ANZ Australian Economics Weekly

Markets begin to price in global recession

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Inside:

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Our Vision:

For Economics & Markets Research to be the most respected, sought-after and commercially valued source of economics and markets research and information on Australia, New Zealand, the Pacific and Asia.

Economic Update

- The global credit crisis deepened further this week and the swings in financial markets have been savage.
- In a week of unprecedented events in markets, global central banks responded in unprecedented ways. We have seen a co-ordinated global central bank easing of monetary policy and governments taking more active roles in the banking sector.
- All eyes now turn to the G7 this weekend in the hope that a further co-ordinated global response will be forthcoming. The government backing of balance sheets now looks vital to restoring investor confidence and the normal flow of funds.
- In slashing interest rates by 1% on Tuesday, the RBA has sought to pre-empt the pain in the financial system from causing a deeper slowdown. Unfortunately, the downside risks facing this economy continue to mount.

Market wrap

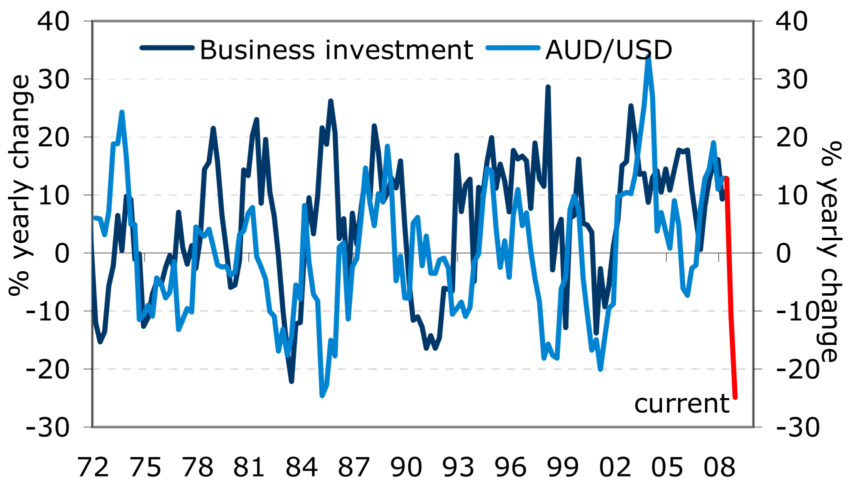
- An eventful week that saw a coordinated cut in interest rates by both major global central banks, as well as a 100bps cut by the RBA. However, under the spectre of the global credit crisis short term money markets remained under extreme pressure, the AUD hit US$0.6451 and global and domestic equity markets plummeted.

Coming up

- **ANZ Job Ads (Sep)** (Mon 13th Oct, 11:30 AEDT).
- **NAB Business Confidence & Conditions (Sep)** (Tues 14th Oct, 11:30 AEDT).
- **International Trade Prices (Q3)** (Friday 17th Oct, 11:30 AEDT). F: Export prices +7.8% QoQ, Import prices +1.9% QoQ

Table of the week

The risks to Australian business investment are mounting



Source: ANZ and ABS

Economic Update

Coming up

- **ANZ Job Ads (Sep)** (Mon 13th Oct, 11:30 AEDT).
- **NAB Business Confidence & Conditions (Sep)**(Tues 14th Oct, 11:30 AEDT). With the credit crisis persisting, stocks plummetting and global economic growth beginning to slow, we anticipate that the NAB indicators will continue to tell us that the outlook is bleak for business.
- **International Trade Prices (Q3)** (Friday 17th Oct, 11:30 AEDT). The softer domestic currency has led to a strong rise in commodity price exports in Australian dollar terms. However, the weakness of the AUD has also added to import prices. For the September quarter, the export price rise should be large enough to offset a relatively small increase in import prices and points to another leg up for the terms of trade.

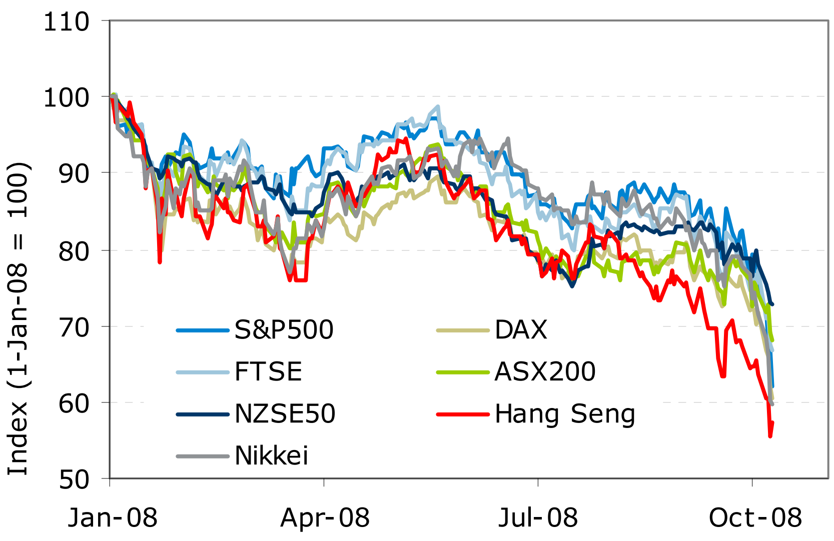
Markets begin to price in global recession

Katie Dean
Senior Economist

The global credit crisis deepened further this week. The passing of the TARP in the US over last weekend did little to restore global investor confidence as hoped. Instead, attention shifted to the tremendous damage that is now being done as the financial market distress transmits through to the real economy. Contagion from the crisis also spread more broadly across the Atlantic as a number of key European banking and corporate institutions sought emergency financial aid. It is now clear that the global financial and economic landscape has changed irrevocably; the ramifications of this will be felt for years to come.

The swings in financial markets have been savage (see Figure 1). The S&P 500 has lost 17% so far this week and is now close to its 2002 lows. That is, all of the gains of the last 6 years have now been lost. European and Asian markets are in similar dire straights (see chart). Australia has been caught in the storm with the ASX 200 dropping by 7.0% so far today to hit new fresh 3-year lows and put in its worst weekly performance since the stockmarket crash of 1987.

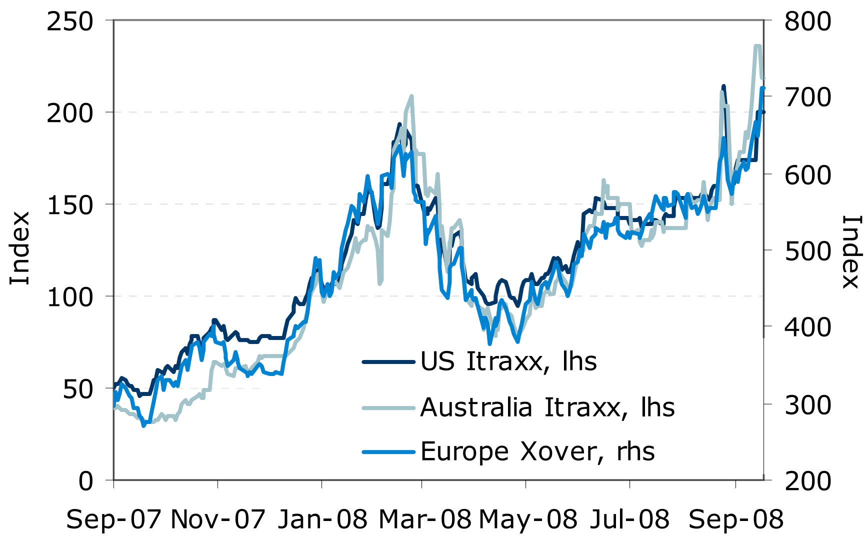
Figure 1: Global sharemarkets fall sharply



Source: ANZ and Bloomberg

The sharp falls in equity markets have been only part of the damage done. Amid new highs in global risk aversion, wholesale funding markets have frozen sending funding costs to record highs. In inter-bank markets the US 3-month OIS-LIBOR spread has widened to record wides of 355bps while in Australia, the 3-month OIS-BBSW spread continues to trade around 95bps, more than double a month ago. Likewise, swap spreads have widened sharply and the cost of credit default swap spreads have blown out to record wides (see Figure 2).

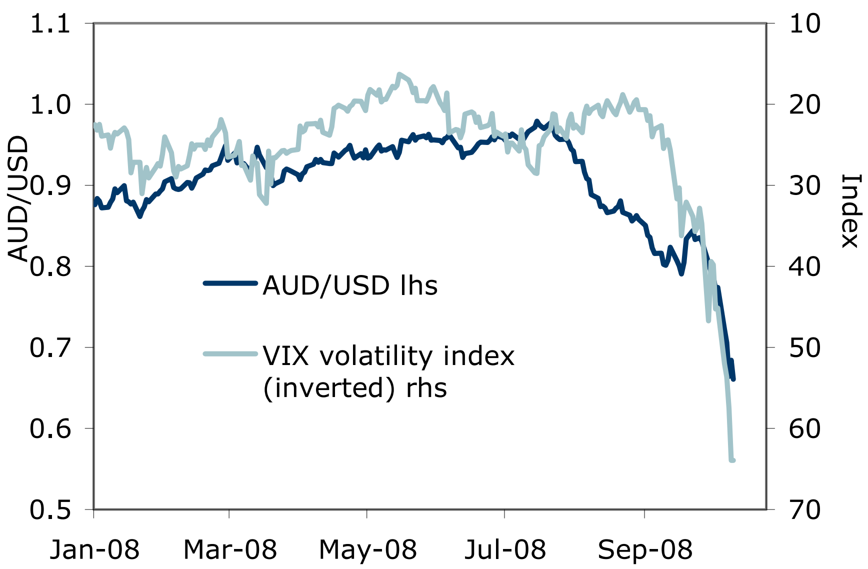
Figure 2: Credit spreads hit new wides



Source: ANZ and Bloomberg

Heightened volatility has seen extraordinary moves in currency markets. This week, the A$ lost 13 cents against the US$ to hit a five-year low of US$0.6346 on 8 October (see Figure 3). Usually the A$ trades in a 13c range over the course of a year, not the course of a week! The A$/US$ has now traded in a US$34c range so far in 2008, the biggest yearly trading range since the float (the previous largest yearly trading range was US$0.19c in 2003).

Figure 3: An extraordinary fall in the Australian dollar



Source: ANZ and Bloomberg

An unprecdented policy intervention

In a week of unprecedented events in markets, global central banks responded in unprecedented ways. The RBA delivered the first pre-emptive strike, slashing its overnight cash rate by 100bps to 6.0% at its monthly board meeting on Tuesday. After days of speculation, we also saw a co-ordinated global central bank interest rate cut, with the Fed, ECB, BoE, BoC, SNB and Riksbank all cutting interest rates by 50bps. Asian central banks have also moved quickly to join this global monetary policy easing with the central banks of China, South Korea, Taiwan and Hong Kong all cutting policy rates in recent days. Central banks also continue to inject massive amounts of new liquidity into the global financial system; the Fed has now added a total of US$900bn through its Term Auction Facility alone.

Meanwhile, the belated realisation that this crisis is too big for central banks to tackle alone has seen Government authorities continue to enter the private payments and financial system. New policy measures announced this week include:

- The Fed will create a special fund, the Commercial Paper Funding Facility (CPFF). This fund will buy 3-month paper and asset-backed CP directly from eligible issuers. It is hoped that this fund will revive the CP market which is a key source of funding for corporates.

- The Fed will provide an additional $37.98bn of liquidity to troubled insurer American International Group (AIG). This comes as AIG has already drawn down on most of the $85bn loan facility previously provided to AIG.

- In a welcome (if belated) sign of unity, EU finance ministers agreed to raise minimum bank deposit guarantees across the 27 EU countries to 50,000 euros, more than double the current floor level of 20,000 euros. Finance Ministers also pledged to step in to avoid vital financial institutions from going under by providing, among other means, "recapitalisation of vulnerable, systemically relevant financial institutions"

- The UK government unveiled a rescue plan that will inject £50bn of capital into UK banks and extend £250bn in guarantees to help banks refinance senior debt.

- The Irish government pledged to guarantee all deposits and loans of Ireland's four domestic banks and two building societies until September 2010. This guarantee was then extended to include the local subsidiaries of four international banks.

Of these policies, it is now becoming clear that the moves in Ireland and the UK to guarantee bank debt, will likely be the next step for other countries in assisting the resolution of this crisis. The disruption of the normal flow of funds within the banking sector, from investors to the banking system and then from the banking system to businesses and households must stop. There is now hope that the government guarantee of bank debt will provide enough reassurance to prompt investors to move out of cash and invest back into the banking and credit system. To this end, news is circulating that US Treasury Secretary Paulson is considering a plan to guarantee US bank deposits and to inject capital directly into banks in exchange for an equity stake or through a quasi-nationalisation. All eyes now shift back to the G7 and G20 Finance Ministers meeting this week, in the hope that a further co-ordinated global assistance to the financial sector along these lines will be decided.

A global recession in 2009

While extremely welcome, policy actions of the last week will do little to stop the global economy from falling into recession. The transmission of this shock from Wall St to Main St is no clearer than in data out this week that showed that US total outstanding consumer credit fell by US$7.9bn in August. This is the biggest fall on record and reflects both slower demand and reduced access to credit amongst consumers. Typically, this indicator only declines when the US is in recession.

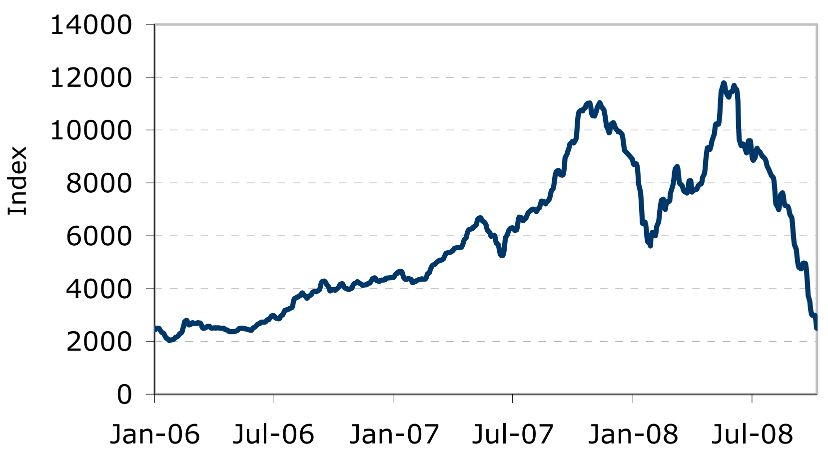
We have slashed our global growth forecasts and now expect the global growth rate to slow to under 3.0% in 2009 – this is slightly below the latest IMF world forecasts that were released this week – and would be the weakest rate of growth 2002. For the G7 we see growth slowing to just ½% - the weakest rate since the 0.2% decline in G7 growth that occurred in 1982.

Can Australia survive the storm?

Unfortunately this week's data confirmed that the Australian economy was continuing to slow entering into this crisis. Employment growth, while staying positive, has eased notably causing the unemployment to tick up to 4.3% (seasonally adjusted). The number of housing finance approvals (for owner-occupiers) meanwhile fell a further 2.1% to now be 29.8% lower than a year ago – the deepest decline in more than 13 years.

In slashing interest rates by 1% on Tuesday, the RBA has sought to pre-empt the pain in the financial system from causing a deeper slowdown. This is a welcome move. But, the downside risks facing this economy continue to mount. The further severe falls that we have seen in equity markets and across some commodity prices in recent days could weigh heavily on exports, consumer spending and business investment and, potentially hiring intentions, in the months ahead. The news that Chinese steel production has turned negative for the first time in at least five years, and that China will now cut steel production by 20%, is a further blow for our commodity exporters. We estimate that this move by China will reduce Australian iron ore sales by around 20mn tonnes next year. Our forecast for a 20% drop in 2009 iron ore prices will now likely become consensus in the next few days. A further 17% drop in the Baltic Freight Rate over the last week is also an ominous sign for our commodity exporters (Figure 4).

Figure 4: Another fall in the Baltic Freight Rate



Source: Bloomberg and ANZ

And while the fall in the A$ will help provide relief to some exporters, it is not clear that this will be enough to offset the impact of weaker demand. The A$ is a great automatic stabiliser for the local economy, but it is also a great bellweather for the outlook for global and local growth. As per our chart of the week, the savage moves we are now seeing in the A$ is starting to make us feel very nervous about our (previous) expectations for business investment to take over from the consumer and lead domestic growth.

In this deteriorating environment it is a sure bet that this week's interest rate cut is not the end of the RBA's policy response. We expect the central bank will seek to cut interest rates to a neutral level by mid 2009 or even earlier. Previously, economists had previously considered a cash rate of around 5.5% to be a neutral level. Given elevated wholesale funding costs however, a cash rate of around 5.0% now looks to be the neutral rate for this environment.

At a 6.0% cash rate now, we are still some way from this level. In the meantime, the longer the current financial market stresses persist and potentially even worsen, the greater the risks of a deeper and more prolonged downturn in the Australian economy.

Key data summary

Alex Joiner
Economist

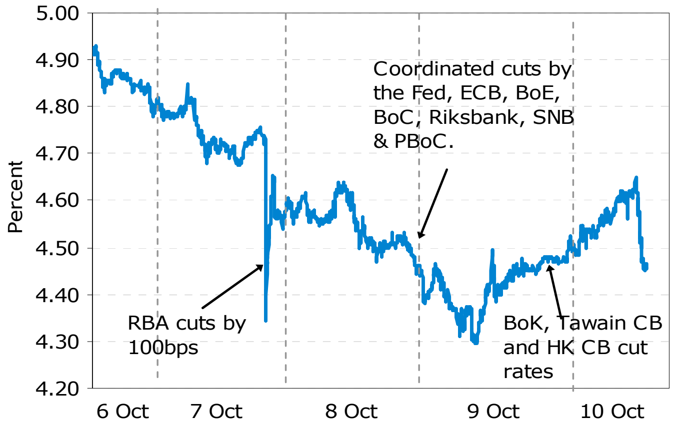
Please see ANZ's separate publication '*ANZ Data and Event Calendar*' for the schedule and previews of upcoming key local and global data events. Please email emr@anz.com if you would like to subscribe to this publication.

Key points to note from this week's economic releases are:

- The RBA slashed **official cash rates** by 100bp to 6.0% on Tuesday. This was the biggest interest rate cut done at a single meeting since May 1992 (when the Australian economy was in deep recession). The RBA's big move was based on (1) the view that the global (and thus the local) outlook has deteriorated significantly in the last month and (2) that heightened borrowing costs mean that changes in policy rates cannot be passed through in full to retail borrowers.
- **WBC Consumer confidence** for October fell 11% on the back of a slumping share market and is now only 3.8% above the 16-year lows it reached in July, when at the peak of both interest rates and petrol prices. It should be noted that the survey took place before the 100bps cut in interest rates by the RBA. **WBC Inflation expectations** remained at 4.4% in October unchanged from the previous month suggesting no significant downward pressure on prices has yet emerged.
- The **value of housing finance commitments** decreased by 3% in August. The value of owner occupied housing finance fell 2.1%, while investor loans slumped by 5%.Housing finance commitments weakened further in August amidst growing uncertainty regarding house prices, the broader economy and job prospects. The number of **owner occupied housing finance commitments** decreased by a further 2.2% in August, broadly in line with market expectations.
- **Employment** rose by just 2.2K in September, broadly in line with expectations for a flat outcome. Annual employment growth has now eased to 1.9% - not too bad given the sharp slowdown that we've seen in activity over the last six months, but still well down on the peak of 3.0% in February. The composition of the employment outcome was of concern, with full-time employment down by 15.4K, the largest monthly fall since June 2007. This was offset by a rise in part-time employment of 17.7K. The falls in employment this month were in QLD, VIC, WA and Tasmania. Employment bounced back in NSW but we note that the unemployment rate in this state remains high at 4.8%.

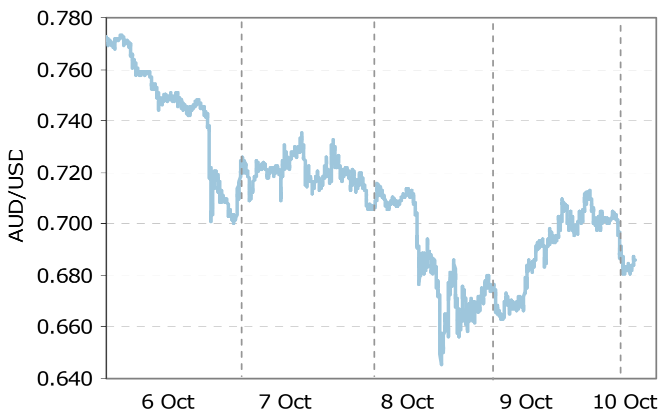
Market Wrap

Chart 1: AUS 3-year yields, intraday



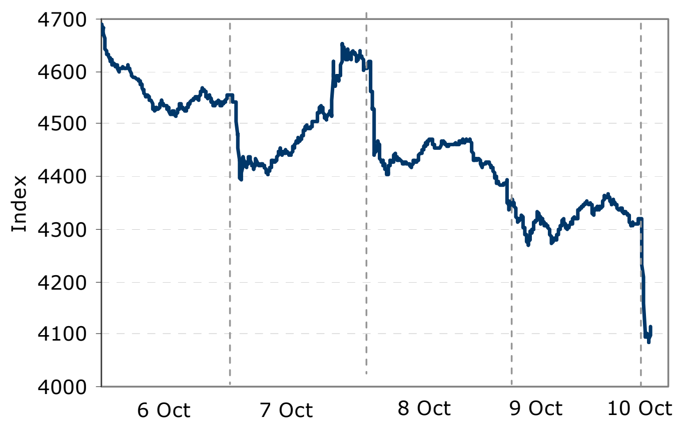
Source: ANZ and Bloomberg

Chart 2: AUD/USD, intraday



Source: ANZ and Bloomberg

Chart 3: ASX 200, intraday data



Source: ANZ and Bloomberg

Central bank move does little to ease stress

- An eventful week in global rate markets starting with the RBA's surprise 100bp cut on Tuesday. This was followed by a coordinated cut by many major developed country central banks as well as several Asian central banks mid-week. Despite these and other measures put in place to bolster liquidity, short term money markets continue to be under extreme pressure. The US OIS/LIBOR spread widened to record wides of 355bps and AUS OIS/BBSW spread continue to trade around 95bps, more than double a month ago.
- At the time of writing, 3-year yields have fallen 57bps to 4.36% from Friday's close, a 4-year low. 10-year yields have fallen 24.5bps to 5.05%, a 3-year low. The 3s10s curve has steepened to around +69bps, its steepest level since November 2001 as markets continue to price aggressive cuts from the RBA. Indeed, markets are now expecting 175bps worth of cuts by February next year.
- Market focus is on the G7 meeting of finance ministers and central bankers tonight, and the G20 meeting on the weekend. Any discussions/agreements regarding guaranteeing commercial bank debt, in line with Ireland and the UK's action this week, will be key for rates markets.

Patricia Gacis

AUD bottoms at US$0.6451 in the week

- It has been another tough and volatile week for the Australian dollar which sold down as far as US$0.6451 before recovering towards US$0.7000 on Friday morning. IT has since eased to US$0.6560 at the time of writing.
- The ongoing credit crisis and global equities sell off has continued to heighten tensions throughout global financial markets. The VIX surged to above 60 by Friday and the mood of extreme risk aversion weighed on the AUD throughout the week.
- The AUD remained fairly stable on Tuesday, even though the unexpectedly large cut in interest rates by the RBA saw interest rate spreads narrow considerably. The RBA move was viewed as being positive for growth and supportive for the currency, but the positive sentiment did not last.
- Co-ordinated interest rate cuts by global central banks saw the AUD rally briefly on Thursday but strong offshore selling saw levels fall off again. A softer outlook for both global growth and commodity prices and continued weakness in equities will weigh heavily on the AUD in coming weeks.

Alex Joiner

Aussie equities sold off in global rout

- Australian equity markets were sold down across the board this week in line with heavy selling across global markets. Investors ran for cover as the credit crisis deepened and sentiment worsened. The Australian market had but one bright spot on Tuesday when the RBA cut rates by 100bps and the market closed higher than it opened for the day. However, the ASX200 has since taken its lead from the carnage on global markets being sold off strongly at each open.
- No sector has been spared. The credit crisis has continued to weigh on domestic financial stocks. And a softer outlook for the Australian economy has seen industrial and consumer stocks also weaken significantly. There was no joy for the resources sector either with global growth revised downwards by the IMF and commodity prices softening.
- Friday's open saw stocks fall almost 400bps on the back of large falls in offshore markets overnight. The ASX200 was at one stage below the key 4000 level, before clawing back some ground. With any luck bargain hunters should continue support the market for the rest of the day. *Alex Joiner*

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008f	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	3.4	2.3	3.0
Household consumption	4.5	2.5	1.9	2.7
Dwelling investment	3.1	-0.1	-0.3	12.7
Business investment	13.0	9.0	4.8	0.6
Public demand	2.9	5.8	3.4	2.1
Domestic final demand	5.3	3.9	2.5	2.8
Inventories (contribution to GDP)	0.6	-0.2	0.0	0.1
Gross National Expenditure (GNE)	5.9	3.7	2.5	2.9
Exports	3.2	6.1	6.0	4.3
Imports	10.8	11.3	2.7	5.0
Net Exports (contribution to GDP)	-1.8	-1.5	0.6	-0.3
Gross Domestic Product (GDP)	4.2	2.4	2.6	2.6
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	2.8	3.1
Underlying*	3.1	4.4	3.6	2.9
Wages	4.1	4.4	4.4	3.7
Labour market				
Employment (annual % change)	2.8	2.3	0.6	0.9
Unemployment rate (%)	4.4	4.3	5.1	5.8
External sector				
Current account balance: A$ bn	-67.2	-54.1	-35.1	-44.8
% of GDP	-6.2	-4.6	-2.8	-3.4

*Average of RBA weighted median and trimmed mean statistical measures.

Australian interest rates	Current	Dec 08f	Mar 09f	Jun 09f	Sep 09f	Dec 09f
RBA cash rate	6.00	5.75	5.25	5.00	5.00	5.00
90 day bill	6.20	6.00	5.70	5.50	5.45	5.35
3 year bond	4.17	4.70	4.55	4.75	4.85	4.90
10 year bond	5.07	5.20	5.05	5.25	5.45	5.55
3s10s yield curve	0.90	0.50	0.50	0.50	0.60	0.65
3 year swap	5.30	5.70	5.83	5.50	5.40	5.40
10 year swap	5.77	6.05	6.05	5.95	6.10	6.15
International interest rates						
RBNZ cash rate	7.50	6.50	6.25	5.75	5.50	5.50
NZ 90 day bill	7.61	7.10	6.48	5.88	5.75	5.75
US Fed funds note	1.50	1.50	1.25	1.25	1.25	1.25
US 2 year note	1.50	1.25	1.25	1.65	2.00	2.15
US 10 year note	3.74	3.55	3.55	3.85	4.10	4.00
Japan call rate	0.50	0.75	0.75	0.75	0.75	1.00
ECB refinance rate	3.75	3.50	3.25	3.00	3.00	3.00
UK repo rate	4.50	4.25	4.00	3.50	3.50	3.50

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.

Foreign exchange rates	Current	Dec 08f	Mar 09f	Jun 09f	Sep 09f	Dec 09f
Australia and NZ exchange rates						
A$/US$	0.6682	0.77	0.75	0.72	0.70	0.68
NZ$/US$	0.5985	0.62	0.64	0.61	0.58	0.56
A$/¥	66.22	78.54	78.75	77.76	77.00	76.16
A$/€	0.4915	0.56	0.56	0.55	0.54	0.54
A$/£	0.3925	0.44	0.43	0.42	0.41	0.41
A$/NZ$	1.116	1.24	1.17	1.18	1.21	1.21
A$/CA$	0.7742	0.83	0.84	0.85	0.84	0.83
A$/CHF	0.7535	0.88	0.87	0.85	0.83	0.82
A$/CNY	4.564	5.35	5.25	5.00	4.83	4.66
A$ Trade weighted index	54.10	62.29	61.65	59.64	58.15	56.71
International cross rates						
US$/¥	99.2	102	105	108	110	112
€/US$	1.360	1.38	1.35	1.32	1.30	1.26
€/¥	134.9	141	142	143	143	141
£/US$	1.703	1.76	1.74	1.72	1.70	1.67
€/£	0.7986	0.78	0.78	0.77	0.76	0.75
US$/CA$	1.159	1.08	1.12	1.18	1.20	1.22
US$/CHF	1.128	1.14	1.16	1.18	1.18	1.20
US$ index	81.46	80.3	82.2	84.2	85.6	87.7
Asia exchange rates						
US$/CNY	6.832	6.95	7.00	6.95	6.90	6.85
US$/HKD	7.762	7.80	7.83	7.81	7.80	7.80
US$/IDR	9635	9600	9800	9700	9600	9400
US$/INR	48.00	48.00	49.00	48.00	47.00	46.00
US$/KRW	1402.05	1260	1300	1275	1250	1225
US$/MYR	3.5145	3.49	3.57	3.58	3.53	3.48
US$/PHP	47.74	49.00	50.00	49.80	49.50	49.00
US$/SGD	1.476	1.46	1.53	1.54	1.52	1.50
US$/THB	34.39	35.50	36.00	35.75	35.25	34.75
US$/TWD	32.44	34.00	35.00	34.50	34.00	33.50
US$/VND	16605	16600	16600	16500	16300	16100
Pacific exchange rates						
PGK/US$	0.394	0.40	0.39	0.38	0.36	0.35
FJD/US$	0.574	0.60	0.59	0.57	0.56	0.55

For additional information on foreign exchange rates please refer to ANZ's *FX Weekly*

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