

Substantial macroeconomic risks lie ahead

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Macro Update: Labour market adjustment underway

- Earlier rate cuts and fiscal policy measures appear to be having a positive impact on housing loan approvals and consumer sentiment.
- However rising unemployment poses a key risk to the outlook for both the housing market and consumer spending.

Interest Rate Markets: Too early to call an end to easing

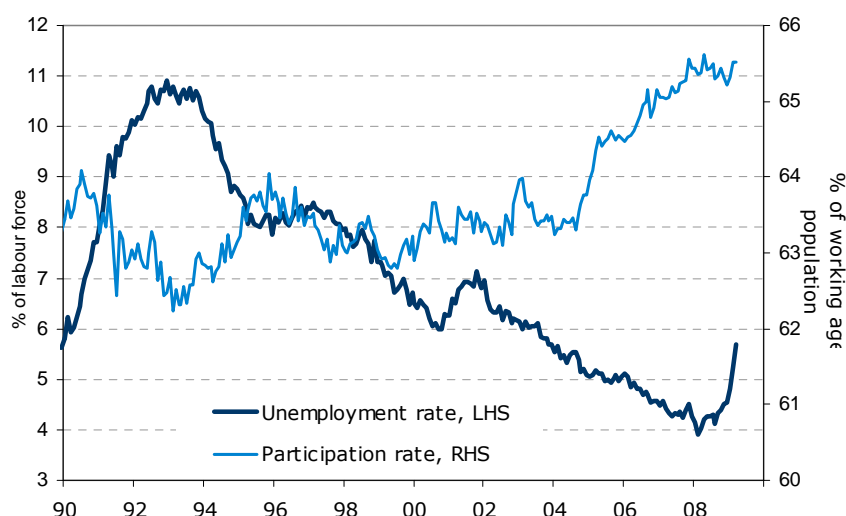
- It is too early to call an end to monetary policy easing from the RBA. While the central bank may pause for some months, further rate cuts are likely. We expect a low point for the cash rate of 2%.
- The back-up in market rates suggests we have seen the lows. Surging bond supply in the major markets suggests upside risks for term rates. However, quantitative easing and a slumping economy should offset this. Hence we do not see a sustained move higher for yields at this stage.

FX: RBA lends support to the AUD

- This week's decision by the RBA to cut the cash rate to 3% has lent support to the AUD which has been solidly sustained above AUD/USD0.70.
- Ranges analysis based on current implied volatility pricing suggests that we could see the AUD trade above the AUD/USD 0.70 US cent level for the next six months, although we remain convinced of an easing profile for the AUD/USD over the next 12 months due to further deterioration in the underlying fundamental drivers of the AUD.

Chart of the week

Figure 1: Australian unemployment and participation on the rise



Source: ABS

Macro Update: Labour market adjustment underway

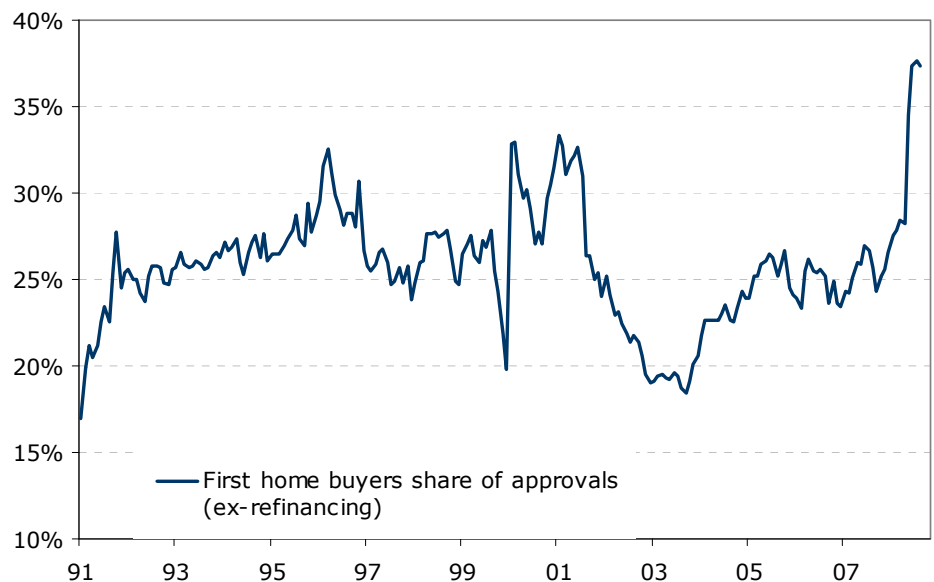
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- Earlier rate cuts and fiscal policy measures appear to be having a positive impact on housing loan approvals and consumer sentiment.
- However rising unemployment poses a key risk to the outlook for both the housing market and consumer spending.

Some response to early policy measures

The RBA this week cut the cash rate by 25bp to 3.0%, with the total reduction since September now amounting to 425bp. Previous rate cuts, together with the boost to the First Home Owners' Grant appear to be having the effect hoped for, at least in the housing market. Approvals to obtain housing finance have now risen for five consecutive months, with the share of first home buyers obtaining loans very high at 37.3% (excluding refinancing), down slightly from 37.6% in the previous month, but nearly the highest proportion since the series began in 1991 (see Figure 2).

Figure 2: First-home buyers re-entering the housing market



Source: ABS and ANZ

Outside of housing, the government's cash handouts (together with improved conditions in equity markets) are helping to boost consumer confidence. Consumer confidence improved 8.3% in April following three consecutive monthly falls and is now at 92.7, the highest level since February 2008. But it remains an open question as to whether this increased confidence will translate into higher spending.

So far the evidence from the first \$8.7bn of cash handouts to low income earners suggests that while much of this extra income was saved, it has provided some boost to household spending, with retail sales easing off in February after being boosted in December and January by the handouts. While larger at \$12.7bn the cash handouts in March and April hit a broader demographic of the population, including middle income earners who tend save more of their income and have a lower marginal propensity to consume.

Overall then, it appears recent policy measures may provide some temporary support to housing and household spending in the next few months. However, substantial macroeconomic risks lie ahead, most importantly the challenge of rising unemployment. As such, we do not expect household spending to recover in a meaningful way until the second half of 2010 and expect the household savings ratio to remain above 10% of disposable income for some years. Rising unemployment is also a key risk to the housing market, particularly at the low end of the market.

... but rising unemployment presents a key challenge

The risk of weakening labour market conditions was brought into focus today following the release of the March official data. Following upside surprises in recent months, it now appears that the long expected adjustment in the labour market is underway. Today's report showed a fall in employment of 34.7K, a continuation of the trend away from full-time towards part-time employment and a surge in the unemployment rate to 5.7%, the highest level since February 2004 (see Figures 1 and 2). The unemployment rate has now risen by 0.9ppt in the past two months and is 1.8ppt higher than its low of 3.9% in February 2008.

Unfortunately, our models suggest we are still near the beginning of the labour market adjustment. Following our downward revisions to economic growth last week, the unemployment rate is now projected to rise to 7.5% by the end of 2009 and to 8¼% by the end of 2010.

The unemployment rate could even rise towards 9.0% should labour force participation rates either stabilise at current record highs or increase further. The participation rate in March at 65.5% was very near the peace-time high of 65.6% seen in April 2008, with female participation rising by 0.6ppt in the past six months to 59.0%.

This could occur if individuals seek to extend their working lives or if second-income earners continue to re-enter the labour force to try to restore 2008's unprecedented loss of household wealth. A higher unemployment rate that is driven by higher labour force participation does not pose the same downside risks to the economy as a rise in unemployment that is driven by falling employment (as our current forecasts are). However, it will increase pressure on the government and the RBA to implement further policy expansion. We continue to expect the RBA to cut the cash rate to 2% by the end of 2009.

We continue to expect further fiscal policy initiatives to be announced in the May budget and maintain that fiscal policy is the most appropriate mechanism to support growth. This is despite the further likely deterioration in the government's budgetary position, with the unemployment rate already above the government's 5.5% estimate for June this year. The now weaker outlook for the labour market will certainly see upward revisions to expenditure because of higher unemployment benefits and downward revision to revenue growth from lower income tax receipts.

Data wrap

- The **AIG Performance of Services Index (PSI)** improved by 3.2 points to 35.6 in March, but is still at levels suggesting deep contraction.
- The **AiG Performance of Construction Index** also picked up slightly to 30.4 but is also at a very low level.
- The **ANZ Job Advertisements Series** showed a fall of 8.5% in March, taking the annual fall to -44.6%. Newspaper advertisements fell 6.6% while internet advertisements were down 8.6%.
- The **TD-MI Inflation Gauge** fell by 0.1% in March to be 2.6% higher over the year, down from 3.1% in February.
- The **RBA cut the official cash rate** by 25bp to 3.0%.
- **WBC-MI consumer sentiment** rose by 8.3% in April to 92.7, the largest jump in 8 months, although pessimists still outweigh optimists.
- The value of **housing loan approvals** rose 1.3% in February, driven by a 2.7% increase in owner-occupier approvals which offset a 2.8% fall in investor approvals. The number of owner-occupier approvals rose 0.4%, suggesting an increase in the average loan value in the month.
- **MI Consumer inflation expectations** increased slightly to 2.4% YoY in April from 2.2% YoY in March, although it remains well down on the peak of 5.9% in July.
- **Labour force data** showed that employment fell by 34.7K in March, driven by a 38.9K drop in part-time employment. The unemployment rate surged up to 5.7% from 5.2% in February and the participation rate was unchanged at 65.5%.

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Interest Rate Markets

- It is too early to call an end to monetary policy easing from the RBA; substantial macroeconomic risks lie ahead for Australia.
- The RBA may be on hold some months but further rate cuts are likely. We expect a low point for the cash rate of 2%.
- The back-up in market rates suggests we have seen the lows. Surging bond supply in the major markets suggests upside risks for term rates. However, quantitative easing and a slumping economy should offset this. Hence we do not see a sustained move higher for yields at this stage.

Too early to call an end to easing; substantial macroeconomic risks lie ahead

As a benchmark for expectations and market pricing, we think that a 25bp cut every other month is the best way to think about the RBA from here on in. Our terminal rate expectations are unchanged at 2%.

Some commentators will be tempted to revise up their terminal rate forecasts after the 25bp cut this week. We see nothing in the *Statement* or the size of the move that tells us anything about where the cash rate will end up. All that we can glean from this week's *Statement* is that the RBA wants to slow the process down and probably wants to save some cuts for when the unemployment rate is printing higher or if the house market takes a turn for the worse.

A more analytical explanation for pausing or slowing the easing cycle is based on the view that fiscal policy is the more appropriate tool for countering the immediate effects of the slump in the global and local economies. Reducing rates is all about encouraging the private sector to take on debt to increase spending in the economy. Is that an appropriate policy response when the problem is a private sector debt overhang? Fiscal stimulus is all about the public sector taking on debt to effect higher spending in the economy.

The end point for cash will be a function of the economic outlook and with the unemployment rate likely to be rising steadily for the next two years, a 2% terminal looks like a level that the cash rate can easily get to. In fact if the downturn is longer or worse than expected then the cash rate could go sub 2% next year.

Market rates continue to back-up

Market rates have risen sharply in recent weeks despite the modest RBA rate cut and confirmation in leading indicators of the labour market (ANZ Job Ads) that further significant rise in the unemployment rate still lies ahead.

Fading momentum on the rally for rates and the weight of positioning has seen sustained upward pressure on market rates, especially at the front of the curve. Supply pressures due to increased bond issuance also appear to be adding momentum to the sell-off. US yields are almost back to levels seen before the surprise announcement of quantitative easing. Some estimates put US borrowing above \$200bn this month alone while the prospects for an ever increasing burden of local bond supply has been underlined with yesterday's announcement of the \$43bn high-speed internet project to be partly financed with infrastructure bonds.

Bonds have moved to new highs for this correction despite the RBA's rate cut. 3-year and 10-year bond yields have moved to 5-month highs, due to increased supply and rising long-term inflation concerns, at a time when quantitative easing has so far helped to limit the rise in US and UK long bonds. Three-year swaps have moved higher by around 80bps from February lows – see chart below – in contrast to the range-trading environment evident in the US and UK.

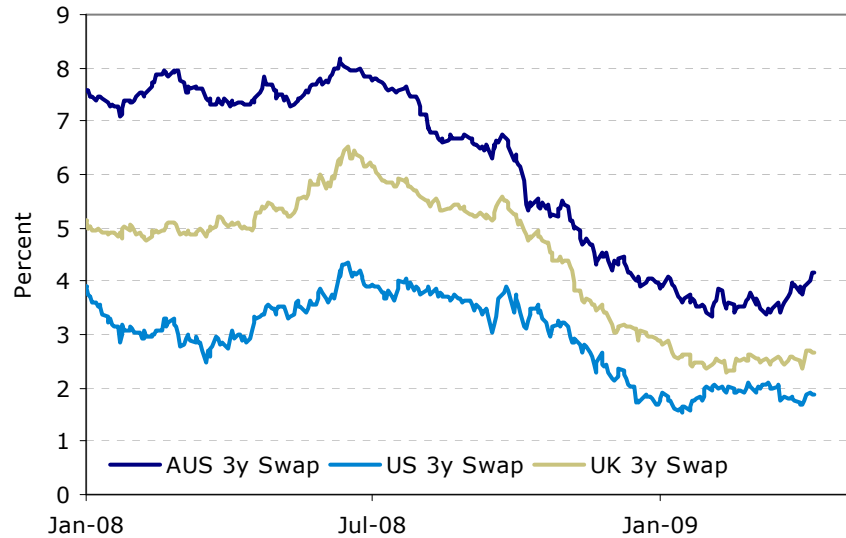
The rise in market rates is unlikely to be sustained. As argued above, the focus for monetary policy remains on further easing later in the year. Stock markets are now backing up after a 25% surge over the past month as we head into the Q1 reporting season. Accounting changes might help to support bank results,

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but the increasing possibility of a move into chapter 11 Bankruptcy for General Motors, a continued move higher for unemployment and no clear sign US house prices have bottomed all highlight that major economic risks remain clearly skewed to the downside in coming months.

We would look to a clear turn to weaker local data to cap the rise in market rates and generate a rally from here, with a primary focus on the labour market.

Figure 1: 3-year swap rates continue to turn higher



Source: ANZ & Bloomberg

Higher borrowing costs and the recent rise in the AUD also represent a mild tightening in financial conditions that will provide headwinds for the local economy, offsetting the impact of the fiscal boost now moving through the system.

The positive momentum for the AUD despite the pull-back in stock markets will also increase the relative attraction of local bonds. The auction of \$700m 2021 bonds yesterday went particularly well. Offshore interest should help to limit the rise in market rates as market positioning comes back in balance.

While we had anticipated yield holding to previously established ranges, we would expect further upward pressure to be limited for the reasons stated above. Expect 3-year yields to find near-term resistance around 3.80-4.00%, from current levels of around 3.65%. For 10-years, 4.70% up to 4.95% is now a major area of resistance for coming weeks after the rise from January lows of around 3.84%. Initial downside targets are around 3.30% for 3-years and 4.25% for 10-years.

The divergence in the swaps market noted above reflects the weight of the unwinding of positions in the 3-year part of the curve. We doubt the momentum of this correction can be sustained, but would target a move back into the 3.70-3.90% area – the previous highs seen in February – as probably the best target levels that can be reasonably expected in coming weeks to fix hedging levels.

FX: RBA lends support to the AUD

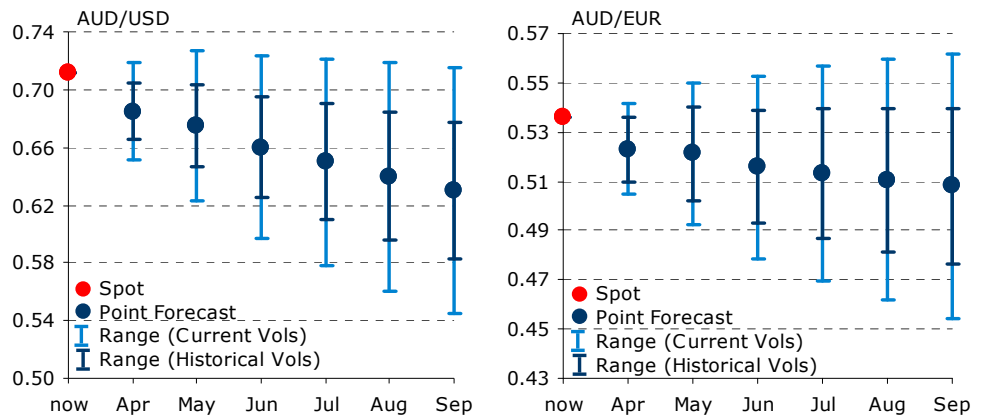
Recommendation

A sustained move above AUD/USD0.70 for the first time since early January continues to present good opportunities for AUD sellers to place bids above 0.71; AUD buyers should look to dips around 0.6950. The Easter break will not yield a quieter week ahead, with some key data due to be released. Of note are Chinese Q1 GDP; and US retail sales, housing starts and the Fed Beige Book. The IMF is set to release new global GDP forecasts in its World Economic Outlook, with any significant downgrade likely to weigh on the AUD. Also, with Q1 corporate earnings season beginning in the US, any worse than expected numbers could weigh on equity markets, and in turn, the AUD/USD.

Overview

This week's decision by the RBA to cut the cash rate by 25bps (to 3%), combined with a sanguine accompanying statement, has lent support to the AUD. Trading in the currency has been solidly sustained above the psychologically important AUD/USD0.70 level over the past week, support which even a weaker than expected labour force result today did not undo. Indeed, a new trading range of 0.6750 – 0.7230 has emerged, some 3½ to 8 US cents above where we estimate current fair value to be. Ranges analysis based on current implied volatility pricing suggests that we could see the AUD trade above the 70 US cent level for the next six months, although we remain convinced of an ultimately easing profile for the AUD/USD over the next 12 months due to further deterioration in the underlying fundamental drivers of the AUD.

Figure 1: Current vols suggest sustained highs in AUD/USD and AUD/EUR



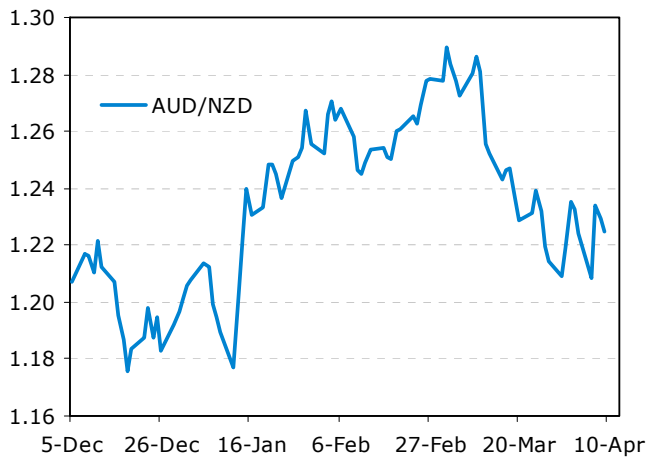
Source: ANZ, Reuters

Currency market traders believe the AUD/USD has further to climb, with IMM positioning on the US Commodity Futures Trading Commission showing a net long position in AUD/USD over the past two weeks (not seen since September 2008). Traders are not as convinced that the current rally in the NZD/USD can continue, although net short positioning has been pared back over the past three weeks.

Market sentiment will dictate the state of play next week, with moves on equity markets highly contingent upon the release of US corporate earnings results. For the AUD, the key test is whether the AUD/USD can move to and hold above 0.7250. If the AUD is unable to push through levels on the major crosses this week, AUD buyers should be on their toes to take advantage of favourable pricing. Beware of move above AUD/EUR0.5370, and towards AUD/JPY74.

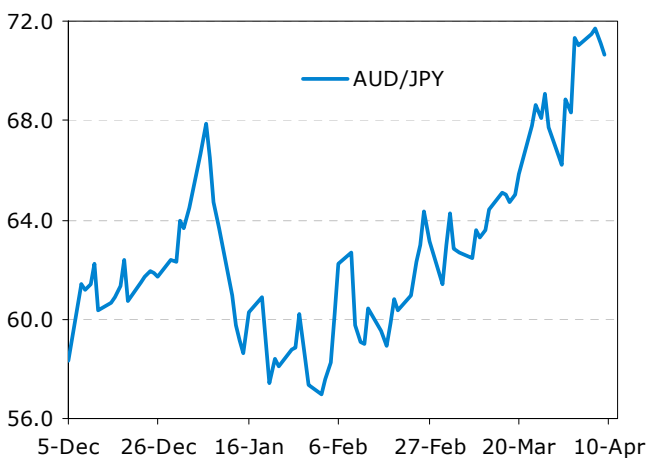
AUD/USD Key levels: 0.6950 – 0.7250. AUD/USD0.7250 is the topside target for the currency, the peak of the mini rallies since October 2008. The AUD/USD has managed to sustain the current break above 0.70, but renewed market uncertainty will see corporate earnings results dictate the state of play in equities, and in turn, the AUD/USD, and may reintroduce some higher volatility.

AUD cross view



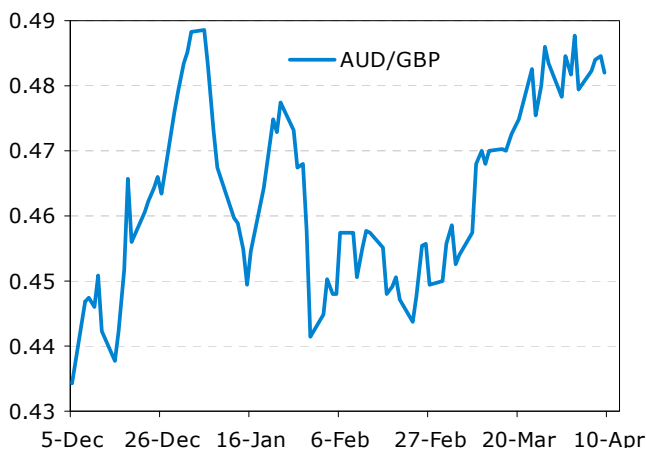
AUD/NZD Key levels: 1.2030 - 1.2590

- The AUD/NZD has not been able to make the break back above AUD/NZD1.2390. Despite a mid-week rally triggered by the RBA's cash rate decision, the NZD/USD has outperformed on the sustained improvement in risk appetite. Near-term dips towards the recent low around AUD/NZD1.2030 are possible, but with global equity markets consolidating, such steep declines are unlikely over the next week. Next level lower is 1.22; target upside moves towards 1.2590.
- Worse than expected outturns in NZ's February retail sales and Q1 CPI due late next week could see the cross rebound towards 1.2590.



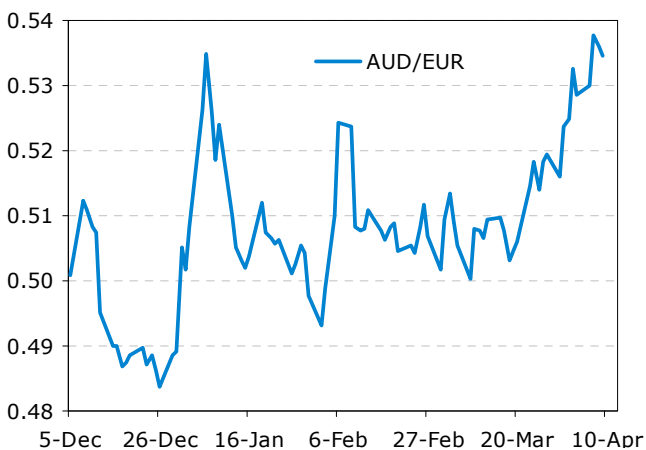
AUD/JPY Key levels: 68.30 - 74.00

- A steady nine-week rally in the AUD/JPY has taken a breather, finding good support above 70.10. The combination of a weak JPY, with dips to USD/JPY101.50, and AUD/USD gains to 0.7230, propelled the AUD/JPY to a six-month high just shy of 73. The next upside target is 74.00 (38.2% retracement level between the 12-month high and low).
- Preliminary March machine tool orders this afternoon could weigh on the cross following this morning's better than expected 1.4% rise in machine orders for February.



AUD/GBP Key levels: 0.4720 - 0.4940

- As mentioned last week, the AUD/GBP appears to have run out of momentum in its push towards the early January peak of 0.4940. Good support has formed around current levels however, with dips limited to 0.4770, then lower at 0.4720. The upside target remains the early January high, although necessary breaks above 0.4860 have been few and short-lived.
- With little economic data due for release in either the UK or Australia, sentiment on equity markets will be the most powerful dictator of play in the AUD/GBP next week.



AUD/EUR Key levels: 0.5190 - 0.5370

- EUR/USD has slipped below 1.3250, the key 38.2% retracement level between March's low and high, and is grinding lower towards the next key level at 1.3090. Combined with the recent rally in the AUD/USD, this has propelled the AUD/EUR very close to breaking through a major level. AUD/EUR0.5370 has been the limit of AUD/EUR mini rallies in recent months. The cross has been unable to hold above this level thus far, and we need to see a sustained move above this level for a push towards the next level at 0.5456. On the downside, good support has formed around AUD/EUR0.5260

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	2.6	2.8
Underlying*	3.1	3.6	2.1	2.7
Wages	4.1	4.2	3.9	3.4
Labour market				
Employment (annual % change)	2.8	2.2	-0.3	-1.1
Unemployment rate (%)	4.4	4.2	6.0	8.1
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	3.25	2.75	2.50	2.00	2.00	2.00
90 day bill	3.13	2.65	2.30	2.30	2.30	2.35
3 year bond	3.59	3.25	3.20	3.05	3.40	3.60
10 year bond	4.59	4.35	4.30	4.15	4.30	4.40
3s10s yield curve	1.00	1.10	1.10	1.10	0.90	0.80
3 year swap	4.04	3.60	3.50	3.35	3.70	3.90
10 year swap	5.19	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	3.20	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	0.93	0.75	0.80	0.85	1.25	1.50
US 10 year note	2.88	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\$	0.7141	0.66	0.63	0.59	0.56	0.57
NZ\$/US\$	0.5830	0.51	0.48	0.45	0.45	0.45
A\$/¥	71.50	69.30	68.04	64.90	64.96	66.12
A\$/€	0.5369	0.52	0.51	0.50	0.50	0.51
A\$/£	0.4839	0.45	0.43	0.40	0.37	0.37
A\$/NZ\$	1.225	1.29	1.31	1.31	1.24	1.27
A\$/CA\$	0.8798	0.82	0.79	0.77	0.74	0.76
A\$/CHF	0.8183	0.79	0.78	0.77	0.77	0.80
A\$/CNY	4.880	4.51	4.31	4.04	3.83	3.90
A\$ Trade weighted index	59.00	56.44	54.41	51.65	49.48	50.10
International cross rates						
US\$/¥	100.1	105	108	110	116	116
€/US\$	1.330	1.28	1.24	1.18	1.12	1.12
€/¥	133.1	134	134	130	130	130
£/US\$	1.476	1.46	1.48	1.48	1.50	1.55
€/£	0.9013	0.88	0.84	0.80	0.75	0.72
US\$/CA\$	1.232	1.24	1.26	1.30	1.32	1.33
US\$/CHF	1.146	1.19	1.24	1.30	1.38	1.41
US\$ index	85.02	88.0	90.1	93.4	97.1	96.7
Asia exchange rates						
US\$/CNY	6.835	6.84	6.84	6.84	6.84	6.84
US\$/HKD	7.751	7.76	7.76	7.76	7.76	7.77
US\$/IDR	11315	12000	11900	11600	11600	11300
US\$/INR	49.90	52.00	51.00	51.00	50.00	50.00
US\$/KRW	1323	1500	1400	1450	1375	1350
US\$/MYR	3.61	3.74	3.80	3.80	3.80	3.75
US\$/PHP	47.81	49.50	50.00	49.50	48.80	48.50
US\$/SGD	1.512	1.58	1.62	1.66	1.66	1.63
US\$/THB	35.34	36.50	37.50	37.00	36.50	36.00
US\$/TWD	33.75	35.20	36.00	36.00	35.50	35.50
US\$/VND	17775	17800	18100	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.338	0.32	0.32	0.35	0.35	0.36
FJD/US\$	0.565	0.52	0.50	0.48	0.47	0.48

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