

## NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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### CONTRIBUTOR

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### ECONOMIC OUTLOOK

In April the RBNZ adopted a patient approach, giving more time for the March MPS insurance cut to work. The Christchurch earthquake was a massive shock, with production lost, activity displaced and balance sheets taking a \$15-20b hit. However, evidence is growing that the economy, particularly ex Canterbury, was and is on a stronger footing, both before and after the February 22 earthquake. Looking through the volatility in quarterly labour market outturns, the labour market is looking respectable, with solid growth in labour earnings. We remain optimistic over prospects for the second half of 2011. A lower level of activity provides a larger springboard from which recovery can occur. Financial conditions have loosened considerably. Export commodity prices are displaying broad-based strength, widening the benefits to rural incomes. The Rugby World Cup is set to provide a sizeable boost to both inbound tourism and domestic spending. Earthquake reconstruction will provide a multi-year boost to economic activity. Although the RBNZ seem fairly relaxed about the inflation outlook, we have a less sanguine view, and we expect a stronger cyclical upswing. Indeed, higher inflation is at the heart of our forecast of the OCR going higher by end of the year.

### RATE VIEW

Swap rates continue to fall, mirroring moves in offshore interest rates, and in response to a pick up in demand for NZGS bonds at the Government's weekly bond tenders. Although this has led to a normalisation of the spread between swaps and bonds (i.e. the swap has lagged the bond in the move lower), better demand for NZ bonds is undeniably a positive development for borrowers. New Zealand is, after all, a net borrower and relies on offshore funding to meet the shortfall. In an environment where fiscal discipline is in the spotlight, it is critical that the Government does what it can to maintain New Zealand's positive image. In that regard, it looks increasingly likely that credit rating agencies will give the Budget the benefit of the doubt. It is certainly clear from comments by the PM that the Budget will be austere, and as such, a credit rating downgrade is not a fait accompli. Contractionary fiscal policy does of course take pressure off monetary policy, but anecdotes point to underlying robustness in the economy, particularly outside Christchurch. As such, we see upside risks to rates relative to what's priced in.

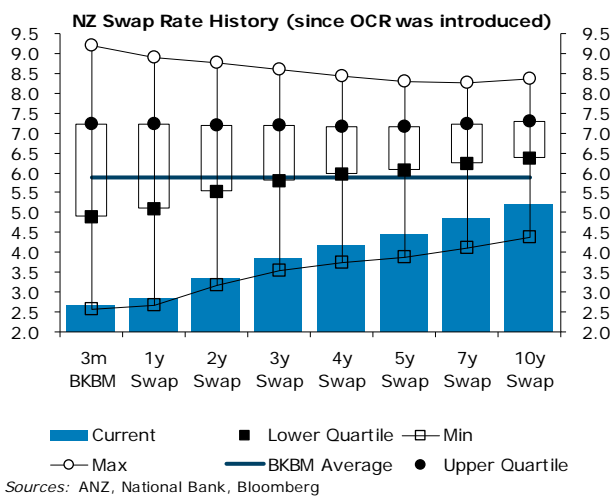
### STRATEGY

Although it makes sense to have above-normal levels of exposure to floating rates given where they are, fixed rates have moved considerably lower in the past few weeks despite improving data and anecdotes. Paying fixed will always involve paying more, but then again as the OCR rises, the cost of floating rate borrowing will also rise. Forward rates look low relative to both our forecasts and past history, and we favour using the recent rally as an opportunity to add to long-term cover. But don't get carried away – factors like deleveraging, the high degree of exposure to floating rates and unsupportive fiscal policy all point to a more muted and staggered monetary policy tightening cycle relative to historical experience.

# BORROWER'S STRATEGY

## VALUATION

Swap rates 2 years and longer are substantially lower than when our last *Borrower's Strategy* was published before Easter. The long end has led the way, with 10 year swaps down over 25 basis points. As a result, the swap curve has flattened, exaggerating the move lower in forward starting swap rates. As an example, whereas the 5yr swap starting in 2 years was at around 5.18% on April 20<sup>th</sup>, it is now around 4.91%, having moved some 7 points further than the vanilla 5 year swap rate.



### Current interest rate levels

Maturity	April 20 <sup>th</sup>	Current
3-mth BKBK	2.65	2.67
2-year swap	3.39	3.35
3-year swap	3.93	3.83
4-year swap	4.35	4.19
5-year swap	4.66	4.46
7-year swap	5.11	4.86
10-year swap	5.51	5.22

### Market expectations for RBNZ OCR (bps)

OCR Dates	April 20 <sup>th</sup>	Current
Thu 28-Apr-11	0	0 (actual)
Thu-9-Jun-11	+1	0
Thu-28-Jul-11	+1	+1
Thu-15-Sep-11	+5	+3
Thu-27-Oct-11	+11	+11
Thu-8-Dec-11	+16	+20
Thu-26-Jan-12	+32	+32

## 20-20 HINDSIGHT

With interest rates set to rise, at some stage it is likely to make sense to extend the term of hedges, and move away from the floating rate. Getting the timing right on this will be virtually impossible, as will choosing the best point on the yield curve. If the last 3 years has taught us anything, it's that the future is impossible to predict, and shocks do come along. But that shouldn't prevent you from having a go, and making the best decision you can on the basis of information available at the moment. Indeed, when it comes to hedging, not making a decision is in fact taking a punt.

Broadly speaking, decisions tend to get judged by two criteria. The first is on the basis of information available at the time. However, although this is the "correct" way to judge a decision, most people tend to use the other, more emotional method, which uses the benefit of hindsight. Any decision judged against the latter criteria is essentially being held up against the highest possible scrutiny – perfect hindsight. Sadly, few of us have perfect foresight. The point is you should not shy away from making tough decisions just because they won't be perfect. This isn't a paper on decision making, but we felt it was worth noting, because we quite often hear people say that they made the "wrong" decision just because a hedge decision went against them.

Of course, that's not to say we should blindly make decisions now, and if they don't work out, blame them on a lack of information at the time, or some unexpected event. What we need to do is assemble as much information as we can before making a decision. And because others (your board, your customers, your customers, and anyone else with a vested interest in what you're up to) tend to use hindsight to judge you, you had better not make any decision that will bury you if you get it wrong. The greater the uncertainty, the greater the odds the decision you make won't be the best one, even with good information. If that is the case, it may pay to spread your risk a little more. Anyway, that's enough on decision theory.

## BINARY ANALYSIS OR SCENARIOS?

As a borrower, at the most basic level, your greatest fear is likely to be that interest rates rise. Truth be told, it should be that you can't get access to funding – but hopefully steps have been taken to alleviate that risk, leaving us to concentrate on the expense, rather than availability, of borrowing.

## BORROWER'S STRATEGY

It will come as no surprise that most people, us included, believe the OCR is going higher. Most people also believe that a higher OCR will lead to a rise in the overall level of interest rates, and not just the OCR. But how can you be sure? Is it conceivable in any way that the OCR might go lower? Of course it is. Is it also conceivable that the OCR and long-term swap rates move in opposite directions to each other? Again, of course it is. Margins also make up a large part of overall interest expense. Straight away it becomes clear that nothing can be taken as a given.

The problem becomes, if you start thinking in binary terms like this (i.e. rates may rise, but they might fall too), you'll never make a decision. In fact, thinking like that is the first step to dithering. So what do you do? In our view, it makes far more sense to nut out a few scenarios, and then make a decision that delivers the best overall result under all scenarios. Chances are, you will favour one scenario over others, and if you do, you may want to make a "maxi-min" decision – that is, make the best decision under the core scenario, subject to the proviso that it doesn't bury you under your alternative scenarios. Alternatively, you could probability weight the scenarios, and make the decision that has the greatest overall payoff.

You need not necessarily use scenario analysis in your planning and as an aid to hedge decision making. But it can be useful, and as it is virtually impossible to make an informed decision about the future without having some view on the future, so you may as well have a forecast. Whatever you do, whether you formally build scenarios, or just temper your views and strategy with common sense – be sure not to ignore the very real link between business conditions and interest rates. That is, if we do see a pick-up in interest rates, chances are business conditions have improved too, and with it, cashflow. The opposite is also likely to be true, and to the extent that it is, be careful not to get too carried away with hedging.

### BREAKING THE DEPENDENCE ON A LOW FLOATING RATE

With interest rates more likely to rise than not, at some stage it is likely to pay to move away from cheap floating rate debt, and hedge. Being on a floating rate has been a boon for many borrowers, especially since the low rates environment has outlasted even the most pessimistic commentator's expectations. But as rates move higher, it is

unlikely to be the best strategy, at least for the whole portfolio.

No matter what sort of analytical framework you use, the difference between what's priced in and where rates end up is likely to be at the heart of your decision. For simplicity, in the table below, we compare the difference between current swap rates and their long term averages.

Swap	Current Rate	10yr Ave	Diff. (bps)	BPV	Value
2yr	3.35	6.22	-287	\$189	\$542
3yr	3.83	6.36	-253	\$275	\$697
4yr	4.19	6.45	-227	\$357	\$809
5yr	4.46	6.52	-206	\$434	\$892
7yr	4.86	6.61	-176	\$573	\$1,008
10yr	5.22	6.71	-149	\$751	\$1,120

Taken at face value, the table suggests that relative to historic averages, short-term rates offer more value than their long-term counterparts. But because the benefit lasts for that much less time, is there really value there? It turns out that if you combine the "cheapness" with the dollar value of a basis point (the "BPV"), longer-term rates offer "better" value. But how do you reconcile "better" value with reduced flexibility? This is where some judgement comes in to play. And the thing is, because the inherent value steps up in a uniform manner as maturity increases, it is not immediately obvious which point to choose. And of course, if we go right back to what we are measuring value against, its long term averages – yet who's to say that's the right benchmark? The truth is, there is no guarantee that the future will be like the past. But it will probably look something like it, so this type of analysis is useful. Of course, scenario analysis would be better.

### A FEW OTHER OBSERVATIONS

Having said all that, and recognising that this is a general newsletter, and not specific advice, we can't do scenario analysis. But it is worth finishing this section with the following observations, all of which have us erring towards favouring adding to medium to long term hedges here:

# BORROWER'S STRATEGY

- The combination of low US bond yields and spectacular demand for NZGS bonds has seen some flow through into NZ swap yields. Yet when we look at the tone of data and activity levels outside of Christchurch, we get the distinct feeling that things are improving with a bit more vigour than most people think. Today's spending data, last week's HLFs data, and housing data all point to underlying economic strength. Or put another way, ask yourself, what might the swap curve look like if the RBNZ starts to acknowledge the recent improvements in data?;
- Our forecasts have the 90 day bill rate moving to 5.00% within 2 years, where it is assumed to peak. If it did, it'd be a remarkable thing, especially as 4.50% used to be the low point in the cycle. Yet the 3 year swap rate starting in 2 years is trading at around 5.3%. That's not much of a margin to our forecast 90 day bill rate (the current margin is around 1.2%), and if you did do some forward hedging, you'd still be able to enjoy low floating rates for the next 2 years;
- Deleveraging has led to a dramatic slowing in demand for credit. And now that banks are well within new regulatory guidelines for funding, and with demand for NZGS picking up, it is likely that demand for bank debt picks up as NZGS issuance slows. If this does happen, financial conditions are likely to free up somewhat, potentially putting upward pressure on swap rates.

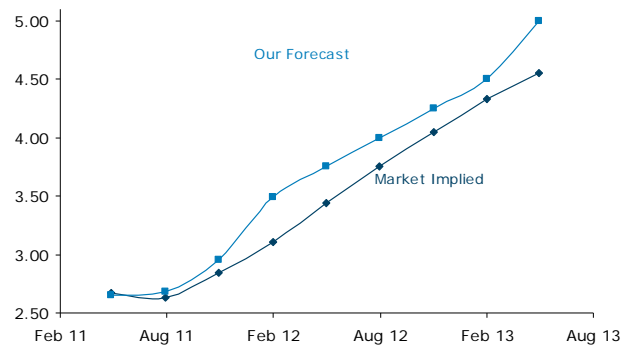
## STRATEGY

It is probably clear by now that generally speaking, we favour adding to hedges. With the yield curve likely to remain steep and structural factors like deleveraging and regulation, and cyclical influences like fiscal policy, likely to restrain upcoming rate hikes (not to mention the dark clouds re-gathering over Europe), don't get carried away. But as noted, the recent fall in rates does seem incongruous with economic anecdotes, and our view that things are okay outside of Christchurch. And as noted, with the yield curve pricing in the bulk of the monetary policy tightening over the next 12-18 months, it is debatable how much upside protection hedging for terms of 2 years or less offers.

But where is the value further out along the curve? And does it make sense to use vanilla swaps or forward starting swaps? Given that what the market has priced in is not substantially different from our forecasts, as the chart below shows, the implied gain from using spot starting swaps over forwards is minimal – but it is a gain. The difference, of course, is that the forward starting swap leaves you on the low floating rate for a bit

longer, and as such, they are likely to be more appealing to borrowers. But remember, there's no free lunch – the rate on the forward is that much higher to compensate, and there is no guarantee that floating rates will stay low for as long as market pricing implies. On balance then, we prefer spot swaps to forwards, particularly given our view of an earlier than generally expected OCR hike.

NZ 90 Day Bill Rate Projections



Sources: ANZ, National Bank, Bloomberg

What about tenor? Broadly speaking, we see more value at the long end than the short end. This is largely based on our view that what's priced in seems reasonable in the near term, but too low further out. Although we expect the upcoming rate hike cycle to be muted, and have 5.00% pencilled in as the terminal rate for the OCR, it is worth noting that such a low terminal rate would be unprecedented. Similarly, the market's assumption (i.e. what's priced in) that the entire swap curve will sit below 6% in 2 years (as the table below shows) seems somewhat brave, particularly if the recovery gathers momentum.

Forward swap rates versus our forecasts					
Swap	Fwd Rate	Our F'cast	Diff.	BPV	Value
2yr	5.10	5.69	0.59	\$189	\$11,094
3yr	5.29	5.99	0.70	\$275	\$19,188
4yr	5.44	6.16	0.72	\$357	\$25,579
5yr	5.58	6.33	0.75	\$434	\$32,389
7yr	5.76	6.49	0.72	\$573	\$41,336
10yr	5.88	6.72	0.84	\$751	\$63,226



## BORROWER'S STRATEGY

As the table above shows, our forecasts have the majority of the swap curve above 6% in 2 years time. Our forecasts also stand much higher than market implied forward rates. Furthermore, the degree to which they are higher generally increases as maturity increases. If one then adjusts this difference with the basis point value (BPV) of each swap, the dollar difference is even more significant. As such, we favour long-term maturities.

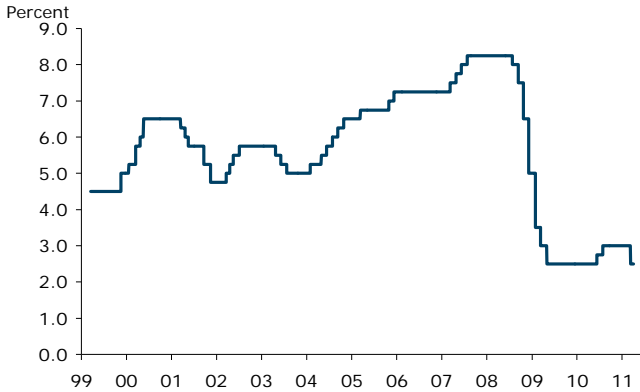
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Auckland	09 377 9450 / 0800 730 100
Wellington	04 471 0030 / 0800 445 088
Christchurch	03 364 5335 / 0800 269 261

# CHARTS (END OF MONTH)

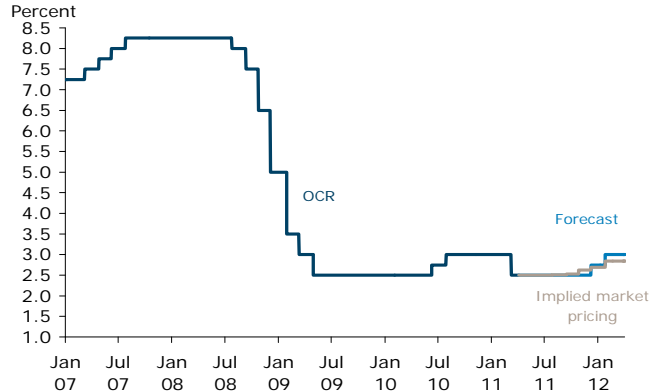
## CHARTS

**Official Cash Rate**



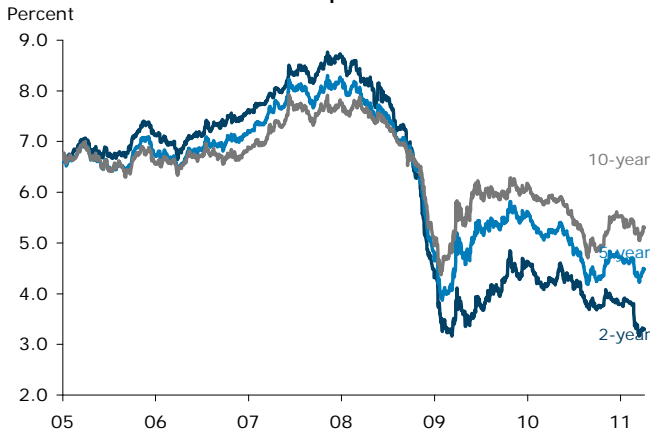
Sources: ANZ, National Bank, RBNZ

**OCR and market pricing**



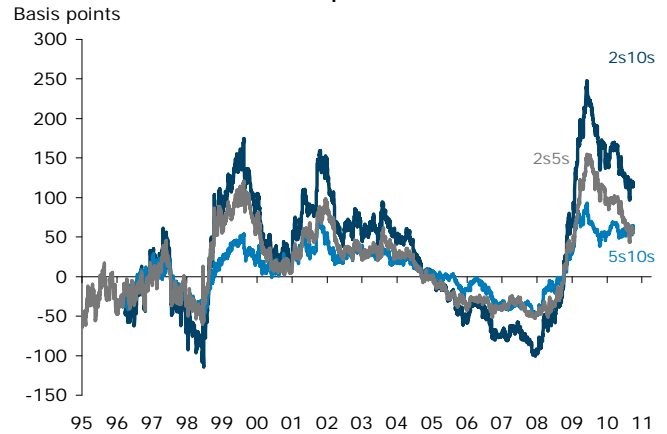
Sources: ANZ, National Bank, RBNZ, Bloomberg

**NZ Swap Yields**



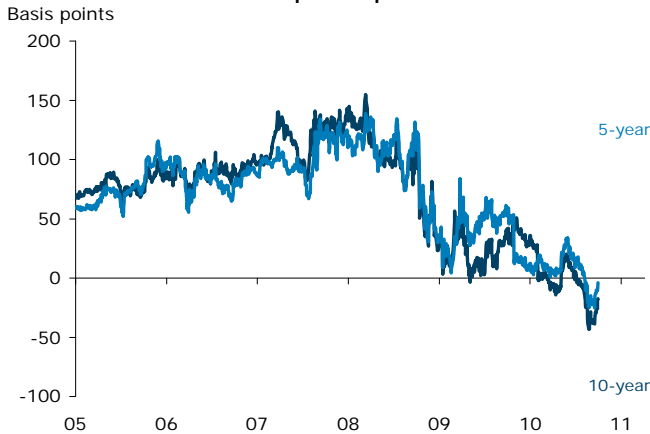
Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curves**



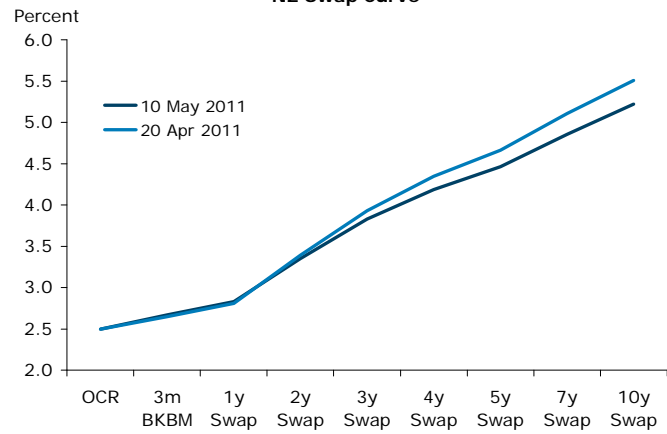
Sources: ANZ, National Bank, Bloomberg

**NZ Swap/EFP Spreads**



Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curve**



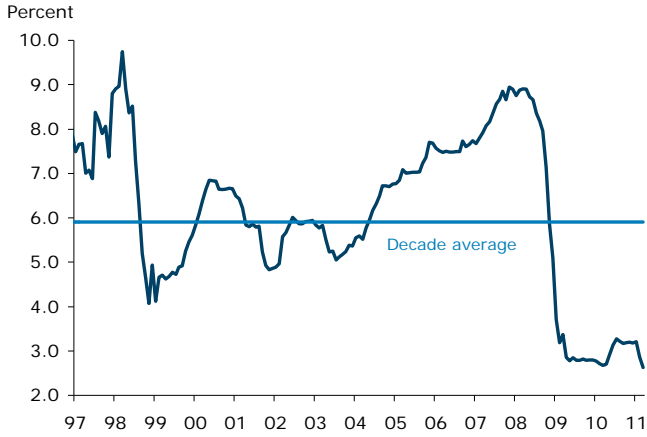
Sources: ANZ, National Bank, Bloomberg



# CHARTS (END OF MONTH)

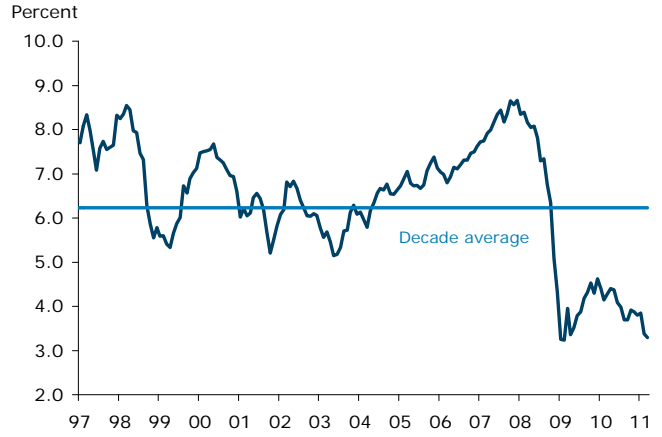
## CHARTS (END OF MONTH)

**3-month BKBM**



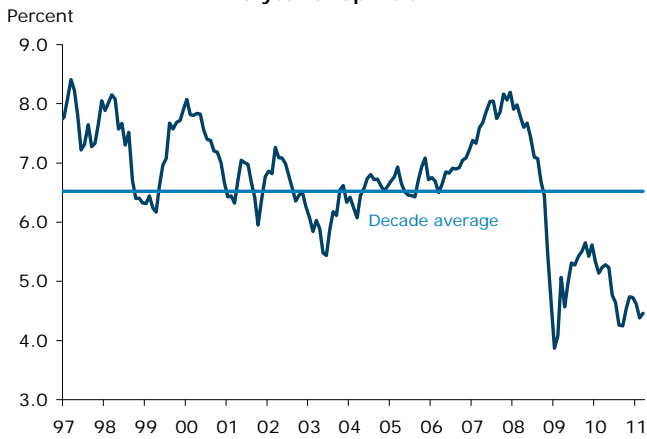
Sources: ANZ, National Bank, Bloomberg

**2-year Swap Yield**



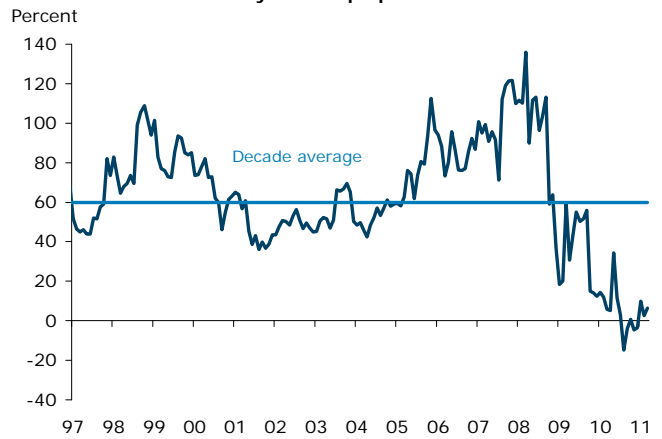
Sources: ANZ, National Bank, Bloomberg

**5-year Swap Yield**



Sources: ANZ, National Bank, Bloomberg

**5-year Swap Spread**



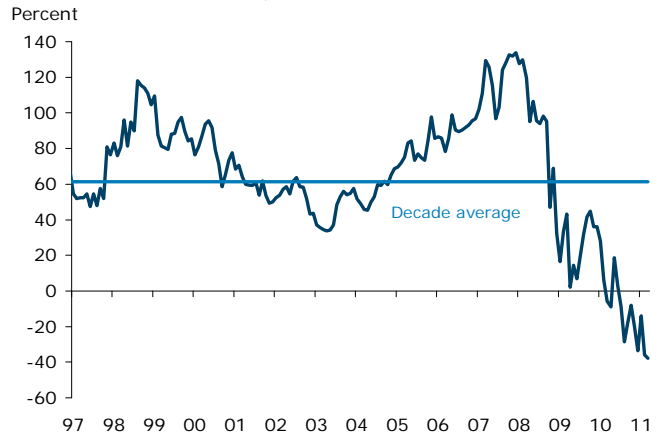
Sources: ANZ, National Bank, Bloomberg

**10-year Swap Yield**



Sources: ANZ, National Bank, Bloomberg

**10-year Swap Spread**



Sources: ANZ, National Bank, Bloomberg

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