

NEW ZEALAND ECONOMICS ANZ BORROWER'S STRATEGY

11 November 2011

CONTRIBUTOR

David Croy
Senior Interest Rate Strategist
Phone: +64 4 576 1022
E-mail: david.croy@anz.com

ECONOMIC OUTLOOK

The global situation completely dominates the outlook, and poses substantial downside risks. Italy is now the centre of attention, and the big fear is that a crisis of confidence there threatens the very survival of the euro. Our readers are no doubt as tired as we are of the European crisis, having long ago concluded that this crisis would be messy and protracted, and not able to be resolved without hard work, political unity, credible fiscal reform, and the passage of a very long time. Yet markets have swung this way and that, from optimism to pessimism. The risk "pendulum" will no doubt keep swinging as markets struggle to decipher if a rebound is simply a short-covering rally or a true shift in sentiment. The situation will be resolved one way or the other – even if measures taken only buy time. We are deeply suspicious that the brinkmanship occurring is more about extracting maximum concessions, and not a credible threat to let Rome burn. Even so, the risk pendulum has now swung so far, and set off such a violent reaction in markets that it has started to undermine confidence. We maintain our reasonably constructive view of the domestic economy. We note for instance that the economy is still growing, and our financial system is in good health. So we are not panicking, but we simply can't ignore events unfolding offshore, and they cast a long shadow. All of the risks are to the downside, and as such, we are cautious.

RATE VIEW

New Zealand interest rates have fallen dramatically over the course of the week on concerns that the fallout from the escalating European debt crisis adds significantly to the downside risks for the domestic economy. We expect them to fall further yet, led by deteriorating global sentiment. All eyes are on the Italian bond market, which looks to be getting sucked into a vicious circle, where rising yields causes more concern, pushing yields higher and so on. Intervention from the ECB might help stabilise the crisis in the near term, but nothing short of massive and credible fiscal reform in association with an expanded ECB balance sheet will stop the rot. With Italian politics in a mess, it is difficult to see tough decisions being made in a timely manner. This increases the odds of a disintegration (whether it is an orderly exit of the core or a disorderly break-up) of the euro, posing significant downside risks to global growth and interest rates. Of concern is the possibility that falling risk appetite leads to a tightening in key funding markets which are so crucial for New Zealand. Any increase in bank funding costs will only further delay OCR increases, which we have long characterised as "fluid".

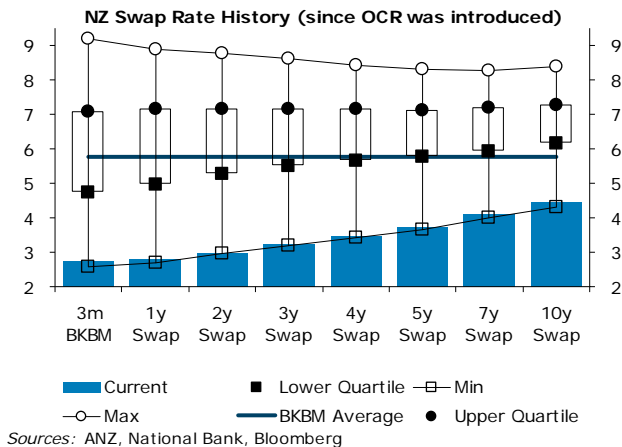
STRATEGY

Watch very closely, worry a little (or perhaps now, worry a lot), but most importantly, wait. That was how we ended our last edition, and our sentiments have not changed. Interest rates have fallen, and as such, the opportunity cost of being fixed has too. But the risks to the downside have increased too, and as such we prefer to stand on the sidelines, and we suspect that what matters most now is not where interest rates are headed, but rather how the business environment looks.

BORROWER'S STRATEGY

VALUATION

Local swap rates have continued to fall, taking the bellwether 2 year swap rate to a new all-time low of 2.94% yesterday. All other swap rates are within 0.15% of all-time lows. The question is, does this represent value? It does if in hindsight they shoot higher all of a sudden. But the likelihood of rates moving higher in a sustainable manner is low at best, particularly in the near term. The RBNZ maintained a tightening bias at the October OCR Review, but this was conditional on global factors having only a mild impact on NZ. Since then, Italy has hit the skids, funding spreads have widened, and the RBNZ has delayed a scheduled increase in the core funding ratio by 6 months. The situation is fluid, and the downside risks are increasing, not decreasing.



Current interest rate levels

Maturity	Last edition	Current
3-mth BKBM	2.74	2.73
1-year swap	2.96	2.80
2-year swap	3.22	2.97
3-year swap	3.49	3.21
4-year swap	3.77	3.48
5-year swap	4.03	3.73
7-year swap	4.45	4.12
10-year swap	4.81	4.45

Market expectations for RBNZ OCR (bps)

OCR Dates	Last edition	Current
Thu-8-Dec-11	+1	-2
Thu-26-Jan-12	+2	-2
Thu-8-Mar-12	+8	0
Thu-26-Apr-12	+14	+2
Thu-14-Jun-12	+20	+6
Thu-26-Jul-12	+27	+8
Thu-13-Sep-12	+31	+8

ARRIVEDERCI

Europe is in a pickle. But we already knew that, and as regular readers will recall, we have long taken a dim view of the situation confronting Europe's leaders, and an equally dim view of steps taken to deal with it. Much of the problem is of course structural. There is unity on the monetary policy front, with one man in charge of an organisation (the ECB) that has been given a clear mandate. But that mandate does not extend to the financing of profligate governments. What is equally clear is that there is no one person in charge of the Eurozone's finances as a whole. The result: decisions don't get made because they need parliamentary consensus; are like political suicide for politicians; or there simply isn't agreement on the best way forward. But as we noted from the outset, none of this is new.

What is new is the level of urgency. Earlier in the month when Italian bond yields started rising, it looked like the market was toying with the ECB, coaxing a reaction. But that reaction (i.e. direct intervention in the market) came too late, and what we have now is a market that is running scared.

We are not experts on Europe, but what we do know is that Italy is vulnerable. In fact, our sovereign debt analysis told us that almost two years ago. But we have moved way beyond working out who's in trouble and now find ourselves contemplating how events might unfold from here. And it is at this point where we simply have to admit that we do not have the expertise to understand what might happen next.

However, when we cast an analytical eye over the situation from a generalist's point of view, we find it difficult to envisage how such a messy problem will be dealt with quickly and comprehensively, and in a way that restores confidence. As such, all we can really do is watch from a distance, and urge our readers to ensure that they are aware of the risks when making decisions. If we were looking at a situation that looked overblown and overdone, and we felt was recoverable, we would have a very different attitude. What the last few weeks and months has told us is that bouts of confidence have tended to be skin-deep, whereas bouts of pessimism tend to run to the core.

DON'T PANIC ...

Having read on this far, chances are you've become somewhat concerned. But what's going on in Italy is of course the bad news. There is of course room for optimism, even insofar as Europe is concerned. As bad as things look, and as poor as Europe's track record has been to date in dealing with the crisis, we

BORROWER'S STRATEGY

simply cannot imagine Berlin and Paris will stand idly by as Europe burns. Lessons have been learnt – not just in Europe – but in the US too, where political brinkmanship led to the loss of Uncle Sam's AAA credit rating. The brinkmanship we are seeing in Europe now is undoubtedly all about extracting maximum concessions from the profligates before action is taken. That action may just buy time – but the point is – Europe might be headed for recession, but it is not likely to be headed for disintegration. At least we hope not.

The good news doesn't just stop there. For instance, the tone of US data has started to improve. The Fed highlighted this in its FOMC statement last week when it mentioned that "economic growth strengthened somewhat" in Q3, led by stronger household spending and business investment. The US has its own problems – unemployment remains high and the housing market is stuck in a bind. It is therefore far from out of the woods. But things are improving.

Let's also not lose sight of how things stand domestically too. Signs of caution are certainly starting to emerge – we have for instance seen a small pullback in consumer confidence. But commodity prices are still holding up even if they have eased, and growth will be supported by earthquake rebuilding over the next few years. But perhaps most importantly, if we are standing on the edge of the abyss, we are still reasonably well placed to respond. We don't have the same fiscal headroom or quite as much capacity to loosen monetary policy than we did in 2008. But deleveraging has purged some debt from the system, banks have strengthened their balance sheets, and the RBNZ have the experience of 2008/2009 to lean on. We also possess a formidable ally – a floating exchange rate. If things really do turn nasty, a falling NZD will cut us some slack. Greece and Italy don't have this choice. We also don't have a housing crisis like the US and parts of Europe do, and as such, bank asset quality is high relative to global peers.

... BUT BE REALISTIC

That said, this is not the time to be smug and dismissive. The New Zealand economy is more plugged into the global economy than it ever has been – not just via trade linkages, but also via financial markets. For example, our government bond market has basically tripled in size since the GFC, and the majority of buyers have been offshore. External debt is also reasonably high, and was one reason cited by credit rating agencies when they downgraded NZ's credit rating in September. For

now, international investors appear to be keen to support our market, as witnessed by strong demand for NZGS bonds at the weekly tenders. This demand has in fact improved since the downgrades, but these markets can be fickle at times of stress.

As another example, China is now New Zealand's 2nd largest export partner. This is a fantastic structural development – in that this is a rapidly growing part of the world. But China is itself dependent on growth in Europe and the US to sustain its exports. So we need to be mindful of the linkages, and as such we prefer to take a more balanced and cautious view, and are focussing heavily on global issues.

STRATEGY

With market conditions worsening, and the global situation looking more fragile and less certain, the sentiments we expressed in our last edition a fortnight ago are valid. That is, our preference is to stand on the sidelines for now. Watch, worry and wait.

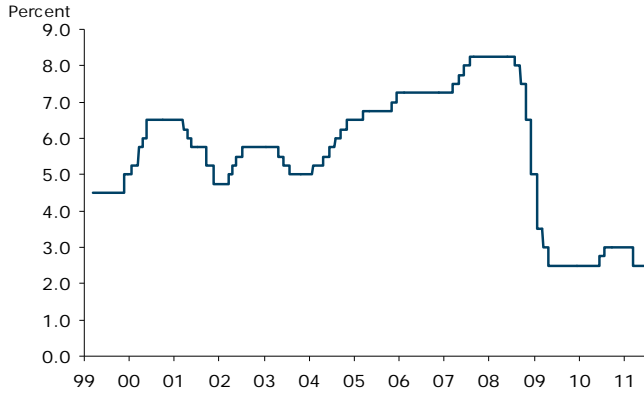
Dealing room contacts

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)

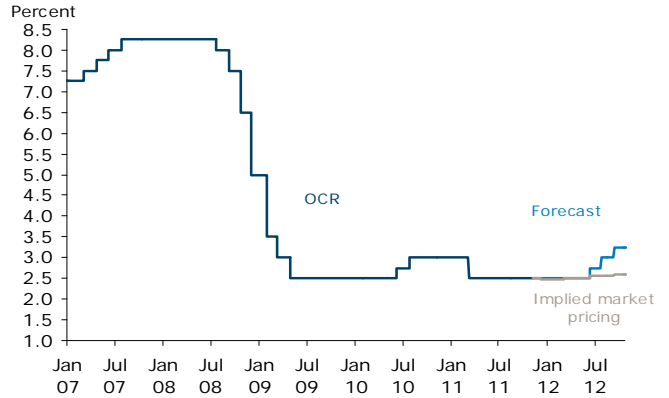
CHARTS

Official Cash Rate



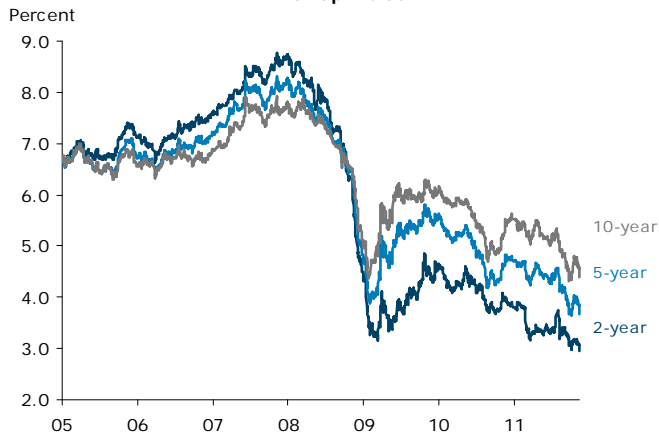
Sources: ANZ, National Bank, RBNZ

OCR and market pricing



Sources: ANZ, National Bank, RBNZ, Bloomberg

NZ Swap Yields



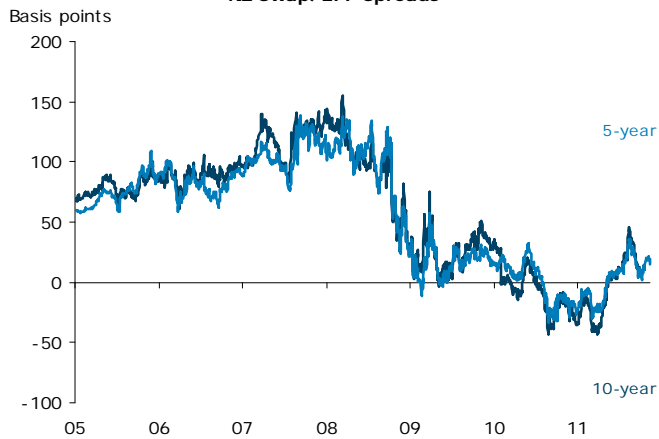
Sources: ANZ, National Bank, Bloomberg

NZ Swap Curves



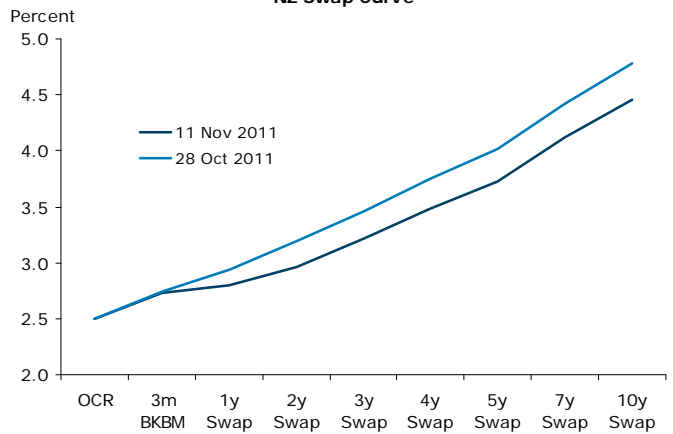
Sources: ANZ, National Bank, Bloomberg

NZ Swap/EFP Spreads



Sources: ANZ, National Bank, Bloomberg

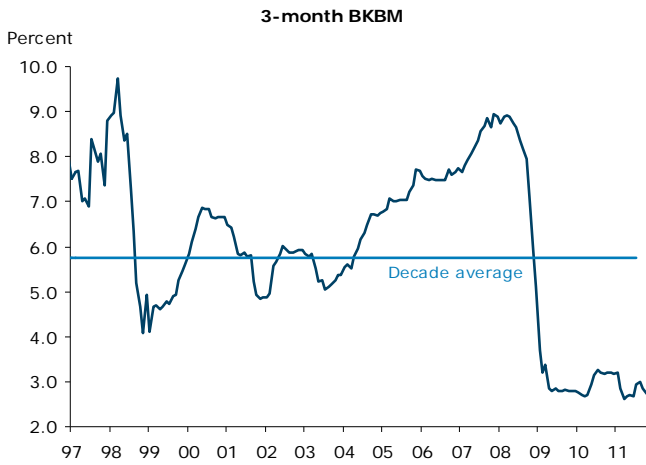
NZ Swap Curve



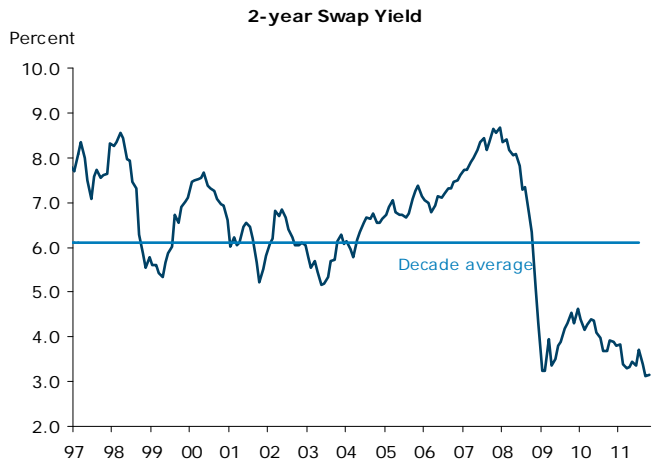
Sources: ANZ, National Bank, Bloomberg

CHARTS (END OF MONTH)

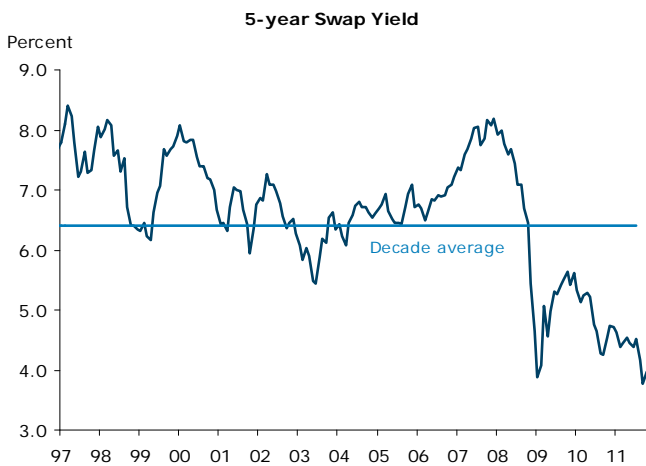
CHARTS (END OF MONTH)



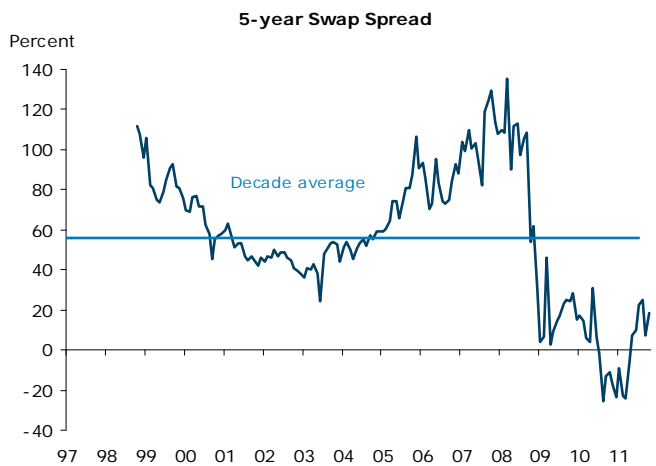
Sources: ANZ, National Bank, Bloomberg



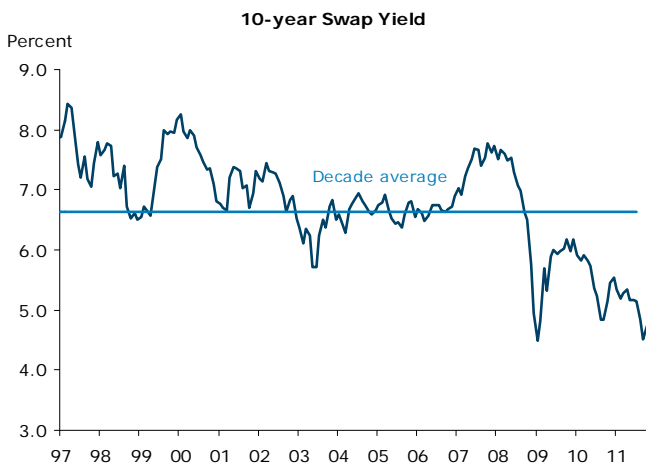
Sources: ANZ, National Bank, Bloomberg



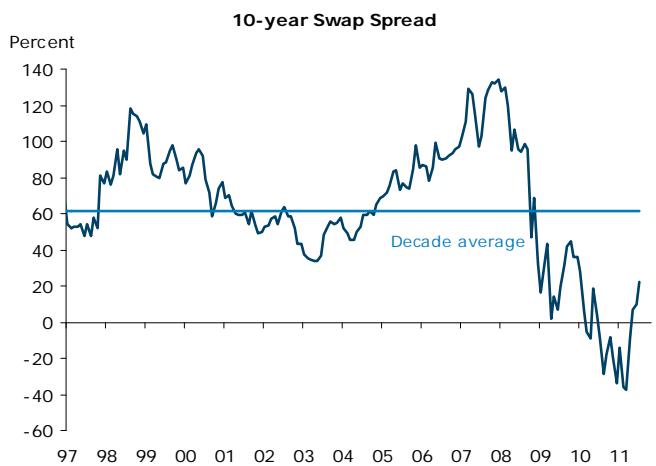
Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg



Sources: ANZ, National Bank, Bloomberg

IMPORTANT NOTICE

NEW ZEALAND DISCLAIMER

This publication is for information purposes only. Its content is intended to be of general nature, does not take into account your financial situation or goals, and is not a personalised adviser service under the Financial Advisers Act 2008. It is recommended you seek advice from a financial adviser which takes into account your individual circumstances before you acquire a financial product. This publication does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this publication can be reproduced, altered, transmitted to, copied to or distributed to any other person without the prior express permission of ANZ National Bank Limited (the "Bank").

This publication is a necessarily brief and general summary of the subjects covered. The information contained in this publication is given in good faith, has been derived from sources perceived by it to be reliable and accurate and the Bank shall not be obliged to update any such information after the date of this publication. To the extent permitted by law, neither the Bank nor any other person involved in the preparation of this publication accepts any liability for the content of this publication (including the accuracy or completeness thereof) or for any consequences flowing from its use.

UNITED STATES DISCLAIMER

This publication is being distributed in the United States by ANZ Securities, Inc. (Member of FINRA [www.finra.org] and registered with the SEC) ("ANZ S") (an affiliated company of Australia and New Zealand Banking Group Limited ("ANZBG") and the Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this publication and wishing to effect transactions in any fixed income securities referred to herein should contact ANZ S 277 Park Avenue, 31st Floor, New York, NY 10172 USA, Tel: 1-212-801-9160, Fax: 1-212-801-9163, not its affiliates.

This publication is issued on the basis that it is only for the information of the particular person to whom it is provided.

This publication may not be reproduced, distributed or published by any recipient for any purpose. This publication does not take into account your personal needs and financial circumstances. Under no circumstances is this publication to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZBG, the Bank, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this publication (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this publication. If you have been referred to ANZBG, the Bank, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this publication accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this publication and are subject to change without notice. No part of the author's compensation was, is or will be directly or indirectly related to specific recommendations or views expressed in this publication. ANZBG, the Bank, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

This document has been prepared by ANZ National Bank Limited. ANZ (part of ANZ National Bank Limited), Level 7, 1 Victoria Street, Wellington 6011, New Zealand, Phone 64-4-802 2000, Fax 64-4-496 8639, e-mail nzeconomics@anz.com, <http://www.anz.co.nz>