NEW ZEALAND ECONOMICS
ANZ BORROWER'S STRATEGY

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CONTRIBUTORS

David Croy
Senior Interest Rate Strategist
Phone: +64 4 576 1022
E-mail: david.croy@anz.com

ECONOMIC OUTLOOK

The New Zealand economy continues to be weighed down by the dynamics of deleveraging. The economy is not moving forward with any great impetus. After stalling over Q2 and Q3 last year, we think economic activity expanded only modestly in Q4. We remain more upbeat on the 2011 outlook, with earthquake related reconstruction and the Rugby World Cup expected to boost activity in the second half of the year. However, underlying momentum remains modest for this stage of the economic cycle, with our 2011 assessment within the spirit and context of a lower trend growth rate. This is a pre-requisite for true rebalancing of the economy to take hold, laying the foundations for more robust and sustainable growth down the track.

We believe the economy is entering 2011 on a firmer footing than how 2010 closed. But it will not be for another six weeks before data starts to bear this out, and it will be off a low base. Until we see some consistency across economic barometers, the curve and interest rate market has limited scope to keep rising. And even then this assumes a stable global backdrop, which seems a rather heroic assumption.

RATE VIEW

Although the economy is recovering slowly from the GFC and will be boosted by a number of favourable developments and one-offs, the after effects of the run up in debt will continue to linger for some time. Monetary policy faces some tough challenges this year: rising food and energy prices, appreciating Asian exchange rates, and imported inflation. These are significant worry factors for the RBNZ, but there are equally challenging offsets: a lack of support from fiscal policy, fragile confidence, and historically high exposure to floating interest rates. We still expect the RBNZ to start raising rates in the middle of the year. However, as with the 2010 rate hikes, we expect higher rates to come in staggered back-to-back 25bp moves, allowing the RBNZ to assess the impact of rate hikes as it goes.

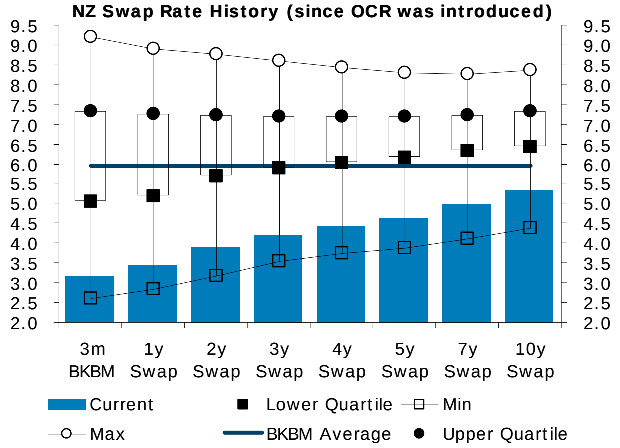
STRATEGY

Although our monetary policy view sees rates rising slightly sooner (mid year) than the consensus (September), our projections are not significantly different compared to what's priced in. They certainly don't differ enough to overcome other considerations, including heightened uncertainty, the slope of the curve, credit market stresses, and heightened sensitivity to rising rates. As such, we continue to favour maintaining an exposure to floating rates. That said, we need to be mindful of the purpose of hedging – which is risk management – not picking trends. We therefore favour employing options in hedge portfolios. This will come at a cost, but then again, so too does traditional fixed rate paying. However, by setting strike levels above market levels to coincide with stress or "worst-case" levels, premiums can be reduced significantly, affording a balance between protection and flexibility.

BORROWER'S STRATEGY

VALUATION

While short end rates are up a few basis points since our last edition, long end rates are down around 10 basis points, making for a substantially flatter yield curve. This does make "blend and extend" strategies cheaper, but with the overall slope of the curve still very steep by historical standards (and steeper than at any time in the second half of 2010) we don't favour it as a strategy at the moment.



Sources: ANZ, National Bank, Bloomberg

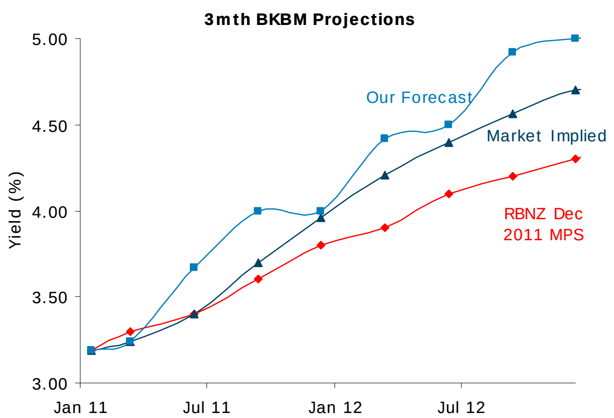
Interest rate levels		
Maturity	**Last issue (9 Dec 2010)**	**Current**
3-mth BKBM	3.16	3.17
1-year swap	3.40	3.46
2-year swap	3.81	3.90
3-year swap	4.19	4.22
4-year swap	4.48	4.44
5-year swap	4.73	4.64
7-year swap	5.10	4.99
10-year swap	5.48	5.37

Market expectations for RBNZ OCR (bps)		
OCR Dates	**Last issue (9 Dec 2010)**	**Current**
Thu 27 Jan-11	+1	+0
Thu 10-Mar-11	+3	+1
Thu 28-Apr-11	+4	+5
Thu-9-Jun-11	+20	+16
Thu-28-Jul-11	+40	+30
Thu-15-Sep-11	+48	+42
Thu-27-Oct-11	Not forecast	+59

THE LAND OF THE LONG SHADOW

Welcome to the first edition of the *Borrower's Strategy* for 2011. We trust our readers had a safe and enjoyable holiday season, and we look forward to sharing our views with you as the year and the recovery unfolds. And although we look to the next few years with anticipation – mindful of ongoing strength in Asia, signs of a gradual pick-up in activity in the US, and a number of favourable one-offs – this needs to be reconciled against the deleveraging dynamic, which casts a long shadow. The key themes behind our views are discussed in detail in this week's *Market Focus*, which was published on Monday, and we encourage clients to familiarise themselves with this foundation document for the year. What becomes clear from our analysis is that New Zealand is well placed, but faces a number of challenges, all of which point to a non-typical, sub-par recovery.

But it is a recovery, and with it will come a monetary policy response. However, we expect a much more measured response this time around, and do not anticipate hefty rate rises. As such, and with the yield curve as steep as it is, we continue to favour exposure to floating rates, which we expect to remain low for some time. We also see little in the way of peculiar opportunities at the moment. Indeed, market pricing is sandwiched in between our forecast and the RBNZ's, suggesting fairly sensible pricing, as the chart below demonstrates. Taken at face value, the fact that our forecasts are slightly higher than market pricing is suggestive of value. However, as we elaborate on later, this needs to be weighed up against other factors, not the least of which is the lack of certainty.



Sources: ANZ, National Bank, RBNZ, Bloomberg

CHALLENGES

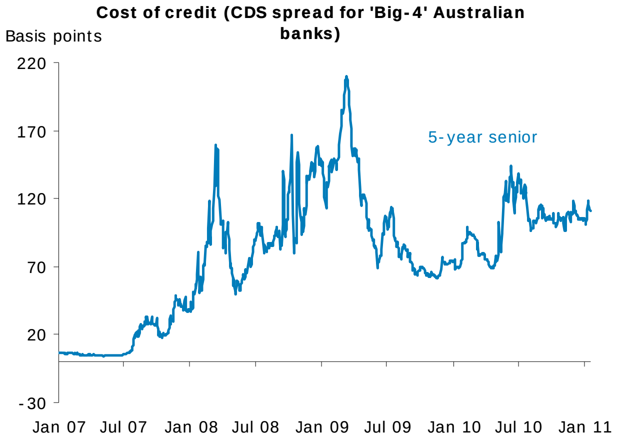
Regular readers will be familiar with the overall thrust of our view, which has not changed over the holiday period. In fact, if anything we have become more circumspect – but not because we see the recovery at greater risk, but because many of the over-arching themes that dominate our thinking (and as noted, are explored in full in this week's *Market Focus*) have become more challenging.

For example, deleveraging is now well entrenched and has had a profound impact on housing and retail activity. Although many people have been talking about deleveraging, the apparent dismay with regard to poor Christmas sales volumes suggests many have been caught by surprise. Deleveraging is a multi-year process, and it is simply not credible to expect it to fade any time soon. As such, it will continue to weigh on growth. Indeed, whereas the economy grew by 0.5-0.75% faster than otherwise as the economy leveraged up during the credit boom, deleveraging will subtract a similar amount over a number of years.

But there are positives. One of them is the one-offs that will boost growth in 2011, including the Rugby World Cup. But this will be transitory, and it would be a mistake to hang one's hat on it, so to speak. Another positive is the surge in commodity prices, particularly food prices. This has not escaped the attention of global markets, which have jumped on it as a theme, mindful of New Zealand's standing as the world's largest net exporter of food as a percentage of GDP. On balance, this is undoubtedly a boon for New Zealand. Indeed, even if it comes at the risk of higher domestic food prices, this will be more than offset by higher farm incomes. But it may not be as simple as that. The surge in leverage in the rural sector is suggestive of a lag in the income effect, with farmers likely to elect to pay down debt, as opposed to spending more. In fact, it's possible we feel the impact of higher supermarket bills before we see the impact of higher incomes, especially if credit growth remains anaemic.

But with Asian inflation trending higher, and food (and fuel) prices set to rise, surely the RBNZ has an inflation problem to contend with? It certainly does and Q1 inflation may well surprise on the upside, coming on the heels of a strong GST-induced Q4 2010 read as well. Rising inflationary pressure from Asia is notable. The realities of a headline inflation rate at five percent may necessitate a change in the RBNZ's tone, despite a still fragile recovery. That said, it may not elicit the same response a generalised rise in price pressures may cause. In fact, given the low growth trajectory and cautious consumer demand, higher prices for key staples like food and fuel are more like a tax, giving the RBNZ more scope to look through them, focussing instead on potential spill-over effects into prices and wages, which may or may not occur. It's certainly hard to argue at this juncture that pricing power resides with retailers and employees.

The process of financial market "healing" has also not yet completely run its course. Central banks slowly moved away from liquidity facilities over the course of 2010, and although bank credit spreads have improved markedly over the past two years, they remain volatile, as the chart below shows.



Sources: ANZ, Bloomberg

Markets also remain suspicious of governments, and sovereign credit spreads in peripheral Europe have generally widened over the past few months. The fact that yields on Greek and Irish government bonds are substantially higher than their German equivalents is a sure sign that the market is entertaining the possibility of some form of default or restructuring. However, if we actually see one, it's difficult to see the fallout being contained. It may not be an accident waiting to happen, but until these stresses go away, markets will remain nervous, and as a net borrower, this is something that New Zealand needs to be wary of. And it's not just that we are at the whim of global markets, we also need to be mindful of the interplay between fiscal and monetary policy. With government debt growing, and New Zealand's credit rating on negative outlook, the Finance Minister has his choices constrained, and that places more pressure on monetary policy, which suggests rates will be lower than otherwise.

STAYING AFLOAT

Given our overall view, it will come as no surprise that we see limited value in adding to long term hedges at this juncture. This view is only further strengthened by the usual seasonal rebound we have seen in short term swap rates, which have risen over the past 10 days, more than unwinding the significant rally over the holiday period.

In formulating a hedge strategy, notwithstanding our macroeconomic view, we are also mindful of a number of other considerations that lend themselves to less, rather than more hedging. These include:

1) Still significant uncertainties with respect to the business cycle. This is not so much the level of activity, but the volatility around it, as demonstrated by wild swings in business confidence over 2010. Business confidence is back in positive territory, but it has been volatile, and is well below where it was at the beginning of 2010;
2) Many businesses are intent on repaying debt. This needs to be borne in mind when contemplating prudent debt ratios;
3) Monetary policy arguably has more bite now than it has in the past. Last year's back-to-back 25bp hikes clearly hit the economy hard, and with more borrowers than ever on floating (and those that are fixed generally fixed for shorter periods), the RBNZ will be mindful of the impact higher rates will have. The more people opt to remain on floating, the deeper the "partnership" between the Bank and borrowers. It is crucial that the RBNZ holds up their end of the bargain if it is to avoid a 1990s style rush to fix;
4) The slope of the yield curve is steep, and is set to remain steep over the foreseeable future. This not only reflects expectations of a gradual recovery, but comes as a result of a tension between low domestic policy rates and rising global yields. Borrowers cannot expect to be "rewarded" for fixing, as they were in the past when curves were inverted.
5) The potential for higher margins. This is not our base scenario, but as noted earlier, if credit markets do become more stressed, funding margins may rise. To the extent that this is an "externality" imposed on NZ by global markets, it reduces the need for the RBNZ to raise the OCR, reducing the effectiveness of swap based hedging (as they are a hedge against base rates, not all-up rates).

Given these considerations, we favour a high degree of exposure to floating rates. However, this is not the same as doing nothing, and we need to acknowledge that hedging is a risk management function, not a punt. We believe our views are well-founded, but we may be wrong. Rates are low, and there are upside risks. As such, borrowers ought to have some cover in place, and the obvious way to do this is via options. This need not be complicated, as we demonstrate below. Vanilla options are highly effective, and do not have to be expensive, particularly if strike levels are set against stress levels, as opposed to market levels.

CAP PRICING

As noted earlier, hedging is more about risk management than picking trends, and the current environment lends itself to caps. Instead of paying away the slope of the curve to fix, it makes more sense to pay option premium in favour of some upside protection, while continuing to enjoy low floating rates. If rates stay low, you will recoup some (or all) of your premium, but if they rise, you'll still be protected.

Consider the table below, which has indicative pricing for caps for various maturities with strikes at the money (ATM), and at 4.50%, 5.00%, 5.50% and 6.00%. As you can see, premiums have moved slightly in the last month, but remain competitive relative to the slope of the curve.

Selected cap premiums (basis points per annum)

Term / Strike	ATM	4.50%	5.00%	5.50%	6.00%
2 yr	46bps	28bps	19bps	14bps	11bps
3 yr	59bps	49bps	35bps	26bps	12bps
4 yr	67bps	64bps	48bps	35bps	27bps
5 yr	74bps	79bps	59bps	45bps	34bps

For example, instead of paying 105bps above BKBM at the moment to be fixed for 3 years, you could spend 35bps on a 3 year option with a strike at

5.00%. As we noted in our last edition, caps don't offer as much upside protection as paying fixed (the strike kicks in 78bps higher than the market). However by setting the strike high, and at a point where any of the caplets that make up the cap are not in (or too far in) the money, the premium drops considerably. You also get the opportunity to participate in the downside, which is, as noted, 105bps at the moment. For a full discussion of caps and ways to reduce premium, we would recommend reading our publication titled *Managing the Cost of Caps, Part 1.* This is available on request.

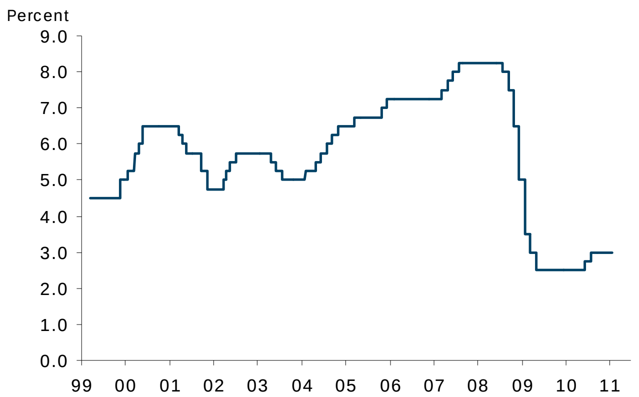
DEALING ROOM CONTACTS:

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

CHARTS

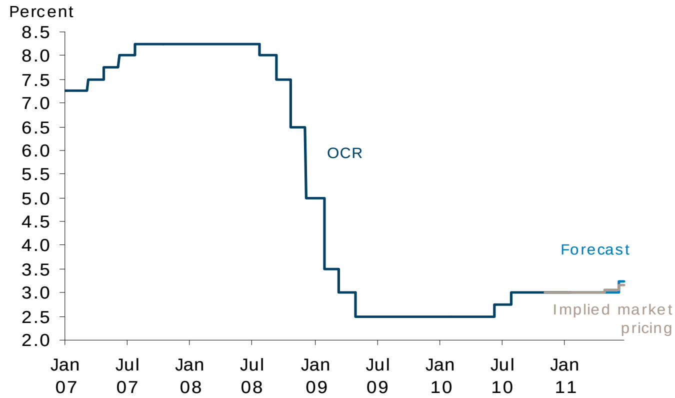
CHARTS

Official Cash Rate



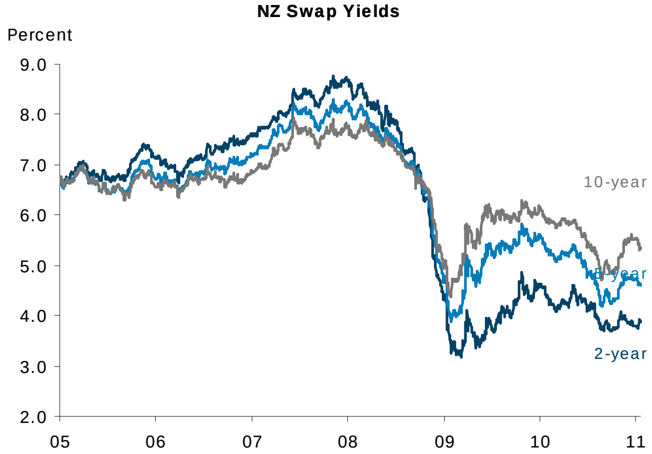
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



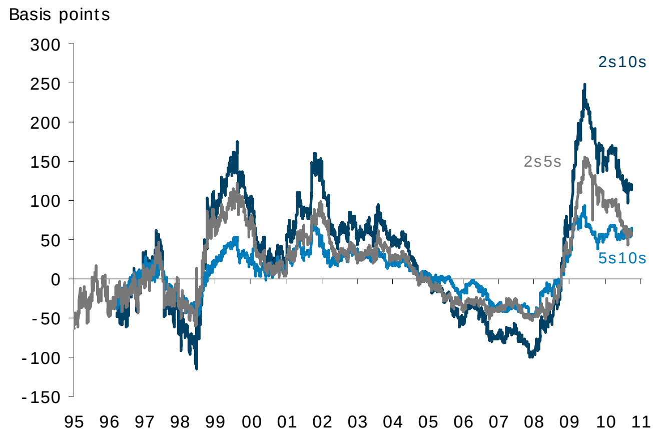
Sources: ANZ, National Bank , RBNZ, Bloomberg

NZ Swap Yields



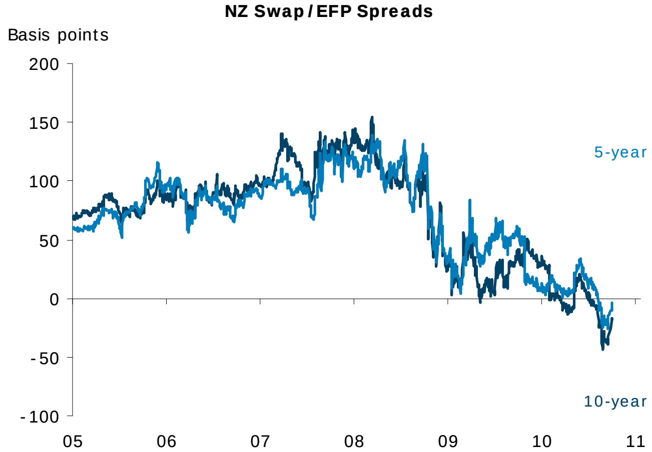
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



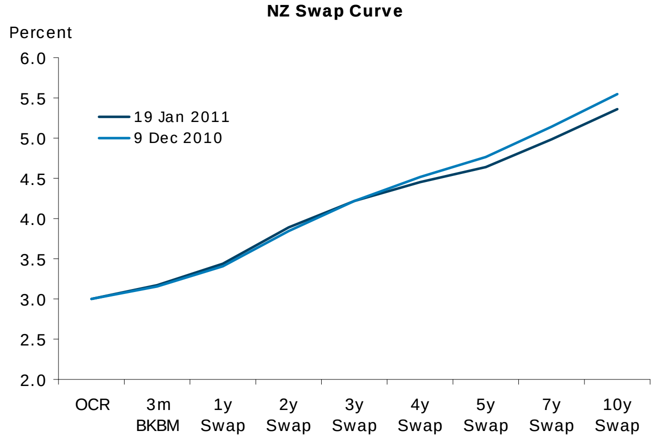
Sources: ANZ, National Bank, Bloomberg

NZ Swap / EFP Spreads



Sources: ANZ, National Bank, Bloomberg

NZ Swap Curve



Sources: ANZ, National Bank, Bloomberg

CHARTS (END OF MONTH)

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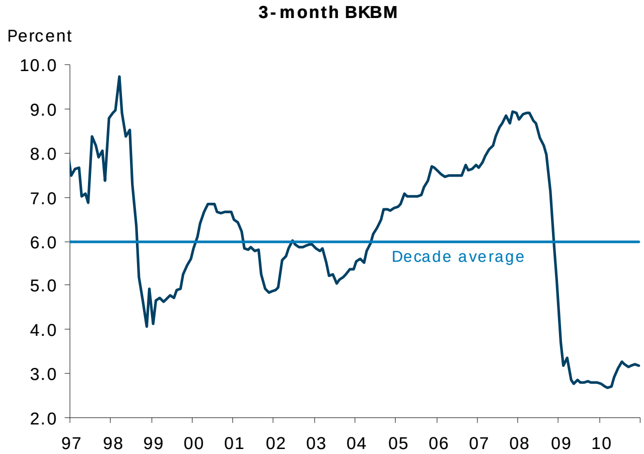
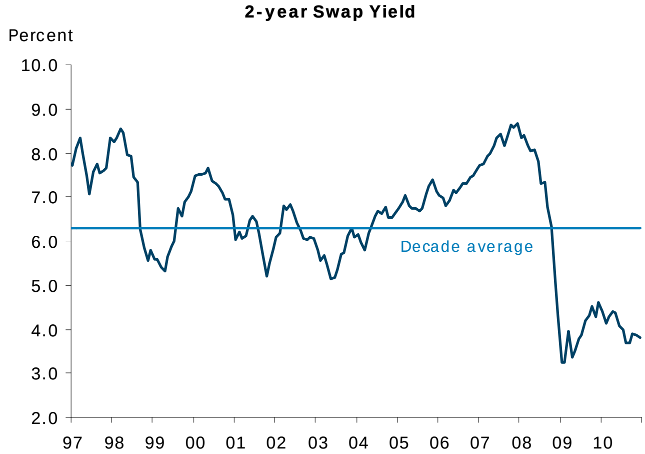
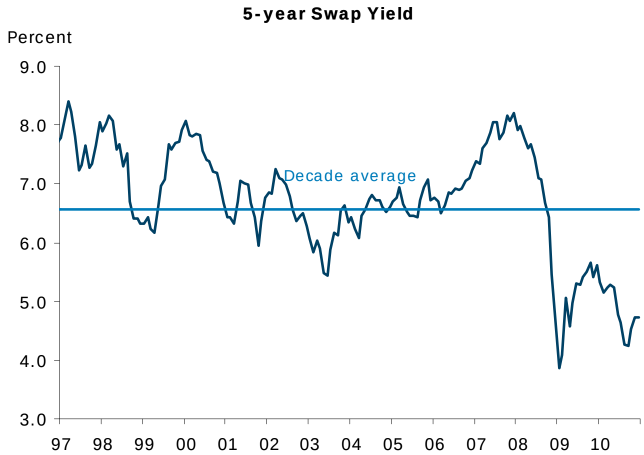


Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg



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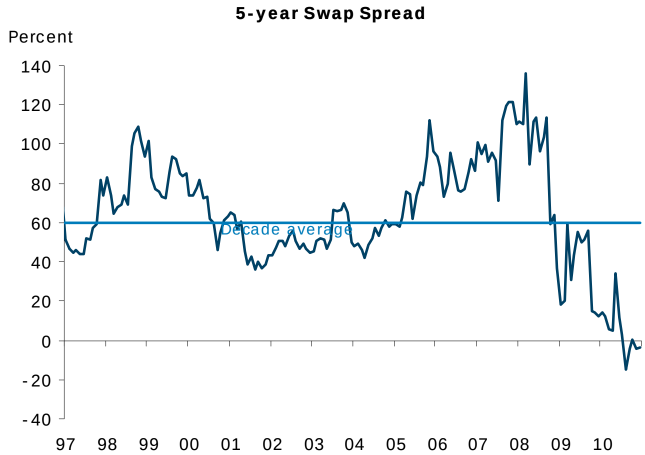

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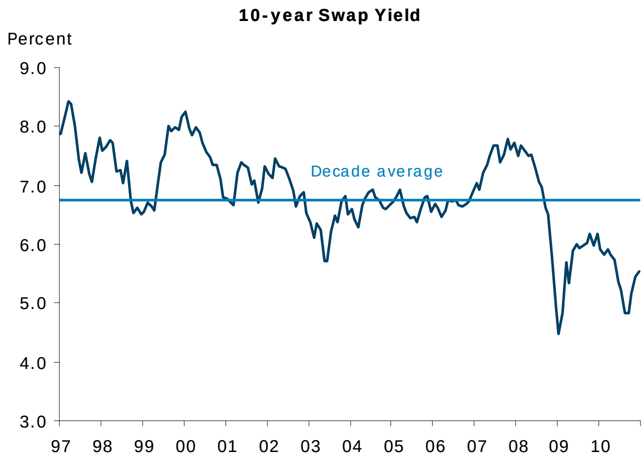

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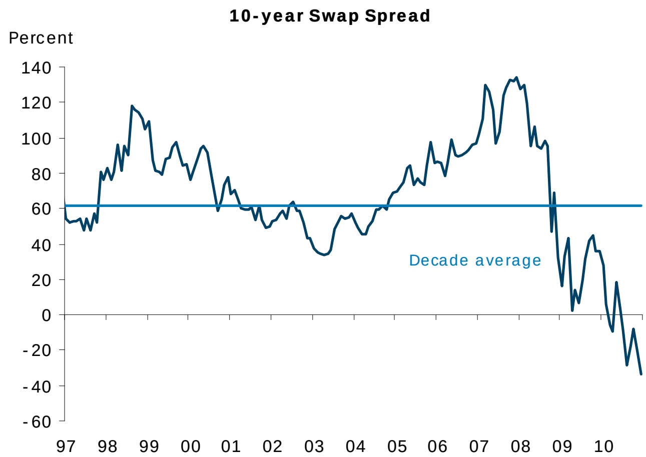

Sources: ANZ, National Bank, Bloomberg

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IMPORTANT NOTICE

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