

# Borrower's Strategy

## New Zealand

1 September 2010



**Economic Outlook:** The tenor of economic data remains sombre. We characterise the softening as consistent with a recovery that is losing momentum, rather than one that has stalled. Indeed, key barometers like business confidence have retreated, but remain in positive territory. Commodity prices have also come back, but remain at high levels. But while recent developments suggest that the RBNZ's projections of around 3.5 percent growth for this year and next will be dashed, they are entirely consistent with our "bathtub with waves" recovery analogy. We remain in the tub, negotiating the waves, and the far end seems some way away. But we are advancing along slowly, restrained by de-leveraging and increased uncertainty offshore.

**Rate View:** US interest rates are in the driving seat again, and having driven long end rates lower, their impact has now been felt on the short end, and on RBNZ expectations. Two weeks ago we felt a September RBNZ OCR hike was a line call – there were justifications for either course of action. However, ongoing uncertainty offshore and the recent fall in business confidence suggest there is no urgency for the RBNZ to raise rates. As such we expect the RBNZ to pause in two weeks. But it's too soon to say the RBNZ is "done", and indeed we expect to see the RBNZ resume raising rates once the uncertainty fades (we catch a positive wave), and it is clear that the US and NZ will escape a renewed downturn. This is far from saying a return to strong growth, merely that downside tail risks will fade somewhat. This could happen as soon as December, particularly if the US Federal Reserve takes more action, bolstering the US outlook and domestic spending recovers into the summer. We certainly feel that market expectations of only one rate hike by April are a touch light. The bottom line is, unless the economy re-enters a recession, the OCR is headed higher, even if only slowly, and punctuated by pauses.

**Strategy:** Three months ago we viewed the NZ curve as pricing in an overly optimistic view of the recovery and overly aggressive view of inevitable rises in the OCR over time. The large ongoing rally in US interest rates is having an unusually large impact on NZ interest rates. Indeed, the potential for US quantitative easing (QE) has seen the traditional term premium evaporate in most interest rate markets, driving rates lower. Rates could move lower yet – but the fact that the NZ yield curve is now at levels consistent with a far more pessimistic outlook than the central case suggests there is an opportunity. We favour adding to long term hedges here, acknowledging that the opportunity may improve. With very little in the way of rate hikes priced into the short end, the opportunity cost of paying fixed for terms like 2 years has fallen dramatically. As such we also favour adding to hedges at the short end. Such trades will look good in due course if the RBNZ resumes raising rates in late 2010/early 2011 as we expect.

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### Current interest rate levels

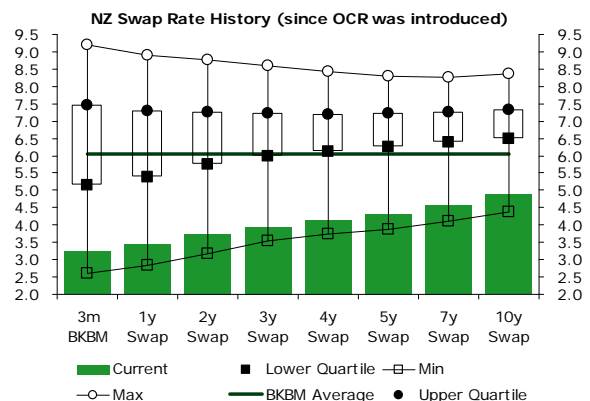
Maturity	2 weeks ago	Current
3-mth BKBM	3.23	3.22
1-year swap	3.52	3.43
2-year swap	3.78	3.68
3-year swap	3.97	3.89
4-year swap	4.12	4.06
5-year swap	4.26	4.23
7-year swap	4.53	4.51
10-year swap	4.84	4.82

### Market expectations for RBNZ OCR (bps)

OCR Dates	2 weeks ago	Current
Thu 16-Sep-10	+10	+2
Thu 28-Oct-10	+14	+6
Thu 9-Dec-10	+21	+11
Thu 27-Jan-11	+25	+18
Thu 10-Mar-11	+31	+20
Thu 28-Apr-11	+41	+27
Thu-9-Jun-11	+53	+40

## Valuation

Swap rates continue to fall, and are lower across the board relative to a fortnight ago. However, whereas the dramatic fall in US interest rates saw the long end do all the moving in the first half of August, recent moves have been concentrated at the short end, led by shifting monetary policy expectations. Indeed, 2yr swap rates have dropped the farthest, and the market is now only pricing in 2bps of rate hikes for September, with one full hike by April 2011. This is a significant change.



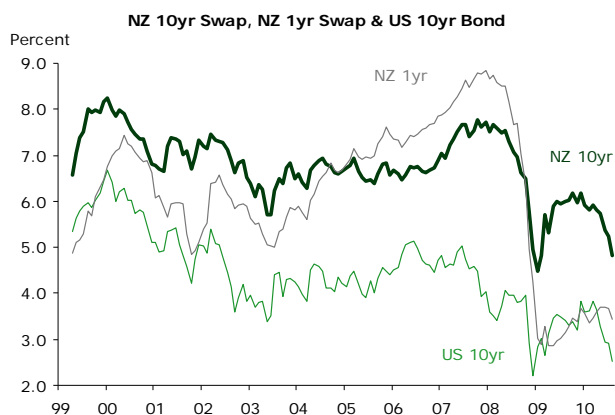
Sources: ANZ, National Bank, Bloomberg

**Looking overseas**

Local interest rates have always been influenced by global rates, particularly at the long end of the curve. Indeed, it's probably fair to say that the short end (i.e. out to 1-2 years) is primarily driven by the monetary policy outlook, whereas the long end (7 years+) is primarily driven by offshore, leaving the middle part of the curve to join the gaps. Of course, what actually happens is much more complex than that, but you get the point. But one conclusion seems inescapable: if you want to know what's in store for NZ rates, you had better get to grips with what's going on offshore. This is borne out by statistical analysis which shows that knowing what's going on with regard to domestic monetary policy matters, knowing what's happening in the US Treasury market matters more.

To be sure, we conducted two basic statistical tests. The first was a regression of the level of NZ 10yr swap rates against the levels of the OCR, the NZ 1yr swap rate, and the US 10yr bond yield (using monthly data since the introduction of the OCR). As the first table below shows, there is a high correlation between NZ 10yr swaps and both the 1yr swap (a proxy for monetary policy expectations) and the US 10yr bond yield (a proxy for global interest rates). But the correlation with US yields is higher. Furthermore, the regression coefficient is larger – suggesting that the level of US bond yields has a larger impact.

Regression of NZ10y Swap (Level) Against:			
Variable	Correlation	Coefficient	Std Error
NZ OCR	54%	-0.29	0.060
NZ 1y Swap	70%	0.21	0.020
US 10y Bond	79%	0.49	0.035



Sources: ANZ, National Bank, Bloomberg

Of course, regressing “levels” against each other can be misleading – especially if things move

together – as interest rates (and many other economic time series) tend to do. Indeed, “levels” correlations are often notoriously high. One way to overcome this bias is to do analysis changes, whose correlations are less spurious. When we repeat our analysis, using 3 month changes, we find that the correlations are lower (not surprisingly). However they are about the same – and in fact, changes in the 1yr swap are more correlated, as the table below shows. However, perhaps more importantly, the US 10yr bond coefficient is much higher. This suggests that a given change in the US bond yield will result in a larger change in the NZ 10yr swap rate than a corresponding change in the NZ 1yr rate. In other words – US yields are more important than NZ monetary policy. Furthermore, given the role US Treasury bond yields play in setting the scene for local monetary policy expectations, it's arguable that the differences would have been even larger had this effect been stripped out. That is, even if it seems NZ 10yr rates are falling because both NZ 1yr and US 10yr rates are falling, if it was US rates driving the NZ 1yr rates down, then the reality is, US rates are in the driving seat.

Regression of NZ10y Swap (3mth Changes) Against:			
Variable	Correlation	Coefficient	Std Error
NZ 1y Swap	71%	0.34	0.038
US 10y Bond	69%	0.47	0.054

Even if global pressures are working in the opposite direction of local pressures, there needs to be some compromise. This means that the yield curve doesn't always behave in a textbook fashion. As such, caution is required in smaller markets when it comes to drawing conclusions about what a particular curve shape means. For example, you often hear it said that an inverse yield curve is a precursor to a recession, and a steep yield curve is a precursor to a recovery. But if the slope of the yield curve is being driven by offshore events, then it's more difficult to draw concrete conclusions. And that's exactly what's happening in NZ at the moment.

For example, consider the level of 10yr swap yields at the moment. Indeed, if the swap is at 4.8%, doesn't that mean that the market expects the 3mth BKBM rate to average 4.8% for the next 10 years? Technically it does – but analysis of the predictive ability of 10yr swaps over time tends to show them up to be poor predictors. This is well known – as is the tendency for term rates to typically overstate the future level of interest rates. Among other things, this suggests that there is a term premium in swap rates. There may be several reasons for this, and it's intuitive to expect such a premium to exist during times of plenty. Coaxing an investor to part with their money is likely to be harder when the stock market is booming than when things look dire. But

when they do look dire, the opposite may be true. Indeed, investors may be prepared to pay a premium for safety. As the saying goes, people may be more interested in return of capital, not return on capital. They may also be chasing opportunities. Consider, for example, the recent eye-watering drop in US Treasury yields (from around 4% to 2.5% since early April). Does this really represent the collective economic assessment of the market, or is it flight to safety? Or is it people buying bonds in the hope that the Fed announces another round of quantitative easing (QE)? In reality all are likely to have played a part. The point is, if the latter two are more prominent, then chances are the positive term premium has become a negative stress premium. And if this is spilling over into the NZ market, then we need to be mindful of it.

For example, we often hear people express surprise that the Australian market is now pricing in rate cuts. Similarly, people are often surprised by how far NZ rates have fallen. But these developments are easy to reconcile if you consider that risk traditional (non credit) risk premiums have evaporated and gone negative. Just as for most of the 2000s the market wasn't really saying that it thought 3mth BKBM would average around 7% (the 10yr swap rate average between Jan 2000 and September 2008 was 6.96%), at the moment it's not saying that 3mth BKBM will average 4.8% for the next 10 years. All its saying is that there's an "elephant in the room" we described last week – i.e. the threat of further QE in the US.

### What's next?

We've dedicated a lot of space in this issue talking about offshore (and specifically US rates), and while it may seem like we're off in a tangent, the reality is, that's what's driving NZ interest rates at the moment. As such, it's worthy of lengthy consideration. But if interest rates are being held artificially low by global rates, can they keep going lower? We think they can, but to be sure, we need to answer 3 key questions. First, will the Fed adopt QE again? Second, if they do, where might US interest rates go? And finally, what does that mean for NZ interest rates. We discuss these points in turn.

Question 1: Will the Fed adopt further QE? In short, yes. In our view the Fed has few other legitimate choices available having now reached the zero lower bound for the Fed Funds rate. To be sure, the hurdle for another round of QE remains high, and we need to see a further deterioration in the outlook yet. Indeed, the Fed minutes indicate that the FOMC were eager that their decision to reinvest the proceeds of maturing/prepaid

mortgage and agency bonds into Treasuries was not regarded by the market as "QE lite". But market pricing clearly indicates a keenness for QE, and if we extrapolate recent trends, we may not be far away. Inflation continues to trend lower, with annual CPI readings at their slowest pace in nearly 50 years. Perhaps worse still, the jobs market shows no signs of improving, and unemployment has held stubbornly above 9 percent for 15 months. Bernanke's tone has changed too. After spending most of the year outlining his so-called exit strategy (i.e. the day policy settings would be tightened), he now acknowledges that the FOMC *"is prepared to provide additional monetary accommodation through unconventional measures if it proves necessary, especially if the outlook were to deteriorate significantly"*.

Question 2: If the Fed does adopt QE, where might rates go? This is the 64 million dollar question (or perhaps the trillion dollar question). It's impossible to say, but we're focussing on two things. The first is the previous low in US 10yr Treasury yields – 2.05% in December 2008. Markets have a habit of gravitating to past levels, and this one stands out. The second thing we are focussing on is "everyday" interest rates, like mortgage rates. The benchmark US 30 year mortgage rate is back to its 2009 low at around 4.5%, and refinancing has increased. But is that rate low enough to entice borrowers? Falling inflation has seen real mortgage rates rise, and they are now around 1 percent higher than they were at their lows in 2009. Remember, falling real interest rates was at the heart of St Louis Fed President Bullard's concerns when he suggested there was a possibility the US may enter a Japanese style deflationary era. This suggests that a circa 2% target (i.e. about 50bps below current levels) for US 10yr Treasury bonds isn't unreasonable.

Question 3: What might such a move mean for NZ interest rates? While it is clear that the main reason NZ interest rates are where they are is because US rates have fallen so far (suggesting that there's a lot already priced in), it is reasonable to expect NZ rates to push lower yet if US rates keep falling. Given the 0.47 coefficient from our earlier regression analysis, if we do see a circa 50bp move in US 10yr rates, we could be in line with a circa 24bp fall in NZ rates. This would take the 10yr swap to close to 4.5%.

### So, what to do?

It's clear that interest rates may move lower yet. But it's also equally clear that they are being held artificially low, courtesy of the elephant in the room that is QE. As such, the broad thrust of our advice is to take advantage of the move, but to acknowledge that the "opportunity" may get better. The stakes are high in regards to where the market may go. If US

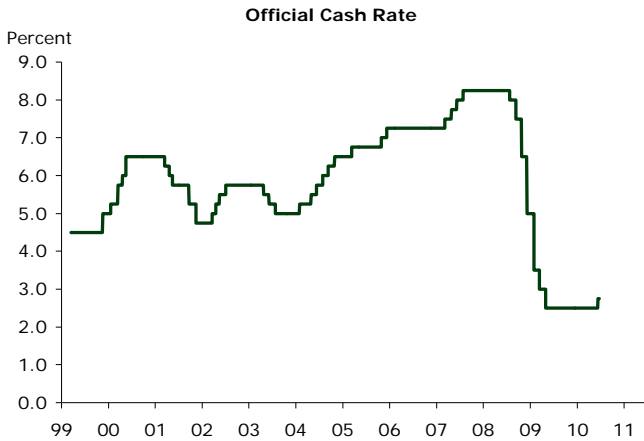
data start to improve, there's a lot of QE premium to be priced out – and rates could move violently higher. If this were to occur, there would inevitably be some spill-over into the local market, which could itself set off a panic reaction. Indeed, liquidity is less in the NZ market, and when everybody runs for the door at the same time, it tends to have an oversized impact. Given the amount of money behind so called "curve flattening" trades, if things do start to change, there may not be much time to act. In our mind, this adds weight to the case for doing more hedging now. That being said, if we see deterioration in key metrics like US unemployment, inflation and confidence, it may trigger QE, sending rates lower. That being the case, we see merit in adding to long term hedges here, keeping some powder dry to do more should we see an extension lower.

Shifting monetary policy expectations have also thrown up opportunities at the short end. Market expectations have compressed so far now (with the first 25bp hike not priced in until April 2011) that the opportunity cost of doing some short term hedging is low. Indeed, at 3.68%, the 2yr swap is trading at its "tightest" spread to the OCR in 18 months. If we do see another rate hike in the next 6 months (and we think we might), this could be a smart move. Indeed, we'd expect to see BKBM rise to around 3.5% on one hike. But it will go higher yet if the RBNZ hikes twice or more – and that's very likely in the next 12 months. Bottom line – negative risk premiums are opening up opportunities.

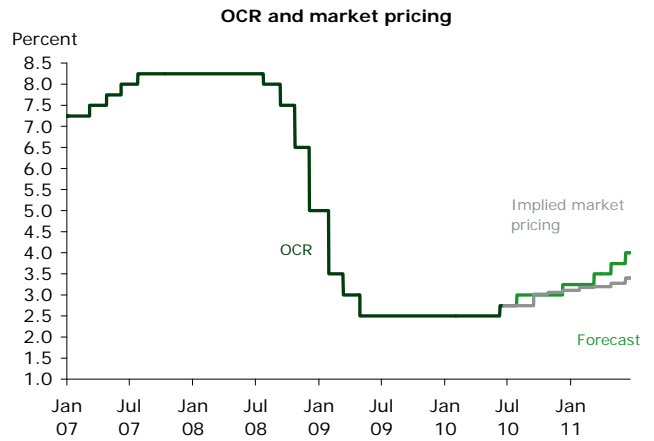
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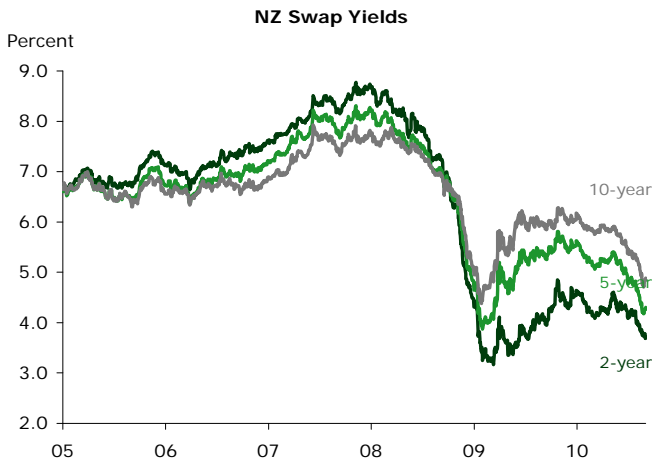
Charts



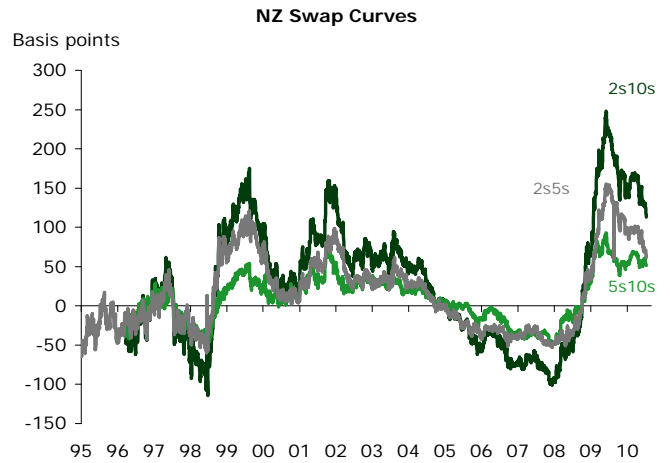
Sources: ANZ, National Bank, RBNZ



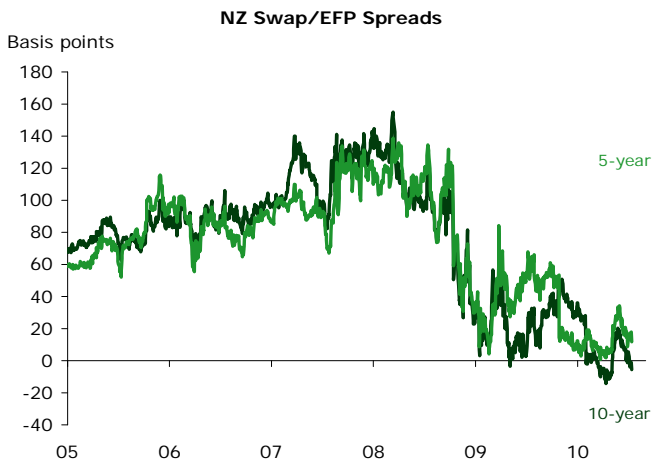
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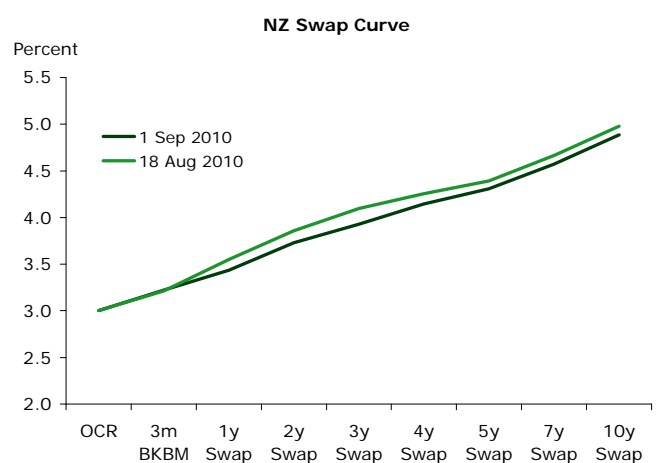
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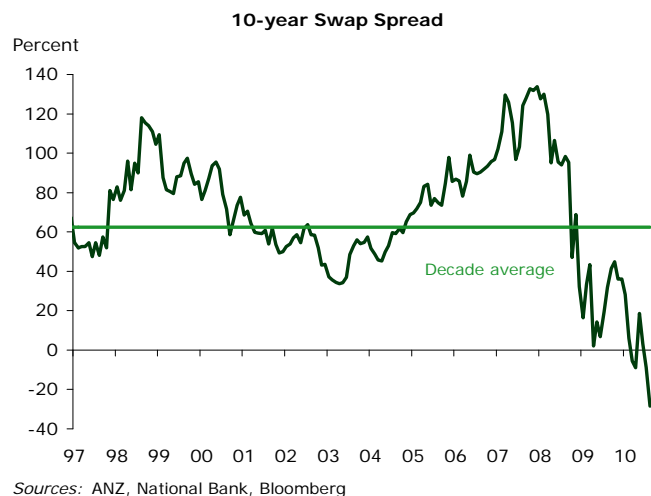
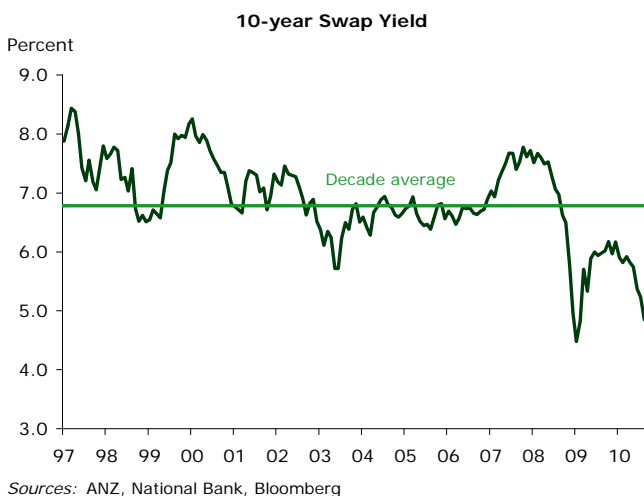
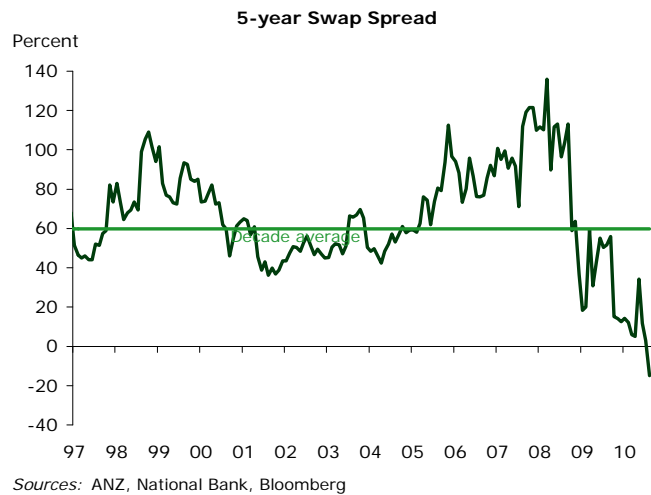
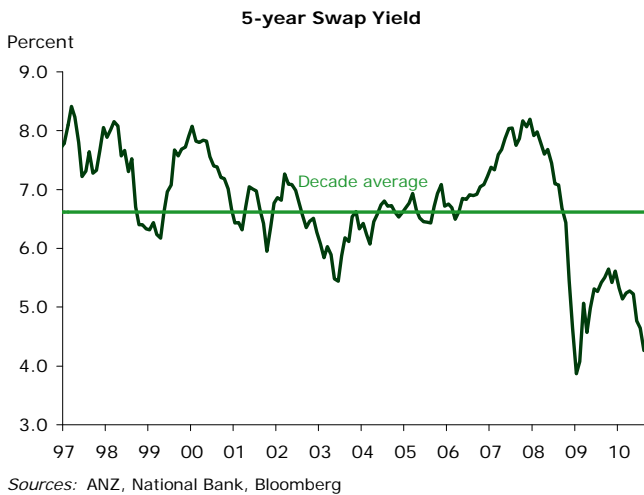
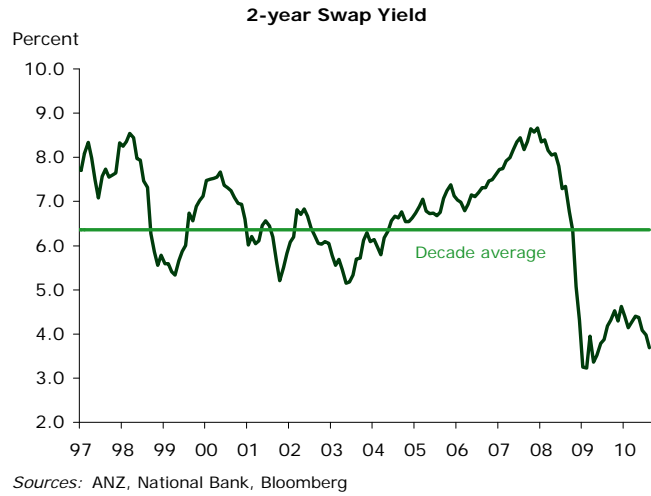
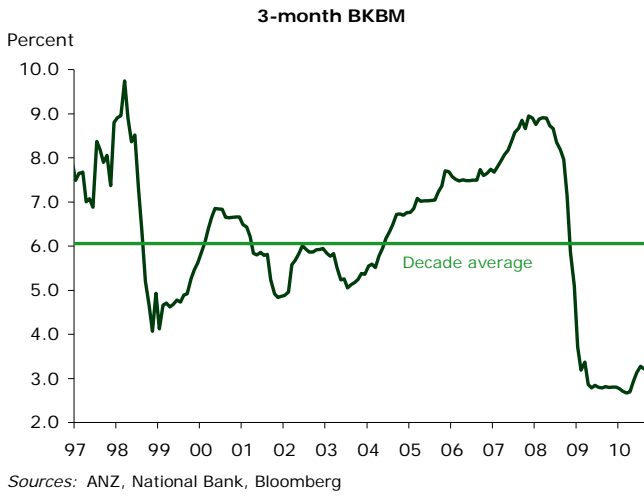


Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg

Charts (end of month)



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