

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

28 October 2011

CONTRIBUTOR

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ECONOMIC OUTLOOK

Global developments continue to dominate, with market sentiment gravitating from one extreme to the next. Although details on the announced plan to tackle a nasty looking European debt crisis are scant and talk will need to be backed up by action, it seems a sketchy plan is better than no plan and markets are providing the benefit of the doubt. We continue to closely monitor the various transmission channels to the New Zealand economy, namely commodity prices, confidence, the cost of funds, China and the currency. On some metrics, the relative resilience of the New Zealand economy is being tested, with the downward revision to the Fonterra 2011/12 milk price forecast, easing domestic business confidence and a weaker recent string of domestic data featuring this month. The October OCR confirmed that while a tightening bias remains, the RBNZ are in no rush to exercise it, with low domestic inflation providing them with more flexibility. We continue to look for a June 2012 start to the tightening cycle, but this remains conditional on global developments improving.

RATE VIEW

It is clear from yesterday's OCR Review that the Reserve Bank are in no hurry to raise rates, with one eye on what is still a fairly rosy domestic picture, and the other on global developments. The tone of domestic data releases has cooled somewhat, but is still robust compared to our peers, and we must not lose sight of this. But global events are in the driving seat at the moment, and recent market reaction to the European debt plan has been nothing short of phenomenal – or what we are calling "Europhoria". Call it blind optimism; call it what you will, but we suspect optimism is close to peaking. The hard grind is still ahead of us. Recent moves have all the hallmarks of a positioning squeeze. It is certainly difficult to reconcile what was announced with the types of moves we have seen (like the 3 cent rally in the euro), particularly when you consider how things are placed after the European plan is implemented. The debt has not gone away, and Greece will still be left with debt levels (120% of GDP) that are twice the Euro-area limit. Perhaps worst of all, the whole plan hinges on Italy and Spain honouring pledges to slash budgets, as there simply isn't the firepower to deal with a blow up of that magnitude. We admit that we underestimated how far markets would go on the recent bout of optimism, but we suspect we are nearing a top, and interest rates are set to moderate from here.

STRATEGY

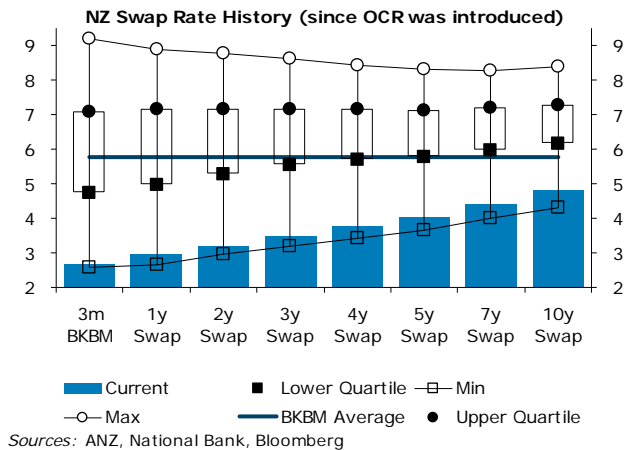
We remain extremely cautious and do not favour adding to hedges at current levels. Our preference remains to stand on the sidelines and wait out global moves. We are not just deeply suspicious that Europe's problems are far from solved, but we are also starting to hear some worrying anecdotes emerging from China. The risk profile with regards to the economy and interest rates certainly seems to be skewed to the downside, and this is not the environment where we would advocate adding to fixed costs. Avoid the temptation of getting caught up in the optimism of the day, and let's see how the dust settles in Europe and Asia.

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VALUATION

Interest rates have continued to rise over the past fortnight. As a result, 2 and 10 year swap rates are now approximately 0.23% and 0.47% respectively above the early October lows. Not only are higher rates less attractive, but the steepening of the curve also makes longer term hedging even less attractive.

We have been somewhat surprised by the duration of the upward move in rates, which has generally reflected increased optimism in Europe. We suspect markets will ultimately be disappointed, with rates settling back to lower levels as a consequence.



Current interest rate levels		
Maturity	Last edition	Current
3-mth BKBM	2.76	2.74
1-year swap	2.94	2.96
2-year swap	3.16	3.22
3-year swap	3.41	3.49
4-year swap	3.69	3.77
5-year swap	3.96	4.03
7-year swap	4.35	4.45
10-year swap	4.69	4.81

Market expectations for RBNZ OCR (bps)		
OCR Dates	Last edition	Current
Thu-8-Dec-11	+2	+1
Thu-26-Jan-12	+4	+2
Thu-8-Mar-12	+10	+8
Thu-26-Apr-12	+17	+14
Thu-14-Jun-12	+20	+20
Thu-26-Jul-12	+26	+27
Thu-13-Sep-12	Not forecast	+31

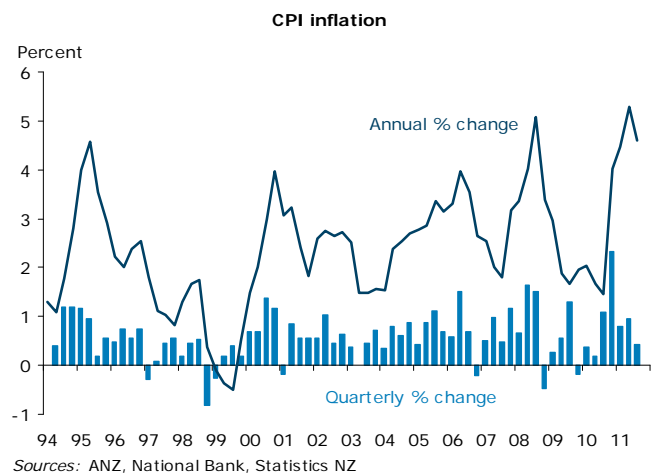
NO RUSH

Although the RBNZ stopped short of abandoning talk that the OCR might need to go higher someday (like the Bank of Canada did earlier in the week), near term policy decisions are highly conditional on global developments. Indeed, as the Bank noted at the end of its OCR Review press release:

"Given the ongoing global economic and financial risks, it remains prudent to continue to keep the OCR on hold at 2.5 percent for now. However, if global developments have only a mild impact on the New Zealand economy, it is likely that gradually increasing pressure on domestic resources will require future OCR increases."

In our view this is a big "if". Although market sentiment has improved vastly over the past two weeks, as we go on to discuss in the next section, Europe remains deep in the mire and we are sceptical on how much true progress has been made with regard to an action plan, and even more sceptical about what the long term holds in store. Moreover, some of the stories emerging from Hong Kong and China are starting to worry us.

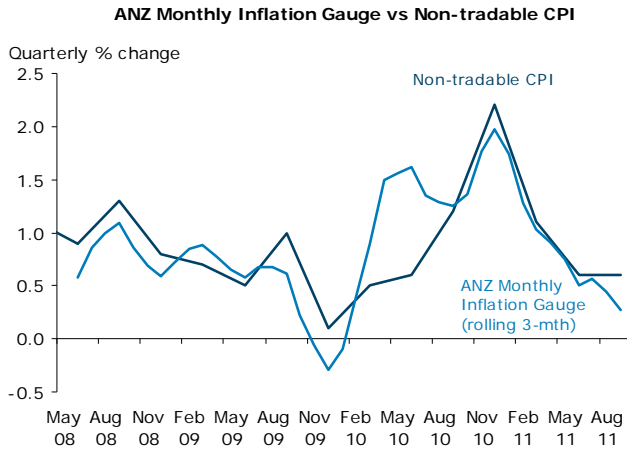
We think the Bank of Canada summed it up well earlier in the week, when they noted that while their "base-case scenario assumes that the euro-area crisis will be contained", they go on to warn that "this assumption is clearly subject to downside risks". We concur completely – and it is for this reason that we discuss both the European and Chinese situation in more detail than one might expect in a domestic interest rate publication.



Recent inflation developments are also worthy of comment, as these have been influential in giving the RBNZ more "wiggle room". As the chart above shows, headline inflation has peaked. This in itself is encouraging, but we are equally encouraged by the fact that domestic non-tradable inflation pressures are also trending lower, as the chart below (which

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shows our inflation gauge as well as official data) shows.



Looking ahead, we do harbour concerns that inflation pressures will start to emerge, particularly if monetary policy is kept too loose for too long, but for now this is not the predominant concern – the pace of domestic growth and global issues are.

SACRÉ BLEU

European markets have reacted with jubilation following yesterday afternoon's announcement of a "plan" to tackle the debt crisis. Although at this stage there is a lack of detail, the very fact that there now is a plan has been viewed as enormously positive by markets. So what does the plan call for? Briefly, the key elements are as follows:

1. Banks will be required to hold at least 9% core tier 1 capital by mid 2012. Stress tests using September data suggest this means an additional €106bn capital;
2. The EFSF will be leveraged to around €1trn, but we do not know which method (SPV or insurance) will be used;
3. 50% "voluntary haircuts on Greek debt", which have been proposed to avoid triggering a credit event, and;
4. Treaty change options "to be explored" which include new rules, closer monitoring, and greater enforcement.

The key components of the plan are in line with what rumours and leaks suggested would be the case, and it comes up well short of what most analysts would consider a lasting solution, so why the "Europhoria"? We suspect it is simply a case of markets being enamoured by headlines, rather than details. This is

important – even for domestic borrowers – because above all else, it has been excessive "Europhoria" that has been behind the spike higher in local swap rates over the past two weeks. Of course, what remains to be seen is how well markets will cope when fuller details emerge, and when it comes to actually implementing the plan. We certainly harbour concerns in that regard. Even forgetting the fact that the size of the EFSF is less than half what most analysts think constitutes real fire-power – even basic issues like how and when the plan gets executed is still up in the air. It won't be easy.

For example, how will so-called "voluntary" haircuts be managed? Which banks will "take one for the team" unless there's payback elsewhere? Making them voluntary was a cunning piece of trickery, as it means that it will not trigger a credit event on CDS contracts. This will probably benefit the writers of contracts (typically banks), but it will disadvantage the purchasers (which include some banks, but a lot of speculators). We suspect banks will benefit overall, but the unintended consequence is that those that did enter the market with the honest intention of buying protection will now be wondering if contracts held against sovereigns like Italy and Spain are now worthless. Ironically, this might lead to selling of bonds (for true protection) and writing of CDSs (why not get the premium if you don't have to pay out!). We also wonder how many lawsuits might be filed against the writers of Greek CDS who happily accepted premium, but have escaped paying out. We suspect there will be some furious people.

Also, how will markets cope when they realise that even after all this, Greece's debt to GDP will still be 120% by 2020! We have also heard that Germany is opposed to the ECB continuing to buy Italian and Spanish bonds. But the one real Achilles Heel of the plan is that it hinges on Italy and Spain honouring their pledges with regard to fiscal reform and getting nominal GDP growth (which drives tax revenue) somewhere close to the yield on 10 year bonds. If these reforms are not honoured, market confidence could yet be eroded, sending yields spiralling higher (again), which would then need to be dealt with. In its current guise, the EFSF does not have the capacity to deal with this, and nor does the ECB if it is prevented from playing a major role, as Germany is adamant of. Still, for now markets are optimistic, and even though it feels like we have euro-fatigue here in NZ, at the end of the day, this is what has been driving markets so we have to keep on top of it.

The bottom line is – be careful not to get caught up in the hysteria – let's see how things stand once the dust settles, as we suspect the devil is in the detail.

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Very little has been said about the long term future. Even if the plan can buy Europe time, and avoid some of the immediate issues of the day, the future will be one of considerable tension, with the need for fiscal austerity detracting from growth, which ironically, is crucial if countries wish to grow their way out of debt. Sustainability is key, and achieving nominal growth is set to be the key focus of Europe in future.

CHINA

Not everything is bad in the world – for example, the tempo of US data has improved vastly, and it now appears that growth there has stopped deteriorating and is showing signs of stabilisation. This is of course welcoming, but with the Fed still engaging in “Operation Twist”, this will not necessarily be accompanied by higher interest rates.

But it is the possibility of a deeper slow-down in China that worries us the most. That's not to say we have concluded that it will happen – because it is not clear that it will. However, the tone of anecdotes and stories coming from top-class media organisations (like the Economist and the FT) suggest that the risks are building. We suspect this is one reason why spot iron ore and copper prices took a hammering earlier this month – although we do note that copper prices have surged overnight on the Euro plan.

With so many conflicting signals, it's hard to make head or tail of it all – especially when much of the volatility stems from broad swings in “risk sentiment” in Europe. But where there is smoke there is inevitably fire, and it is the Hong Kong and China property sector that has us most worried at the moment. We don't know how this will pan out, but like most analysts, we worry when we see property prices falling, as this has a knock on impact on demand for raw materials, investment, share prices, and bank collateral values. Growth is already slowing in China, but most expect a so-called “soft landing”, yet these are notoriously difficult to achieve, and if we do see a fall in property prices, we may yet see a hard landing. As such, we are keeping a guarded eye on developments.

STRATEGY

Our long held preference to stand by the sidelines remains intact. Although we have seen a fairly brisk rise in swap rates off lows seen earlier in the month, we do not see this move as very sustainable. Europe has a plan – but the devil is in the detail, and as noted earlier, we think the market will ultimately be disappointed with the European plan. As such, we expect rates to retreat lower as “Europhoria” fades.

For now, the floating rate remains the lowest rate, and with the RBNZ clearly in no hurry to lift the OCR, we favour taking a leaf out of the RBNZ's book: stand aside, watch a lot, worry a little, but most of all, wait.

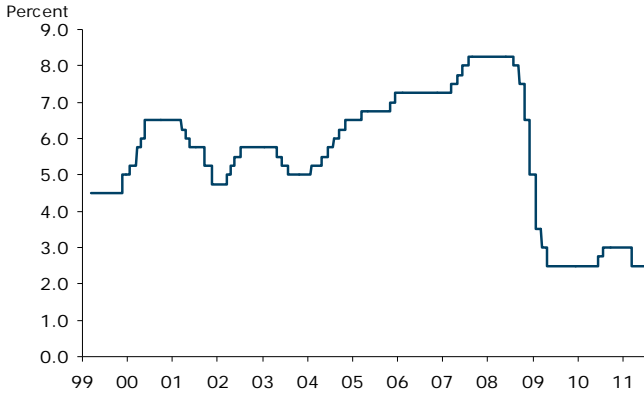
Dealing room contacts

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)

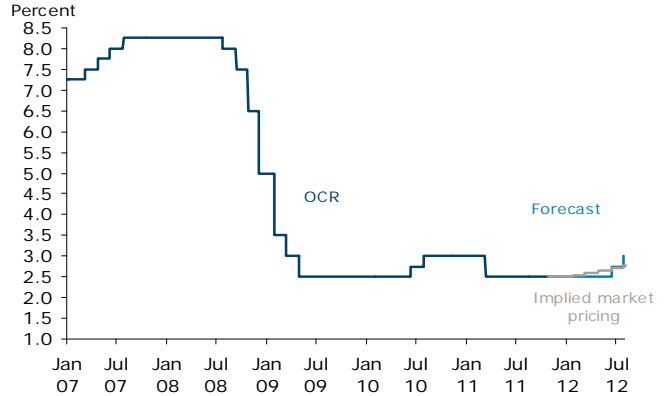
CHARTS

Official Cash Rate



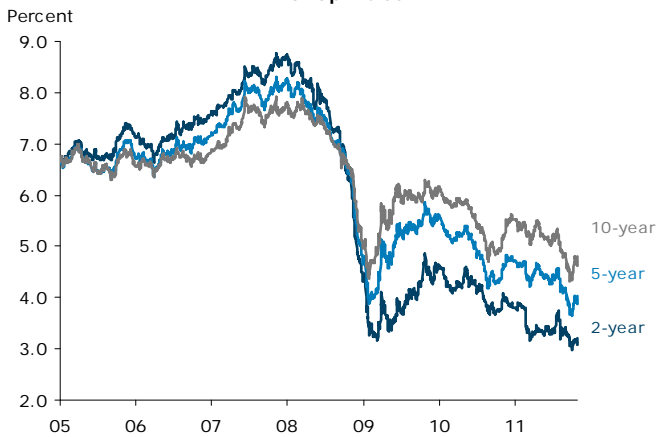
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



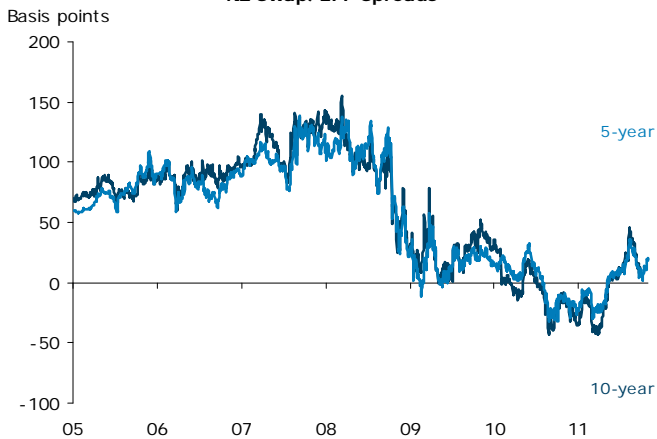
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



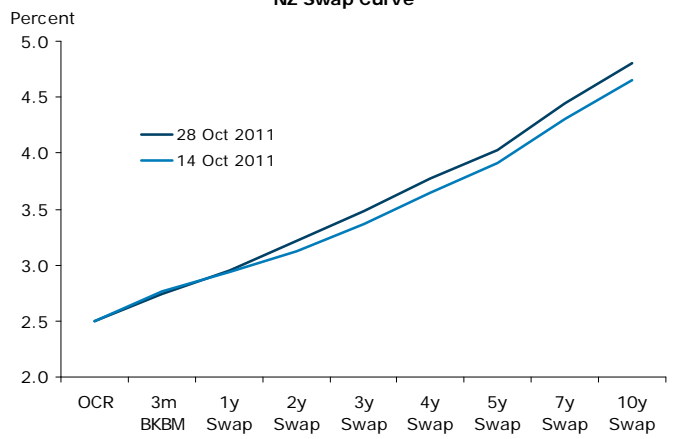
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

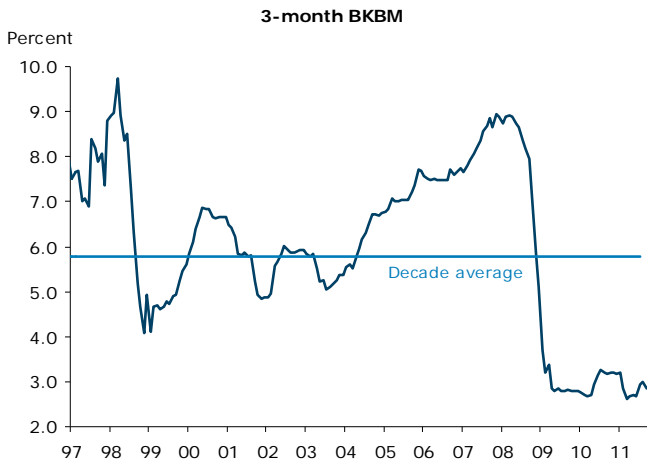
NZ Swap Curve



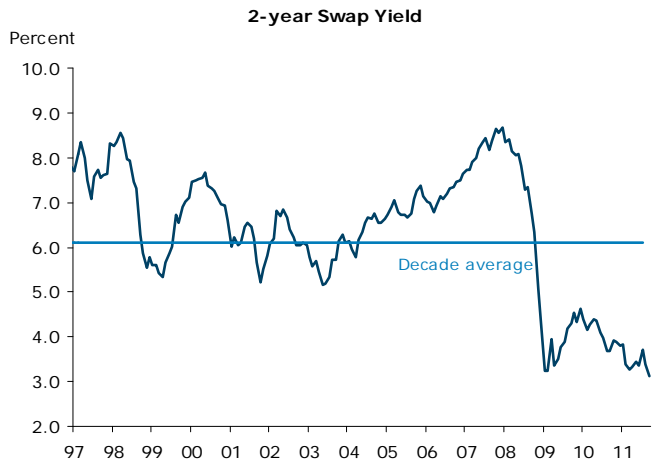
Sources: ANZ, National Bank, Bloomberg

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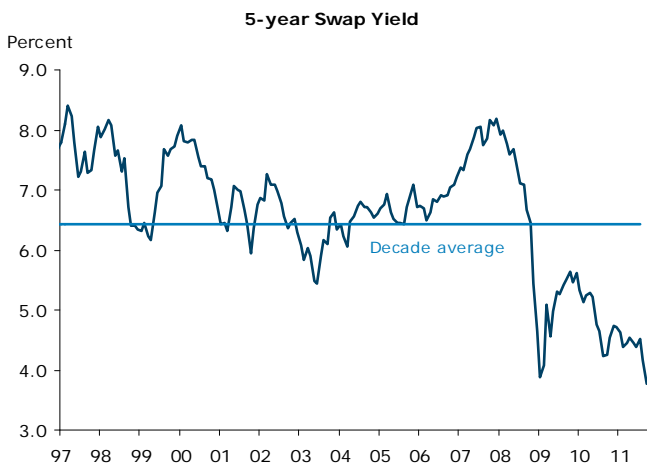
CHARTS (END OF MONTH)



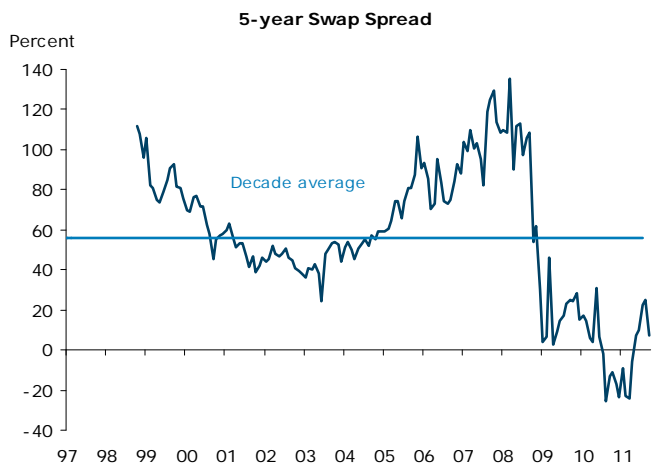
Sources: ANZ, National Bank, Bloomberg



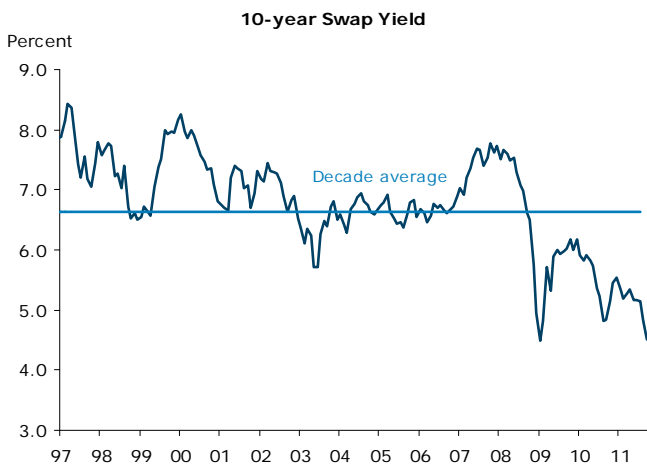
Sources: ANZ, National Bank, Bloomberg



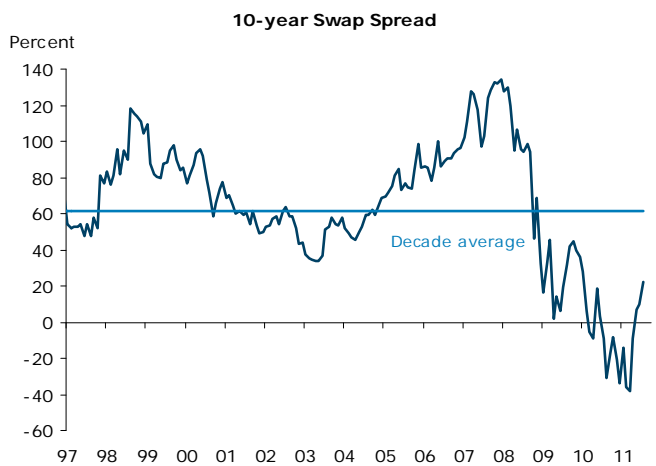
Sources: ANZ, National Bank, Bloomberg



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