

Another close call for the RBA

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Macro Update: Another pause

- It's a close call but we expect the RBA will pause next week as fiscal measures assume new importance in the policy response.
- Further policy stimulus will be required over H2 as the local economy deteriorates further.
- We have downgraded our economic forecasts and now expect GDP could contract by 1.0% this year.

Interest Rate Markets: Bond yields firmly established in ranges

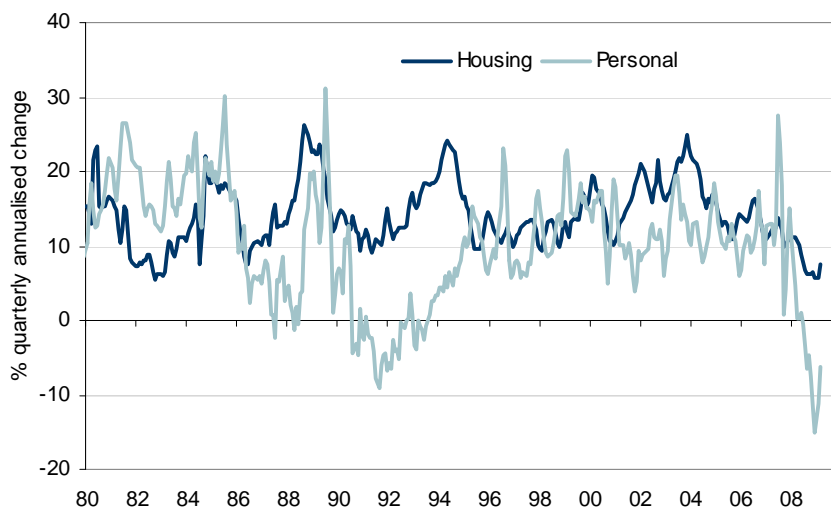
- Upward pressure on bond yields has abated in recent days, reinforcing that broad ranges remain intact for the near term.
- A sharp rise in NZ market rates last week is a reminder that with gradual monetary policy easing largely priced into current market levels, there is a risk of a sharp move higher in rates at some stage.

FX: AUD and EUR forecasts adjusted higher

- The recent sustained up tick in global risk currencies has led us to revise up our three-to-six-month outlook, particularly for the AUD/USD and EUR/USD.
- Short term, good opportunities continue to be presented to AUD sellers above the AUD/USD0.6950 level, while the lower trend in volatility continues to keep options affordable.
- With more of the market (including ANZ) now expecting the RBA to leave interest rates on hold next week, even a 25bp cut in rates could weigh on the AUD/USD and send it below its key support at 0.6780.

Chart of the week

Figure 1: Australian households are consolidating balance sheets outside of housing



Source: RBA and ANZ

Macro Update: Another pause

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- Further policy stimulus will be required over H2 as the local economy deteriorates further. Growth could contract by 1.0% this year.

Another close call for the RBA

Next Tuesday's Board meeting is shaping up as another close call for the RBA.

The case to cut. The global outlook continues to deteriorate, in Europe but also, of most importance to Australia, Japan. Local leading indicators confirm that the worst is yet to come for most segments of the Australian economy; the PMI suggests our manufacturing sector continues to contract, non-residential building approvals are plummeting and next week's employment report is expected to print poorly. The recent rise in the A\$ has inadvertently tightened local monetary conditions (albeit slightly).

The case to hold. Financial conditions have settled, particularly credit spreads and credit market indicators. The Commonwealth Guarantee on State Government debt means the States are in a much improved position to deliver on infrastructure investment plans. And this week's data flow confirms policy is working; housing market data continues to improve with building approvals rising for the first time in eight months in February, while RP Data/Rismark reported Australian house prices rose 1.1% for the first two months of the year.

Figure 2: Retail sales remain above the November lows



Source: ABS and ANZ

While retail sales collapsed 2.0% in February, this largely reflects the unwind from last year's fiscal stimulus. While there is no disputing consumer spending is weak, the level and yearly growth rate of retail sales remains above the pre-fiscal stimulus period, further implying policy is providing some support (Figure 2). Importantly, this week's personal credit data (credit cards, unsecured finance, margin loans etc) showed the household sector is repairing its balance sheet outside of housing (see Chart of the Week on page 1). While weaker personal credit growth may be desired, the RBA may be cautious about further stoking housing credit; driving up household debt is not a sustainable response to the current risks.

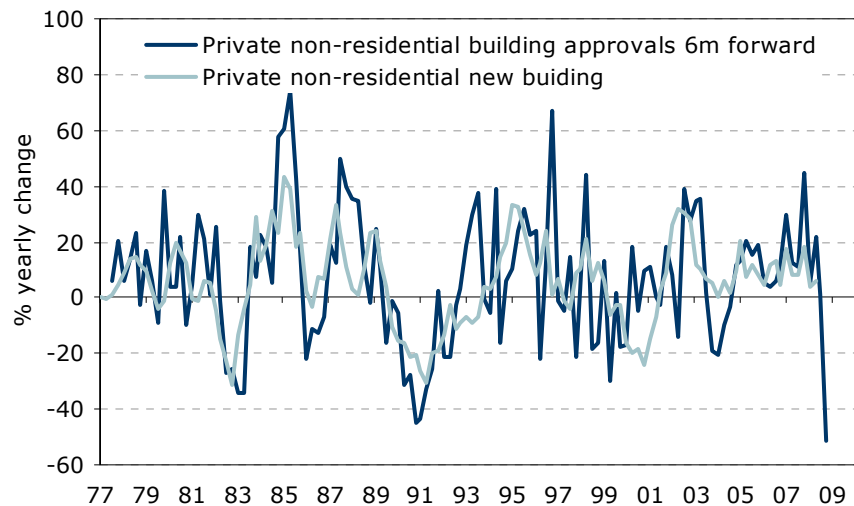
Conclusion? It is not clear that further rate reductions will have a material impact on the short-term economic outlook. With the next round of fiscal stimulus around the corner (pending tomorrow's High Court decision) and with further 'significant' fiscal stimulus anticipated in next month's Budget, why use up increasingly scarce policy resources at the same time? We therefore expect the RBA will pause next week, but that rates will still fall to 2.0% by year end.

Another downward revision our forecasts

The need for further stimulus later this year is highlighted by our latest economic forecasts. We have reviewed our Australian forecasts this week and unfortunately have been forced to make a further downgrade to our view. We now expect the Australian economy to shrink by around 1.0% in 2009. This will involve at least two and possibly four quarters of negative growth (including the -0.5% result in Q4 2008).

The primary driver of our downgrade is the continued collapse in private non-residential building approvals. These approvals have plummeted in recent months to be down 61.0% YoY. This sector is at the forefront of the abrupt shock to credit conditions and the slowing and uncertain economic outlook. Figure 3 below shows the depth of this impending cycle has eerily similarities to the early 1990s. While a record high level of work in the pipeline should provide some offset to falling approvals for new building activity, it is unlikely to be enough to prevent a sharp contraction overall. We expect this sector will impose a significant drag on economic growth and employment over 2009-10.

Figure 2: Non-residential building is the next leg of Australia's slowdown



N.B. Approval values deflated by ANZ

Source: Bloomberg and ANZ

What of the broader economy and prospects for recovery? We expect that counter-cyclical policy (in particular its stimulatory impact to housing demand) and some stabilisation in global demand will allow the Australian economy to stabilise by end 2009. But we expect the recovery to be protracted and soft over 2010, as continued balance sheet consolidation across households and businesses and thus a protracted business investment cycle constrains spending. We are not forecasting a return to trend economic growth before mid-2011.

Data wrap

- **Private sector credit** was flat in February, as falls in business and personal credit offset another solid rise in housing credit.
- The **AIG Performance of Manufacturing Index (PMI)** improved slightly to 33.4 in March but is still at levels suggesting deep contraction in the sector.
- **DEWR Skilled Vacancies** fell by 10.8% in March.
- **Retail sales** fell 2.0% in February as the impact of last year's fiscal stimulus unwound. All industries posted sharply weaker sales, as did all States excluding Tasmania.
- **Building approvals** jumped 7.8% in February, the first rise in eight months, led by a sharp rebound in approvals for 'other' buildings (mainly apartments).
- The **RBA commodity price index** fell 5.0% in AUD terms in March. Lower rural and non-rural prices offset higher base metal prices.
- **The trade surplus** improved sharply to \$2.1bn in March reflecting a combination of stronger exports (led by higher gold prices) and falling imports.

Interest Rate Markets: Bond yields firmly established in ranges

- Upward pressure on bond yields has abated in recent days, reinforcing that broad ranges remain intact for the near term.
- A sharp rise in NZ market rates last week is a reminder that with gradual monetary policy easing largely priced into current market levels, there is a risk of a sharp move higher in rates at some stage.

Broad ranges remain intact for bond yields

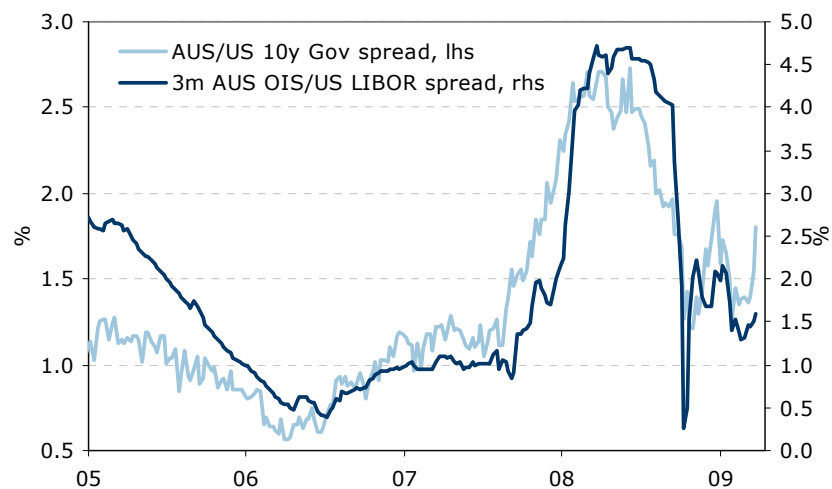
Upward pressure on bonds yields has abated in recent days. Weak economic data, failing momentum for the global stock market rally and expectations that the RBA is still on track to ease again later in the year have helped to support bonds. This has reinforced the notion that broad ranges remain intact for the near term. Official buying of US Treasuries as part of quantitative easing also supports this view, as such purchases help to cap US bond yields despite the heavy weigh of supply now being seen on bond markets.

Rising speculation that the RBA could pause in April sparked a notable sell-off in interest rate markets earlier this week. Three-year yields had moved up to test early January highs around 3.60%. The yield on the 10-year Australian Commonwealth Government Bonds (ACGB) reached a 4-month high last week near 4.60%.

While there appears to be scope for yields to ease modestly from here, the downside also looks to be limited by the possibility of a pause from the RBA until after the May Budget, weaker flight-to-quality demand for bonds as stock markets stabilise, increased supply and a sharp narrowing in Semi spreads following last week's announcement by the Commonwealth Government's offer to guarantee State borrowing. The relative out performance story for the domestic economy has been reinforced by recent positive housing data and some signs of easing pressures in the banking system.

The base of the recent range looks to be around 3.0% for 3-year yields and around 4.0% for 10-year yields. For the 3-year swap we still see 3.50% as a target level to hedge borrowing. But we would need to see a more accelerated pace of policy easing and run of exceptionally weak data to threaten these levels.

Figure 1: AUS-US rate spreads



Source: ANZ & Bloomberg

The Australian government has this week flagged downgrades to growth and labour market forecasts, suggesting further fiscal stimulus is in the works. This is likely to further inflate the large borrowing programme of the AOFM that will triple the size of Commonwealth bonds on issue, even on current estimates.

The New Zealand experience is instructive

A sharp rise in NZ market rates last week is a reminder that with gradual monetary policy easing from current levels largely priced into current market levels, there is a risk of a sharp move higher in rates at some stage. NZ 3-year bond yields rose more than 80bps at one stage last week while the 2-year swap was up over 1% from recent lows, prompting some verbal intervention from the RBNZ that this rise was inconsistent with their view of the economy and financial conditions.

US Treasury buying of bonds as part of quantitative easing and weak US data has helped to cap US bond yields and push 30-year mortgage rates to record lows, higher local yields have pushed out the AUS-US 10-year spread – see above.

Aus-US spread unlikely to widen much further

The 10-year AUS-US yield spread looks to be heading back towards its December wide of around 200 bps. This would be inconsistent with likely moves at the short end over coming months as we still see the RBA taking official cash down towards 2.0%. With US yields clearly contained in a range, buying of AUD bonds for a relatively high running yield is limiting the upside for local bond yields, helping to reinforce the ranges highlighted above. This widening of yield spreads is helping to underpin a better performance from the AUD and is certainly helping to minimise current account funding pressures at this stage of the cycle.

Figure 2: AUS 3/10-year yield spread



Source: ANZ & Bloomberg

While the RBA board decision next week still looks to be a close call, the more cautious stance from the RBA is putting the 3/10-years curve under some pressure. The recent 100-125 bps range looks to be giving way to a 90-115bps range. While the major uptrend has given way the RBA remains in easing mode so we would not expect flattening pressures to intensify at this stage.

Summary: We still feel that we have probably seen the low in yields, especially further out the curve, and we can expect higher ranges to develop from here. We would recommend borrowers take the opportunity to lock in borrowing on any move lower in market rates from current levels.

FX: AUD and EUR forecasts adjusted higher

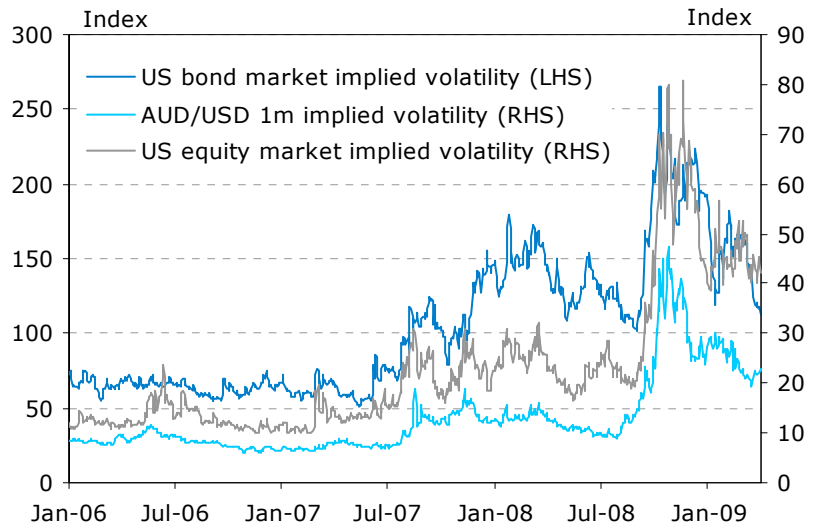
Recommendation

Good opportunities continue to be presented to AUD sellers above the AUD/USD0.6950 level, while the lower trend in volatility continues to keep options affordable. With more of the market (including ANZ) now expecting the RBA to leave interest rates on hold next week, even a 25bp cut in rates could weigh on the AUD/USD and send it below its key support at 0.6780. The solid data flow persists into next week, with eyes focused on US non-farm payrolls, a speech by Fed Chairman Bernanke, and Australian employment data for March. Tonight's G20 meeting is unlikely to make much of an impression on the market.

Overview

The recent sustained up tick in global risk currencies has led us to revise up our three-to-six-month outlook, particularly for the AUD/USD and EUR/USD. As noted last week, the sustained rally on global bourses, combined with continued improvement in global risk indicators, has buoyed risk appetite and boosted demand for non-USD flows. These developments have generated currency moves on supply-demand and technical factors rather than fundamentals.

Figure 3: Market risk indicators continue to ease



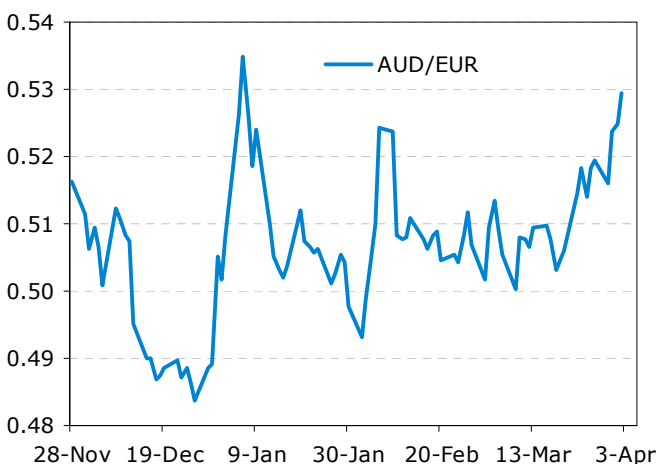
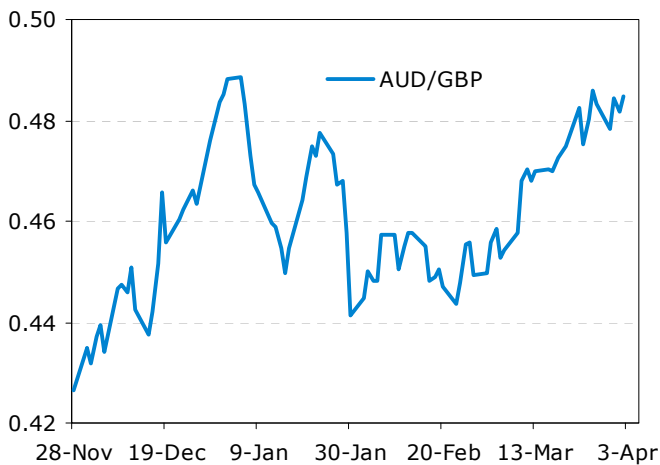
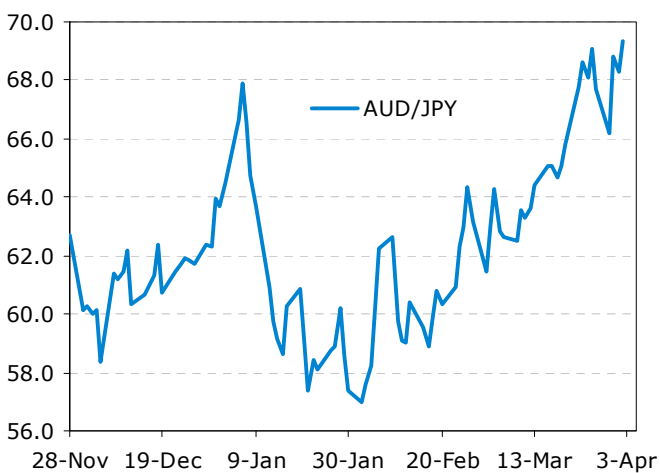
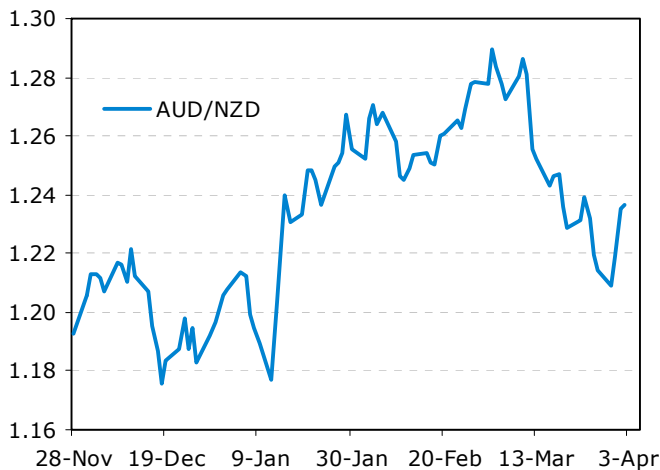
Source: ANZ, Bloomberg

While we do believe that the fundamental currency drivers will return to the fore over the coming months to once again weigh on the AUD and EUR, the risk is that it will be a slower grind lower towards our year-end targets of AUD/USD0.54 and EUR/USD1.10. We now see the AUD/USD reaching 0.62 by the end of June and 0.58 by the end of September, while the EUR/USD is expected to decline to 1.25 by June and 1.18 in September. Our NZ colleagues have similarly revised their numbers higher for the NZD/USD, with the currency expected to reach 0.49 by the end of June and 0.45 by year's end. Note that despite these changes, the downward trends previously forecast in the AUD, EUR and NZD remain intact.

In the short term, the key risk for the AUD lies around next week's RBA rate decision. With more of the market moving towards a 'no change' policy expectation, even a 25bp cut in the cash rate could see the AUD/USD quickly sell-off three big figures. What about the G20? After being disappointed on a number of previous occasions, the market is not expecting anything substantial from tonight's meeting, with the official communiqué unlikely to dislodge the 'good news' feel of the market that is currently supporting the AUD.

AUD/USD Key levels: 0.6780 – 0.7100. AUD/USD0.7100 is the topside target for the currency. However, such a move requires a sustained hold above 0.70 which has not been forthcoming as yet. With markets split on the RBA rate decision next week, any reduction in the cash rate could weigh on the AUD/USD and push it below 0.6780.

AUD cross view



AUD/NZD Key levels: 1.2070 - 1.2500

- The revival in global risk appetite has seen the NZD continue to outperform the AUD (albeit after a period of relative underperformance). The AUD/NZD dipped to a low of 1.2068 before rapidly recovering towards 1.24 on RBNZ Governor Bollard's comments that long-term NZ yields were too high. Recently revised NZD/USD forecasts suggest that the AUD/NZD will continue to track in the low-to-mid 1.20s over the next 12 months.
- A cut in the RBA cash rate next week, or worse than expected March employment numbers in Australia could weigh on the AUD/NZD and push it back towards 1.2070.

AUD/JPY Key levels: 65.00 - 70.00

- Trading levels in the AUD/JPY remain close to a five-month high. The Tankan business survey released this week for Q1 was dire, particularly for manufacturers, and has added further downward pressure on the JPY while supporting the cross. Dips in the USD/JPY appear capped around 99.00-99.50, so any further upside in the AUD/JPY is relying on another push higher in the AUD/USD.
- No changes are expected from the BoJ policy meeting next week. Watch for market interest in next week's release of Japanese current account data for February and machine tool orders for March, although disappointing results are likely.

AUD/GBP Key levels: 0.4650 - 0.4940

- AUD/GBP has been closing in on the early January high of 0.4940, although it appears that it is running out of momentum. Rather than push higher over the past week, the cross has been treading water and we are likely to see some consolidation towards 0.4720, with good support lower at 0.4650 (50% retracement between 2009's high and low).
- No change is expected from the BoE meeting next week. February industrial and manufacturing production data due for release next week could lend support to the GBP/USD if they print in line with recent improvements in global PMI data.

AUD/EUR Key levels: 0.5140 - 0.5370

- AUD/EUR accelerated higher this week towards the 6 January peak of AUD/EUR0.5372. Following such a sharp move, some consolidation towards the support level at 0.5140 (50% retracement level between 2009's high and low) is expected.
- The ECB interest rate decision tonight is a key focus, with the market looking for a 50bp cut to the refi rate (to 1%) and any direction from ECB President Trichet regarding future plans for a move to quantitative easing. Retail sales data for February and April investor confidence numbers due next week could also generate some short-term fluctuations in the AUD/EUR.

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	0.7
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	2.8	2.7
Underlying*	3.1	4.3	2.7	2.8
Wages	4.1	4.2	3.9	3.4
Labour market				
Employment (annual % change)	2.8	2.2	-0.3	-1.2
Unemployment rate (%)	4.4	4.2	6.0	8.1
External sector				
Current account balance: A\$ bn	-68.1	-50.1	-36.4	-42.7
% 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	3.25	2.75	2.50	2.00	2.00	2.00
90 day bill	3.09	2.75	2.30	2.30	2.30	2.35
3 year bond	3.40	3.25	3.20	3.05	3.40	3.60
10 year bond	4.37	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	3.81	3.60	3.50	3.35	3.70	3.90
10 year swap	4.96	4.85	4.70	4.50	4.60	4.70
International interest rates						
RBNZ cash rate	3.00	2.50	2.50	2.50	2.50	2.50
NZ 90 day bill	3.24	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	0.84	0.75	0.80	0.85	1.25	1.50
US 10 year note	2.68	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	1.50	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
Australia and NZ exchange rates						
A\$/US\$	0.7033	0.62	0.58	0.54	0.54	0.56
NZ\$/US\$	0.5684	0.49	0.47	0.45	0.44	0.44
A\$/¥	69.46	62.00	58.58	55.08	56.70	60.48
A\$/€	0.5296	0.50	0.49	0.49	0.50	0.51
A\$/£	0.4830	0.42	0.39	0.36	0.35	0.35
A\$/NZ\$	1.237	1.27	1.23	1.20	1.23	1.27
A\$/CA\$	0.8830	0.76	0.72	0.70	0.71	0.74
A\$/CHF	0.8040	0.73	0.71	0.73	0.77	0.81
A\$/CNY	4.805	4.24	3.97	3.69	3.69	3.82
A\$ Trade weighted index	58.50	52.64	49.89	46.95	47.15	48.65
International cross rates						
US\$/¥	98.8	100	101	102	105	108
€/US\$	1.328	1.25	1.18	1.10	1.08	1.10
€/¥	131.2	125	119	112	113	119
£/US\$	1.456	1.46	1.48	1.50	1.55	1.60
€/£	0.9120	0.86	0.80	0.73	0.70	0.69
US\$/CA\$	1.256	1.22	1.24	1.30	1.32	1.33
US\$/CHF	1.143	1.18	1.22	1.35	1.42	1.45
US\$ index	85.26	88.5	91.7	96.2	97.5	96.5
Asia exchange rates						
US\$/CNY	6.834	6.84	6.84	6.84	6.84	6.82
US\$/HKD	7.751	7.76	7.76	7.76	7.78	7.80
US\$/IDR	11505	12000	11900	11600	11600	11300
US\$/INR	50.35	49.00	48.00	48.00	47.00	47.00
US\$/KRW	1334	1400	1400	1375	1350	1300
US\$/MYR	3.63	3.74	3.80	3.80	3.80	3.75
US\$/PHP	48.13	49.50	50.00	49.50	48.80	48.50
US\$/SGD	1.514	1.58	1.62	1.66	1.66	1.63
US\$/THB	35.46	37.60	39.40	39.40	38.80	38.80
US\$/TWD	33.55	36.00	36.00	35.50	35.50	35.00
US\$/VND	17770	17800	18100	18500	18500	18000
Pacific exchange rates						
PGK/US\$	0.335	0.32	0.32	0.35	0.35	0.36
FJD/US\$	0.560	0.50	0.48	0.47	0.47	0.48

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