

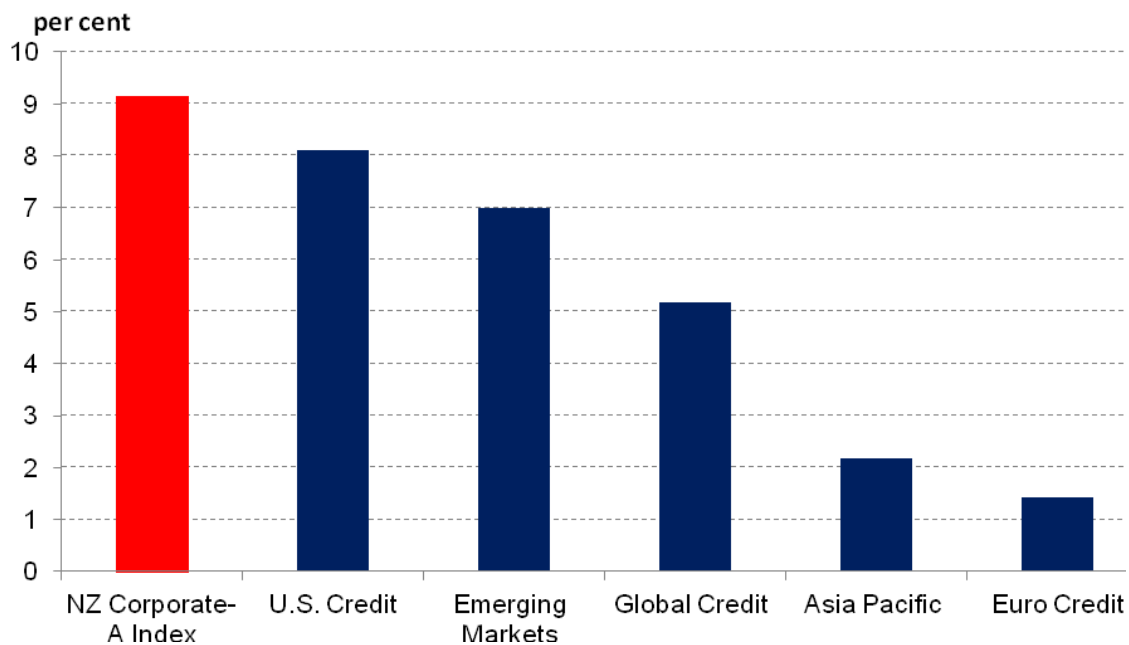
NZ Credit: A Top Performer in 2011

New Zealand Fixed Income Monthly Commentary

17 January 2012 | Christian@harbourasset.co.nz +64 4 460 8309

- NZ credit was a top performing asset class globally in 2011.
- Global credit markets deteriorated mid-year, faced with the European sovereign crisis and the US macroeconomic slowdown.
- NZ credit markets remained oddly insulated until November, when credit margins widened sharply as domestic issuance picked up.
- While the backdrop in 2012 remains challenging, wider credit margins are available to investors, especially on issuers in the financial sector.

Chart 1: Annual Returns on Selected Bond Indices



Source: NZX and Barclays Capital

Returns on the NZ Corporate A-Grade Index outstripped other major credit indices in 2011. The running yield on the index was supplemented by the capital gain from fall in prevailing market interest rates.

A Year that Started Well

Through the latter half of 2010, asset markets had been buoyed by the efforts of authorities to kick start markets and economic activity after the GFC. In particular, the US Federal Reserve's program of Quantitative Easing (QE), had given markets a new confidence.

Moving into the first half of 2011, this fillip continued with global share markets rising and credit spreads slowly narrowing as the economic outlook looked to be improving. Indeed, the greatest worry of commentators over the first half of 2011 was that the system might be getting a little too much stimulus, creating an inflation problem to be dealt with somewhere down the track.

In New Zealand, the only variation on this story came through the impact of the Christchurch earthquake in February. In response, the RBNZ judged that it was appropriate to cut official interest rates by 50 basis points to 2.5% as an insurance measure to help shore-up business and consumer confidence. In NZ credit markets this caused reset securities¹ trading on the NZDX to underperform in the early months of the year.

However, apart from that exception, conditions were reasonably strong in both NZ and global credit markets in the first half of 2011. Perhaps the best illustration of this comes from the Australian iTraxx Index, which captures the credit margin on the 15 most traded Australian corporates. This index remained within a remarkably stable range of 100-120 basis points from January to June 2011

Chart 2: Australian iTraxx Credit Index



Source: Bloomberg

¹ The simplest form of reset security is the Floating Rate Note, where the coupon is typically reset every 3 months. In NZ there are a variety of forms of reset securities on issue, including where the coupon is reset annually or even once every 3 or 5 years.

A Dramatic Change in Global Credit Markets

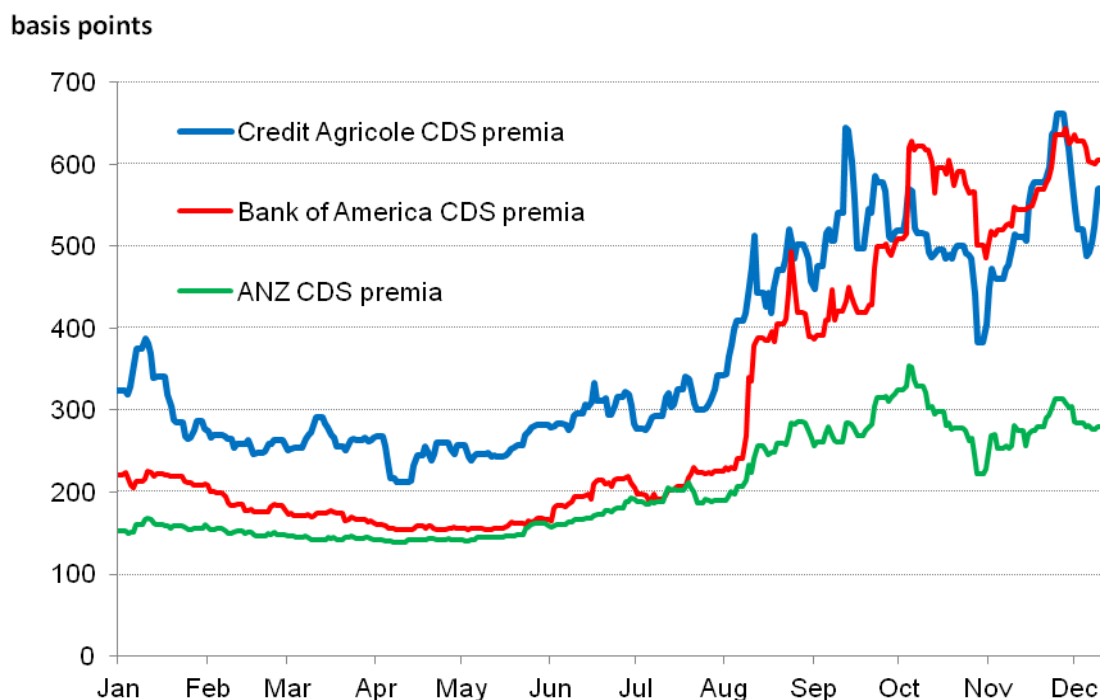
The global outlook changed dramatically by the middle of the year.

By late July, cracks were starting to show in the efforts of the European authorities to deal with the sovereign debt crisis which had started in 2009 in the small periphery countries of Greece, Ireland and Portugal. Indeed, there were doubts that it could even be contained in the periphery, as worries about Spain and Italy grew.

At the same time, US macroeconomic data started to disappoint so much so that the conversation changed from concern that there was too much stimulus, to worries that authorities needed to act quickly to do even more. The final straw came on 5 August with Standard & Poor's downgrade of the US sovereign rating from AAA. This caused a panicked rush out of any 'risky assets' into traditional safe havens. And, given the lack of alternatives, US Treasuries were (ironically) the main benefactor.

In global credit markets, the financial sector was the worst hit by this rapid flight to safety. Financial institutions were the most exposed to an economic slowdown, and their direct holdings of European sovereign debt put them at risk from a disorderly sovereign default. Given the interconnected nature of the global financial system and fresh memories of the GFC, very few European or US banks were given the benefit of the doubt, and their credit spreads widened sharply.

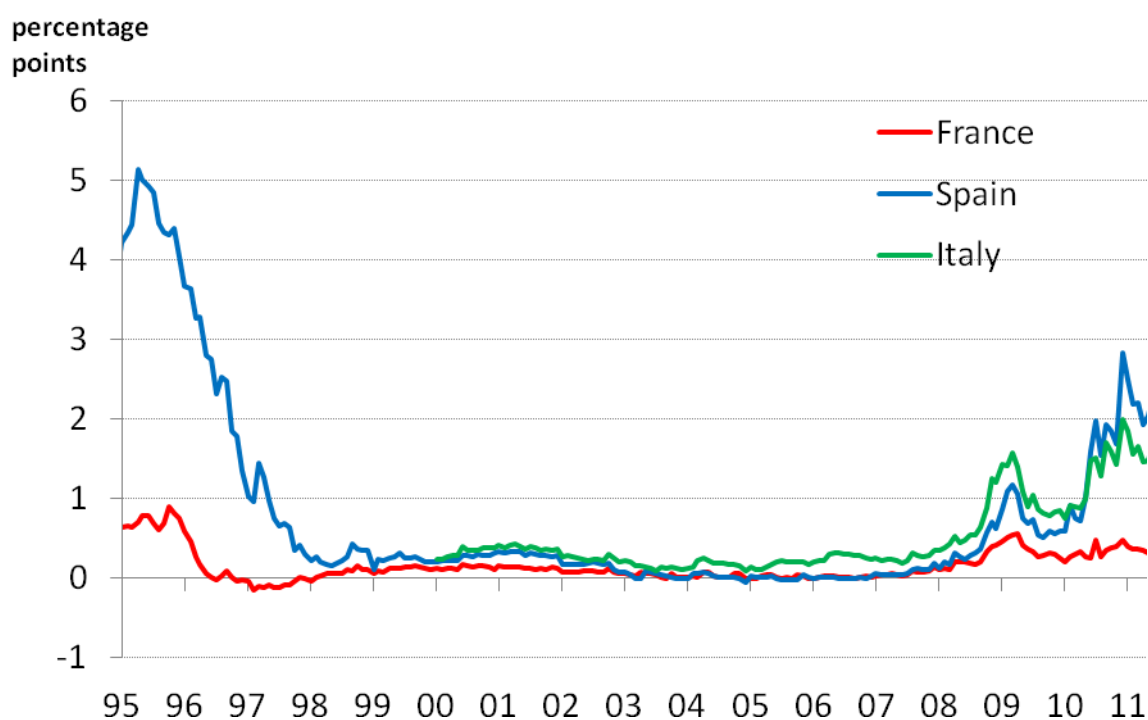
Chart 3: Individual Bank CDS Premium (sub-debt)



Source: Bloomberg

However, the most dramatic development was probably within the sovereign debt market itself. It started behaving like a credit market with much greater differentiation between the perceived credit worthiness of individual countries. This was most stark in Europe, which leading into the introduction of the euro in 1999 had undergone a convergence towards the bond yields of all governments moving into line with the 'risk free rate' benchmark of Germany. In 2011, this unravelled violently leaving the dispersion between European countries back where it was before the euro. By the end of 2011, Germany and the US were two of a small group of sovereign states not trading like credit.

Chart 4: 10 Year Government Bond Spreads to Germany



Source: Bloomberg

NZ Credit Oddly Insulated (well, at least the beginning)

Initially, through July to October, the NZ credit market was oddly insulated from what was happening in the rest of the world, with credit spreads only moving very marginally. With the NZ economy and corporate balance sheets remaining in relatively good shape by global standards, the NZ credit market could remain a bystander at first.

Nevertheless, by early November, time had run out for NZ credit.

The first main catalyst was a downward revision in the path of the RBNZ official cash rate. Until November, the market had been expecting the RBNZ to slowly remove its insurance cut made in February. But by November, the situation in Europe looked so dire that the market began to factor in the chance that the RBNZ would indeed need to cut official rates even further below 2.5%. This caused a further deterioration in the pricing of reset securities trading on the NZDX, which are most sensitive to prevailing official rates.

As global markets became increasingly nervous, new issuance in global credit markets in Europe and the US ground to a halt. NZ corporates who had been accessing funding from these markets turned back to their home market. So, after a dearth of local issuance in the first half of 2011, there was **a flurry of NZ corporate bond issuance in November and December**. To absorb this increase in supply, credit spreads on these new issues were marked wider, creating a new reference point for the local market. Indeed, this new issuance also drew investors out of reset securities trading on the NZDX, leaving this part of the market with an additional body blow and trading at a large discount.

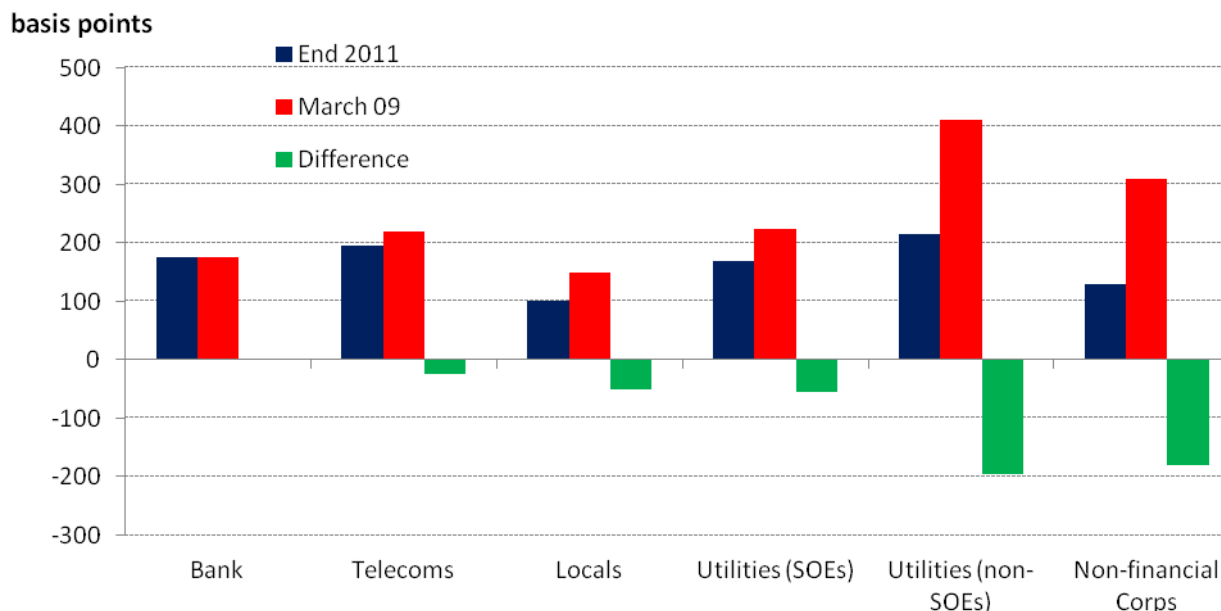
Where to From Here?

Going into 2012, global credit markets face many of the same challenges as 2011.

The US economy is still in a recovery phase from the post-GFC recession. More worryingly, the European sovereign crisis is still playing out, and there is likely to be more stages to this drama in months to come. However successful policy makers are in stemming the crisis, macroeconomic growth out of Europe is likely to be subdued in 2012.

For investors, these ongoing challenges need to be weighed against the attraction of wider credit spreads, as compensation for investing in credit.

Chart 5: NZ Credit Spreads by Sector* – End 2011 vs GFC



Source: BNZ Corporate Portfolio and ANZ Credit Focus

* Approximate 5 years to maturity. Sector proxies: Banks=ANZ, Telecoms=Telecom NZ, Locals = Auckland City Council and Dunedin City Treasury, Utilities (SOEs) = Meridian and Mighty River Power, Utilities (non-SOEs) = PowerCo, Non-Financial Corps = Fonterra.

In the NZ credit market, so far spreads on long-maturity senior bank debt have moved out the most. Indeed, credit spreads on these securities are now as wide as the levels they reached during the height of the GFC. By contrast, spreads on other sectors have to date lagged behind the move in financials. For example, a AA-rated ANZ Feb 2016 bond is trading with a credit margin of around 175 basis points, compared to just 100 basis point for a AA-rated Auckland City Council May 2015 bond or 130 basis points for a A-rated Fonterra March 2016 bond.

While financial sector spreads may be most vulnerable if European sovereign crisis intensifies and spins out of control, at these elevated levels they are already factoring-in a lot of bad news. Whereas, credit spreads on corporates and local authorities may have scope to widen further if credit markets remain strained well into 2012.

For those reset securities trading on the NZDX, their outlook is dependent on both the health of the individual issuers and the return of liquidity to this market. While some European bank issuers to this market are trading at a deep discount, their fortunes will be closely linked to the resolution of the European sovereign crisis. Other reset securities trading at a discount are more reliant on a general improvement in liquidity and expectation that the economic outlook is robust enough for interest rates to beginning heading north to more normal levels.

In short, for investors it is an environment to move carefully into more attractively priced credit opportunities, and to retain a relatively cautious approach until there is further evidence that policymakers are fundamentally addressing the challenges facing markets and economies.

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