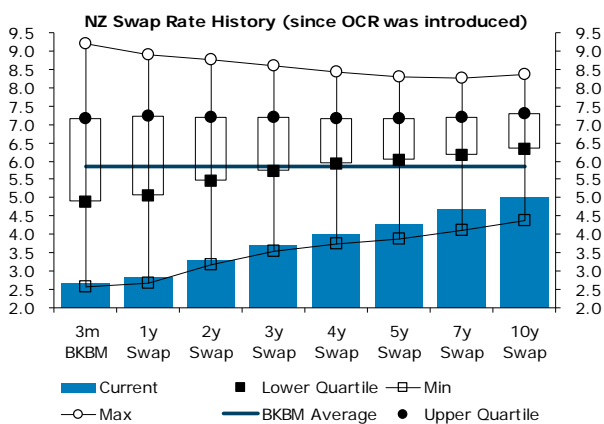
STRATEGY

If we were being clinical, we could point to the fact that 1-3 year swap rates are well below where they ought to be if the market was to "subscribe" to the Reserve Bank's 90 day bill projection as proof of value. The problem is, there's more to it than just the numbers, and as noted above, uncertainty is having an abnormally large impact on interest rates. Had it not been for global events – we can't see the Greece situation settling soon and not spilling over into other eurozone countries – we would have a strong preference for fixing at these levels. Yet, we also see a potential repricing catalyst in the form of upcoming inflation centric releases (think jobs, expectations, and inflation itself) and suspect the rally in US treasuries is starting to unwind. This portends of a market that is going to remain fickle and whippy. Until we see some consistency, both locally and globally, time still looks to be on borrowers' side.

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VALUATION

Interest rates are higher across the board relative to where they were two weeks ago, but they remain at very low levels relative to past experience and the RBNZ's 90 day bill projections. Given the upbeat domestic economic picture, this would normally be a sign of value. However, uncertainty is extremely high at the moment, putting valuations somewhat on the back-burner. The curve remains steep, further reducing the incentive to pay fixed.



Sources: ANZ, National Bank, Bloomberg

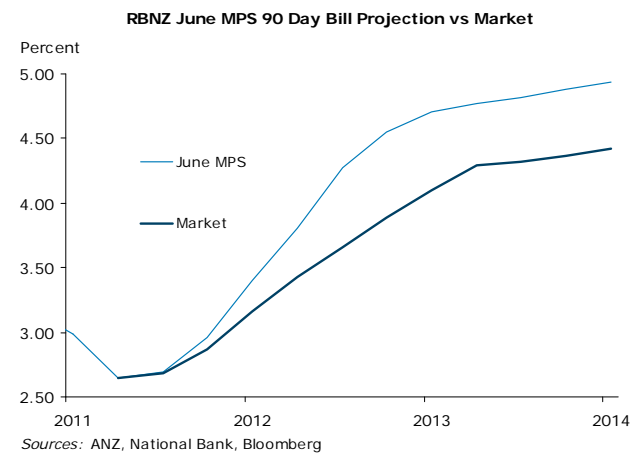
Current interest rate levels		
Maturity	2 weeks ago	Current
3-mth BKBM	2.66	2.67
1-year swap	2.85	2.91
2-year swap	3.30	3.38
3-year swap	3.70	3.79
4-year swap	4.02	4.13
5-year swap	4.28	4.42
7-year swap	4.67	4.82
10-year swap	5.01	5.18

Market expectations for RBNZ OCR (bps)		
OCR Dates	2 weeks ago	Current
Thu-28-Jul-11	0	0
Thu-15-Sep-11	0	+2
Thu-27-Oct-11	+1	+6
Thu-8-Dec-11	+11	+15
Thu-26-Jan-12	+18	+22
Thu-8-Mar-12	+33	+39
Thu-26-Apr-12	+43	+60

OLD HAT?

Regular readers will recall we discussed the details of the RBNZ's new upward revised 90 day bill projections from their June *Monetary Policy Statement* at length in our last issue. To be sure, the key feature of the projections was that (a) they were revised up, and (b) that the pace at which they rise was and is well above what current market pricing implies. The question is; what should we make of the projections now? Are they old hat? We discuss this in more detail over the next few paragraphs.

To start with, let's debate whether the projections are old hat. This is important, if only because of the massive wedge that has formed between market pricing and the Bank's projections, as the chart below shows. But for us to really answer the question, we really need to explore two questions. The first is; now that we have had two weeks to assess the impact of the Christchurch aftershocks, what can we say about the domestic outlook? The second is; what do global market jitters mean?



Sources: ANZ, National Bank, Bloomberg

So, what is the post-aftershock outlook, and has it changed? In some ways it has – and the market was probably right to water down its growth expectations in the immediate aftermath, at least initially. But in other ways, this month's aftershocks can be viewed as a catalyst. They certainly appear to have been instrumental in the bringing forward of last week's announcement on the future of Christchurch. Complex as the issues are, and difficult as the choices will be for some people, the fact that the city has been zoned means that the majority of people are now in a position to get on with things. This is surely a positive, even if not all uncertainties (most notably the insurance situation) have been dealt with.



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TRAFFIC LIGHTS

For those in the red zone, this probably means accepting a cheque from the government. Whether that then means moving elsewhere in the district, or overseas remains to be seen. However, it does unlock a great deal of capital, and much of it will be put to work in New Zealand. Indeed, if anecdotes about section enquiries in Christchurch are to be believed, it is fast becoming property central. Those in the green zone have largely been overlooked by the commentators – yet last week's announcements were a major step forward for them. Indeed, the government has given them the green light to start rebuilding, putting paid to the question of should I, or shouldn't I. Christchurch, it would seem, is set to become a hive of activity (there were more jobs advertised in Christchurch in May than in Wellington and Auckland combined) though at this juncture we need to acknowledge two dynamics. Non-residential activity is still a long way off and there is the obvious risk of subsequent shakes. The latter could be a backbreaker and a non-trivial risk.

But what are the prospects for the rest of the country? We won't go into a detailed analysis, but notwithstanding the rise in global uncertainty, which we will discuss in a moment, it's becoming clearer by the day that the rest of the country has better momentum. Indeed, Q1 indicators have generally surprised on the upside. Elements of weakness remain – building consents are still low and retailing fragile. Yet the weight of data is now pointing towards improvement and after a year long delay it now looks like the terms of trade boost (to a 37 year high) is filtering into the wider economy.

RISK OFF, YOU SAY?

If the domestic picture looks constructive, the same can't be said about the global picture, and in fact, the two key issues we raised in our last edition have simply intensified. They are the US economic outlook and the Greek debt situation. In our view the former is critical – and in fact *the* major risk to the New Zealand recovery. As the FX punters call it, we're in a "risk off" phase. However, as we explain in more detail in the next section, Greece looks more like a sideshow than anything else. It's like watching a bad horror movie really – scary and entertaining – but ultimately it ends.

Turning back to the US – as noted – the situation has intensified. Broadly speaking, the last two weeks has brought with it two new developments. The first has been the ongoing deterioration of US data. Of

particular concern are the sharp drops in the regional manufacturing surveys. Confidence has also slipped, as have housing data.

Two schools of thought have emerged. The first thinks the weakness is endemic and will ultimately end in QE part 3. The second believes short-term supply disruptions have played a significant role. A lot of people have feet in both camps. We respect the former (we don't think the US economy can grow strongly given challenges but that's both supply and demand induced) but also believe the latter is playing an under-appreciated role. Last night's Chicago PMI certainly portends of a better tone across the likes of the ISM and we've seen US Treasuries come off their lows easily.

The Fed seems be mindful of the latter as well with Bernanke personally noting that he believed the US slowdown was "at least partly temporary", though he also added that "we have an awful lot of uncertainty right now about how much of this slowdown is temporary, how much is permanent. So that would suggest, all else equal, a little bit of time to see what's going to happen is it would be useful in making policy decisions". Net on net this sounds like normal central bank speak with a foot in both camps but the big picture remains that the inflation-unemployment tradeoffs don't look the same as in 2010 when they rolled out QE part 2.

SIDESHOW

Sideshow Bob's a pretty funny guy. But he's not the main character in "The Simpsons". Similarly, Greece is a bit of a sideshow as far as the global economy is concerned. Sure, it was one of the early entrants into the euro after the single currency was formed, and as much as it was a surprise at the time that they made the criteria, we now know they fiddled the numbers. And as high as Greece's debt burden is, and as strong as the feeling is in Europe that they're all "in this together", the reality is that the Greek economy is pretty small, and markets are probably overstating the importance of it.

MELBOURNE AND ATHENS

To give an idea about the size of Greece, consider this: its GDP is about the same as the Australian state of Victoria. In fact, it's actually slightly less, despite the fact that it has about twice as many people (11.3 million) as Victoria (5.5 million). That's not a good look and one would argue that if it was Victoria having a budget meltdown, it'd barely make

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the headlines outside Australia. Yet Greece is on the front page of every financial paper just about every day. It's becoming fatiguing.

Perhaps more importantly, as the Economist pointed out, Greece is not "Europe's Lehman". As that newspaper pointed out, while Lehman's "fall caused panic because others in the markets had no way of knowing who the counterparties to its trades were and whether Lehman owed them so much that they too might fail. That ought not to be true of Greece. It has far fewer creditors: two-thirds of its debt is probably held by about 30 institutions. And whereas Lehman's exposures were hidden from public view, Greece's are largely out in the open and are also reasonably easy to value. The more light has been shone into the dark vaults of banks holding Greek government debt over the past year, the more markets have been reassured that few, if any, foreign banks are dangerously exposed".

We don't know what will happen with Greece, but it does seem to us that markets have learned what happens when liquidity dries up (governments and central banks step in); when falling risk appetite threatens growth (central banks cut). Markets are certainly less likely to be as panicked as they were when Lehman failed, and will be wary of getting too bearish having experienced a snappy rebound in 2009. And to the extent that New Zealand regulators (and others) have taken steps to bolster bank balance sheets, we ought to be in a better position to withstand a downturn, if Greece is capable of causing one. Perhaps more importantly, as the RBA has pointed out, bank asset quality is more important than access to funding (and in fact, should open the door to funding). Thankfully, bank asset quality in New Zealand remains high, reducing systemic risk in the eyes of creditors

Indeed, as our sovereign debt analysis has consistently shown, New Zealand has consistently differentiated itself from Greece and the other so-called PIIGS (not to mention the US and UK) and we are simply not likely to be the target of the market's ire unless the wheels really fall off. And as we suggested earlier, Greece looks more like a speed bump than a fender bender.

Why is all this relevant? Because we need to be mindful that once the sideshow fades, we'll be back to business as usual. And while that seems some time away (at least weeks, rather than days), buying us some time, it isn't likely to be a permanent shift. For that reason, we will resist from getting too bearish, and would rather characterise our preference to watch and wait as something that will buy us more time, as

opposed to more value. We may well see rates move lower –but it is far more likely to be because the US has a meltdown, and not because Greece stumbles. Yet at the same time there looks like solid potential for the NZ curve to re-price upwards when we look at pending medium-term dictators of inflation trends including the labour market, inflation expectations and inflation itself for Q2 (due mid July). Yet until we see some consistency both locally and globally, it looks simply a case of ranges playing out and every month one remains on floating is another month where one saves having to step up onto the fixed rate curve.

INTEGRATION

The final point to make in relation to global events is one of integration. Even if events outside NZ may seem to be obscure, to the extent that they impact on investment decisions, they are critical. One obvious development has been the return to popularity of "carry" as an investment motive in the wake of slowing US data, and the Fed's concession that they may take additional action if necessary. This can (and has) had an enormous impact on our market, with investors from all over the world interested in our market for its attractive carry. In other words, it's not just things like relative interest rates that matter, so too does the psychology of the market. And when things are uncertain – as they are now – this can have a huge impact on pricing.

TREADING WATER

Despite our upbeat domestic economy view, we are extremely mindful of significant uncertainties that lie ahead, particularly on the global front. We are then, in a nutshell, treading water, and as such, we prefer to stand by for now, waiting for more clarity before adding to hedges.

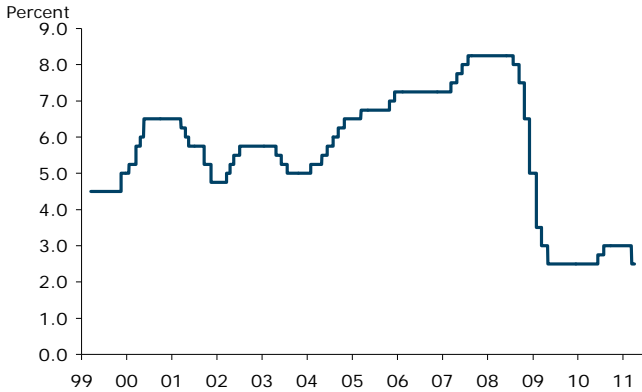
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CHARTS (END OF MONTH)

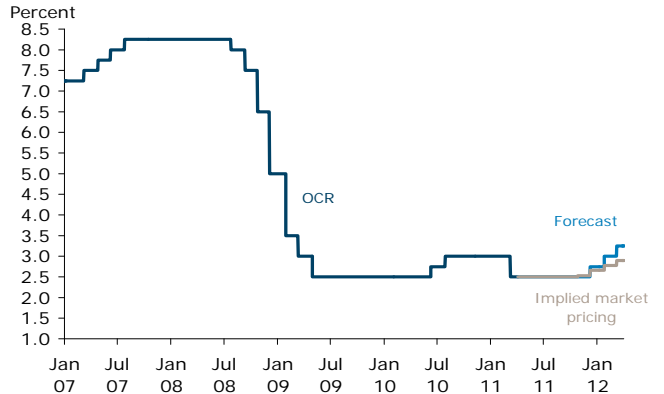
CHARTS

Official Cash Rate



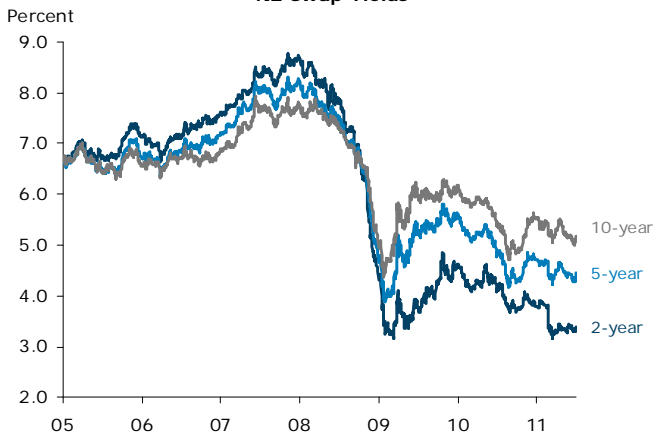
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



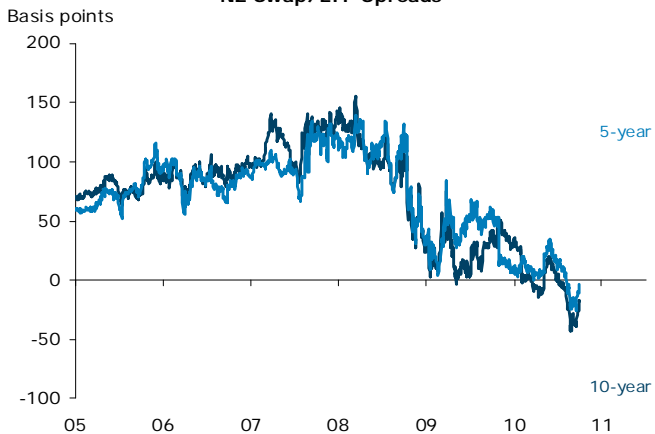
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



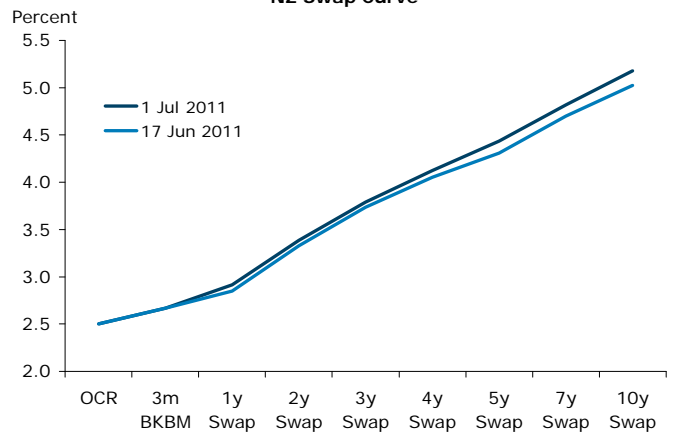
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

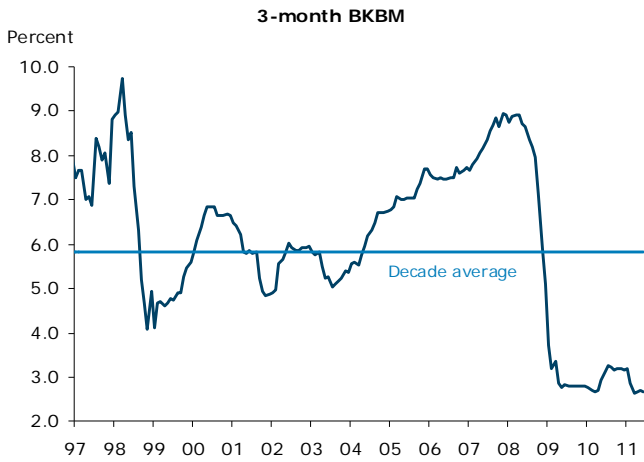
NZ Swap Curve



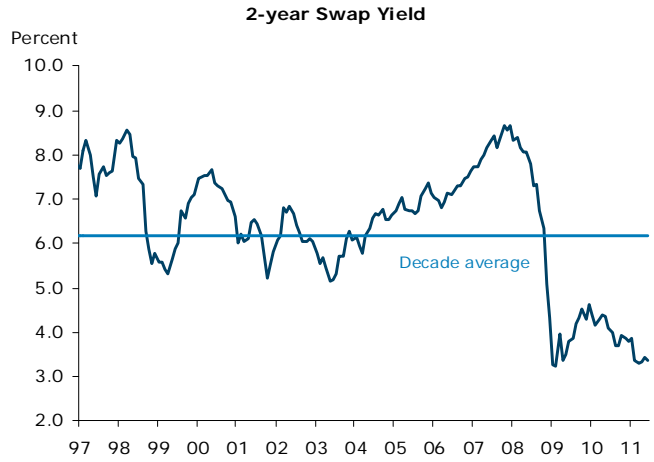
Sources: ANZ, National Bank, Bloomberg

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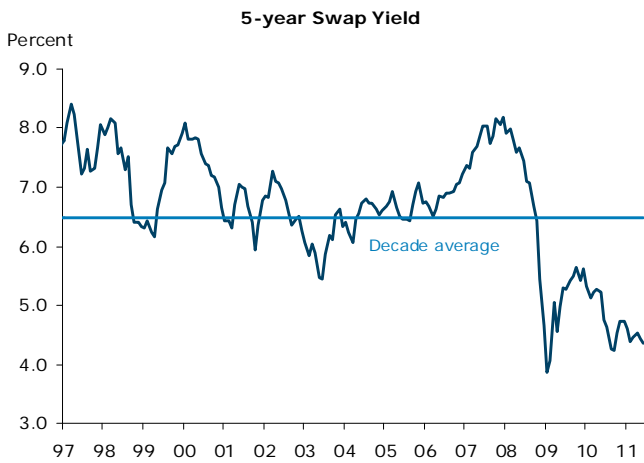
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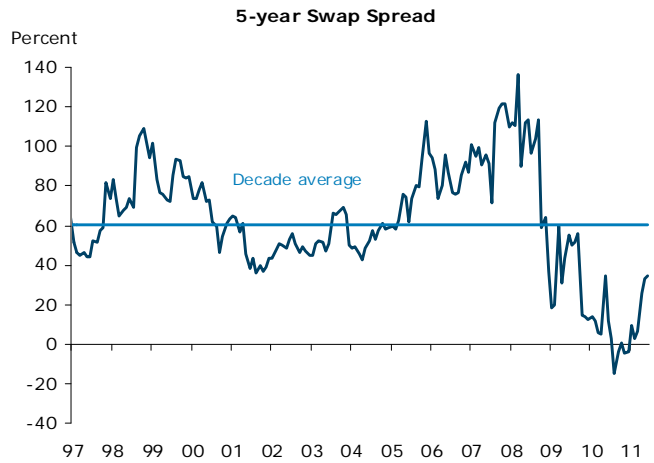
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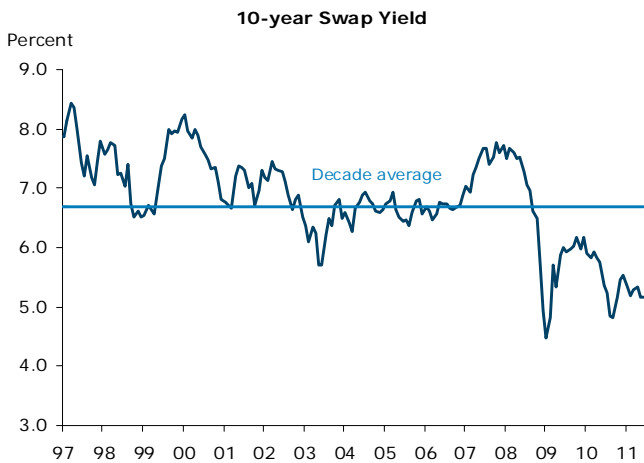
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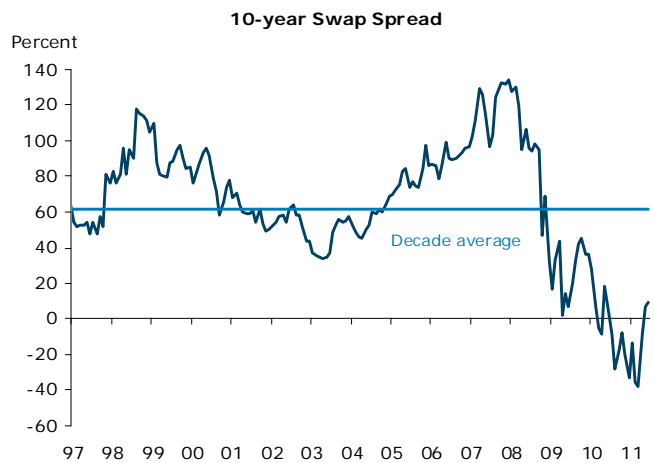
Sources: ANZ, National Bank, Bloomberg



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