

## Government support steps up

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### Macro Update: More downside to trade

- 2009 is shaping up to be the weakest year for the global economy in 60 years.
- Resultant falls in bulk commodity prices and the accompanying reversal in terms of trade will hit the Australian economy hard from Q2 onwards.
- The Federal Government has offered the states a guarantee for existing and future debt to ensure spending programs are not cut back.

### Interest Rate Markets

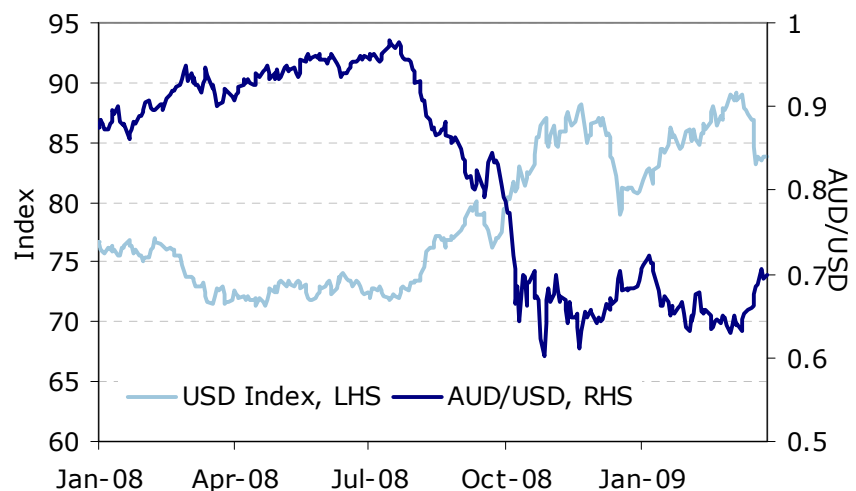
- The newly introduced guarantee for State borrowing reduces the risk of severe countercyclical fiscal policy by the States. The RBA has more reason to pause.
- Yields look to be moving into a higher range as supply of government bonds becomes more problematic.

### FX: Paradigm shift or overshooting market?

- Last week's sharp turnaround in sentiment on currency markets has taken a further step up as markets were buoyed by the US Treasury's latest plan to help banks dispose of toxic assets.
- These developments have been broadly USD negative, and have helped to support higher 'risk' currencies such as the AUD, which has teased the market around the psychologically important AUD/USD 0.70 level over the past week.
- However, this latest rally is at odds with fair value analysis which suggests that the AUD/USD should be trading around 0.64.

### Chart of the week

Figure 1: Improved risk appetite weighs on USD and supports AUD



Source: Bloomberg

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## Macro Update: More downside to trade

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### Global growth revised down...again

The IMF again lowered its global forecasts last week foreshadowing a contraction of between ½% and 1% in 2009, the first such negative outcome in 60 years. The epicentres of the financial crisis, the developed economies of the world, will bear the brunt of the slowdown. Deep recessions are forecast in 2009 for the US (-2.6%), Euro area (-3.2%) and Japan (-5.8%). Not even unprecedented fiscal stimulus and near zero official interest rates can stop that now. Developing countries are anticipated to experience drastically lower rates of growth than recent years, with forecast of between 1½% and 2½% growth for 2009. Such slow growth has not been seen in developing economies since the Asian crisis.

For the Australian economy, the consequences of this synchronised global slowdown are yet to fully impact on the economy. Economic growth in Asia – the destination of 66% of our exports – has slowed sharply, as has demand for our exports. Most notably our biggest trading partner Japan (accounting for around 22% of merchandise exports in 2008) is anticipated to contract nearly 6% in 2009. Worse still, industrial production and steel output have both slumped to record low levels and with them demand for our primary commodity exports. Second on the list, China (destination for 15% of our exports) will see GDP growth halve from 13% in 2008 to 6% in 2009. Third, Korea (8% of exports) is expected to contract 3-4% in the year, and the list goes on... The WTO now estimates the volume of trade will contract 9% in the year – the largest decline since the Second World War.

### More downside to Australia's commodity exports

The slump in the global economy has seen the commodities boom that the Australian economy has ridden on over the past few years come crashing down. Traded commodity prices have already come off by as much as 50% over the past 12 months. But the full impact of the commodities reversal has not hit the economy because bulk commodity contract prices have remained high. These commodities account for 35% of Australia's total merchandise exports.

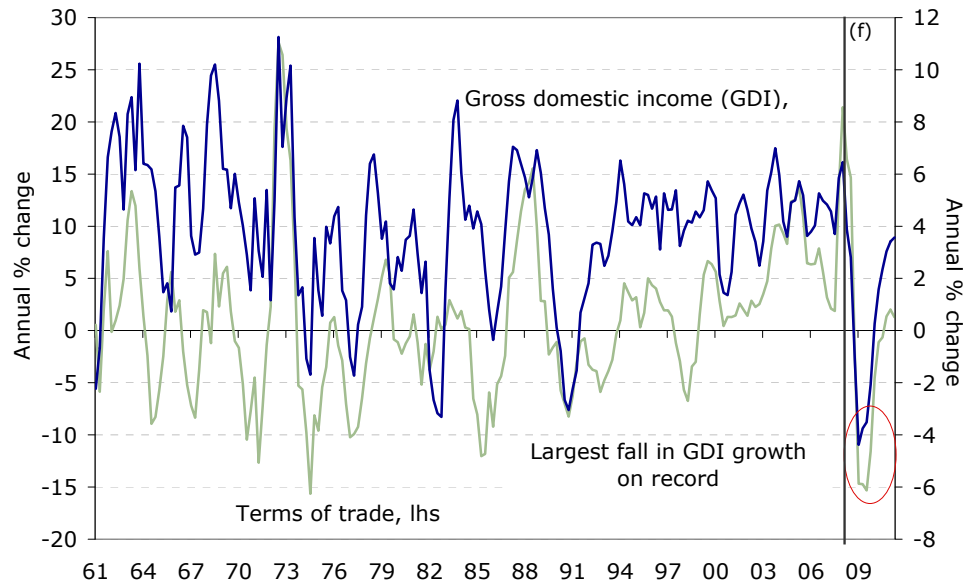
In recent years we have seen extraordinary upside to coal and iron ore prices in the vicinity of 100%-200% and these have been locked until end-March this year. These unprecedented increases fuelled the nation's income, drove mining profits and investment ever higher and filled the governments coffers, particularly in WA and Queensland. The positive is that all this allowed Australia to enter the global downturn in relatively good shape and provided the government with a strong fiscal position from which to spend to buoy the economy.

However the downside is now here, bulk commodities contract negotiations are currently underway and they are expected to be settled well down on last year's prices. After last year's massive increases, it is expected that the Chinese and Japanese will be playing hardball this time around. ANZ's commodities forecasters anticipate a 50% fall in thermal coal prices, as much as 60-70% falls in metallurgical coal prices and 40% falls in iron ore. If these forecasts come to pass, the reduction in bulk prices will wipe \$40bn Australia's export receipts this year (or 3% of GDP). Further, there is downside to this figure as weak global demand has seen volumes of exports also weaken sharply, not to mention the falls in traded commodity prices (such as copper and nickel, although not gold) that we have already experienced. The softer Australian dollar has and will continue to provide some protection from the bursting of the commodities bubble (as prices are in \$US), but nevertheless the consequences will be far reaching.

### The fall out will be significant.

After setting a blistering pace in 2007 and 2008 nominal GDP will contract as the terms of trade slumps 15-20% in the year. This essentially means the nation will get a pay cut as gross domestic income growth contracts by 4% through 2009, the largest fall in GDI since 1959 (since the ABS series began). Corporate profits will slump in the mining sector and investment will be wound back or cancelled. The engine of Australian growth in recent years will start to splutter. Government finances will be hit with the windfall revenues it was collecting from the mining sector evaporating and leaving a massive hole in the budget. It is almost a sure thing that the government's estimate of a cumulative four-year deficit of \$118bn will be revised upwards.

**Figure 2: The nation's income will be cut in 2009**



Source: Bloomberg and ANZ

This move from budget surplus to deficit marks the re-emergence of twin deficits for Australia as the reversal of the terms of trade will also mark a sharp turnaround in the current account. The current account deficit enters 2009 close to 2% of GDP, the best result since 2001, as the trade surplus offsets some of the net income deficit. However, the turnaround in the terms of trade will see a sharp adjustment as the trade surplus turns to massive deficit. This will push the CAD towards around 6-7% of GDP by year's end. The funding of the CAD will require access to still dislocated global credit markets where funding costs will remain elevated for some time yet. The larger CAD will also mean limited further downside to local term rates with Australia needing to attract foreign capital and could put further downward pressure on the Australian dollar through the year. The tougher times for the economy are just about to begin...

### Federal government offer to guarantee state debt.

The Federal government this week moved to provide a temporary, voluntary guarantee for state government borrowing, worth up to \$150bn. The guarantee will cost the states up to 15-35bps if they choose to take it up, depending on the credit rating of the state and whether it is new or existing debt. Although the guarantee will increase the liabilities of the Commonwealth it is unlikely to impact Australia's AAA rating. The guarantee is aimed at helping to ensure state government expenditure proceeds, especially the infrastructure spending that is a key plank in the Rudd government's fiscal stimulus package through 2009. (See page 3 for further implications for rates markets).

### Data wrap

- **The Conference Board Leading index** for Australia indicator fell 0.6% in January the fifth straight contraction on a higher unemployment rate and weak building approvals.

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## Interest Rate Markets

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- Yields look to be moving into a higher range as supply of government bonds becomes more problematic.

The decision by the Commonwealth to offer a range of guarantees to State debt is an undoubted positive outcome for the Semi markets and the ability of the States to borrow to fund large Capex programmes. This will give the States a greater capacity to deliver on existing infrastructure plans to support economic growth. This also strengthens the argument for the maintenance of a cautious stance from the RBA considering current expansionary policy settings.

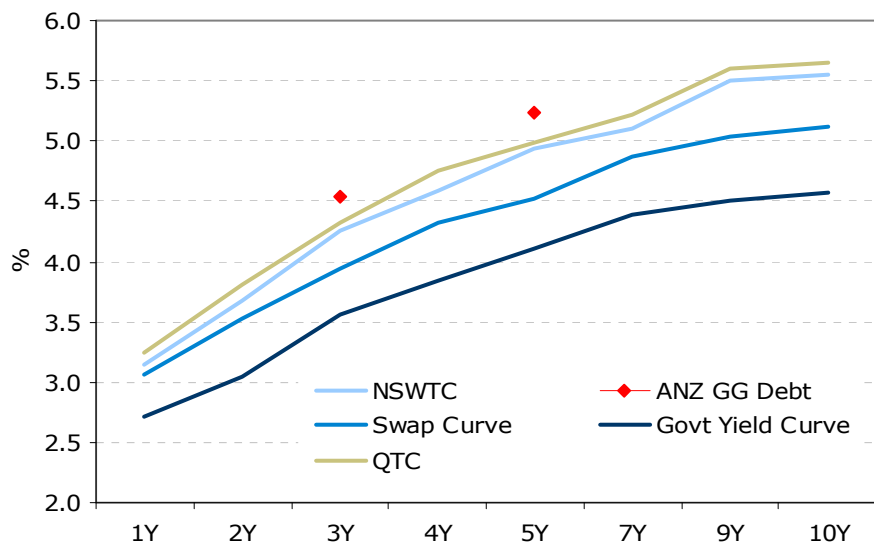
States with an AAA rating (NSW, VIC, WA & SA) can pay a 15bps fee to cover existing debt and 30bps for new debt while AA+ rated States (QLD and TAS) can pay 20 and 35bps respectively. This is for domestic debt only. While optional the deal is positive as it guarantees both existing and new debt at relatively little cost. This represents comprehensive support for the States and is probably the best outcome that could be achieved in current circumstances.

The broader political background is that the Commonwealth Government needs State spending on infrastructure to limit the rise in unemployment in the coming year, ahead of the next national election in late 2010/early 2011. The deal is positive for Queensland as the 5bps pricing of the guarantee is very tight between AAA and AA+ ratings.

There is still some uncertainty surrounding the plan: Will the States decide to take the opportunity to cover existing debt? We will not learn this for 28 days, but the market would welcome early indications from the States.

While this decision represents explicit AAA sovereign support for the States, we think the States will use the option to cover existing debt as it is a) cheap and b) would risk alienating investors if they did not take up this option at a time when the States need investors to buy new debt. If some States decide not to use this option expect some tiering of pricing to emerge after the deadline on April 22<sup>nd</sup>.

**Figure 2: Australian Yield Curves converge**

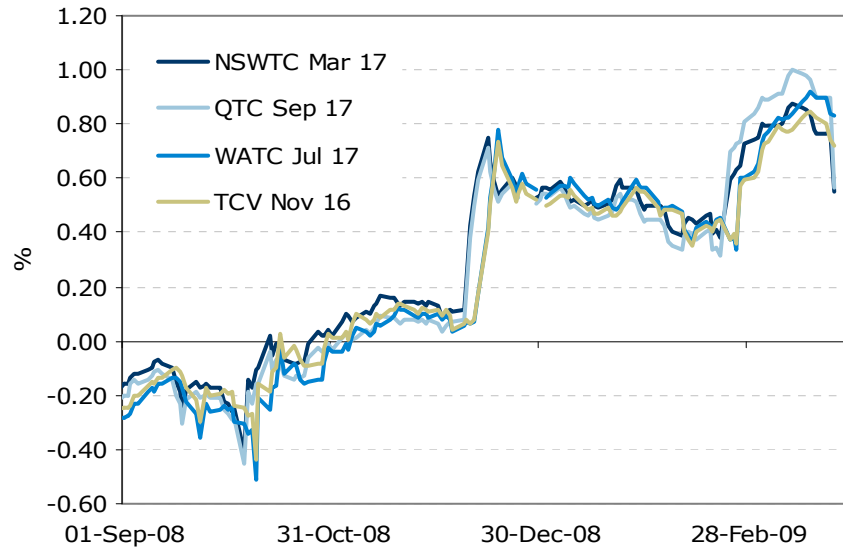


Source: ANZ & Bloomberg

The cost to the States of being downgraded by the ratings agencies may now be less of a worry with the sovereign rating being used to raise debt. The guarantee may well reduce the fiscal discipline on big spending States heading into the Budget round. On the other hand, sharp declines in State revenues and the higher cost of funding may still prompt a cautious approach by State governments and so not necessarily lead to large increases in capital spending.

As for the market implications, we would expect to see Semis to ACGB spreads narrow back towards levels prior to the Qld downgrade. The Semi-to-swap move is already underway – see Figure 4 below. While the sovereign rating is not under threat we would also expect a longer-term trend of the ACGB curve moving towards swap as the Commonwealth's contingent liabilities continue to soar under this and the bank guarantee scheme. The operation of the "Ruddbank" could add a further \$26bn to Commonwealth contingent liabilities.

**Figure 4: Semis to swap**



Source: ANZ & Bloomberg

Semi yields should also trade a little below those yields currently offered by bank GG paper due to greater liquidity and the fact that the fees being paid by the States for use of the guarantee are considerably below the 70bps that the AA rated banks are paying – see Figure 3 above.

### Yields move into a higher range

This significant development comes at a time when all major governments are stepping up operations in debt markets to fund large stimulus plans and falling revenues. This is putting upward pressure on yields despite the onset of government purchases of government bonds under quantitative easing. A UK Gilt auction of £1.75 billion failed overnight while the BoE bought a range of corporate bonds as part of quantitative easing. And US bond yields have risen for the past 5 days despite US Treasury purchases of bonds. The bid/cover on the 5-year auction last night eased to 2.02 from an average of 2.18 over the past 10 sales.

With stock markets and recent US data suggest some stability might be returning to economic conditions, there may now be less reason for the RBA to ease much from here, at least for now. These developments have pushed local bond yields higher: 3-years are testing the previous highs around 3.60% (almost +60bps in 5 days) while 10s are at 4-month highs above 4.50% (+50bps). It is a similar picture for swaps.

We can conclude that we have probably seen the low in yields, especially further out the curve, and we can expect higher ranges to develop from here in the near-term. We would be looking at a tentative range around 3.00-3.60% for 3-years and from 4.10-4.70% for ACGB 10-years. Our rate forecasts are at the lower end of this range. While 3-year swaps are back near 4% due to this sell-off, anything back towards 3.50% for 3-year swaps would now look attractive hedging levels. We would recommend borrowers take the opportunity to for any move lower in market rates from current levels to lock in borrowing.

## FX: Paradigm shift or overshooting market?

### Recommendation

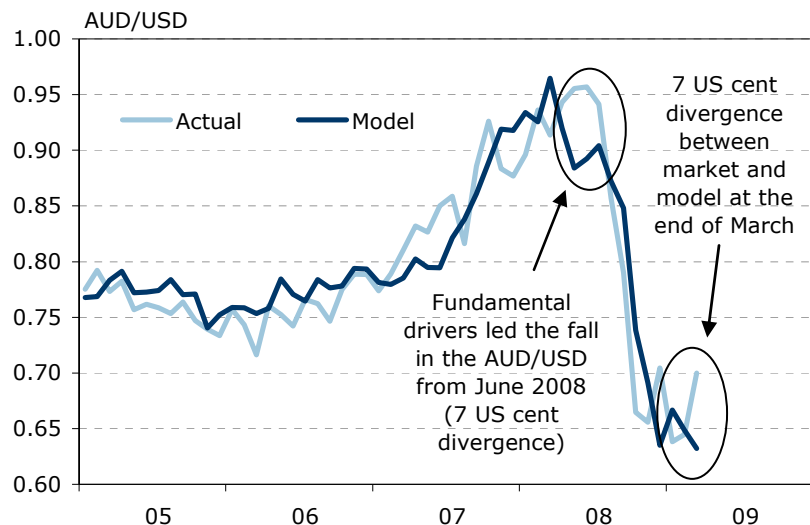
The AUD has teased the market around the psychologically important AUD/USD 0.70 level over the past week. Some good opportunities have been provided for AUD sellers, who should continue to look for moves above 0.6950. A busy data week should keep trade interesting - look out for Australian retail sales, building approvals and trade balance data for February; speeches by RBA officials Battellino and DeBelle; in the US, consumer confidence, Case-Shiller house prices, the ISM Index and non-farm payrolls; and the ECB rate decision.

### Overview

Last week's sharp turnaround in sentiment on currency markets has taken a further step up as markets were buoyed by the US Treasury's latest plan to help banks dispose of toxic assets. Persistent improvement in risk appetite has seen a rally in equity markets, with global bourses galloping some 15-20% higher since troughs recorded in early March. These developments have been broadly USD negative, and have helped to support higher 'risk' currencies such as the AUD (see Chart of the Week on page 1).

However, this latest rally is at odds with fair value analysis which suggests that the AUD/USD should be trading around 0.64. Technical and risk factors have taken hold of the markets and are overriding what the fundamental drivers are suggesting where the AUD/USD should be trading. As discussed in previous research notes, we have observed that the AUD/USD can trade at a 5-8 US cent premium to our estimate of fair value during periods of a surge in risk appetite.

**Figure 1: AUD/USD trading above where fundamentals suggest it should**



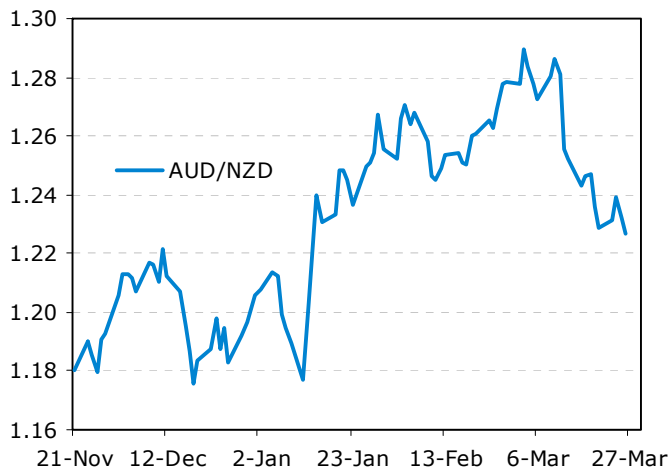
Source: ANZ, Bloomberg

However, this is not just an AUD phenomenon, but is also behind the latest moves in the EUR and JPY. As currencies are relative prices, traditional fundamental drivers incorporate the relative economic outlooks of countries. Thus until recently the JPY had been trading far stronger against the USD than the underlying economic outlook would suggest. A similar argument can be presented for the EUR: with the Euro zone entering the economic downturn later than the US, the consensus outlook is for a far slower recovery and this should be reflected in what we believe should be a lower EUR/USD than is presently priced.

But will risk and technical factors continue to dominate currency pricing or will the broader fundamentals once again take hold? In the case of the AUD/USD, a sustained rally above 0.7250-0.60 may indicate a shift in the economic fundamentals that is as yet not anticipated in other asset markets.

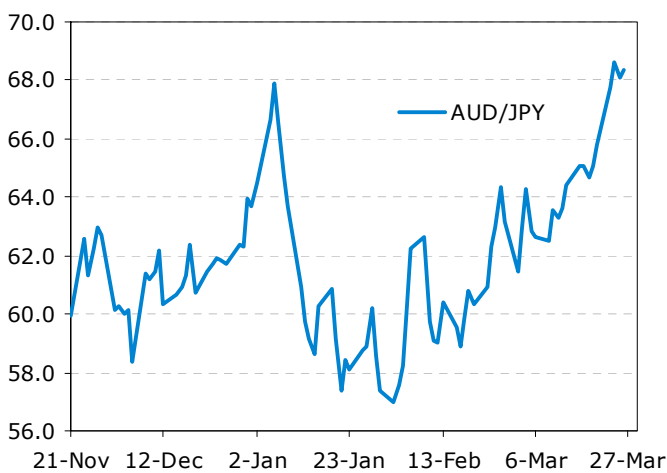
**AUD/USD Key levels: 0.6850 – 0.7250.** AUD/USD 0.7250 has become the new topside target for the currency to break above and hold. Conversely, if a sustained dip below 0.6850 occurs, this could signal the end of the AUD's run, although good support lies around 0.6920.

## AUD cross view



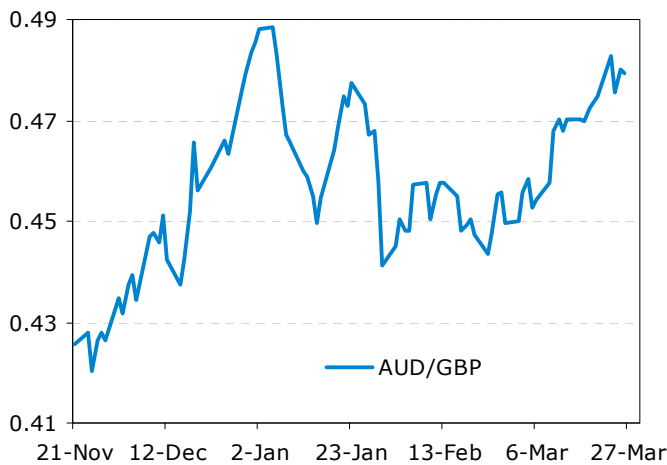
### AUD/NZD Key levels: 1.2030 - 1.2550

- The return of risk appetite on global markets, , has driven the NZD/USD 16.5% higher over the past 2½ weeks, outperforming an 11% move in the AUD/USD over the same period. A spike in NZ term yields has also lent support to the NZD/USD. These factors have driven the AUD/NZD to below the key 1.2350 level (the 50% retracement level between this year's trough and peak), with the cross headed towards the next supports at 1.2210 and 1.2030.
- A shocker NZ Q4 GDP release tomorrow is largely priced in by the market, so a better than expected read could weigh further on the AUD/NZD.



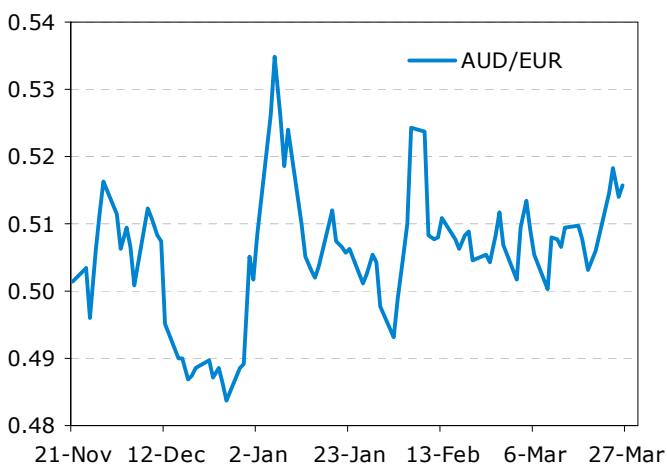
### AUD/JPY Key levels: 63.60 - 68.80

- The AUD/JPY 50-day moving average is on the verge of climbing above the 100-day moving average, underlying the strong uptrend in the cross over the past seven weeks. Indeed, given that the AUD has soared more than 20% against the JPY over this period to levels not seen since early November 2008, some consolidation in the AUD/JPY can be expected over the following week. Good support exists around 65.00 - 65.50.
- A raft of Japanese economic data are due for release over the next week; watch for market interest in retail trade, industrial production, PMI, jobless and Tankan business survey numbers.



### AUD/GBP Key levels: 0.4650 - 0.4830

- The AUD/GBP surged this week on the continued recovery in global risk appetite. The cross has persisted to test the key AUD/GBP 0.48 level; the next target in sight will be the early January peak of 0.4940. Underlying the upward trend of this cross over the past three months is the steady climb of the 100-day moving average, which has just crossed above the 200 day moving average.
- Better than expected UK retail sales for February and PMI data for March could provide a boost for the GBP/USD and weigh on the AUD/GBP. Importers may wish to take advantage of the current surge in the cross.



### AUD/EUR Key levels: 0.5010 - 0.5190

- AUD outperformance this week has seen the AUD/EUR break comfortably above the top of its five-week trading cap of 0.5150, and above the 50% retracement level between this year's peak and trough. Strong resistance exists at 0.5190, with the cross needing to sustain a move above this level to gather steam towards the next level at 0.5250. Failure to maintain this current higher move above 0.5150 could see the cross head towards downside support around 0.51.
- Be aware of the release of Euro zone PMI data and an interest rate announcement from the ECB (with market expectations of a cut to 1%) this week.

## ANZ economic and financial market forecasts

Australian economic indicators	2007	2008	2009f	2010f
<b>Economic activity (annual % change)</b>				
Private final demand	6.0	3.9	-1.9	-0.8
Household consumption	4.3	2.1	-0.4	0.9
Dwelling investment	2.7	2.0	-5.1	9.6
Business investment	13.8	13.2	-4.7	-10.5
Public demand	2.8	5.0	3.2	5.2
Domestic final demand	5.4	4.1	-0.7	0.6
Inventories (contribution to GDP)	0.6	-0.6	-0.3	0.2
Gross National Expenditure (GNE)	5.9	3.5	-1.0	0.7
Exports	3.2	4.7	-4.2	0.4
Imports	11.5	10.6	-6.9	1.0
Net Exports (contribution to GDP)	-1.8	-1.4	0.8	-0.1
<b>Gross Domestic Product (GDP)</b>	<b>4.0</b>	<b>2.1</b>	<b>-0.4</b>	<b>0.9</b>
<b>Prices and wages (annual % change)</b>				
Inflation: Headline CPI	2.3	4.4	2.8	2.8
Underlying*	3.1	4.3	2.7	2.8
Wages	4.1	4.2	3.9	3.4
<b>Labour market</b>				
Employment (annual % change)	2.8	2.2	-0.2	-0.8
Unemployment rate (%)	4.4	4.2	5.6	7.4
<b>External sector</b>				
Current account balance: A\$ bn	-68.1	-50.1	-52.9	-79.5
% of GDP	-6.3	-4.2	-4.4	-6.5

\*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	3.25	2.75	2.25	2.00	2.00	2.00
90 day bill	3.18	2.93	2.10	2.30	2.30	2.35
3 year bond	3.50	3.15	3.20	3.35	3.65	3.85
10 year bond	4.52	4.25	4.30	4.45	4.55	4.65
3s10s yield curve	1.02	1.10	1.10	1.10	0.90	0.80
3 year swap	3.93	3.50	3.50	3.65	3.95	4.15
10 year swap	5.07	4.65	4.65	4.75	4.85	4.95
<b>International interest rates</b>						
RBNZ cash rate	3.00	2.50	2.50	2.50	2.50	2.50
NZ 90 day bill	3.35	2.89	2.84	2.80	2.77	2.75
US Fed funds note	0.25	0.25	0.25	0.25	0.50	1.00
US 2 year note	0.91	0.85	0.95	1.25	1.50	1.75
US 10 year note	2.74	3.60	3.70	3.95	4.00	4.15
Japan call rate	0.10	0.10	0.10	0.25	0.50	0.50
ECB refinance rate	1.50	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
<b>Australia and NZ exchange rates</b>						
A\$/US\$	0.7020	0.58	0.56	0.54	0.54	0.56
NZ\$/US\$	0.5743	0.45	0.43	0.41	0.42	0.43
A\$/¥	69.32	58.00	56.56	55.08	56.70	60.48
A\$/€	0.5192	0.46	0.47	0.49	0.50	0.51
A\$/£	0.4857	0.40	0.38	0.36	0.35	0.35
A\$/NZ\$	1.222	1.29	1.30	1.32	1.29	1.30
A\$/CA\$	0.8630	0.71	0.66	0.59	0.57	0.62
A\$/CHF	0.7914	0.70	0.71	0.74	0.76	0.77
A\$/CNY	4.795	3.97	3.83	3.69	3.69	3.82
A\$ Trade weighted index	57.80	50.08	48.89	47.73	47.79	49.25
<b>International cross rates</b>						
US\$/¥	98.8	100	101	102	105	108
€/US\$	1.352	1.25	1.20	1.10	1.08	1.10
€/¥	133.5	125	121	112	113	119
£/US\$	1.445	1.46	1.48	1.50	1.55	1.60
€/£	0.9356	0.86	0.81	0.73	0.70	0.69
US\$/CA\$	1.229	1.22	1.18	1.10	1.06	1.10
US\$/CHF	1.128	1.20	1.26	1.37	1.40	1.38
US\$ index	84.17	88.5	90.5	94.8	95.5	94.7
<b>Asia exchange rates</b>						
US\$/CNY	6.832	6.84	6.84	6.84	6.84	6.82
US\$/HKD	7.750	7.76	7.76	7.76	7.78	7.80
US\$/IDR	11610	12000	11900	11600	11600	11300
US\$/INR	50.60	49.00	48.00	48.00	47.00	47.00
US\$/KRW	1331	1400	1400	1375	1350	1300
US\$/MYR	3.63	3.74	3.80	3.80	3.80	3.75
US\$/PHP	48.16	49.50	50.00	49.50	48.80	48.50
US\$/SGD	1.508	1.58	1.62	1.66	1.66	1.63
US\$/THB	35.26	37.60	39.40	39.40	38.80	38.80
US\$/TWD	33.81	36.00	36.00	35.50	35.50	35.00
US\$/VND	17787	17800	18100	18500	18500	18000
<b>Pacific exchange rates</b>						
PGK/US\$	0.333	0.35	0.34	0.35	0.35	0.36
FJD/US\$	0.564	0.50	0.48	0.47	0.47	0.48

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