

Regather, regroup

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Macroeconomic Update: How bad is the trade deficit?

- The downturn in Australia's trade performance in recent data looks, on the face of it, quite poor. However the monthly figures do not tell the entire story, which contains good and bad news.
- The falls in traded commodity prices in the last 12-months, combined now with marked falls in bulk commodity prices will see the terms of trade fall sharply. But what of trade volumes? The news here may be a little more positive (or at least less negative) than initially thought.

Interest Rate Markets: Consolidation

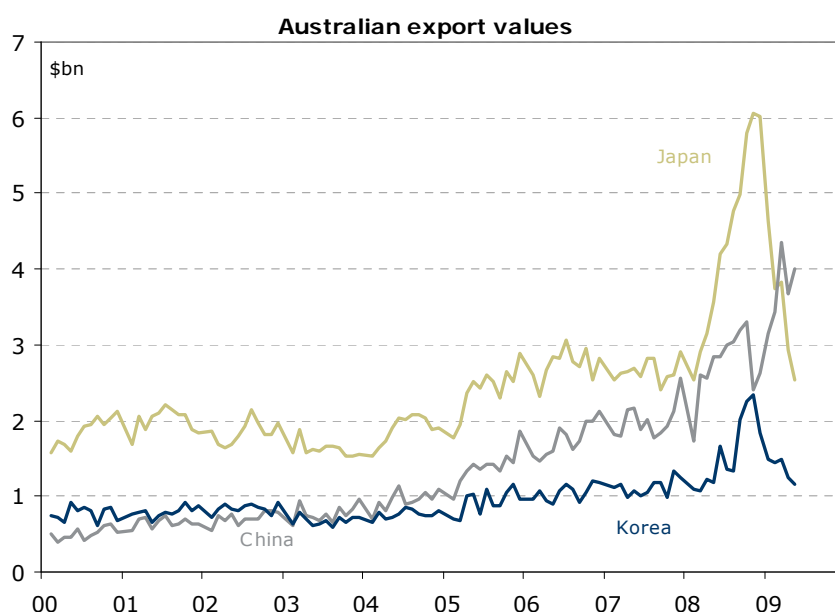
- Market yields move into consolidation patterns after recent rises.
- The yield curve remains steep.
- There is a consistent line from Fed officials to keep rates anchored.

FX: Q3 to see a stabilisation in FX markets

- AUD/USD remained largely stuck in the upper part of its recent 0.7800-0.8100 trading range this week.
- In Q3, a hesitant improvement in the economic data is expected to trigger a pull back in risk appetite as the market's expectation for a global recovery is tempered, lending support to the USD and putting downward pressure on the other major currencies.
- AUD/USD is particularly vulnerable to a downward correction, although the Australian yield advantage and expectations of only a moderation in commodity prices should see dips limited to around AUD/USD0.76 in Q3.

Chart of the week

Figure 1: Exports to China hold up, while exports to Japan collapse



Source: ABS and ANZ.

Macroeconomic Update: How bad is the trade deficit?

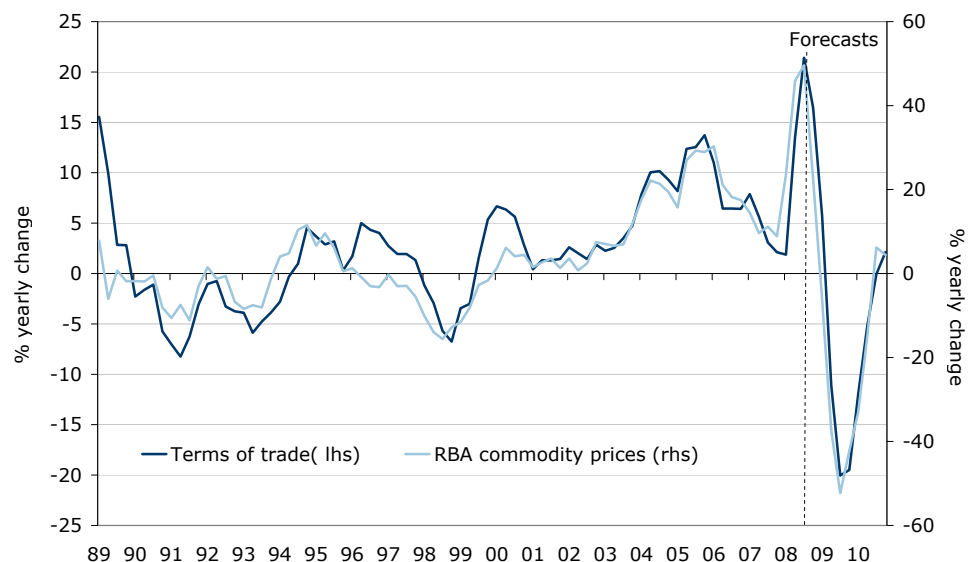
- The downturn in Australia's trade performance in recent data looks, on the face of it, quite poor. However the monthly figures do not tell the entire story, which contains good and bad news.
- The falls in traded commodity prices in the last 12-months, combined now with marked falls in bulk commodity prices will see the terms of trade fall sharply. But what of trade volumes? The news here may be a little more positive (or at least less negative) than initially thought.

The trade deficit deteriorated for the second successive month in May on the back of softer global demand, a rising Australian dollar and significant falls in commodity prices. Recent trade were seemingly only a brief flirtation (lasting from Aug-08 to Mar-09) and we are now looking at the deficit being entrenched for the coming year at least. Given the still very weak global economic backdrop a return to deficit is unsurprising. The downturn in Australia's trade performance in recent data looks, on the face of it, quite poor, but the monthly data do not tell the entire story – which contains good and bad news.

Terms of trade to fall sharply

The bad news first - trade prices. The falls in traded commodity prices in the last 12 months, combined now with marked falls in bulk commodity prices will see the terms of trade fall sharply in 2009, starting this quarter. This will result in the current account deficit widening markedly from 1.5% in the March quarter 2009 to 5% in the December quarter 2009. Despite the magnitude of deficit being quite 'normal' for Australia, this time around it will need to be funded by overseas borrowings from global credit markets that remain dislocated, with liquidity still relatively expensive. Further, the fall in the terms of trade foreshadows a contraction in the nation's income (gross domestic income, GDI). In the boom, GDI growth was fuelling the economy. Now in 2009 a sharp contraction in GDI is expected bring nominal GDP growth to a virtual standstill – leaving businesses, governments and households with less to spend and weighing heavily on GDP growth through the coming 12 months.

Figure 2: Terms of trade to weaken as bulk commodity prices fall



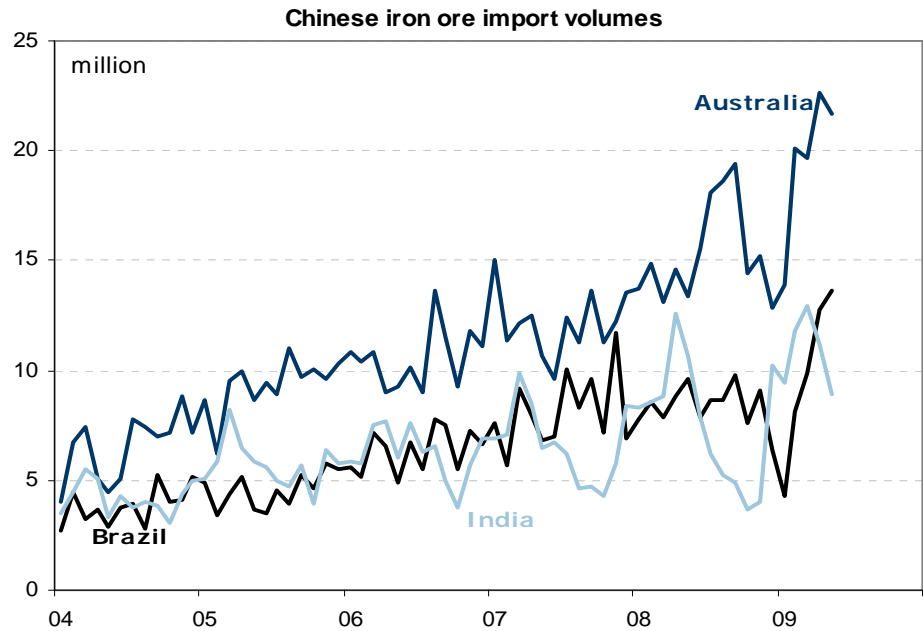
Source: ANZ & Bloomberg

Yet short-term export volumes appear to have some upside risk

But what of trade volumes? Our base case has been for some time that export volumes will continue to be relatively soft in 2009 with the downturn in the global economy not yet having reached a trough and the majority of our trading partners still contracting. But, the news here may be a little more positive in the short term at least. Surprisingly strong export volumes in the Q1 GDP added 0.5ppts to

economic growth and combined with the slump in imports, net exports went on to add 2.2% to growth in the quarter. It may be too much to hope that net exports will again save GDP growth in Q2-2009. However, clear upside risks to our short-term export volumes forecasts have emerged which, in light of the ongoing slump in imports, may see any negative impact from net exports be limited in this quarter. This is due to the strength of recent Chinese demand for commodities that has taken most by surprise. Volumes data from China indicate that iron ore imports from Australia were up 37% in the 3 months to May (see Figure 3). This rise significantly outperforms imports from other major providers Brazil and India. Further, although being quite small relative to iron ore, coal import volumes from Australia to China have increased 130% over the same period.

Figure 3: Australian imports of iron ore to China are outperforming



Source: ANZ & Bloomberg

Local Chinese demand for the bulks has largely been due to domestic prices remaining relatively high compared to global prices. As such, Chinese importers have taken the opportunity to buy commodities at a relatively low price, stockpiling excess supply as industrial production is still only in the early stages of recovery. High levels of inventories suggest that there may be a pull-back in Chinese iron ore imports, however recent data out of China suggests that this pull-back could be more short-lived than initially thought. In particular, a Reuters report today suggested Chinese steel production in mid-June has recovered to levels seen in mid-2008, largely on the back of government-financed fixed asset investment, which should mean iron ore imports remain solid in coming months.

Going forward, more sustainable demand as the Chinese economy recovers may limit any further significant falls in resource export volumes from Australia, particularly as we enter 2010. However, despite the news from China being increasingly positive, a broad-based turnaround in exports and a return to solid growth is still some way off with much of the developed world still mired deep in recession.

Data wrap

- **AIG Performance of manufacturing index** rose marginally in June reaching 38.4 up from 37.5 the previous month.
- **DEWR Skilled Vacancies** were down 3.7% in June another after falling a revised 5.6% in May.
- **Retail sales** increased 1% in May, twice the rate the market had expected.
- **Building approvals** fell 12.5% in May led down by a 44% fall in "other dwelling" approvals, detached housing approvals fell 2%.
- The **trade balance** deteriorated in May widening to \$556mn.

Interest Rate markets: Consolidation

- Market yields move into consolidation patterns after recent rises.
- The yield curve remains steep.
- There is a consistent line from Fed officials to keep rates anchored.

Data, seasonal factors and better supply dynamics argue for some modest consolidation for market rates.

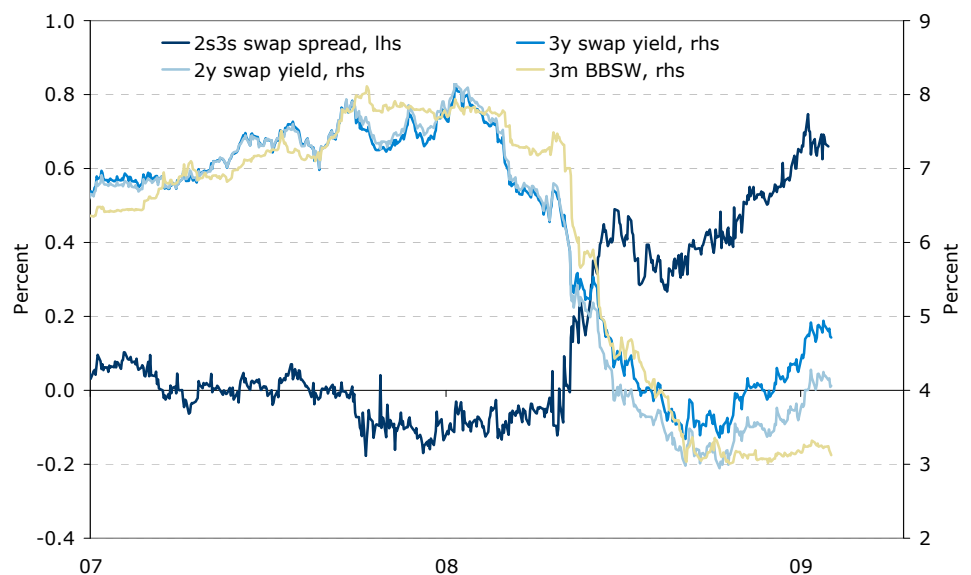
The sustained move higher for market yields seen in recent weeks appears to have lost some momentum this week. There are several factors that have been at work that have helped to capped yields. These include the following:

- We have seen some softer than expected domestic data that challenges the view that the RBA will be forced to lift rates anytime soon. Very weak RBA credit data and the 12% drop in building approvals (including a 44% drop in approvals for units and other projects) suggest there are still economic challenges in the months ahead.
- US data has been mixed at best ahead of key labour market data later today. Consumer confidence was surprisingly weak. And stock markets have gone sideways of late.
- There has been a strong and consistent Fed commentary on the need to keep rates lower for longer since the FOMC meeting last week. Senior FOMC member Yellen said this yesterday: *"I expect that we will turn the growth corner sometime later this year, but I am not optimistic that the economy will spring back to normal anytime soon. What's more, I expect the unemployment rate to remain painfully high for several more years."* She also said near zero interest rates for the next several years is *"not outside the realm of possibility."*

Supply has not been an issue for the local of US market this week. A record \$104bn of US Treasury issuance last week was easily absorbed. And the AOFM has not issued a Commonwealth government bond since Wednesday 24th June due to the financial year-end. (There had been initial signs of investor fatigue in recent weeks).

Finally, the financial year-end, the US 4th July holiday and move into summer trading conditions in the Northern Hemisphere might be supporting mild seasonal demand for safe-haven bonds to park cash.

Figure 4: Swap yields



Source: ANZ & Bloomberg

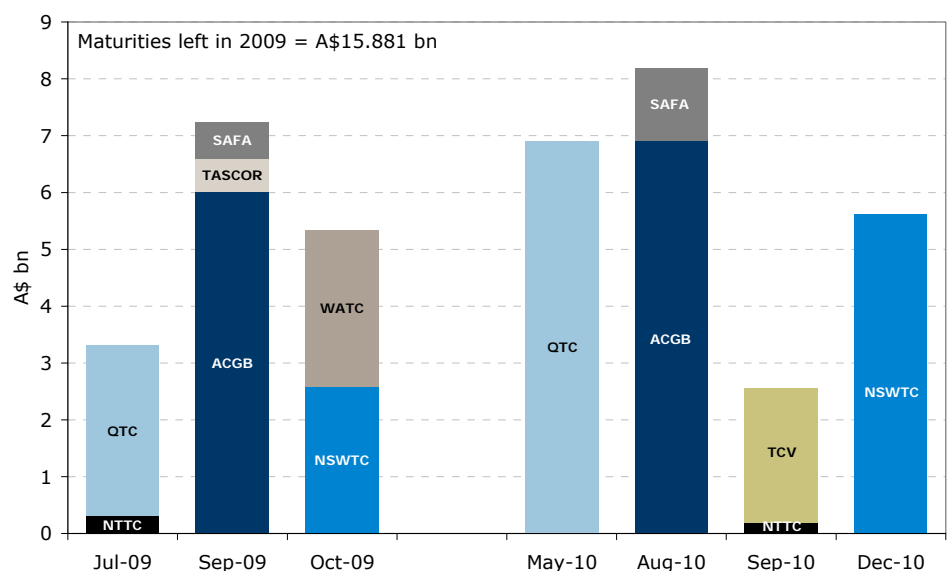
Signs that there is excess cash in the system can be seen from the recent drop in short-term wholesale borrowing rates. The BBSW 3-month rate is down almost 20bps from the recent high posted on June 12th – see chart above - while the US\$ 3-month Libor has been at record lows under the 0.60 level for the past 4 days. This is helping to anchor shorter-dated market rates.

This is helping to keep yield curves steep around the world. Looking more closely at the front part of the AUS swap curve, the chart above highlights the relative steepness between 2 and 3-year swap rates. This has become more marked since the start of October last year as monetary policy was eased in the aftermath of the Lehman’s collapse.

Market rates have started to normalise while cash rates remain anchored at extraordinary levels. Increased bond supply has added to the steepness of the curve. But 3-year swaps appear to have stalled below 5.0% as a consequence of the factors listed above. And is it unclear if continued curve steepening can be sustained while outright bonds move into a consolidation phase.

So yields at the front of the curve look likely to remain anchored for a while yet to maintain the attraction of shorter-dated funding. A correction lower for longer-dated yields might still provide opportunities to lock in borrowing further out the curve, but we are unlikely to see a return to previous lows.

Figure 5: Government benchmark bond maturity profile



Source: ANZ

The consolidation phase is set to be limited by the return to increased supply conditions as the AOFM resumes bond tenders. We estimate there is almost \$16bn of Commonwealth and state government bond domestic benchmark maturities before the end of October that need to be refinanced before addressing increased borrowing requirements for the year ahead.

We would need to see an extended period of weak economic data for yields to head significantly lower from current levels.

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FX: Q3 to see a stabilisation in FX markets

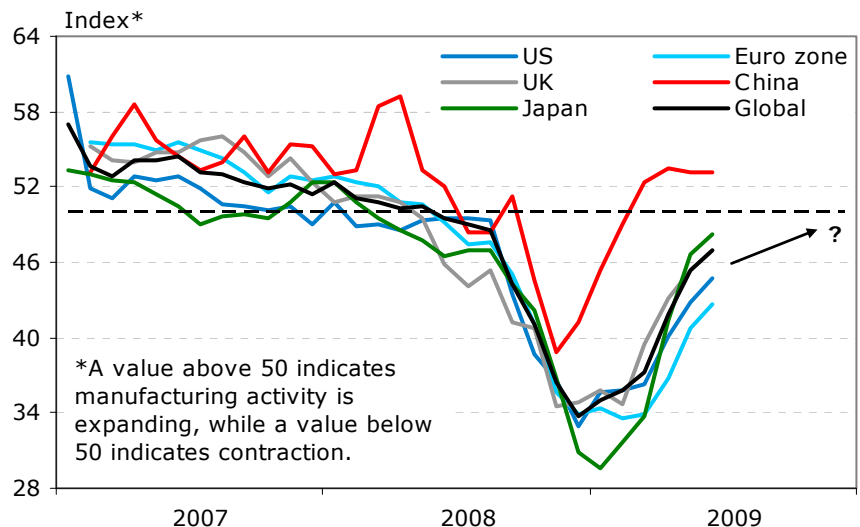
Recommendation: With major currencies range-bound, options volatility has fallen sharply lower across the curve. In the last week, AUD/USD 3-month vols have fallen from 20% to 17.5% and 1-month AUD/USD vols are down to 17% (levels not seen since September 2008). This has seen a significant fall in the cost of hedging currency exposure out to a six-month duration, creating attractive opportunities for clients to take out insurance against any possible rebound in FX market volatility.

The outlook for Q3

The second quarter of 2009 ushered in a major turnaround in currency markets. AUD/USD rallied over 16% from below 0.70 to spike above 0.80 as a bottoming-out in forward-looking economic indicators sparked a rebound in global risk appetite as the worst of the global recession appeared to have passed. This saw the USD (in broad trade-weighted terms) depreciate over 6%, while EUR/USD gained 6% and GBP/USD improved 15% from a 24-year low in Q1. The bounce in 'commodity' currencies was particularly impressive as metals and energy prices recovered on renewed economic optimism, particularly on the outlook for China, with USD/ZAR up 23%, USD/BRL gaining 18% and USD/CAD rising 9%.

But the outlook for currency markets in Q3 is less rosy. Q2's turnaround has largely been predicated on the fact that the global economy and financial markets have moved away from the Armageddon scenario feared in the beginning of 2009. In Q3, leading economic activity indicators such as purchasing managers' indices (PMIs) are likely to largely remain in 'recessionary' territory, with a stuttering improvement in the economic data not expected to yield any concrete evidence of fully-fledged economic expansion.

Figure 6: Global PMIs to remain in 'recessionary' territory in Q3

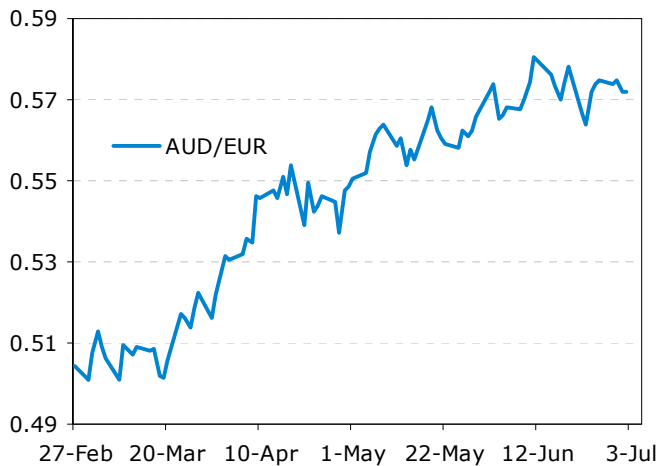


Source: ANZ, Bloomberg

For Q3, we expect a hesitant improvement in the economic data to trigger a pull back in risk appetite as the market's expectation for a global recovery is tempered, lending support to the USD. This means that the major currencies could be in store for a move lower; we look to EUR/USD to decline towards 1.35 and GBP/USD to fall below 1.60, although a stronger JPY could push USD/JPY higher to 98. AUD/USD is particularly vulnerable to a downward correction, although the solid Australian yield advantage and expectations of only a moderation in commodity prices should see dips in AUD/USD limited to around 0.76 in Q3. AUD is also likely to underperform on the major crosses except the NZD, with challenges faced by the NZ economy set to weigh on NZD/USD.

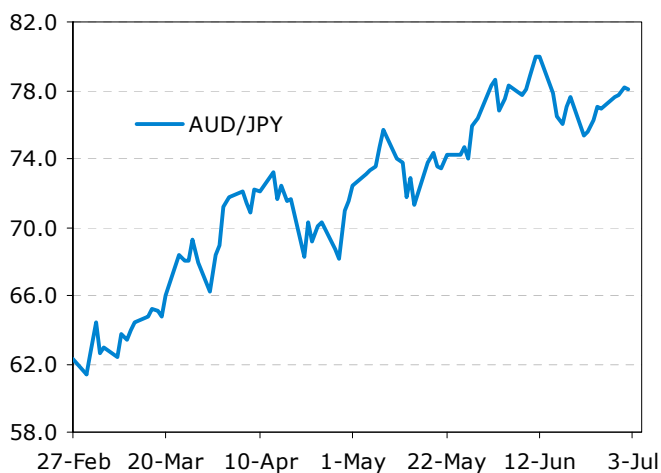
AUD/USD Key levels: 0.7790 – 0.8150. AUD/USD remains stuck in a range. On any move lower we expect 0.7790 should continue to provide strong support for now. On the upside, a sustained rise to 0.8150 is required to lay the groundwork for a run back towards the 2009 high of 0.8263.

AUD cross view



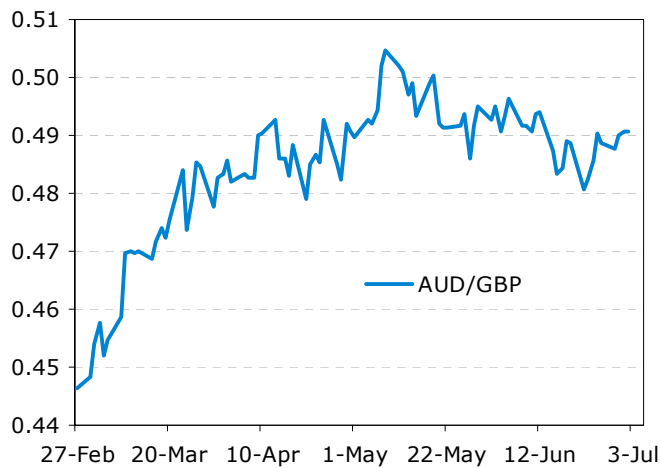
AUD/EUR Key levels: 0.5610 – 0.5800

- AUD/EUR remains in a tight range. Support was tested and held at 0.5700 this week but upside moves were capped at lower highs below 0.5780. While this momentum suggests AUD/EUR will continue to drift lower next week (with initial support holding at 0.5610) we remain cautious of a potential spike in AUD/EUR should next week's RBA meeting and Australian employment data attract a more positive tone.
- Also look out for German IP on Wednesday with a worse than expected result a potential driver for AUD/EUR to spike higher and re-test 0.5800.



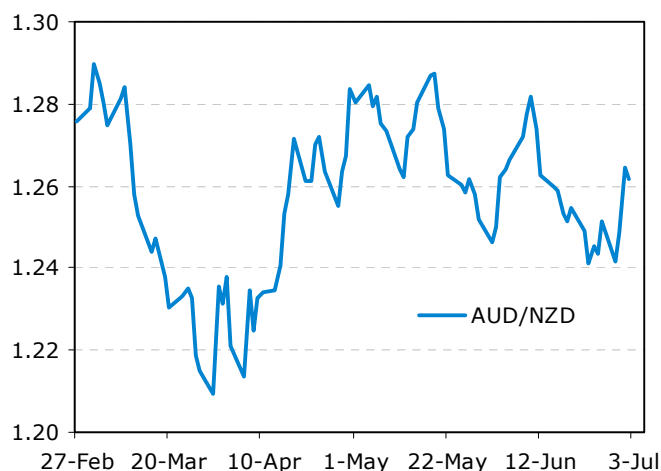
AUD/JPY Key levels: 74.60 – 78.30

- AUD/JPY drifted higher this week but ran into strong resistance at last week's suggested upside level of 78.30 and was unable to sustain a break to 78.40. The short-term risk is for AUD/JPY to re-test this resistance next week, which is required for any meaningful stab at 80. On the downside, expect strong buying interest to kick in from 74.60.
- Australian data and general risk appetite will provide most direction for AUD/JPY next week. It is a quiet week in Japan, with second-tier data unlikely to matter for this cross.



AUD/GBP Key levels: 0.4800 – 0.4960

- This cross drifted higher within a very tight range last week but continues to run into strong resistance at its 50-day moving average of 0.4920. The 100-day moving average of 0.48 remains a key downside risk level.
- Next week is a potentially volatile one for AUD/GBP with an outside chance that next Thursday's BoE meeting could see some discussion of the need to further expand QE. This would see GBP vulnerable to a move back towards 1.62, leaving AUD/GBP poised to make a run at 0.4960.



AUD/NZD Key levels: 1.2400 - 1.2660

- Underperformance by the NZD has seen the AUD/NZD make a break higher in recent days and it is currently trading around a key 2009 retracement level at 1.2600. Could this be the long-awaited resumption of a sustained uptrend in the AUD/NZD?
- Next week provides a good chance for AUD/NZD to consolidate at these higher levels, provided the Australian data flow doesn't disappoint. If 1.2610 is broken, the door is open for a move back towards 1.28 in coming weeks. On the downside, expect good buying interest to persist at 1.2400.

ANZ economic and financial market forecasts

Australian economic indicators	2008	2009f	2010f	2011f
Economic activity (annual % change)				
Private final demand	4.1	-2.0	-1.3	3.2
Household consumption	2.2	1.0	1.2	2.9
Dwelling investment	2.5	-6.8	8.4	10.3
Business investment	13.8	-9.8	-14.2	1.0
Public demand	5.3	2.0	6.6	4.1
Domestic final demand	4.4	-1.1	0.5	3.4
Inventories (contribution to GDP)	-0.6	-0.2	0.3	0.1
Gross National Expenditure (GNE)	3.8	-1.3	0.8	3.5
Exports	3.9	-1.9	-3.5	4.2
Imports	10.3	-11.7	1.1	7.7
Net Exports (contribution to GDP)	-1.5	2.5	-1.0	-0.9
Gross Domestic Product (GDP)	2.2	0.1	0.5	3.1
Prices and wages (annual % change)				
Inflation: Headline CPI	4.4	1.8	2.4	2.0
Underlying*	4.5	3.7	2.7	2.2
Wages	4.3	3.6	3.2	3.6
Labour market				
Employment (annual % change)	2.2	-0.3	-0.7	2.0
Unemployment rate (%)	4.3	6.1	7.8	7.6
External sector				
Current account balance: A\$ bn	-51.0	-42.6	-65.5	-73.0
% of GDP	-4.3	-3.6	-5.4	-5.6

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

Australian interest rates	Current	Sep 09f	Dec 09f	Mar 10f	Jun 10f	Sep 10f
RBA cash rate	3.00	3.00	2.50	2.50	2.50	2.50
90 day bill	3.13	2.90	2.75	2.75	2.80	3.00
3 year bond	4.41	4.05	4.05	4.15	4.20	4.60
10 year bond	5.41	5.35	5.25	5.25	5.20	5.45
3s10s yield curve	1.01	1.30	1.20	1.10	1.00	0.85
3 year swap	4.69	4.35	4.35	4.45	4.50	5.07
10 year swap	5.88	5.75	5.60	5.55	5.50	6.00
International interest rates						
RBNZ cash rate	2.50	2.50	2.50	2.50	2.50	2.50
NZ 90 day bill	2.82	2.80	2.80	2.80	2.80	2.80
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.50
US 2 year note	1.05	1.10	1.00	1.25	1.50	2.00
US 10 year note	3.54	4.25	4.00	4.15	4.30	4.50
Japan call rate	0.10	0.10	0.10	0.10	0.10	0.25
ECB refinance rate	1.00	0.75	0.75	0.75	0.75	1.00
UK repo rate	0.50	0.50	0.50	0.50	0.50	0.50

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

Foreign exchange rates	Current	Sep 09f	Dec 09f	Mar 10f	Jun 10f	Sep 10f
Australia and NZ exchange rates						
A\$/US\$	0.80	0.76	0.73	0.74	0.76	0.78
NZ\$/US\$	0.64	0.58	0.55	0.54	0.54	0.55
A\$/¥	77.71	74.48	73.00	77.70	82.08	85.80
A\$/€	0.57	0.56	0.56	0.57	0.58	0.59
A\$/£	0.49	0.48	0.46	0.46	0.48	0.48
A\$/NZ\$	1.26	1.31	1.33	1.37	1.41	1.42
A\$/CA\$	0.92	0.87	0.88	0.87	0.87	0.90
A\$/CHF	0.87	0.85	0.83	0.84	0.85	0.87
A\$/CNY	5.50	5.19	4.99	5.05	5.19	5.32
A\$ Trade weighted index	64.30	61.99	59.62	60.85	62.88	63.90
International cross rates						
US\$/¥	96.6	98.0	100.0	105.0	108.0	110.0
€/US\$	1.41	1.35	1.30	1.30	1.31	1.32
€/¥	136	132	130	137	141	145.20
£/US\$	1.65	1.59	1.58	1.60	1.60	1.62
€/£	0.86	0.85	0.82	0.81	0.82	0.81
US\$/CA\$	1.15	1.15	1.20	1.18	1.15	1.15
US\$/CHF	1.08	1.12	1.14	1.14	1.12	1.12
US\$ index	79.8	83.0	85.5	85.7	85.4	85.10
Asia exchange rates						
US\$/CNY	6.83	6.83	6.83	6.83	6.83	6.82
US\$/HKD	7.75	7.75	7.75	7.75	7.76	7.77
US\$/IDR	10210	10250	9750	9500	10000	9500
US\$/INR	47.80	48.50	48.00	47.00	47.50	47.00
US\$/KRW	1267	1225	1125	1175	1225	1100
US\$/MYR	3.52	3.60	3.55	3.50	3.50	3.45
US\$/PHP	48.05	49.00	48.00	48.00	47.00	47.00
US\$/SGD	1.45	1.52	1.51	1.50	1.50	1.49
US\$/THB	34.06	36.00	35.50	35.00	35.00	34.50
US\$/TWD	32.81	32.50	32.00	31.50	31.00	30.30
US\$/VND	17795	18500	18500	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.381	0.320	0.350	0.350	0.360	0.360
FJD/US\$	0.485	0.418	0.406	0.400	0.403	0.407

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