

## NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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### CONTRIBUTOR

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### ECONOMIC OUTLOOK

The domestic economic outlook remains constructive as we have written about this in many of our recent publications. We won't repeat our views at length here now, but suffice to say that terms of trade boom, earthquake rebuild and temporary factors like the Rugby World Cup were at the heart of our assessment. This view was always tempered by structural headwinds like deleveraging, and global concerns, like the one currently unfolding. The sovereign debt crisis in Europe is escalating and looks particularly troubling. It is evident from the significant rise in yields in hitherto core markets like France and Italy that the contagion has spread from Portugal, Ireland and Greece. The problem is, global issues are escalating at such a pace, and if they are not dealt with in a decisive manner, they could seriously derail the outlook. This is exactly where the debate is at the moment. No matter how constructive your view of the NZ outlook is, you must acknowledge global developments.

### RATE VIEW

Distant as offshore developments are for NZ, they've been nothing short of eye-watering in terms of the impact they have had on markets. This time last week, the day before the Reserve Bank of Australia's August meeting, the debate was whether the RBA would hike or not. By contrast the market now has 6 (no, that's not a typo) rate *cuts* priced in by Christmas. The RBNZ made it clear last month that global market stability was a pre-condition for raising rates. That condition can no longer be considered to be satisfied. We doubt the RBNZ will be raising rates if markets are still like this come 15<sup>th</sup> September. The market has been right to re-price lower in yield, and things may yet intensify. Equally, we doubt authorities in the US and Europe will stand idly by while markets burn. As such, we would caution against getting too negative. Time would seem to be on the borrower's side, extending what's already been a fantastic run for those on floating rates.

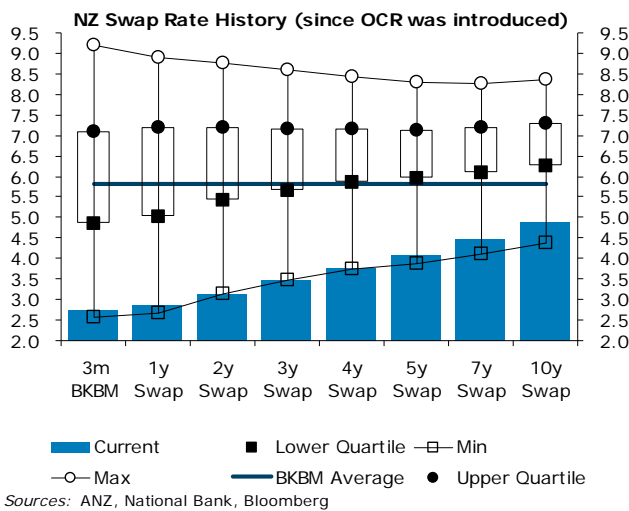
### STRATEGY

Until it's clear that we are through the current period of malaise, we see no point in taking maverick views or instigating aggressive hedges. Remember, it's not domestic factors that are driving rates at the moment, global factors are. One way or another the European debt problem will be sorted, whether via default and euro disintegration, or unwavering government support. However, the nucleus of sustained improvement resides in a long slow period of growth across Western nations. With this backdrop it is difficult to present a compelling case for rapid rises in interest rates. Regular readers will recall that we have been reticent to call for all-out fixing as some other commentators have. This is precisely because we have been weary of the potential for events like the one unfolding right now to upset the apple cart. This is at the heart of our "bathtub with waves" hypothesis. Things still look good for New Zealand, but there will be bumps along the way and it won't all be plain sailing. Right now we are in a storm, and we'd prefer to sit it out, and concentrate on the business, not trying to get clever about interest rate hedging.

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## VALUATION

Making comments on valuations in the face of a massive fall in yields is, ironically, rather tricky. Indeed, if you think nothing has changed, the 31bp fall in the 10yr swap rate makes it better value by definition. But much has changed, and while we see no scope for the RBNZ to cut rates, we do have sympathy for the market delaying rate hikes. The flattening of the curve does make paying fixed for longer terms more affordable. But equally, recent events are a reminder that we should be cautious in expecting interest rates to rise back towards historic averages, questioning the desire to fix in the first place.



### Current interest rate levels

Maturity	Last edition	Current
3-mth BKBM	2.70	2.74
1-year swap	2.91	2.86
2-year swap	3.38	3.15
3-year swap	3.79	3.47
4-year swap	4.13	3.78
5-year swap	4.42	4.07
7-year swap	4.82	4.49
10-year swap	5.18	4.87

### Market expectations for RBNZ OCR (bps)

OCR Dates	Last edition	Current
Thu-15-Sep-11	+11	+3
Thu-27-Oct-11	+27	+7
Thu-8-Dec-11	+40	+11
Thu-26-Jan-12	+62	+15
Thu-8-Mar-12	+71	+17
Thu-26-Apr-12	+79	+19
Thu-14-Jun-12	Not forecast	+25

## RE-WRITING THE SCRIPT

This fortnight's edition is deliberately short. This is simply a reflection of the fact that markets are re-pricing at breakneck speed. In such an environment, analyses and commentary can be out of date within the hour. Volatility is extreme. And given that the recent developments are global centric, as opposed to domestic, we prefer to "sit out" the turmoil before making significant decisions. Here in New Zealand we simply don't have a comparative advantage in making calls on global events. In this edition we discuss recent events, including the recent US credit rating downgrade and European debt issues. Things have clearly changed substantially in the past few days – so much so that this entire document has had to be re-written – hence the delay. Indeed, we had originally intended to publish Friday, but it was clear by mid afternoon that the world had changed. And things have not improved in the past two trading days, they have in fact deteriorated.

Yet, in some ways not much has changed and we need to acknowledge this. We always expected the post GFC world to be littered with ups and downs and volatility amid a lower trend growth rate, and this remained an anchor behind a more cautious approach to extending hedges. However, what has changed and is worrying has been the savagery of market movements of late. This in itself is telling for it portends of a global economy sitting at a cusp of a wholesale breakdown in confidence, with policymakers having less firepower than prior to stabilise the system and political gridlock threatening to further undermine confidence.

## RECENT GLOBAL TURMOIL

So what has happened? In a nutshell, market sentiment has shifted from nervousness to outright panic since Thursday. We need to be coy about interpreting panic moves as quite often such capitulation can signify opportunities. Yet as the old adage goes: never try to catch a falling knife either!

The precursor to events had been building for some time. Sovereign concerns were slowly escalating in Europe. The tenor of US data was soft. All eyes were initially on the US last week as debt ceiling negotiations went down to the wire. But in the end, the debt ceiling deal was a sideshow in comparison to what was happening in Europe, with the European Central Bank threatening to hike, insistent still that liquidity, rather than solvency was the issue. Bond markets disagreed, and peripheral bond spreads rocketed higher. Panning back to the US, just as the mood was starting to improve, enter S&P after the market close with a downgrade.

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Even before the US downgrade, market sentiment was in a state of heightened stress. The problem this time was Italy, where 10yr government bond yields had started to rise above 6%, which was deemed to be unsustainable given government debt of 119% of GDP. Italy is the 8<sup>th</sup> largest economy in the world and has the 3<sup>rd</sup> largest government bond market. This makes it too big to fail. Remember, markets have already set their sights on the UK and more recently the US. But in both cases their currencies bore the brunt of the market's ire. Both governments also responded with plans to address fiscal largesse – even if, as we now know the US plan didn't avert a downgrade.

By contrast, markets have no confidence that Europe has a plan. Massive buying of Italian and Spanish bonds by the ECB overnight has seen those two markets recover, as you'd expect. But you'd also expect yields in the core markets to rise. But they didn't, and in fact, US 10yr Treasuries never budged an inch, grinding progressively lower. They now stand at around 2.30%, plumbing depths not seen since late 2008/early 2009. Recall that was the height of the GFC.

So what's going on? Is this the market telling us that they don't believe the ECB bond buying plan will make a difference, and this is just another stop gap solution? It looks like it, and it's not hard to see why. For one, EU officials still seem to be in denial. Recall last week, ECB President Trichet was still talking about rate hikes. Now the ECB is actively engaged in quantitative easing (QE). And today, the EU has said that Spain and Italy don't need aid, and that declarations by the ECB, G7 and G20 will bring back confidence. Say what! Given the scale of the problem (PIIGS government debt alone stands at around €3.4 trillion), and without exchange rate flexibility, or confidence that concrete steps will be taken to get debt down, who wants to touch it. Perhaps worse still, if steps are taken and they involve acute spending cuts (which is pretty well the only thing that will appease the bond vigilantes), what chance does growth have – particularly if there is no scope for exchange rate adjustment. The bottom line is, in the absence of a concrete "shock and awe" plan that is sufficiently large to allay fears of government and bank collapses in Europe, we can expect markets to go after governments in what will become an endless game of dominoes.

Having said that, it is almost inconceivable that the powers that be in Europe and America will stand idly by while markets burn. Some kind of response is inevitable. It is simply untenable that current dislocation will continue, and it is way too soon to

conclude that this is a repeat of 2008. With luck, it will be sufficient to stop the rot, but it will need to be comprehensive and timely. And even then it will not change our core economic anchor: slow growth will be here for some time. There are challenges ahead, and we need to brace for them.

### WHERE DOES IT MEAN FOR NEW ZEALAND?

The question is, what does it all mean for NZ? We're not in the business of scaremongering, but by the same token, we have to acknowledge that markets are running scared, and analysts are now talking about recession in Europe and America. We concur with the former but not the latter.

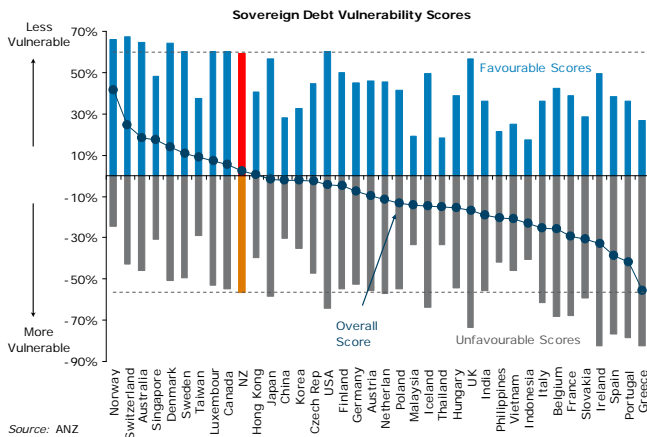
Whatever happens, we expect more caution on the part of the RBNZ, which means policy on hold for the time being. Remember, the RBNZ has made it clear that market stability was a pre-condition for raising rates, noting at the July *OCR Review* that it would only raise rates "provided current global financial risks recede". As such, we can expect the RBNZ to stand pat until markets calm down. We still like the local story so eventually rates will move up. However, the risk-return strategy is to stand pat – for now.

But could we see the OCR move down? The Australian market is gunning for rate cuts, pricing in 150 basis points of easing at last count, though coming from a 4.75% starting point represents a different proposition to sitting with an OCR at 2.5%. Recall, the OCR was at 2.5% through the GFC, and that served us well, and back then we did not have special factors like the Canterbury re-build and Rugby World Cup propping up growth. Nor were commodity prices at lofty levels like they are now, even if they have receded. The difference between us and Australia is that the RBA has been tightening policy, and their cash rate is well up off its GFC lows. It is therefore not surprising that the Australian market is pricing in some reversal in policy (though we question the magnitude), even if inflation is high.

Another reason why we don't think rate cuts are needed is simply because markets remain confident about New Zealand Inc and the national balance sheet has improved massively since 2008. We repaid debt (net external debt has fallen from 90 to 75% of GDP) while other nations simply shuffled it from the private to the public sector. While NZ was showing penance in 2009 and 2010 via weak growth, other nations weren't. This has us better placed now. We aren't perfect and we do have vulnerabilities with our eyes watching the transmission of weaker growth in the US and Europe to Asia. But local banks have

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generally kept their noses clean, so to speak, since the GFC. We don't have sub-prime here. Banks don't own masses of PIIGS bonds. House prices have held steady, and loan and collateral quality is high. Banks remain well capitalised. Government debt is also very low by international standards, and although volatility is severely testing the idea, New Zealand is regarded by many as a sort of safe haven. As our analysis of sovereign credit has consistently shown, New Zealand is placed at the "right" end of the spectrum when compared with global peers, as the chart below shows. We are simply not keeping company with the truly vulnerable, i.e. the likes of Greece and Ireland.



Source: ANZ

In fact, the strength of the NZD in the lead-up to the current crisis and the resilience of it since is testimony to the confidence markets have in us. This has also been reflected in the government bond market, which remains incredibly well supported. There have been times over the past few days when the "safe haven" view has been severely tested. Indeed, as the risk pendulum swung deeply into "risk off" territory, the NZD came under pressure on the view that NZ was a safe port in a storm, but not in a hurricane. However, the relative strength of the NZD (which remains well above 80 cents) in the past two days has us believing that it is still regarded as a relatively safe place to be. We suspect it will remain that way, but all eyes will be on Asia, for it is critical that Asia remains strong.

## CONCLUSIONS

In the current environment we strongly favour standing on the sidelines and seeing how things pan out. We would caution against chasing markets in either direction – getting downbeat at the bottom and exuberant at the top. Cool heads need to prevail. Time is on the borrower's side, and until the volatility

subsides, we favour taking advantage of low floating rates, which look like they will persist for longer.

It is possible that markets settle and we see interest rates move higher again, rendering inaction now to be an opportunity lost. But equally, confidence in the global economy has been undermined, and we don't see the situation correcting itself quickly.

We have been consistent in our view that we weren't out of the woods yet, and have long argued that the recovery would be buffeted by storms – hence we stopped short of favouring all out fixing as some other commentators have. Right now we are in such a storm, and we'd prefer to sit it out, and concentrate on the business, not trying to get clever about interest rate hedging.

Extending duration may look attractive now (via "blend and extend" trades and the like), but we would urge borrowers to seriously consider whether they have the fortitude to introduce fixed costs to their business at times of uncertainty like this. This is certainly not a strategy we favour at this juncture.

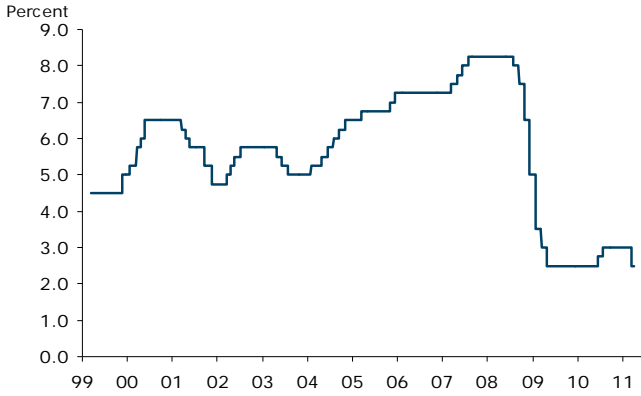
Dealing room contacts		
Location	Local	Toll free
Auckland	09 377 9450	0800 730 100
Wellington	04 471 0030	0800 445 088
Christchurch	03 364 5335	0800 269 261



# CHARTS (END OF MONTH)

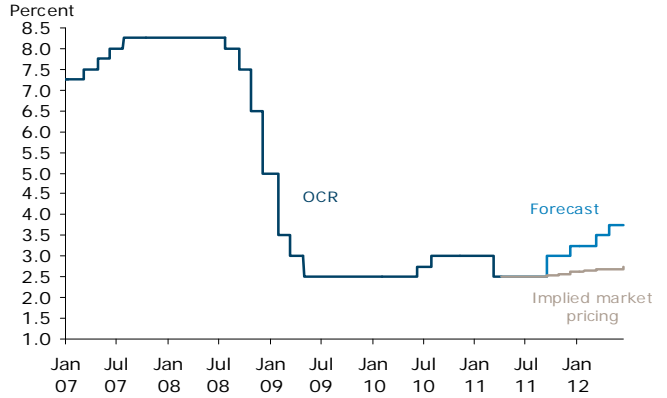
## CHARTS

**Official Cash Rate**



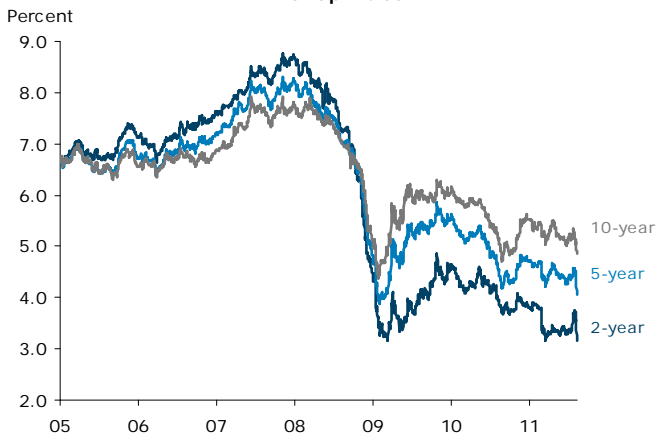
Sources: ANZ, National Bank, RBNZ

**OCR and market pricing**



Sources: ANZ, National Bank, RBNZ, Bloomberg

**NZ Swap Yields**



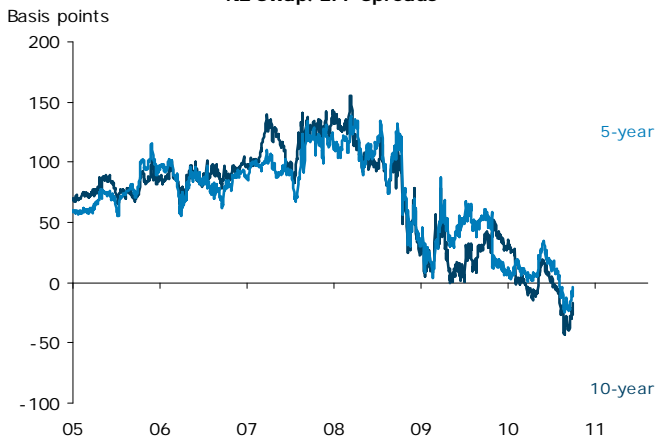
Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curves**



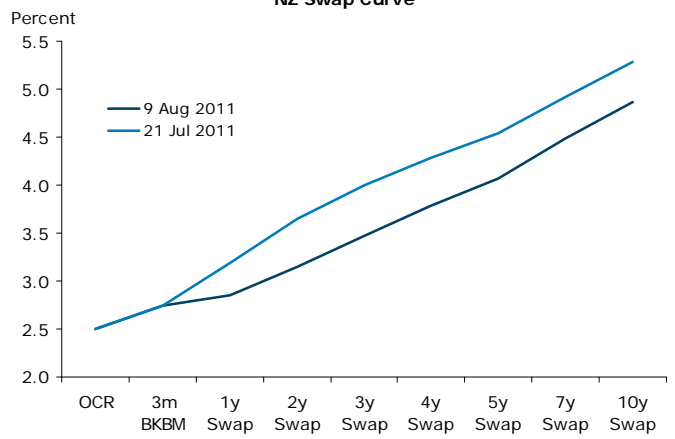
Sources: ANZ, National Bank, Bloomberg

**NZ Swap/EFP Spreads**



Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curve**

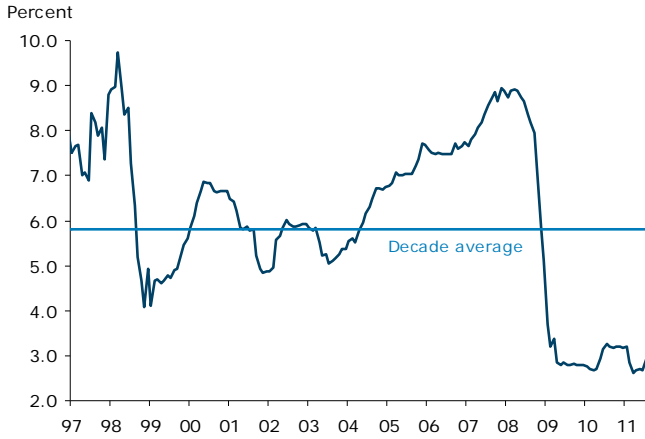


Sources: ANZ, National Bank, Bloomberg

# CHARTS (END OF MONTH)

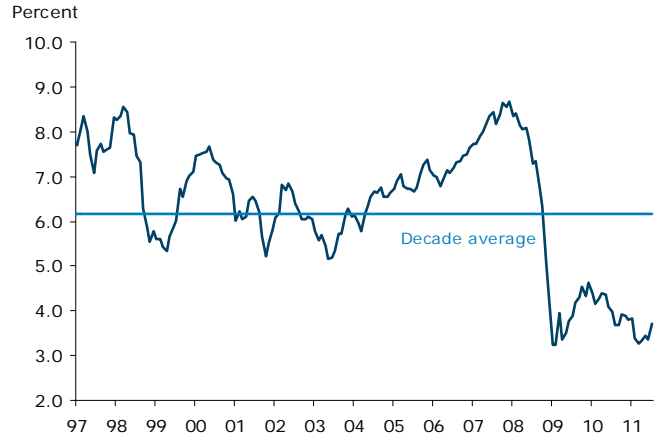
## CHARTS (END OF MONTH)

**3-month BKBM**



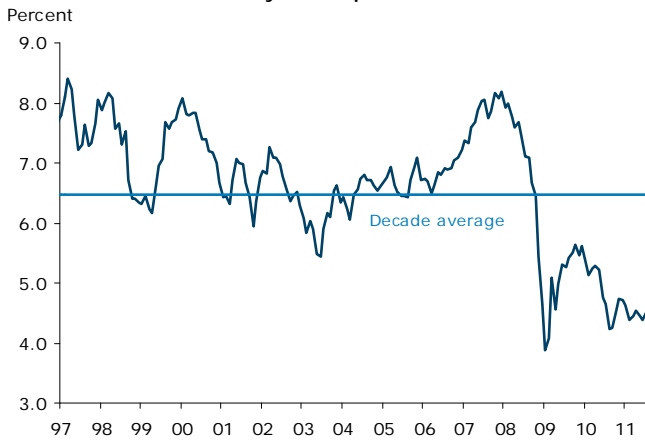
Sources: ANZ, National Bank, Bloomberg

**2-year Swap Yield**



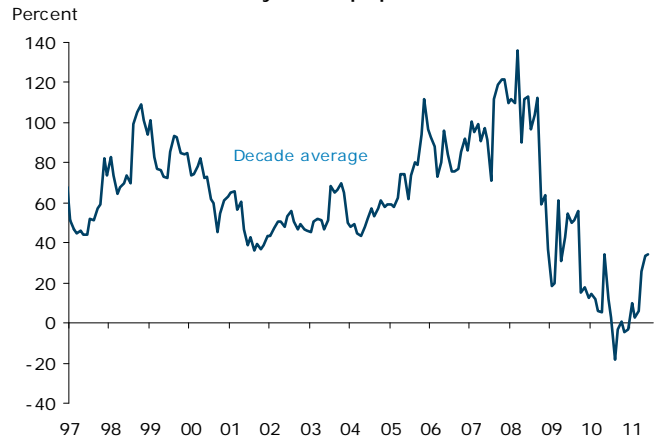
Sources: ANZ, National Bank, Bloomberg

**5-year Swap Yield**



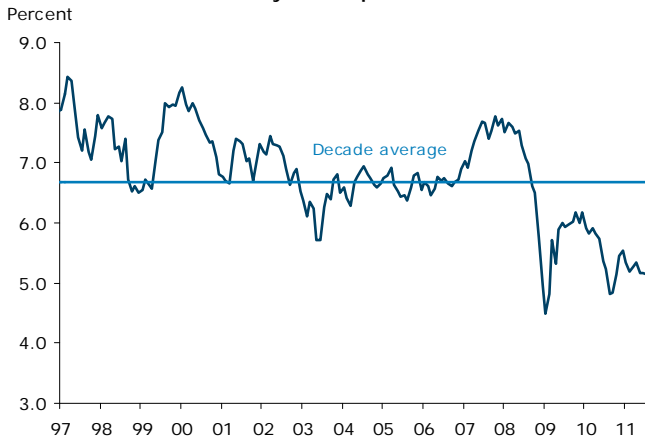
Sources: ANZ, National Bank, Bloomberg

**5-year Swap Spread**



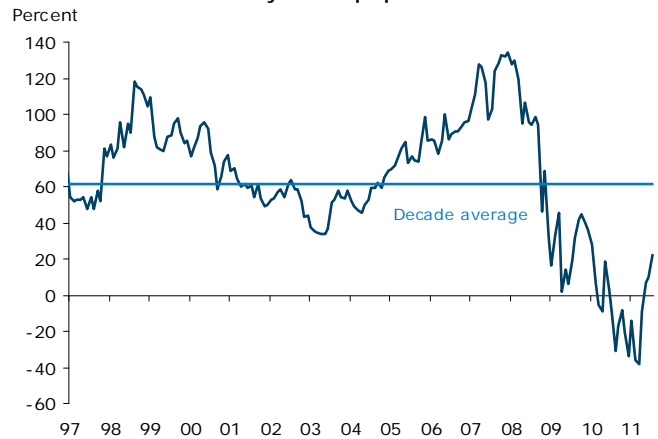
Sources: ANZ, National Bank, Bloomberg

**10-year Swap Yield**



Sources: ANZ, National Bank, Bloomberg

**10-year Swap Spread**



Sources: ANZ, National Bank, Bloomberg

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