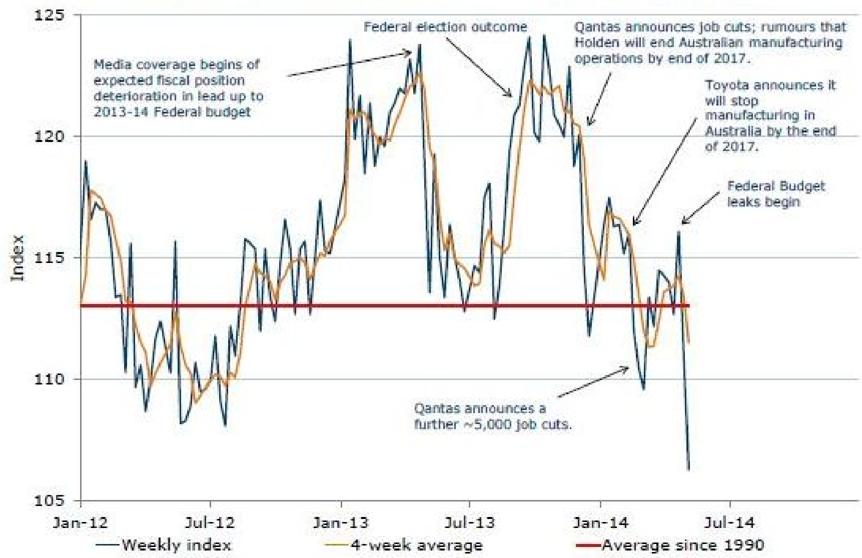
Interest Rate Outlook - May 2014

Dear << Test First Name >>,

Stamford Capital is pleased to provide a commentary on the interest rate outlook from our strategic partner, Russell Maisner, principal of Global Treasury Risk Management Pty. Ltd.

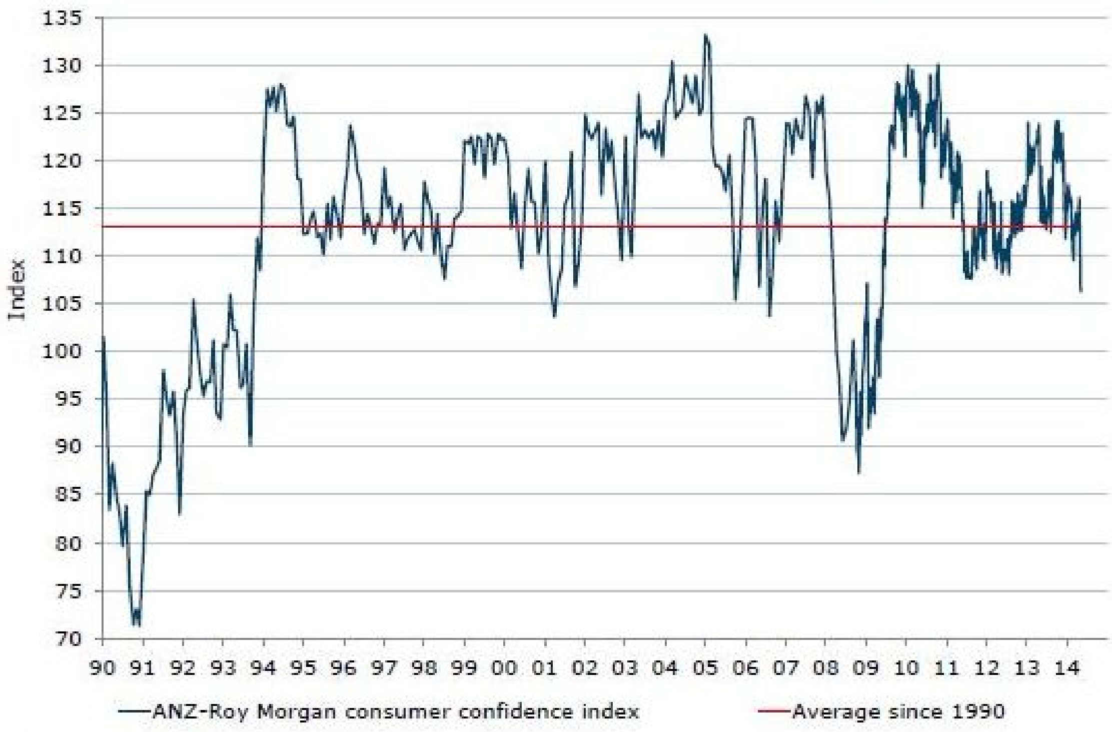
As we head into the federal budget with a conservative government at the helm, it would appear that the strategy of leaking bad news of fiscal restraint and austerity measures are having an impact on consumer sentiment at least. The Weekly ANZ - Roy Morgan consumer confidence survey has taken a 4% drop in a week and an 8% nose dive over the past fortnight.

FIGURE 2. WEEKLY ANZ-ROY MORGAN CONSUMER CONFIDENCE



Source: ANZ-Roy Morgan

FIGURE 3. WEEKLY ANZ-ROY MORGAN CONSUMER CONFIDENCE



Source: ANZ-Roy Morgan

Having respect for the volatility in these indicators, makes drawing out any long term decisions of investment, debt, asset holding, etc, with a degree of caution around their significance. Of slightly more concern is the index drop below the long term average. The strategy of the government using the sledge hammer approach of leaking heavy handed fiscal restraint news prior to the budget release, is likely to see the reality of more moderate spending cuts, although still significant, upon its actual release next Tuesday. This should make us all feel better about the measures of austerity to go forward and perhaps even see a reverse of the above index over the pursuing period.

It is likely that the RBA will therefore have a more moderate role to play in regards to controlling inflation and asset prices. As has been identified in recent press, the major cities are experiencing some moderation in pricing of real estate with the exceptions being the inner city and affluent fringe suburbs. It would appear that the consumer is not feeling any great positive wealth effects which would add to the containment of inflation.

We read with interest that inflation is the scourge of economies and as soon as inflation hits the upper band of the RBA's inflation target, the central bank gets an itchy trigger finger to raise rates – perhaps so. Another interpretation is that inflation can be indicator of an economy growing and should not be feared if the underlying inflation is within targeted ranges and can be identified and analysed as to where it is emanating from. Nevertheless, professional markets will always anticipate where the next movement in rates is likely and all forward expectations currently are for the next move to be upwards.

There do not appear to be any headwinds on the horizon that can derail the Australian economy at the moment, even though the boom halcyon days of commodity prices have abated, there is still and will continue to be an overwhelming appetite for our resources from Asia. Recent travelers to China only need to witness the massive development of a growth economy. Whilst the headline GDP number of China's economy is down, i.e around 7% growth, the Chinese economy is a lot larger than it once used to be.

Interest Rates – where to next?

Market weighted probability of a rate cut or increase as at 6 may 2014	
Date	**Probability of 25 bpt cut**
Jun-14	>5%
Aug-14	8%
Nov-14	>5%
Dec-14	>5%
Mar-15	68%
May-15	52%
Aug-15	96%

AUD Implied Cash Rate - 6 May 2014		
Date	**Rate%**	**Adjustment**
Jun-14	2.50	0.00
Aug-14	2.48	0.00
Nov-14	2.51	0.00
Dec-14	2.52	0.00
Mar-15	2.58	+0.08
May-15	2.62	+0.12
Aug-15	2.735	+0.235

Clearly not a lot of expectation of any cash rate movement until August 2015 by the professional market, but as it has been identified, it can all change quite quickly on the back of data releases and event driven outcomes. In researching bank's market divisions and client activity, it is apparent that there is no perceived risk by clients and therefore little desire and motivation to address any interest rate exposure.

The table below is a snapshot of mid market swap rates, with a distinct bias of steepening as maturity tenor increases.

Swap Rates as at 6 May 2014 - Bloomberg		
Maturity	**Basis**	**Yield-mid**
1 YR	Q/Q	2.69
2 YR	Q/Q	2.86
3 YR	Q/Q	3.04
4 YR	S/S	3.32
5 YR	S/S	3.51
7 YR	S/S	3.85
10 YR	S/S	4.18

The following two graphs highlight the relationship between cash, the 3 year swap rate and the historical averages over a 5 and 10 year period.

6/5/14 -5 year history chart 3 year swap, 3 mth BBSW, RBA cash rate

6/5/14 - 10 year history 3 year swap, 3 mth BBSW, RBA cash rate

Salient Points:

- The cost of carry has increased, being the spread widening between the 3 year swap rate and BBSW. It now sits at around 40 bpts excluding any credit and other margins.
- Over the 5 & 10 year history, the swap rate average has been above the cash rate, but the current rate of 3.06% is below both historical averages still – It is not too late to take some fixed rate cover.
- It is our experience that when lower rates are not locked in, that clients tend to punish themselves for missing out on those lower rates by not acting at all.
- It is our view that rates will rise, but not for some time. To use an analogy of a bath tub shaped movement upwards, i.e it will be long and slow.
- Fiscal restraint will assist the RBA in containing inflationary pressures.
- This does not mean that the market will steepen the curve, well ahead of any official increase in rates.

- A recent review identified, that the two year swap was in the lowest 3.5% percentile it had traded over the past 10 years. This means that in 96.5% of the time, the rate has traded at higher levels.
- Market expectation is for the next move in interest rates to be higher. There is little support across the yield curve of any further reductions at this time.
- There are ways of taking out alternative interest rate cover by using optionality collars, which won’t be as effective a hedge if rates do rise, but conversely, may be structured to eliminate the cost of carry between BBSY and the contractual 3 year rate that may be fixed.
- Our view is that the AUD is likely to trade up towards .9700 and then reverse down to circa .8280 next year. This is a macro view based upon technical factors, not fundamentals.

Stamford Capital would be delighted to discuss any of your risk management requirements.

With regards,
Russell Maisner

Global Treasury Risk Management

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