Economics & Markets Research

ANZ Australian Markets Weekly

Time to consider interest rate hedging

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Our Vision:

For Economics & Markets Research to be the most respected, sought-after and commercially valued source of economics and markets research and information on Australia, New Zealand, the Pacific and Asia.

Welcome to the launch of our new *ANZ Australian Markets Weekly*. The new report includes detailed comments on interest rate and foreign exchange markets each week. These sections will include forecast changes, recommendations and analysis of these markets. In addition, our release time is now Thursday afternoon. With the inclusion of weekly analysis on the FX markets in this publication, we will no longer publish the stand-alone *FX Weekly* report. We will publish a separate report with a detailed analysis of FX forecasts in the first week of each month. We will also continue to publish a separate *Data and Event Calendar* that covers the major Australian and global market events due in the coming week.

Warren Hogan and Amy Auster

Macro Update: A tremendous shock

- Evidence is accumulating that the financial crisis is taking a heavy toll on the Australian economy.

Interest Rate Markets: Time to consider hedging

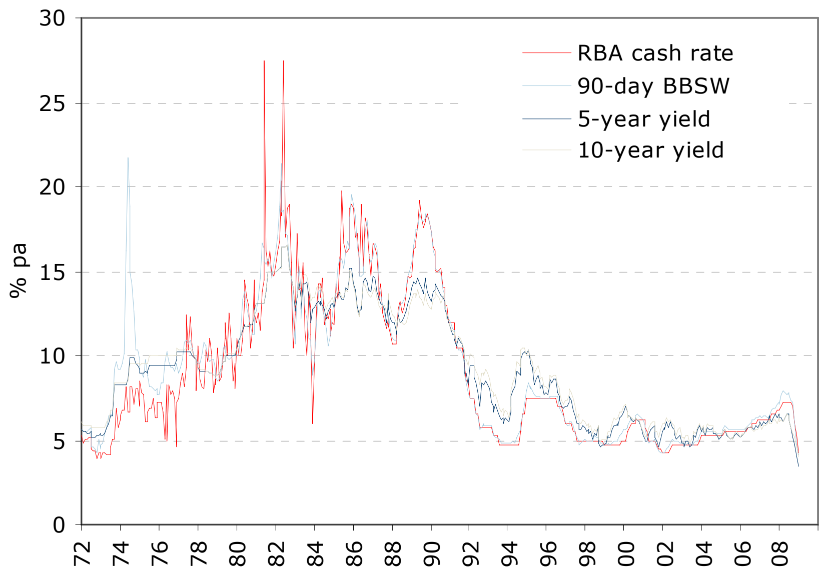
- A collapse in global interest rates and current market pricing for further significant rate cuts from the RBA over the next six months has provided an opportunity to hedge floating rate debt for the medium-term.

FX: AUD and the short-term bounce

- The AUD's seasonal strength provides an opportunity for those who are looking to purchase foreign currency.

Chart of the week

Figure 1: Multi-decade lows in term interest rates suggest it is time to consider hedging floating interest rate exposures



Source: ANZ and Bloomberg

Macro Update: A tremendous shock

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- Evidence is accumulating that the global financial crisis is taking a heavy toll on Australia's economy. We now expect the Australian economy to stagnate in 2009 (GDP of +0.4%) with the risk of recession looming large.
- It is clear that the RBA has more work to do. However after a period of radical adjustment, we expect the board will now resume a more normal approach to monetary policy; that is, policy decisions will be based on the evolution of the economic data.
- We now expect the RBA to cut its official cash rate by 50bps to 3.75% in February. We expect the RBA will follow up with a series of 25bps cuts to take the cash rate to 3.00% by September 2009.

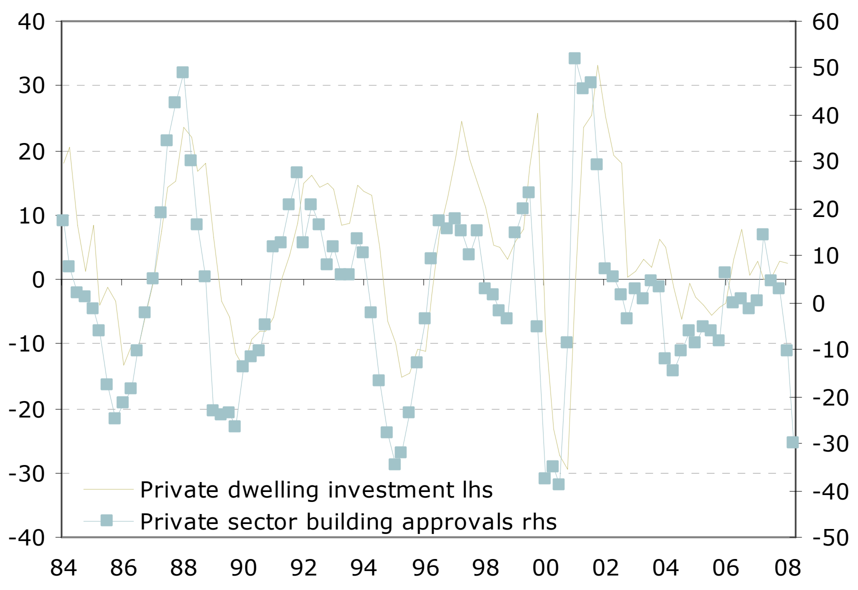
A tremendous shock

It has become clear that the impact of the global financial crisis on the Australian economy is operating via a number of different channels. Weak global growth is hurting our traded sector, tight financing conditions is impacting the provision of finance across the economy and weak confidence and growing economic uncertainty is dampening spending.

Unsurprisingly, exporters have been hit hard. Australia's international trade surplus was decimated by $1.5bn in November, largely as exports fell. While some of this was related to plummeting commodity prices, what is of particular concern is that mining volumes were down sharply; the ABS reports that (in original terms) iron ore volumes plunged 24% and metallurgical coal fell 15%.

Just as shocking was the November building approvals data. Approvals plunged 12.8% in the month (-35% over the year) with housing approvals falling 9.7% and other dwellings down 21.9%. This shocking result has led us to significantly revise down our forecasts for dwelling investment and we now expect GDP growth will be at best flat (+0.4%) in 2009. With just about all analysis suggesting Australia has an undersupply of housing stock, the recent collapse in building approvals is more likely due to a tightening of access to credit. In any case, residential construction will act as a headwind to economic growth and employment for the year ahead.

Figure 2: Building approvals plunge



Source: ABS and ANZ. N.B Q4 approvals are an estimate, assuming flat growth in Dec08

If there was some bright news this week, it was that in contrast to what we are seeing in the US and UK, Australian consumer spending doesn't (yet) appear to have experienced a second leg down (some may say capitulation) in response to the financial crisis. Partly, this is because the Australian unemployment rate still remains relatively low. But we can also thank the Government's $8.7bn bonus to pensioners and families, which on our estimates boosted national household income growth by around 4ppts in Q4. Data this week showed that retail sales continued to grow in November and while official retail sales data for December is not due for another month, early partial indicators back up the positive anecdotes of a bumper christmas sales period. The weekly Roy Morgan consumer confidence survey, which rose consistently over December reached its highest level since March in the days before Christmas. And after declining in yearly terms over October and November, retail giant Harvey Norman reported sales jumped 8.7% YoY in the week to 21st December. Car sales also bounced in December, the first monthly rise since June.

To be sure, this is a one-off boost to households. We expect other parts of the economy slowed sharply in Q4 and look for household spending to experience a post-handout hangover as unemployment climbs over 2009. In the short-term however, it looks like fiscal policy has provided some welcome relief.

After a period of radical policy adjustment, we expect the RBA will now resume a more 'normal' approach to monetary policy. That is, having taken interest rates to a level that is now clearly stimulatory, the RBA will re-focus on digesting the data flow and making judgements accordingly.

At this stage, we expect the RBA will cut its official cash rate by 50bps to 3.75% in February. However this week's shocking data on the export and building sector suggests the risks are for the RBA to do more front-loading of interest rate cuts. Next week's employment result and the ANZ Job Ads series (both for the month of December) will be the key additional data points going into the Board's February meeting. As the local economy continues to slow and unemployment rises, we expect the RBA will respond with a series of 25bps cuts in March, May and August, bringing the cash rate to a new historic low of 3.0%

Data wrap

Data released in recent weeks suggested the Australian economy slowed sharply in November:

- Retail sales grew by a surprisingly robust 0.4% in November but were just 2% higher than a year ago. Ex-food, retail sales fell 1.1% YoY, the weakest outcome (excluding the impact of the GST) since the survey began in 1983.
- Building approvals collapsed by 12.8% in November, down 35% YoY.
- The International trade balance deteriorated sharply from $2.1bn to $1.4bn in November. Exports dropped 4% and imports rose 2%.
- Private sector credit growth eased to 0.4% in November. Yearly credit growth dropped to 8.2%, the weakest since 1994.
- Motor vehicle sales improved in December with VFACTS data pointing to a 6.8% rise in original terms (we estimate a 3% rise in sa terms).
- The AiG Performance of Manufacturing and Performance of Services indexes (the PMI and PSI) both improved slightly in December, although remain at extremely low levels consistent with contraction.
- The RBA announced some re-shuffling of their senior staff. Dr Philip Lowe will become Assistant Governor (Economic), replacing Dr Malcolm Edey who had been in the job for 7 years. Dr Edey in turn will take Dr Lowe's previous position as Assistant Governor (Financial System).

Interest Rate Markets: Time to hedge

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- Australian interest rates hit 40 year lows in the final days of 2008 following slumping expectations for global economic growth and inflation following the seizure of global financial markets. The Australian 3 year swap rate fell to around 3.85% and has since risen to around 4.10%.
- High grade credit spreads are contracting as risk appetite improves. In Australia this has seen some contraction in guaranteed bank paper spreads and some further contraction in swap spreads. Easing market volatility and an associated improvement in risk appetite have been key factors driving the improvement in credit markets over the past month.

Recommendation

A collapse in global interest rates and current market pricing for further significant rate cuts from the RBA over the next six months has provided an opportunity to hedge floating rate debt for the medium-term.

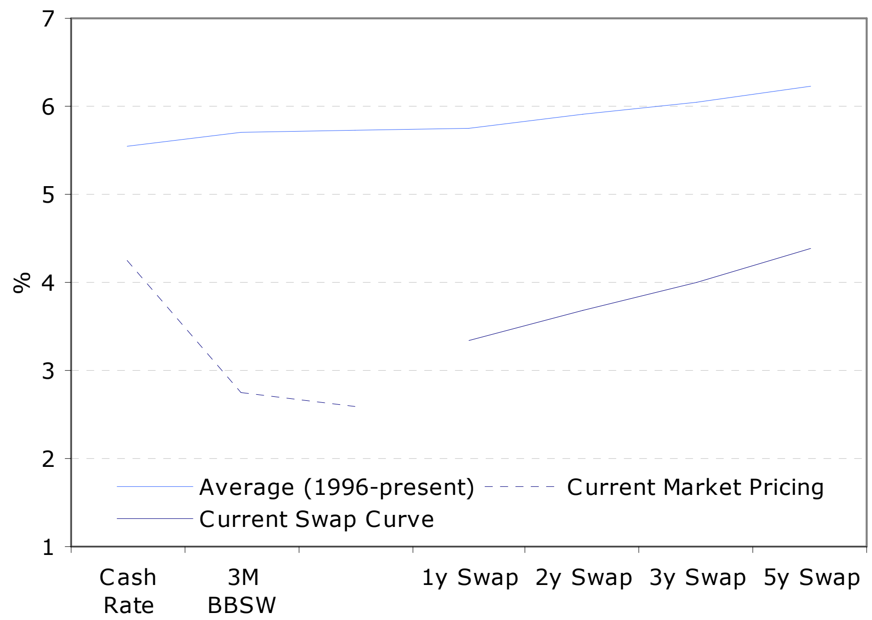
Overview

An unprecedented reduction of the cash rate from the RBA, market pricing for even more rate cuts in the next six months and a large decline in global term interest rates to multi-decade lows have put the question of when to hedge floating rate debt right back on the agenda at the start of 2009.

Although we expect the RBA to reduce interest rates further over the year ahead, the interest rate markets have factored this into term rates. The market is pricing a 100bp reduction to the cash rate at the February RBA board meeting followed by a further 50bp of cuts by the middle of the year. This implies that the term structure of interest rates (bond and derivative rates out the yield curve) has a 2.75% cash rate already factored into the current market prices.

Unless the cash rate falls well below our expectation of a 3% trough level, it is now worth locking in low levels of interest rates by hedging floating rate debt. Figure 3 highlights the point showing the current cash rate (4.25%) and market pricing for the next three months (from OIS market); the current swap yield curve out to 5yrs, and the historical average (15yrs) of the term structure.

Figure 3: Current Australian yield curve



Source: ANZ and Bloomberg

The current level of swap yields reflect the market expectation that the cash rate will fall to around 2.75% by the middle of the year. Given this aggressive pricing by interest rate markets, the opportunity to fix floating rate debt exposures has come up much more quickly than is typical in the easing cycle. Indeed, cash rates may not trough for another 12 months and the first increase in the cash rate may well be 2 years away, but that doesn't preclude locking in low term rates now given the extent to which future substantial reductions to the cash rate are already priced into term swap rates. And by locking in now, the risk that this expectation is disappointed is removed.

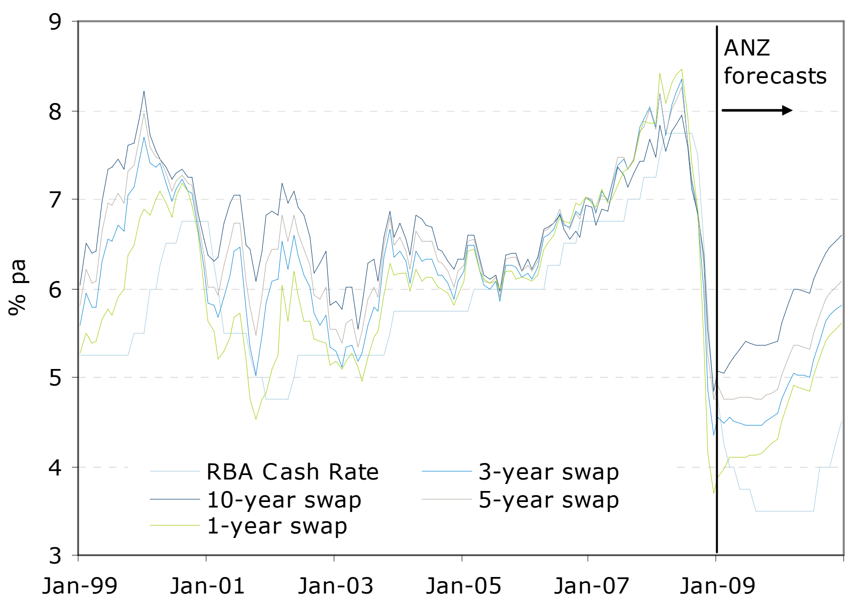
Risks to locking in current low interest rates now: The main risk to fixing debt at current levels is that term interest rates fall further. This is a distinct possibility given the severity of the financial problems plaguing the world economy and the widely held view that the worst is ahead for the Australian economy. However, the debt markets are largely factoring in a high probability of severe economic outcomes in Australia. The fact that the market is pricing in a further 150bp of RBA rate cuts provides debt holders with a buffer that economic conditions get much worse.

Some reasons to hedge immediately: Part of the reason that term rates are so low has been the decline in global interest rates. Economic recession in the US, UK, Europe and Japan has seen rates fall across the world; dragging Australian terms rate down (see chart of the week). With government bond issuance set to surge in the major markets as governments use deficit spending to put a floor under demand in these economies, the risk is that longer-term yields begin to rise. As noted above we believe this process has begun with large increases in US term rates this year despite some very weak economic data being released.

If global rates rise on the back of improving risk appetite, rising bond supply and inflation risks, Australian term rates will inevitably be dragged higher. If this does play out then the effective hedge levels for interest rates will deteriorate.

Contracting swap spreads support hedging now: High grade credit spreads have contracted around the world in the past month as investors put capital to work in high quality fixed income assets. This has helped to bring in swap/efp spreads in Australia. The 3yr swap spread, which had been as wide as 150bp at various times through the worst of the financial crisis, is now just above 50bp. This has allowed swap yield levels to fall in line with government bond yields and they are now at the lowest level seen since these markets have been developed in the past three decades. As Figure 4 shows, our forecasts for term interest rates in Australia is to drift higher over the medium-term despite some further reductions in the RBA's cash rate. This suggests that those with floating rate debt should be seriously considering various ways to lock-in low term interest rates via various hedging instruments.

Figure 4: Australian swap rates



Source: ANZ and Bloomberg

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FX: AUD and the short-term bounce

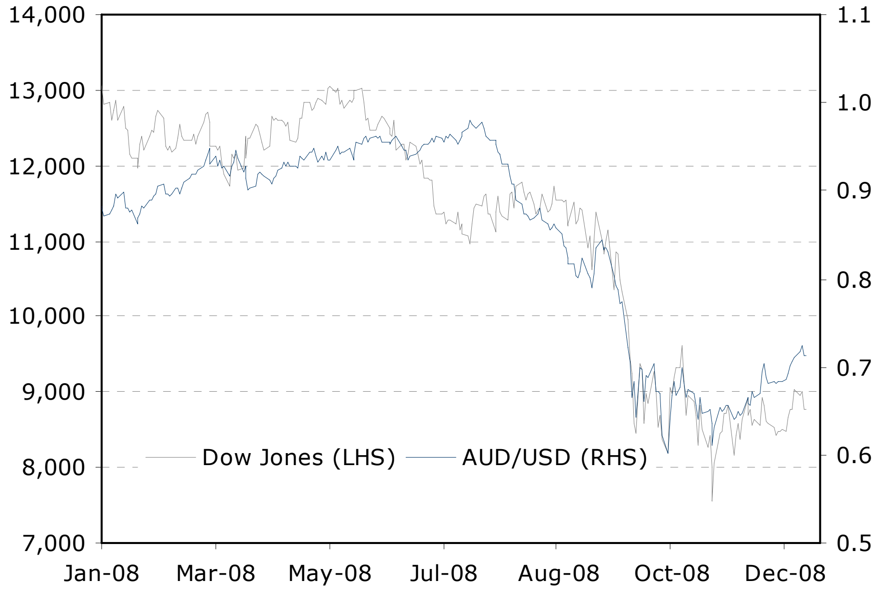
Recommendation

The AUD's seasonal strength provides an opportunity for those who are looking to purchase foreign currency. The AUD/USD may not regain this week's highs, but our forecasts anticipate the AUD will fall below 0.65 in the months ahead. The decline in the forward discount along with this rally in spot makes it an ideal time for AUD sellers to put some hedges in place.

Overview

The AUD has had a big run in early 2009, rising from a low of AUD/USD0.6738 on Boxing Day to a high of 0.7268 this week. This renewed strength is in part due to increased investor confidence, as global share markets have rallied 20% or more since their low of 20 November. However, rising risk appetite does not account for all of the AUD's strength. As shown in the chart below, the AUD's rise against the USD has been above and beyond what the relationship suggests should have taken place over the past few weeks.

Figure 4: Dow Jones has helped AUD, but other forces at work



Source: Bloomberg

Most likely, the AUD has been responding to seasonal factors that have often seen the AUD rise in January. The beginning of the year sees demand for AUD arising from investors looking to safely park their cash over the holidays as well as offshore investors putting some cash to work in Australian shares.

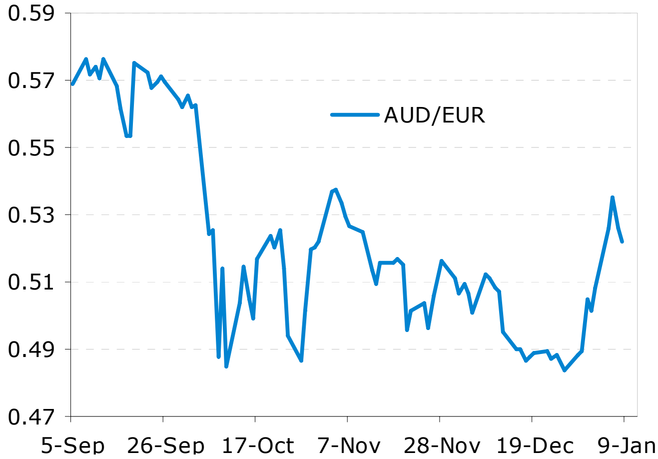
We do not anticipate that AUD strength will persist, however, with our forecasts calling for AUD/USD to fall to below 0.6500 by the end of the first quarter. There are two key drivers of AUD/USD "fair value": commodity prices; and the yield advantage offered by the AUD over the USD. ANZ projects further falls in commodity prices, and particularly for iron ore and coal contracts in 2009. The AUD's yield advantage should decline as the RBA continues to cut interest rates.

Investors' risk appetite is an important, short-term AUD driver. In the latter half of 2008, the AUD/USD traded at a discount to our estimate of fair value, as risk aversion weighed on AUD. For the past month, the AUD has been at a premium to our fair value estimate, due to seasonal effects. We anticipate that this effect will wane in the coming weeks, taking the AUD closer to fair value 0.63-0.66.

While we expect the AUD to decline, this recent rally opens the possibility for further AUD strength in the near term. Stronger commodity prices, tempered interest rate expectations or a sustained, strong equity market rally could all see the AUD reaching past 0.7350. The fourth quarter of 2008 saw a range of more than 20 cents for the AUD (AUD/USD0.6009 – 0.8020); such a wide range could easily unfold in the first quarter of 2009.

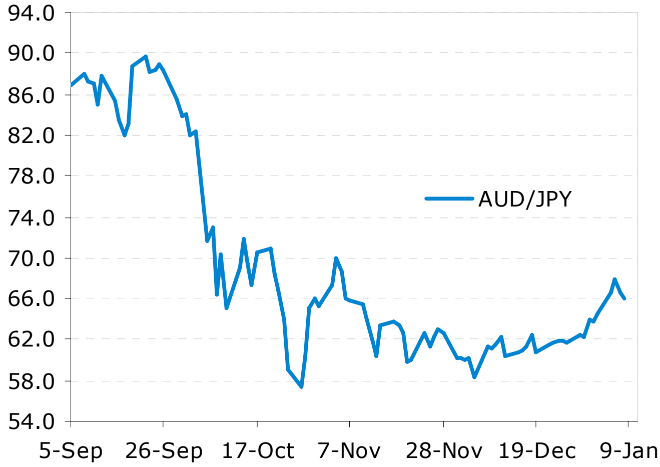
AUD/USD Key levels: 0.6950 – 0.7250. The AUD needs to get past resistance at 0.7250 and 0.7350 to reach for much greater gains toward 0.7500-7700. There is strong support just below the 0.7000 figure.

AUD cross view



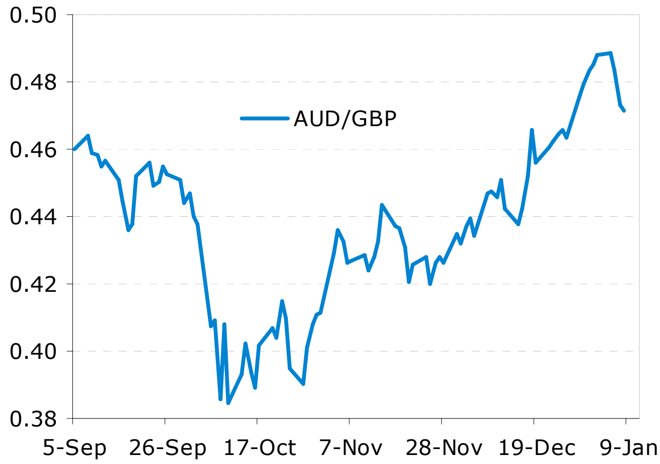
AUD / EUR Key levels: 0.5080 – 0.5270

- The recent strength of the AUD has allowed it to re-establish a more "normal" trading range versus the EUR. We expect this range to be maintained for now, until AUD weakness resumes later in the first quarter of the year.
- A break above AUD/EUR0.5270 opens up potential for a move to 0.5430.
- EUR/USD has failed at 1.40 in 2009, suggesting downside risks. The ECB rate announcement on 15 Jan could be a catalyst, with the ECB expected to cut rates by 50 bps amid deteriorating data.



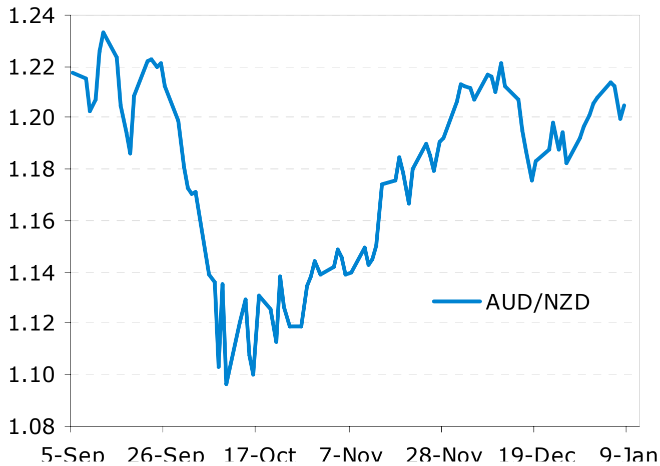
AUD / JPY Key levels: 60.30 – 68.75

- The rally in global equity markets has taken AUD/JPY well off its November low of 56.95. The Friday payrolls data out of the US and resulting equity market reaction could put the cross under a bit of pressure early next week.
- However, the Japanese markets are closed on Monday, so initial reaction to weekend news may be somewhat delayed. The machine orders data due out on Thursday could weigh on the JPY as it should confirm the manufacturing slowdown underway.



AUD / GBP Key levels: 0.4680 – 0.4960

- The AUD/GBP has had a huge run, and the fact that the 50-day moving average has crossed the 100-day moving average provides a signal that the recent strength should persist.
- The move up in AUD/GBP comes amid extraordinary GBP weakness, with GBP having reached an historic low versus EUR, and a low against USD not seen since 2001.
- The Bank of England is expected to cut its benchmark rate by at least 50 bps tonight. A larger cut could lead to more GBP weakness.



AUD / NZD Key levels: 1.1940-1.220

- The AUD/NZD is another currency pair where the 50-day moving average has crossed over the 100-day moving average. A strong base has been formed at 1.1680, but the signal from the 50-day moving average suggests that a new base of 1.1930 could hold.
- NZD/USD has rallied along with AUD/NZD, but it may be difficult for NZD/USD to extend past the technical target of 0.5998.
- Eyes will be on NZ business confidence and building approvals data next week.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008f	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	3.7	-1.0	1.4
Household consumption	4.3	2.1	0.3	1.4
Dwelling investment	2.7	0.9	-4.2	17.8
Business investment	13.9	12.4	-3.2	-4.5
Public demand	2.7	5.7	3.7	2.4
Domestic final demand	5.4	4.1	0.0	1.6
Inventories (contribution to GDP)	0.6	-0.2	-0.1	0.0
Gross National Expenditure (GNE)	5.9	3.9	-0.1	1.6
Exports	3.3	5.1	-1.5	3.1
Imports	11.4	11.8	-2.4	1.3
Net Exports (contribution to GDP)	-1.7	-1.6	0.3	0.3
Gross Domestic Product (GDP)	**4.0**	**2.3**	**0.4**	**2.1**
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	2.9	2.9
Underlying*	3.1	4.5	3.5	2.8
Wages	4.1	4.2	3.6	3.5
Labour market				
Employment (annual % change)	2.8	2.3	-0.1	0.4
Unemployment rate (%)	4.4	4.3	5.5	6.4
External sector				
Current account balance: A$ bn	-68.2	-52.0	-66.9	-83.6
% of GDP	-6.3	-4.4	-5.5	-6.6

*Average of RBA weighted median and trimmed mean statistical measures.

Australian interest rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
RBA cash rate	4.25	3.50	3.25	3.00	3.00	3.00
90 day bill	4.01	4.00	3.75	3.70	3.75	3.75
3 year bond	3.23	3.40	3.40	3.45	3.60	4.00
10 year bond	4.18	4.15	4.40	4.35	4.40	4.80
3s10s yield curve	0.95	0.75	1.00	0.90	0.80	0.80
3 year swap	4.01	4.05	3.95	3.95	4.10	4.55
10 year swap	4.53	4.65	4.90	4.85	4.90	5.50
International interest rates						
RBNZ cash rate	5.00	4.00	3.50	3.50	3.50	3.50
NZ 90 day bill	4.81	4.12	3.84	3.76	3.75	3.75
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.50
US 2 year note	0.80	0.60	0.70	0.75	1.00	1.50
US 10 year note	2.49	2.90	3.20	3.75	3.80	4.20
Japan call rate	0.10	0.60	0.60	0.60	0.80	1.10
ECB refinance rate	2.50	1.75	1.50	1.50	1.50	1.75
UK repo rate	2.00	1.00	0.75	0.75	0.75	1.00

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.

Foreign exchange rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
Australia and NZ exchange rates						
A$/US$	0.7046	0.63	0.58	0.56	0.54	0.54
NZ$/US$	0.5845	0.52	0.47	0.45	0.44	0.45
A$/¥	65.35	61.74	58.00	56.56	55.08	56.70
A$/€	0.5185	0.50	0.48	0.50	0.50	0.50
A$/£	0.4681	0.43	0.41	0.40	0.39	0.39
A$/NZ$	1.205	1.21	1.23	1.24	1.23	1.20
A$/CA$	0.8438	0.76	0.70	0.69	0.70	0.71
A$/CHF	0.7790	0.76	0.72	0.75	0.76	0.77
A$/CNY	4.816	4.31	3.98	3.84	3.69	3.69
A$ Trade weighted index	57.40	52.65	49.34	48.41	46.97	46.91
International cross rates						
US$/¥	92.7	98	100	101	102	105
€/US$	1.359	1.25	1.20	1.12	1.08	1.08
€/¥	126.0	123	120	113	110	113
£/US$	1.505	1.46	1.43	1.41	1.40	1.40
€/£	0.9030	0.86	0.84	0.79	0.77	0.77
US$/CA$	1.198	1.20	1.20	1.24	1.30	1.32
US$/CHF	1.106	1.20	1.24	1.34	1.40	1.42
US$ index	82.44	87.7	90.5	95.1	98.0	98.6
Asia exchange rates						
US$/CNY	6.835	6.84	6.86	6.86	6.84	6.84
US$/HKD	7.754	7.76	7.77	7.80	7.80	7.80
US$/IDR	10940	16000	14600	14200	13500	12400
US$/INR	48.77	50.00	49.00	49.00	48.00	48.00
US$/KRW	1323.85	1475	1500	1450	1400	1350
US$/MYR	3.529	3.60	3.64	3.74	3.80	3.80
US$/PHP	46.885	50.26	52.50	54.10	55.20	55.00
US$/SGD	1.481	1.54	1.58	1.62	1.66	1.66
US$/THB	34.92	35.80	37.60	39.40	39.40	38.75
US$/TWD	33.09	34.00	35.20	36.00	36.00	36.00
US$/VND	17477	17400	17800	18100	18500	18500
Pacific exchange rates						
PGK/US$	0.381	0.37	0.37	0.36	0.35	0.35
FJD/US$	0.571	0.53	0.51	0.49	0.48	0.48

For additional information on foreign exchange rates please refer to ANZ's *FX Weekly*

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