20 July 2012

- **Demand for LGFA bonds is high from domestic investors**
- **Spreads have narrowed notably for LGFAB17s**
- **Further spread compression will likely be limited until global participation increases**
- **Though rising term rates we expect next year could assist spread narrowing**
- **We see spreads as closer to the bottom than the top of their trading range**
- **A 50bps spread to Government benchmarks still looks a bit of a stretch, in our view**

Five successful tenders after the inaugural auction its time to revisit the outlook for Local Government Funding Agency (LGFA) bonds.

How are things tracking?

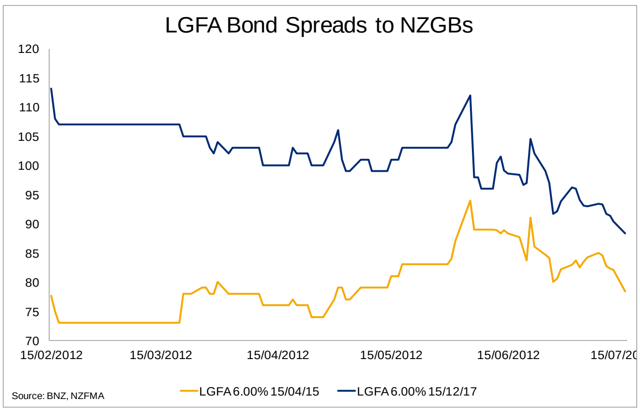
After last week's tender there are now $980m of LGFA bonds in issuance across three maturities; April 2015, December 2017 and March 2019.

Already, the LGFA has almost reached its initially stated goal of having NZ$1b of issuance in its first year. While the pace of issuance will likely now slow, it is still probable the first year will see NZ$1.3 –$NZ1.5b of total issuance.

Issuance ahead of schedule has been a result of both supply and demand dynamics. Member council interest has been greater than anticipated. Fifteen of the signed up eighteen borrowing entities have made use of the facility to date.

Going forward, council participation is expected to broaden. Up to another 25 councils have expressed interest in using the facility. The majority look to uptake membership at the next intake round, in coming months. All potential members will need to meet the eligibility criteria set out in the LGFA financial covenants.

In addition, solid investor demand (tenders have received an average 4.5x bid-to-cover ratio), and lower yields have acted as a positive feedback loop to borrowers.



Lower LGFA yields are the result of two factors; (i) declining 'term' rates over the period. (ii) some narrowing of spreads. Spreads for LGFA 2017s relative to Government bonds have narrowed notably since launch. Spreads for the LGFA 2015s have been more stable.

Tenders have been running on a 5-6 week schedule, and this is likely to remain the case for the foreseeable future. It provides the necessary balance between meeting borrower demand and building liquidity in tranches, but not swamping the market with supply.

Who is buying them?

While precise data are not available, it is our understanding the vast majority of LGFA bonds have been bought by domestic investors. There is a small global presence.

LGFA 17s have seen the greatest issuance. There is now $0.6b outstanding. We believe they are widely held by fund managers and prudential books and are actively traded.

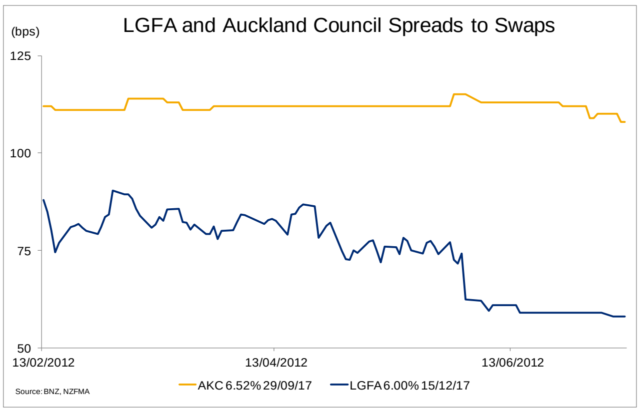
We suspect the smaller tranche of LGFA 15s is mostly held by bank prudential books, attracted by the LGFA bonds' low capital risk weighting and low repo 'haircut'. The haircut assigned to LGFA bonds by the RBNZ has now been confirmed at 6%<3-years and 8% >/= 3-years.

Instrument (bonds)	Rating	RBNZ required cover factor *maturity* < 3 years	RBNZ required cover factor *maturity* >/= 3 years
NZ Government	AA+	1%	3%
Kauri SSAs	AAA	3%	5%
Local Authority	AA- to AA+	8%	10%
LGFA bonds	AA+	6%	8%

Source: RBNZ

The LGFA 19s have seen only a very limited number of successful bids at auction. We believe these bonds are quite tightly held by investors with the need for long-duration assets. Until tranche size builds, therefore. low turnover will likely remain.

Pricing developments



It is clear that price discovery has diminished as tenders have progressed. Early tenders saw successful bid ranges from 5-30bps. In the past couple of tenders this range has narrowed to 1-2bps, more in keeping with results in Government bond tenders.

LGFA bond spreads to swap have narrowed independently of moves in spreads of individual local authority bonds, or generic credit spreads.

Since inception, the correlation of weekly moves between swap spreads for LGFA bonds and other credits/local authorities bonds has been quite low (e.g 16% for Auckland Council 2017s and 22% for ASB 2017s).

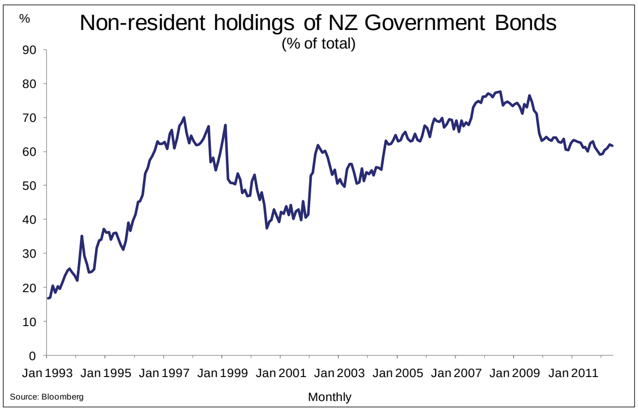
		Rating (S&P)	Issue	Yield	Spread to Swap
SSA	KBN	AAA	May-17	3.86%	83
	Munifin	AAA	Oct-18	4.36%	111
	EIB	AAA	Dec-17	4.45%	133
	IFC	AAA	Dec-17	3.45%	33
NZ Bank Covered	BNZ	AAA	Jun-17	4.57%	152
Bank Senior Bond	ASB	AA-	Jun-17	4.87%	183
Local Authority	Auckland City Council	AA-	Sep-17	4.15%	106
Corporate	Transpower NZ	AA-	Nov-18	4.58%	131
	Fonterra	A+	Mar-16	4.15%	129
LGFA	LGFA	AA+	Dec-17	3.72%	60

The appropriate reference for LGFA pricing remains open to debate. It is our view that as the market matures we will see spreads to swap increasingly used as the point of reference. Local authorities have historically been priced in this way. It is also used by many participants in pricing Australian semi-Government bonds.

On this basis, LGFA 17s now trade well inside NZ bank bond spreads, whether covered or senior *(see table above).* They also trade some way narrower than the local authority benchmark, Auckland Council.

LGFA bonds also trade well inside certain European Agencies given obvious concerns for their respective sovereigns. Spreads however, sit outside those for non-European Agencies, such as the IFC, whose name is in high demand given its relative 'safe haven' appeal.

Further tightening of LGFA spreads would be supported by (i) continuing search for yield in a low yielding world (ii) increasing tranche size and liquidity (iii) improving familiarity with the instruments and secondary trading (iv) greater global investor participation.



However, until the pool of global investors increases, further compression of LGFA spreads may be limited. Non-residents hold 62%of NZ Government bonds, suggesting (i) potential demand is greater for NZGBs relative to LGFAs (ii) demand for NZGBs will be more driven by global factors. This is important in a low yield environment globally, where NZ bonds benefit from their relative 'safe' and relatively high yield.

When LGFA bonds do become more widely held by global investors, valuation comparisons with Australian semi-Government bonds will also become a useful reference point. Until then comparisons to NZ swaps and bonds are more appropriate.

Attracting global investors

Establishing global participation in the LGFA market will be helped a number of factors. Firstly, increased tranche size and liquidity. Secondly, direct targeted marketing of the product off-shore by the LGFA.

Thirdly, the proposed addition of a '10-year' LGFA bond benchmarked to NZGB 23s. This could help demand, in that it is a recognised point on the yield curve global investors use as a point of comparison. However, the LGFA is unlikely to launch a LGFA 23 bond until the NZGB 23s becomes better established as the new '10-year' bond. In addition, it would want to see greater liquidity in LGFA19s is already established.

Attracting domestic investors.

Retail investor participation is likely to remain limited while outright yields on LGFA bonds remain low, given low term rates. Irrespective of spreads to swap, a 3.72% (current) yield on a LGFA 17s finds it hard to compete with retail 5-year deposit rates.

However, conservative retails investors who are buyers of NZGBs, even at current yields, may see LGFA bonds as providing an attractive yield pick-up at limited extra risk.

Demand should remain strong from fund managers and prudential books. But here, reference to related alternatives such as Auckland Council will always remain relevant. Switching potential will remain high if LGFA-Auckland Council spreads become too pronounced.

The way forward

All up, the LGFA's first six months has been a success on many fronts, in terms of issuance, borrower demand, investors demand and spread narrowing. LGFA bonds are still some way from the espoused goal of trading within 50bps over Governments bonds within their first couple of years (currently 88bps). To us, this still looks like a potential stretch for 2012/2013.

As the LGFA market matures it remains to be seen if these bonds trade as pure credits in the NZ market, with performance more highly correlated with moves in corporate and local authority bonds.

However, as previously discussed, in out note *"NZ Credit Spreads and a Rising OCR", 30, March 2012,* we anticipate that a rising OCR next year and rising term rates will be accompanied by some narrowing in credit spreads. i.e. investors have more of the 'required yield' satisfied through term rates. This could also assist in tighter spreads for LGFA bonds.

However, we believe spread compression will be limited until global participation increases. It will also be limited by related Auckland Council spreads. For now, we see spreads as being closer to the bottom than the top of their expected trading range relative to swap.

Credit Market News

Westpac New Zealand priced its NZ$235m 7yr fixed rate issue at 5.61% or swap+205bps. The issuer printed NZ$385m of the FRN at BKBM+185bps bringing the total to NZ$620m.

Auckland Council tapped its March 2016 for NZ$50m at swap+97bps.

Unrated issuer Z Energy has taken NZ$135m in its firm book build. The 7.25 year par bonds have been set with a coupon of 6.50%. The issue size caps out at NZ$150m and is now available to the public.

The AA/A-1+ (outlook neg) credit rating of Rabobank New Zealand Ltd was withdrawn and then reinstated at the entity's request – the same rating as unconditional guarantor Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A. (Rabobank Nederland).

Asian Development Bank issued a new NZ$250m 3.25% 5 year Kauri at swap+30bps.

The LGFA had its fifth tender, issuing just NZ$10m of 4/15s and NZ$135m of 3/19s. The 4/15s went well below market at swap+43bps although the weighted average of unsuccessful bids was swap+51bps. The 3/19s came with a 3.8x bid to cover and issued at a weighted average of swap+71bps across two bids.

Telstra announced the sale of Telstraclear (itsNZ operations) to Vodafone for NZ$840mn.

Moody's downgraded Italy to Baa2 from A3 stating "Italy's near-term economic outlook has deteriorated, as manifest in both weaker growth and higher unemployment, which creates risk of failure to meet fiscal consolidation targets. Failure to meet fiscal targets in turn could weaken market confidence further, raising the risk of a sudden stop in market funding".

Westpac printed US$2bn of new 3yr covered bonds overnight across two tranches (US$1.5bn fixed and US$500mn FRN). The deal priced at ms/3m Libor +80bps.

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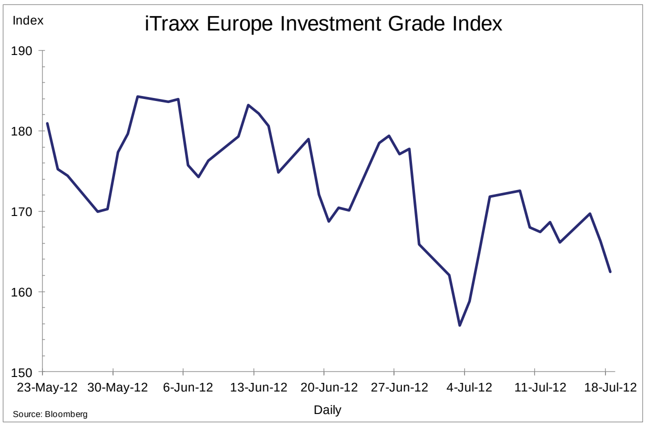
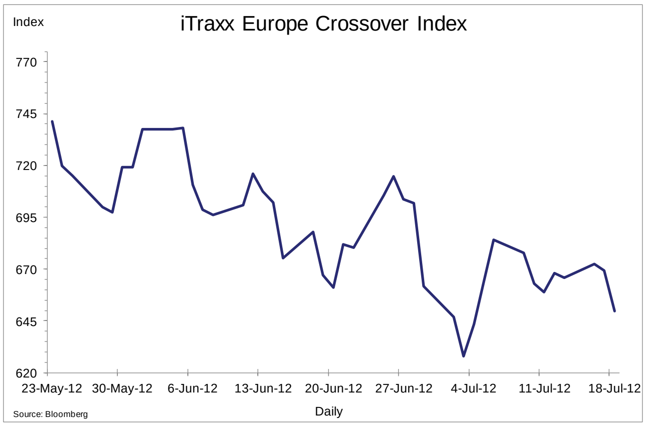
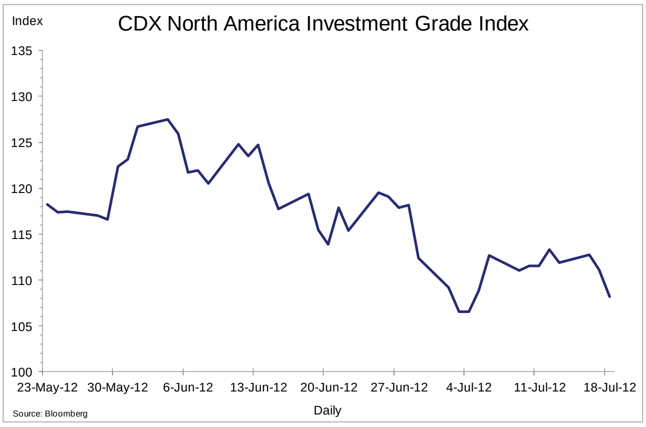
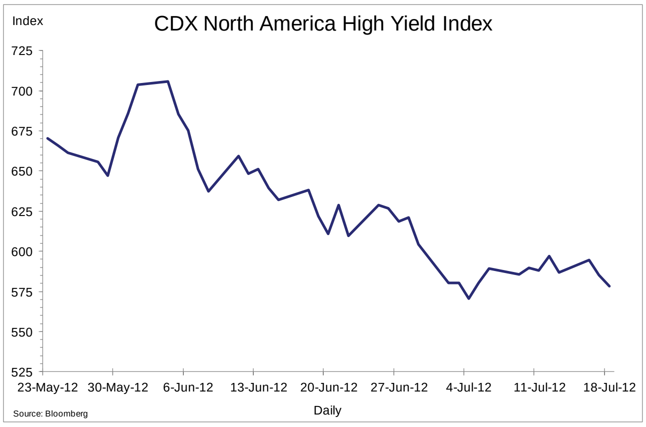
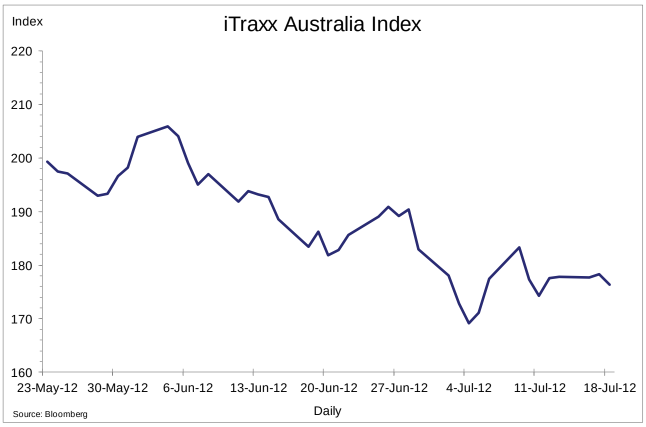
Global Credit Indices

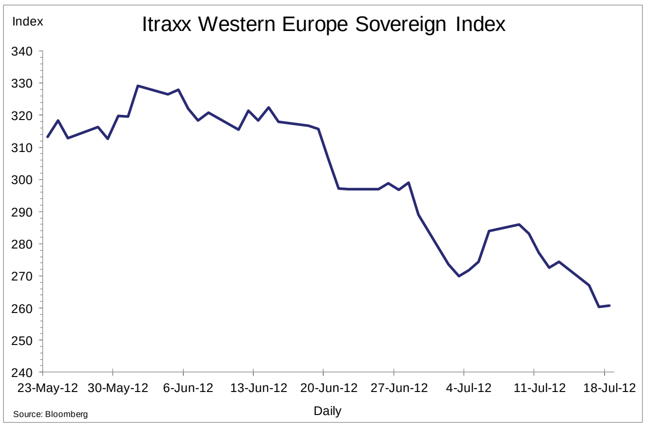












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