



ANZ RESEARCH QUARTERLY

Economics, Commodities and Markets

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CONTENTS

EXECUTIVE SUMMARY	3
GLOBAL OUTLOOK Warren Hogan	4
G3 OUTLOOK Tom Kenny & Amber Rabinov	6
AUSTRALIA OUTLOOK Ivan Colhoun	10
GREATER CHINA OUTLOOK Li-Gang Liu	12
EMERGING ASIA OUTLOOK Paul Gruenwald	14
NEW ZEALAND OUTLOOK Cameron Bagrie	16
MARKETS	
FOREIGN EXCHANGE OUTLOOK Richard Yetsenga, Andrew Salter & Khoon Goh	18
COMMODITY MARKETS OUTLOOK Mark Pervan, Nicholas Trevethan & Natalie Robertson Paul Deane & Victor Thianpiriya	20
FEATURE NOTES	
FAST TRACKING RMB INTERNATIONALISATION Li-Gang Liu & Raymond Yeung	24
SOUTH EAST ASIA – RESILIENT SOVEREIGN RETURNS Aninda Mitra & Kerry Duce	30
FORECASTS	34

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EXECUTIVE SUMMARY

Global growth expectations have begun to improve through the first quarter of 2012 in response to better economic data in the US and further central bank balance sheet expansion in Europe and Japan. We expect global growth of around 3.75% in 2012 and 4.25% in 2013, compared to a long-term average of around 3.5%.

Central bank balance sheet expansion remains a critical element of the policy response to the persistent de-leveraging occurring in the industrialised economies. Abundant liquidity will support growth and asset prices despite the still substantial risks plaguing the global economy. Financial volatility will remain a feature of the global economic scene for the foreseeable future.

The ECB's Long-Term Refinancing Operation has reduced the probability of a credit crunch and severe economic contraction in Europe. Other risks remain, including a political backlash against reforms in Europe, a rising oil price and the potential for inflation expectations to rise on the back of widespread 'quantitative easing'.

The US economy continues to improve modestly but we maintain our view that a rebound in the housing sector is essential to a sustained recovery and, while there are encouraging signs in construction and affordability indicators, any recovery in housing looks very gradual at this stage.

A moderation of inflation pressures in China will provide the People's Bank of China with the scope to ease monetary conditions and support stronger economic growth in this all important leadership transition year. Despite the official forecast of 7.5% growth in 2012, we expect something closer to 9% as global demand recovers.

Financial markets, in the form of capital inflows, have been 'betting' on a recovery in Emerging Asia since late 2011. Only in the last few months has the macro data supported the view that economic activity will accelerate across the region in 2012. We see little scope for further monetary policy easing in most Asian economies.

A large number of diverse and sometimes conflicting forces are still at play in the Australian economy, ranging from the energy, mining and infrastructure investment boom to consumer caution and recessionary conditions in certain trade exposed industries. Trends in the labour market remain the best way to gauge the overall effect of these forces. The recent improvement in the *ANZ Job Advertisement Series* suggests a cyclical recovery in the economy is underway.

Both cyclical and structural forces are driving a very complex picture of the New Zealand economy at present. Despite lingering structural headwinds we are expecting a cyclical pick-up in economic activity in 2012 and 2013. The record high terms of trade, low interest rates and the rebuild from the Christchurch earthquake should offset a high currency, household balance sheet repair and fiscal conservatism.

The US dollar is expected to remain weak until there is a sustained improvement in the US trade account. Conversely we expect the secular improvement in Asian currencies to continue. Commodity currencies will remain elevated but volatile. While Europe faces many challenges, the region as a whole is broadly in financial balance with the rest of the world. This should prevent a substantial decline in the euro except in the most extreme circumstances; a breakdown of the common currency.

Commodity markets are unlikely to sustain their current stellar performance into the second quarter. We expect greater volatility in the near-term as investors remain highly sensitive to market news and data. Energy and precious metals may be the exception because supply issues and inflation risks should support strong prices in both sectors.

Our first feature article provides an outline and analysis of the 'Shanghai 2015' plan. The Chinese government has accelerated plans for the internationalisation of the RMB and aims to transform Shanghai into an international financial centre with almost three times its current market turnover by 2015. If China can implement a range of complementary domestic reforms such as deeper local bond markets, the plan is, in our view, achievable, and will see profound changes in the way Chinese citizens and banks participate in global markets.

The second feature article examines the resilience of South-East Asian financial markets through the latest crisis phase. The analysis suggests that the markets' attraction to the Philippines, and more recently Indonesia, is well placed. The subdued volatility of their sovereign bond returns, despite stresses in the global environment, is a reflection of the strong macro and policy fundamentals in these two countries.

Warren Hogan
Chief Economist, ANZ

A SLOW GRINDING RECOVERY

In the days following the publication of our last *ANZ Research Quarterly*, the ECB announced the Long-Term Refinancing Operation (LTRO). At the time global markets were heavily impaired. Global capital markets had become dysfunctional, denying term financing to both corporations and banks. The risk of a disorderly de-leveraging of the continental European banking system was on the rise.

In an act seemingly at odds with decades of German central banking tradition, the ECB agreed to lend money against a wide array of collateral for up to three years at a 1% interest rate. This was followed up in February this year with a second LTRO. In total the ECB lent around USD1.4trn to a variety of European financial institutions. The ECB has now joined other major central banks of the world in a rapid balance sheet expansion aimed primarily at the liquidity of the banking system.

The LTRO has successfully shored up confidence in the European banks, providing substantial funding to the banking system for the next three years and removing the risk of a 'Lehman' type event. Importantly, the risk of a severe contraction in European economic activity has been reduced materially. This has been extraordinarily important for the stability of global financial markets which were looking over the abyss in November last year.

The actions of the ECB have bought time for the governments of Europe to work through new treaty arrangements as well as enact the plethora of reforms required to put sovereign finances on a sustainable footing. Progress is being made in Greece with the Private Sector Involvement (PSI) arrangements now established for a restructure of government debt.

Significant political risks remain, however, not least a backlash from the citizenry over the severity of labour market reforms in the least productive economies. The upcoming French general election will be a critical barometer.

The ECB has also bought the banks some time. They may no longer face a liquidity problem but there is still a substantial capital deficit. European banks will need to rebuild their capital position via retained earnings, new equity raising and the shrinking of balance sheets. They have three years also.

THINGS TO WATCH

Global risk factors include oil prices, election outcomes in Europe, and long-term inflation expectations.

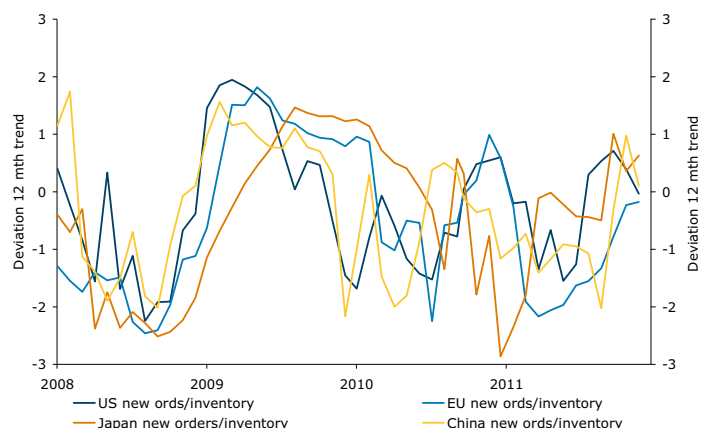
Signs of strengthening Asian (including Chinese) growth indicators post the Lunar New Year distortions.

The US housing market is critical to the global outlook – NAHB is the best leading indicator.

While the ECB has removed a great deal of the immediate financial risk from the European scene, there are still considerable uncertainties about the political commitment to making the European monetary union work. Any underlying political shift away from the reform effort needed to harmonise economic conditions across the euro zone could still leave the euro vulnerable to a break up.

Our lead indicators of global growth momentum have been improving for the past six months. But it was only with the successful implementation of the LTRO in Europe that financial markets refocused on the underlying trajectory of global economic activity. Fears of a US double dip recession and a hard landing for China have been put to the side on the back of much better economic data flow. Expectations for global economic growth appear to have bottomed out in early 2012 following almost a year of constant downward revision.

FIGURE 1. GLOBAL MACRO MOMENTUM INDICATORS



Sources: Markit, ANZ

The initial rally in risky asset markets has been strong, highlighted by a rapid compression of credit spreads, increased corporate debt issuance and a rise in equity values. Financial market volatility dropped considerably. The US equity market has rallied 27% from the October low and is now at the highest level since June 2008.

Global macro momentum indicators are now topping out as displayed in Figure 1. In recent years a loss of growth momentum across the world economy has left financial markets susceptible to bouts of weakness. The second quarter of 2012 is likely to become a good test of the resilience of the world economy and financial markets.

Despite ongoing risks to the outlook, there are many elements of the global economy that are vastly improved over recent years. The US economic expansion appears to be gaining greater breadth. The unemployment rate is trending down, a clear indication of a recovery in the labour market. There are early signs of a genuine recovery in housing. The US economic expansion looks to be broadening beyond manufacturing and large corporations to housing, services and the small and medium-sized enterprise sector. This will result in an economy that is more resilient to shocks.

It appears that the Chinese have avoided the hard landing that many feared late last year. Economic growth has slowed to slightly below growth potential of 9%. With inflation pressures now moderating, the Chinese authorities are comfortable in easing back tight monetary conditions. We believe this will not only support growth above 8%, but in the context of a brighter global economic outlook is likely to lead to a pick-up in growth towards 9% later in the year.

While the Chinese will want to continue to get the right mix of strong growth and stable inflation, the main economic challenges will be structural. The next great wave of economic transformation in China is upon us with the announcement of RMB internationalisation by 2015. This is fast tracking previous timelines and will put tremendous pressure on authorities to reform domestic financial arrangements (see article on page 12 'Fast tracking RMB internationalisation').

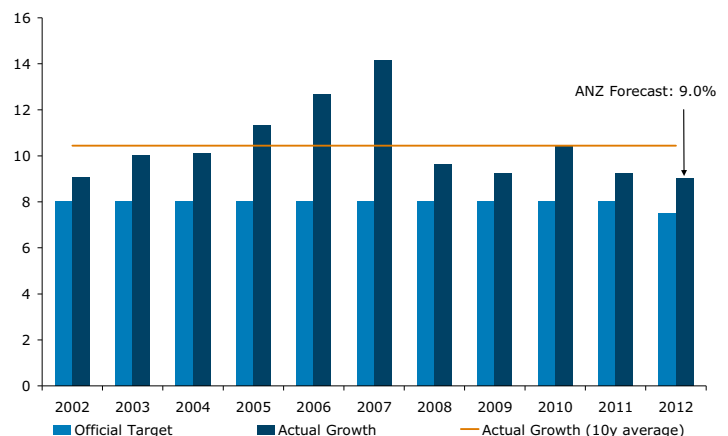
Hand in hand with the next step of modernisation will be a shift towards domestic consumption as a driver of growth rather than business and infrastructure investment. This is a key focus of the Chinese leadership and in conjunction with a more open financial system will reduce the size of China's external surpluses, and more importantly, the way in which these surpluses are re-cycled back to the rest of the world. Official outflows will moderate as the private sector takes a more prominent role in allocating Chinese savings back into global capital markets.

Notwithstanding these structural changes and policy challenges, underlying economic momentum should remain strong in 2012. The Chinese leadership is 'forecasting' 7.5% growth this year. They have a track record of under-promising and over-delivering on this front. More importantly it is a leadership transition year, and history shows that economic activity tends to strengthen through this period (see Figure 2).

Emerging markets more generally remain on a firm footing, benefiting from ongoing capital inflow to support strong domestic investment. A key feature of global markets over the past six months has been the strong performance of financial markets in the emerging economies through the crisis period. This has been particularly the case in South East Asia with strong outcomes for both debt and equity markets in Indonesia and the Philippines. In recent months the underlying macro data has started to confirm the brighter outlook for emerging economies. We are increasingly confident that Emerging Asia will experience strengthening economic activity over the year ahead.

Warren Hogan
Chief Economist, ANZ

FIGURE 2. CHINA'S OFFICIAL FORECASTS FOR GROWTH



Sources: Chinese National Bureau of Statistics

US – HOUSING RECOVERY IS THE KEY

The US economy finished 2011 on a positive note with GDP growing by 3% annualised in Q4 2011, the fastest quarterly pace since Q2 2010. This outcome was particularly heartening given volatility on global financial markets was elevated amid fears of a global slowdown and a banking meltdown in Europe. Encouragingly there has been a decent pick up in household sentiment following a mid-year collapse. The better mood is not surprising given more upbeat job prospects and a significant bounce in the equity market. This has seen household attitudes to big ticket purchases improve, particularly motor vehicles.

We expect GDP to cool a touch in early 2012 from Q4 2011. In part this is owing to the fact that an inventory build contributed a reasonable chunk of last quarter's growth and this is likely to be unwound. In addition, the pace of household spending and business investment has eased. Household wallets are being squeezed by rising petrol prices (more on this later). That said, the fiscal contraction this year won't be as bad as we previously feared as the Republicans recently agreed to extend payroll tax cuts and unemployment benefits (to the long-term out of work) to the end of 2012.

For some time we have identified a US housing recovery as essential for a broadening in overall economic activity and thus sustainability. There are a couple of encouraging longer-term developments which should bolster demand for housing – housing affordability is at near record levels (see Figure 1) and rents are rising amid tighter vacancy rates. More recently, a number of lead indicators are pointing to a pick up in residential construction activity, namely: a sharp increase in the NAHB Housing Market Index; and rising building permits. In addition, renovation activity is up strongly.

However, there are obstacles to a smooth housing recovery. These largely relate to a sizeable stock of distressed mortgages and ongoing house price falls. The Case-Shiller Home Price Index fell by 0.6% m/m in December and is now currently over 30% below the 2006 peak. Further price falls are anticipated over the next few months. Falling prices are problematic for a housing recovery in that it hinders the ability to refinance (in most cases refinancing is not possible when a mortgagee holds a negative equity position), which thus stymies the effectiveness of monetary policy.

THINGS TO WATCH

A rebound in the housing sector is necessary for a broader and thus sustained US recovery. There are some encouraging signs that this may not be far off.

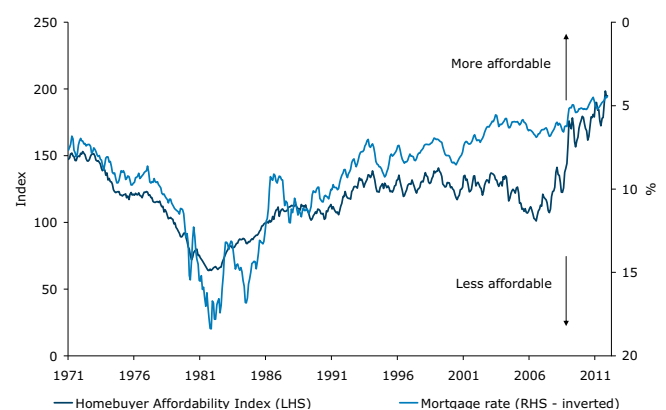
Reconstruction spending post the Tohoku earthquake should provide a sizeable boost to growth in Japan in H1 2012.

Although the European Central Bank has managed to avoid a potential bank deleveraging crunch to the region, political risk remains a threat to growth.

Perhaps the biggest obstacle to a housing recovery is the rising stock of delinquent and/or foreclosed mortgages. A solution to this is multifaceted. A healthier jobs market would help, as rising incomes would enhance the capacity to repay debt. This is why the Federal Open Market Committee (FOMC) is keen for a buoyant jobs recovery. In addition, direct intervention policy measures would also help. The US Federal Reserve outlined a number of possible measures in its Housing White Paper (released on 4 January 2012), including: increasing the availability of refinancing; bridge financing; renegotiation of principal loan; and using some of the distressed housing stock as rental property to alleviate some of the pressures rising in the rental market.

Although there are grounds for optimism about the prospects for the US housing market, the recovery is likely to be gradual in 2012. We will be watching this space carefully.

FIGURE 1. US HOUSING AFFORDABILITY



There have been some positive developments in the jobs market. Since September 2011 non-farm payrolls have averaged around 200k m/m. There has also been a rapid fall in the unemployment rate from 9.0% to 8.3%. On the other hand, there is some doubt on whether the current rate of decline can be sustained even if there is strong jobs growth. Indeed, there are a couple of reasons to be cautious against extrapolating recent trends.

- > The great recession appears to have distorted seasonal patterns. Post 2009 the unemployment rate has tended to fall reasonably sharply late/early in the calendar year before stabilising then edging up. This pattern occurs despite reasonably solid job growth.
- > There has been a sharp decline in the participation rate in the last couple of years. Although demographic factors are contributing to a long-run trend decline in the participation rate, the recent fall is far greater than what can be explained by demographics. Indeed, the drop likely reflects a discouraged worker effect given the sogginess of the labour market. Going forward, any strength in the jobs market is likely to draw people back into the work force. This will restrain the rate of decline in the unemployment rate.

The rapid increase in oil prices in recent months could be disruptive for growth, particularly if prices continue to rise. The price of petrol at the pump has leapt by around USD0.50/gallon since the start of 2012 and is approaching USD4.00/gallon. The recent rise may prove temporary as it appears to be mainly attributable to geopolitical tensions (Iran) which may not last. In any event, if recent oil price strength persists, and/or steps up a touch, there are a couple of mitigating forces at work.

FIGURE 2. BOWSER PRICE AND HENRY HUB GAS PRICE



Sources: Bloomberg, ANZ

First, US households have cut substantially their oil consumption in the last decade. Indeed, there has been a sizeable shift to use natural gas (away from oil) to heat housing. According to the US Energy International Agency over 50% of homes currently use natural gas for heating. This is significant given there has been a substantial decline in the price of natural gas (see Figure 2). Second, the US job market seems much stronger now than it has in a number of years. This will be supportive of incomes and should help to counter the higher fuel bill.

We have raised our 2012 GDP forecast to 2.4% from 1.7%. In part this reflects a slightly more encouraging view on housing but mainly reflects a better fiscal outcome than we had anticipated.

JAPAN – RECONSTRUCTION SPENDING TO BOOST GROWTH IN H1 2012

Japan's economy shrank in Q4 2011 by 0.2% q/q, following 1.7% q/q in the previous quarter. This was largely driven by a deterioration in external demand as domestic demand was reasonably solid, with private consumption and business investment firm. Weighing on exports was yen strength, which has been hovering near record highs, and slowing global growth. In addition, imports of oil and coal have increased substantially to cover the loss in electricity production generated by nuclear energy following the 11 March Tohoku earthquake and tsunami.

Despite a slight pick up in the unemployment rate Japan's labour market has been solid. The unemployment rate has drifted up to 4.6% in early 2012 after falling to a low of 4.1% in September 2011. The recent rise is somewhat at odds with reasonable job creation and an upward trend in the jobs-to-applicant ratio. The latter stood at 0.73 in February, which is the highest since late 2008 just after the collapse of Lehmans.

Real GDP is likely to grow at a 3% annualised pace in H1 2012, largely underpinned by construction spending flowing from the government's rebuilding measures. To this end, the government recently passed a fourth FY 2011 supplementary budget, worth ¥2.5trn. This takes the total amount of reconstruction spending from the four supplementary budgets to ¥20.9trn. In addition, a solid jobs market should support household spending. Spending on motor vehicles should be strong as the government has a ¥300bn subsidy scheme in place to stimulate buying of eco-friendly cars.

GDP growth in H2 2012 should ease as government spending on reconstruction winds back, albeit the absolute level of public spending will remain elevated relative to recent years. In underlying terms public capex is on a long-term trend decline, which is not surprising given public debt as a share of GDP exceeds 200%.

Japan's economic prospects have received a boost by the recent actions of the Bank of Japan (BoJ). On 14 February the central bank surprised the market by increasing its latest asset purchase programme by ¥10trn, targeting just government bonds. This takes the total purchase under the programme (which started in October 2010) to ¥65trn. The latest move seems largely aimed at countering yen strength which has been weighing on economic activity. The BoJ's action appears to have had success, with the value of the yen falling over 5% in the two weeks following the announcement.

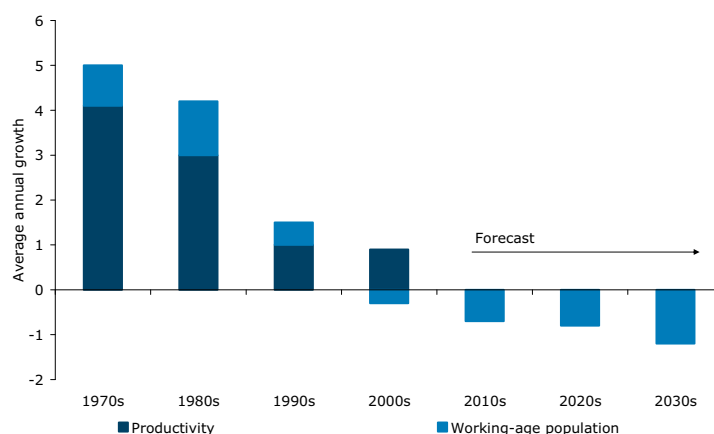
The other major news from the BoJ's 14 February policy announcement is the introduction of its 'price stability goal in the medium to long term'. The central bank said its goal for price stability is 2% y/y or lower for the CPI, although for now it has set this at 1%. The BoJ also strengthened the duration impact of its policy stance, ie the guidance it gives about the future policy path. Specifically, the central bank has said that it will continue with powerful easing (ie keeping rates virtually zero and implementing its asset purchase program) until it judges the 1% goal is within sight, provided no financial imbalances arise. The BoJ's approach to duration is different to that of the US Federal Reserve. In particular, the latter has specified a time path for the policy rate while the former is linking the policy rate to an economic objective.

The BoJ's comprehensive easing strategy along with its inflation objective is, of course, aimed at eventually overcoming deflation. Deflation has been ingrained in Japan for over a decade and represents one of the biggest challenges for policy-makers (and the economy) to overcome. Falling prices are bad for growth as it encourages households and businesses to defer spending. A recent speech by BoJ Governor Shirakawa highlights just how difficult this challenge will be. In order to overcome deflation, potential growth needs to be lifted.

This will be extremely difficult to achieve given an ageing population and slowing productivity (see Figure 3). The former appears irreversible for now, so productivity needs to lift. This will take time. In the interim the BoJ governor said the best thing monetary policy can do is set rates to support sustainable growth.

In the short term, rising oil prices have re-emerged as a downside risk particularly given that Japan has become more dependant on oil imports. Moreover, rising oil prices will add further downward pressure to an already trend decline in the terms of trade. This will have negative implications for incomes, particularly the trading profits of Japanese companies.

FIGURE 3. DECOMPOSITION OF JAPAN'S GDP GROWTH

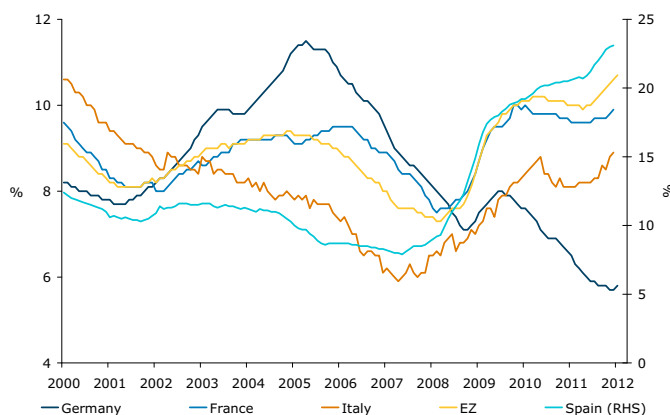


Sources: Bank of Japan, ANZ

EUROPE – POLITICAL RISKS ARE HIGH

The euro zone (EZ) looks certain to have slipped into a mild recession — GDP contracted by 0.3% q/q in Q4 2011 and partial activity data indicate that the economy went backwards again in Q1 2012. The divergence between Germany and the rest (especially the weak periphery) continues to widen. This is succinctly captured by the unemployment rate (see Figure 4). In Germany the rate continues to trend down while it is climbing elsewhere — in early 2012 the unemployment rate in Germany was 5.8% versus 10.7% for the aggregate region, the two were equivalent just over three years ago.

FIGURE 4. EURO ZONE UNEMPLOYMENT RATES



Sources: Bloomberg, ANZ

However, things could have been much worse for the region. The European Central Bank (ECB) has injected a substantial amount of liquidity into the banking system over the past three months. In total the central bank pumped over EUR1trn into European banks via its Long-Term Refinancing Operations. This unconventional policy measure appears to have eased funding pressures/costs in sovereign debt and interbank markets. These were becoming highly strained late last year (see Figure 5). Significantly, this measure may have averted a potentially nasty deleveraging shock to the economy.

Any future ECB actions will likely depend upon how the central bank gauges the effectiveness of these measures. Although a substantial component of the funds taken up are being placed in overnight deposits with the central bank, this is not necessarily a negative. Indeed, banks could be simply waiting for uncertainty to ease further before deploying the funds. Alternatively, banks are securing low cost funds now they know they will need them in the not too distant future. This reduces the worry of whether or not funding markets will be accessible at a later date, and/or the cost of getting those funds. Ideally, from a macroeconomic perspective, these funds will eventually work their way into the real economy.

Unfortunately, the political risks to the EZ economy remain high. There is still significant uncertainty surrounding the second Greek bailout, with the success of the latest package contingent upon some courageous macro assumptions (that said we think that the significance of Greek events on real activity is overplayed).

National political risk is high, with a number of key elections to take place over the coming year. At the forefront is the French presidential election in April/May, with a potential changing of the guard. We are concerned about some of the policy suggestions emanating from the

contenders for France's top post. These seem to be too narrowly focused on how to tax the 'rich' in an attempt to tackle the country's fiscal deficit and outstanding debt — the state's high debt to GDP ratio was one of the reasons behind the sovereign's recent credit downgrade/negative warning.

An improvement in the fiscal position will be one of the biggest challenges facing whoever leads France. Indeed, achieving a budget surplus (by the general government) would be an amazing feat given the last time this occurred was in 1974. In our opinion, the concerning part of the (arguably populist) election campaign is that there has been little mention of spending cuts. This is despite numerous studies pointing to a mix of both tax increases and spending cuts as being the optimal way to reducing deficits. Moreover, taxing the 'rich' could do more damage to the French economy than good by driving away some of its economically more productive citizens.

In contrast to popular opinion, France is already a relatively 'equal' country, with a Gini coefficient on disposable (net) income for working-age persons of below 0.3 (lower than Germany, the UK, US and Australia). Real household incomes for the poorest members of society actually grew at a faster pace (+1.6% pa) than those of the richest (+1.3% pa) from 1984 to 2008. Indeed, France was one of the few countries over this time period where inequality did not rise.¹ In addition, France is a relatively high taxed country, with a total tax take of 42% of GDP versus an OECD average of 34%.

The incumbent President, Nicolas Sarkozy, is trailing the Socialist candidate François Hollande in the polls, so the risk of political change is high. Hollande has expressed a desire to renegotiate the recently agreed 'fiscal compact' between EZ members to be more favourable for France. This has opened up doubts about what other recent euro-wide agreements that Hollande may be reconsidering.

Overall, the EZ outlook remains very uncertain. We expect no growth in the aggregate economy this year, with only a mild recovery on the cards for 2013.

Tom Kenny
Senior Economist

Amber Rabinov
Senior Economist

FIGURE 5. SPREAD ON EUROPEAN BANK'S SHORT-TERM FUNDING COST



Sources: Bloomberg, ANZ

¹See: *Growing income inequality in OECD countries: what drives it and how can policy tackle it?* Forum, Paris, 2 May 2011, <http://www.oecd.org/dataoecd/32/20/47723414.pdf>.

GROUNDHOG YEAR?

As the end of the first quarter of 2012 nears, it's clear that the major themes in operation over the past few years remain very much in play for the Australian economy. There has also been a number of important developments, particularly the strengthening recovery in the US economy and some abatement of concerns about Europe's sovereign crisis. Chief among the existing themes is the multi-speed nature of the Australian economy. This owes its nature largely to the conflicting forces of several factors: extremely strong growth in the emerging markets, especially China, and the related Australian mining and energy investment boom; structural change and associated pressures due to the very high AUD; 'light' versions of consumer caution and fiscal consolidation in Australia; and relatively tight monetary policy settings by the RBA.

These forces are often in conflict. On the surface, the economy may seem to be currently at some form of equilibrium with growth around trend, unemployment close to full-employment levels, overall business conditions around average, inflation in the middle of the RBA's target band and monetary policy about neutral. But these 'averages' conceal major divergences from the average in just about every aspect of the economy that one cares to examine!

To expand:

- > Overall business conditions are consistent with the long-term average, but no industry sector is at the average. Much of manufacturing, residential and non-residential construction and retail are experiencing weak or challenging conditions, while the mining, engineering construction, finance, recreation and transport sectors are experiencing generally above-average conditions;
- > Inflation is in the middle of the RBA's medium-term 2-3% target band. However, only two expenditure groups are recording price increases within the band, six groups have readings of 3-6% y/y, while three have readings of 0-2% y/y;
- > The housing sector is also multi speed, with the top end of the market weak due to a reduced appetite for debt. But the bottom end is beginning to recover on the back of improved affordability due to recent modest house price and interest rate falls and resurgent population growth; and
- > Economic activity is beginning to noticeably diverge by state. The states and territories most positively

THINGS TO WATCH

Labour Market Trends – these provide the best indication of the net effect of the many conflicting forces at work in the Australian economy at the present time. Recent trends in job advertising have been mixed – strengthening in January and February but easing modestly in March so far.

impacted by the mining investment boom are beginning to record accelerating trends (Western Australia, Queensland and the Northern Territory). The two largest states (New South Wales and Victoria) along with the Australian Capital Territory, South Australia and Tasmania remain relatively weaker, likely partly reflecting greater relative exposure to manufacturing.

Since the last Quarterly article, however, there has been a number of important and encouraging developments both globally and in the Australian economy. The US economy has continued to strengthen, with growth becoming more self-sustaining due to strengthening employment and a nascent upturn in the housing sector. These are important given: (i) the US economy is around the same size as Europe; and (ii) the significant drag on growth that the very cyclical housing sector has had for much of the past five or so years. At the same time, the concerns that enveloped the globe in Q4 emanating from Europe's sovereign crisis have also abated, at least for the moment.

In Australia, the main emerging development has been clearer signs that activity from the massive mining and energy investment pipeline is finally ramping up, with accelerating activity in directly affected sectors and regions, especially in Western Australia, the Northern Territory and Queensland. In fact, the recent acceleration of almost all economic indicators in Queensland has been quite noticeable. And Q4 capital expenditure data confirm that the capital spending pipeline continues to grow. Recent data on investment and construction spending, however, have been quite volatile, which is not surprising given the large and lumpy nature of the projects involved. This is an important reminder to focus on the broad trend for investment spending rather than the quarterly wobbles in these series.

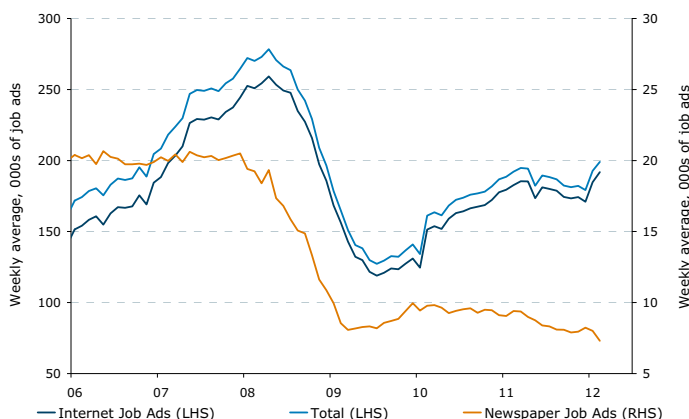
At the same time as activity in mining and infrastructure investment has been more clearly accelerating, there has been a host of announcements on restructuring and job losses in the manufacturing sector. The high AUD may be the chief culprit, but wage differentials to emerging market nations and undervalued currencies in some countries are also likely to be contributory factors. Activity in residential construction, non-residential construction other than engineering construction, and many parts of retail also remain weak.

In its recent communications, the RBA has appeared less certain about the net impact on the economy of the large and opposing forces of the mining boom on the one hand and the high AUD and related structural adjustment on the other. For nearly twelve months we have been suggesting that labour market indicators are likely to provide the simplest way of measuring this net impact as the employment and unemployment data will aggregate the job gains from mining, engineering construction and related sectors against the job losses in manufacturing, tourism and other sectors negatively impacted by the high AUD.

This assessment remains in force as does our reliance on trends in the *ANZ Job Advertisement Series*, which is an excellent leading indicator of emerging trends in the demand for labour and future trends in the unemployment rate.

January and February job advertising data provided encouraging news. After declining between April 2011 and October 2011, job advertising strengthened in the first two months of 2012, but has been easing slightly in March. The rise was driven by internet advertising with newspaper advertising (increasingly a smaller and smaller proportion of total job advertising – now less than 5% of total job advertising) especially weak in January and February.

FIGURE 1. NEWSPAPER VERSUS INTERNET JOB ADVERTISING



Sources: ABS, ANZ

Ordinarily, the latter trend would be a cause for strong caution as we have observed that newspaper advertising often leads trends in internet advertising. Our suspicion is that the current divergent trends between newspaper and internet advertising very much reflect the increasingly two-speed nature of the Australian economy on a sectoral basis (see Figure 1). This appears to us to be manifesting itself in blue-collar labour demand at the expense of managerial and white-collar labour, the latter likely to be over-represented in newspaper job advertising. Factors supporting this interpretation include the significant acceleration in job advertising in the mining states and territories in recent months (see Figure 2).

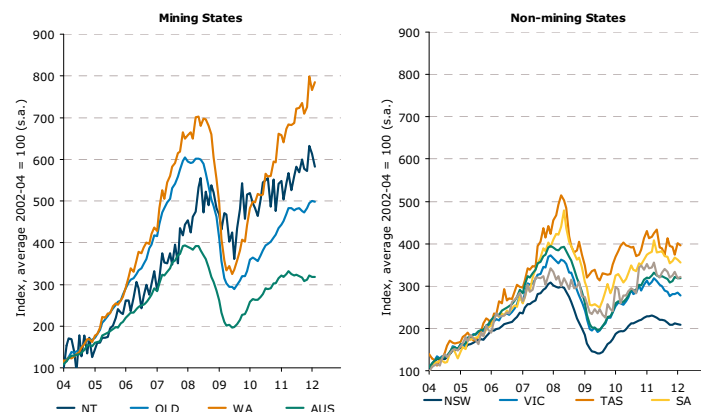
Nevertheless, early March readings suggest the recent spate of job loss announcements appears to be arresting the nascent renewed uptrend in advertising meaning it is too early to call an end to monetary policy easing.

MONETARY POLICY IMPLICATIONS

The RBA was comfortable leaving rates on hold in February and March as global concerns eased and the Australian unemployment rate remained stable at low levels. Q4 GDP data confirmed the mining investment boom but also ongoing weakness in residential and non-residential construction and parts of retail. While the Bank appears comfortably on hold at present, the answer to whether it will reduce rates further remains in the hands of the trend for the unemployment rate in coming months. For now, we continue to keep a 25bp rate cut in our forecasts for May.

Ivan Colhoun
Head of Australian Economics
& Property Research

FIGURE 2. NEW JOB ADVERTISING – MINING VERSUS NON-MINING STATES



Source: SEEK

GROWTH MOMENTUM REBOUNDS ON POLICY EASING

Q4 GDP FALLS BELOW POTENTIAL

Below-trend growth in 2011 suggests that monetary tightening had started to bite and that the gloomy global outlook was weighing on China's economy. China's GDP growth in Q4 2011 fell to 8.9%, below its potential of 9.0-9.5% for the first time since Q4 2009, and the 9.1% gain in the previous quarter. However, the result was still better than expected. On a sequential basis, the economy expanded 2.0%, also down from the 2.3% gain in Q3. For the year, China's economy grew 9.2% y/y, and though this is consistent with our scenario of a soft landing, it was still 1.2ppts lower than 2010's result.

While consumption remained upbeat in 2011, investment and net exports slowed, dragging the economy's performance down. Growth was mainly led by domestic demand; net exports continued to register a negative contribution to growth.

Meanwhile, industrial production growth slowed to 13.9% y/y, almost 2ppts lower than in 2010, and was the major factor behind the slow down. Heavy industry, including steel, cement and chemistry, which account for 70% of China's manufacturing sector, moderated significantly due to depressed demand in the property sector.

RESERVE REQUIREMENT CUTS TO THE RESCUE

As growth slowed to below potential and the risk of inflation has largely faded, the People's Bank of China (PBoC) cut the reserve requirement ratio (RRR) for banks by 50 bps in late November, and again in mid February, in an effort to support economic growth.

Monetary conditions have improved significantly. Following three years of declining total bank credits, the PBoC has set a 2012 M2 growth target of 14%, implying a new loan target of around CNY 8.0trn, or CNY 0.5trn higher than in 2011. Additionally, as more local governments tap into the bond market and the borrowings of local government financing platforms are rolled over by commercial banks, there will be a lower risk of default by these financing platforms.

THINGS TO WATCH

A further monetary easing via a 50bp cut in the banks' reserve requirement ratio is expected in early Q2.

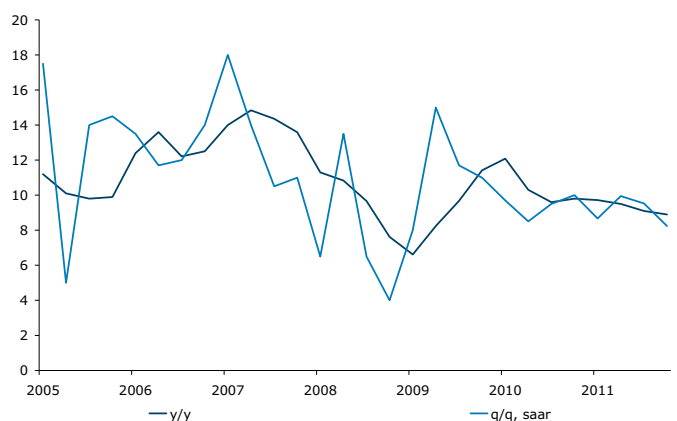
The recent spike in global crude oil prices has added an upside risk to China's inflation outlook.

Economic growth rates in the major provinces remain high in those with a leadership change.

FISCAL POLICY TO REMAIN STIMULATIVE

Other than an expected monetary policy easing, China's fiscal policy continues to remain stimulative. Fiscal revenue in 2011 grew by 25%, or around RMB 10trn in total revenue terms, far higher than GDP growth in 2012. According to Premier Wen Jiabao's report to the National People's Congress, China will increase its fiscal spending by 14.1%, outpacing the expected 9.7% growth in fiscal revenue in 2012. The government will increase its spending on education, public housing and the healthcare system with the aim of shifting the economy away from an investment-driven model to a more balanced consumption-driven one.

FIGURE 1. CHINA'S 2011 GDP GROWTH FALLS TO BELOW POTENTIAL



Sources: NBS, PBoC, ANZ

POLITICAL BUSINESS CYCLE TO AID GROWTH

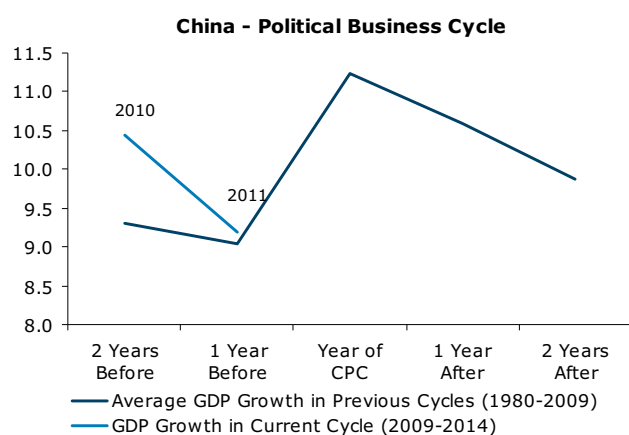
We expect China's retail sales to grow as fast as, or faster than in 2011 on the full implementation of a universal medical reform package, and a generally stimulative fiscal policy.

The start of a new political business cycle will also help boost investment and economic growth. In the past two years, all but eight provinces have a new party secretary or governor in place; these provinces with new administrations represent about 73.4% of China's GDP.

Historically, the economy tends to rebound in the year that a Communist Party Congress (CPC) is held. With many favourable positions up for contention at this October's 18th CPC – where there will also be a leadership change at the top – newly-installed provincial governors and party secretaries have great incentive to enhance their credentials by engaging in activities that speed up economic growth in their respective provinces.

A new political business cycle, coupled with favourable conditions that allow many provincial and municipal governments to issue bonds in 2012, will help boost investment this year; and as investment growth is an effective instrument to increase activity, we believe that economic growth for China as a whole may surprise on the upside.

FIGURE 2. GDP GROWTH: WHERE POLITICS COMES INTO PLAY



Sources: Bloomberg, ANZ

EXTERNAL DEMAND, WHILE UNCERTAIN, WILL NOT BE A REPEAT OF 2009

Finally, external demand, although uncertain, started to improve in December last year and helped stabilise China's economy via the trade channel. While external demand will remain weak on a mild European recession, recently released European PMI indices have shown signs of a rebound, suggesting that a 2009-style economic 'free fall' is less likely.

US confidence is improving on much stronger-than-expected consumption growth and faster job growth. Notably, the market consensus on G3 economies has picked up strongly, reflecting improving sentiment. We therefore maintain our above-consensus forecast that China will achieve a growth rate of 9% in 2012 an improving external environment and accommodative fiscal and monetary policies.

NEAR-TERM OUTLOOK

As policy easing gradually takes effect, liquidity conditions improve, and external conditions continue to stabilise we expect that China's economy will have grown at around 8.6% in Q1, with a rebound in growth momentum.

GDP growth will pick up from the second quarter to a rate above 9% in H2 of 2012. Investment growth could slow somewhat; however, we may have an upside surprise in the export sector, as early 2012 data show that shipments to both the US and the EU performed better than expected.

As the GDP gap remains in H1 2012, inflation pressures will remain moderate. CPI inflation could be close to 3% in the next two months, well below the government's full year target of 4%, due to a continued decline in food prices after the Chinese New Year. This will allow the PBoC to cut the banks' reserve requirement ratio by another 50bps in early Q2. However, the recent spike in global crude oil prices has added an upside risk to China's inflation outlook. Though our ANZ model shows that the first-round effects from oil prices to PPI and CPI inflation will likely be subdued, second-round effects from high production costs cannot be ignored. Inflation will return as a potential risk from Q2 onwards, which will help shift the expectation of monetary policy outlook in the second half of the year.

Li-Gang Liu
Head of Greater China Economics

MOMENTUM RISING – REBOUND AHEAD?

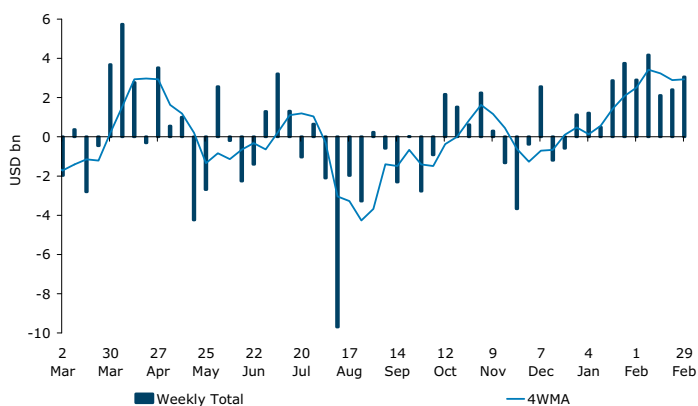
Emerging Asia entered 2012 with a tension between rising asset values and currencies—driven by a surge of capital inflows—and a lacklustre macroeconomic performance. The issue was how this tension would be resolved. As Q1 draws to a close, the macro data have begun to turn up and risk-on behaviour has paused, suggesting that a resolution is at hand. Barring any nasty surprises out of Europe, 2012 is setting up as a decent year in Emerging Asia.

RISK-ON: CAPITAL INFLOWS

The first quarter of 2012 has been characterised by uninterrupted capital inflows into Emerging Asia as risk-on sentiment has dominated. In our view this reflects a combination of a diminution of the EU debt crisis (stemming largely from the Long-Term Refinancing Operation of the European Central Bank), and increasing evidence of a broader recovery in the US economy and a soft landing in China. Indeed, our measure of weekly (equity) capital flows has registered inflow in every week of 2012 (Figure 1).

These flows have led to rising equity prices, tighter bond spreads and stronger currencies. On the latter, we have seen the return of the 'high-beta' currencies in Q1. This group includes the Indian rupee (the strongest currency in the region so far this year), the Singapore dollar, the Thai baht and the Malaysian ringgit. These currencies tend to do well when risk appetite is rising. On the contrary, the 'USD sticky' currencies—the Chinese yuan and the Hong Kong dollar—which were at the top of the currency league table in 2011, have underperformed this year (Figure 2).

FIGURE 1. SO FAR, SO GOOD: CAPITAL FLOWING INTO EMERGING ASIA



Total includes: India, Indonesia, Philippines, Korea, Taiwan, Thailand, Vietnam

Source: Bloomberg, ANZ

THINGS TO WATCH

Momentum will continue to rise in exports and investment.

We could see some central banks hike rates in the second half of the year as output gaps close and commodity price inflation re-emerges.

Asian consumption will need to drive an increasing portion of demand in the region.

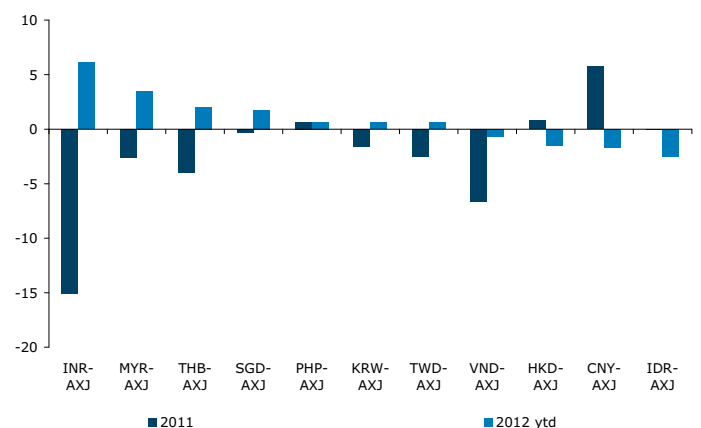
All told, markets appear to be pricing in a reasonably robust recovery in 2012. However, until recently, evidence of a recovery in the macro economic data has been scant.

MOMENTUM FINALLY RISING

Emerging Asia's recovery was cut short in mid-2011 as the European debt crisis intensified. The order in which this slowdown occurred is relevant because a restoration of growth in 2012 would imply that the chain of events can be reversed.

The sequence began with a drop in exports owing to a widespread loss of confidence and spending with the escalation of the European debt crisis. This spilled over to investment (especially in the smaller economies where exports are a larger part of GDP) and then, later in the year, to the consumer. Emerging Asia thus had all three engines of demand impaired.

FIGURE 2. USD-STICKY CURRENCIES ARE UNDERPERFORMING IN 2012



Sources: Bloomberg, ANZ

Encouragingly, trade momentum on both the import and export side bottomed around end-2011 (Figure 3). This was nearly across the board in the region, with the clearest rise coming in Singapore and South Korea. This suggests that the year-on-year growth numbers are set to rise soon. Our recent research suggests that Korea and Thailand are the two markets to watch in gauging whether a regional export recovery is at hand.

Purchasing managers' indices (PMIs) have also begun to rise as well. These leading indicators of investment activity fell steadily through most of the second half of 2011 as lower (export) orders fed through, reaching levels below 50, which is consistent with a contraction in manufacturing activity. However, beginning in December and continuing through the February data, PMIs in China and all the Newly Industrialised Economies of Asia have rebounded and pushed back above the 50 mark (Figure 4).

END OF MONETARY POLICY EASING?

Central banks in the region responded to the weakening of activity in mid-2011 by shifting their focus from fighting inflation to supporting growth. Bank Indonesia was the most aggressive, cutting rates three times by a total of 100 basis points. Also lowering rates were the Philippines, Thailand and, most recently, Vietnam. China and India have lowered their banks' reserve requirement ratios (RRRs) twice by a cumulative 100bps and 125bps respectively, but left their benchmark policy rates unchanged as real interest rate levels remain a concern.

With signs of a growth rebound, we expect central banks to be cautious regarding further rate cuts. We continue to forecast two more RRR reductions in China and a continued normalisation of rates in Vietnam as part of their inflation reduction efforts. For the rest of the region we expect the rate cutting cycle to be at or near the end.

Indeed, should the expected rebound in activity occur in conjunction with a reasonably strong US upturn, we could see some central banks begin to hike rates in the second half of the year as output gaps close and commodity price inflation re-emerges.

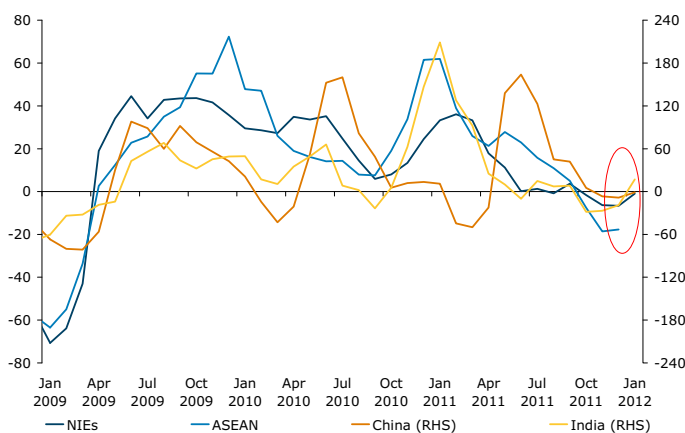
2012 NOW LOOKING UP

All told the latest data out of Emerging Asia point to upside risks for our growth forecasts. This is based on the view that: (i) momentum will continue to rise in exports and investment; (ii) a Chinese soft landing is assured; (iii) the US recovery gains steam, particularly as regards the labour market and small and medium-sized enterprise activity; and (iv) Europe continues to muddle through. The region could therefore have a decent year even though its main trading partner—Europe—remains mired in a debt crisis.

Underpinning this view is our structural theme that Asian consumption will need to drive an increasing portion of demand in the region. Evidence of this in the form of Chinese sales driving intra-Asian trade flows and demand has already been documented. But the more the region is able to move away from an over-reliance on foreign demand, the more it can drive its own growth and destiny.

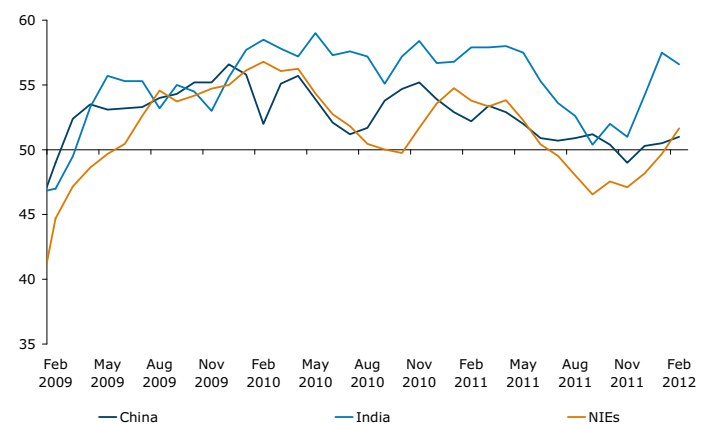
*Paul Gruenwald
Chief Economist, Asia-Pacific*

FIGURE 3. AXJ EXPORTS



Sources: Bloomberg, ANZ

FIGURE 4. ASIA – MANUFACTURING PMIS



Sources: Bloomberg, ANZ

BUTTING HEADS

We envisage ongoing volatility across the business cycle for the New Zealand economy amidst a lower trend growth rate as structural and cyclical forces clash. We have pencilled in around 2% growth for this year and around 3% growth over the next two years. We continue to characterise the outlook as one of 'grumpy growth'. A better national balance sheet is a precursor to a strong pro-cyclical upswing, but this will take time.

PICK YOUR DRIVER

The economic outlook is arguably more complicated than at any time in New Zealand's history reflecting the interaction of both structural and cyclical forces.

The global outlook remains fraught with uncertainty. Abundant global liquidity is going head to head with a sizeable debt overhang and poor fundamentals.

The New Zealand economy is facing enormous tensions. With the level of per-capita activity about 5 percent lower than 2007 levels, and with residential and private investment at cyclically low levels, there is potentially scope for a large cyclical spring board and V shaped lift. The OCR is at a historical low. Add to this a multi-year earthquake reconstruction boost potentially equivalent to a 0.75 percent of GDP per annum boost, and a return to 4 percent plus annual rates of growth would seem assured. However, cyclical imperatives are being offset by 'big picture' structural themes. These include:

THINGS TO WATCH

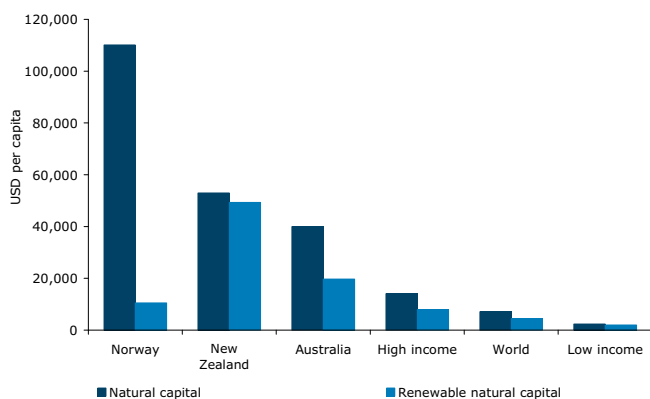
The global scene and five key channels to NZ: confidence, commodity prices, cost of funds, China and the currency.

The prospective rebuild in Christchurch. Activity is lifting but critical mass is a 2013 story.

Progress at the political level, unlocking New Zealand's natural endowments.

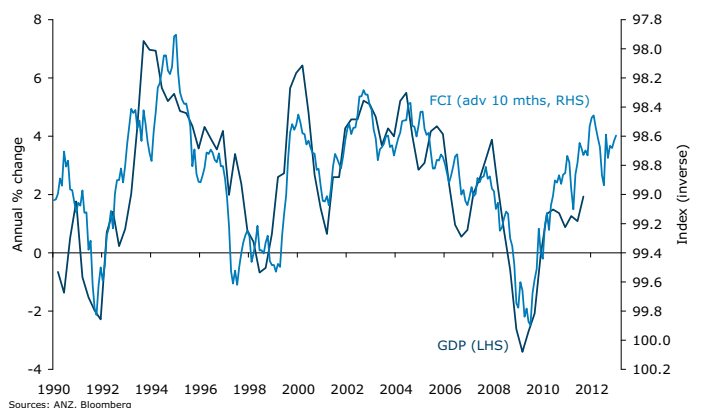
- > **Deleveraging.** With net external debt at nearly 80 percent of GDP in an underlying sense, our national balance sheet remains weak. New Zealand's household savings rate is barely positive. The combination of a large external debt position, housing skewed balance sheet, weak productivity performance, and low returns from the productive side of the economy tells a sub-par story. A gargantuan fiscal deficit needs to be addressed. Deleveraging headwinds are not as intense as they were over the past three years – some progress has been made, but they remain a headwind and structural imperative for the economy.
- > **Rebalancing.** Despite the highest goods terms of trade in a generation – an income shock, the economy remains lopsided, with excessive concentration in spendthrift activity. A huge divide remains between tradable and non-tradable GDP, reflecting a lop-sided economy. Resources need to adjust. There will be frictions.

FIGURE 1. NATURAL CAPITAL



Sources: The World Bank, 'The Changing Wealth of Nations' 2010

FIGURE 2. FINANCIAL CONDITIONS AND NZ GDP



Sources: Bloomberg, ANZ

> **Rebuilding capacity.** A legacy of low investment and the \$25-30bn damage bill from the Canterbury earthquakes necessitate the rebuilding of nationwide capital stock. Consumption will have to make way. If not, the current account will blow out and the duration of the recovery will be short as supply-side frictions hamper productive capacity and cause pricing pressures to rear their ugly head.

The shocks hitting the economy are complementary in some facets but opposing in others. Deleveraging is deflationary. Commodity income shocks and natural disasters are not. The income shock is helping New Zealand get its balance sheet back in order via income generation (by getting the debt to GDP ratio, the current account deficit, and the consumption to income ratio down via movements in the denominator). Conversely, rebuilding Canterbury will involve dedicating huge amounts of resources to rebuilding domestic capital (ie housing and infrastructure) at a time when we are also supposed to be investing in other areas to address our national indebtedness and rotate the economy.

New Zealand is currently in a 'transition' phase, where normal pro-cyclical forces and drivers of the business cycle have been dampened by a debt payback dynamic and structural constraints. This transition period is occurring on a number of levels, including altering the mix of growth (rebalancing) and lowering indebtedness relative to GDP (deleveraging), both here and abroad. This entails a period of stuttering and 'grumpy' growth as contrasting shocks, cyclical and structural forces effectively butt heads.

A host of factors will determine how an economy performs during the transition phase, a period likely to be more than five years. The weaker the balance sheet, the larger the growth hangover. Economic flexibility can help ease frictions and speed the adjustment process. You need leadership to prevail over populism, microeconomic reform to alter pricing signals, and importantly society needs to be along for the ride. New Zealand is working through a significant hangover but looks solid across the other criteria.

We put the trend rate of growth for the New Zealand economy during the transition stage at no more than 2%. This is low compared to a host of trading peers, but will look stellar compared to the UK and Europe.

There is however, a magic bullet: it's called growth and New Zealand is blessed with a huge endowment of natural resources. It is easier to transition if you have strategic areas of excellence or comparative advantages. Just as businesses need points of differentiation to be successful, so too do entire economies. Areas of strategic advantage are the big bang investment and growth opportunities.

New Zealand ranks eight in the world for per capita natural capital (the top 7 are oil producing nations such as Norway) and leads the world in terms of per capita renewable natural capital. Such a resource base does not guarantee success; it merely gives an economy a massive head-start on others. Moreover, areas that New Zealand is overweight ('long') in regard to natural resources (water, land, protected areas including a large economic exclusive zone), huge pockets of Asia are 'short'. The so-called lucky country, Australia, ranks below New Zealand on the natural capital rankings.

Last year was dominated by a deleveraging headwind and we expect the same dynamic to be influential in 2012. **Restoring a modicum of health to the national balance sheet is a prerequisite to any sort of cyclical upturn taking hold.** We have pencilled in 2% growth for 2012.

Momentum looks set to recover in the second half of 2012. This will be primarily investment-led, with a modest recovery in consumer spending.

Prospects for 2013 look more encouraging, with further growth in private investment and recovering ex-primary exports. Growth in private consumption will remain modest as ongoing deleveraging and a patchy labour market recovery keep saving front of brain for households. The government sector will start to impart a contractionary fiscal impulse as public sector deleveraging gets underway.

We also assume 2013 will be the year in which the pace of earthquake reconstruction steps up and gets some critical mass. With this will also come progressive lifts in the Official Cash Rate.

*Cameron Bagrie
Chief Economist, New Zealand*

FOREIGN EXCHANGE OUTLOOK

USD: STILL A WEAK CURRENCY

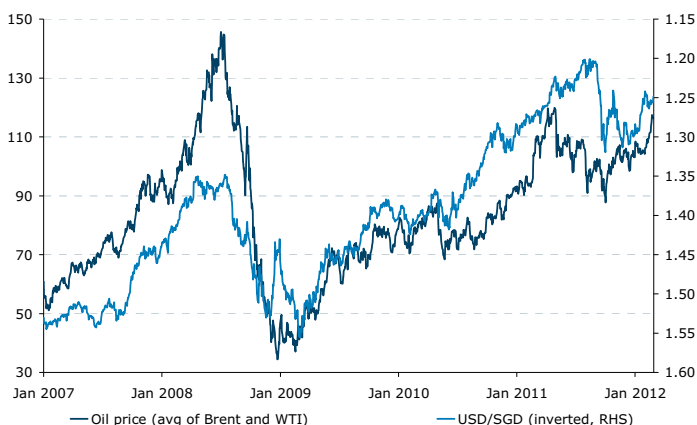
While the EUR's vulnerabilities have gradually been priced out over recent months, other potential risk factors for currency markets have quickly arisen as potential replacement worries. These include oil prices, whether Europe has really turned the corner and whether the USD can start to rally in line with a gradual US recovery. It seems that most generally gravitate towards potentially negative drivers for local currencies in this post crisis environment. In this article we consider some of these negative issues before reaffirming our view that the USD is likely to remain quite weak against Asia and the commodity bloc.

OIL - A REAL THREAT?

We are not so concerned about oil potentially causing problems for risk currencies. There already seems to be a substantial political risk premium in oil according to our commodity team, of perhaps USD15 in Brent. And oil prices are still only at USD115 per barrel, compared with a peak of USD150 in 2008. It is also difficult to see either the US or Saudi Arabia accepting a politically-generated oil spike that would damage the global economy, without attempting some counter measures.

In addition, the facts about oil and currencies say something quite interesting. Most risky currencies are in fact positively correlated with oil, not negatively. Even in 2008, the SGD and oil moved together (see Figure 1). Certainly a spike in oil is an outside risk, but that's all it is in our view. Owning SGD is a great hedge against this risk, and is a view also supported by strong fundamentals.

FIGURE 1. OIL PRICES AND THE SGD



Source: Bloomberg, ANZ

THINGS TO WATCH

The US trade data. Without sustained improvement in the trade account the USD is likely to remain weak against Asia and the commodity currencies.

Euro zone trade data which have been improving of late.

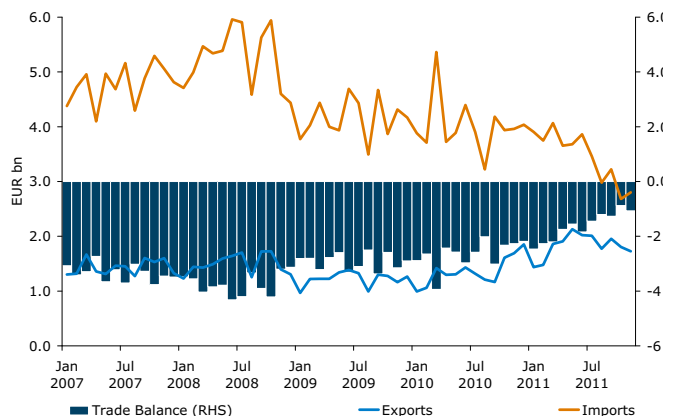
Asia growth momentum. This and gradual US recovery to keep Asia currencies strong.

EUR TURNING AS TRADE ADJUSTMENT GATHERS PACE

While Europe clearly has some fiscal issues, we have found that the best way to conceptualise Europe's adjustment is as a classic balance of payments problem. Left to its own devices, an unsustainable import boom will result in a crisis of domestic demand, which will help to rebalance conditions. In Europe's case this adjustment is more painful because the currency cannot contribute, but the adjustment nevertheless is occurring.

In this way fiscal contraction is not a self-defeating process. Certainly it weakens the domestic economy even further. But, it also compresses import demand, which ultimately is what is needed to get all of Europe's countries onto a more sustainable footing. We are not sure that Greece will reach that position for a long time (see Figure 2), suggesting ongoing state aid will be necessary for many years yet. The rest of Europe, however, seems to have much less significant adjustment tasks.

FIGURE 2. GREEK TRADE ACCOUNTS



Sources: Bloomberg, ANZ

FOREIGN EXCHANGE OUTLOOK

The latest data show a marked improvement in the trade accounts for almost all countries (see Figure 3). The signs of a recovery in the US and Asian economies make us hopeful that this adjustment process can continue with a contribution from stronger exports. With Europe's current account balance superior to that in the US, this should be sufficient to see the EUR stabilise.

THE US DOLLAR

Beyond these issues, perhaps the key question hanging over markets is with the US economy leading the global cycle can the USD finally rally across a broad front? Certainly the US economy seems to be in better shape, which should attract more private sector capital inflows. This, however, is likely to be at the expense of public capital inflows (ie resulting in less intervention in other currencies) and will be insufficient to overcome the currency drag of a large external deficit.

The US current account deficit is still around 3½% of GDP (see Figure 4). Adding in a net FDI deficit yields a basic balance deficit of more than 4% of GDP. With US interest rates at such low levels, and likely to remain there for quite some time, we continue to view the USD as a weak currency. As such, the beneficiaries of stronger US growth will continue to be other currencies, in particular those in the Asian region such as SGD, TWD and KRW.

AXJ – THE SWEET SPOT

It seems we're there. There is plenty of liquidity being provided by the major central banks. The Fed is prepared to leave rates at zero until 2014 and embark on QE3 if necessary. The BoE and BoJ both announced an additional GBP50bn and JPY10trn to their respective asset purchase programmes.

Our China economists estimate that the recent 50bp cut to the RRR for all depository financial institutions will release around CNY400bn into the banking system. All this liquidity will find a home somewhere. Little wonder then that Asia has seen large foreign net inflows into its equity and bond markets. Inflation may still be high in some parts, but it is taking a back seat (for now anyway) as policymakers are more focused on growth. And growth indicators are still looking okay.

Greece (and Europe in general) remain a potential spoiler and could derail the present risk rally. But more relevant in our view is the potential for a disruption to the global economic recovery. It's definitely not 2011 again, but such a pause in the activity indicators could see risk assets off. In our view such a clear out of positions is healthy for the rally's long term integrity and should only prove a temporary interruption to what has been a strong and powerful rally.

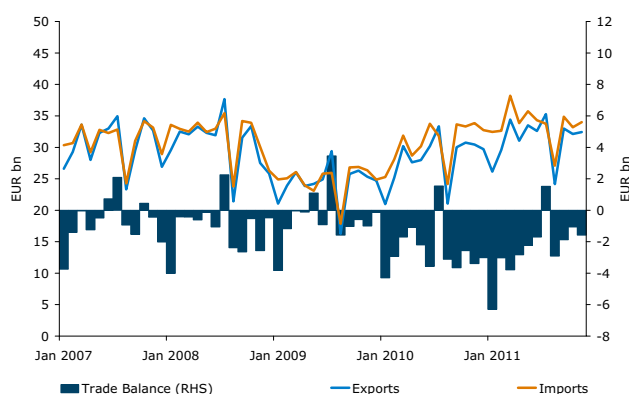
Underlying our constructive Asian currency, and in fact commodity currency view, is a robust China. Both the Chinese economy and currency are expected to do well in 2012, and provide an anchor for the region. Recent instability in many currencies we feel can be linked to rising uncertainties about China's commitment to RMB appreciation. While we may well see more currency volatility over time, we still view the RMB as undervalued, and a robust Chinese recovery this year should see that trend re-emerge.

Richard Yetsenga
Global Head of FX Strategy

Khoon Goh
Senior FX Strategist

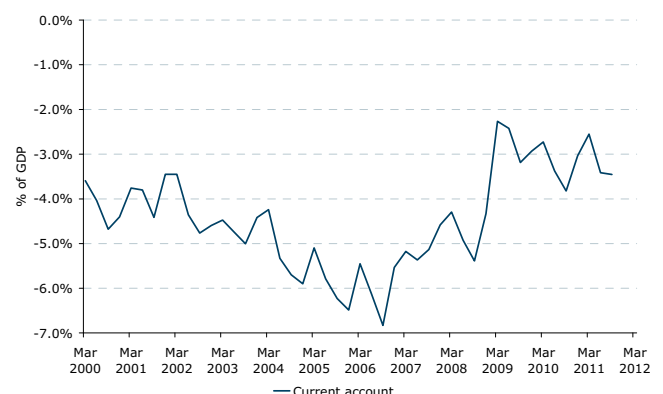
Andrew Salter
FX Strategist

FIGURE 3. EURO ZONE TRADE ACCOUNTS



Sources: Bloomberg, ANZ

FIGURE 4. US CURRENT ACCOUNT



Sources: Bloomberg, ANZ

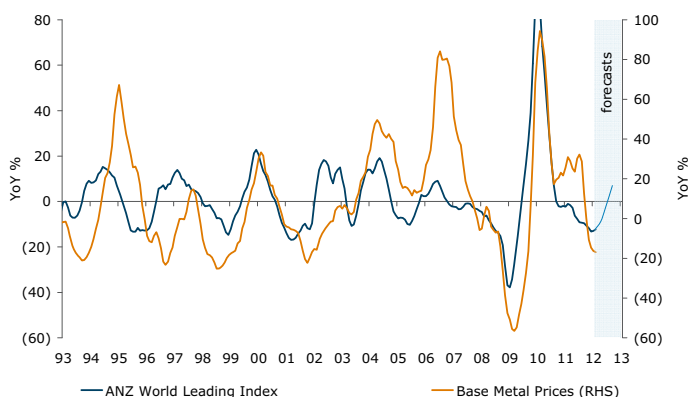
SUPPLY RISKS TO DOMINATE

Commodity markets in the second quarter may struggle to repeat the strong performance seen so far in the first quarter, which has seen some key industrial raw materials rise by double digit percentages. The June quarter is typically strong for commodity and energy markets as prices respond to seasonal upswings in Chinese activity, and there are risks of some restocking by Chinese consumers who are running on very low inventories. However, this positive scenario may be tempered by supply-driven gains in oil prices that have the potential to sap growth globally, particularly in Europe, where crude oil in euro terms has been hitting record highs.

Sentiment remains ahead of fundamentals, and will only catch up in the second half. As a result, investors will remain highly sensitive to market news and data. With considerable upside already parked into prices, the market is vulnerable to softer data or to news fading from the front pages. Our ANZ Global Leading Index points to a bottom in the current cycle by the second quarter of 2012 (see Figure 1). Historically, commodity prices have followed with a three month lag, implying a recovery in prices in the second half of 2012.

In the meantime markets are likely to be choppy once more, but we expect to see signs that the extreme volatility of the past three years has started to abate. Markets will remain sensitive to the pace of Chinese policy easing, the contagion risks posed by the European debt crisis and the appetite of investment funds to re-price a bullish backdrop. Encouragingly most of the movements in investment fund flows have been on the long side, suggesting that participants are looking to buy on the dip rather than position for a weaker outlook (see Figure 2).

FIGURE 1. ANZ GLOBAL LEADING INDEX



Sources: Bloomberg, ANZ

THINGS TO WATCH

Potentially volatile backdrop to Q2 after a stronger-than-expected performance in Q1.

Sentiment to remain ahead of fundamentals, with investors highly sensitive to softer news and data.

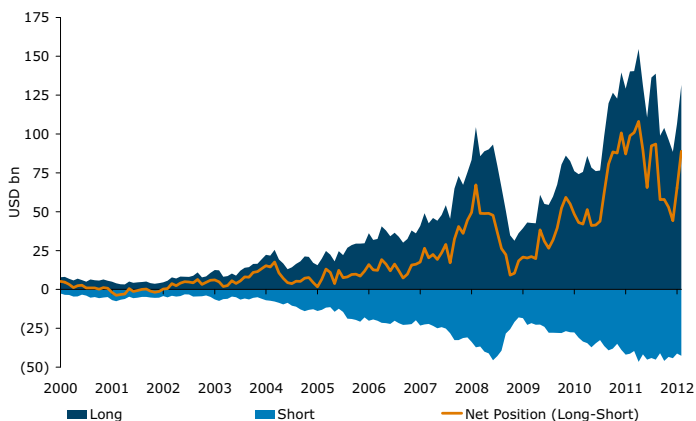
Energy and precious metal markets better placed, with on-going supply issues and inflation risks supporting prices.

ENERGY

The energy outlook looks blurred with the supply driven first quarter rally looking vulnerable to correction. A lot of upside has been priced in for concerns about supply from Iran (see Figure 3), Sudan and to a lesser extent Nigeria. The market is especially sensitive to any conflict between Iran and the West over the former's nuclear program. In the United States the delayed reversal of the Seaway pipeline in June should support WTI prices at the end of the quarter and into the third, by improving market access to Cushing Oklahoma stockpiles.

Military action or an Iranian naval blockade of the Straits of Hormuz, an artery for more than a quarter of the world's seaborne crude, could send oil prices well above the previous record near USD150. But this appears highly improbable, and is not an outcome significantly reflected in prices. Crude is currently trading with a risk premium of perhaps \$10-\$15 relating to the possibility of low level disruptions to the supply of oil due to increased scrutiny or other safety and security checks by Iran of vessels transiting the Straits. If we start to see signs of agreement between the West and Iran, we could see that risk premium halve.

FIGURE 2. CFTC NON-COMMERCIAL POSITIONS



Sources: Bloomberg, ANZ

COMMODITY MARKETS OUTLOOK

Crude demand in H1 is likely to be 89.0mbbls/day, but will pick up in the second half. Demand growth will be driven by improving sentiment in the US and by growth in China. However, increased energy efficiency, especially in China, will keep oil demand growth about 2-3 percentage points below the rate of GDP expansion. The outlook for Europe is flatter as the region deals with austerity measures and high euro-denominated prices.

BULK COMMODITIES

Bulk commodity prices should bottom out in the second quarter as seasonal restocking demand improves in China, but the upside may be limited by low end-user margins. Weaker Chinese imports will be offset by tighter supplies from Australia and we expect prices will start to firm later in the second quarter as policy easing in China props up demand from the steel and power end use sectors.

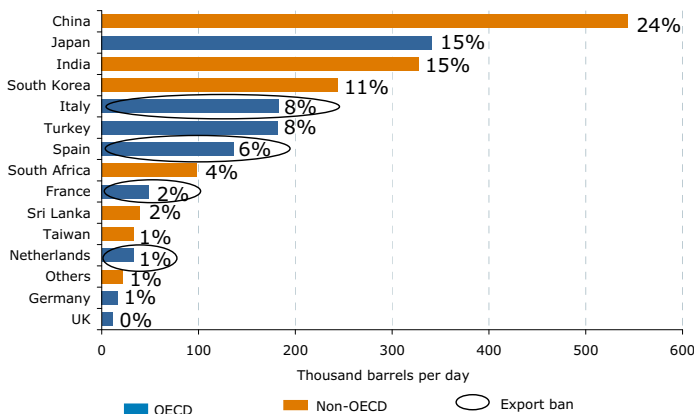
Iron ore remains heavily dependant on Chinese steel output and prices. Steel demand has eased recently, but domestic output appears to be moving towards record levels (see Figure 4). Demand will also firm as we enter the seasonally strong second quarter construction period. That said, steel mill margins still remain under severe pressure, which suggests iron ore prices will not match the very high levels of the first quarter of 2011. We forecast prices will regain 4.3% to USD154/t CIF China in the second quarter, after falling 5.4% first.

Coking coal prices should bottom out in the second quarter, but like iron ore, prices will hinge on China's steel outlook. Destocking in the Chinese steel sector implies slightly stronger end-use, and will eventually lead to higher prices, but skinny margins mean there is very little headroom right now for higher coking coal prices. The market will also keep an eye on rolling industrial action in Queensland for its impact on supply which so far has had little influence, in part due to stockpile builds by miners in the past two months. Thermal coal prices are weaker this quarter, but appear to be holding up reasonably well considering the pullback in Chinese and Indian imports.

Seasonal rainy weather in Australia has limited the supply overhang, while rising oil prices have created additional support for alternative energy markets such as coal. However, China's capped domestic thermal coal prices will dictate seaborne prices, limiting any significant arbitrage opportunity.

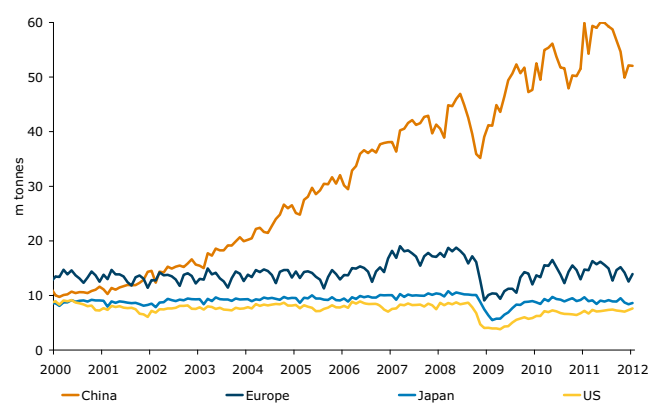
Tight power plant margins are likely to be ongoing, which suggests that demand for lower priced, lower value coals from Indonesia will be well sought. Coal customer stocks are high in China, but tighter in India, which should smooth out any weakness in the second quarter. The more active Newcastle spot market is expected to improve by 4.3% to USD120/t in the second quarter, after being dragged lower in the March quarter by an expected fall in the Japanese 2012 benchmark contract price.

FIGURE 3. IRAN OIL EXPORTS



Sources: Bloomberg, ANZ

FIGURE 4. GLOBAL STEEL OUTPUT



Sources: Bloomberg, ANZ

COMMODITY MARKETS OUTLOOK

PRECIOUS METALS

Gold prices should remain firm, underpinned by a continuation of retail and central bank buying. Retail investors will continue to diversify to seek protection from negative real interest rates and the banking crisis in Europe. Gold will also continue to garner support from the liquidity injections by the ECB in the past three months and potentially from other central banks seeking to stimulate their economies through fiscal and monetary policy.

We expect to see physical demand from China continue to rise. Chinese savers may look more to gold to protect against inflation. Data for 2011 showed some 430 tonnes of gold were exported from Hong Kong to mainland China, three times more than in 2010 (see Figure 5). Demand from India may be sluggish in the first part of the year as the country continues to grapple with a weak currency. But a bottoming in the rupee and the likelihood of easier policy may lift the economy and drive demand higher later in the year.

Platinum prices are expected to remain volatile, with significant upside risks stemming from threats to supply from southern Africa. Impala Platinum, the world's second biggest platinum producer, is dealing with a strike in its domestic base South Africa, and is squaring off against Zimbabwe in a USD300 million dispute over ceding ownership of its mines to locals.

BASE METALS

Base metals will be mixed. Copper prices will see continued support in the second quarter from the tighter supply environment in the international market. Available stocks have dropped to a critical 3.4 days of supply, and total stocks, at less than 300,000 tonnes, are well below the 10-year average.

LME cancelled warrants are also signalling further withdrawals (approximately 11%) in stockpiles (see Figure 6). In China stocks have increased in the Shanghai exchange and bonded warehouses, but importantly, stores held by copper consumers are more or less zero, creating the potential for upside rallies.

Aluminium is likely to struggle in the current environment with gains limited by record stocks of metal in LME warehouses and a forecast surplus of 1.3 million tonnes in 2012. Smelters have started to trim output, but have lagged the reductions made by the alumina sector which embarked upon a series of output cuts in 2011. We expect global primary metal output growth to slow to 5.8% to 48.8 million tonnes in 2012 from 8.6% last year, but it is a case of too little, too late, to deal with the surplus.

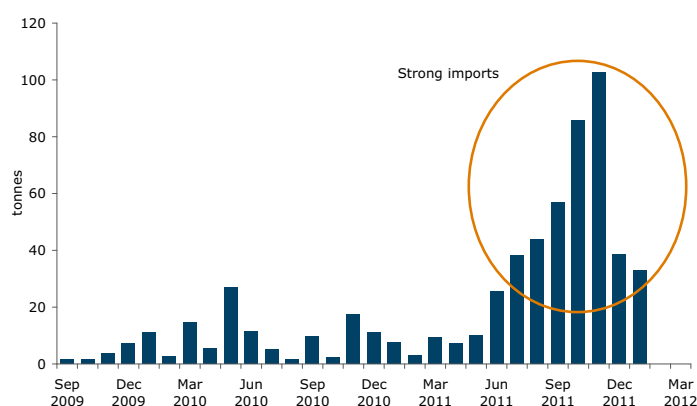
At the same time, downside risks are contained. As much as a third of the world's smelters are losing money at current prices. The flat cost curve creates significant risks if prices start to fall or input prices rise and we are particularly worried in case we see an energy price blow out. The demand side remains reasonable. Anecdotal evidence from automakers in Europe whom we visited recently points to increasing intensity of aluminium in vehicles to save weight and improve efficiency. Those same automakers are also reporting strong sales in core European markets, while loss of demand at the peripheral has been made up in Asia and the United States.

Mark Pervan
Global Head of Commodity Strategy

Nicholas Trevethan
Senior Metals Strategist

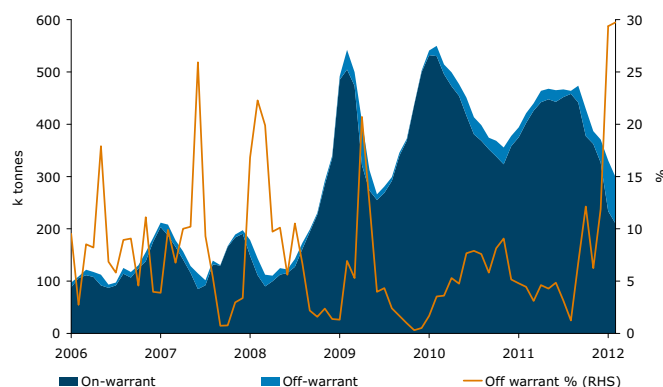
Natalie Robertson
Commodity Strategist

FIGURE 5. HONG KONG GOLD EXPORTS TO CHINA



Sources: Bloomberg, ANZ

FIGURE 6. LME STOCKS & CANCELLED WARRANTS



Sources: Bloomberg, ANZ

COMMODITY MARKETS OUTLOOK

AGRICULTURE AND SOFTS

Global agricultural commodity prices are expected to remain high after strong gains in the first quarter. Speculative funds have re-emerged as a supportive factor – especially in sugar and oilseeds. Dryness in one of the major food production hubs in the world – central South America – has resulted in production downgrades in corn and soybean crops in Brazil, Argentina and Paraguay (see Figure 6). This has been instrumental in pushing prices higher in recent months.

Uncertainty surrounding the size of the 2012 US corn crop and Brazilian sugarcane harvest will also ensure a 'risk premium' for prices is maintained through Q2. The production outcome of these two crops will be instrumental in determining whether the underlying bull market in agricultural commodities is intact by the end of 2012. The outcome of both of these crops won't be known with any confidence until well into Q3.

Short term investor flows (specs) have re-emerged as a positive factor in the market. However, specs are only still playing markets on a selective basis. In the last month, this segment of the market has moved aggressively into agricultural commodities where South American weather concerns are most likely to be reflected in prices – soybeans, oilseed products and sugar (see Figure 7). This is likely to remain a positive factor in Q2 as funds continue to chase alpha returns. Excess returns are more easily obtained when a tight underlying stock situation is combined with a supply disruption or production downgrades from short term weather events.

In the quarter since December, global soybean and corn prices have rallied 20% and 10% respectively due to the weather issues in South America.

A lack of rainfall early in the growth season has resulted in downward production revisions as crop stress flows through to lower yields for corn and early planted soybeans. While recent rainfalls have largely mitigated further crop losses, dryness has persisted in parts of Brazil. But overall, Brazil's grain and oilseed production losses were minimised by a sufficient crop in the central west (Mato Grosso) versus large production losses in the south.

Dryness in the region has also added to the uncertainty for global sugar markets. The centre south region in Brazil, which has now recorded below average rainfall for the last four months, is at the heart of world sugar supply. Brazil accounts for 45% of global sugar exports and a global stock rebuild (surplus) in sugar markets is premised on a larger sugarcane crop from Brazil this year. Recent dryness and the impact of ageing cane fields on yield in the region has increased the uncertainty around Brazil's upcoming harvest. In our view this will ensure a 'risk premium' is maintained in the sugar market well into Q3.

Equally for grain markets, corn prices can ill-afford to fall significantly lower given global stock levels remain particularly tight and certainty around the upcoming US corn crop is still six months away. US corn production accounts for 40% of global corn output, and the fate of 2012 US corn yields will determine the direction of global grain prices in the second half of 2012. The critical stage in determining US corn yields is July to August. Until the crop moves safely through this period with no extreme temperature or adverse moisture conditions, grain prices will remain well supported.

Paul Deane
Senior Agricultural Economist

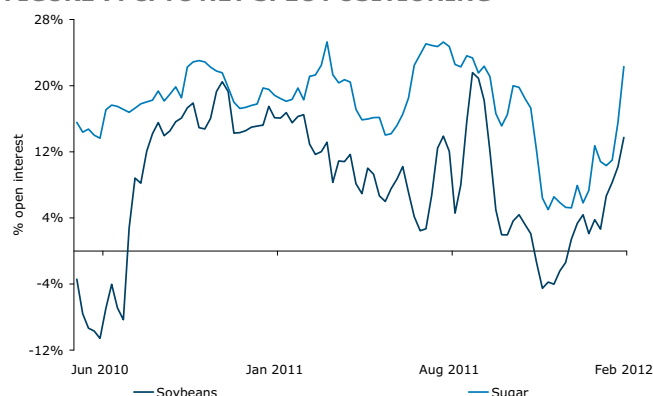
Victor Thianpiriya
Agricultural Commodity Analyst

FIGURE 6. USA, BRAZIL & ARGENTINA SOYBEAN STOCKS



Sources: USDA, ANZ

FIGURE 7. CFTC NET SPEC POSITIONING



Sources: CFTC, ANZ

FAST TRACKING RMB INTERNATIONALISATION

CATAPULTING SHANGHAI ONTO THE WORLD'S FINANCIAL STAGE

China plans to turn Shanghai into an international financial centre in four years according to a blueprint released by the Chinese National Development and Reform Commission (NDRC) and the Shanghai Municipal Government on 30 January. Not only will the scale and scope of the Shanghai financial market be increased but also the city's standing in global financial markets. This ambitious blueprint has been endorsed by the central government under the 12th Five Year Plan.

In 2009, the State Council released a plan for Shanghai to be a financial centre by 2020. That vision has now been fast tracked to 2015 and concrete targets have been set. Topping the list is the goal to boost total market turnover to RMB1000trn by 2015 from RMB386trn in 2010. Other goals include raising Shanghai's ranking in the global league tables for bonds, gold and financial derivatives; and doubling assets under management (See Figure 1).

The plan is to position Shanghai as a global RMB business centre, taking the lead in product innovation, transactions, pricing and clearing. Specifically:

- > Shanghai will be a centre for cross-border RMB investment and financing, and RMB-denominated IPOs and foreign corporate bond issuances;
- > The SHIBOR (Shanghai inter-bank borrowing rate) will be the major benchmark interest rate for pricing onshore and offshore RMB assets;
- > The RMB's daily fixing, set by the People's Bank of China (PBoC), will be the main benchmark for onshore and offshore RMB transactions;
- > Development of a global interface for RMB payments and a clearing network.

However, for Shanghai to be front and centre in the global RMB business by 2015, China will need to liberalise its capital account far more quickly than previously expected.

Most importantly, a range of domestic reforms will need to be in place before this transition can safely occur. In particular, a more flexible RMB exchange rate, more rapid interest rate liberalisation, and more mature bond & debt capital markets are essential. Without these preconditions, large flows of funds could threaten already vulnerable domestic financial infrastructure and cause macroeconomic instability. The South Korean experience of the 1980s and 1990s should serve as a warning in that regard (see 'Lessons from South Korea' on page 27).

THINGS TO WATCH

'Shanghai 2015' fast tracks RMB internationalisation and aims to nearly treble total financial market turnover in Shanghai by 2015.

Capital account liberalisation will accelerate. Domestic reforms such as a flexible RMB exchange rate, interest rate liberalisation and deeper bond markets are needed to avoid instability.

Rapid liberalisation of China's capital account will likely see:

- > Chinese private capital move to low cost economies;
- > Chinese residents diversify their asset portfolios;
- > Chinese capital flows catch up with trade flows seeking high yield assets;
- > Chinese banks follow the money of Chinese citizens into markets abroad.

On balance though, we believe China can and will make the necessary changes, and the implications for global markets will be profound. As the flow of capital in and out of China frees up, the private sector will overtake the government sector as the principal engine for recycling China's large external surplus. Currency appreciation will mean less FX reserve accumulation. The pool of domestic savings will increasingly seek investment opportunities offshore via the financial markets.

Greater financial liberalisation will see Chinese private capital move rapidly to low cost economies such as Vietnam. Chinese residents will diversify their asset portfolios by investing in global equity and FX markets, which will in turn take pressure off the domestic property market. Chinese capital flows will catch up with trade flows, seeking countries like Australia with high yield assets, and Chinese banks will likely follow suit by establishing many more offices abroad.

FAST TRACKING RMB INTERNATIONALISATION

FIGURE 1. SHANGHAI 2015 PERFORMANCE TARGETS (RMB)

	2010	2015
Size of financial markets		
Total turnover of financial markets (excl. forex)	386.2trn	1000trn
Bond custodian, world ranking	Top 5	Top 3
Gold market turnover, world ranking	No. 1	No. 1
Financial derivatives, world ranking	-	Top 5
Insurance premiums	69.5bn	140bn
Bank card transactions	10trn	25trn
Level of internationalisation		
Foreign investors	Scarce	Abundant
Shanghai to influence global financial markets	Insignificant	Indices of the securities market and commodity futures to affect global pricing
Level of financial services		
Capital market financing as % of total social financing	16.70%	22%
Assets under management	15trn	30trn
Operating environment		
Financial personnel	245000	320000
International competitiveness	Best in China	Operating environment (legal, regulatory, taxation etc.) to be more compatible with international practice

FAST TRACKING RMB INTERNATIONALISATION

PREPARING FOR A FLEXIBLE RMB EXCHANGE RATE

The NDRC plan specifies the use of SHIBOR and the PBoC's CNY fixing rate to price both onshore and offshore RMB assets. This suggests two things: that development of the RMB market will accelerate so that the conditions are in place to float the RMB exchange rate eventually, but that a free floating of the currency without referencing the PBoC's fixing is unlikely before 2015.

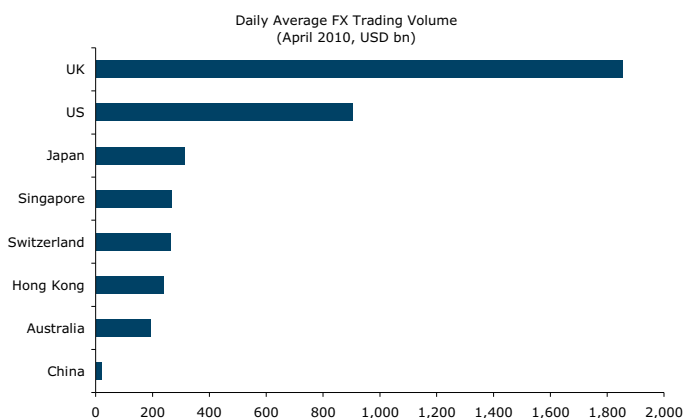
On the other hand, the money market interest rate in Shanghai, which is highly influenced by the central bank's open market operations, will also inform the pricing of the offshore RMB, and act as a benchmark for pricing RMB-denominated derivative products.

This arrangement may be due to the government not expecting to set up an offshore market for yuan, similar to the eurodollar market for the dollar, by 2015. As such, the internationalisation of the RMB through offshore centres – Hong Kong inclusive – will remain a highly controlled experiment.

IS 2015 A REALISTIC DEADLINE?

Notably, the NDRC's plan does not set a volume target for foreign exchange transactions (see Figure 2), preferring a milestone for the overall financial market turnover. Given that the plan is to increase financial market turnover to RMB1000trn in 2015, from RMB386.2trn in 2010, an annual average growth rate of 21% will be required.

FIGURE 2. AVERAGE DAILY FX TRADING VOLUME



Sources: BIS, ANZ

According to a PBoC report (Q4 2011) FX turnover in 2011 – including spot, forwards and swaps – totalled USD5.5trn (see Figure 3). This year, if China's international trade and investment flows are as large, or larger, than those in 2011; if the government accelerates the development of the foreign exchange market; and if the currency market expands at the same pace as the overall financial market, total RMB transactions should approach USD12trn in 2015.

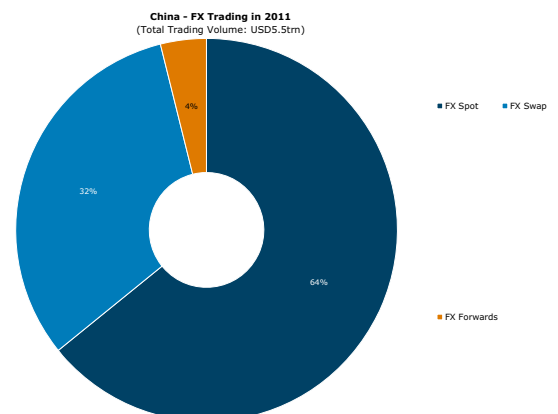
The RMB exchange rate needs to be more flexible and allow two-way movements if the onshore FX market is to develop rapidly. The trading band of the RMB against USD will need to be enlarged and increased volatility of the exchange rate will allow the development of futures and other hedging products. Chinese commercial banks will need to develop new products, take more risks and improve risk management.

CAPITAL ACCOUNT LIBERALISATION IS KEY

The other institutional obstacle that Shanghai needs to overcome to achieve its ambitious goal, is, to state the obvious, a faster liberalisation of China's capital account so as to facilitate the bilateral flow of funds.

According to the PBoC, there are only four items in China's capital account that remain tightly controlled: limiting non-resident participation in the domestic money market; fund management; trust companies and the buying and selling of derivatives. Meanwhile, there are 22 partially liberalised items which represent about 55% of total capital account transactions, mainly in the bond market, equities, property and private equity transactions. The remaining items are mostly liberalised and are mainly credit-related transactions, direct investment and trade-related current account transactions. In total, relative to countries with similar levels of development, China's capital controls remain tight.

FIGURE 3. FX SPOT, SWAP AND FORWARDS TRADING



Sources: CEIC, ANZ

FAST TRACKING RMB INTERNATIONALISATION

But opening the capital account without a well-prepared and sophisticated domestic financial market could threaten the country's financial stability. There is an international consensus that an appropriate sequencing of reforms is required (ie capital account liberalisation should happen after complementary domestic reforms are in place). Otherwise, massive flows of funds may impact not only a vulnerable domestic infrastructure, but also macroeconomic stability.

THE NEED TO SPEED UP FINANCIAL REFORMS

To support capital account liberalisation, interest rate liberalisation has to move forward to provide an accurate price signal to market participants and reflect credit market conditions. At this stage, China's short-term interest rates are mostly liberalised, though lending rates are subject to floor and deposit rates

To some extent, the deposit rate is the only rate still under control, resulting in a serious negative real interest rate that has enabled very low funding costs and encouraged investment. If capital accounts were to open, the negative real interest rate is likely to create even larger financial market distortions and possibly lead to an investment boom and bubble in asset markets, such as the property market.

Bond and debt capital markets, more importantly, need to expand so as to lessen the reliance upon, and the concentration of financial risk in, the banking system. A market-based yield curve will best gauge and guide flows of funds amongst assets of different maturity. A sizeable market will also act as a reservoir to prevent large capital flows from accentuating the volatility of domestic interest rates and the RMB exchange rate.

However, China's bond market is rudimentary. In 2011 the capital market was responsible for just 14% of new social financing, compared with 80% of bank lending and indirectly entrusted loans (see Figure 4). Furthermore, corporate bonds remain an infant concept in enterprise financing, representing only 8% of the outstanding debt capital market (see Figure 5). Policy measures are needed to activate a vibrant capital market.

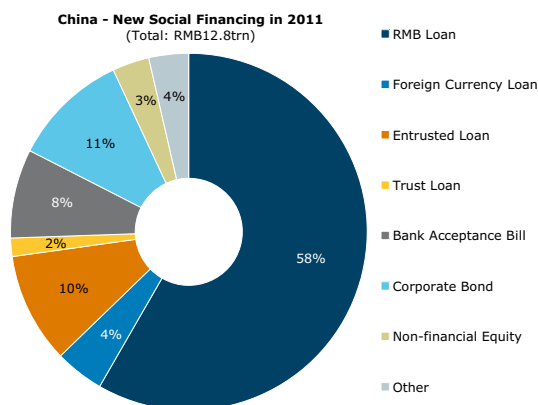
LESSONS FROM SOUTH KOREA

In considering capital account liberalisation, the experience of South Korea provides a lesson for other emerging markets. In response to large current account surpluses of the late 1980s, capital outflows were the first to be liberalised, but inflows remained tightly controlled.

As the current account surplus fell, the authorities started to allow inflows. However, the regulatory bias toward short-term external borrowing was compounded by domestic weaknesses, particularly lax banking regulations and poor corporate governance with respect to relationship lending to conglomerates known as *chaebols*.

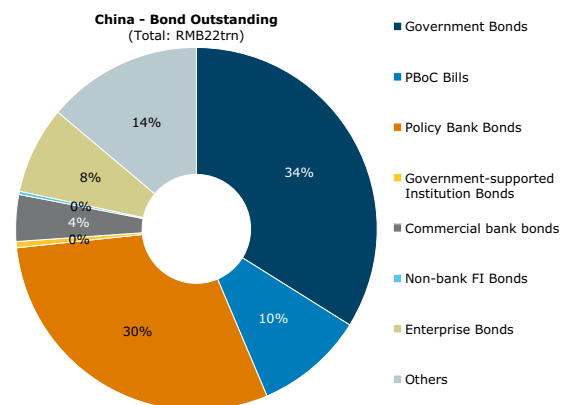
With the outbreak of the Asian Financial Crisis, and the quick shift in market sentiment, external financing conditions deteriorated significantly. By late October 1997 Korean banks started to have difficulty rolling over their short-term foreign debt. KRW depreciated by more than one-fifth, and foreign exchange reserves were down 75% within two months to USD6bn (compared with today's USD311bn). South Korea then sought a bailout from the IMF.

FIGURE 4. NEW SOCIAL FINANCING



Sources: PBoC, ANZ

FIGURE 5. BONDS OUTSTANDING



Sources: CEIC, ANZ

FAST TRACKING RMB INTERNATIONALISATION

The government currently controls an 80% share of Chinese banks. Further diversifying state ownership and allowing more competition could help encourage efficiency and sophistication of the banking system.

Foreign participation will also help domestic financial institutions move closer to international standards of risk management and product innovation. Meanwhile, prudential regulation and supervision and financial restructuring policies should be implemented to complement other financial reforms aimed at enhancing competitive efficiency and market development.

IMPLICATIONS FOR GLOBAL FINANCIAL MARKETS

Shanghai's emergence onto the international stage will also have important implications for global capital flows, banking, and Hong Kong's role as an offshore RMB centre.

Capital flows

The possibility of earlier than expected capital account liberalisation will facilitate greater Chinese capital outflows than inflows as current capital controls are mainly imposed on private residents' investment abroad.

Chinese private capital, especially in labour intensive sectors, will move at a faster rate to low-cost economies and countries with already close trade linkages.

Chinese residents will also diversify their asset portfolios to include more foreign assets. This will naturally reduce China's official portfolio outflows that are mainly in liquid but low-yielding government bonds, and will have far reaching implications for global equity and foreign exchange markets.

Multinational companies will also be able to raise funds in the Shanghai market for both their Chinese and international operations. Facilitated by Chinese and international banks, surplus Chinese capital will flow to countries with high yield assets. Capital flows will gradually catch up with trade flows and will be an important force for global markets.

Once Chinese residents are allowed to invest abroad, the RMB may experience a period of depreciation rather than appreciation, largely because capital outflows may outweigh inflows and the RMB's undervaluation may have

already been exhausted by 2015. This will help ease the pressure of rising asset prices as more investment opportunities abroad will help mitigate Chinese residents' excessive asset allocation in the domestic property market.

International banking

With increased outward foreign direct investments, Chinese banks will follow their customers to the rest of the world, bringing about both opportunity and competition to the international banking business.

Meanwhile, international banks will benefit from the opening of the Shanghai market with an increase in their RMB-related business. It is likely that more international banks will move a major part of their operations to Shanghai, creating job opportunities and enhancing Shanghai's status further.

Hong Kong's CNH market

Will Shanghai pose a threat to Hong Kong's CNH market? We do not think CNH will cease to exist with the rise of Shanghai as an onshore market. Capital account convertibility is essential for Shanghai to develop. Onshore banks need to have the capability and infrastructure to transfer funds freely with offshore counterparties. In Hong Kong, enterprises raise RMB funds via dim sum bonds and repatriate the funds for onshore investment. This sequence means that the development of Hong Kong's RMB business will also accelerate before a globalised RMB market matures in Shanghai. Unless there are asymmetric regulatory treatments in favour of onshore banks, the CNH market will retain its first mover advantage.

The downside, however, is the impact on Hong Kong's own currency. Once the Chinese capital account becomes largely convertible, questions will be raised as to whether the Hong Kong dollar should continue its peg with the USD. This will test the Hong Kong government's resolve in maintaining the linked exchange rate system and the uncertainty could undermine Hong Kong's financial stability. This issue requires greater clarity in Hong Kong's policy pronouncement and intentions.

FAST TRACKING RMB INTERNATIONALISATION

CONCLUSION

The Shanghai 2015 performance targets effectively fast-track internationalisation of the RMB and aims to nearly treble total turnover of financial markets in Shanghai by 2015. These targets will only be achievable and sustainable if complementary domestic reforms are in place to ensure that local markets are sufficiently sophisticated and flexible to accommodate the enormous flows that they envisage. In particular, a flexible RMB exchange rate, interest rate liberalisation, and mature bond and debt capital markets need to be in place if problems like those experienced by South Korea in the 90s are to be avoided.

If these issues can be appropriately managed and the performance targets met, the implications will be profound for global capital flows, banking and Hong Kong's CNH market. Among other things we will likely see Shanghai opened to the world of foreign banks and, conversely, Chinese banks following the money of Chinese citizens as they invest in markets around the world.

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Head of Greater China Economics

Raymond Yeung
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SOUTH EAST ASIA – RESILIENT SOVEREIGN RETURNS

SOUTH EAST ASIAN SOVEREIGNS ON INVESTORS' RADAR SCREENS

The sovereign debt crisis in the advanced industrialised economies has resulted in a market re-rating of sovereign risk around the world. We have seen higher sovereign risk premiums associated with European debt and higher volatility of European debt. By contrast, risk premiums and sovereign bond volatility have fallen in relation to other advanced economies and some emerging markets (EMs).

In the December 2011 *ANZ Research Quarterly* we argued that Australia's low government debt, credible monetary and fiscal policies, favourable demographics and flexible economy made it a candidate for resilient sovereign bond returns. In this article we turn our attention to emerging markets in Asia and find that the market has already re-rated Malaysian and Philippine sovereign risk and Indonesia is not far behind.

First, we assess recent trends in risk-adjusted returns on sovereign bonds by reference to the Bank of America-Merrill Lynch (BAML) Index. Second, we undertake a forward looking peer assessment of the credibility of fiscal and monetary policies in EMs as well as balance of payments stability and underlying growth resilience.

We find that the Philippines and Indonesia are being recognised by the markets as sound investment destinations and we see good reason for that to continue. Strong or improving fundamentals, both macro and policy, should continue to set these economies apart.

THINGS TO WATCH

Deepening local markets in Indonesia and the Philippines.

Further diversification of the foreign institutional investor base in those markets.

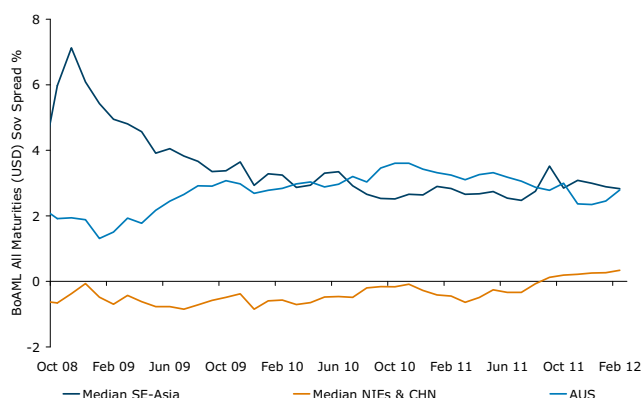
Faster capital accumulation, and improving non-inflationary growth prospects.

Sovereign spreads converging in some EMs

The landscape of sovereign bond returns has changed dramatically since the GFC. Although quantitative easing, in particular by the European Central Bank, is easing market access, the risk adjusted performance of sovereign bond returns in the European periphery remains weak. Meanwhile, other advanced sovereigns have benefited from safe-haven flows which have reduced their borrowing costs to unprecedented lows. Concomitantly, we have also seen lower spreads across several emerging markets. Figure 1 shows South east Asian sovereign spreads narrowing and converging with Australian sovereign risk.

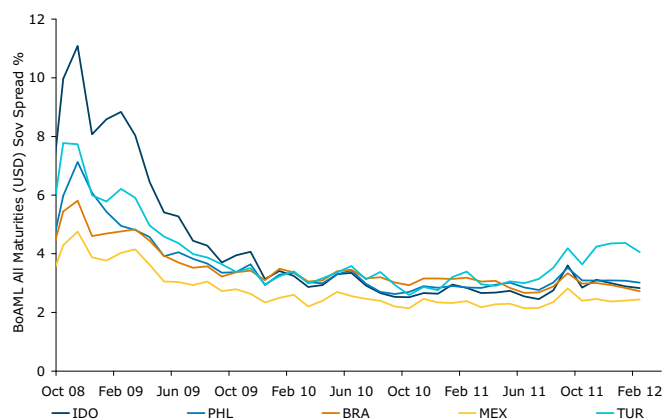
At an individual country level, sovereign spread compression is evident in several emerging markets as indicated in Figure 2. The decline of Indonesian sovereign risk premiums, in particular, has proceeded at a faster pace than in comparable countries. Interestingly, the spread compression in several EMs remained intact through an intense risk-off period in global markets in H2 2011. A key question worth exploring is whether the Indonesian, and to lesser extent, Philippine, sovereign spread compression can last, and how strong is the structural basis for it?

FIGURE 1. SOUTHEAST ASIA SOVEREIGN SPREADS CONVERGE WITH AUSTRALIA



Sources: BoAML, Datastream, ANZ

FIGURE 2. WILL THE CONVERGENCE LAST?



Sources: BoAML, Datastream, ANZ

SOUTH EAST ASIA – RESILIENT SOVEREIGN RETURNS

SOVEREIGN RETURN VOLATILITIES AND RISK-ADJUSTED RETURNS IN EMS

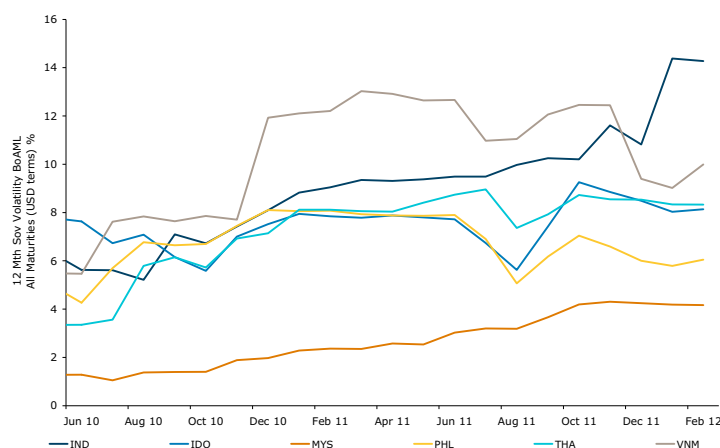
We analysed BAML data on 'all maturities' sovereign bond returns for a range of countries and found that the annualised monthly volatility for several EMs remained subdued, despite considerable uncertainty in H2 2011 (see Figures 3 & 4). During this time Europe remained mired in its debt and fiscal consolidation woes. Greece made slow progress in arranging for its voluntary debt restructuring with the 'Troika' and European banks remained under great capital stress.

This highlights an improving shift in local and global perceptions of the credibility of EM policymakers and confidence about the net present value of future payments of their sovereign obligations. In particular, it may be the first time when adverse changes in the core of the global economy did not weaken or destabilize sovereign bond returns in emerging markets. Sovereign volatility held up especially well in Malaysia, Brazil and Mexico.

There are important exceptions, though. India's bond return volatility (expressed in USD) rose perceptibly as macroeconomic imbalances and a weakening currency took its toll on growth. Russian and Turkish sovereign volatility also edged up, possibly on account of their geographical and economic proximity to the rest of crisis-stricken Europe.

The main consequence of the subdued volatility is a strong pickup in risk-adjusted sovereign bond returns (see Figure 5). Latin American sovereigns led the pack, but, the recent pickup in sovereign returns from the Philippines was also quite strong, with Indonesia not far behind. The reduction of volatility, in our view, is not fragile for the simple reason that it materialised at a time of considerable global economic and credit stress, accompanied by policy uncertainty.

FIGURE 3. ASIAN EM SOVEREIGN VOLATILITY SUBDUED, EXCEPT INDIA



Sources: BoAML, Datastream, ANZ

If, as we believe, relatively strong or improving macro- and policy fundamentals continue to set these EM economies apart from their developed country peers, we see a strong justification for low sovereign volatilities to remain well anchored and improved risk-adjusted returns to remain resilient over time.

EXAMINING MACRO-FUNDAMENTALS

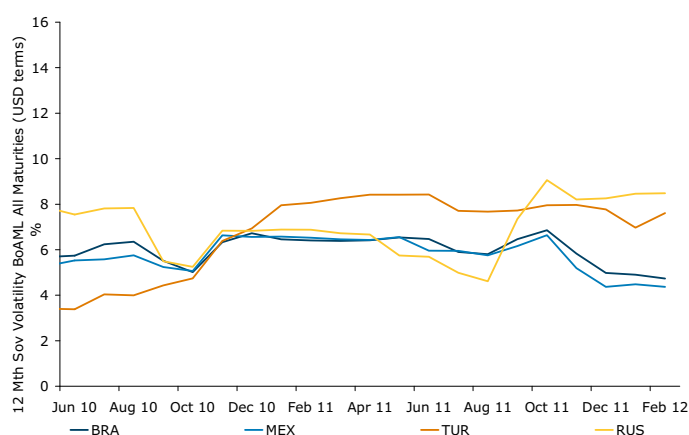
We believe macro and policy fundamentals support the re-rating of some EM sovereigns. Debt and fiscal sustainability, balance of payments stability and monetary credibility are all key measures.

Government debt burden

The level of government debt is clearly an issue which has caught a lot of attention in view of the growing divergence between indebted advanced industrial governments and increasingly debt-free EM sovereigns. Figure 6 plots debt trends in several EMs through the last decade.

All but two EM sovereigns have debt in excess of 60% of GDP (India and Brazil) - levels considered less safe for EMs. Meanwhile, a steep rate of debt reduction was seen in Indonesia - which now has one of the lowest EM government debt burdens. Falling government debt relative to GDP as well as in relation to global financial assets potentially heightens the structural bid for Indonesian sovereign risk. Moreover, the development of greater onshore repo activity is enhancing onshore turnover of Indonesian government bonds.

FIGURE 4. LATIN AMERICAN VOLATILITY SUBDUED BUT RUSSIAN & TURKISH VOLATILITY EDGE UPWARD



Sources: BoAML, Datastream, ANZ

SOUTH EAST ASIA – RESILIENT SOVEREIGN RETURNS

Refinancing requirements

Near-term total government borrowing needs are also well managed, especially, in Asia. Figure 7 shows total refinancing requirements rarely exceed 10% of GDP or 20% of the stock of financial assets. Once again, Indonesia outperforms most other countries on this measure. Although the tenor of its marketable sovereign debt has increased, the Indonesian government's long-term (and low cost) liabilities to official creditors help limit its overall borrowing costs and refinancing requirements. The Philippines has made considerable headway in lengthening government debt maturities, but still faces a sizeable gross borrowing requirement.

Fiscal performance

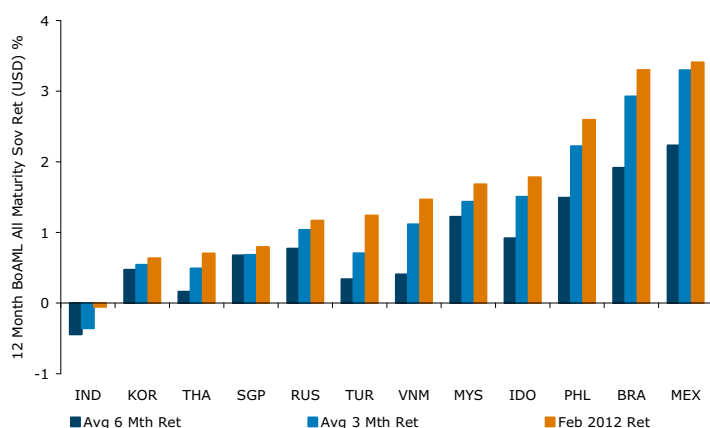
Fiscal performance in emerging Asia is also generally sound. All but two EMs (India and Malaysia) continue to run prudent fiscal policies which result in primary fiscal balances ranging from of -1 to +3% of GDP (see Figure 9). However, there is more variability in the overall nominal fiscal balance as interest costs across EMs vary considerably. The higher interest costs of sovereign debt in India reflect the predominantly local currency denomination, resident holding, and fixed rate funding. And India has yet to demonstrate a credible reduction in its fiscal deficit. Meanwhile, Indonesia continues to post fiscal deficits of between 1-2% of GDP, which is consistent with a declining government debt ratio, comfortable market access, and overall macro stability.

Balance of payments

Turning to balance of payments stability and monetary credibility, we find that with the exception of Turkey and, to a lesser extent, India, all other countries have a reasonably comfortable basic balance position. The Philippines, Thailand and Malaysia derive their strong external position from a sizeable current account surplus. Indonesia and several Latin American countries derive the bulk of their basic balance surplus from larger FDI flows (as a proportion of GDP). Although Indonesia's current account slipped into a small deficit in Q4 2011, recent evidence of growth resilience and greater economic integration within Asia should also spur ongoing increases in FDI into Indonesia, albeit from low levels. Moreover, the competitiveness of the Indonesian economy as well as its terms-of-trade advantages are highlighted by the scale of overall trade which doubled to \$367bn at the end of 2011, from its level in 2006.

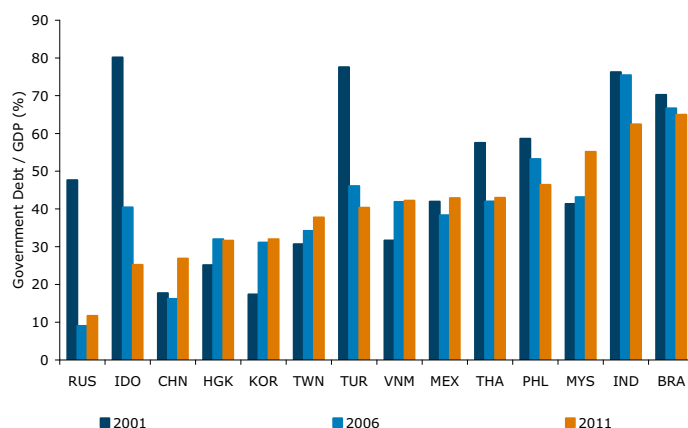
Inflation across most emerging markets eased in late 2011 and into 2012, though, high energy price premiums on account of ongoing geo-political uncertainties in the Mid-East could re-impose price pressures. Nonetheless, the main point is that policy rates in most EMs have been high enough to be positive in real terms (adjusted for inflation) and for anchoring price expectations. Ample liquidity in Indonesia and Philippines has lowered short-term rates. In the case of Bank Indonesia, its effective intervention rate has recently been lowered considerably below its reference rate and these developments have raised the risk of policy and market distortions. Nonetheless, in view of well anchored core price pressures and still high average lending rates, these developments are unlikely to become a widespread threat to overall monetary stability.

FIGURE 5. RISK ADJUSTED SOVEREIGN RETURNS



Sources: BoAML, Datastream, ANZ

FIGURE 6. EM GOVERNMENT DEBT IS LOW



Sources: IMF, ANZ

SOUTH EAST ASIA – RESILIENT SOVEREIGN RETURNS

Indonesia's nominal growth-inflation differential is large enough to assist further debt reduction and, if needed, more fiscal expansion

Lastly, growth - interest differentials (on a nominal basis) are highest in Asian EMs, which goes to show that sovereign dynamics across the region can accommodate primary fiscal deficits without undermining sovereign debt sustainability or its finance-ability. Countries with low growth-interest differentials require either resilient growth or a stronger fiscal effort, and this condition is satisfied in most large EMs in Asia which have either low 'growth betas' to G2 economic developments or continue to post reasonably stable primary and nominal fiscal balances. Growth profiles in Asia are slowing in 2012 but remain robust relative to other regions.

Conclusion

We believe that select Asian EMs such as the Philippines, and in particular Indonesia have been 'recognised' by the markets as attractive investment destinations. This is reflected in the subdued volatility of Indonesia's sovereign bond returns through a stressful period in the global economy. In our view, faith in the economic resilience of these two countries is well placed. Sovereign indebtedness continues to improve relative to other regions, vulnerability to sudden stops is low, gross sovereign borrowing requirements are falling further and the balance of payments position remains strong.

Lastly both countries are growing healthily. Capital accumulation is picking up speed. The higher share of investment in GDP should enhance the non-inflationary rate of GDP growth. Inflation has also dropped to below 4% - lower than in all BRIC countries.

Improved price stability coupled with prospects for improving growth and healthy sovereign balance sheets makes the Philippines and Indonesia worthy candidates for long-term economic and credit resilience. A supply-side oil price shock poses a risk (as it does to all other countries) as does the risk of excessive loosening of monetary policy settings, but the trend improvements in public and private balance sheets, economic resilience, and overall policy credibility are unlikely to erode easily.

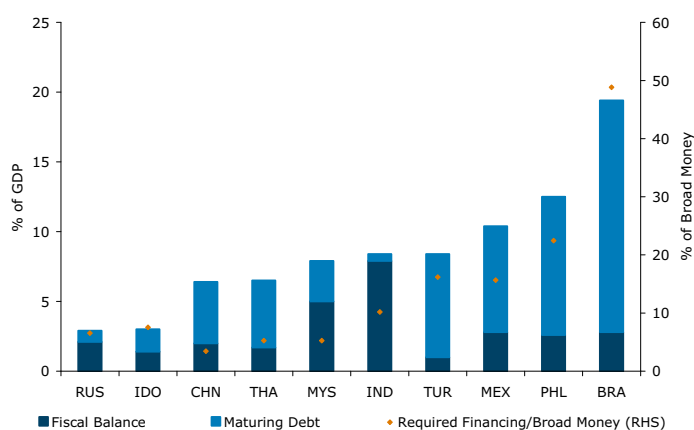
Aninda Mitra
Head, Southeast Asia Economics

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Senior Credit Strategist

FIGURE 8. FORECASTS FOR INDONESIA & THE PHILIPPINES

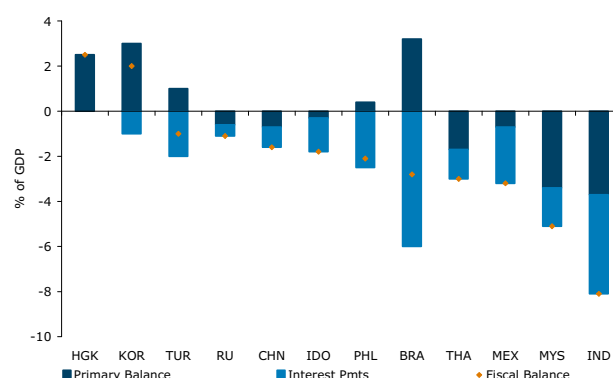
	2012	2013	2014	2015	2016
Indonesia					
Real GDP Growth (y/y)	6.3	6.7	7.0	7.0	7.0
Inflation (Average y/y)	6.4	5.4	5.3	4.7	4.5
Current Account (% of Gov't Balance (% of GDP))	-0.4	-0.6	-0.8	-1.1	-1.3
Gov't Balance (% of GDP)	-1.3	-1.2	-1.2	-1.2	-1.0
Gov't Gross Debt (% of)	24.0	22.7	21.4	20.2	19.0
Philippines					
Real GDP Growth (y/y)	4.9	5.0	5.0	5.0	5.0
Inflation (Average y/y)	4.1	4.0	4.0	4.0	4.0
Current Account (% of Gov't Balance (% of GDP))	1.3	1.2	1.0	1.3	1.6
Gov't Balance (% of GDP)	-2.5	-2.0	-2.0	-2.0	-2.0
Gov't Gross Debt (% of)	43.6	42.2	40.9	39.7	38.5

FIGURE 7. REFINANCING REQUIREMENTS FOR EMs



Sources: IMF, ANZ

FIGURE 9. EXCEPT MALAYSIA & INDIA, PRIMARY FISCAL EFFORT IS GENERALLY STRONG



Sources: IMF, ANZ

COMMODITIES

COMMODITY	Unit	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13
Base metals										
Aluminium	USD/lb	1.18	1.14	0.96	0.90	1.02	1.00	1.03	1.06	1.05
Copper	USD/lb	4.39	4.27	3.17	3.44	3.80	3.90	4.05	4.10	4.05
Nickel	USD/lb	12.27	10.61	7.97	8.49	8.90	9.40	10.00	10.30	10.20
Zinc	USD/lb	1.07	1.06	0.83	0.83	0.91	0.89	0.93	0.96	1.00
Lead	USD/lb	1.23	1.21	0.92	0.91	0.97	0.94	0.98	1.00	1.04
Precious metals										
Gold	USD/oz	1,430	1,500	1,624	1,564	1,700	1,780	1,800	1,830	1,880
Platinum	USD/oz	1,752	1,720	1,526	1,401	1,650	1,720	1,680	1,720	1,810
Palladium	USD/oz	751	757	620	620	720	850	950	1000	950
Silver	USD/oz	37.3	34.7	29.9	27.8	34.5	35.0	35.5	36.8	38.0
Energy										
WTI NYMEX	USD/bbl	105	95	79	99	106	108	109	113	116
Brent IPE	USD/bbl	116	112	104	108	124	123	122	124	125
Uranium	USD/lb	53.0	54.1	53	52	54	58	63	67	70
Bulks										
Thermal coal	USD/t	98	130	130	130	130	125	125	125	125
Premium hard coking	USD/t	225	330	315	285	235	240	220	230	230
Hard coking	USD/t	205	300	290	265	225	196	195	200	200
Semi-soft coking coal	USD/t	185	275	230	208	171	151	170	175	175
Iron ore lump	USD/t	178.5	206.1	202	178	168	175	180	184	184
Iron ore fines	USD/t	149	172	168	148	140	146	150	152	152
Other metals										
Alumina	USD/t	400	384	361	309	405	375	386	385	382
Molybdenum	USD/lb	16.7	15.1	14.0	13.6	14.0	15.5	16.0	16.5	16.5
Cobalt	USD/lb	18.7	16.9	17.0	14.7	14.8	15.8	16.5	17.0	17.0
Agriculture										
Corn	USc/bu	670	731	696	620	635	637	589	570	585
Wheat	USc/bu	786	745	690	615	639	640	624	627	612
Soybeans	USc/bu	1379	1361	1356	1174	1298	1374	1328	1247	1243
Soybean Oil	USc/lb	57	57	56	51	54	57	56	53	53
Palm Oil	MYR/t	3675	3362	3097	3018	3146	3360	3216	3078	3042
Canola	CAD/t	585	576	560	518	590	559	522	520	532
Sugar	USc/lb	31	24	29	25	24	24	24	23	21
Beef	USc/lb	111	111	115	121	125	134	132	131	120
Milk Powder	US\$/t	4245	4042	3636	3567	3573	3500	3500	3500	3600
Cotton	USc/lb	208	185	115	104	101	84	83	87	80

Hard commodity forecasts are end of period prices and ags/softs forecasts are average quarterly prices.

Source: ANZ

CONSUMER PRICE INDEX INFLATION (YEAR-AVERAGE)

Country/region	1990-2007	Forecasts					
	Average	2008	2009	2010	2011	2012	2013
World¹	4.8	5.4	1.7	3.0	4.2	3.7	3.5
G7	2.4	3.2	-0.1	1.4	2.5	1.9	1.6
US	2.9	3.8	-0.3	1.6	3.1	2.2	1.8
Euro zone	2.8	3.3	0.3	1.6	2.7	2.2	1.8
Japan	0.6	1.4	-1.4	-0.7	-0.3	-0.2	0.0
UK	2.6	3.6	2.2	3.3	4.5	3.0	2.6
China	5.1	5.9	-0.7	3.2	5.4	4.0	4.5
Australia	2.8	4.3	1.8	2.8	3.4	2.0	3.3
New Zealand	2.3	3.4	2.0	4.0	4.0	2.3	2.5
OECD	2.5	3.3	0.0	1.5	2.6	1.9	1.7
East Asia	5.3	6.3	0.3	3.2	5.2	3.9	4.3
South Asia	7.4	9.9	6.0	6.0	9.2	8.6	7.5
Emerging Economies¹	9.5	8.0	3.7	4.7	6.0	5.5	5.3

Sources: Consensus Economics, Datastream, ANZ

¹Long-Term average from 1995

GROSS DOMESTIC PRODUCT (YEAR-AVERAGE % CHANGE)

	1990-2007	Forecasts					
	Average	2008	2009	2010	2011	2012	2013
World (PPP)	3.4	2.5	0.5	5.0	3.7	3.7	4.3
World (Market)	3.0	1.5	-1.3	3.9	2.5	2.3	2.9
G7	2.5	-0.4	-3.7	3.0	1.3	1.7	2.1
US	3.0	-0.3	-2.6	3.0	1.7	2.4	2.7
Euro zone	2.4	0.2	-3.6	1.7	1.4	0.0	0.8
Japan	1.6	-1.1	-6.3	4.5	-0.7	2.5	1.7
UK	2.4	-1.1	-4.9	2.1	0.9	0.5	1.8
Canada	2.7	0.7	-2.5	3.2	2.3	2.0	2.3
Asia-Pacific	5.3	5.1	3.6	8.1	5.8	6.5	7.0
Asia-Pacific less Japan	6.9	6.6	5.8	8.9	7.1	7.2	7.9
Australia	3.2	2.5	1.4	2.5	2.0	3.1	3.4
New Zealand	3.0	-0.1	-2.1	1.3	1.6	1.9	3.2
China	9.9	9.6	9.1	10.3	9.2	9.0	9.3
Hong Kong	4.2	2.3	-2.7	7.0	5.0	4.4	5.1
India	6.1	6.2	7.0	9.6	7.1	7.3	8.5
Indonesia	4.9	6.0	4.6	6.1	6.5	6.4	6.9
Malaysia	6.5	4.8	-1.7	7.2	5.1	4.6	6.1
Philippines	3.6	4.2	1.1	7.6	3.7	5.0	5.3
Singapore	6.8	1.7	-0.8	14.8	5.0	3.0	6.7
South Korea	5.8	2.3	0.2	6.2	3.6	3.4	4.9
Taiwan	5.4	0.7	-1.9	10.9	4.0	4.0	5.1
Thailand	5.2	2.5	-2.3	7.8	0.1	5.5	6.3
Vietnam	7.5	6.3	5.3	6.8	6.1	6.0	7.0
Latin America¹	2.7	4.3	3.6	6.2	4.5	3.6	4.0
Brazil	1.2	5.2	3.2	7.5	2.9	3.2	4.3
Mexico	3.2	1.2	3.3	5.4	3.9	3.3	3.4
Argentina	3.8	6.8	3.7	9.2	8.9	3.7	3.7
OECD	2.6	-0.2	-3.4	2.6	1.3	1.5	1.9
Emerging Economies	4.8	5.8	5.0	7.8	6.3	5.9	6.6

Sources: Consensus Economics, Datastream, ANZ

¹ Forecasts sourced from Latin America Consensus Economics

RATES (%)

	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
Europe								
Refinance rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
3m euribor	0.86	1.20	1.20	1.20	1.20	1.20	1.20	1.20
10y bond	1.97	2.30	2.50	2.60	2.80	3.00	3.00	3.40
UK								
Base rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3m libor	1.04	0.70	0.70	0.70	0.70	0.70	0.70	0.70
Canada								
Discount rate	1.00	1.00	1.00	1.00	1.25	1.50	1.50	1.50
3m libor	1.37	1.40	1.40	1.60	1.70	1.90	1.80	1.80
10y bond	2.20	2.20	2.30	2.50	2.80	3.10	3.10	3.10
Japan								
Target rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3m tibur	0.34	0.35	0.35	0.35	0.35	0.35	0.35	0.35
10y JGB	1.05	1.20	1.30	1.40	1.50	1.50	1.60	1.80
US								
Fed funds rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3m libor	0.47	0.35	0.35	0.35	0.35	0.35	0.35	0.35
6m libor	0.74	0.50	0.50	0.50	0.50	0.60	0.70	0.80
2y note	0.37	0.20	0.20	0.20	0.20	0.30	0.50	0.80
5y note	1.10	0.80	0.80	0.80	0.80	1.00	1.30	1.70
10y note	2.30	1.90	2.00	2.00	2.10	2.20	2.50	2.80
30y bond	3.43	2.90	3.00	3.00	3.10	3.30	3.50	3.80
2s5s curve	0.74	0.60	0.60	0.60	0.60	0.70	0.80	0.90
2s10s curve	1.93	1.70	1.80	1.80	1.90	1.90	2.00	2.00
2s30s curve	3.06	2.70	2.80	2.80	2.90	3.00	3.00	3.00
5s10s curve	1.20	1.10	1.20	1.20	1.30	1.20	1.20	1.10

RATES CONTINUED (%)

Australia	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
RBA cash rate	4.25	4.00	4.00	4.00	4.00	4.00	4.00	4.00
90-day bank bills	4.43	4.15	4.15	4.15	4.15	4.15	4.10	4.10
3y bond	3.79	3.20	3.40	3.40	3.30	3.30	3.50	3.70
10y bond	4.23	3.80	4.00	3.90	3.80	3.80	4.00	4.30
3y swap	4.36	3.80	3.90	3.85	3.75	3.70	3.90	4.10
5y swap	4.69	4.20	4.30	4.17	3.97	3.92	4.12	4.35
10y swap	5.02	4.60	4.70	4.50	4.35	4.35	4.55	4.85
10y spread to US	1.93	1.90	2.00	1.90	1.70	1.60	1.50	1.50
3s10s bond curve	0.44	0.60	0.60	0.50	0.50	0.50	0.50	0.60
2s10s swap curve	0.72	0.75	0.75	0.65	0.65	0.65	0.65	0.75
2s5s swap curve	0.38	0.35	0.35	0.32	0.27	0.22	0.22	0.25
5s10s swap curve	0.33	0.40	0.40	0.33	0.38	0.43	0.43	0.50
NZ OCR	2.50	2.50	2.50	2.75	3.25	3.50	3.75	4.25
90-day rate	2.73	2.75	2.75	3.17	3.67	3.75	4.17	4.50
180-day rate	2.81	2.85	2.85	3.27	3.77	3.85	4.27	4.60
3y bond	2.79	3.37	3.51	3.72	3.93	3.98	4.25	4.39
10y bond	4.50	3.90	4.00	4.00	4.10	4.05	4.20	4.30
10y spread to the US	2.20	2.00	2.00	2.00	2.00	1.85	1.70	1.50
10y spread to AUS	0.27	0.10	0.00	0.10	0.30	0.25	0.20	0.00
POLICY RATES								
Emerging Asia	Mar 12	Jun 12	Sep 12	Dec 12	Mar 13	Jun 13	Sep 13	Dec 13
China	6.56	6.56	6.81	6.81	6.81	6.81	n.a.	n.a.
Hong Kong	0.50	0.50	0.50	0.50	0.50	0.50	n.a.	n.a.
India	8.50	8.25	8.00	7.75	7.50	7.50	n.a.	n.a.
Indonesia	5.75	5.75	5.75	5.75	5.75	5.75	n.a.	n.a.
Malaysia	3.00	3.00	3.00	3.00	3.00	3.25	n.a.	n.a.
Philippines	4.00	4.00	4.00	4.00	4.00	4.00	n.a.	n.a.
Singapore	0.39	0.39	0.39	0.39	0.39	0.39	n.a.	n.a.
South Korea	3.25	3.25	3.50	3.75	4.00	4.25	n.a.	n.a.
Taiwan	1.875	1.875	2.000	2.125	2.250	2.375	n.a.	n.a.
Thailand	3.00	3.00	3.00	3.25	3.25	3.50	n.a.	n.a.
Vietnam	14.00	13.00	12.00	11.00	10.00	10.00	n.a.	n.a.

Sources: Relevant Central Banks, Bloomberg, ANZ

FOREIGN EXCHANGE RATES

	Current	Forecasts				Forwards		
	20-Mar-12	Jun 12	Sep 12	Dec 12	Mar 13	3 mths	6 mths	12 mths
EUR/USD	1.324	1.35	1.37	1.37	1.37	1.325	1.325	1.328
GBP/USD	1.590	1.59	1.61	1.63	1.63	1.589	1.588	1.585
USD/JPY	83.37	77.00	75.00	72.00	70.00	83.30	83.20	82.92
AUD/USD	1.062	1.10	1.10	1.10	1.10	1.051	1.040	1.021
NZD/USD	0.827	0.86	0.86	0.89	0.90	0.821	0.816	0.805
USD/CNY	6.3226	6.23	6.19	6.13	6.10	6.327	6.326	6.324
USD/IDR	9169	8800	8750	8700	8650	9268	9365	9585
USD/INR	50.2	47.5	47.0	46.5	46.0	51.34	52.21	53.49
USD/KRW	1121	1080	1070	1065	1060	1128	1134	1141
USD/MYR	3.051	3.00	2.98	2.98	2.98	3.070	3.085	3.108
USD/PHP	42.84	42.6	42.5	41.7	41.9	43.27	43.54	43.88
USD/SGD	1.256	1.23	1.22	1.22	1.22	1.258	1.257	1.255
USD/THB	30.72	30.4	30.2	30.0	30.0	30.91	31.07	31.38
USD/TWD	29.50	28.8	28.7	28.7	28.7	29.47	29.41	29.24
USD/VND	20830	21300	21500	21700	21800	21367	21775	22639

Sources: Bloomberg, ANZ

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