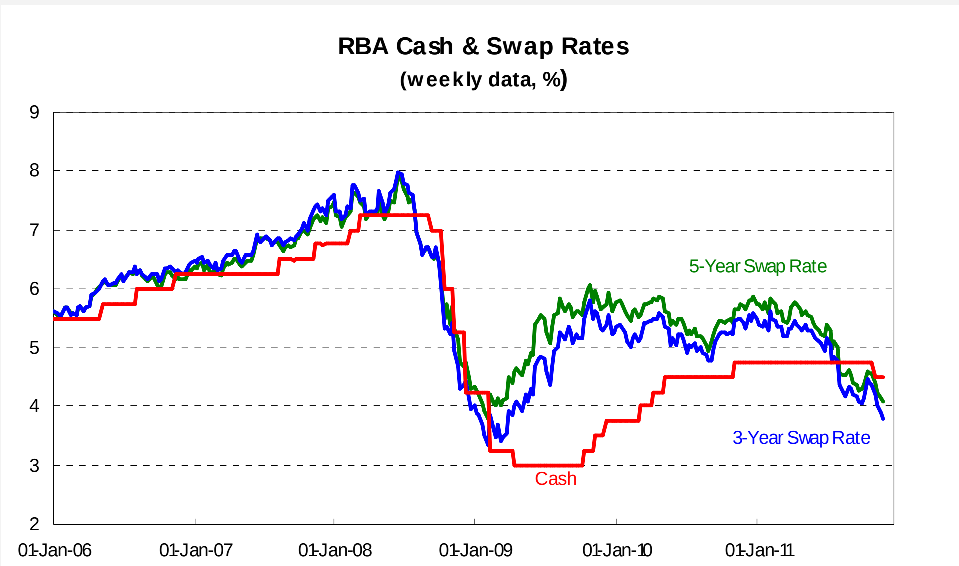
INTEREST RATE UPDATE

An Opportunity for Borrowers

Thursday 24 November, 2011

- **Downside risks to the European sovereign debt crisis are increasing; funding pressures are growing and contagion has hit Italy, Spain and France.**
- **As Europe continues to deteriorate the risks will grow for a deeper or longer easing cycle from the RBA, which could include a rate cut as soon as December. Much will depend on how Europe plays out and here uncertainty is high.**
- **Swap rates have fallen a long way in recent months. The uncertainty over Europe means that while swap rates could revisit the 2009 lows, there is also a good possibility that they will not revisit these lows or breach below these lows.**
- **Swap rates are pricing in a GFC-type scenario where the RBA cash rate will fall to 3% next year. While a scenario as nasty as the GFC cannot be fully ruled out, we believe that swap rates at these levels are attractive. So we believe now is a good opportunity for borrows to consider hedging some of their interest-rate exposures.**



The Reserve Bank (RBA) cut the cash rate on November 1 by 25bp to 4.50%. The low underlying inflation outcome of 2.50% for the September quarter (published in October) allowed the RBA to cut rates at a time when the global backdrop was darkening.

The sovereign debt crisis has been growing and is leading to an ongoing deterioration in the world growth outlook. Earlier this year worries centred on Greece. But the number of countries under pressure and in the spotlight is rising. Further, the growing list of countries includes larger borrowers like Italy.

We flagged earlier this year that it was crucial European policymakers and leaders contained the crisis in Greece in order to stop the contagion spreading to bigger countries like Italy and Spain. It has not happened. It increasingly looks like Europe have done too little, too late, and the contagion is spreading. The downside risks to the European outlook and sovereign debt crisis are growing and appear significant.

The 10-year bond yields of Italy, Spain and France remain elevated. Stresses in funding markets are growing. These stresses in funding markets are evident in Europe and there are also some signs of stress outside of Europe. For example, the three-month spread between the Euribor

and Overnight Indexed Swap rates has risen to nearly 100bp, from as little as 25bp earlier in the

year – highlighting that funding in the European short-term money market has become more costly. At the height of the global financial crisis (GFC), this spread breached 200bp. Lending by European banks has also been pared back. At this stage, it is modest but the fear is there will be a deeper pullback if the crisis keeps expanding.

Not surprisingly then risk aversion remains heightened and is a theme that is likely to be dominant over the next few months.

The sovereign debt crisis has been brewing for some time but escalated in early August 2011. Since this time, there has been strong demand for Australian Commonwealth government bonds, which has seen prices rise and yields decline. Downgrades to the world growth outlook and a massive flow of funds towards the safety of government bonds have underpinned this demand for Australian government bonds.

Swap rates have also fallen a long way. Australian 3-year and 5-year swap rates have fallen from near 5.40% and 5.45%, respectively, at the end of June this year to around 3.80% and 4.25% at the time of writing. These swap rates are not far from the lows recorded during the worst of the GFC; the lows for the 3-year and 5-year swap rates during the height of the GFC were 3.34% and 3.81%, respectively (refer to chart).

The level of current swap rates reflects pessimism over how Europe will play out. It also reflects market expectations that the RBA will cut rates aggressively in coming months as it did in the wake of the GFC.

Indeed, financial markets are currently pricing in a cash rate of 3% from the RBA by the middle of 2012 (from the current cash rate of 4.50%). The RBA last took the cash rate to 3% during the GFC and did not leave rates at this emergency rate of 3% for long. So essentially financial markets are expecting something similar to the GFC to be played out again or something as nasty as the GFC in nature.

There are factors to support the argument that the world financial system and economy should hold up better this time round. These factors are (i) regulation is tighter around the world since the GFC (ii) sovereign debt instruments are simpler and more easily understood compared with structured products during the GFC (iii) company balance sheets are generally stronger (iv) most banks of any significant size in the advanced economies have gone through stress tests and understand their exposures better unlike during the GFC when exposures were generally poorly understood.

However, the hands of policymakers' in many advanced countries are tied with traditional policy mechanisms like monetary policy limited because benchmark cash rates are very low (UK: 0.50%, US: 0.25%, Eurozone: 1.0% and Japan 0.10%) and governments are grappling with huge levels of debt.

So we cannot fully rule out a scenario as nasty as the GFC playing out, especially given the lack of a co-ordinated swift policy response to the growing crisis to date. Further, in an environment where conditions in Europe are deteriorating it might be hard for financial markets to unwind their RBA cash-rate expectations significantly so in the short term.

Our core view is that the RBA will follow up with at least one further cut in the next few months. The Board left the door open for further rate cuts on November 1 by not describing the policy stance as now neutral but as being at "a more neutral setting". It won't take much more easing to get to neutral. But as Europe continues to deteriorate the risks will grow for a deeper or longer easing cycle from the RBA, which could include a rate cut as soon as December.

Whether one entertains a GFC-type scenario being played out or not, swap rates at these levels are very attractive.

Uncertainty remains high about the European sovereign debt crisis, especially as predicting the outcome for Europe involves predicting what the political response will be of its member States. The uncertainty means that while swap rates could revisit the 2009 lows, there is also a good possibility that they will not revisit these lows or breach below these lows. So we believe now is a good opportunity for borrows to consider hedging some of their interest-rate exposure.

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