ANZ Economics & Markets Research

ANZ Australian Markets Weekly

IMF: There is worse to come

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Inside:

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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: IMF downgrades forecasts

- April's World Economic Outlook sees the IMF downgrade global growth prospects significantly.
- Developed economies will contract sharply this year weighed down by potentially massive financial sector write-downs to come.
- The IMF has downgraded Australia's GDP growth forecast to -1.4% for 2009 - if it comes to pass this will be the worst calendar year result for GDP growth for over half a century.

Interest Rate Markets: Wait for the re-rally

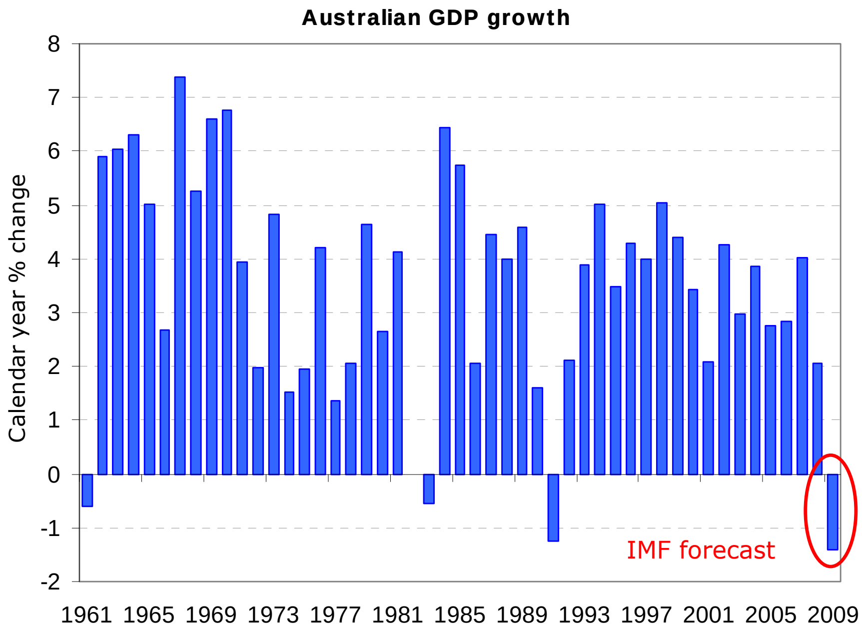
- A more measured pace of monetary policy easing is likely from here, the possibility that rates will now be on hold for a few months.
- The recent rise in Australian term rate is unlikely to be sustained, should the economy weaken further in line with our expectations.
- The UK government's enormous budget deficit, revealed overnight, highlights the risk to the Australian fiscal deficit and the likely substantial increase in local government bond issuance. This will keep upward pressure on the 3/10s yield curve.

FX: Risk reversal

- Easy come, easy go – the turnaround in risk appetite has been swift and brutal. Last week's target towards AUD/USD0.7475 now looks like a dream as the AUD struggles to maintain momentum above 0.70.

Chart of the week

Figure 1: IMF tips Australia will have the worst calendar year GDP growth rate for over half a century



Source: ABS

Macro Update: IMF downgrades forecasts

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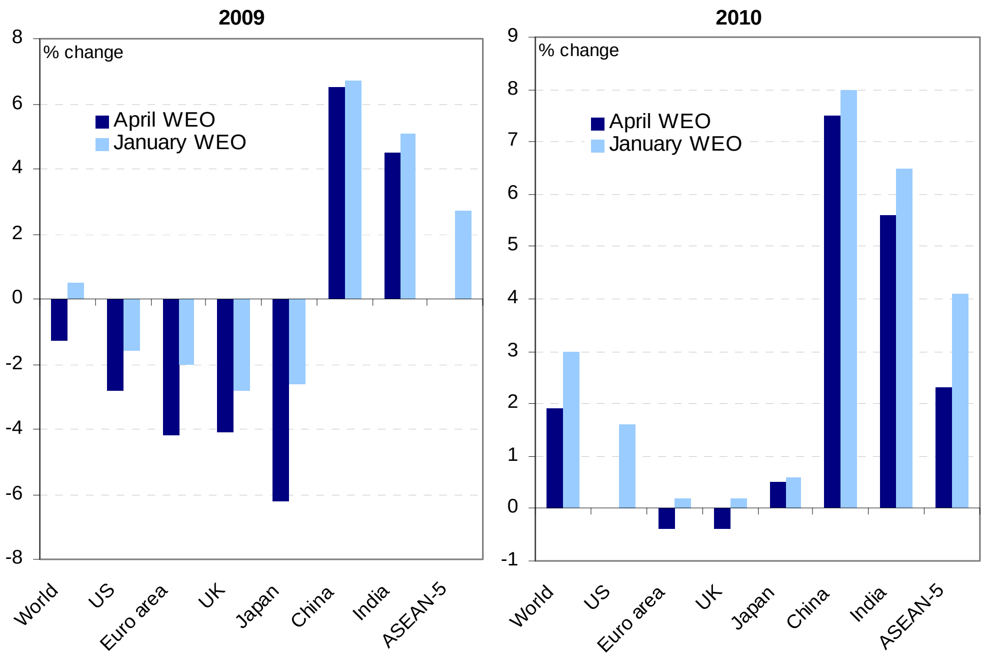
- April's World Economic Outlook sees the IMF downgrade global growth prospects significantly.
- Developed economies will contract sharply weighed down by potentially massive financial sector write downs to come in the wake of the financial crisis.
- The IMF has downgraded Australia's growth forecast to -1.4% for 2009, if it comes to pass this will be the worst calendar year result for GDP growth for over half a century.

Further downside for global growth and financial crisis fallout

The IMF's April World Economic Outlook overnight showed another sharp downgrade to its economic forecasts as the global recession deepens. This is the fifth downgrade to the IMF's forecasts since October, and is substantially weaker than what was foreshadowed at the G20 meetings just a few weeks ago. The global economy is now expected to contract by 1.3% in 2009, the worst downturn since the Great Depression. This is a significant downgrade from the 0.5% expansion forecast in the IMF's January update and a world away from the 2.2% growth rate forecast last November.

According to the IMF, the epicentres of the financial crisis, the larger 'advanced' economies of the world, are where recession will hit hardest. This is because the fallout from the crisis if far from over. Collectively, developed nations will shrink 3.8% in 2009. The US economy is anticipated to reverse 2.8% in the year, while the downturn in Europe will be even deeper; Euro area GDP is expected to fall by 4.2% led by Germany contracting 5.6% and the UK down 4.1%. Perhaps even more concerning for Australia is that our major trading partners are also heavily impacted. Our largest trading partner, Japan, is anticipated to contract a massive (and unprecedented) 6.2%. China's growth is expected to be whittled down to only 6.5% and Korea will reverse 4.0% to round out a fairly sorry state for Australia's top three export destinations. However, the hope is that 2010 brings *slightly* better growth prospects for emerging Asia.

Figure 2: Economies downgraded across the board…



Source: IMF

The tougher road will be for the advanced economies with no growth expected in 2010. The IMF suggests that the synchronised nature of the recession combined with financial crisis foreshadows a longer and deeper downturn with prospect for only a measured and gradual recovery. Clearly a prerequisite for such a recovery will be the decisive restoration of financial stability by public authorities. This is especially true given the IMF estimates that we may potentially have most of the financial sector fallout from the crisis ahead of us.

This ongoing dislocation of credit markets in particular has curtailed the effectiveness of remedial monetary policy. Low official interest rates would not seem to be enough with ongoing direct financial assistance required to stabilise the banking system. By the IMF's reckoning we are only around one-third or US$1.2 trillion of the way through potential write-downs that may amount to as much as $US4.1 trillion. Write downs on US originated assets may reach US$2.7-trillion, significantly higher than the US$2.2-trillion forecast in January.

The IMF suggests fiscal policy, although effective in shortening recessions, may be blunted by high public debt. And this is just the position the US, UK, Europe and Japan find themselves in all with relatively high government debt leading into the crisis and now the need to borrow more to spend their way out.

These factors are a point of difference for Australia. Our financial system is in better shape, our monetary policy is more effective and the government is tackling the problem from a position of very little debt. But, as outlined below, this will not be enough to avert a deep downturn in the year ahead.

IMF expecting a deep Australian recession

This week the RBA confirmed we are in recession and the IMF has indicated the worst is yet to come for Australia. The Fund has slashed its outlook and is now forecasting the Australian economy to shrink by 1.4% in 2009 with an anaemic recovery of just 0.6% expected in 2010. As the economy contracts, the IMF predicts the unemployment rate will average 6.8% in 2009 and 7.8% in 2010. The IMF's forecasts for Australian GDP growth are slightly worse than our own, which themselves are towards the bottom of market expectations.

The IMF's point estimates of the Australian economy are notoriously inaccurate. But it cannot be ignored that the Fund is now forecasting the Australian economy to suffer its biggest calendar year contraction since ABS records began in 1959. These projections imply not just one more quarter of negative economic growth, but potentially up to five quarters of contraction. The message is clear; this recession will be as bad, if not worse, than the early 1990s recession, and we are nowhere near the bottom of the domestic downturn. This again highlights that the RBA Board's predictions this week for the Australian economy to start to recover in the second half of this year "*output in Australia was now weaker than earlier expected, though a recovery in demand was likely towards the end of the year.*" is highly vulnerable to disappointment.

Data wrap

- The **headline CPI** was surprisingly benign in Q1, rising by just 0.1% (+2.5%), but this was almost entirely due to a 14% fall in deposit and loan facilities (as bank margins contracted). Underlying inflation was much higher than expected at 1.1% (4.2% YoY) with prices rises broad-based across most categories and also evidence of some pass-through from the weaker A$.
- **Final stage producer prices (PPI)** fell 0.4% in Q1, despite higher prices for imports, suggesting further downward pressure on the CPI in the period ahead.
- The **Minutes from the RBA's April policy meeting** showed that ""*the question for the Board was whether there was a case for additional monetary easing*". It appears a 50bp cut was never raised. We think this confirms recent market pricing for less easing in the next few months but there is nothing in the minutes to suggest the easing cycle is over.
- The **RBA Governor Stevens** stated that Australia is in recession but remains optimistic over Australia's post-recession prospects.

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Interest Rate Markets: Wait for the re-rally

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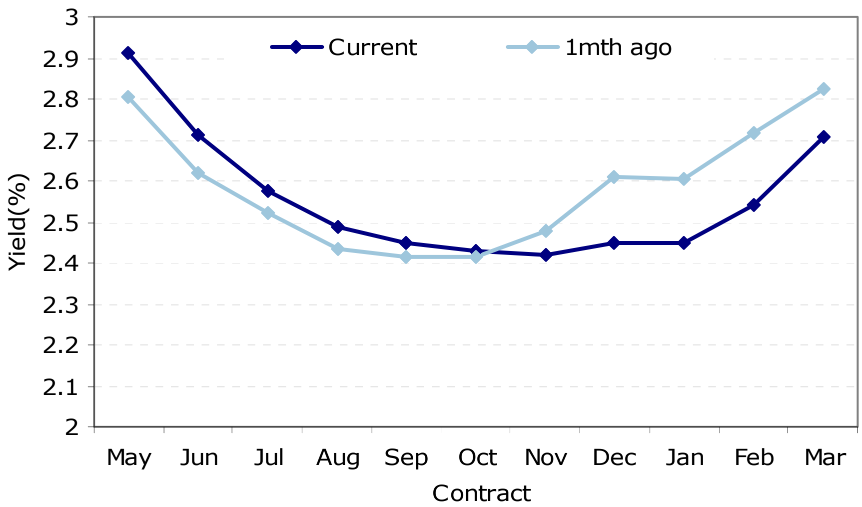
- The recent rise in Australian term rate is unlikely to be sustained, should the economy weaken further in line with our expectations.
- The UK government's enormous budget deficit, revealed overnight, highlights the risk to the Australian fiscal deficit and the likely substantial increase in local government bond issuance. This will keep upward pressure on the 3/10s yield curve.

RBA on hold for a few months

Minutes of the RBA's April board meeting this week suggest that the debate was between no change and a 25bp adjustment. The key sentence was: *"the question for the Board was whether there was a case for additional monetary easing".* The RBA is thus effectively signalling a more measured approach to policy easing from now.

Together with this week's higher than expected core CPI outcome, this supports recent market pricing for less easing in the next few months. Indeed there is now a good chance that the RBA will be on hold for at least a few months.

Figure 3: Current market pricing



Source: ANZ and Bloomberg

There was however nothing in the Minutes to suggest that the easing cycle is over and we remain comfortable with our view that the RBA will ease further later in the year. A no change view relies on the RBA's forecasts for the economy starting to recover in H2 to be realised. In our view, this leaves open the door to disappointment, with the worst is yet to come for many parts of the Australian economy including business investment and unemployment. Indeed, this was backed up by last night's IMF report, which is now forecasting the Australian economy to contract by 1.4% this year (see *Macro Update*).

So unless inflation remains a problem, we remain comfortable with our view that the RBA will cut the cash rate to 2% by the end of 2009 (current market pricing is for the cash rate to bottom at around 2.5%). This will most likely take place in small 25bp increments as the economic picture gradually evolves. As we have highlighted previously, a more effective monetary policy transmission mechanism (in particular a stable banking system) means rates in Australia are unlikely to fall as low as in the US or the UK.

We also expect markets to price out the chance of the policy rate heading back up in 2010. The cash rate is unlikely to start rising until late 2010 when the unemployment rate stops rising and as evidence of a sustained recovery gains traction.

3-year yields expected to re-rally

Global term rates have consolidated at higher levels over the past month driven by improved risk appetite, a concurrent rise in global equity markets and concerns about increasing government bond supply. In Australia, the move has been particularly pronounced in the 3-year part of the curve, with additional upward pressure from the market pricing out 50bp incremental cuts from the RBA and lifting expectations for the terminal cash rate from around 2.25% towards 2.5%. The 3-year swap rate is now sitting at 4.01% compared with a low of 3.34% in early February and 3-year bond yields are at 3.527% versus a low of 2.865%.

We thus suggest holding off fixing floating rate exposures in this part of the curve as we have been previously recommending. Nevertheless, it is likely we could see a re-rally in the 1 to 3 year sector in coming months given: (a) still dire predictions for the global economy (see discussion of IMF's latest forecasts on page 2 and (b) our view that market pricing moves back towards our view of a 2% terminal cash rate and pushes out the timing of expected rate rises to later in 2010. We therefore recommend waiting for a re-rally in the 3-year part of the curve before fixing floating rate exposures.

Figure 4: 3-year swap rates

Source: ANZ & Bloomberg

Global government bond supply to surge

Overnight the pressure on global public finances from the deep recession was brought home when the British government announced that its budget deficit had ballooned to 12% of GDP. As a result, the British Government borrowing programme has swelled by an additional £269, requiring a mammoth £220bn Gilt programme for 2009-10 fiscal year.

While Australian government debt is unlikely to rise to 12.4% of GDP as in the UK, we can still expect Australian government bond issuance will increase significantly to finance deficits in coming years. We expect the May 12 Budget to reveal a big jump in the Government deficit for 2009-10 and thus a substantial upward revision to the borrowing program.

With the RBA set to anchor short-term rates as discussed above, we would expect the significant increase in supply to keep upward pressure on the 3/10-year curve. Rates out to the 2 to 3 year sector do not tend to rise all that much before the end of the easing cycle, and as explained above a re-rally in this part of the curve is likely. This also should instil a steepening bias in the term yield curve (3/10yrs) following the clear flattening sequence in recent weeks.

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FX: Risk reversal

Recommendation

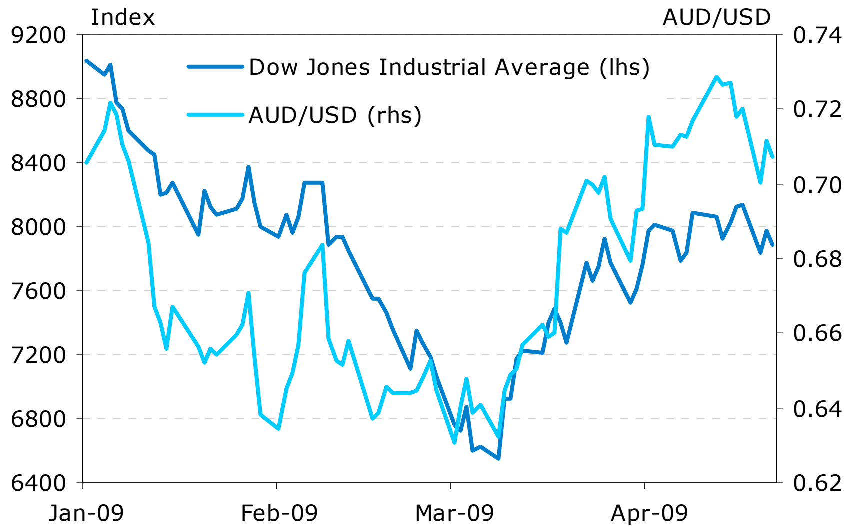
The AUD looks set for a spell of range-trading as the calendar of data releases and corporate earnings reports abates. AUD sellers may wish to take advantage of spikes above AUD/USD0.7100; buyers can look to dips towards 0.6850. Late next week the news heats up again with the first estimate of US Q1 GDP on Wednesday 29 April, the FOMC on Thursday (4:15AEST) and the G7 finance ministers' meeting on Friday. Volatility has been very tame during this latest bout of consolidation, but a further sell-off risks seeing vol spike again.

Overview

Easy come, easy go – the turnaround in risk appetite has been swift and brutal. Last week's target towards AUD/USD0.7475 now looks like a dream as the AUD struggles to maintain momentum above 0.70. The fact that the AUD remains range-bound is reflective of wider market sentiment.

The equity markets, after rallying by 20% or more over the past month, have paused to assess whether the economic outlook can justify further gains. The credit markets, on the other hand, have started to rally on the view that the worst may be behind us. With the equity markets now looking at the glass as half-empty and the credit markets starting to see the glass as half-full, we are slowing reaching an equilibrium point that could mark an important point for a more stable, longer-term recovery.

Figure 5: AUD/USD tracking the US equity market trend



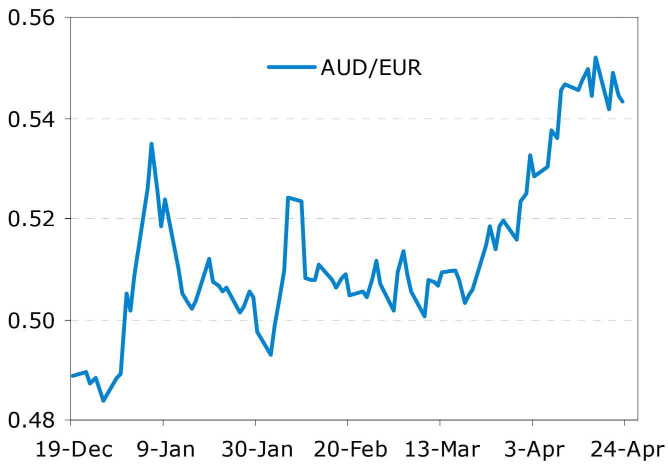
Source: ANZ, Bloomberg

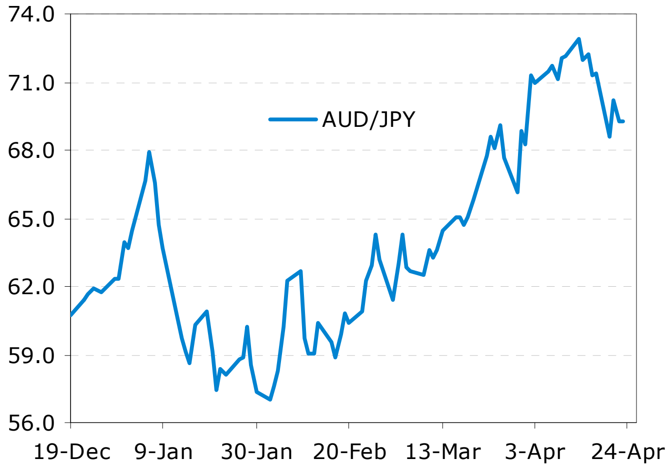
For the AUD, a reduced sense of euphoria in the equity markets means the risk premium that has been associated with the AUD has ended, for now. The AUD dipped below AUD/USD0.70 for the first time in 2½ weeks this week, and now looks unlikely to reach above 0.7200-0.7250 again in the near term unless something remarkable happens.

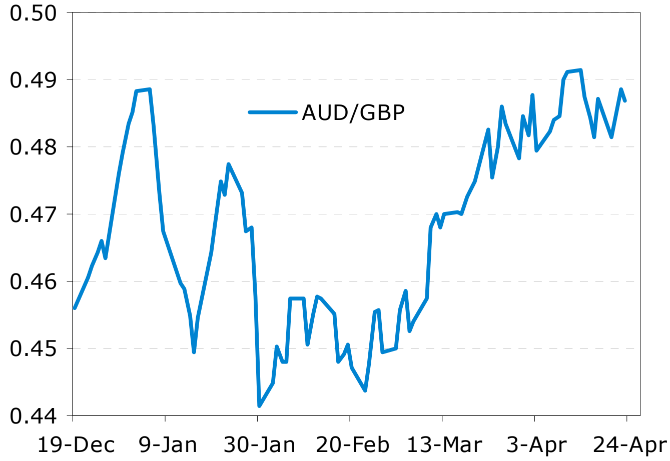
Important for the AUD's fortunes over the coming weeks will be whether the commodity markets take the view of the equity market (half empty) or the credit market (half full). This week's announcement by BHP that it will sell more of its iron ore on the spot market due to the cancellation of long-term contracts from buyers is a warning shot across the bow of base metals, and indicates that a degree of caution is still required on a fundamental medium term view for AUD. The AUD has been highly correlated with copper prices in recent weeks, as copper has pushed to a 6-month high of US$4,925 on 14 April. However, prices have since softened, and a key risk to the outlook for the AUD over the next couple of weeks is a further downturn in base metals prices.

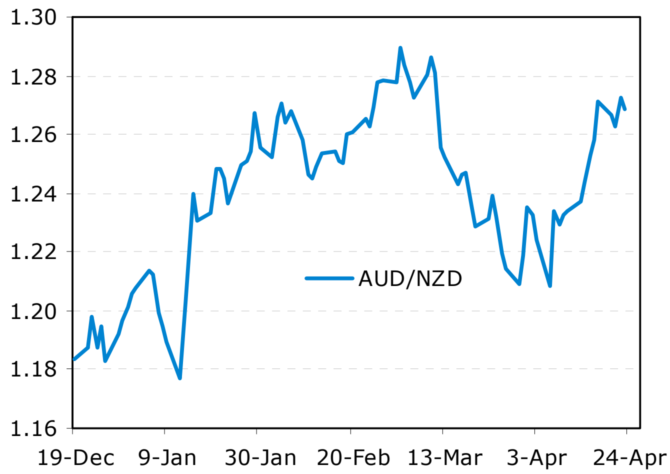
AUD/USD Key levels: 0.6850 – 0.7200. AUD/USD pushed below last week's suggested downside limit at 0.7030. Maintaining a break above 0.7070 is necessary to avoid further declines towards 0.6930 then lower to 0.6850.

AUD cross view









AUD / EUR Key levels: 0.5260 – 0.5510

- AUD/EUR is a bellwether cross that has decisively moved above its 200-day moving average, and looks likely to settle into this higher trading range for now. A break above 0.5510 would be an important signal of potential further strength for AUD broadly across multiple currency pairs. A push below 0.5260 could signal renewed AUD weakness.
- There is no major data out in the coming week, but debate about what the ECB will announce at its next meeting on 7 May is heating up. Remarks from ECB officials will be key to the behaviour of the EUR.

AUD / JPY Key levels: 68.00 – 72.00

- The reversal in global risk appetite caused a strong move down in the cross, with resistance now forming around the 72.0 level. While a return to a run of equity market gains could take the cross back to last week's high of 73.50, we think markets remain wary and as such the cross should be capped.
- The Bank of Japan meets next week on 30 April. While few expect the BOJ to shift its target rate from the current 0.10%, the market will be watching to see if the BOJ returns to quantitative easing via balance sheet expansion. If this occurs, USD/JPY would again move up past 100.

AUD / GBP Key levels: 0.4780 – 0.4900

- The AUD/GBP remains in the basic trading range of 0.48 – 0.49 that has dominated since the beginning of April. This week's release of a UK budget revealing a yawning budget deficit and a 50% increase in government debt issuance led to a weakening of GBP/USD that means the AUD cross is unlikely to test recent lows any time soon.
- News out of the UK continues tomorrow with a final estimate of Q1 GDP growth as well as March retail sales. On balance, the data is expected to be rather negative and so seems likely to help maintain the cross toward the top of its trading range.

AUD / NZD Key levels: 1.2230 - 1.2780

- AUD/NZD has remained near the top of its trading range for most of the past week, and has at points pushed above 1.2650 to reach a peak of 1.2770.
- A flow of negative news on the NZ economy plus a reduction in term yields is responsible for this strong move up on the cross rate.
- The RBNZ's next monetary policy meeting is on 29 April, and has the potential to push the cross up to nearly 1.28 as the market is debating whether the RBNZ will cut by 25 or 50 bps. A more aggressive stance by the RBNZ relative to the on-hold RBA has the potential to take this cross higher again.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	3.9	-2.4	-2.4
Household consumption	4.3	2.1	-0.2	0.7
Dwelling investment	2.7	2.0	-5.1	9.6
Business investment	13.8	13.2	-7.5	-17.9
Public demand	2.8	5.0	3.1	5.2
Domestic final demand	5.4	4.1	-1.2	-0.7
Inventories (contribution to GDP)	0.6	-0.6	-0.2	0.2
Gross National Expenditure (GNE)	5.9	3.5	-1.3	-0.5
Exports	3.2	4.7	-4.9	0.2
Imports	11.5	10.6	-11.0	-6.0
Net Exports (contribution to GDP)	-1.8	-1.4	1.7	1.4
Gross Domestic Product (GDP)	**4.0**	**2.1**	**-0.9**	**0.8**
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	1.6	2.6
Underlying*	3.1	4.5	3.7	2.7
Wages	4.1	4.2	3.9	3.4
Labour market				
Employment (annual % change)	2.8	2.2	-0.3	-1.0
Unemployment rate (%)	4.4	4.2	6.0	8.0
External sector				
Current account balance: A$ bn	-68.1	-50.1	-36.4	-42.6
% of GDP	-6.3	-4.2	-3.0	-3.5

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

Australian interest rates	Current	Jun 09f	Sep 09f	Dec 09f	Mar 10f	Jun 10f
RBA cash rate	3.00	2.75	2.50	2.00	2.00	2.00
90 day bill	3.08	2.65	2.30	2.30	2.30	2.35
3 year bond	3.53	3.25	3.20	3.05	3.40	3.60
10 year bond	4.49	4.35	4.30	4.15	4.30	4.40
3s10s yield curve	0.97	1.10	1.10	1.10	0.90	0.80
3 year swap	4.01	3.60	3.50	3.35	3.70	3.90
10 year swap	5.08	4.85	4.70	4.50	4.60	4.70
International interest rates						
RBNZ cash rate	3.00	2.25	2.25	2.25	2.25	2.25
NZ 90 day bill	3.03	2.70	2.70	2.70	2.70	2.70
US Fed funds note	0.25	0.25	0.25	0.25	0.50	1.00
US 2 year note	0.95	0.75	0.80	0.85	1.25	1.50
US 10 year note	2.93	3.50	3.55	3.55	3.75	3.90
Japan call rate	0.10	0.10	0.10	0.25	0.50	0.50
ECB refinance rate	1.25	1.25	1.25	1.25	1.75	2.00
UK repo rate	0.50	0.50	0.50	0.50	0.75	1.50

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

Foreign exchange rates	Current	Jun 09f	Sep 09f	Dec 09f	Mar 10f	Jun 10f
Australia and NZ exchange rates						
A$/US$	0.7084	0.66	0.63	0.59	0.56	0.57
NZ$/US$	0.5588	0.54	0.51	0.48	0.47	0.47
A$/¥	69.38	69.30	68.04	64.90	64.96	66.12
A$/€	0.5436	0.52	0.51	0.50	0.50	0.51
A$/£	0.4869	0.45	0.43	0.40	0.37	0.37
A$/NZ$	1.268	1.22	1.24	1.23	1.20	1.21
A$/CA$	0.8771	0.82	0.79	0.77	0.74	0.76
A$/CHF	0.8244	0.79	0.78	0.77	0.77	0.80
A$/CNY	4.838	4.51	4.31	4.04	3.83	3.90
A$ Trade weighted index	58.90	56.20	54.17	51.41	49.33	49.92
International cross rates						
US$/¥	98.0	105	108	110	116	116
€/US$	1.303	1.28	1.24	1.18	1.12	1.12
€/¥	127.7	134	134	130	130	130
£/US$	1.455	1.46	1.48	1.48	1.50	1.55
€/£	0.8956	0.88	0.84	0.80	0.75	0.72
US$/CA$	1.238	1.24	1.26	1.30	1.32	1.33
US$/CHF	1.164	1.19	1.24	1.30	1.38	1.41
US$ index	86.10	87.8	89.9	93.2	96.9	96.5
Asia exchange rates						
US$/CNY	6.829	6.84	6.84	6.84	6.84	6.84
US$/HKD	7.750	7.76	7.76	7.76	7.76	7.77
US$/IDR	10946	12000	11900	11600	11600	11300
US$/INR	50.19	52.00	51.00	51.00	50.00	50.00
US$/KRW	1348.15	1500	1400	1450	1375	1350
US$/MYR	3.63225	3.74	3.80	3.80	3.80	3.75
US$/PHP	48.75	49.50	50.00	49.50	48.80	48.50
US$/SGD	1.504	1.58	1.62	1.66	1.66	1.63
US$/THB	35.54	36.50	37.50	37.00	36.50	36.00
US$/TWD	33.81	35.20	36.00	36.00	35.50	35.50
US$/VND	17783	17800	18100	18500	18500	18500
Pacific exchange rates						
PGK/US$	0.348	0.32	0.32	0.35	0.35	0.36
FJD/US$	0.449	0.52	0.50	0.48	0.47	0.48

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