29 March 2010

De-leveraging: Just the Start?

- Borrowers using low rates to help de-leverage
- But debt still high, short-dated, with OCR to rise
- Debt servicing pinch-points thus loom large
- February's credit aggregates due Tuesday
- Building consents: housing better, non-housing not
- Will Wednesday's business survey stay strong, or waver?

While economic activity continues to struggle out of the mire, it's good to see the progress is not reliant on renewed recourse to debt.

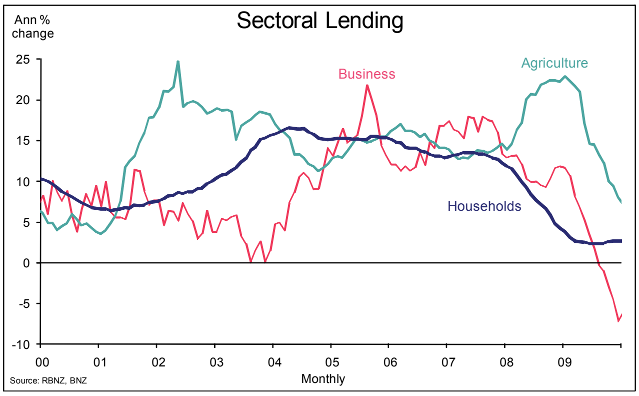
Indeed, there have been clear indications of de-leveraging occurring as GDP has recovered. For example, the outstanding level of business borrowing – from banks and non-bank financial institutions alike – contracted 6.2% over the year to January 2010.

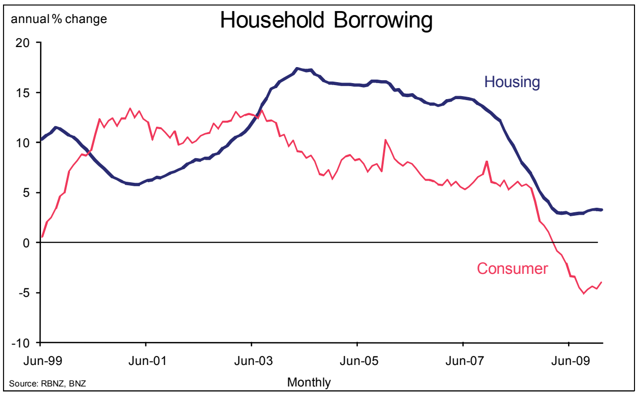
Consumer debt shrank 4.1% y/y. Interest-bearing credit card balances were down 0.5% over the twelve months to January while card limits in February fell 0.9% y/y.

Other areas of credit have simply been struggling. While borrowing by agricultural firms expanded $5.13b (12.3%) over the year to September 2009 it has since stalled (partly relating to issues around farm valuations, but also probably as some farmers pay down debt, aided by the upward bump to the dairy payout expectations late last year).

Housing-related debt has increased at a paper-thin pace for the best part of the year to January. And we see little sign of any return to normality if the still-soporific tendency in mortgage approvals into mid-March is anything to go by.

The recent debt trends, combined with relatively low short-term interest rates, have implied much relief for borrowers.



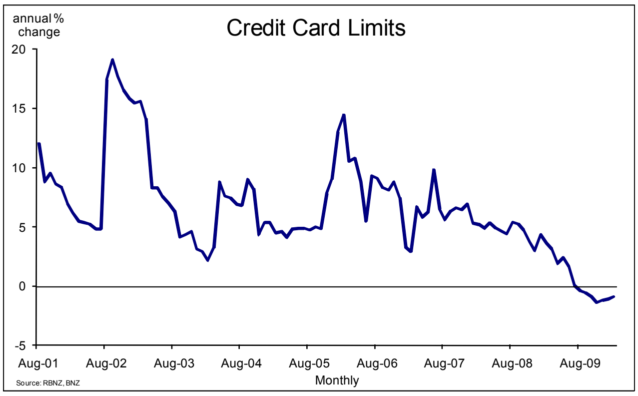


And the reprieve has been bigger for businesses than households, if estimates provided in recent RBNZ documents are any guide. That's saying something, when the household sector has enjoyed substantial reductions in interest payments as it has rolled off relatively high fixed rates of old, onto much lower shorter mortgage rates of late.

Still, this all seems more a point of cyclical respite to New Zealand's debt issues rather than a structural resolution, as far as we can see it.

For a start, the de-leveraging to date – welcome as it is – doesn't much dent the fact the nation's debt load remains relatively high, especially in the household sector.

We saw this in last week's external accounts, with private sector net debt, while having come down a bit over the course of 2009, was about twice as high as it was in 2004. As a proportion of nominal GDP it was 87%, compared to about 60% five years prior. These are high ratios by international standards.



Yes, much of this debt is recorded against the sturdy domestic banking sector. However, it ultimately takes the form of mortgage securities, backed by housing valuations and the ability of households to maintain the mortgage. Housing-related debt increased approximately $63b over the five years to 2009, as the nation's overall foreign debt ballooned about $80b, to $243b (131% of GDP).

The big private-sector component of this offsets some of the good news around the nation's public-sector debt picture. The latter is certainly low in gross terms and near enough to nothing once the Government's financial assets are taken into account. Yet New Zealand's public debt is on a rising path for the foreseeable future.

This is bound to offset any further containment in private-sector debt, such that the nation's total (foreign) debt load is likely to increase even further as a percentage of GDP over the coming years.

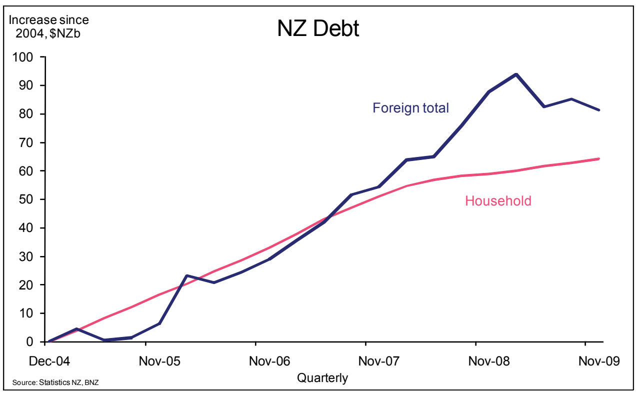
While the quantum of debt is one reason to remain wary, the interest rate charges against it are another.

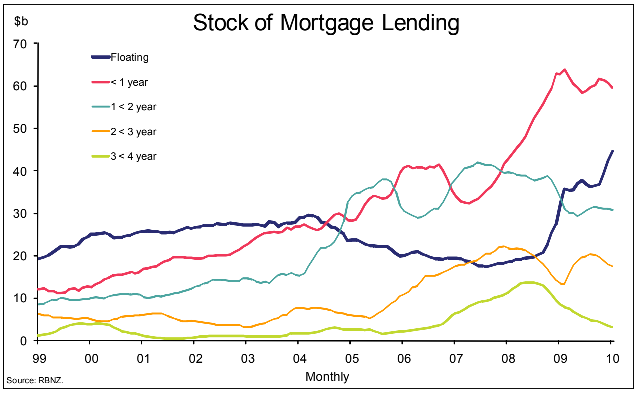
We say this with the economy facing increases in the Official Cash Rate from about the middle of the year. There are still issues around the exact timing, and eventual extent. However, New Zealand's short-term interest rates are on course to be materially higher in a year's time than they are now.

This return of interest rates, to closer to normal, will be the ultimate test for the nation's debt load.

We suspect we'll get a good sense of the sensitivity early in the process. As helpful as it's been for households, and businesses, to load into short-dated debt, and the relatively low rates charged for it, this simply increases the vulnerability to OCR reversal.

The potential squeeze will be that much more acute given the shape of the interest rate curve. Through the Reserve Bank's last tightening cycle, the curve was flat to typically inverted, allowing folk to run down the curve into cheaper fixed-rate loans. And the farther they ran the cheaper it got.





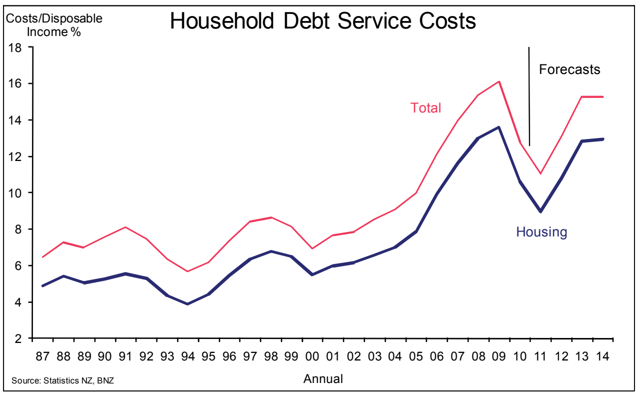
Now we have a situation quite different in that fixed rates are generally higher than floating rates – and the longer the more expensive the jump. The increased proportion of households, and businesses, on short-term rates will thus either have to bite the bullet, and fix at a higher interest rate, or keep sitting on rates that will be inexorably rising.

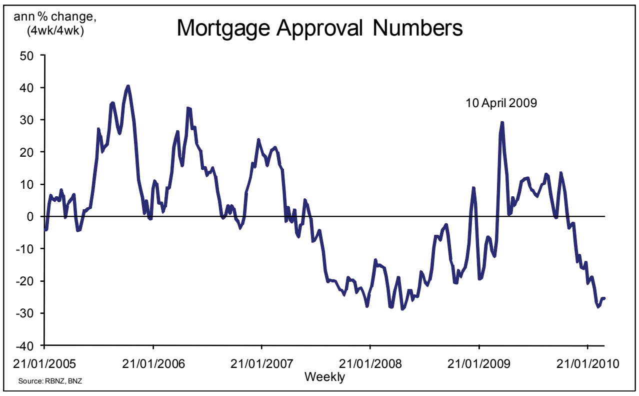
It's one of many reasons why the RBNZ "expects its monetary policy to have a sharper impact in the post-crisis economic and financial environment" – as it described last week on its website.

While the precise course of NZ interest rates and debt is, of course, difficult to predict, we would point out that our best guess on both melds a troubling picture over the coming two or three years. It takes no longer than this for debt servicing ratios to run into the sort of pinch points we saw a couple of years ago.

This does presume debt increase will resume. However, only at a moderate pace, not to the speed we saw during the 2004-07 binge. The chief cause of high debt servicing ratios we forecast is thus the normalisation of interest rates. Of course, our calculations have their own sensitivities. However, we certainly believe the issue is worth doing some serious number crunching on.

As for the very near-term analysis, note we'll be getting February's money and credit aggregates tomorrow afternoon. We expect these to confirm continued mild up-ticks in mortgages, relatively flat rural lending, and





broader business and consumer financing still contracting (in part reflecting ongoing de-leveraging).

Tuesday morning delivers February's building consents. We anticipate the residential numbers will be back on the front foot, following January's slip, but that non-residential consents will probably keep fading.

The most substantive local data item for the week, however, promises to be Wednesday afternoon's NBNZ business survey. Its last edition proved even stronger than we imagined, signalling GDP growth picking up to a 4% annualised pace. Has the March update retained that momentum or has it had second thoughts? We don't have a strong feeling, either way.

But the actual result will be important news, in the context of the Q4 GDP of last week simply matching expectations and with early indications that Q1 growth is moderate rather than strong.

After the NBNZ business survey there are no further official local releases to watch for. However, do keep an eye out for the possibility of some March housing statistics, courtesy of the website realestate.co.nz on Thursday. This would include the all-important trend in new listings (still picking up?), as well as information on asking prices, along with anecdotal evidence.

Then it's a holiday for Good Friday, then the end of daylight saving on Sunday, then another day off for Easter Monday.

The BNZ Markets Outlook thus returns next Tuesday – to tackle the day's Quarterly Survey of Business Opinion. This will build upon the themes of this Wednesday's NBNZ business survey.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates saw a small sell off on the week with offshore moves the key driver. The OIS curve is pricing very close to a 25bp hike in the June meeting, followed by 25bp per meeting through to the end of 2010. However, the futures curve is somewhat inconsistent with this currently. The bank bill margin (margin between three month OIS and the 3-mth bank bill) is priced at around 15bp for the June meeting, increasing to 30bp for the December meeting.

The move by the local banks towards term funding has reduced the desire of the banks to fund through the bank bills, which has pushed this bill margin down steadily over the past few months. With the change in regulatory framework, we feel this is a change in the structure of the market and the lower level of bank bill margins is here to stay. With this in mind, we favour paying 3-mth OIS out of the December futures date against buying the bank bill future.

The bond market had a sharp sell off on the week, with the driver a big sell off in US treasuries. This was caused initially by a poor tender in the 5-yr note, but sparked a widespread sell off and steepening of the USD curve. This fed through into NZD rates and we finished the week off around 10bp higher through the curve. Offshore moves will likely continue to drive the NZ market for the coming week. With the continued issuance, it is unlikely the market will rally too strongly.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
19-Mar-10	2.64%	3.72%	5.60%	4.17%	5.85%	168
26-Mar-10	2.66%	3.82%	5.71%	4.28%	5.91%	163
Change (bps)	**2**	**10**	**11**	**11**	**6**	**-5**

The swaps market was also pushed by the move in offshore rates with a sharp sell off through the curve. The move was somewhat less pronounced than in the bond market as offshore moves saw a crunching in of the spread between swap rates and the equivalent treasury rates. Most notably, the 10-yr swap spread in the US went negative for the first time, which helped to support longer end swap rates. The coming week's data is again fairly light, so it is likely offshore moves will drive the market for the coming Easter shortened week.

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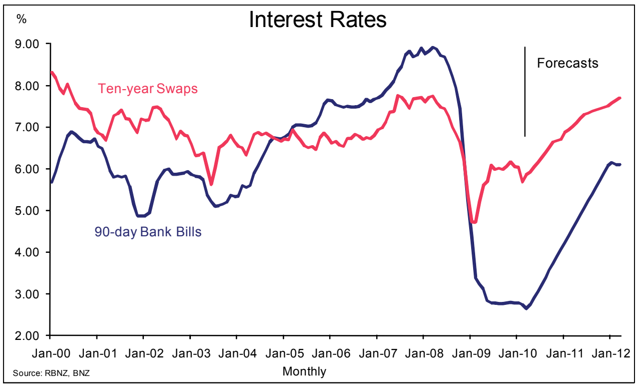

Interest Rate Technicals

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NZD 5yr Swap Rate

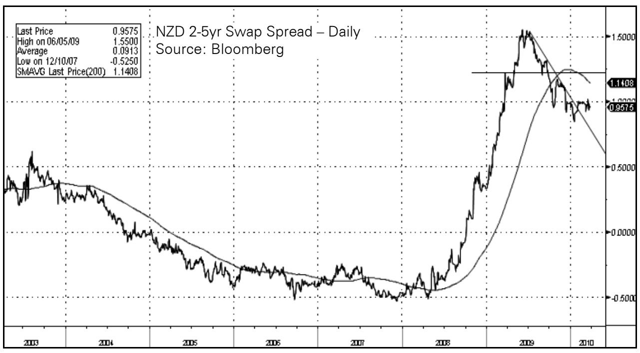
Outlook: Higher
ST Resistance: 5.50%
ST Support: 5.03%

The market has tested the downside and failed. We are likely in a fairly tight range but we look for support at 5.03% to hold and a gradual move higher towards 5.50% resistance.

NZ 2yr-5yr Swap Spread (yield curve)

Outlook: Rangebound
MT Resistance: +122
MT Support: +92

Trendline from mid 09 has been broken suggesting a near-term steepening. However expect resistance at +122 to hold.



Foreign Exchange Market

Reuters pg BNZWFWDS

The NZD was one of the strongest performing currencies last week. Still, it was really a case of NZD/USD consolidating within a relatively tight 0.7000-0.7100 range.

Against a backdrop of broad USD strength and plunging European currencies, NZD/USD managed to hold its ground. What's more, on a trade-weighted basis, the NZD pushed around 1% higher.

NZ's economic data, while not exactly shooting the lights out, continue to paint a picture of relative health compared to many of our trading partners. Fourth quarter data showed NZ's current account deficit narrowing to 2.9% of GDP (from 8.7% a year earlier) and annual GDP growth creeping into positive territory for the first time since June 2008. So, while NZD/USD basically went sideways last week, NZD/GBP surged to fresh 30-year highs above 0.4750 and NZD/EUR reached 2-year highs close to 0.5300.

However, gains in NZD/GBP and NZD/EUR were tempered on Friday night, providing a drag for NZD/USD. European leaders finally announced the details of a support package for Greece. In combination with the IMF, Euro-zone countries will make loans to Greece available (worth around €20b), should it end up asking for help. While Greece is undoubtedly still ill, easing fears over a Greek default propped up the struggling EUR on Friday. EUR/USD surged from sub-1.3300 to nearly 1.3450 sending NZD/EUR back below 0.5250.

Wednesday afternoon's NBNZ business survey is the coming week's only substantive data item. Its last edition proved even stronger than we imagined, signalling GDP growth picking up to a 4% annualised pace. Offshore, the data line-up is packed, despite the holiday-shortened week. Most notably, US non-farm payrolls will be a crucial test of whether US bond yields, and the USD, can hold onto recent gains (analysts expect 15,000 jobs were added in March).

It's worth noting, according to our short-term "fair-value" model, NZD/USD is still 'cheap' around current levels. Our model suggests that the current combination of NZ commodity prices, NZ-US 3-year swap spreads, and global risk appetite is equivalent to a NZD/USD 'fair-value' range of 0.7200-0.7400. In the absence of another bout of global risk aversion, we expect NZD/USD to creep into this range in coming weeks.

For this week, we suspect reduced pessimism about Greece's fiscal woes and expectations of a building NZ economic recovery will limit dips in NZD/USD to around 0.6960. Rallies are expected to be capped to the 0.7100 region in the short-term.

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Foreign Exchange Technicals

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NZD/USD

Outlook:	Consolidation
ST Resistance:	0.7190 (ahead of 0.7230)
ST Support:	0.6965 (ahead of 0.6920)

The rejection of 0.7200 suggests we are in for more range trading near-term. A daily close below 0.6965 would indicate the emergence of a new downtrend.

NZD/USD – Daily
Source: Bloomberg

NZD/AUD

Outlook:	Consolidation
ST Resistance:	0.7795 (ahead of 0.7835)
ST Support:	0.7670 (ahead of 0.7620)

The failure to sustain dips below 0.7700 suggests the downtrend has run out of steam. A daily close above 0.7835 is needed to suggest the uptrend is gaining traction.

NZD/AUD – Daily
Source: Bloomberg

Key Upcoming Events

	Forecast	Median	Last
Monday 29 March			
Jpn, Retail Trade, February y/y		+1.6%	+2.3%
Euro, Economic Confidence, March		97.1	95.9
US, Personal Spending, February		+0.3%	+0.5%
Tuesday 30 March			
NZ, Household Credit, February y/y			+2.7%
NZ, Building Consents, February (res, #)			-2.8%
Jpn, Industrial Production, February 1st est		-0.5%	+2.7%
Jpn, Unemployment Rate, February		4.9%	4.9%
UK, GDP, Q4 3rd est		+0.3%	+0.3%P
US, Shiller Home Price Index, January y/y		-0.6%	-3.1%
US, Consumer Confidence, March		50.0	46.0
Wednesday 31 March			
NZ, NBNZ Business Survey, March			+50.1
Aus, Building Approvals, February	+2.0%	+2.1%	-7.0%
Aus, Private Sector Credit, February	+0.5%	+0.4%	+0.4%
Aus, Retail Trade, February s.a.	+0.2%	+0.3%	+1.2%
Euro, Unemployment Rate, February		10.0%	9.9%
Euro, CPI, Mar y/y 1st est.		+1.1%	+0.9%
US, Chicago PMI, March		61.0	62.6
US, Factory Orders, February		+0.5%	+1.7%
US, ADP Employment, March		+40k	-20k

	Forecast	Median	Last
Thursday 1 April			
Aus, International Trade, February	-$1.50b	-$1.34b	-$1.18b
Jpn, Tankan (lge manuf), Q1		-13	-24
UK, BOE Credit Conditions Survey, Q1			
UK, CIPS Manuf Survey, March		56.8	56.6
US, ISM Manufacturing, March		57.0	56.5
US, Construction Spending, February		-1.0%	-0.6%
Germ, Retail Sales - vol, February		flat	-0.5%
China, PMI (HSBC), March		55.0	52.0
Friday 2 April			
NZ, Aus, US, Holiday, Good Friday			
US, Non-Farm Payrolls, March		+190k	-36k
Sunday 4 April			
NZ, Daylight Saving Ends, -1hr to GMT+12hrs			
Aus, Daylight Saving Ends, -1hr to GMT+10hrs			
Monday 5 April			
NZ, Aus, Holiday, Easter Monday			
US, ISM Non-Manuf, March		54.0	53.0
US, Pending Home Sales, February		-0.2%	-7.6%

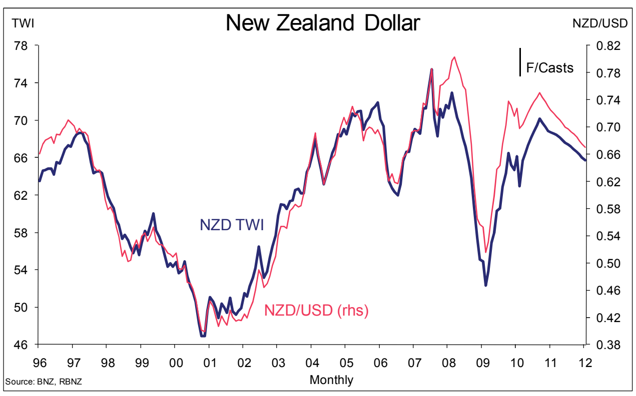
Due to the Easter holiday on Monday, the next BNZMO will be published on Tuesday 6 April

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	3.00
1 mth	2.59	2.58	2.67	3.41
2 mth	2.67	2.63	2.70	3.39
3 mth	2.68	2.62	2.70	3.38
6 mth	2.84	2.84	2.86	3.23
GOVERNMENT STOCK				
11/11	3.82	3.72	3.69	3.99
04/13	4.62	4.53	4.50	4.56
04/15	5.21	5.11	5.02	4.95
12/17	5.71	5.60	5.48	5.37
05/21	5.99	5.89	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.39	3.41	3.47	0.00
BNZ 05/15	6.55	6.38	6.40	4.54
GEN 03/14	6.49	6.45	6.46	7.21
GEN 03/16	7.15	7.07	7.10	7.35
TRP 12/10	3.76	3.79	3.83	4.80
TRP 06/20	7.19	7.12	7.11	7.31
SWAP RATES				
2 years	4.28	4.18	4.14	4.10
3 years	4.73	4.64	4.63	4.67
5 years	5.25	5.17	5.14	5.22
10 years	5.91	5.86	5.82	5.87

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7053	0.7066	0.6996	0.5643
NZD/AUD	0.7792	0.7717	0.7780	0.8215
NZD/JPY	65.16	63.95	62.09	55.14
NZD/EUR	0.5234	0.5219	0.5118	0.4255
NZD/GBP	0.4720	0.4701	0.4600	0.3965
NZD/CAD	0.7231	0.7176	0.7363	0.7018
TWI	65.82	65.45	64.66	56.65

NZD Outlook



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