The next ten years may be a low interest rate environment

Interest rates in New Zealand continue to be low relative to the levels experienced a decade ago. As a result, the returns for the immediate future from cash assets while being positive, will be well less than normal. Returns from bonds over the medium term are also likely to be low, but should be higher than cash though there is a risk, should interest rates rise to their "normal" levels, that the return from bonds over the shorter periods (e.g. over a month) are negative.

With this low interest rate environment, the investment strategy in the next few months, for the assets an investor wants to be managed conservatively, should probably favour bonds over cash. We believe that even though rates are low, the above average "gap" between cash rates and longer-term bond yields compensates an investor for the consequences, if the longer term interest rates rise.

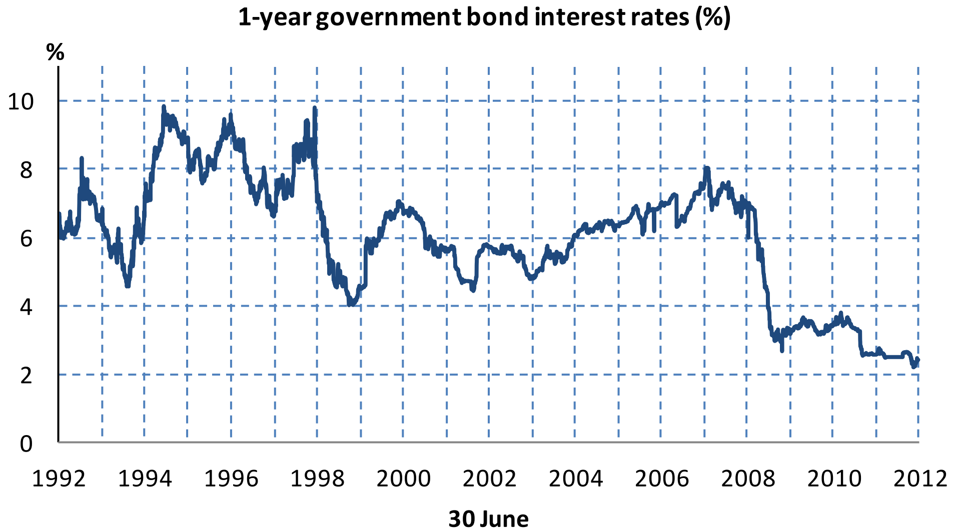
We would therefore keep the cash assets to the minimum level an investor feels comfortable with, but keep sufficient cash to cover expected expenditure over the next 6 to 9 months. We expect that the return on these assets will be lower than normal and probably lower than bonds. However, we believe that the management of risk is more important over the very short-term.

Short-term rates

For the last three and a half years, the interest rates on 1 year government bonds have been under 4% (see chart 1). By the time tax is taken off, this left investors with little protection against inflation as the average inflation rate for the same period was 3.0% p.a.. The 4% is also low, relative to history.

Over the last 22 years, the 1-year rate has averaged 6% to 6.5%. During this time, inflation has averaged 2.4% p.a. meaning that the 1-year interest rates have provided a good real return. The rates have been:

Chart 1



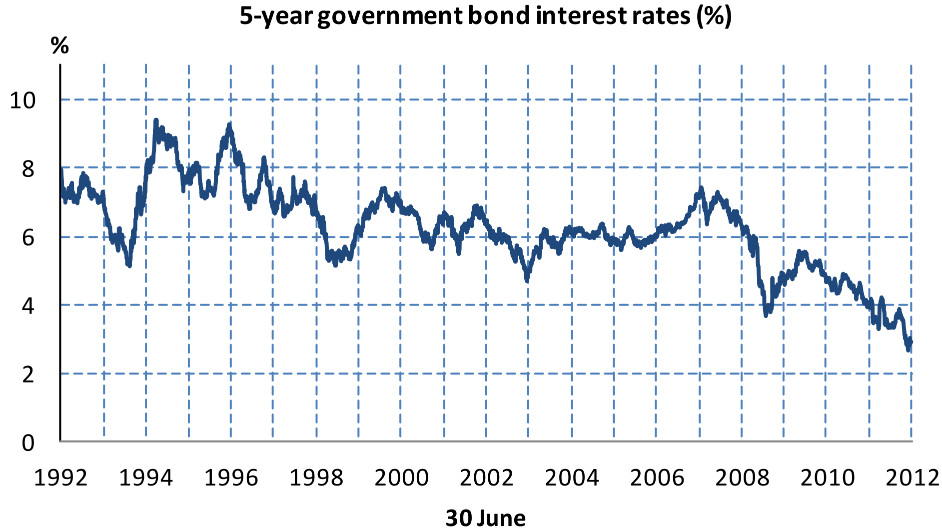
With current rates below 4%, we expect cash assets to generate a relatively low return for the next few years.

In part, the fall in the 1-year rates reflects the changes to the official cash rate and the general fall in inflation, and also the global uncertainty and the demand for perceived safety. In a normal environment going forward, we expect 1-year bonds to be around 5.5% to 5.75% but they will be unlikely to reach these levels in the next few years.

Longer term rates

The interest rates for longer periods (e.g. 5 years) have also fallen, but not to the same level.

Chart 2



Until the early 2000's, the 5 year rate was generally above 6%. Since then it has oscillated around the 6% level and, more recently, fallen well below 6%. This fall is not as fast as the fall in short-term rates, leading initially to an increasing gap between the two.

Chart 3

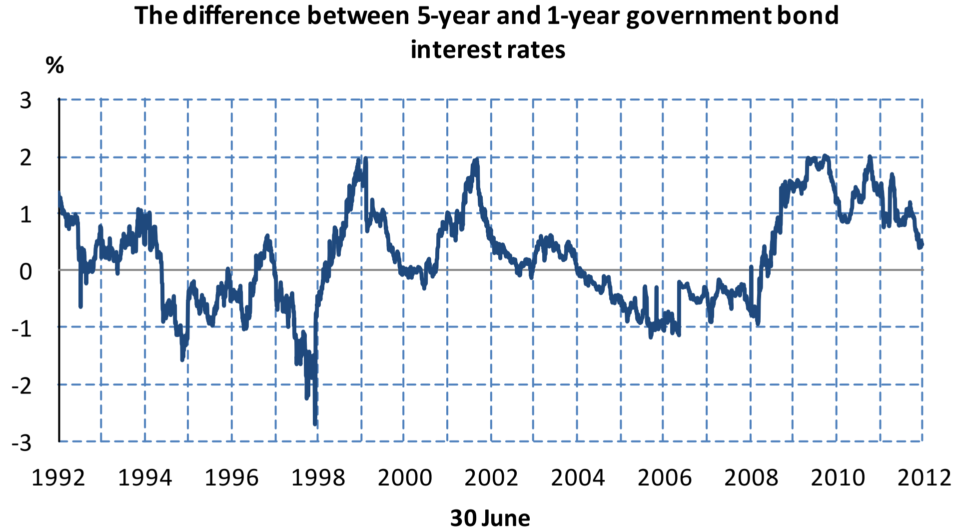
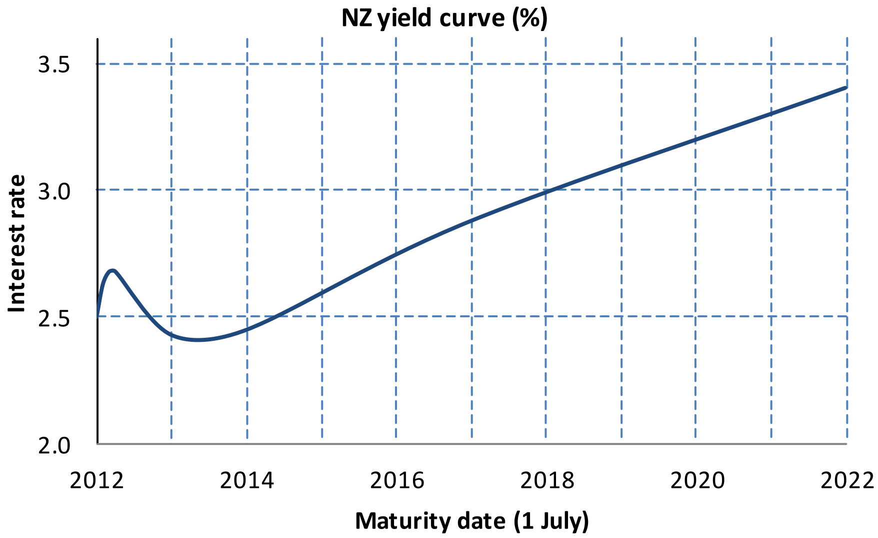


Chart 3 plots the 5-year rate less the 1-year rate. It highlights that the gap between the two normally varies between -2% and +2% and has averaged just over zero. However, in recent times, the gap has been at the higher end and in the +1% to 2% range. This provides greater returns for those willing to tie their money up for periods longer than 1 year. This is also confirmed by looking at the implied future 1-year rates.

Typical future cash rates

The current New Zealand interest rates at, each duration, are in chart 4. If a 10-year bond is bought (maturity date 1 July 2022), the yield is approximately 3.4% p.a..

Chart 4



If the yield curve is efficient, the implied short-term interest rate in 2017 will remain below 4%.

Assuming that the current yield curve provides a reasonable prediction of future interest rates, it means that to get the yields indicated by the above yield curve, the future average 1-year rates in the periods shown will be:

1 July to 30 June periods	1-year rate
2012/2013	2.43%
2013/2014	2.47%
2014/2017	3.17%
2017/2022	3.94%

The implied rates are the future rates required, when combined with the current 1-year rate (2.43%), to give the correct average rate on yield curve.

Given the implied cash rates, and given the current yield on the SuperLife NZ bond portfolio, we would expect bonds to provide a clear return advantage relative to cash over the next few years, if not 5 years. How long the advantage stays will depend on future government policy decisions and global events.