Economics & Markets Research

ANZ Australian Markets Weekly

Policy overdrive

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

Macro Update: Will it work?

- This week policy-makers stepped up the fight. The RBA cut its official interest rate by a further 100bps to a 44-year low of 3.25% while the Government announced new fiscal spending worth $42bn, or 3½% of GDP. Since the onset of the global recession the Government has now committed in total 5.8% of GDP in fiscal stimulus.
- The fiscal response should put some floor under growth in the first half of this year. But the short-term focus of the stimulus still leaves the economy vulnerable to a deeper downturn from the second half of 2009.

Interest Rate Markets: End game for the RBA?

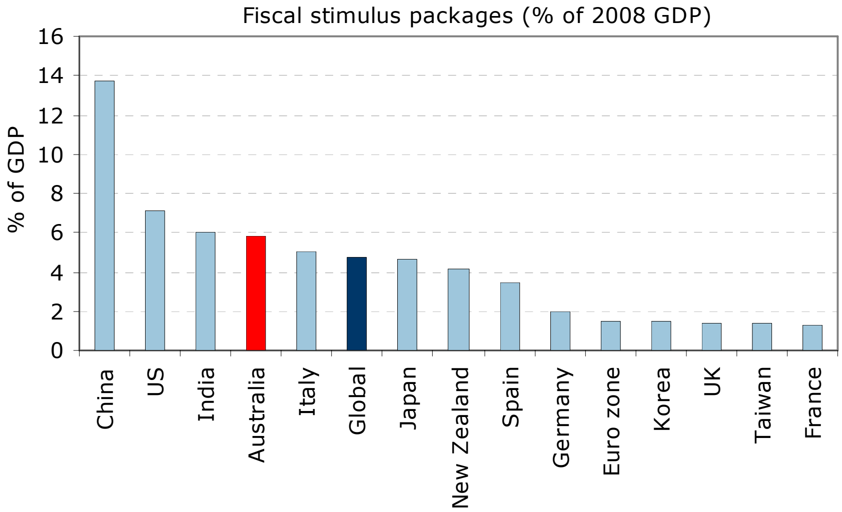
- The market is still looking for the RBA to cut rates further but after 400bps of cuts over the past 5 months, we can safely conclude that the most aggressive part of the easing cycle is now behind us.
- Yields have risen over the past week in line with developments in overseas markets and on the announcement of a significant change to the funding task of the Government in light of the deterioration of the underlying Budget position.

FX: Lower AUD trading range to persist

- The AUD has moved lower this week on continued downbeat economic data. Dismal US Q4 GDP and declines on Wall Street saw the AUD/USD track below 0.6250 for the first time since late November 2008.
- However, encouragement was provided from efforts by the Federal Government and RBA to cushion the Australian economy from the effects of the crisis in financial markets and the seizing up of global demand.

Chart of the week

Figure 1: Australian government is on the front foot



Source: Bloomberg and ANZ

Macro Update: Will it work?

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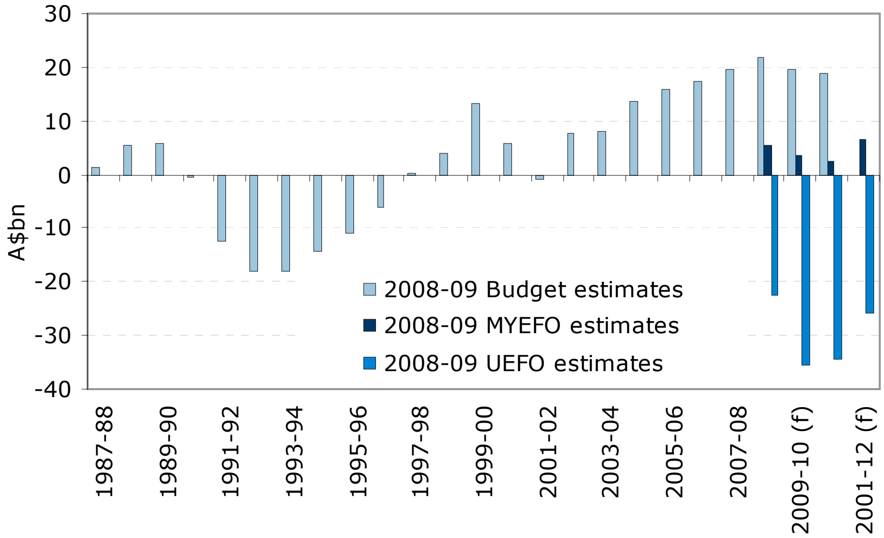
- The government has now committed 5.8% of GDP in fiscal stimulus.
- The fiscal response should put some floor under growth in the first half of this year. But the short-term focus of the stimulus still leaves the economy vulnerable to a deeper downturn from the second half of 2009.

Policy action steps up

This week policy-makers stepped up the fight. The RBA cut its official interest rate by a further 100bps to a 44-year low of 3.25% while the Government announced new fiscal spending worth $42bn, or 3½% of GDP. Moreover, the Government revealed that, in the three months since November, government revenues for the next four years have collapsed by $75bn, mainly due to a weaker corporate tax take. As a result, the Government is now expected to run a cumulative budget deficit of $118bn from 2008-09 to 2011-12, averaging almost 2½% of GDP (Figure 2). For further information on the details of the fiscal package, please see our *Fiscal Policy Update* from 3rd February[1].

Figure 1: The global recession has taken an axe to the Budget



Source: ANZ and Commonwealth Government

Will it work?

The Government's growth forecasts have been revised down sharply, to 1% in 2008-09 and ¾% in 2009-10. But with the government claiming the stimulus package will add ½ppt to growth in 2008-09 and ¾-1ppt in 2009-10, the implication is that without this policy action growth would have been flat to negative next financial year. This suggests the Government believes its fiscal policy will avert a local recession.

How realistic is this? Certainly, there is now a lot of stimulus in the economy. Rates have fallen 4ppt in the last six months, reducing consumer debt interest paid in this period by almost 30%. All up, the government has thrown $68bn at the economy since the budget. This is 5.8% of (estimated) 2008 GDP and is large by international comparisons. The US has committed 7% of GDP, the Euro-zone 1.5% of GDP and the UK 1.4% of GDP. Indeed, the Australian response is bigger, in a relative sense, than the total global response of 4.7% of global GDP (see chart of the week).

This week's retail sales data shows the first part of the government's response – the $8.7bn handout to households in December – provided good support to the economy. Retail sales jumped 3.8% in the month with spending on many

[1] Available at http://www.anz.com/aus/corporate/Economic-Research-And-Publications/Economic-Publications-And-Research/Australian-Research/default.asp

discretionary items up around 5%. Lower interest rates and the increased first-home owners grant is also supporting confidence in the demand side of the housing market. Housing finance approvals have turned slightly positive and are expected to rise solidly again in December (this data is out next week with ANZ expecting a rise of around 7%). This tentative confidence should be helpful in avoiding any significant fall in house prices.

In our judgement, the Government's fiscal spend will do a lot to soften the severity of the downturn in the economy in the short-term. Even if a good portion of the government's next set of handouts (worth $12.7bn) are saved, it should still boost consumer spending as the payments are distributed over March and April. Likewise, it should continue to put a floor under consumer confidence and provide good support for overstretched households, again helping to avert any substantial fall in house prices.

The short-term stimulus now in the system may give the RBA room to become a little more measured in the pace of easing. While we expect rates will fall to 2.5%, we would be surprised if this happened as early as next month. Markets have also scaled back expectations for further aggressive rate cuts; the OIS market is now pricing a rate cut of around 66bps in March, down from nearly 100bps earlier this week. More on the RBA's likely strategy should be revealed when the Bank's latest forecasts are outlined in the *Quarterly Statement on Monetary Policy* tomorrow. We suspect the Bank's outlook is unlikely to differ too much from the Government's.

Too much, too soon?

The major issue we have with the Government's fiscal response is that about half of the total spend is centred on the short term. Yes, this should put some floor under the fall in activity Q4 and the first half of this year. Given the calamitous collapse in activity in other parts of the world, the benefits of this should not be underestimated.

But as the household payments are one-off, the boost to consumption will also be one-off, not permanent. Hence, the nature of the package raises the risk of a very poor second half of 2009 (and in particular Q3), as households adjust once more to a lower level of income. And while the government's intended spend on infrastructure over 2009-10 is welcomed, it may well not be enough to avert the expected sharp fall in business investment. It will also do little to soften the impact from a deteriorating export outlook; data this week showed export volumes collapsed by around 5% in Q4 with further falls, particularly in commodities, now assured. Nor will the fiscal package prevent a further rise in the unemployment rate, which on the Government's own estimates will rise to 7.0% by mid-2010.

Hence, the fiscal package has prompted us to only make a small upward revision to growth in 2009 (although economic activity is still likely to be broadly flat) and no change to our 2010 outlook (see forecasts on p8). Given the amount of money the government has now thrown at the economy, it is a shame that only a small portion of the spend will be available to fight the significant risks Australia faces in the second half of 2009, including (and not limited to) a collapse in private business investment as few new projects commence to replace existing projects that roll off, and the risk of a sharp response in the labour market.

Data wrap

- The **TDS/MI inflation gauge** rose 0.8% in January after falling in the two previous months as petrol prices stabilised.
- Falling exports saw December's **trade surplus** narrow by $390m to $589m.
- The RBA cut the **cash rate** by 1% to 3.25%, the lowest rate since 1964.
- **Retail sales** jumped 3.8% in December with consumers responding to the government's first fiscal stimulus package.
- **Building approvals** failed to recover after collapsing last month, down another -2.9% in December.

Interest Rate Markets

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End game for the RBA?

We could see some upward pressure on the yield curve and outright yields from the significant increase in Government bond issuance

The market is still looking for the RBA to cut rates further but after 400bps of cuts over the past 5 months, we can safely conclude that the most aggressive part of the easing cycle is now behind us. We are less likely to see another 100bps cut in this cycle at least. It is difficult to read too much into the RBA's statement this week, coming on the same day the Government unveiled a huge stimulus package that will lead to a significant increase in Commonwealth debt issuance to cover the move into deficit.

As expected, in its decision to cut rates by 100bps this week the RBA highlighted the unexpected deterioration in the global economy, but appeared to tone down guidance on policy from here. The market has moved to pare back expectations for rate cuts from here with the base for the cash rate now seen around 2.2% for this cycle having flirted with the idea of sub-2.0% last week. And the market is now looking at a 50-75bps move at the next meeting.

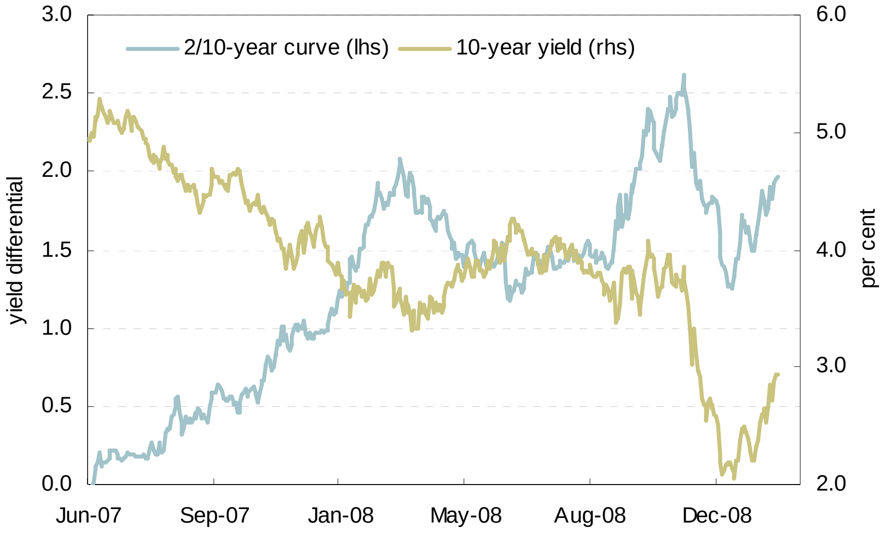
We still expect some further easing from the RBA but we are less sure how they will want to play it from here. Is it a case of getting to the end point quickly (the recent strategy) or do they wish to leave some scope for more rate cuts down the track? If the RBA forecasts for the economy look anything like those of the Government (growth of 0.75% and inflation around 2.5% for 2009/10) then a cash rate of around 3.25% looks about right. They may pause and assess the impact of the unprecedented fiscal and monetary stimulus put into the system.

We will keep our 2.5% forecast for the cash rate for mid 2009 but we will have to await the more detailed and comprehensive outlook on the economy and financial developments contained in the Statement on Monetary Policy (SOMP) due out tomorrow morning. The Bank must have incorporated new thinking on the outlook for global growth and support to growth from Government action into their outlook. Therefore any further guidance on their assessment of stimulatory policy settings in Australia has the potential to have a big impact on market expectations from here.

Yields are starting to see some upward pressure

Yields have risen over the past week in line with developments in overseas markets and on the announcement of a significant change to the funding task of the Government in light of the deterioration of the underlying Budget position.

Figure 3: US yields and curve respond to supply



Source: ANZ & Bloomberg

The AOFM is now looking to issue between $22-24bn for this fiscal year (to the end of June), up from $15bn previously announced in December. We estimate that total Government bonds on issue are likely to head above $120bn into 2010 and possibly towards $180bn from current levels around $60bn.

The AOFM has also announced that they will be coming to market for around $1bn a week from here on in with a tender starting tomorrow.

With the RBA likely to keep rates low for an extended period, this surge in Government bond issuance argues for a steeper yield curve and upward pressure on terms yields. This comes at a time when there is a huge global call on markets to fund official support packages.

The funding task in the US has started to push up longer-dated yields as the US Treasury issues more longer-dated debt. The US Treasury is issuing $US67bn of debt next week (A$105bn). Ten-year yields are 90bps higher from the lows seen in December and the yield curve has steepened over the same period (Figure 3 above).

Australia will need to offer competitive returns to attract these funds. The net debt position of the Government will deteriorate, but from a very healthy level. We could start to see similar sorts of pressure in our market to compete for scarce funds. Remember State Governments and Government Guaranteed bank debt issuance will also represent a call on the markets in coming months.

And while the RBA can take rates lower from here, the limited scope for big moves probably means that there is only limited scope for longer-dated yields to fall much further. Downward momentum for swap yields already appears to be dissipating, at least for now (Figure 4).

Figure 4: Five-year swap

Source: ANZ and Bloomberg

So current longer-term rates provide a good opportunity to lock in some funding considering the balance of risks that appear to be emerging in light of some of the macro developments over the past week.

FX: Lower AUD trading range to persist

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Recommendation

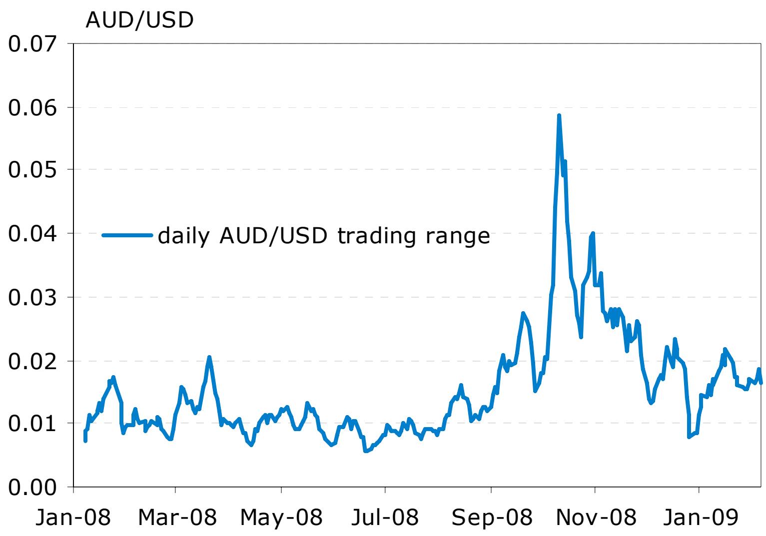
The key AUD short-term risks remain to the downside. An unexpected interest rate cut tonight in the Euro zone has the potential to send the AUD/USD back towards 0.6250. Take advantage of continued wide intra-day moves with active participation. Importers should beware of the downward channel.

Overview

The AUD has moved lower this week on continued downbeat economic data. Dismal US Q4 GDP and declines on Wall Street saw the AUD/USD track below 0.6250 for the first time since late November 2008. Encouragement was provided by official efforts to cushion the Australian economy from the effects of the crisis in financial markets and the seizing up of global demand. The market was short AUD going into Tuesday afternoon's rates announcement - after experiencing larger than expected rate cuts at past meetings, the market didn't want to be caught out again - with an ensuing rally demonstrating the covering of these short positions. The AUD has since stepped back over 1 US cent since the week high of AUD/USD0.6553.

We see the currency now capped at AUD/USD0.66 over the coming weeks. The weakening Australian economy and swings in risk aversion mean that selling pressure will continue to weigh on the AUD. As the chart below highlights, trading volatility in the AUD/USD has been in decline since late October 2008, but the daily trading range remains wide. This means intra-day moves of 2 US cents can cover a fair bit of the established 0.6250 - 0.6550 trading range in a single day.

Figure 2: AUD/USD trading volatility has eased significantly since October, but intra-day trading ranges remain wide

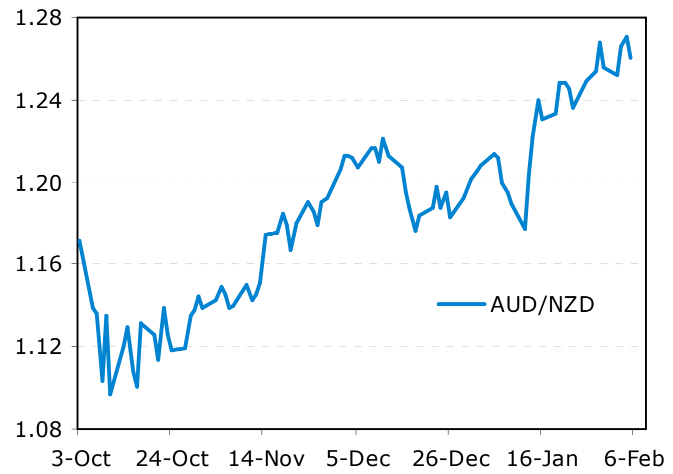


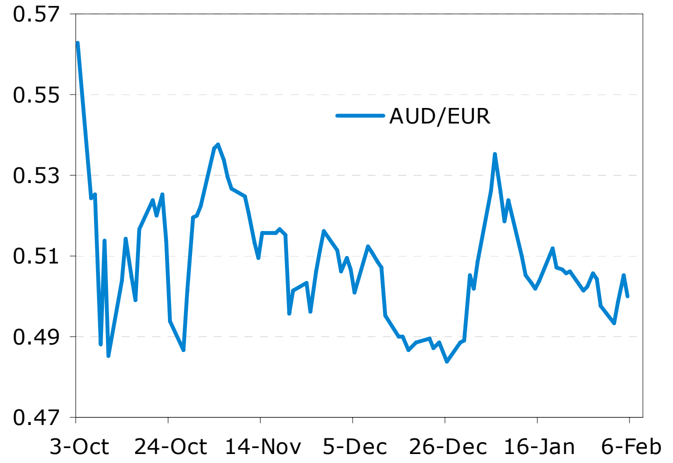
Source: ANZ & Bloomberg

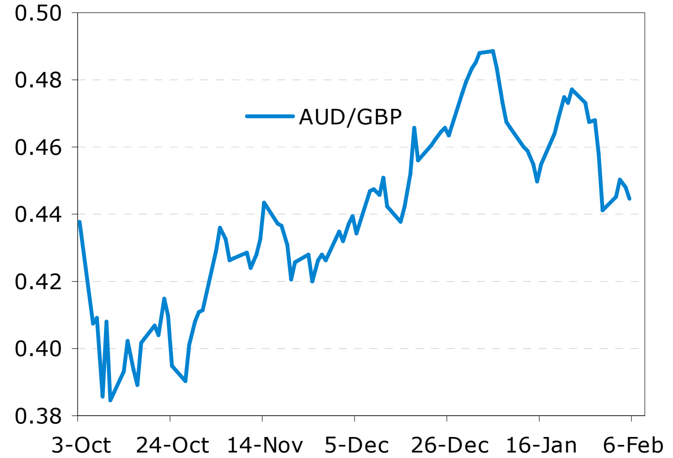
Further out into the forecast horizon, the prognosis is downbeat. Though the RBA may not cut rates in the future as aggressively as over the past few months, and the economy may respond positively to the government's stimulus package, this doesn't really change the medium term outlook for the AUD, and we should see the currency trade in a progressively lower range. Moreover, yesterday's announcement that the federal government will be expanding its bond issuance schedule to finance its new stimulus measures could put additional pressure on Australia's balance of payments, and consequently would argue for further weakness in the AUD.

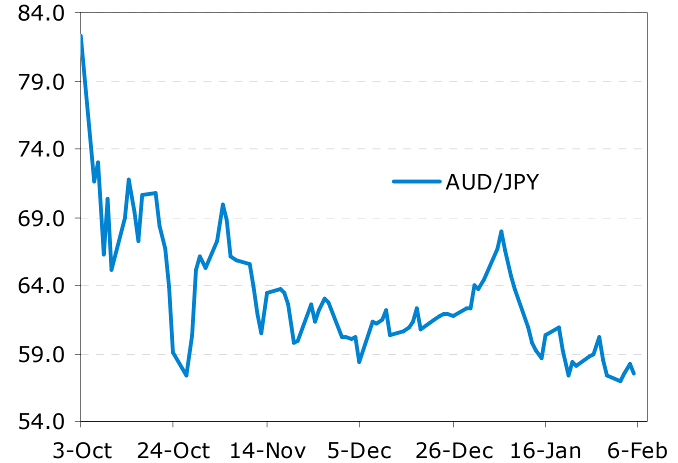
AUD/USD Key levels: 0.6250 – 0.6640. Support should be maintained above 0.6250. A sustained break above 0.6640 could see the AUD rally towards 0.6760, although the coming week's data flow is likely to limit any topside moves.

AUD cross view









AUD / NZD Key levels: 1.2480 – 1.2810

- The AUD has maintained its run against the NZD this week, with most of the action tracking between AUZ/NZD1.25-1.27. Few economic announcements on the other side of the Tasman next week will mean that Australian business confidence and employment data releases will provide the most local direction. Key support remains at AUD/NZD1.2480.
- We have downgraded our NZD forecasts in light of a lower interest rate profile and problematic balance of payments, with the AUD to maintain its dominance over the NZD in the medium term.

AUD / EUR Key levels: 0.4900 – 0.5100

- A whippy AUD has seen the AUD/EUR trade between 0.4900 - 0.5050 over the past week. An unexpected interest rate cut tonight by the ECB has the potential to send the EUR sharply lower towards EUR/USD1.25. As a result, the AUD/EUR could appreciate towards 0.5100, although a lower trading range should soon resume as the AUD heads lower. Support at AUD/EUR0.4900 remains solid.
- Our forecasts suggest that the AUD/EUR will remain stable in the range 0.49- 0.50 over the coming months as both currencies are expected to depreciate against the USD.

AUD / GBP Key levels: 0.4370 – 0.4650

- The GBP/USD has found good support above 1.41 as market participants cease predicting its downfall for the time being. This has weighed on the AUD/GBP, which remained bound within a tight 0.4360-0.4440 rang this week. The BoE is likely not to disappoint the market tonight, with a 50 bp cut to the repo rate (to 1%) expected.
- The depreciation in the GBP appears to have found its nadir, and we have updated our forecasts. The GBP/USD is now expected to steadily improve, reaching 1.50 by year end. With the AUD/USD to fall further, the AUD/GBP is now forecast to decline to 0.36 by the end of December 2009.

AUD / JPY Key levels: 55.50 – 60.40

- The AUD/JPY dipped towards 55.50 this week, the lowest level since late October 2008, as safe-haven flows strengthened the USD/JPY and weighed on the AUD/USD. A worse than expected January payrolls number in the US tomorrow night could see a repeat of this and test the AUD/JPY55.50 level again.
- The medium-term outlook is for JPY outperformance, with the AUD/JPY to head lower to 55 by year end.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008f	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	3.7	-1.2	0.3
Household consumption	4.3	2.2	0.9	1.2
Dwelling investment	2.7	0.9	-4.5	15.1
Business investment	13.9	12.3	-5.9	-8.2
Public demand	2.7	5.8	5.4	6.0
Domestic final demand	5.4	4.1	0.2	1.6
Inventories (contribution to GDP)	0.6	-0.2	-0.1	0.0
Gross National Expenditure (GNE)	5.9	4.0	0.1	1.6
Exports	3.3	3.9	-5.6	2.9
Imports	11.4	11.0	-5.0	1.0
Net Exports (contribution to GDP)	-1.7	-1.7	0.0	0.3
Gross Domestic Product (GDP)	**4.0**	**2.3**	**0.1**	**2.0**
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	3.0	3.0
Underlying*	3.1	4.5	3.5	2.8
Wages	4.1	4.2	3.6	3.5
Labour market				
Employment (annual % change)	2.8	2.3	-0.1	-0.2
Unemployment rate (%)	4.4	4.2	5.4	6.8
External sector				
Current account balance: A$ bn	-68.2	-51.1	-58.9	-83.0
% of GDP	-6.3	-4.3	-4.9	-6.6

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

Australian interest rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
RBA cash rate	3.25	3.00	2.75	2.50	2.50	2.50
90 day bill	3.23	3.45	2.80	2.80	2.80	3.15
3 year bond	3.15	2.55	2.75	2.85	3.15	3.65
10 year bond	4.35	3.90	4.15	4.15	4.25	4.55
3s10s yield curve	1.19	1.35	1.40	1.30	1.10	0.90
3 year swap	3.60	3.15	3.20	3.35	3.65	4.15
10 year swap	4.63	4.40	4.60	4.65	4.75	5.05
International interest rates						
RBNZ cash rate	3.50	2.75	2.50	2.50	2.50	2.50
NZ 90 day bill	3.53	3.04	2.85	2.77	2.75	2.75
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.50
US 2 year note	0.96	0.60	0.70	0.75	1.00	1.50
US 10 year note	2.90	2.90	3.20	3.75	3.80	4.20
Japan call rate	0.10	0.10	0.10	0.10	0.25	0.50
ECB refinance rate	2.00	1.25	1.25	1.25	1.25	1.75
UK repo rate	1.50	1.00	0.75	0.75	0.75	1.00

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

Foreign exchange rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
Australia and NZ exchange rates						
A$/US$	0.6426	0.63	0.58	0.56	0.54	0.54
NZ$/US$	0.5108	0.50	0.45	0.43	0.41	0.42
A$/¥	57.38	61.74	58.00	56.56	55.08	56.70
A$/€	0.5011	0.50	0.48	0.50	0.49	0.50
A$/£	0.4456	0.44	0.40	0.38	0.36	0.35
A$/NZ$	1.258	1.26	1.29	1.30	1.32	1.29
A$/CA$	0.7929	0.76	0.70	0.69	0.70	0.71
A$/CHF	0.7461	0.76	0.73	0.75	0.76	0.77
A$/CNY	4.391	4.31	3.97	3.83	3.69	3.69
A$ Trade weighted index	53.10	53.62	50.30	49.40	47.94	48.01
International cross rates						
US$/¥	89.3	98	100	101	102	105
€/US$	1.283	1.25	1.20	1.12	1.10	1.08
€/¥	114.5	123	120	113	112	113
£/US$	1.442	1.42	1.46	1.48	1.50	1.55
€/£	0.8895	0.88	0.82	0.76	0.73	0.70
US$/CA$	1.234	1.20	1.20	1.24	1.30	1.32
US$/CHF	1.161	1.20	1.25	1.34	1.40	1.42
US$ index	85.84	88.2	90.4	94.7	96.3	97.6
Asia exchange rates						
US$/CNY	6.835	6.84	6.84	6.84	6.84	6.84
US$/HKD	7.754	7.76	7.77	7.80	7.80	7.80
US$/IDR	11900	11350	11500	11900	11600	11600
US$/INR	48.82	49.00	49.00	48.00	48.00	47.00
US$/KRW	1383.725	1375	1400	1400	1375	1350
US$/MYR	3.6215	3.64	3.74	3.80	3.80	3.80
US$/PHP	47.515	47.50	48.50	49.30	49.50	49.50
US$/SGD	1.509	1.54	1.58	1.62	1.66	1.66
US$/THB	34.94	35.80	37.60	39.40	39.40	38.80
US$/TWD	33.65	34.20	35.20	36.00	36.00	35.50
US$/VND	17488	17500	17800	18100	18500	18500
Pacific exchange rates						
PGK/US$	0.372	0.37	0.36	0.36	0.35	0.35
FJD/US$	0.537	0.53	0.51	0.49	0.48	0.48

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