

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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CONTRIBUTOR

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ECONOMIC OUTLOOK

Global developments continue to steal the headlines from local data. Looking through the market gyrations, the key theme remains: tidying up the mess in the developed world will be a long and unpleasant. Excessive indebtedness has no quick fixes. Recent global data confirms a slowing in many economies. The European situation muddles on through the political mire, and US data is mixed at best. In contrast, the local dataflow has been encouragingly resilient. With solid underlying momentum, and the Rugby World Cup and earthquake reconstruction overlaid, we expect New Zealand to be an economic out-performer versus some fairly grim scenarios abroad. But the New Zealand economy is not immune from global weakness, and commodity prices are key. So far they have held up, but the risks are clear. The OCR is expected to remain at low levels until the global scene stabilises.

RATE VIEW

Regular readers will recall we have always had an upbeat view of the local economy, and expected the RBNZ to be raising rates later in 2011. Nonetheless, the RBNZ have made it clear that it was unlikely to raise rates with global markets in turmoil, and as such, interest rate markets were likely to be subdued for some time. Global markets remain in a state of flux, and uncertainty remains high. On the face of it, this suggests the RBNZ might adopt a cautious tone at next week's *Monetary Policy Statement*. But when one considers the strength of recent data and the expected impact of one-offs like the Rugby World Cup, we suspect the RBNZ's tone may shift away from global uncertainty, and towards characterising NZ as being in its own growth microcosm. Interest rates are assuming the worst, pricing in just 2 hikes by mid 2012. Although we cannot rule out further bad news on the global front, one has to question how much lower rates can go even if news was to deteriorate. By contrast, the market is very vulnerable to positive news.

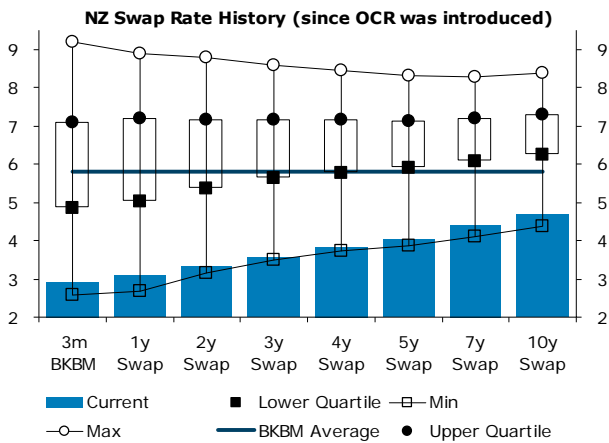
STRATEGY

We have largely stood on the sidelines, watching how developments have unfolded over the past few weeks. This strategy has paid off, and in an ideal world, one could sit on the sidelines for a bit longer, and wait till we have confirmation that we're in the clear and the OCR is heading higher before fixing. Of course, if one waits till then, rates may have already moved. Although the level of stress and tension remains high, our preference is to have more hedge cover in place ahead of the *MPS*. In short, we doubt the RBNZ will condone further downside, but they are likely to reinforce the upside. Some fortitude is of course required, and this isn't a suggestion to "fill your boots", particularly given global uncertainty. But we do feel that short term swaps like the 2 and 3 year offer reasonable value. They're certainly trading well below where they "ought to" if our OCR forecasts eventuate. Our preference is not to add to long dated cover unless the intention is to take profit on this later, and embed profit into shorter hedges – but such a strategy isn't for the faint-hearted. We also provide a brief analysis of the Australian market, which we believe is severely dislocated from the monetary policy outlook. If you thought the NZ market was priced for Armageddon, it has nothing on the Australian market.

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VALUATION

While short end yields have moved slightly higher over the past fortnight, long end swap rates are lower. As a result, the curve is flatter, reducing the cost of fixing. Furthermore, mid curve swaps like the 3yr and 4yr are within a few basis points of all-time lows. In our view this is somewhat inconsistent with the likelihood that the RBNZ starts tightening later in the year, and as such our preference is to add to cover in the 2-3 year part of the curve. Longer dated swaps are "low", but the curve is still too steep in our view to make paying fixed for 5yrs+ good value unless it's part of a dynamic strategy.



Sources: ANZ, National Bank, Bloomberg

Current interest rate levels		
Maturity	Last edition	Current
3-mth BKBM	2.88	2.92
1-year swap	3.03	3.09
2-year swap	3.27	3.34
3-year swap	3.56	3.58
4-year swap	3.84	3.82
5-year swap	4.08	4.04
7-year swap	4.47	4.40
10-year swap	4.79	4.69

Market expectations for RBNZ OCR (bps)		
OCR Dates	Last edition	Current
Thu-15-Sep-11	+4	+3
Thu-27-Oct-11	+10	+9
Thu-8-Dec-11	+18	+16
Thu-26-Jan-12	+25	+27
Thu-8-Mar-12	+29	+34
Thu-26-Apr-12	+38	+36
Thu-14-Jun-12	+41	+42

FAIR ENOUGH

As we alluded to in our introduction, our preference is to add to hedge cover before next week's MPS, on the view that the RBNZ is likely to shift the focus away from reasons why it shouldn't hike (global financial market turmoil) and towards reasons why it should be hiking (the pickup in domestic growth momentum and high inflation expectations). That said, we certainly don't think it's the environment to go "filling your boots" on cover. Indeed, there are still significant downside risks. We may, for instance, be headed into another financial crisis, and the US may slip into recession. But the point is, the market seems to be giving full credit to the downside risks, and is too eager to dismiss the upside risks. That may sound like a strong statement given that NZ is one of the few markets pricing in rate hikes – but with less than 2 hikes priced in by June, the market is hardly positioned for an upside surprise.

But how far out of whack are rates? This is of course a subjective question, and it depends completely on where you think the OCR is headed. However, when we compare the current set of rates against where they might be if our 3mth BKBM (i.e. the floating leg on a swap) forecasts eventuate, we find that they are way out of line. This is shown in the table below.

"Fair Value" assuming ANZ Forecasts		
Term	"Fair Value"	Current Market Rates
1-year swap	3.54	3.09
2-year swap	4.10	3.34
3-year swap	4.40	3.58

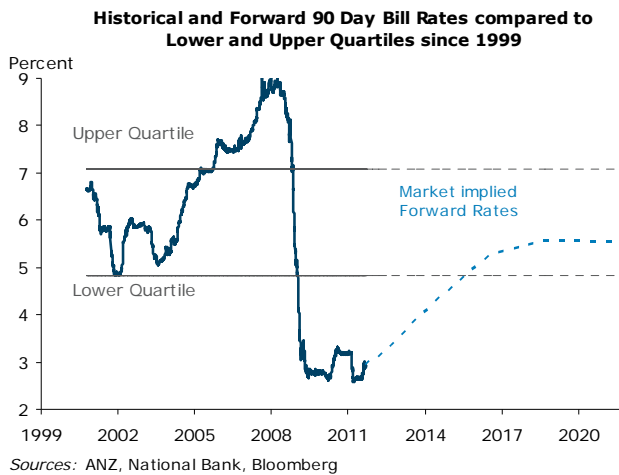
Unfortunately, because we don't forecast beyond 3 years, we can't calculate fair values for longer term rates. However, on the basis that we don't expect the OCR to move beyond 4.75% this cycle (and further that it won't get there till mid 2013), this is not suggestive of significant value at the long end of the curve, particularly when you consider the lack of flexibility that goes with long term hedges. This point deserves some clarification. We are not suggesting that when measured against the yardstick of forecast future interest rates, long end swaps like the 7 and 10 year are too high. In fact, if anything, the contrary is true – long term rates look cheap on both a "fair value" basis and by historical comparison. Indeed, the latter point is clear upon closer inspection of the chart at the top left of this page.

As noted, we can't derive a fair value estimate for long end swaps due to fact that we don't produce a long term forecast. But we can turn this problem on its head, and show where market implied 3mth bill

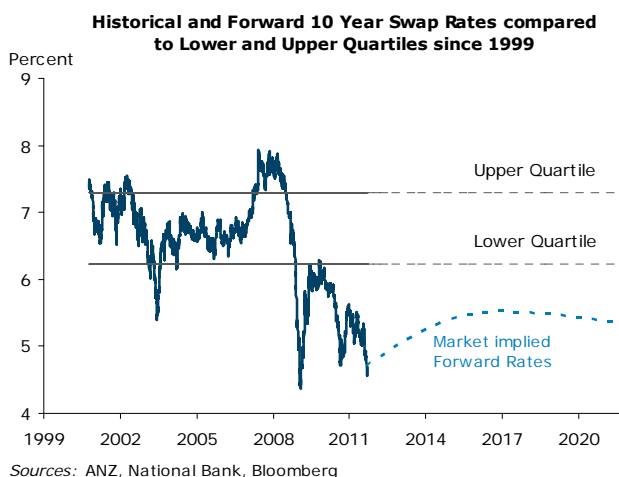


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rates are expected to go over the next 10 years. This is illustrated in the chart below, which shows that the 90 day rate isn't expected to hit 5% until around 4½ years from now – well beyond when we expect it to get there.



Similarly, when we analyse market implied forward rates, we find that they are extremely low, and in fact, start to track lower beyond 5 years. Of course, this track depends on where you see 12yr, 15yr and 20yr swap rates, and liquidity that far out is ropery at best. Nonetheless, the fact that forward long rates are so low *ad infinitum* smacks of opportunity.



The problem is, who wants to commit for that long, even if the rates on offer look sensationally attractive? One only needs to look back at some of the horror stories of the immediate post-GFC period to see how costly a lack of flexibility and erroneous judgements on long term interest rates can be. And

though the NZ economy looks to be on a stronger footing, given the uncertain global outlook, it might not be a good idea to bet the house on higher rates in the future.

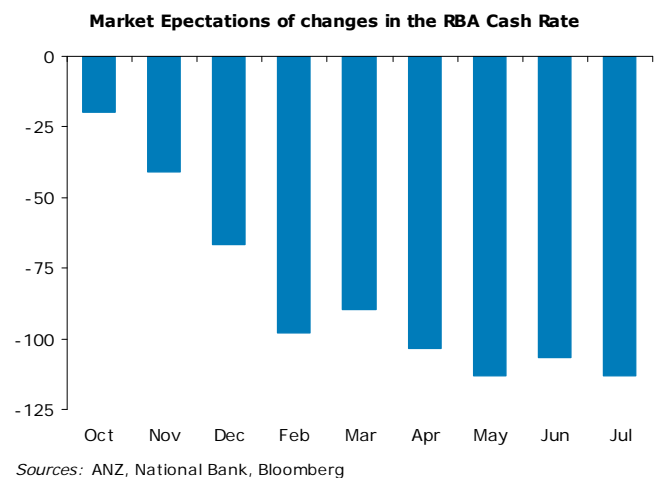
That said, those engaged in active interest rate expense management could consider adding much longer term hedges, or pursuing “blend and extend” type strategies. But even with the curve as flat as it is now relative to a few weeks ago, it is still very steep, and we would only favour engaging in extensions if there was an intention to shorten them later, and embed any profit into shorter hedges. Such strategies only suit the most experienced hedgers, and need to be done with open eyes, as the risks are substantial.

When we bring all these arguments together, our preference is to put additional cover in place in the 2-3 year part of the curve at current levels.

HOW DO THINGS LOOK IN AUSTRALIA?

One question we often get asked to comment on is the state of play of the Australian market, particularly by those clients with debt denominated in AUD. As such, what follows is a brief analysis of the Australian market.

What stands out the most about the Australian market is how far “through” cash the swap curve is trading. Indeed, as we pointed out in the summary on page 1, if you thought the NZ market was priced for downside scenarios, it is tame compared to the Australian market. As the chart below shows, the Australian market is pricing in nearly three 25bp cuts by Christmas.



The key question for borrowers is, is this a realistic expectation? In our view, it is not. Not only do our Australian colleagues expect policy to remain on hold for the foreseeable future, but the RBA themselves

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haven't even hinted at cuts. In fact, if we examine the tone of their comments following Tuesday's monetary policy decision (where the cash rate was left unchanged), if anything, it is neutral, and mildly hawkish at best. Although the RBA highlight that "the outlook for the global economy is less clear than it was earlier in the year", they concede that "little evidence is available to gauge any effects of the European and US problems on other regions". This includes Australia, which, as the RBA point out, is simultaneously navigating through both a terms of trade boom and "cautious behaviour by households".

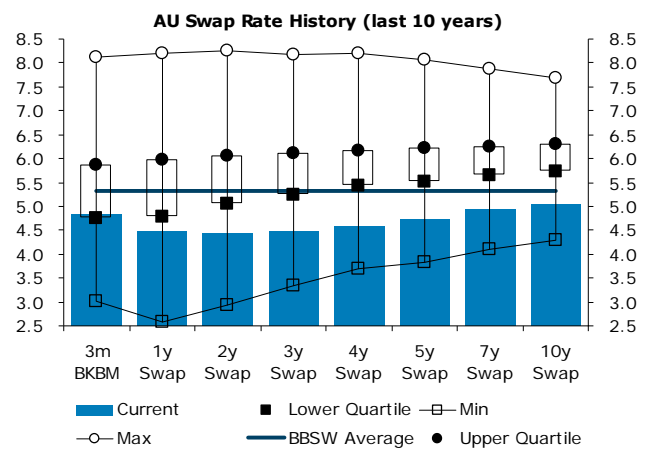
The RBA go on to say that while the growth outlook does "look somewhat weaker than was expected a few months ago", they go on to say that "beyond the near term, growth is still likely to be at trend or higher, unless the world economic outlook continues to deteriorate". Moreover, productivity growth has been poor, and the unemployment rate remains low, even if it has stagnated at around 5%. But the real troubling aspect is the inflation outlook, and as the RBA succinctly note, "a key question will be the extent to which softer global and domestic growth will work, in due course, to contain inflation".

Although the RBA concludes by noting that monetary policy has been "exerting a degree of restraint" and the exchange rate is high, there is nothing whatsoever in Tuesday's statement that even comes close to justifying market expectations. The outlook is obviously fluid, and much depends on how global events unfold. The point we are trying to make is, whereas the RBA point out that it is unclear what impact softer growth will have on inflation, the market has made up its mind – things are so bad that the RBA will be cutting three times by Christmas. At face value, this would also seem to be well out of line with recent data flow, including surprisingly strong Q2 GDP data.

Of course, as many commentators have pointed out, even though OIS markets are pricing in much lower rates, some of this reflects a demand-supply mismatch in the market, which is skewing rates to the downside. Even so, there is no escaping the fact that the entire swap curve out to 5 years is trading below cash.

We'll stop short of making a strategic call on the market, but suffice to say that when viewed from afar, there seems to be a significant disconnect between the level of interest rates priced in by the market and current RBA rhetoric.

Current interest rate levels	
Maturity	Current
3-mth BBSW	4.84
1-year swap (qtrly)	4.35
2-year swap (qtrly)	4.26
3-year swap (qtrly)	4.36
4-year swap (semi)	4.59
5-year swap (semi)	4.73
7-year swap (semi)	4.94
10-year swap (semi)	5.06



Sources: ANZ, Bloomberg

As the table and chart above shows, the main difference between the Australian rates environment and the local environment is that whereas NZ rates are close to their 2009 lows, Australian rates are low compared to the 3 month rate, but remain significantly higher than their 2009 lows. Any decision to hedge in Australia is thus more a judgement on the near term direction of monetary policy, as opposed to a judgement on the broad state of the economy, which is more how things are in New Zealand.

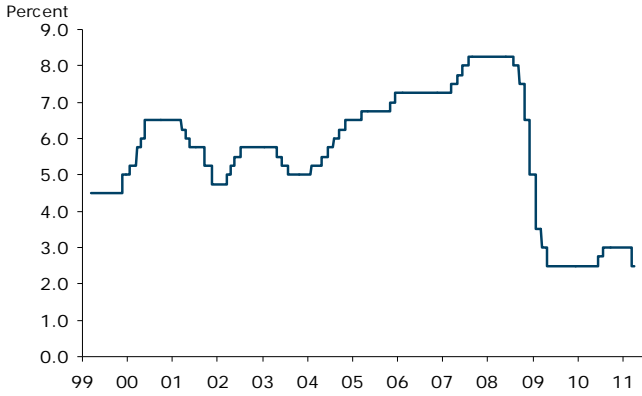
Dealing room contacts		
Location	Local	Toll free
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Wellington	04 471 0030	0800 445 088
Christchurch	03 364 5335	0800 269 261



CHARTS (END OF MONTH)

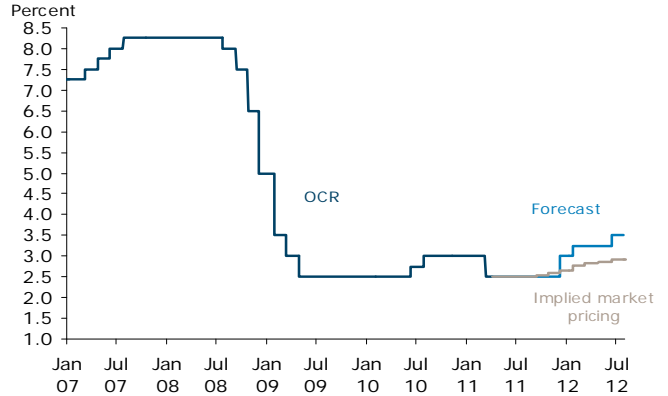
CHARTS

Official Cash Rate



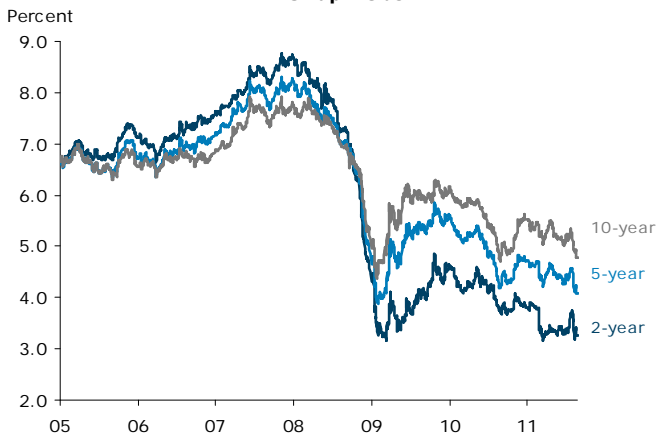
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



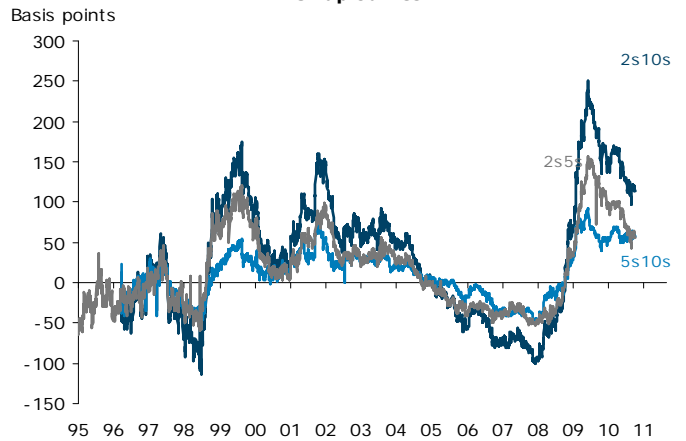
Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



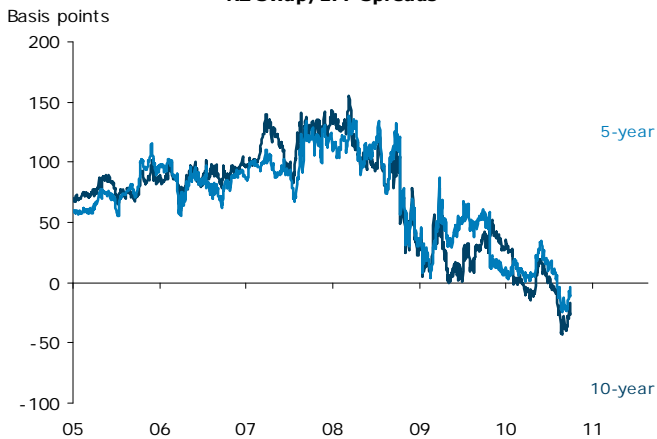
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



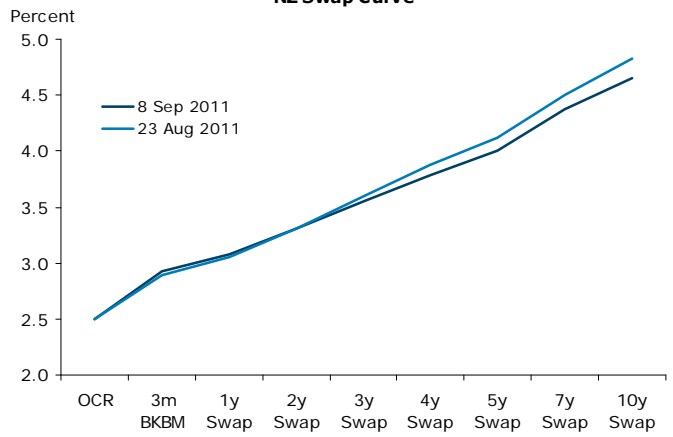
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

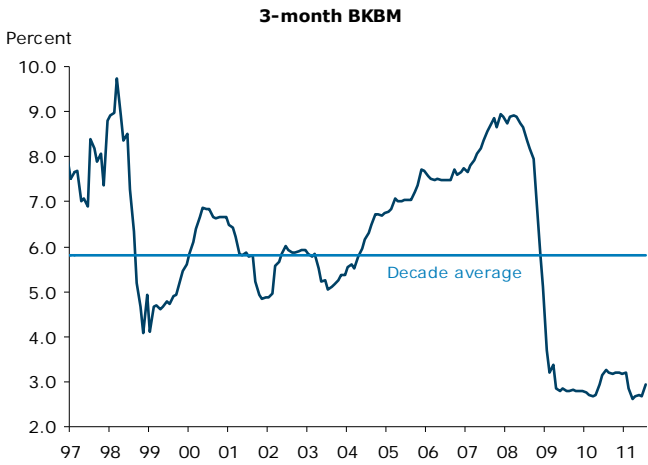
NZ Swap Curve



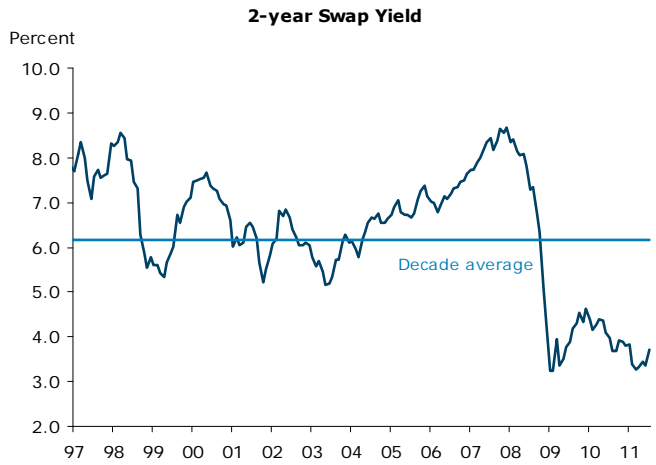
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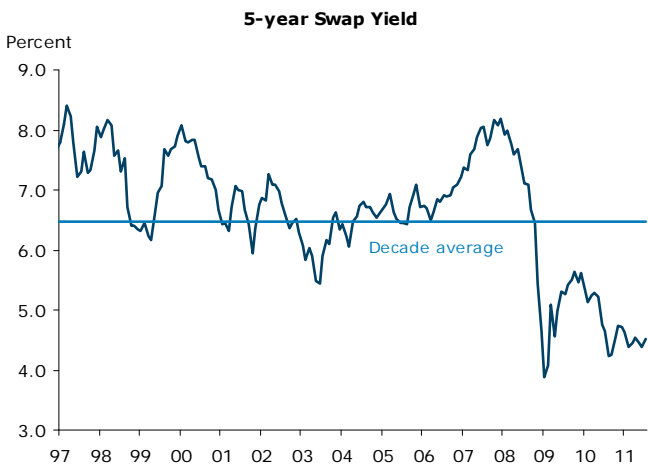
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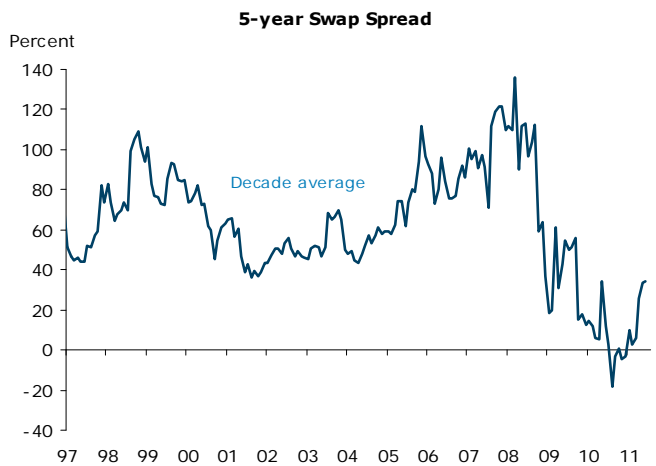
Sources: ANZ, National Bank, Bloomberg



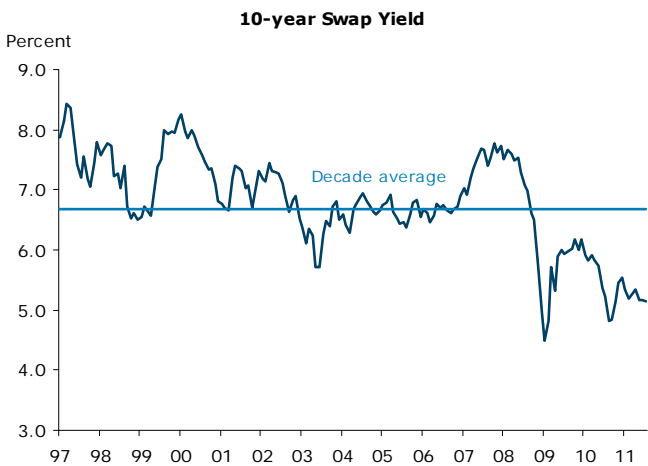
Sources: ANZ, National Bank, Bloomberg



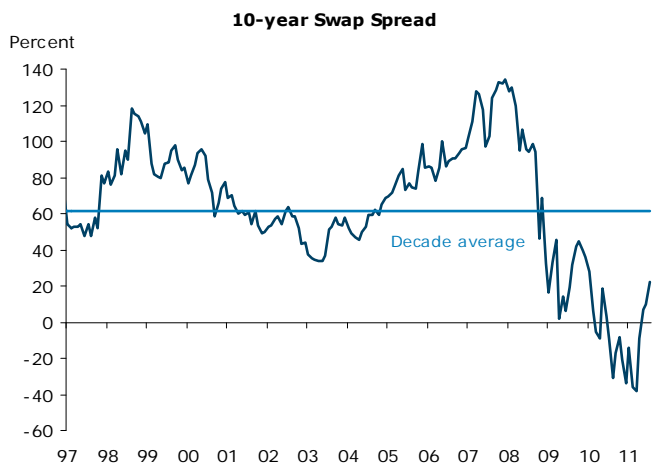
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