

Global worries intensify again

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Macro Update: Can Australia avoid the Q4 collapse?

- Global economic data continues to fall below expectations. Australia's major export destinations look to have shrunk by an average 2.7% in Q4.
- Disappointing retail sales volumes suggests the fiscal stimulus package may not have been enough to prevent Australia's economy from contracting in Q4, although the decline will be small by global standards.
- RBA Governor Stevens' Senate testimony tomorrow will hopefully provide further insight on the strategy for the timing and size of further rate cuts.

Interest Rate Markets: Global worries keep yields low

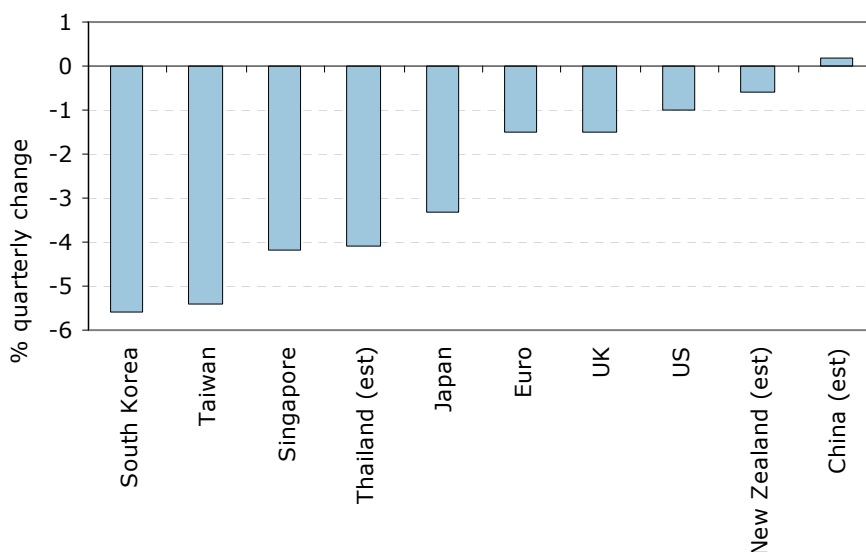
- Demand for safe-haven bonds has increased this week, driven by a shift in market focus to sovereign and banking risks in peripheral Europe due to economic duress. Further deterioration of the situation has the potential to keep bond yields near historical lows, especially as inflation falls.
- The market is now fully priced for a 50bps cut from the RBA in March and for official rates to head to 2.0% by mid year. Inter-bank rates (IBs) have moved to reflect the increasing likelihood of rates staying lower for longer.

FX: The fall of the Euro

- AUD outperformance against the major crosses may retrace in the short term, so AUD sellers should beware of a move down on the cross rates, particularly AUD/EUR.
- The EUR is in decline. The release of a Moody's report on Tuesday warning of potential downgrades of Euro zone banks exposed to economic woes in Eastern Europe was the trigger for this week's fall in the EUR.

Chart of the week

Figure 1: Growth collapsed in Australia's major trading partners in Q4



Source: Bloomberg and ANZ

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Macro Update: Can Australia avoid the Q4 collapse?

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Global economic shock worse than first thought

This week's global data run again highlighted the collapse in the global economy that occurred in the final months of 2008. The biggest shock this week was Japan's GDP figures, which showed the world's third largest economy (and Australia's biggest merchandise export destination) shrunk by 3.3% in the December quarter, a 12.7% annualised decline. This is Japan's biggest contraction since the 1970s oil shock and is the third consecutive quarter of negative growth. Expectations are now that Japan's economy will contract by a similar, or worse, amount in Q1.

The collapse of the Japanese economy could not come at a worse time for Australian commodity producers, with our bulk coal producers now in the thick of contract price negotiations with Japanese steelmakers. While our long-standing forecast has been for 50% price declines, market talk is now that the falls could be in the order of 60%. Moreover, the depth of Japan's downturn raises concerns about further commodity contract price declines (and thus another fall in Australia's terms of trade) in 2010-11.

The synchronised nature of last year's global shock has also seen the smaller (more manufacturing-intensive) East Asian economies suffer very significant contractions in activity. Earlier in the year it was revealed that the economy of South Korea (Australia's third biggest merchandise export destination) shrank by 5.6% in Q4. This week Taiwan reported a similarly deep decline of 5.4%. OECD economic growth is now expected to fall by 1.5% in Q4 following a 0.2% contraction in Q3. Australia's top 10 major merchandise export destinations appear to have shrunk by an average 2.7% in Q4 (see Chart of the week on p1).

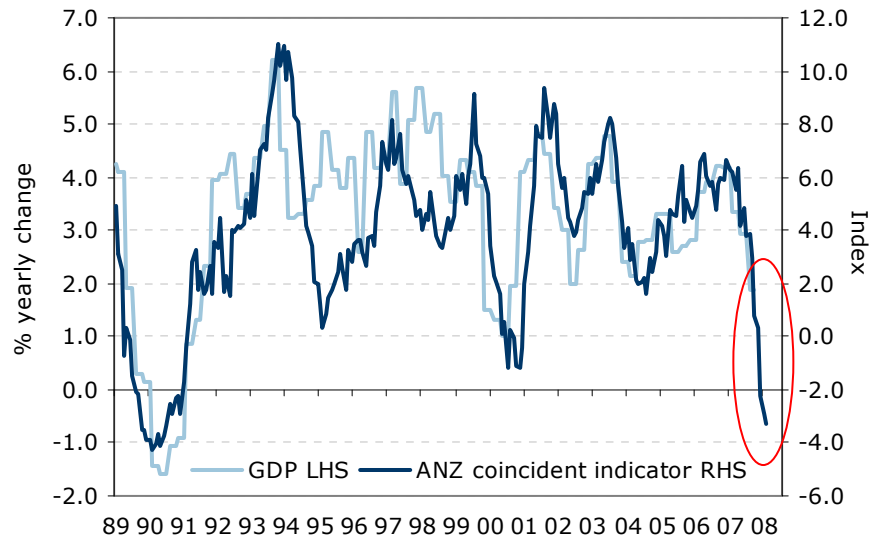
Australian growth will struggle to stay positive

The Australian economy is unlikely to suffer the same degree of distress as most other parts of the world in Q4. However it is clear that the economy did slow very sharply. Exports and dwelling investment both appear to have suffered heavy falls in the quarter and it is also likely that there were some pretty big shocks to production, especially in the mining sector. Next week's capital expenditure survey is expected to show a fall in machinery and equipment investment (following sharply weaker capital imports in the quarter). Non-residential construction, especially in engineering, is also expected to decline, reversing sharp rises in Q3. Survey measures meanwhile point to a run down in inventories in Q4, another potential drag on growth in the quarter. On the upside, employment remained positive in the quarter and the weaker A\$ should have provided some offset for mining profits from weaker sales and prices.

One factor that had also provided vital support to the economy, although not as much as expected, is consumer spending. This is partly thanks to the resilient labour market but mainly because of the Government's December fiscal stimulus package. That said, fiscal policy appears to have delivered less of a short-term boost than policy-makers probably hoped for with the ABS revealing this week that retail sales volumes rose by 'just' 0.8% in Q4. While a strong pick up from 0.2% growth in Q3, the result was below market expectations and is probably not enough to 'save' the economy from experiencing a contraction in Q4 GDP. Ahead of the key CAPEX and corporate profits surveys, we have been forced to revise down our forecasts for quarterly Q4 GDP from flat to a fall of around 0.1%, a relatively small contraction by global standards. In yearly terms,

growth is expected to stay positive but still slow sharply to 0.9% from 1.9% in Q3. Figure 2 below highlights that there are downside risks to our view.

Figure 2: The risks are for a deeper downturn in Australia in Q4



Source: Bloomberg and ANZ

Future rate cuts: how large and how fast?

Against this deteriorating backdrop, further interest rate cuts from the RBA seem likely. We maintain our forecast for the cash rate to fall to 2.5% by mid-year. However while the market is united in the call for further cuts, views remain split as to the appropriate size and pace of rate cuts going forward now that rates have already been cut by 400bp since September and the cash rate is at a generational low of 3.25%.

If rates need to be lowered further to stimulate economic activity, it can be argued that it should happen sooner rather than later. However the economy has already received significant monetary and fiscal policy stimulus and the RBA may need to some ammunition for later in the year when the economy is at risk of faltering as the rise in the unemployment rate accelerates. The argument really centres on whether it is the *level* of interest rates or the *change* in interest rates that matters for economic activity, especially now that rates are already at a clearly stimulatory setting.

Minutes from the February Board Meeting provided little guidance on the RBA's strategy. The Minutes do argue that the Australian economy has been more resilient than other industrialised economies. They also highlight that monetary and fiscal stimulus has occurred relatively early in Australia's business cycle and that monetary policy here has been more effective with the reduction in Australian lending rates substantial. At the same time however, the RBA views the headwinds from the global economy as "very strong" and that the significant fiscal and monetary stimulus "would take time to be effective and could be expected to have only a modest effect on the near-term outlook in Australia."

It is important to note that the Minutes are now two weeks old, a long time given the rapidly shifting landscape. We may receive a more up to date view on the RBA's strategy from here from the Governor tomorrow, when he gives his semi-annual parliamentary testimony tomorrow. Any further elaboration on how potent the RBA sees the latest round of fiscal policy initiatives and how quickly they will stimulate the economy will also be watched for closely.

Data wrap

- **Real retail sales rose 0.8% in Q4.** Nominal sales rose by a strong 1.6% but volumes were eroded by a 1.0% rise in the retail sales price deflator.
- **Motor vehicle sales fell 1.1% in January** to be 16.9% lower YoY.

Interest Rate Markets

Global worries and further rate cuts keep short-dated yields anchored near recent lows.

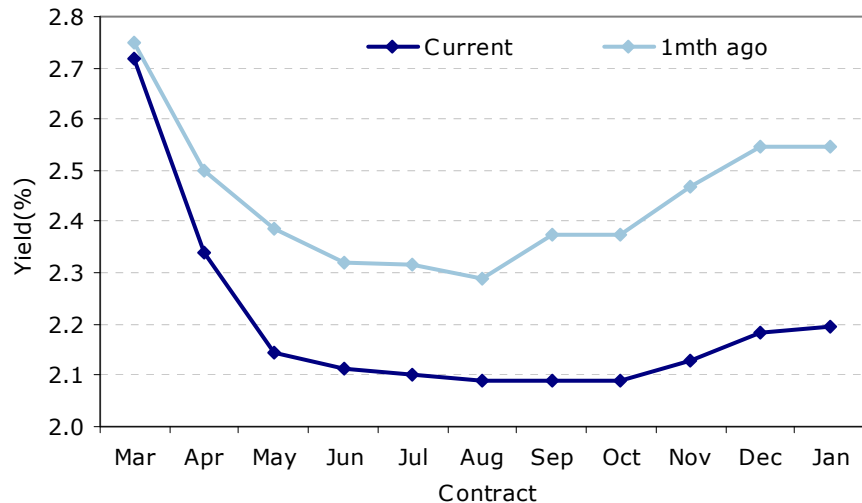
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Bond yields have come under renewed downward pressure over the past week in light of an intensification of concerns over the global outlook. While the RBA is likely to be more measured in easing policy from here, the Bank is still set to cut rates further in coming months so shorter-dated yields are set to remain anchored near January lows.

Concerns over global banking exposures to a deteriorating economic outlook in Europe have provided a safe-haven bid for bonds in recent days. Market expectations for further RBA rate cuts will be reinforced if the global growth outlook continues to deteriorate while systemic risks remain high.

The accelerated supply of Government bonds has been easily absorbed in this environment. The latest tender of 2012 bonds attracted a very strong 4.8 bid to cover ratio, the strongest since the AOFM announced a big jump in issuance for the remainder of this fiscal year.

Figure 3: 30-day Inter Bank rates - expectations still moving lower



Source: ANZ & Bloomberg

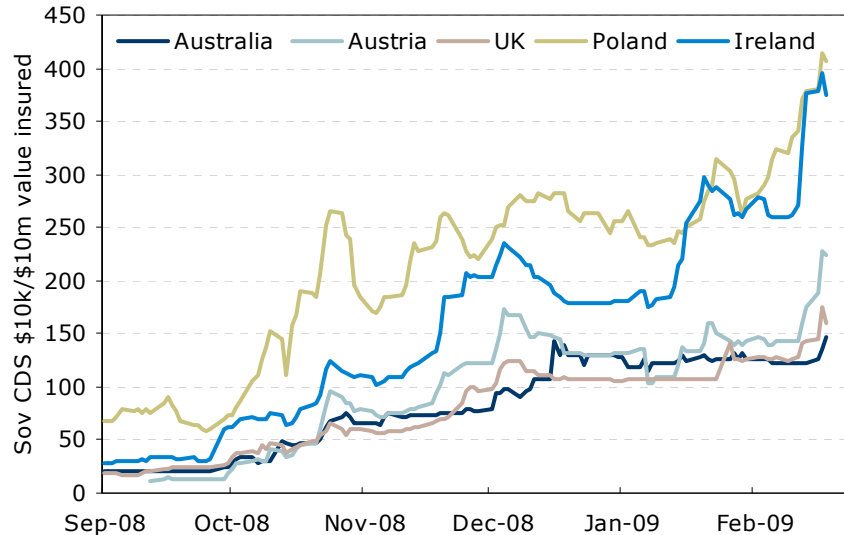
The market is now fully priced for a 50bps cut from the RBA in March and for official rates to head to 2.0% by mid-year. So it would take a further downgrade to growth prospects to push bond yields to new lows. The safe-haven bid this week still failed to support a move to new highs for bond futures. It is the move by inter-bank rates (IBs) to increasingly price the likelihood of rates staying lower for longer that is more striking in Figure 3. This makes sense as there is little prospect of the RBA reversing course anytime soon.

There is little reason to expect the RBA to follow other central banks in taking rates towards zero. RBA Assistant Governor Edey took the opportunity yesterday to stress that Australia will outperform international counterparts as the local financial system remains in relatively good shape. He went on to ask: "So despite the gloomy circumstances, it's important to ask the question: what are the factors that can contribute to an upturn in due course?" He highlighted fiscal and monetary stimulus (Australia was cited as implementing a fiscal stimulus at least as large as the US and China as a % of GDP), support of the financial sector and normal cyclical dynamics.

A large part of the demand for safe-haven bonds in recent days has been driven by a shift in market focus to sovereign and banking risks in peripheral Europe due to economic duress. Moody's has warned of downgrades to banks with heavy exposures in this area. The cost of insuring sovereign debt via credit default swaps has taken another step higher this week – see Figure 4 below. Pressure

abated overnight as the bad news has been absorbed. With the ability of Governments to stand behind growing losses now significantly constrained by pressures on public finances, the risk of possible default on sovereign debt is rising. The risk of a default in Ireland (rated AAA) is being viewed as nearly the same as Poland (rated A2). Poland is now seeking fast-tracked EU membership. While the CDS for Australia is also responding to these developments, Australia still looks to be in better relative shape than other major economies.

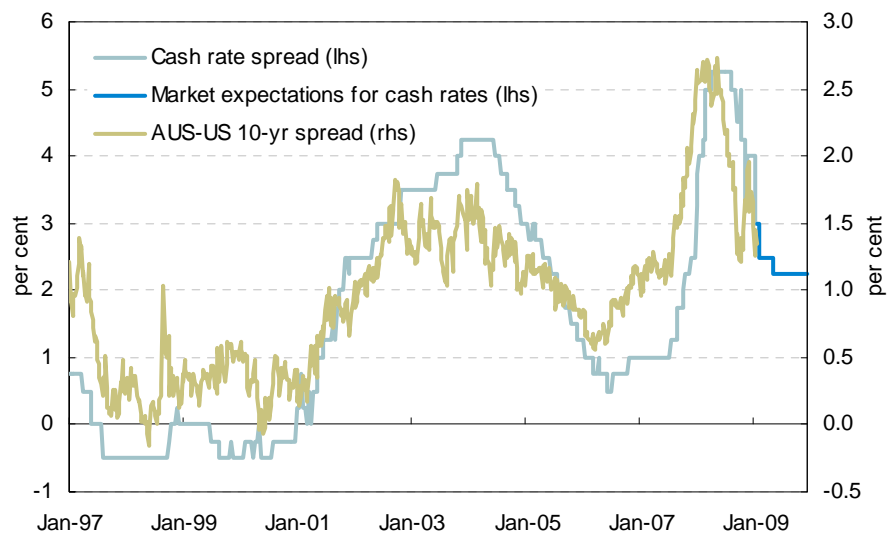
Figure 4: Sovereign Credit Default Risks continue to move



Source: ANZ & Bloomberg

Further deterioration of the situation in peripheral markets has the potential to keep bond yields near historical lows, especially as inflation falls. But recent ranges still look to be in force as the market absorbs new supply and adjusts to a more measured stance from the RBA. We continue to advise borrowers to set target levels to take advantage of any dip in yields over coming months.

Figure 5: AUS-US 10-year spread still under downward pressure



Source: ANZ and Bloomberg

Further rate cuts from here should continue to see the AUS-US rate spread remain under downward pressure as US rates are held near zero – see Figure 5. The heavier funding volume needed to finance the deficit in the US should also work in this direction.

FX: The fall of the Euro

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Recommendation

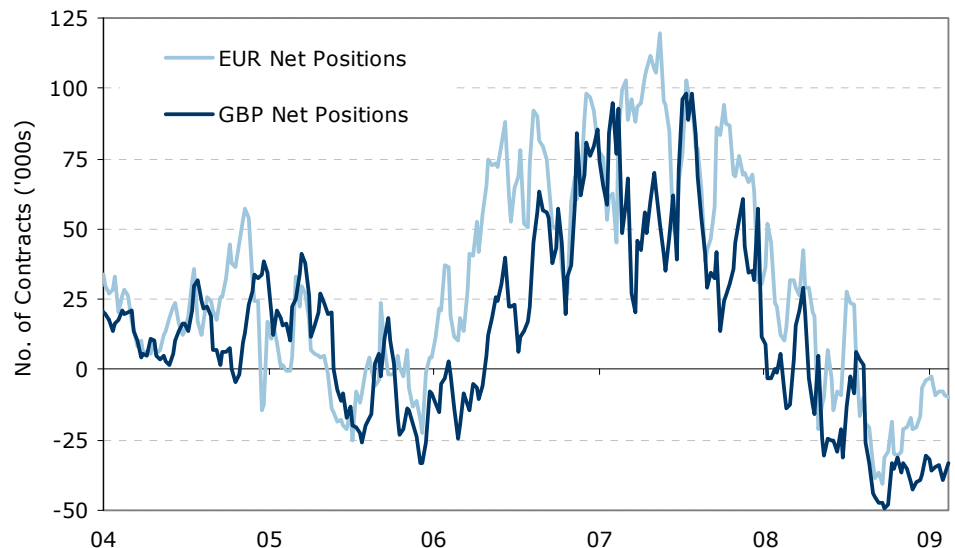
AUD outperformance against the major crosses may retrace in the short term, so AUD sellers should beware of a move down on the cross rates, particularly AUD/EUR. Now is a good time to sell short-dated AUD/JPY implied volatility.

Overview

The EUR is in decline. The release of a Moody's report on Tuesday warning of potential downgrades of Euro zone banks exposed to economic woes in Eastern Europe was the trigger for this week's fall to around EUR/USD1.2550 (at the time of writing). The report sparked a sell-off in the EUR and a surge in USD buying in thin trade generated by the closure of US markets due to the President's Day holiday. The EUR/USD broke a key support level at 1.2760, and rapidly fell to 1.2650 on the day as stop loss orders were quickly met.

This fall in the EUR is in line with our forecasts. ANZ is targeting an end Q1 value of EUR/USD1.25, with the currency to trough below 1.10 in the first quarter of 2010. With negative sentiment for the EUR gaining traction, we would expect speculators to begin to accumulate EUR shorts.

Figure 1: Expect IMM speculators to extend shorts in the EUR/USD



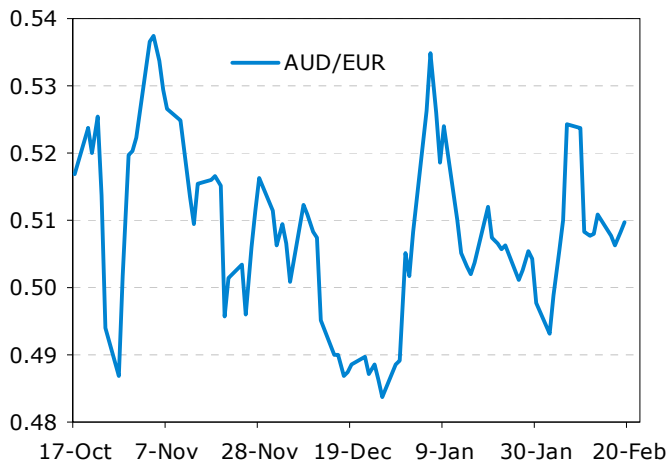
Source: ANZ & Bloomberg

The problem for the Euro zone recession is two-fold: the PIIGS (Portugal, Ireland, Italy, Greece and Spain) are highly indebted and unable to consume their way out of the downturn, while Germany, the Euro zone's engine of growth, seems practically allergic to the notion of spending. Interest rates clearly have further to fall to stimulate demand. Moreover, once in a downturn, it will be a lot more difficult for the Euro zone to rebound relative to the US or UK due to its tighter regulatory environment. This in turn implies a slower eventual return of interest rates to a more 'neutral' level. These factors will continue to weigh on the EUR over the next two years.

As an aside, the sell-off in the EUR has sparked a more general rally in the USD, the current safe-haven currency of choice. This has seen the JPY trade towards USD/JPY94, with a recovery below 90 unlikely. AUD/JPY appears to have stabilised, with now a good time to sell short-dated AUD/JPY implied volatility which is currently trading at a premium to spot volatility.

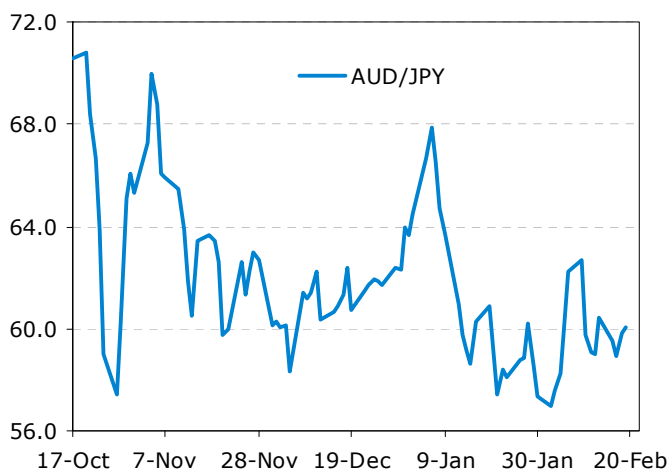
AUD/USD Key levels: 0.6250 – 0.6710. Dragged lower by the EUR/USD, the trading range for the AUD/USD has shifted down a notch. The currency broke below the key 0.6480 level this week but is hanging on around 0.6390. Downside support still lies at the 2 Feb low of 0.6250, and topside resistance at 0.6710.

AUD cross view



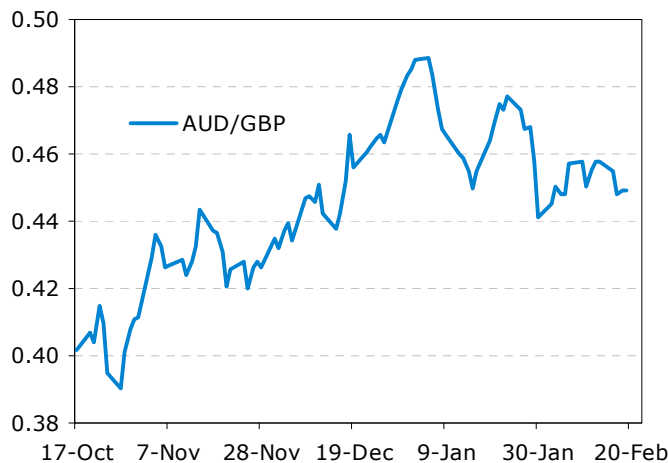
AUD/EUR Key levels: 0.4900 – 0.5160

- The AUD/EUR remained well within the key levels outlined last week, with a solid base forming above 0.5030. The possibility is for the cross to grind lower over the coming week as the AUD retraces recent outperformance versus the EUR.
- The EUR is just 2½ big figures off of its 28 October low, but this week's move lower has been sharp and swift and we could see a pull back toward 1.2620 in the next few sessions. Weaker than expected Purchasing Manager data released tomorrow could weigh on the currency and see it capped below EUR/USD1.2550.



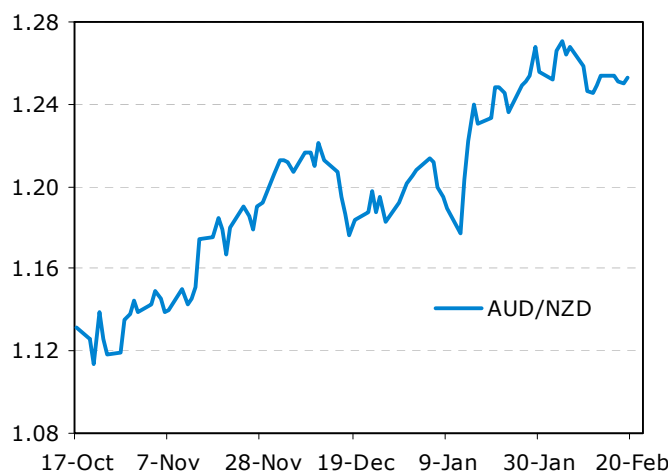
AUD/JPY Key levels: 55.50 – 61.00

- The JPY has been big news this week. A broad USD rally initiated by a sell-off in the EUR has seen the USD/JPY surge past 93.50. With the 20-day moving average about to cross over the 50-day moving average, it looks as though a move to a new trading range of 90-95 has been established.
- The AUD/JPY has stabilised in a 58 – 61 range. The risk is for a move to the downside over the coming week, with a retracement lower likely following AUD outperformance over the past week. Good support exists at AUD/JPY58.



AUD/GBP Key levels: 0.4360 – 0.4710

- The AUD/GBP has traded in a tight range between 0.4450 – 0.4600 this week.
- The BoE's February meeting minutes released this week revealed that the Bank is close to commencing quantitative easing (QE). With the repurchase rate at 1% and likely to fall further, such 'alternative policy measures' to increase the money supply and in turn raise inflation (or prevent deflation) should weigh on the GBP in the medium term. However Japan's experience with QE in the early 2000s suggests this may not be the case, with the JPY broadly appreciating during its period of QE.



AUD/NZD Key levels: 1.2280-1.2720

- The AUD/NZD largely traded in a tight 1.2450 – 1.2550 range over the past week, with an attempted surge higher capped just above 1.26. The NZD was dragged below NZD/USD0.51 following Tuesday's EUR sell-off, although it has since recovered towards 0.5125. There exists good support around AUD/NZD1.2430.
- RBA Governor Glenn Stevens' semi-annual parliamentary testimony tomorrow will be a key event for policy expectations in Australia and could generate some volatility in this cross. The longer-term outlook is remains AUD positive, with the downturn forecast to bite harder in New Zealand.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008f	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	3.7	-1.4	0.1
Household consumption	4.3	2.2	0.8	1.2
Dwelling investment	2.7	0.9	-4.8	11.9
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	0.1	1.5
Inventories (contribution to GDP)	0.6	-0.2	-0.1	0.0
Gross National Expenditure (GNE)	5.9	4.0	0.0	1.4
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	2.2	0.0	1.9
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	2.9	3.1
Underlying*	3.1	4.5	3.3	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	-4.8	-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	3.08	3.45	2.80	2.80	2.80	3.15
3 year bond	3.08	2.55	2.75	2.85	3.15	3.65
10 year bond	4.19	3.90	4.15	4.15	4.25	4.55
3s10s yield curve	1.11	1.35	1.40	1.30	1.10	0.90
3 year swap	3.50	3.15	3.20	3.35	3.65	4.15
10 year swap	4.70	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	3.30	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	0.92	0.60	0.70	0.75	1.00	1.50
US 10 year note	2.73	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	1.50	1.25	1.25	1.25	1.75
UK repo rate	1.00	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\$	0.6413	0.63	0.58	0.56	0.54	0.54
NZ\$/US\$	0.5117	0.50	0.45	0.43	0.41	0.42
A\$/¥	60.07	61.74	58.00	56.56	55.08	56.70
A\$/€	0.5097	0.50	0.48	0.50	0.49	0.50
A\$/£	0.4495	0.44	0.40	0.38	0.36	0.35
A\$/NZ\$	1.253	1.26	1.29	1.30	1.32	1.29
A\$/CA\$	0.8067	0.76	0.70	0.69	0.70	0.71
A\$/CHF	0.7525	0.76	0.73	0.75	0.76	0.77
A\$/CNY	4.384	4.31	3.97	3.83	3.69	3.69
A\$ Trade weighted index	54.00	53.53	50.21	49.32	47.86	47.93
International cross rates						
US\$/¥	93.7	98	100	101	102	105
€/US\$	1.258	1.25	1.20	1.12	1.10	1.08
€/¥	117.8	123	120	113	112	113
£/US\$	1.427	1.42	1.46	1.48	1.50	1.55
€/£	0.8817	0.88	0.82	0.76	0.73	0.70
US\$/CA\$	1.258	1.20	1.20	1.24	1.30	1.32
US\$/CHF	1.174	1.20	1.25	1.34	1.40	1.42
US\$ index	87.89	88.1	90.4	94.7	96.3	97.5
Asia exchange rates						
US\$/CNY	6.838	6.84	6.84	6.84	6.84	6.84
US\$/HKD	7.756	7.76	7.77	7.80	7.80	7.80
US\$/IDR	12050	11350	11500	11900	11600	11600
US\$/INR	49.93	49.00	49.00	48.00	48.00	47.00
US\$/KRW	1471.1	1375	1400	1400	1375	1350
US\$/MYR	3.6545	3.64	3.74	3.80	3.80	3.80
US\$/PHP	47.835	47.50	48.50	49.30	49.50	49.50
US\$/SGD	1.530	1.54	1.58	1.62	1.66	1.66
US\$/THB	35.40	35.80	37.60	39.40	39.40	38.80
US\$/TWD	34.64	34.20	35.20	36.00	36.00	35.50
US\$/VND	17486	17500	17800	18100	18500	18500
Pacific exchange rates						
PGK/US\$	0.369	0.37	0.36	0.36	0.35	0.35
FJD/US\$	0.534	0.53	0.51	0.49	0.48	0.48

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