



NEW ZEALAND ECONOMICS NBNZ BORROWER'S STRATEGY

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ECONOMIC OUTLOOK

The recent run of patchy local data suggests the economy is close to an inflexion point. Global developments continue to swamp local nuances, and while market sentiment has been supported by increasing liquidity, weak fundamentals still need addressing and this keeps the risk profile pointed downward. High commodity prices remain a key source of economic support and are another reason why the OCR will eventually move higher, although this is being blunted by ongoing deleveraging and the high NZD. The January RBNZ *OCR Review* showed a watering down of the tightening bias and signalled a longer period on the sidelines. The RBNZ acknowledged increasing comfort over the inflation outlook, and while a limited recovery in the housing market was underway, recent RBNZ comments over the worsening situation in Europe and a later prospective start to the pick-up in earthquake reconstruction suggest no hurry to lift OCR settings.

RATE VIEW

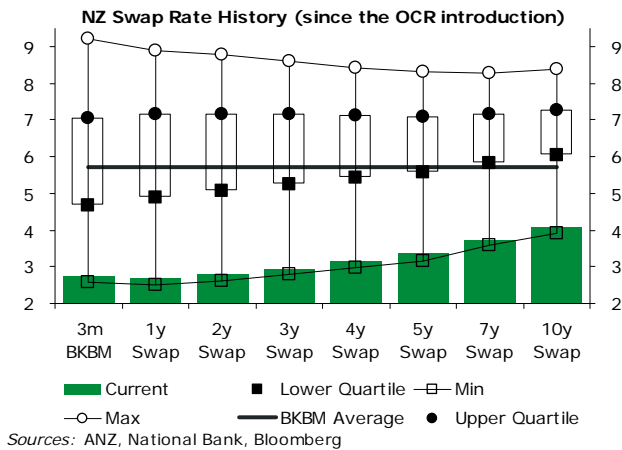
The two major events since our last edition on January 20th have been the RBNZ *OCR Review* and the US Federal Reserve's January *FOMC Statement*. Although both central banks had a dovish message to tell, there were subtle yet important differences. Indeed, whereas the RBNZ's message was one of stability, with rates likely to be on hold for a long period, the Fed opened the door to more easing. But with the Fed Funds rate already at zero, any future easing would be quantitative if it occurs. Importantly, the RBNZ stopped short of raising the possibility that the OCR may go lower yet, and in a subsequent speech, Governor Bollard reiterated that the Bank also has other tools at its disposal. We therefore do not expect the RBNZ to seriously contemplate cutting the OCR should financial market stresses worsen. In our view then, the market has been right to discount the odds of a cut, and to shift from expecting cuts to expect a longer period of the OCR on hold. With US interest rates likely to remain low as the market contemplates the possibility of quantitative easing (QE), we expect local interest rates to be biased lower, and for the yield curve to flatten further.

STRATEGY

The broad thrust of our thinking has not changed since our last issue, and as such, this edition is concise, and gives a brief update on recent developments. Lower swap rates and the flatter yield curve make hedging more appealing, particularly now that all swap rates are within touching distance of their 2011 lows. We can't argue with this logic – after all, hedging is all about managing risk and reducing volatility, and with the curve flatter, the marginal cost of that insurance has fallen. The counter argument is that there is no hurry, particularly if one takes the US Federal Reserve at face value, and contemplates the impact that might have on US interest rates, and by association, NZ rates. The ongoing deepening of the European debt crisis also poses downside risk to core global interest rates. So while we believe time is on the borrower's side, we must acknowledge that rates are extremely attractive. Such an outlook is suggestive of using optionality, particularly swaptions, which we discussed in our last issue. After all, if one knew for sure rates weren't heading lower, fixing now would be the obvious choice.

VALUATION

Interest rates continue to edge broadly lower, led by the long end, flattening the yield curve. The main catalyst here has been the US Federal Reserve's suggestion that it may need to engage in further QE in order to kick start growth (again) in the US. A flatter curve does make fixing a tad more attractive, but with the RBNZ on hold till the end of the year at the earliest, time ought to be as big a consideration as cost. However, with all swap rates now within 0.2% of their respective all-time lows, this suggests that there is increased value in fixing. Remember, hedging is not just about minimising cost, it is also about minimising volatility and avoiding surprises.



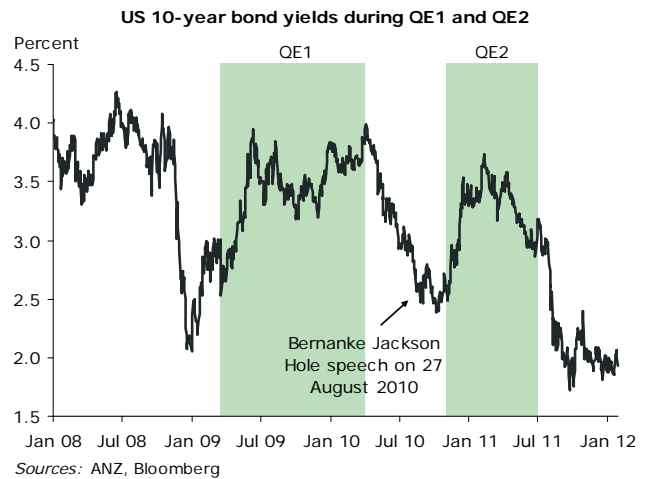
Current interest rate levels		
Maturity	Last edition	Current
3-mth BKBM	2.75	2.75
1-year swap	2.69	2.70
2-year swap	2.78	2.79
3-year swap	2.96	2.96
4-year swap	3.17	3.15
5-year swap	3.40	3.36
7-year swap	3.79	3.75
10-year swap	4.16	4.09

Market expectations for RBNZ OCR (bps)		
OCR Dates	Last edition	Current
Thu-8-Mar-12	-9	-5
Thu-26-Apr-12	-11	-8
Thu-14-Jun-12	-12	-10
Thu-26-Jul-12	-12	-10
Thu-13-Sep-12	-10	-10
Thu-25-Oct-12	-7	-8
Thu-6-Dec-12	-Not forecast	-7

SAME, SAME, BUT DIFFERENT

The broad thrust of our thinking has not changed since our last edition. That is, there's a lot of bad news already priced into the market, and with rates close to historic lows, the urge to fix is high. This is especially so for those who benchmark against term rates, as opposed to floating (as this is a tacit acknowledgement that term funding costs more).

What is different now is that we know more about what the RBNZ and the Fed are thinking, and at the margin, nothing either bank has said adds to the sense of urgency to hedge. In fact, if anything, dovish messages buy borrowers time. But rates are low, and we need to acknowledge that.



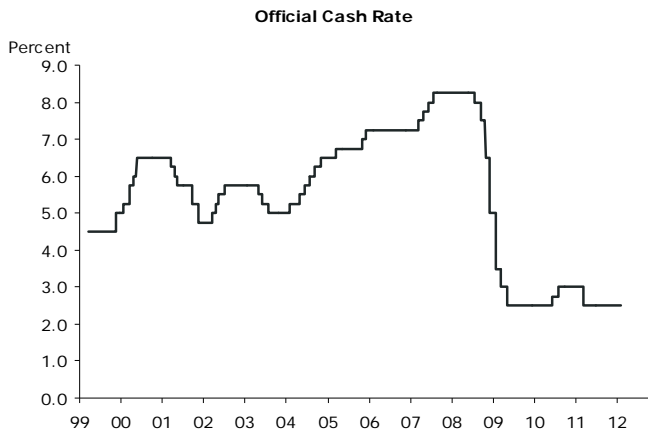
At some point, interest rates are likely to rise. As the chart above shows, US interest rates rose during the early stages of both earlier bouts of QE as the market concluded that the economy would rebound from the stimulus. The market is likely to react in a similar fashion again if the Fed goes ahead with "QE3". However, the Fed have not yet actually confirmed they will embark on it, and at this stage have just flagged it as a possibility, so we need to be careful not to put the cart before the horse. In the interim, we expect interest rates to be biased lower.

STRATEGY

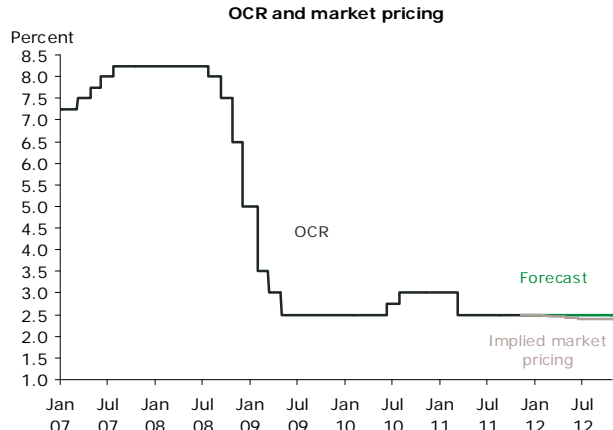
We prefer to maintain a high degree of exposure to floating, but to also have some cover in place in the event interest rates don't fall further. We believe the most cost effective way to do this is via swaptions, as discussed in our last edition (available on request).

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

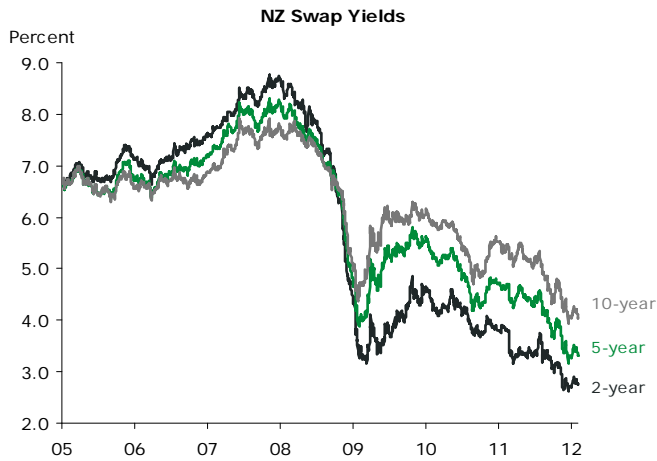
CHARTS



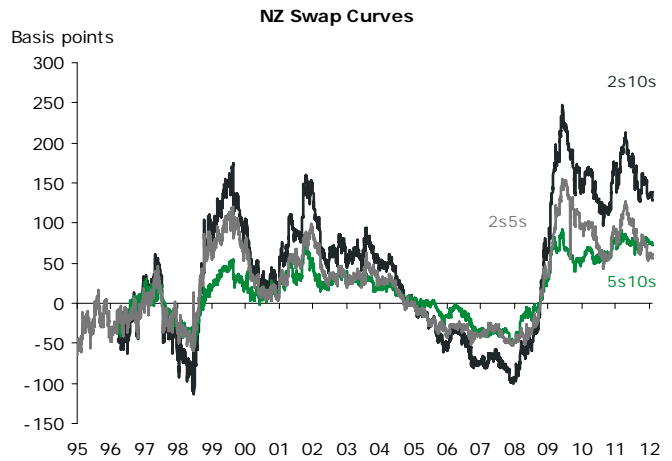
Sources: ANZ, National Bank, RBNZ



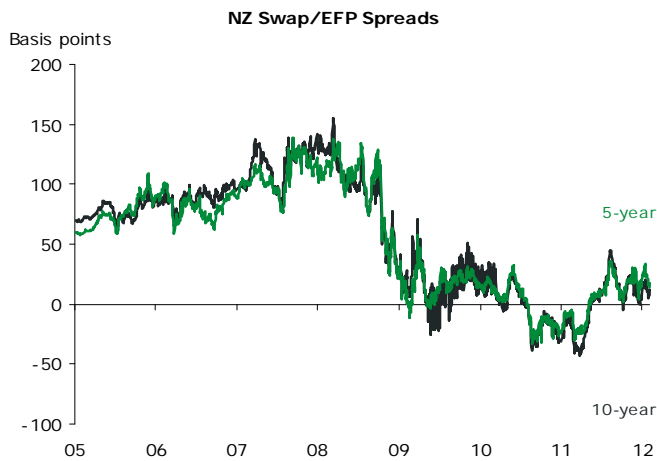
Sources: ANZ, National Bank, RBNZ, Bloomberg



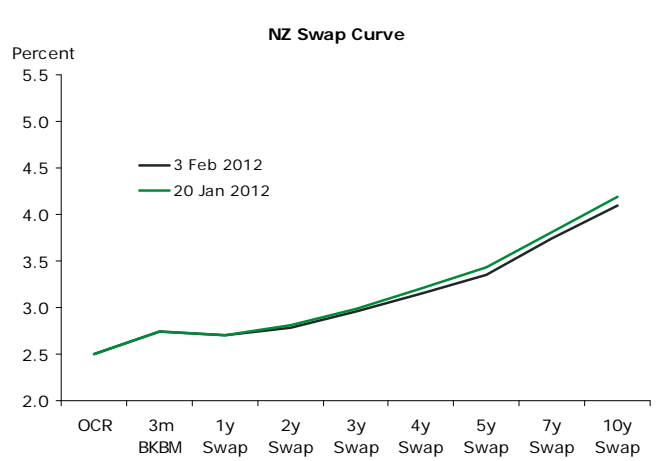
Sources: ANZ, National Bank, Bloomberg



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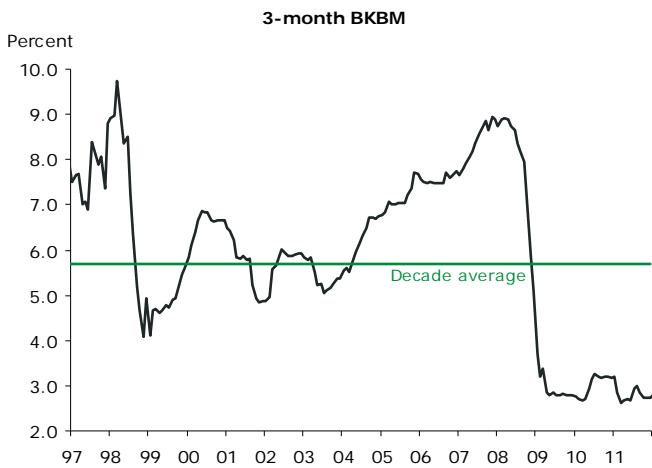


Sources: ANZ, National Bank, Bloomberg

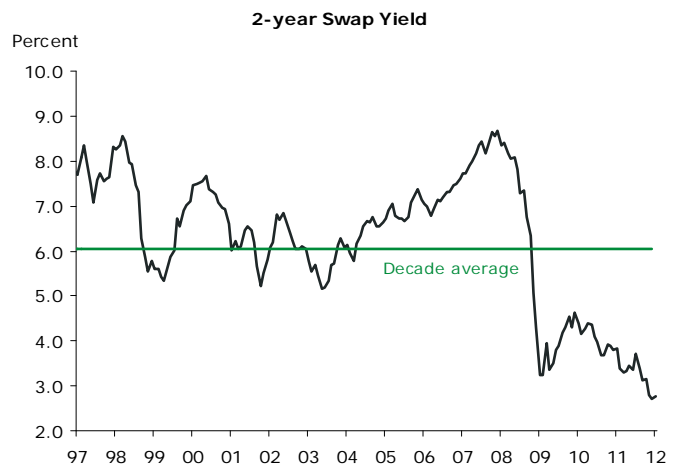


Sources: ANZ, National Bank, Bloomberg

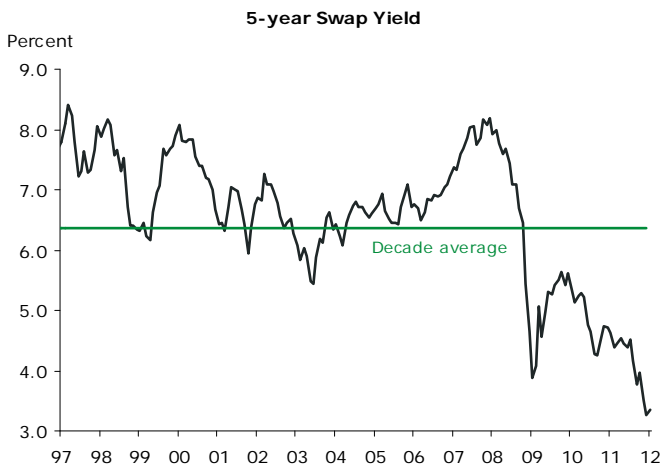
CHARTS (END OF MONTH)



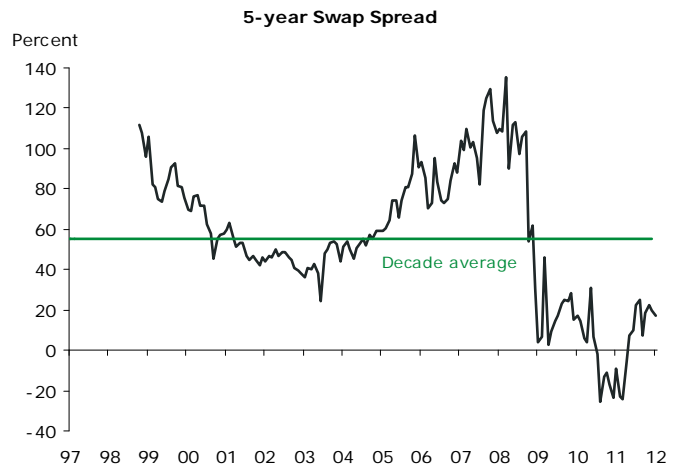
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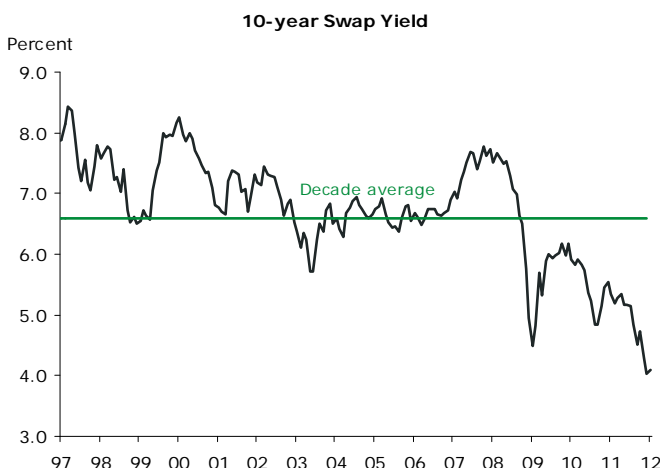
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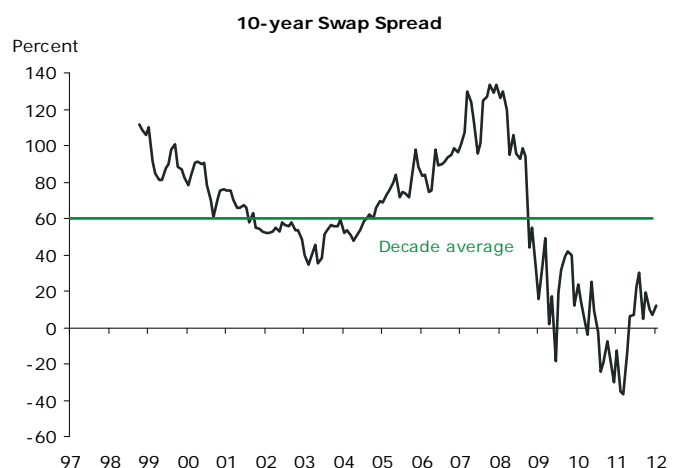
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