



# NEW ZEALAND ECONOMICS NBNZ BORROWER'S STRATEGY

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## CONTRIBUTORS

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## ECONOMIC OUTLOOK

The global economy – and by extension the state of global markets – is all that matters right now. Domestic data is likely to be reasonable but patchy for a while yet, and we expect a bumper Q3 GDP result. But even so, domestic political and economic developments are likely to be nuances around global events. The focus has changed – Europe remains the issue de jour. What has changed is the intensity at which things are deteriorating in Europe. This is important for New Zealand because Europe is where key funding markets are. US data is improving, but Fed minutes reveal that even they are worried. The risk profile certainly hasn't improved, it has gotten worse.

## RATE VIEW

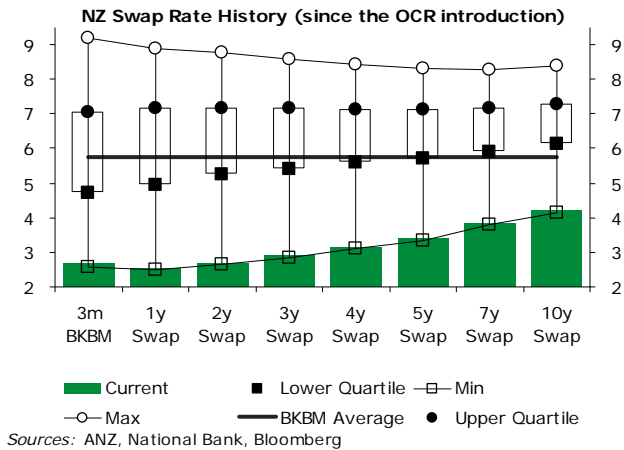
Markets are at a turning point. We are beyond debating when the next hike will be. The question now is whether it is appropriate for the RBNZ to cut rates. At the moment, the case for a cut is somewhat flimsy (even if it is emotionally appealing). However, if funding markets tighten much further, and risk appetite continues to get hammered, cuts could be on the cards. The market has certainly been right to shift the debate. Part of the move lower in interest rates has been a positioning "squeeze", but even accounting for this, the level of fear in markets is growing by the day, especially in Europe. And the problems are not just confined to the periphery. Indeed, Germany struggled to get bonds away at auction this week. Developments like this just give more weight to the view that the European debt crisis is becoming systemic. We may well yet see a shock and awe response from politicians and central banks – and if we do, interest rates will almost certainly spike higher. But unless we see real change (and the reality is that time is a key ingredient here) any spike is likely to be short-lived. Although interest rates continue to tumble, we remain extremely circumspect. If systemic problems intensify, New Zealand interest rates will keep falling. We are priced for one rate cut, yet one would be just tinkering. If the OCR is moving lower, it won't be by 25 basis points. This is not our core view but where the obvious risk profile resides.

## STRATEGY

With swap rates at record lows across the entire yield curve, by definition there is unprecedented value to be had for hedgers at the moment. Of course, interest rates are not the only thing that has changed – so too has the outlook, and more importantly, so too has the risk profile. If you need to fix to maintain hedge ratios, current rates may be enticing. But with the level of uncertainty growing by the day, and the outlook deteriorating, it's impossible to say how much further rates may fall. Our suspicion is that we are not at the bottom yet. We can't put any science behind this, because we just don't know how things will unfold in Europe. What we do know is that there are no quick fixes, and markets are now looking for blood. Good interest risk management is about controlling costs and minimising overall volatility. Adding to hedges here could make you a hero, but it could also cost you dearly. We do not feel that now is the time to stick your neck out. We favour remaining on the sidelines if there is any discretion. Keep watching, keep worrying, but most importantly, watch very closely.

**VALUATION**

All domestic interest rates with the exception of the 3mth BKBM rate (which overshot earlier in the year) have hit record lows in the past few days. This does, by definition make them better value – at least in comparison with historic rates. But it remains to be seen how they will look if we do see an extended period of monetary policy stability, or even rate cuts. Although the spread between the OCR and mid curve swaps like the 5yr has narrowed, the spread to the 2yr swap remains wide. It still costs a lot more to fix for an extended period relative to fixing for just 2 years.



Current interest rate levels		
Maturity	Last edition	Current
3-mth BKBM	2.73	2.67
1-year swap	2.80	2.53
2-year swap	2.97	2.68
3-year swap	3.21	2.90
4-year swap	3.48	3.15
5-year swap	3.73	3.40
7-year swap	4.12	3.84
10-year swap	4.45	4.21

Market expectations for RBNZ OCR (bps)		
OCR Dates	Last edition	Current
Thu-8-Dec-11	-2	-5
Thu-26-Jan-12	-2	-22
Thu-8-Mar-12	0	-26
Thu-26-Apr-12	+2	-28
Thu-14-Jun-12	+6	-30
Thu-26-Jul-12	+8	-33
Thu-13-Sep-12	+8	-30

**WHAT TO MAKE OF IT ALL?**

Given the extent of the moves we have seen in interest rates over the past few weeks, the pace of which has only intensified in the past week, we're tempted to embark on a lengthy analysis of what's happened, and what might happen. The problem is, what has happened has been almost entirely been

driven by offshore events. Furthermore, how things pan out from here depends crucially on such fickle things like the mood of the market, and the will of politicians and bureaucrats. This makes making sense of the situation extremely difficult and emotive. Analysis can get you so far in situations like this.

What's the upshot of all this? In short, we are in dangerous territory. We have no firm "anchors" upon which to build views. We don't know how bad things will get – and equally we don't know if we have overshot. Forget the old adage that what you don't know won't hurt you. In this situation it might do just that, and in fact it is uncertainty more than anything else that leaves us very guarded and hesitant to embrace these low interest rates just because they are at record lows.

**WHAT WE DO KNOW**

If there is a lot that we don't know, what then do we know? That's a pretty open-ended question, so let's not get carried away here. If we start from the same premise as the "smart money", we can probably assume that Europe's debt crisis won't get resolved on its own. That is, we are now well past the point of "muddling through", and what's needed now is some kind of circuit breaker. We don't know what this might look like, but we can have a guess – and top of the list is probably quantitative easing, European style. This is far from a perfect solution, but it is probably more tolerable and workable than ad hoc intervention, promises of austerity, and reliance on fickle markets.

What we do know is:

1. That volatility will be heightened for some time yet.
2. Deleveraging means growth must be sacrificed for years to come. Interest rates will remain low in this environment.
3. There is more near-term downside risk ahead, as the Fed, Bank of England and RBA have been at pains to point out.

Stepping beyond market noise, these remain core pillars underpinning our economic view.

We also know that New Zealand is more linked in to what's going on around the globe now than it has ever been. It's not just instant access to market information (that has dramatically sped up contagion), but as noted a few weeks ago, it's also things like the near tripling in size of our government bond market in the past 5 years. This simply would not have been possible without international investors. Similarly, commodity prices wouldn't be where they were had it not been for the vibrant export scene, and advances in payment systems. The run up in house prices of the last 2 decades here (and in the US, UK and Australia) would also not have been possible without liberalisation of global markets.

But why are we mentioning all these things – isn't this getting off topic somewhat? It's simple – if you harm or break any of these linkages, things start to go badly wrong. Recall the slump in Chinese trade as banks refused to accept L/Cs in 2008. Recall the panic that ensued as funding markets collapsed after Lehman went belly up. And it is precisely a breaking of these linkages that we are witnessing now – i.e. the slow closure of funding markets, even for erstwhile "safe" borrowers like governments. The deep mistrust in markets at the moment won't go away overnight.

### TELL ME A STORY

Turning again to our earlier comment, let's say for now that European QE becomes the solution. If it is, our strong suspicion is that the market would exhibit a spectacular rebound. European interest rates would presumably tumble, and equity markets would likely skyrocket (as was the US experience after QE1 and QE2). But the euro would be savaged (as was also the US experience).

For small countries like New Zealand, it's what happens next that matters. If we were optimists, we might expect global investors to steer clear of the euro and to start looking for alternatives like the NZD. Such an outcome might be extremely well received by borrowers (including the Government). But if the NZD stays strong as money flows in, and commodity prices fall to reflect a more competitive Europe (presuming the EUR continues its trend depreciation), and Asia finds itself struggling to compete in Europe (China's largest export market), then what's going to happen to commodity prices? They could plummet.

This may all sound like a neat little story of what might happen (and remember – it was just one scenario). But the point is, even if we do see some sort of "comprehensive" intervention, we need to be careful to consider the long term ramifications, and avoid the temptation of focussing on the immediate effects. As such, even though it is highly likely that we do see some kind of intervention in the next few weeks, it will not be a silver bullet, and it won't lead to a resumption of "normal service". There is nothing short of time that will heal Europe's woes – and with that realisation comes the reality that things are going to be strained for a while.

### LOOKIN' GOOD

It's clear then that we are deeply bearish, and harbour serious concerns about the outlook. But let's not lose sight of where things stand domestically. For one, we need to acknowledge that the dataflow between now and Christmas is likely to be solid as the effects of the Rugby World Cup linger. Readers of our internal surveys will also be aware of how well anecdotes are holding up. Along with the fact that the hurdle for a rate cut is very high (and our feeling is that as bad as some of the news has been, what we have seen globally so far does not justify a cut), this makes a

rate cut very unlikely in the near future. That is, unless the wheels really fall off in Europe. As such, we need to take note when the market starts pricing in cuts, as it is at the moment. On its own, this is an argument to wade into the market at the moment, and to add to hedges. But when one considers the balance of risks, despite the value, we are reluctant to act just yet.

### FX EFFECTS

We also need to be careful not to assume that global turmoil means lower interest rates. It might well do, but there is every possibility (or indeed probability) that the currency will bear the brunt of the burden. We may even see interest rates rise if things get really difficult – after all, if you need to attract investors, you need to make it more attractive for them. And nothing works better in situations like this than a weak exchange rate and high interest rates. At face value, this might also sound like an argument for adding to hedges. However, it is our deep suspicion that if it comes to interest rates having to rise to attract investment, it won't be base swap rates that need to rise, it will be margins. And hedging with swaps will do nothing to protect against rising margins. In fact, they could be dangerous – because we would rate rising margins as the number one cause of RBNZ rate cuts were they to eventuate.

### STRATEGY

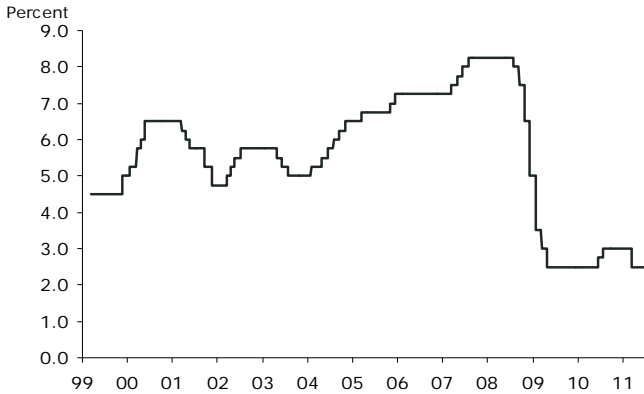
We can see value in swap rates at current levels in the traditional sense. But we remain extremely cautious and see things like this week's failed German government bond tender as symptomatic of a cautious and dysfunctional market. As such, we reiterate comments from our last edition. Watch, worry and wait. Lots needs to go our way for swap rates to sustainably settle at a higher level again, and frankly, if we were borrowers, we'd rather see the state of the world improve, and for interest rates to move higher than take a punt that this is the low. Just as value is at an extreme, so is uncertainty. In fact, we found out earlier this week that of the 17 governors of the US Federal Reserve System, 16 of them felt that the GDP outlook was more uncertain, and 14 of them thought the outlook for US unemployment was more uncertain. Only 1 governor thought certainty had improved. In our view, this says a lot.

At times like this, liquidity matters more than interest rate risk management – and we cannot stress the importance of ensuring the importance of access to funding at such an uncertain time.

Dealing room contacts		
Location	Local	Toll free
Auckland	09 377 9450	0800 730 100
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Christchurch	03 364 5335	0800 269 261

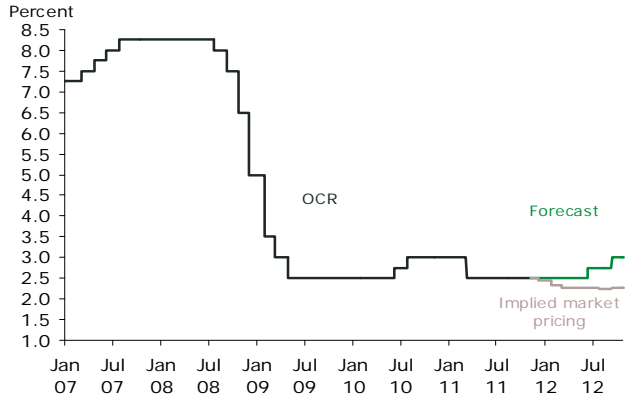
**CHARTS**

**Official Cash Rate**



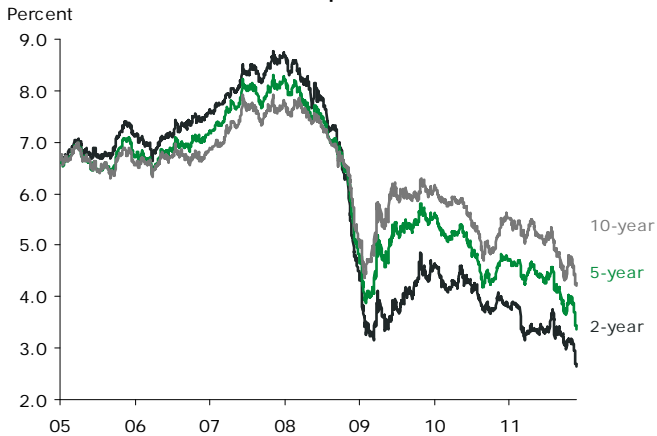
Sources: ANZ, National Bank, RBNZ

**OCR and market pricing**



Sources: ANZ, National Bank, RBNZ, Bloomberg

**NZ Swap Yields**



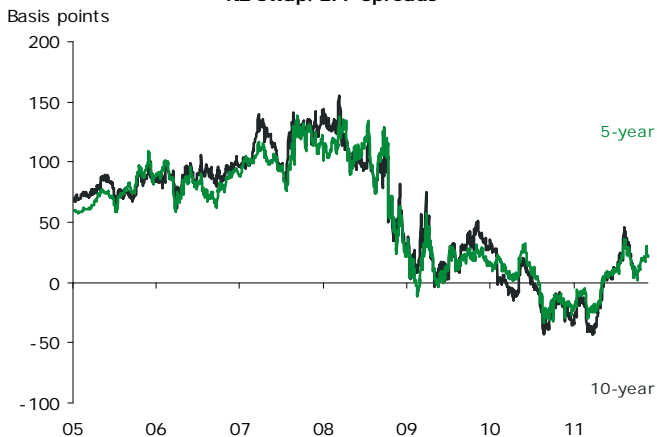
Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curves**



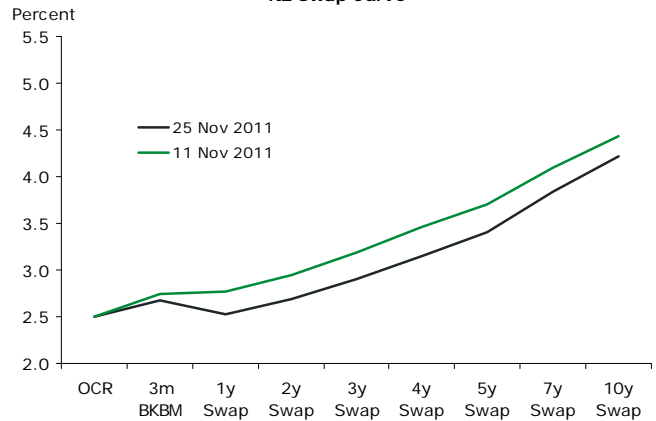
Sources: ANZ, National Bank, Bloomberg

**NZ Swap/EFP Spreads**



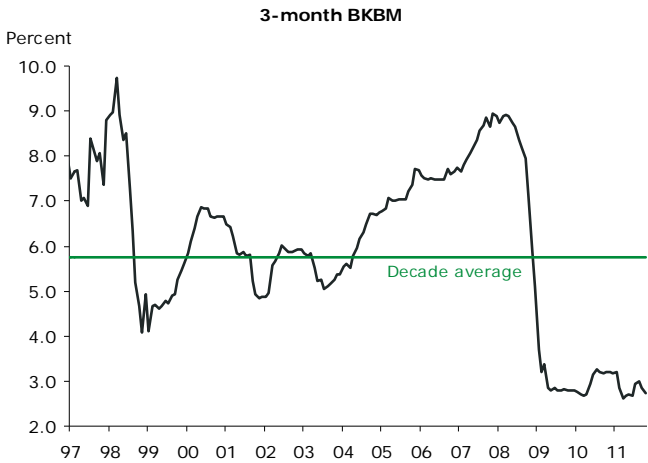
Sources: ANZ, National Bank, Bloomberg

**NZ Swap Curve**

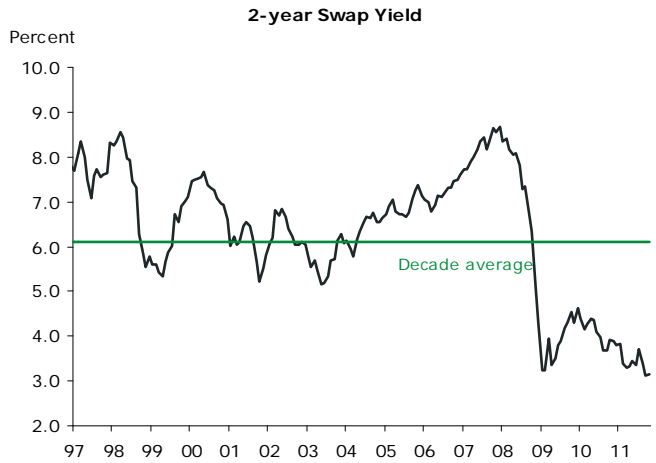


Sources: ANZ, National Bank, Bloomberg

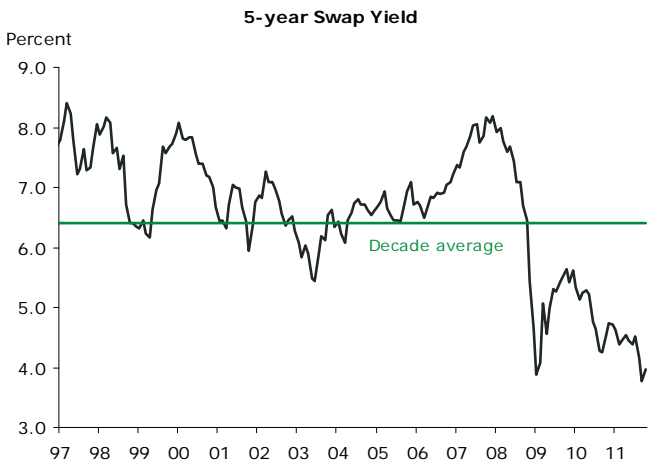
**CHARTS (END OF MONTH)**



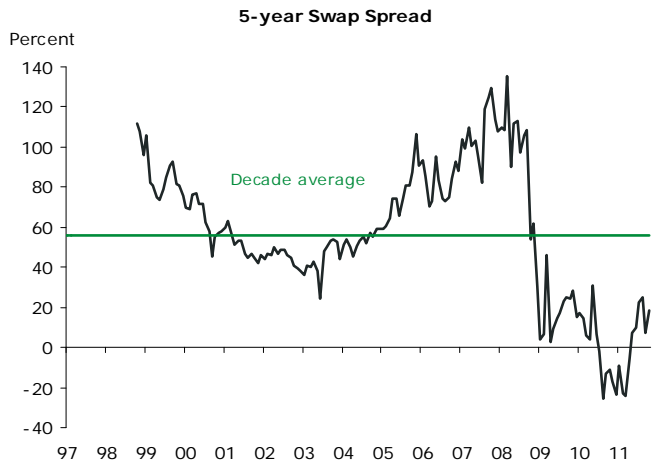
Sources: ANZ, National Bank, Bloomberg



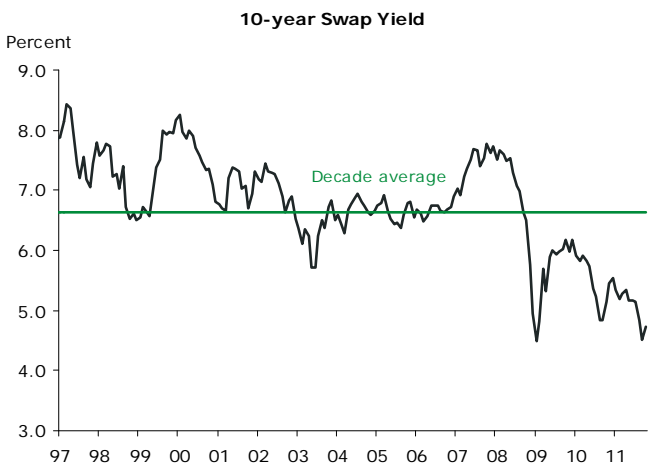
Sources: ANZ, National Bank, Bloomberg



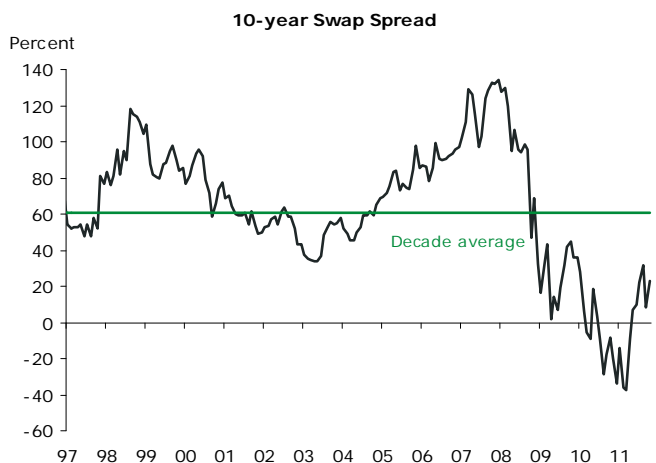
Sources: ANZ, National Bank, Bloomberg



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