

Borrower's Strategy

New Zealand

20 August 2010



Economic Outlook: Economic data has generally disappointed over the past month, and is consistent with a recovery that is losing some momentum. Key areas like the housing and jobs markets remain subdued, though we suspect the latter is not as bad as what the official headline statistics portray. Retail sales surprised on the strong side and will make a positive contribution to GDP, but this has been achieved at the expense of heavy discounting. While few will admit it, we suspect many were expecting 2010 to be a classic V-shaped type recovery. After all, this was the message to be taken from sharp spikes higher in business and consumer confidence late last year and earlier this year. However, ongoing deleveraging and now, increased uncertainty surrounding the global outlook, are resulting in a more muted recovery compared to past economic cycles. This has seen confidence adjust to reflect reality. Although it won't help near term growth, the deleveraging process will ultimately result in a better platform from which the economy can bounce off from. So while we expect continued subdued and patchy growth for the rest of the year, we remain positive on the outlook for 2011.

Rate View: Market expectations of RBNZ rate hikes have been pared back significantly, with market pricing now in favour of a pause as opposed to a hike in September. While we broadly concur with the spirit of this move, particularly in the short term (we still see the odds of a pause in September as being 50/50), what has surprised us has been the degree of tightening that has been "priced out" over the next 12 months. With only one 25bp hike priced in by January 2011 and another by June, markets look to have overreacted. The general level of interest rates has fallen to levels that we would regard as over-stretched relative to domestic fundamentals. But markets have been overwhelmed by talk of further quantitative easing in the US, and this is proving to be like having an elephant in the room for the local interest rate market. Rates may move lower yet, but the drivers will be global, not domestic.

Strategy: Long term swap rates have fallen to levels that would have been unthinkable a month ago, and although they may go lower yet in the near term, they do offer outstanding value vis-à-vis the domestic outlook. We are not buying into the double-dip recession view, and as such we favour taking advantage of rates spikes lower like this. Our preferred strategy at the moment is to adopt "delta hedging". This involves putting a plan in place to add to incrementally at pre-determined yields. If rates move lower you'll be happy to do more, but if they rise, you'll be thankful you did some. While this is a fairly simple strategy, it is a valuation based one, and it is appropriate in an environment when uncertainty is high (and rates could go either way). The fact that we think domestic fundamentals are not consistent with the current level of longer term interest rates (and are being held down by global factors) only adds to the appeal of this strategy.

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Current interest rate levels

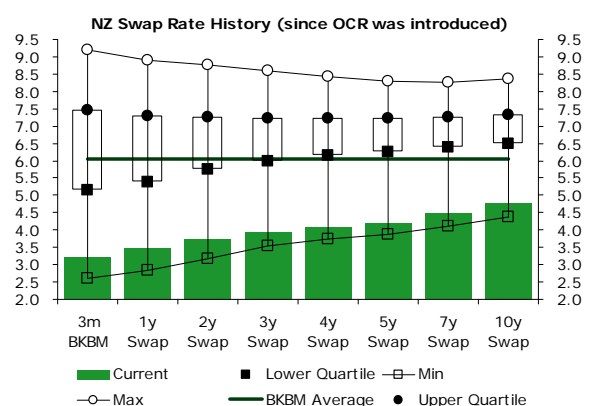
Maturity	2 weeks ago	Current
3-mth BKBM	3.28	3.23
2-year swap	3.95	3.78
3-year swap	4.22	3.97
4-year swap	4.44	4.12
5-year swap	4.62	4.26
7-year swap	4.90	4.53
10-year swap	5.19	4.84

Market expectations for RBNZ OCR (bps)

OCR Dates	2 weeks ago	Current
Thu 16-Sep-10	+16	+10
Thu 28-Oct-10	+28	+14
Thu 9-Dec-10	+36	+21
Thu 27-Jan-11	+41	+25
Thu 10-Mar-11	+47	+31
Thu 28-Apr-11	+57	+41
Thu-9-Jun-11	+68	+53

Valuation

Swap rates have fallen significantly in the past fortnight, particularly beyond 5 years, taking 5 and 7yr rates within a few pips of 4.25% and 4.50% respectively. The 10yr is now well below 5%. Falling global rates have been particularly influential in the move, and we believe rates have significantly under-shot what we would consider reasonable levels based purely on the domestic economic outlook. The swap yield curve has flattened substantially as a result, and is now at its "flattest" since early 2009.



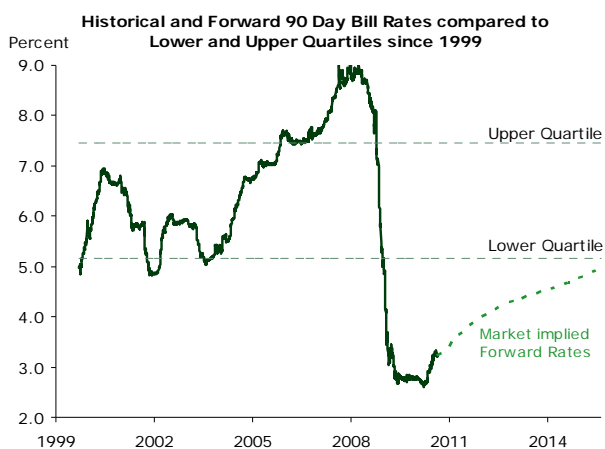
Sources: ANZ, National Bank, Bloomberg

An elephant in the room

Did anyone see the elephant in the room? Look again. There he is, he comes from the United States and his name is quantitative easing (or QE for short). Although short term NZ interest rates have fallen primarily in response to weaker domestic data (which has added weight to the view that there is less urgency for the RBNZ to continue raising rates), market conjecture that the US Federal Reserve (the Fed) is inching closer to implementing another round of QE has had a major impact on global interest rates, and this is being felt in New Zealand. And that's precisely why we like the elephant analogy. It's always been important to keep an eye on US interest rates, but when the markets start to contemplate seismic shifts like QE, it's literally like an elephant coming into the room. And you can't ignore it.

In terms of the impact QE has had on domestic rates, it has been two-fold. The most intuitive impact has been at the long end, where there is a higher correlation between NZ and US interest rates. However the impact has also been felt at the short end, on the premise that if the Fed is contemplating QE, the odds of the RBNZ swimming against the tide are that much less. Whether or not events in the US will have a direct impact on RBNZ policy depends on how things unfold, but for now, markets are taking a cautious view, especially with the RBA content to sit on the sidelines for the time being.

To give an idea of how far the market has gone, consider this. As the chart below shows, market expectations now have the 90 day bill rate holding below the lower quartile for at least the next 5 years. This is remarkable, and while it is fair to say this recovery will be "different", we doubt it will be that different!



We explain QE in more detail later on, but what seems abundantly clear is that the effect of it is so

powerful that NZ interest rates have divorced themselves from domestic fundamentals. Indeed, the 10yr swap rate is now below 5% again, something that has not occurred since early 2009. But whereas back then the RBNZ was slashing the OCR (in clips of 150bps!) and the NZ economy was already in deep recession with prospects for more to come, at the moment the economy is actually on the mend. To be sure, the recovery is proving to be somewhat less vigorous than at first assumed (and well short of the RBNZ's projections of growth of 1% per quarter through 2010 and into 2011). But make no mistake, it is recovering, and the implication that the 3mth Bank Bill "BKBM" rate will average below 5% for the next 10 years (as implied by swap yield) is a stretch. That is, of course, unless you expect the economy to start going backwards again or remain in an anaemic state for quite a few years. It's also worth adding that forward rates implied by the term structure have historically tended to overstate future interest rates. In other words, although over the life of a swap the two parties to it will exchange interest payments which are assumed at the outset to be of equal value, it would be a mistake to assume that because the 10yr swap is trading at, say, 5% that this is somehow akin to saying that the market "thinks" BKBM will average 5% over the next 10 years. When adjusted for the term premium, the 10yr swap rate is actually implying an even lower average for BKBM.

Opportunity knocks

Two weeks ago we noted that although long end rates could go lower yet, it was worth using what we considered to be over-stretched levels to add to hedges at the long end, leaving some powder dry to do more if rates did indeed move lower. Rates are now at an even deeper extreme, and while they may move lower still, the fact that rates have become so overwhelmed by global events and disconnected from domestic developments suggests there are opportunities for borrowers. This stems wholly from our view that the interest rate environment is not as benign as the term structure of interest rates assumes.

The economy may not be booming, but it is still recovering and we do expect positive growth (albeit patchy and slow) over the next few years. However it would be foolish not to ignore the elephant in the room that is QE. While not specific to New Zealand, it has had a significant impact on bringing rates lower here and it may well yet have more impact going forward. But interest rates are already stretched, and at some point we expect a rebound. This could be mild if, for example the Fed makes small concessions that are seen to take effect. Or it could be sharp if the Fed rules out QE and data start to recover. But the point is, valuations look stretched. And while it's always difficult to make a decision in an environment

where opposing forces exist, or to go against the trend for fear of missing out on better levels, you'll never know till after the fact whether the decision you made was the most cost effective. But that's not a reason to shy away from making a decision.

Our preferred strategy from here could be likened to "delta hedging". While we are mindful of the reasons why interest rates are falling (namely fears of a deteriorating global outlook), falling rates do favour borrowers. Furthermore, we believe they are well below where they would be if it weren't for global influences. As noted earlier, rates could keep moving lower yet, but equally, they may start rising again. As such we favour a strategy of adding to hedges incrementally as rates move lower, with an intention to add more at regular intervals should they ratchet lower yet. In some ways it's like having a dollar each way – if rates rise, you're pleased to have done some hedging – but if rates fall, you're happy to do more. It's a simple strategy, but it's a good one if you like the level of rates, but don't know what might happen. And let's face it, what's driving NZ rates now are not NZ fundamentals, with recent moves mostly dictated by offshore events.

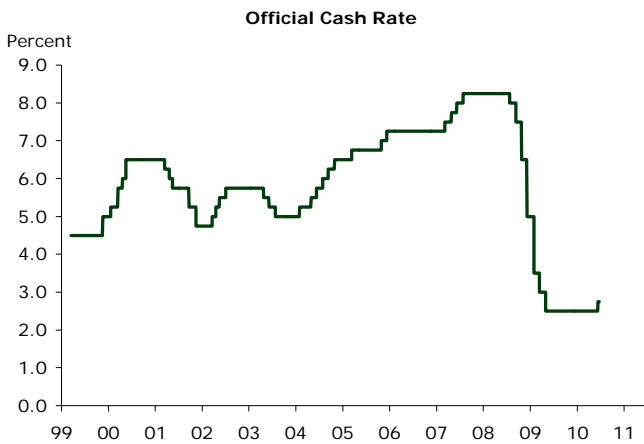
What is QE?

Given all the talk (in this paper and in the market) we thought it might be useful to elaborate on exactly what QE is, especially as it is having an outsized impact on US interest rate. Some describe QE as printing money, and in its crudest form this is true. However in the modern monetary economic context it's slightly different. What actually happens is the Fed buys bonds with money that is "created" by simply crediting the seller's account. This leaves sellers cashed up, forcing them to contemplate other investment or spending decisions, and as this spending and investment filters through the economy, it typically produces growth. In reality it is far more complex, and the Fed will target specific bonds of specific maturities in specific sectors to force what it sees as a desirable outcome. But the one inescapable fact is the downward pressure QE will have on benchmark interest rates – after all, that's the whole point of QE. Indeed, central banks prefer to implement monetary policy by adjusting the cash rate (and in many cases giving guidance around likely future decisions), but when the cash rate is at zero already (as it is in the US), this leaves the Fed with few alternatives. Among these, getting long term rates lower via QE is seen as a viable alternative.

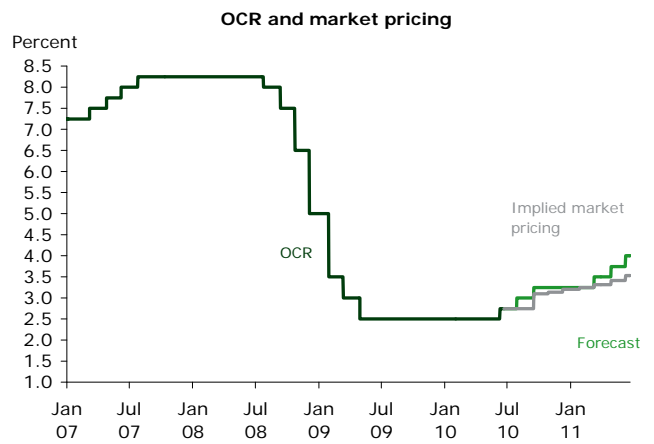
Dealing Room Contacts:

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Christchurch	03 364 5335 / 0800 269261

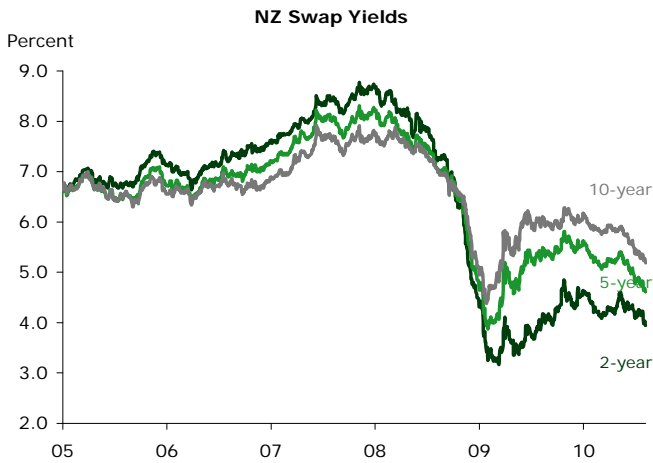
Charts



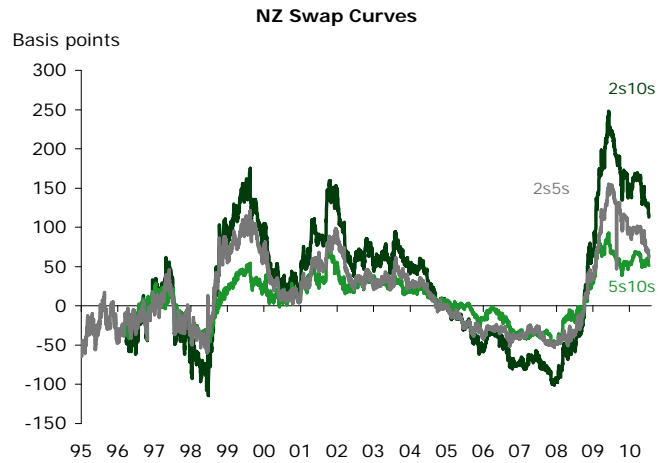
Sources: ANZ, National Bank, RBNZ



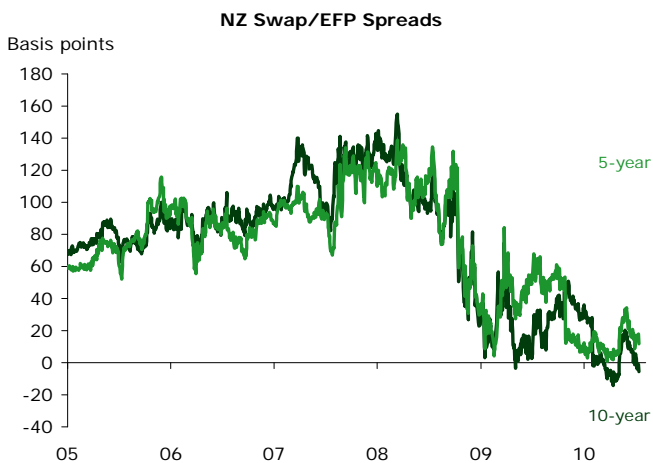
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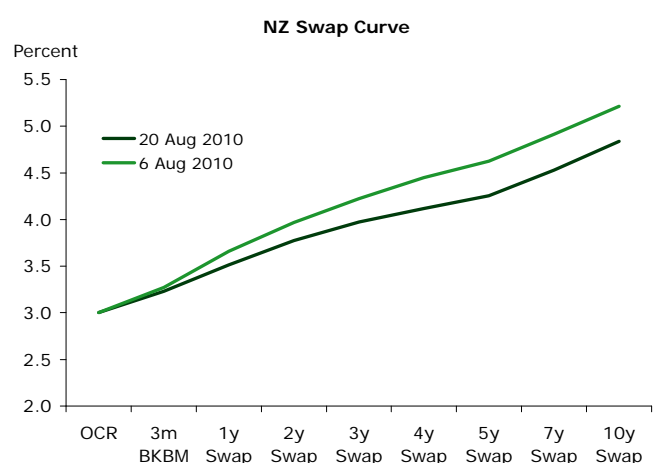
Sources: ANZ, National Bank, Bloomberg



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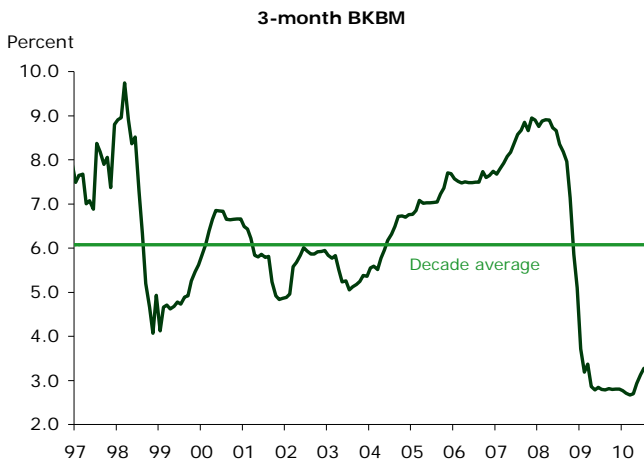


Sources: ANZ, National Bank, Bloomberg

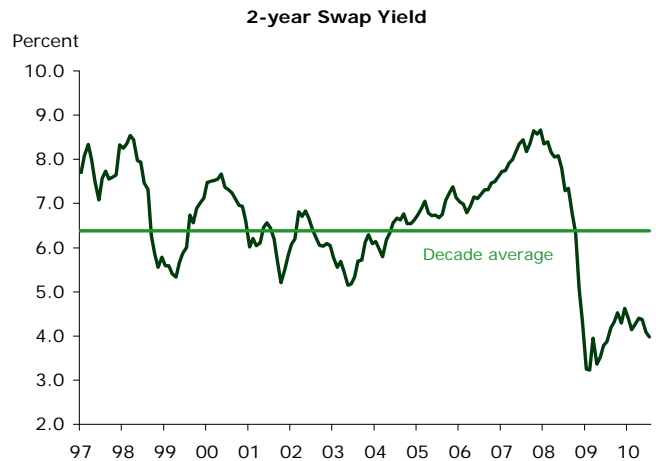


Sources: ANZ, National Bank, Bloomberg

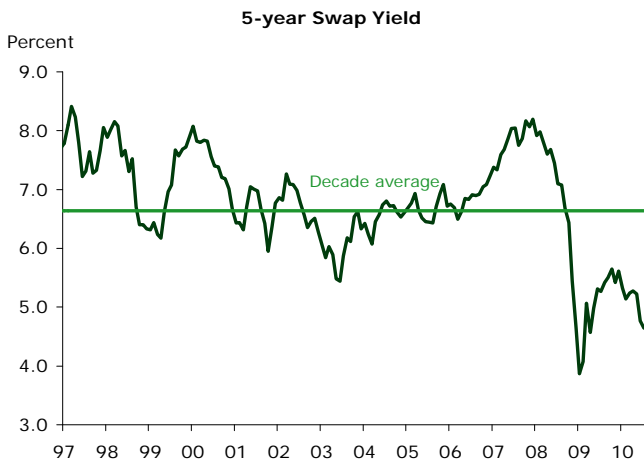
Charts (end of month)



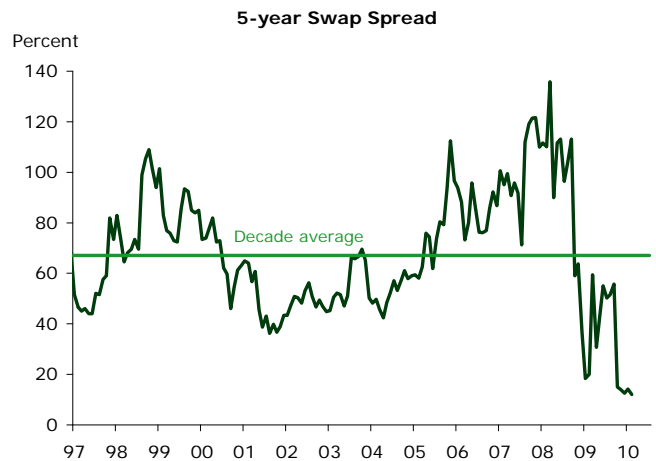
Sources: ANZ, National Bank, Bloomberg



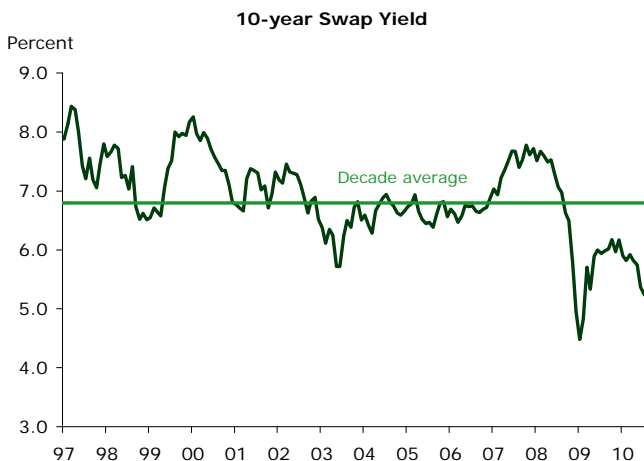
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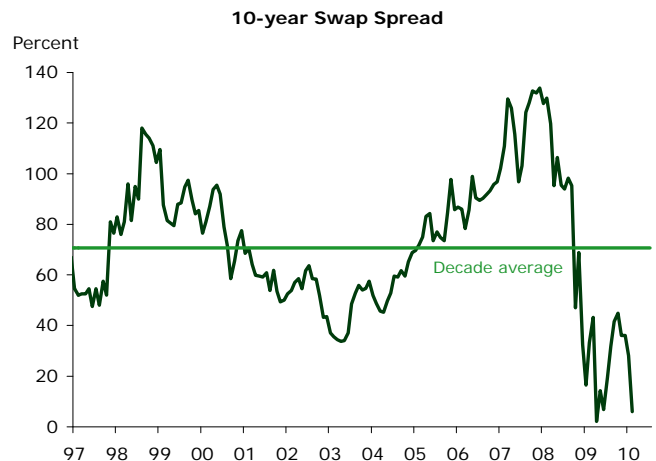
Sources: ANZ, National Bank, Bloomberg



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- Financial Markets Operations Association; and
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- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
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