

# A Budget for the Rating Agencies

## New Zealand Market Commentary

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### Key points

- Government books return to surplus faster than expected, holding off a downgrade from S&P for now.
- Bond sales programme reduced, and maturities of new issuance lengthened, adding resilience to the government's funding path.
- Exceptionally strong demand for NZ long-term bonds continues, but government yields look less attractive as they near lows.
- Part privatisations generate \$5-7bn revenue and will broaden and deepen the NZ equity market.
- Private sector savings encouraged through KiwiSaver changes; onwards to \$25bn by 2015.

### **An Austere Budget in Extraordinary Circumstances**

On Thursday 19 May, the NZ Government presented the 2011 Budget. This was a Budget set against the extraordinary circumstances of the Christchurch earthquakes, financial bailouts, and the European sovereign debt crisis.

Before the Budget, John Key and Bill English had hinted strongly that it would be focused on expenditure control, with one eye on the approval of the rating agencies.<sup>2</sup> But the Budget still managed to contain a surprise by forecasting the fiscal accounts to return to surplus by the 2014/15 fiscal year (a year earlier than most expected) and keeping net debt below 30% of GDP (Charts 1 and 2).

In response, NZ 10 government bond yields fell around 5 basis points to 5.10%, well south of the 5.50-5.75% range they have occupied over much of 2011.

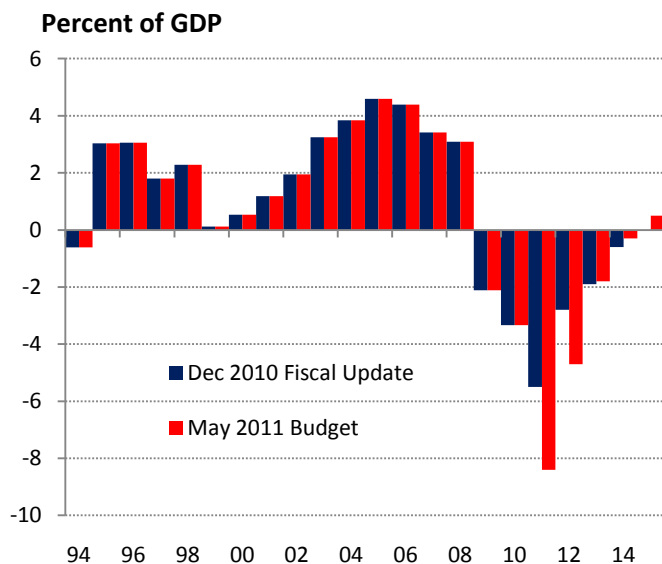
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<sup>1</sup> Thanks to input from Mark Brown, Andrew Bascand and Darryl Briggs.

<sup>2</sup> See for example, <http://www.stuff.co.nz/business/budget-2011/5014646/Meeker-bond-sales-possible>

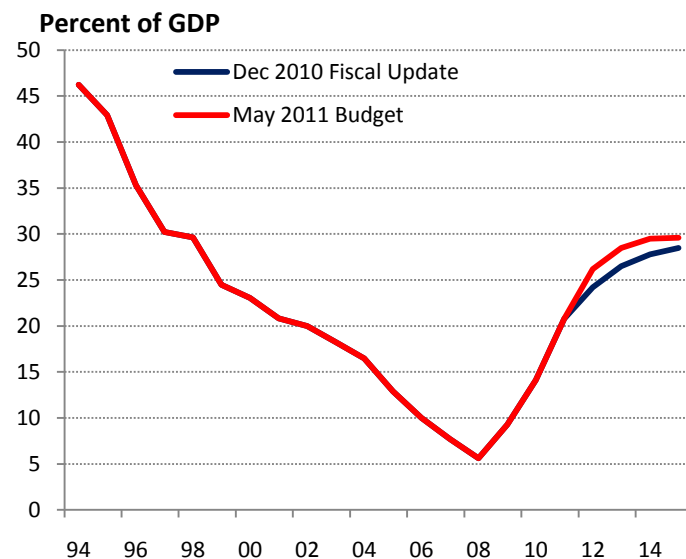
Some market commentators questioned whether the Treasury’s economic growth forecasts were a bit overly optimistic. But they were broadly in line with the many local bank economists. So on balance the NZD rose as a sign of confidence in a “realistic and fiscally responsible” Budget.

**Chart 1: NZ government deficit/surplus**



Source: NZ Treasury

**Chart 2: NZ government net debt**



Source: NZ Treasury

The speed of the return to fiscal surplus is one factor that has enabled the government to reduce the size of its debt issuance programme over the next four years by \$2.5bn to \$43bn. The amount borrowed will drop from a run rate of \$380mn per week to \$100mn per week in 2012.

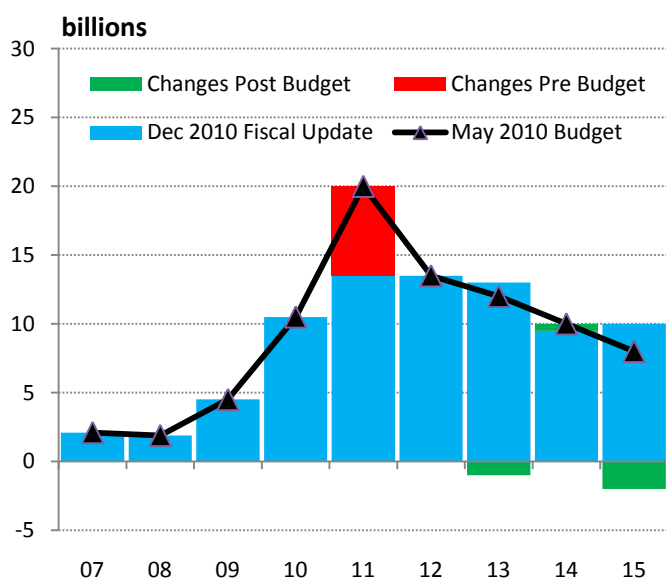
### Feeding the Ducks While They Quack

The other factor that has enabled the issuance programme to be reduced is the record amount of pre-funding to date this year.

The 2010/11 issuance programme was continually revised through March and April from \$13.5bn to \$20bn (Chart 3), leaving the government with record cash balances. Much of this extra issuance was in direct response to exceptionally strong demand from foreign investors, attracted to NZ government bonds by their relatively high yields and high sovereign credit rating. Indeed, record issuance over 2011 has been met by record demand via bids in Debt Management Office (DMO) tenders (Chart 4). They have effectively been ‘feeding the ducks while they quack’, reducing the need for more funding later.

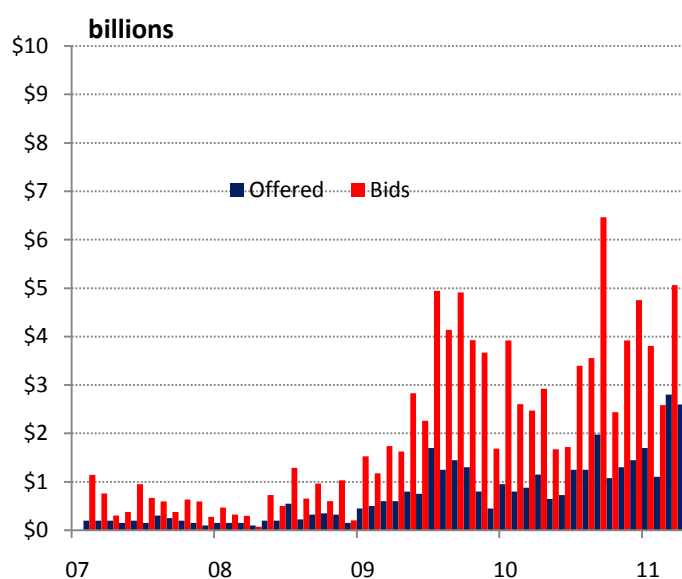
Taking advantage of these supportive conditions, the government also announced a number of new initiatives with the Budget that will all lengthen the maturity of NZ government debt: launching a new 2023 maturity bond (longer than the current 10 year benchmark); underlining their commitment to new 2025 maturity inflation-linked bond; and increasing the tranche sizes of existing government bonds over 5 years to maturity. All of these measures reduce rollover risk facing the government, and help put the government finances on a sounder footing.

**Chart 3: Bond programme (annual)**



Source: NZ DMO

**Chart 4: DMO auction results (monthly)**



Source: NZ DMO

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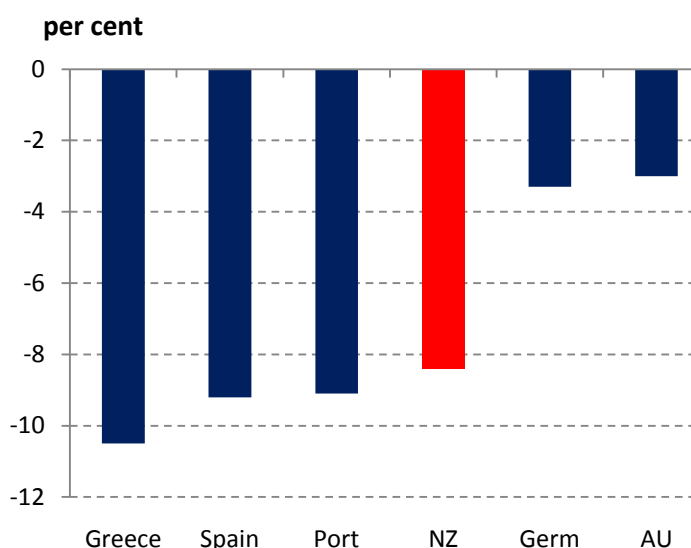
Following the Budget, S&P announced that the NZ government’s rating was unaffected, but that it would remain on negative outlook.

While the NZ fiscal situation deteriorated in recent years (Chart 5), by international standards it looks less ugly than many other countries. In particular, New Zealand started the GFC with a relatively low level of government debt to GDP (Chart 6). By keeping the net government debt to GDP below 30%, the strategy of this government is to keep foreign investors and rating agencies at bay, and so retain the capacity to borrow more later if times get bad. (The key risk here is a sharp slowdown in China that stalls NZ’s commodity-led recovery.)

But S&P’s main concern is New Zealand’s net external liabilities (public sector and private sector combined) that stand at over 80% of GDP and rising. So long as the government is assumed to stand behind the private sector, its credit rating will

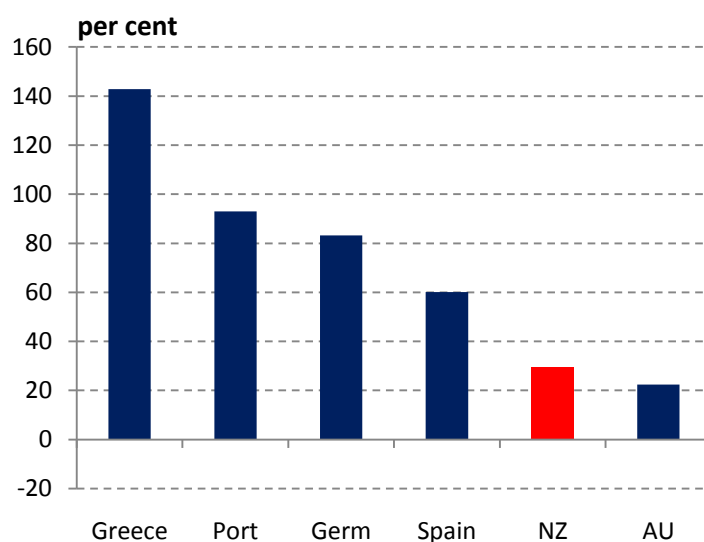
largely be driven by the debt positions of NZ households, businesses and financial institutions. Given this vulnerability will take some time to work down, even by the Treasury’s own forecasts, the NZ government could remain on negative outlook with S&P for some time yet.

**Chart 5: Fiscal deficits to GDP**



Source: Eurostat and NZ Treasury

**Chart 6: Government debt to GDP**



Source: Eurostat and NZ Treasury

Even if New Zealand was downgraded one notch by S&P, in absolute terms the government’s rating remains high by international standards. It would be a differentiation in degrees of excellence (Table 1).

**Table 1: Credit rating assessments**

Country	Local currency rating			Foreign currency rating			Ratings outlook		
	S&P	Moody	Fitch	S&P	Moody	Fitch	S&P	Moody	Fitch
NZ	AAA	Aaa	AAA	AA+	Aaa	AA+	NEG	STABLE	NEG
Australia	AAA	Aaa	AAA	AAA	Aaa	AA+	STABLE	STABLE	STABLE
Germany	AAA	Aaa	AAA	AAA	Aaa	AAA	STABLE	STABLE	STABLE
Greece	B	B1	BB+	B	B1	BB+	--	NEG	NEG
Ireland	BBB+	Baa3	BBB+	BBB+	Baa3	BBB+	STABLE	NEG	NEG
Japan	AA-	Aa2	AA-	AA-	--	AA	NEG	NEG	STABLE
Portugal	BBB-	Baa1	BBB-	BBB-	Baa1	BBB-	NEG	--	--
Spain	AA	Aa2	AA+	AA	Aa2	AA+	NEG	NEG	NEG
UK	AAA	Aaa	AAA	AAA	Aaa	AAA	STABLE	STABLE	STABLE
US	AAA	Aaa	AAA	AAA	--	AAA	NEG	STABLE	STABLE

Source: Bloomberg.

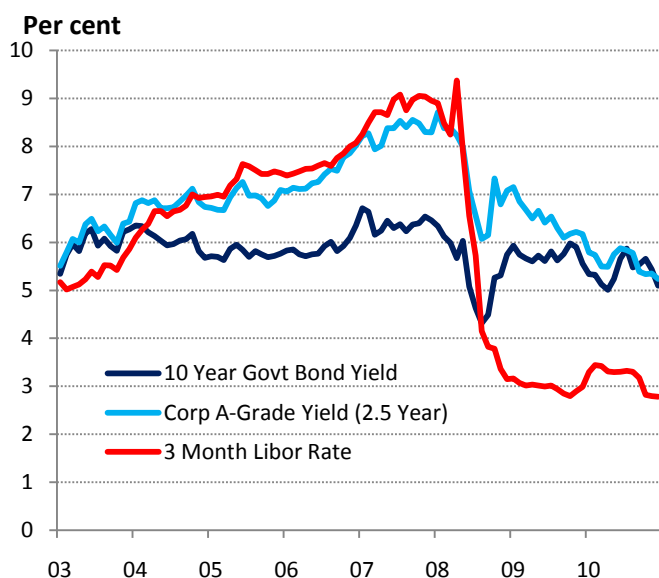
## Interest Rates Have Fallen a Long Way

At the margin, the tighter fiscal policy announced in the Budget affords the RBNZ time to remain in wait-and-see mode, before raising short-term interest rates. Reflecting this, short-term rates remained well anchored after the Budget, and the market is still picking the RBNZ to stay on hold until the end of the year.

For much of this year, NZ 10 year government bonds have been the most attractive point on the yield curve, when compared against both NZ short-term interest rates (Chart 7) and US long-term interest rates (Chart 8). The reduction in the bond programme announced in the Budget will bring further confidence, by reducing the risk that yields need to rise sharply to absorb heavy government bond issuance.

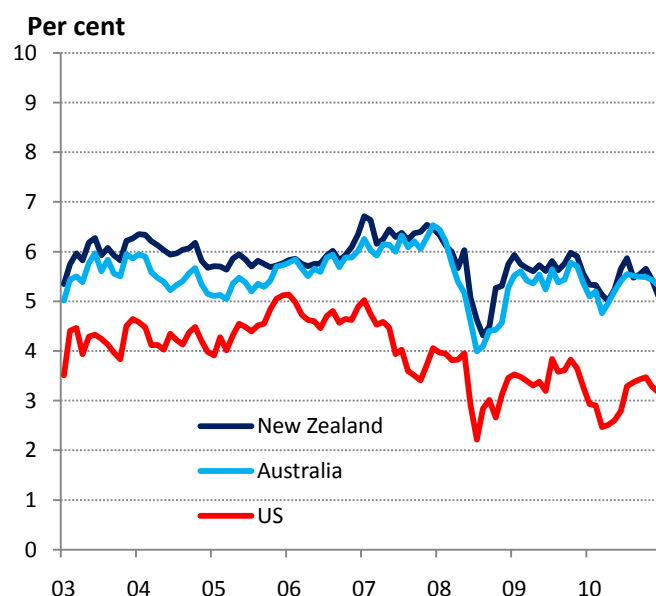
However, NZ 10 year yields have already fallen significantly over the month, down 40 basis points to 5.10%, well south of the 5.50-5.75% range seen earlier in 2011. While the fall in yields may retain some post-Budget momentum, as the NZ and global economies eventually recover, long rates are more likely to be drawn back to their centre of gravity around 5.50%. So at current levels other choices along the yield curve are beginning to look more attractive, such as shorter-maturity corporate and local authority bonds that are less sensitive to duration risk.

**Chart 7: NZ interest rates**



Source: Bloomberg

**Chart 8: 10-year govt bond yields**



Source: Bloomberg

## **Equity Market: Scope For Stronger Profit Results**

Budgets rarely have any immediate equity market implications other than those implied by movements in interest rates, bond yields and the currency. And so it was for the 2011 Budget, with the larger policy elements all pre-announced or expected by the equity market.

To the extent that this Budget is seen to be credible, then the overall NZ equity risk premium may trend lower. To the extent that this "fiscally responsible" Budget allows private sector growth, rather than crowding out the private sector, then this Budget paints a path that the market can believe in. However, there is little in terms of new bold initiatives to spark real productivity growth; perhaps they come in the next term of Parliament?

A more important trend for the equity market is the outlook for NZ economic growth. The early signs are promising, especially in Auckland, but increasingly in the regions. With strong commodity prices, Rugby World Cup and the rebuilding of Christchurch, the path of growth looks stronger than that of the past 2-3 years. If GDP forecasts in the Budget prove right, we may be set for a sequence of stronger profit results in the next few years.

In terms of market reaction, it may be the case that some market participants were looking for a further update on progress with the Ultra-Fast Broadband initiative, and may have been disappointed on the day, with Telecom down about 3% in an otherwise buoyant day for equity markets.

## **KiwiSaver and Part Privatisation: Deepening Capital Markets**

The Government's resolve to seek a mandate for their "mixed-ownership-model" in the November election provides a key focus point for policy direction. To the extent that these part privatisations of the SOEs happen, the local equity market is significantly deepened and investment choice for savers is improved.

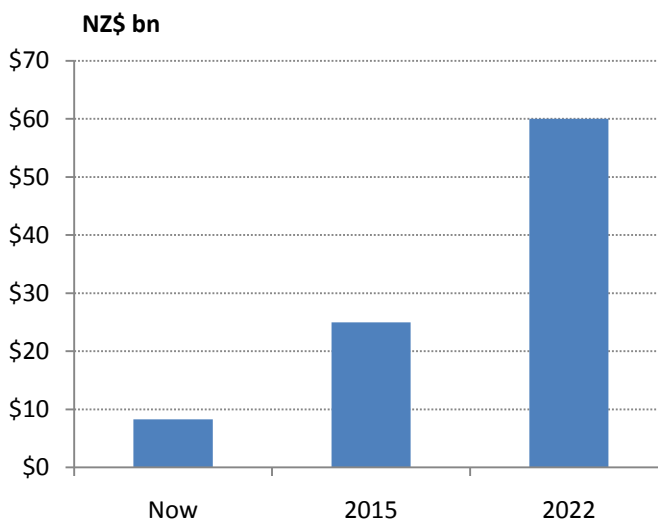
The other longer term feature of the 2011 Budget is the proposal to lift both employee and employer KiwiSaver contributions to 3%. While the media might focus on the halving of Government's KiwiSaver tax credit, the true longer term story is that there is a very strong financial imperative to build New Zealand's private savings culture. We think that this step is a logical progression for KiwiSaver that also will serve to deepen New Zealand's capital base for both retirement savings and for productive investment.

### Chart 9: KiwiSaver is Changing

	Gross Salary	Employee Contribution	Employer Contribution	Member Tax Credit	KiwiSaver Savings
Now	55,000	1,100	1,100	1,040	3,240
	100,000	2,000	2,000	1,040	5,040
From 2013	55,000	1,650	1,361	521	3,532
	100,000	3,000	2,010	521	5,531

Source: NZ Treasury

### Chart 10: KiwiSaver Funds



Source: PriceWaterHouseCoopers

Note individuals will also receive the \$1,000 Government Kickstart

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