

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

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CONTRIBUTOR

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

ECONOMIC OUTLOOK

Global risk and uncertainty dominate the outlook, and completely swamped local nuances. Europe is at the heart of the problem, and although Greece is half a world away, the potential for a partial default has sent shock waves through funding markets. This is a key transmission mechanism for global shocks, and we are mindful that political point-scoring and a lack of urgency in Europe will see market sentiment deteriorate further, derailing the outlook. Domestic developments have not been plain sailing either. Indeed, the domestic data pulse has been strong for most of this year, and as such, markets were taken aback by softness in Q2 GDP data released last week. Although it is historic, it has gone a long way to validate the RBNZ's cautious tone, and adds weight to the view that some of the improved confidence we saw over Q2 didn't translate to improved actual activity. Prospects for Q3 and Q4 are brighter, thanks largely to the Rugby World Cup. But once the Cup is over, we have to run the gauntlet of slowing and increasingly fractious global growth before the Christchurch rebuild kicks in hopefully from mid 2012.

RATE VIEW

Extreme levels of global uncertainty coupled with a loss of momentum (though we question somewhat the 0.1 percent Q2 GDP figure) locally has bought the RBNZ more time to sit on its hands and see how events unfold. Even before this most recent bout of turmoil, the RBNZ had adopted a more cautious tone, having lowered its 90 day bank bill projections. It also removed references to March's "insurance" rate cut, clearing the decks of any baggage associated with past decisions. Looking ahead, the best way to characterise the timing of the next rate hike is that it is fluid, and depends crucially on global developments, and on markets calming down. A rate hike in 2011 is now highly unlikely, and in fact, we would not be surprised to see further downside in short end rates, or rule out the possibility of the market moving to price in cuts. That's not to say we expect a cut, but as we saw in Australia, there is nothing to stop a nervous market pricing one in. This suggests there is still some downside at the short end. Operation "Twist" and flaky risk appetites should keep the long-end anchored.

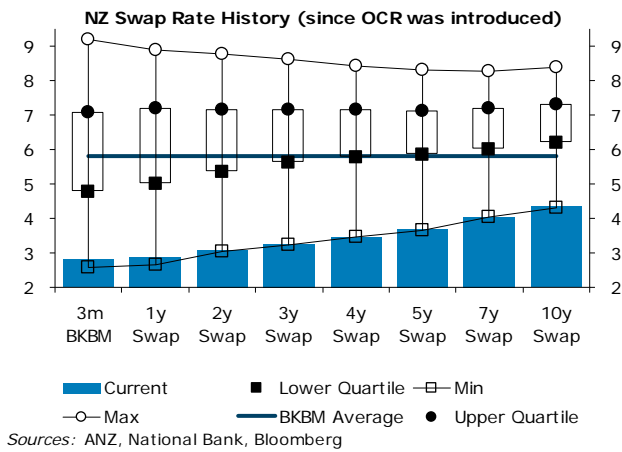
STRATEGY

Although swap rates are lower across the board, with all maturities hitting record lows last week, we do not favour jumping in to fix. The outlook at this juncture is binary: policymakers could deliver a huge package, or the combination of political gridlock and wholesale uncertainty could see another leg lower. When such uncertainty is prevalent it pays to keep your powder dry. Indeed, we see very little reason to stray from our long held strategy of being highly exposed to floating, and avoiding the temptation to fix for very long terms despite those rates being at or close to record lows. Regular readers will recall that in our last edition we favoured adding slightly to hedges in the 2-3 year part of the curve ahead of the *MPS*. That preference was based on the view the RBNZ would focus a little more on the domestic outlook. However, the global outlook has continued to deteriorate, and a solution to the world's challenges is a precursor to a sharp uplift in rates. With time the only true healing dynamic, this puts time on borrower's side.

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VALUATION

Interest rates are lower across the board, and the curve has flattened substantially in the past 2 weeks. All swap rates 2yrs and longer hit record lows last week, and remain close to lows. At face value, this makes paying fixed more attractive. Not only are swap rates trading at less of a premium to the floating rate, but individual rates are low relative to their own trading ranges. But as we have long cautioned, the yield curve remains steep, even now. Moreover, uncertainty is high, and as such, some caution needs to be used in interpreting where value lies on the yield curve, if indeed there is value.



Current interest rate levels		
Maturity	Last edition	Current
3-mth BKBM	2.92	2.82
1-year swap	3.09	2.88
2-year swap	3.34	3.06
3-year swap	3.58	3.26
4-year swap	3.82	3.46
5-year swap	4.04	3.67
7-year swap	4.40	4.03
10-year swap	4.69	4.34

Market expectations for RBNZ OCR (bps)		
OCR Dates	Last edition	Current
Thu-15-Sep-11	+3	0 (actual)
Thu-27-Oct-11	+9	-2
Thu-8-Dec-11	+16	-1
Thu-26-Jan-12	+27	0
Thu-8-Mar-12	+34	+2
Thu-26-Apr-12	+36	+6
Thu-14-Jun-12	+42	+7

GOING GLOBAL

Much has happened in the fortnight or so since our last edition. As noted, swap yields are lower across the board. We also saw the release of the RBNZ *Monetary Policy Statement (MPS)* and Q2 GDP data. The latter two developments have both shaped changes in interest rates, but let's get realistic – what really matters is what's happening offshore. Nuances in the tone of comments by the RBNZ are certainly interesting – but they pale in comparison with things that are unfolding overseas. Europe continues to “muddle through” its mounting debt issues, and while there is talk of an imminent shock and awe style plan to deal with it, the reality is anything concrete needs to be approved, voted upon, and put into action. We've been here before, and experience tells us that talk has not always been followed by action. But even if a comprehensive and credible plan is put in place, it's hardly a silver bullet. Belts need to be tightened. Greece may be small enough to get away with a partial default, but that option is not available to the big countries. Suffice to say growth will be slow in Europe for a while yet.

But Europe is a long way away from NZ – so why is it so important? For one, it's a financial hub. Much of the funding we rely on comes from Europe. And here's the rub – instability and nervousness in Europe has led to wider funding spreads for all banks – including NZ banks. This is a key transmission mechanism, and it's something we will be keeping a close eye on. The bottom line is, Greece may be half a world away, but if it stumbles, we will inevitably get caught up in the ripples emanating from it.

THE PLAN

Regular readers will recall we tend to refrain from making big calls on offshore events. It's simply not our area of comparative advantage, though readers of our weekly will have noticed a strong emphasis on Europe's pending challenges over the past year. You can't divorce NZ from what's going on across the global scene. In that regard, we note that the weekend rumour mill has it that European officials are working on a plan that would allow Greece to “default” on half of its debt. This default would, in turn, lead to massive losses among European banks, so the plan calls for the banks to be forcibly recapitalised from private funds where possible and by the European Financial Stability Facility (EFSF) where not. The next problem, contagion, is the real issue with a Greek default. To that end, the plan also calls for the EFSF to be leveraged, with the additional funds to provide financing (ring fencing) to Spain and Italy, as well as Ireland and Portugal. This is



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rumoured to be achieved by the ECB providing additional funds on the basis that the EFSF takes the "first loss" piece should any future losses be incurred.

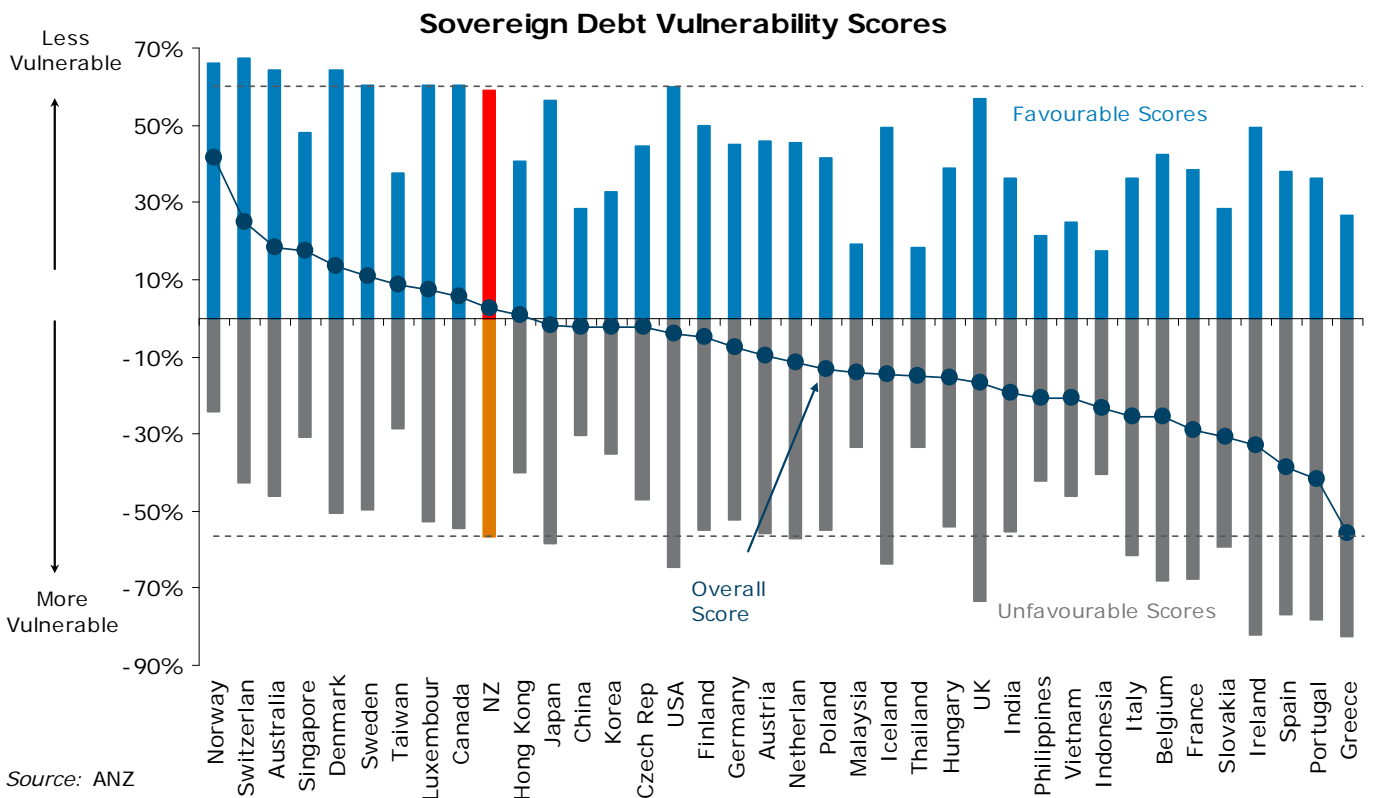
To effectively "firewall" Italy, as US Treasury Secretary Geithner put it, the plan may need to see the EFSF leveraged up to 2 trillion euros. These are huge numbers, way in excess of the IMF's war chest (thought to be US\$384bn) and the existing EFSF (€440bn). Recall that the July changes to the EFSF (which expanded its powers, allowing it to buy sovereign debt and to lend to troubled banks) have yet to be ratified by all EU members. The attraction of the leveraged scenario is that "theoretically" it wouldn't need further parliamentary approval. However, with the original extension still to be approved, it is a risky strategy to have in the public domain. German politicians seem to be in no hurry to embrace the concept, with some publicly voicing opposition to it. And there's the sticking point – nationalist-style political arguments are growing stronger by the day. As German Chancellor Merkel has found, bailing out the profligates abroad is not popular at home.

Of course, none of this is hugely surprising. We identified sovereign risk as a key Achilles heel about eighteen months ago, and came up with our own

measure of vulnerability. It was no surprise that the "usual suspects" (being Greece, Portugal, Ireland and Spain) showed up as being the most vulnerable as the chart below shows. What really bothered us though is where some of the larger countries – like France and Italy reside. As the UK's Telegraph newspaper noted, they're not just too big to fail, there is also "too big to bail". The upshot is, we need to keep a close eye on how things unfold in Europe, as this is a critical scene setter here. But even if that goes well (and to be fair, it looks more like its headed for a train wreck rather than something constructive), we also have the US slowdown and signs of slowing in China to contend with.

OPERATION TWIST

With global developments at the fore, we also need to be mindful of what's happening on the global policy agenda. US monetary policy is again front-of-mind following the Fed's decision to embark on what markets have dubbed "Operation twist". This is an important development, particularly for borrowers, as this policy was adopted specifically to flatten the US yield curve. Indeed, the FOMC press release last week noted that their intention is to "put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative". That is, the Fed is extending its influence beyond the



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traditional tweaking of the overnight rate, and is now targeting low yields in the 6-30 year part of the curve. There is a host of Federal Reserve Governors due to speak this week which will add clarity (though with 3 dissenters we could also see the reverse!).

This is activist monetary policy at its sharpest, and if it is successful in keeping US long end interest rates down, there will be some spill-over here. Of course, there is no mechanistic link between US and NZ interest rates. But the correlation is high, and we tend to see long term interest rates move closely together. As such, any initiatives by the Fed aimed at lowering term rates will keep the curve flat here, and needs to be considered when making decisions.

NO RUSH

Although global developments are in the driving seat, no discussion of interest rates would be complete without some comment on the RBNZ's *MPS*. Much has changed in the eleven days since – but it is clear that even then the Bank was cautious, having pared back their apparent “enthusiasm” for lifting the OCR. Indeed, in July the Bank said that “provided current global financial risks recede and the economy continues to recover, the Bank sees little need for the March 2011 ‘insurance’ cut to remain in place much longer”. By contrast, in the September *MPS* the Bank noted that “if recent global developments have only a mild impact on the New Zealand economy, it is likely that the OCR will need to increase”. This most recent comment is hardly an imminent warning that the OCR is heading higher, and with the global outlook still very uncertain, it is looking increasingly likely that the OCR will remain on hold for the remainder of 2011.

The lack of urgency to shift policy was reinforced by comments Governor Bollard made while travelling in the USA last week, when he said that while he does “have a picture where we still do expect to have to push rates up ...we don't think there is any particular rush to do that”.

It's also worth considering two other aspects of the Reserve Bank's message. The first was the Bank's deliberate removal of any references to March's “insurance” rate cut. Not only was this wording confusing, but it gave the impression that there was somehow a need for that cut to be reversed. It made no sense to maintain this stance given global developments. The second aspect was the lower 90-day bank bill projections. In short, these had the bill rate peaking at just 4.3 percent, well below the June projections. In short, they add weight to our long held view that domestic interest rates will be lower

for longer. That's what you get when the economy undergoes structural changes.

WHAT TO MAKE OF IT ALL

It should be clear by now that this is a high stakes environment. With any luck, European politicians will be able to enact a sufficiently credible plan that will stop the rot in Europe.

We are now seeing prospects for concerted global action across the G20. This is not just a pan Eurozone problem. A failure to address issues in Europe will likely see the US under the pump next. Hence the sense of urgency. History shows we shouldn't underestimate policymakers. See the policy responses in 1998 (the Asian crisis), Dot Com bust (2000/01), 9/11 and Financial Crisis of 2008. Risk off could quickly turn to be risk on.

Yet the challenges are huge. The global economy's problems are one of solvency. This requires concerted austerity. We need a group-wide consensus at a time the likes of the US can't properly put its own debt ceiling debate to bed in a constructive fashion. France and Germany are seeing steps to the left of the political spectrum. If it takes 6 weeks for a plan to be implemented, by then it may be too late to save sentiment.

Bringing it altogether, what this means is that the outlook is fraught with risks – locally and globally. We are in a binary world, where the capitulation seen last week could prove to be a counter-cyclical signal. Yet things could still go horribly wrong. And that means that interest rates are not likely to rise any time soon, for the path of least resistance for policymakers is to cover off the more immediate negative risks. At this stage it's probably a bridge too far to say that the RBNZ may cut rates, but we would not be surprised to see the market gunning for cuts if the situation deteriorates.

In this environment, we see little point in adding to hedge cover even though rates are close to record lows. Much is riding on how things unfold globally, and we would prefer to make better quality decisions in the knowledge that things are starting to improve, rather than to fix now, and essentially have a punt that things can't get any worse.

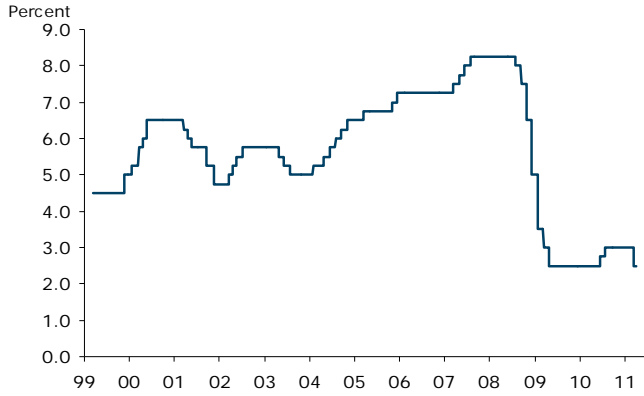
Dealing room contacts

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)

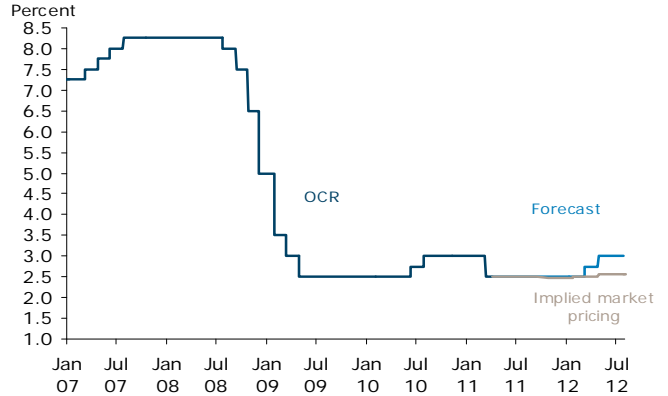
CHARTS

Official Cash Rate



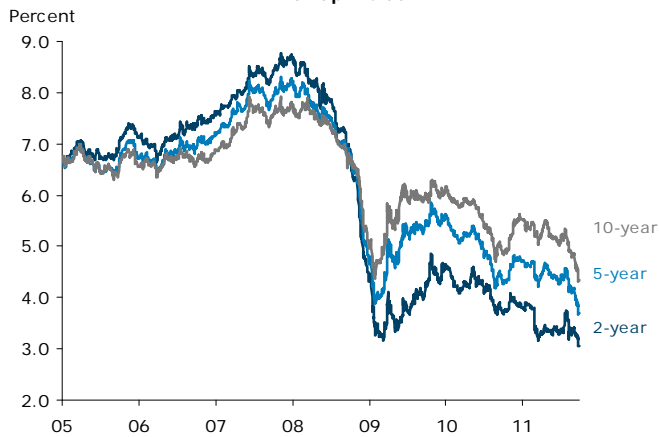
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



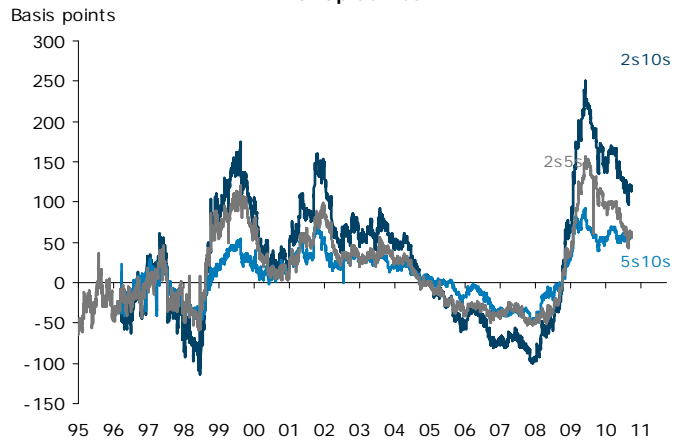
Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



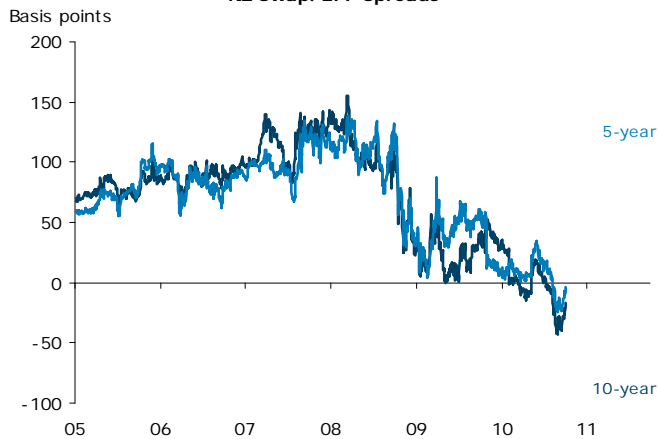
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



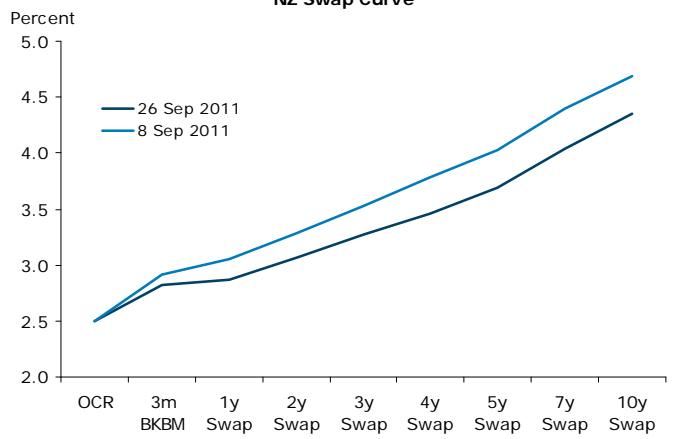
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

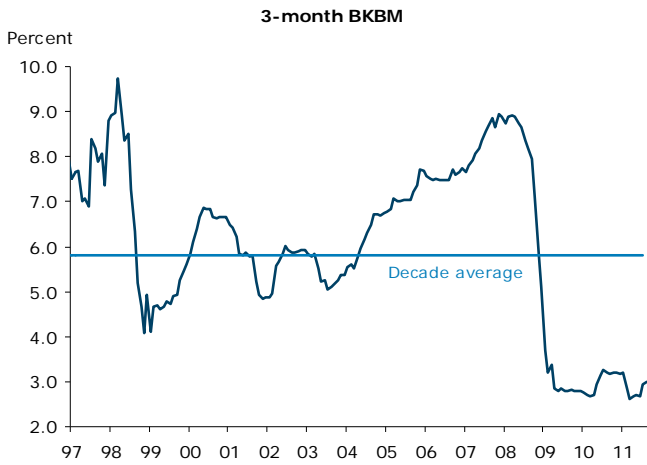
NZ Swap Curve



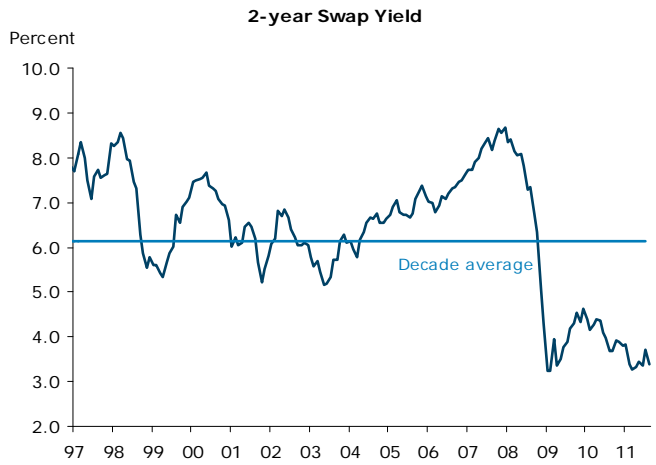
Sources: ANZ, National Bank, Bloomberg

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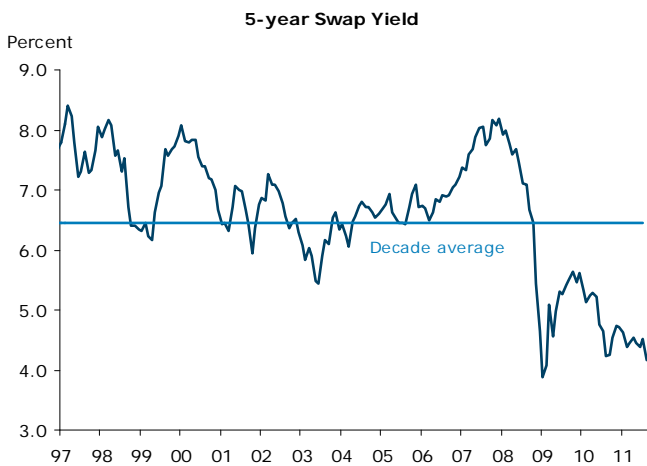
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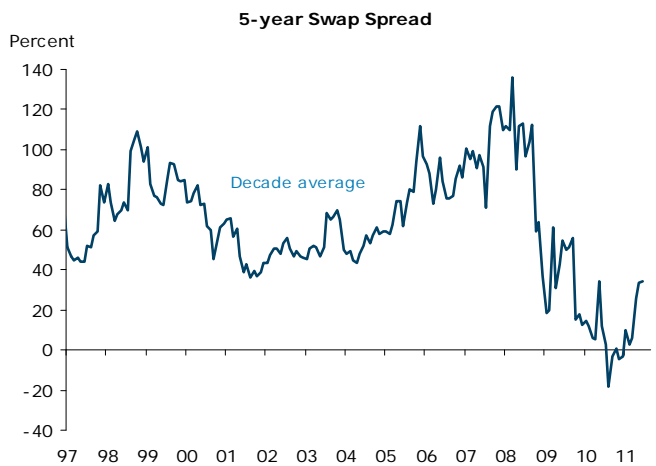
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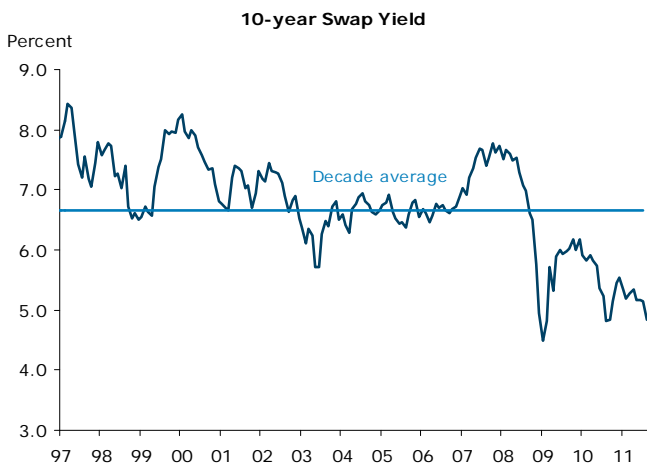
Sources: ANZ, National Bank, Bloomberg



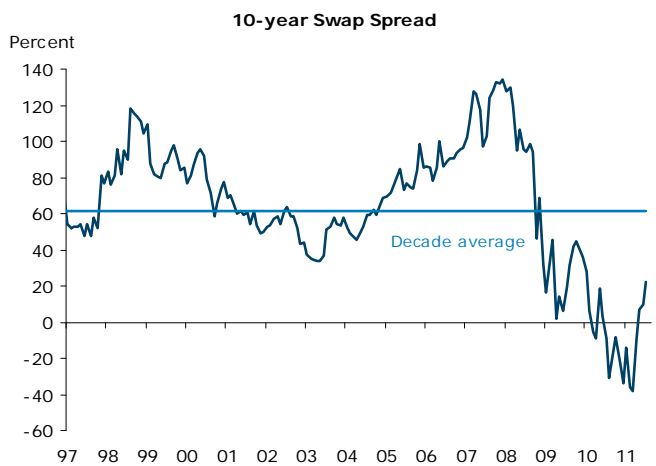
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