

Inflation to be down but not out

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Macro Update: Disinflation to continue

- While the quarterly rate of inflation will print relatively high in Q1, the annual rate will continue to ease.
- This process of disinflation will continue over the next two years in response to weaker demand conditions in both labour and product markets. There is however little threat of deflation in Australia.
- The Chinese economy slumped in Q1. But there are early indicators that this will be the trough, with a gradual recovery to gain traction over 2009.

Interest Rate Markets: Inflation expectations start to edge higher

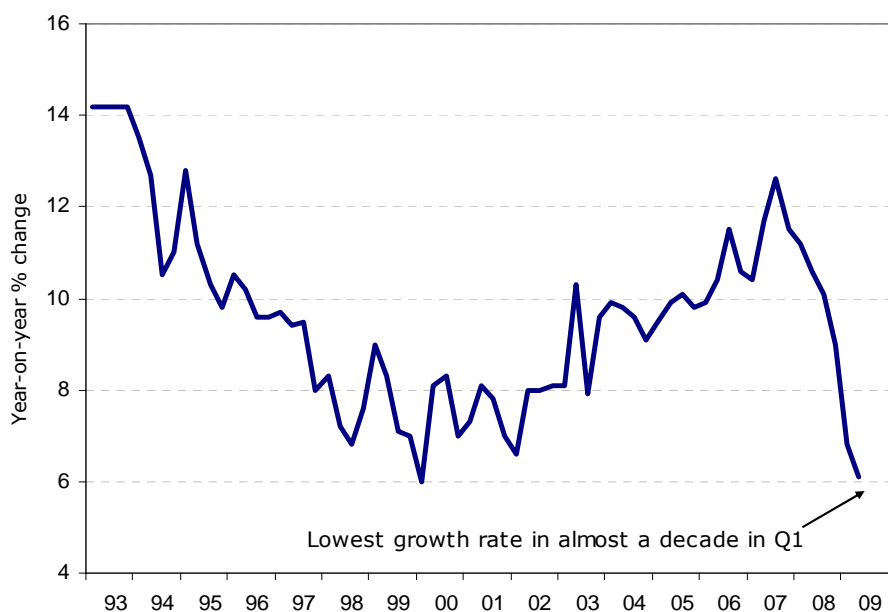
- Inflation expectations add to medium-term upward pressure on term yields. But it is premature to expect an inflation surge.
- The correlation between yields and stock markets is high, but the RBA's stance likely to see AUS markets under-perform if stocks falter.

FX: AUD/EUR reaches six-month high

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- Trading at a six-month high, the AUD/EUR suggests the current AUD/USD rally is due to the merits of the AUD, and not because of a broad USD weakening.

Chart of the week

Figure 1: Chinese GDP growth – are we near the bottom?



Source: Bloomberg

Macro Update: Disinflation to continue

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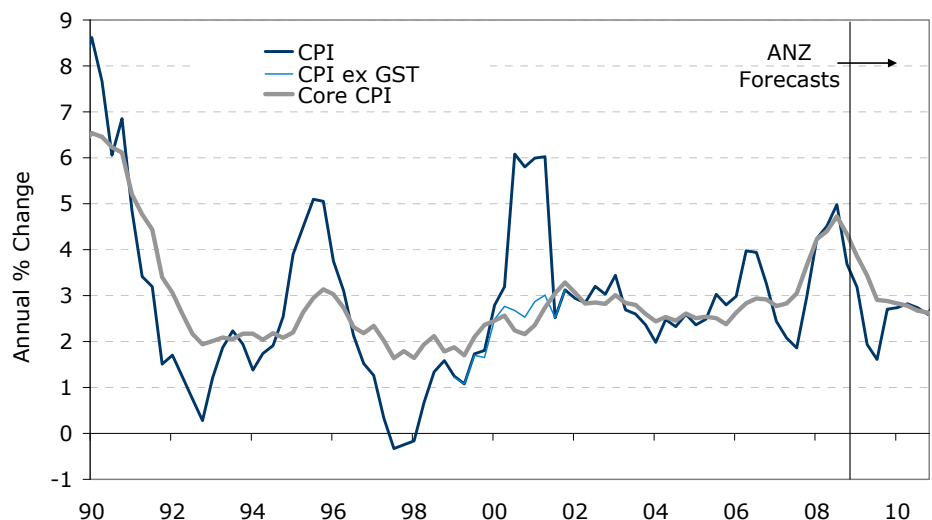
Q4 CPI: High but decelerating

Locally, inflation data will be the main focus next week. The CPI is expected to show a gradual deceleration in the annual rate of inflation, despite a relatively solid reading in the quarter of 0.8%. The annual headline inflation rate is expected to ease to 3.2%, still above the top of the RBA's 2-3% target rate, but the lowest annual rate since Q4 2007 and well down from the peak of 5.0% in Q3 2008. The RBA's preferred measures of underlying (core) inflation are expected to move in a similar fashion, with the quarterly rate picking up a fraction to 0.75%, and the annual rate easing to 3.9%, again the lowest rate since late 2007.

The expected relatively high quarterly rate of headline inflation comes despite a 7.5% fall in petrol prices in the quarter (which will subtract 0.3ppt from the headline CPI), and will be largely be due to seasonal price increases for a large number of goods and services. These include education, childcare, healthcare, pharmaceuticals, electricity and gas services and fruit and vegetables.

The lagged impact of the fall in the AUD in late 2008 will also see a rise in the price of imported goods, or a smaller-than-usual seasonal fall, with price falls for items such as clothing and footwear and households goods likely to have been less pronounced that may be suggested by weak demand conditions. While firms are likely to have absorbed some of the cost increase into their margins, the sheer size of the currency depreciation (from a peak of over AUD/USD0.97 to a low of just above 0.60 and around 0.725 currently) suggests this was not possible in full. There was little evidence of currency pass-through in late 2008, probably because of firms running down stocks purchased at a higher exchange rate. This is unlikely to have continued far into Q1 however (although there was some evidence of this in January) and we expect the currency impact to have been more pronounced. This will have offset the downward impact of lower petrol prices which fell 7.5% in the quarter and will take 0.3ppt off the CPI.

Figure 2: Underlying inflation to ease over coming two years



Source: ABS and ANZ

Disinflation to continue, but not deflation

Further out, we can expect lower rates of inflation (disinflation) over the next two years. Two key fundamental drivers of inflation, capacity utilisation and unit labour costs, are both projected to ease considerably in line with weaker demand conditions in both product and labour markets. Indeed, businesses are reporting both lower labour costs and capacity utilisation according to the NAB business survey. Capacity utilisation in particular has already fallen to 78.9% in February from a peak of 84.1% in early 2008.

Deflation is however not a serious threat in Australia as is it in other parts of the globe. Indeed, we expect both headline and underlying inflation to slow to 2½% by the end of 2010. Demand conditions are not expected to weaken as substantially in Australia, with economic growth contracting by 0.9% compared with -2.7% in the G7 economies. Moreover, while Australia will experience the same drop off in commodity prices, the fall will be offset by the upward impact on imported products from the lower currency, particularly if our forecast for the AUD to reach USD0.56 by March 2010 is realised.

Chinese data offers a glimmer of hope?

This week's data confirmed that the global recession continued to weigh on China in the early part of this year. March quarter GDP growth slowed to just 6.1% YoY, the slowest since quarterly accounts began in 1992. That said, high-frequency data for March contained a few glimmers of hope. New lending has continued to accelerate, the decline in export growth eased (from -26% YoY to -17% YoY), and fixed asset investment in urban areas accelerated slightly to 28.6% YTD YoY compared with 25.9% for the same period a year ago.

Although it is premature to anticipate a sharp rebound in China, these data suggest that the pace of deterioration is slowing. Indeed, our forecast remains for Chinese economic growth to trough in Q1, steadily rising to 6.8% by year-end and then above the authorities' 8% "comfort level" in the first part of 2010. Nearer-term, Chinese industrial production growth remains relatively subdued at 8.3% YoY in March, slower than the 11.0% growth recorded in January-February, and about half the pace of a year ago. Also, the decline in Chinese imports increased slightly in March (to -25.1% YoY from -24.1%). We do not have the breakdown between import values and import volumes; however, it is likely that much (if not most) of the contraction in imports is due to the sharp drop in commodity prices. As such, we expect to see a contraction in YoY import growth rates until we get beyond the distorting base-period effects from late Q3 and early Q4.

While Chinese iron ore and coal import growth was robust in March, there are concerns that this will be sharply reversed in coming months because these higher imports appear to be going into stockpiling, as opposed to new production. Not a good sign for Australian commodity producers, with global iron ore production already falling 15% in the last quarter according to Rio Tinto. Combined with this week's sobering news that Australian commercial finance approvals are now 43% lower than a year ago (the biggest fall since the survey began in 1986), it is difficult not to remain pessimistic about Australia's prospects (in exports and business investment) for the rest of this year.

Data wrap

- **NAB Business Confidence** improved by 9 points to -12.5 in February, the highest level since September 2008. **Business Conditions** rose 3 points to -16.8, only a slight improvement from February's record low. The **employment index** however continued to fall to -29 the lowest level since June 1991.
- **Lending finance** data showed a fall in commercial loan approvals of 14.7% in February, with the series down 43% YoY, a record low for the series which began in 1986. Personal loan approvals fell slightly by 0.2%, although have stabilised in recent months.
- The **Westpac Leading Index** fell to -5.1% in annualised terms, lower than during the 1990s recession.

Interest Rate Markets: Inflation expectations start to edge higher

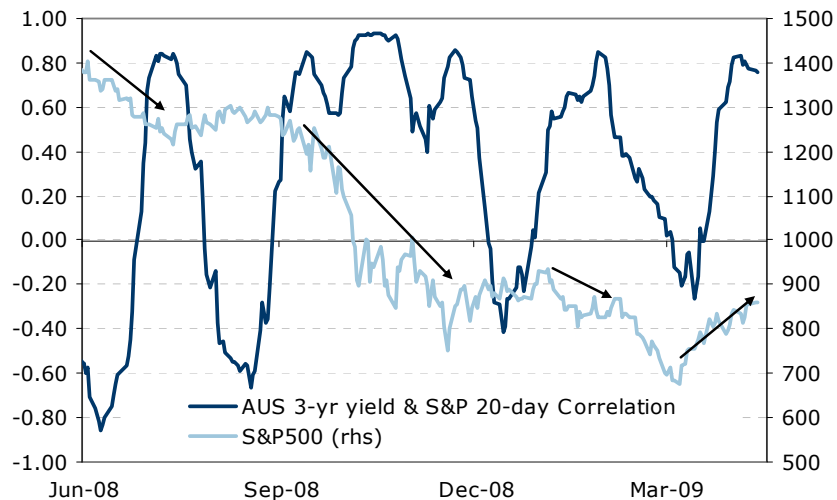
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- The correlation between yields and stock markets is high, but the RBA's stance likely to see local markets under-perform if stocks falter.

The focus is now firmly on next week's RBA Minutes and a speech by Governor Glenn Stevens that should underline his intent for monetary policy to remain on the sidelines until after the Budget round allowing more time to assess the impact of policy actions to date. The curve remains steep to reflect expectations that further official interest rate cuts are likely later in the year. We still have 2.0% as the target end point.

Figure 1 below highlights the short-term correlation between local 3-year bond yields and the US stock market. It shows the recent backing-up in yields to highs for the year has been made with a high correlation to the global stock market correction – recent gains for stocks have unwound flight-to-quality demand for bonds.

Figure 1: Short-term correlation between 3-year yields and S&P



Source: ANZ & Bloomberg

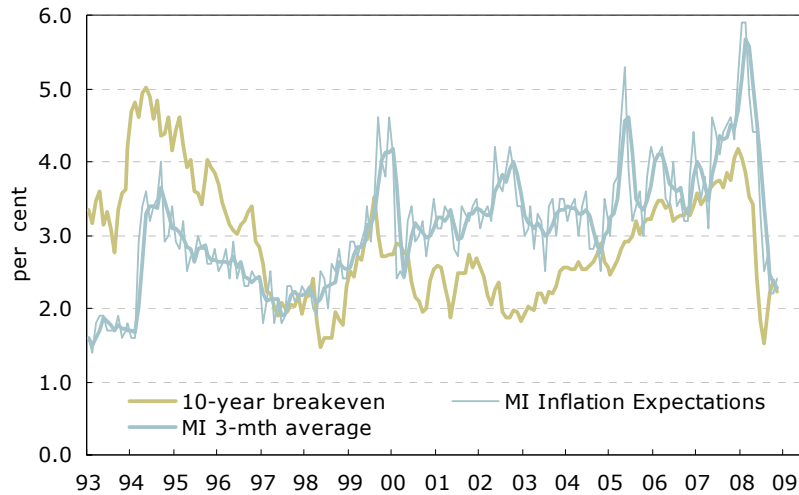
What is interesting is that we are seeing a positive correlation between rising local yields and US stock prices. Since the middle of last year the correlation was strongest when stocks were falling sharply, particularly over the October-December period. Market dynamics appear to be changing. While the correlation appears to be weakening, the faltering stock market rally and another round of weak US data heading into the US reporting round should help to cap the rise in local term yields.

The stock market rebound has also coincided with a raft of solid economic data out of China in recent weeks. Commodity prices have held up to underline the strength of arguments that the local economy will out-perform in coming months. Oil has held near \$US50 per barrel while copper has hit 6-month highs. Local bonds are likely to under perform US Treasuries in this environment, particularly if stocks continue to weaken. The Fed continues to buy Treasuries as part of quantitative easing with the total value of Treasuries bought so far now above \$US50bn.

Fears of deflation in the Australian economy also appear to be receding. Figure 2 below highlights that local inflation breakeven yields (nominal less the yield on inflation-linked bonds) have again found a base in recent weeks around the 1.5% level last seen in 1998. And while the monthly reads on inflation expectations surveys by the Melbourne Institute are volatile, expectations are starting to near previous lows seen over 1997-98. The monthly data has posted a solid up tick this month ahead of the release of March quarter CPI data next Wednesday, the day after Stevens speaks.

While US core inflation readings continue to ease – US annual CPI posted the first negative reading since 1954 in March - the adoption of QE policies in the US has raised the prospect of an eventual return to more normal inflation expectations over time.

Figure 2: AUS inflation breakevens and expectations



Source: ANZ & Bloomberg

The US inflation breakeven curve has moved significantly higher since the adoption of quantitative easing to reflect more “normal” expectations out to 10-years and beyond. However, inflation breakevens are still negative out to 3-years, so the market is hardly signalling that inflation is about to surge in the foreseeable future.

There is a risk that QE could result in higher inflationary over time, especially if combined with a sharply weaker USD that push commodity prices higher. But the actual track of the US 10-year inflation breakeven in recent months would suggest that the adoption of QE has actually been successful in averting intense deflation fears rather than generate new inflationary pressures – see below. Ten-year breakevens have not recovered back to levels seen prior to the most intense phase of the stock market crash last year.

Figure 3: US 10-year inflation breakeven



Source: ANZ & Bloomberg

If US inflation expectations have bottomed then the recent rebound in local inflation breakevens is likely to endure. But we are still looking at a modest deceleration in headline and core inflation rates here in coming quarters. This does not suggest we are seeing a move to even higher levels for local bond yields without further gains for stock markets. The high correlation with stocks also argues for local bonds to underperform any rally in the US, so that the AUS-US spread should remain wide until the RBA comes back into play later in the year.

FX: AUD/EUR reaches six-month high

Recommendation

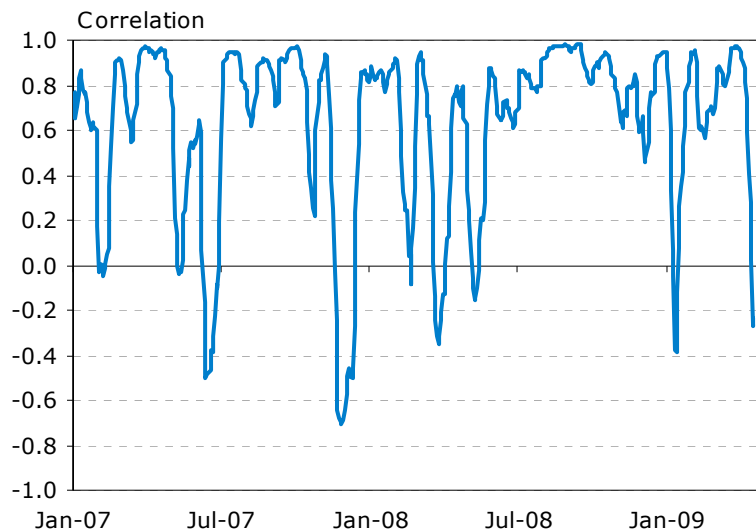
This week's rally in the AUD/USD to a six-month peak of 0.7326 has provided welcome opportunities to AUD sellers. With volatility remaining relatively subdued, sellers should look to spikes above 0.7150; AUD buyers be attuned to dips below 0.71. Note that the AUD remains vulnerable to any shift in sentiment on global bourses, as worse than expected Q1 corporate earnings results next week would weigh on equities, and on the AUD in turn. Key US housing data are also to be released; be particularly conscious of tonight's release of housing starts for March (the market got very excited about this series last month when it posted its first rise in eight months, albeit from a very low base).

Overview

AUD/EUR soared over a key level this week, exceeding the 38.2% retracement between the cross's historical 2000 high and late 2008 low when it cracked 0.55 this morning. Trading at a six-month high, the AUD/EUR suggests the current AUD/USD rally is due to the merits of the AUD, and not because of a broad USD weakening.

Movements in the AUD/USD and EUR/USD tend to be strongly correlated, with only brief instances since 2007 when the 20-day rolling correlation has turned negative. Yesterday, the correlation between these two currencies dipped to -0.27 - the last time that this occurred in early January 2009, the AUD/USD closing price plunged from 0.7106 to 0.6557 over the space of five trading sessions. A move of a similar magnitude this time could see the AUD/USD fall to around 0.67 from yesterday's close of 0.7272. However, if the AUD is performing well on its own merits, then such an outcome may not eventuate again.

Figure 1: AUD/USD & EUR/USD 20-day rolling correlation turns negative

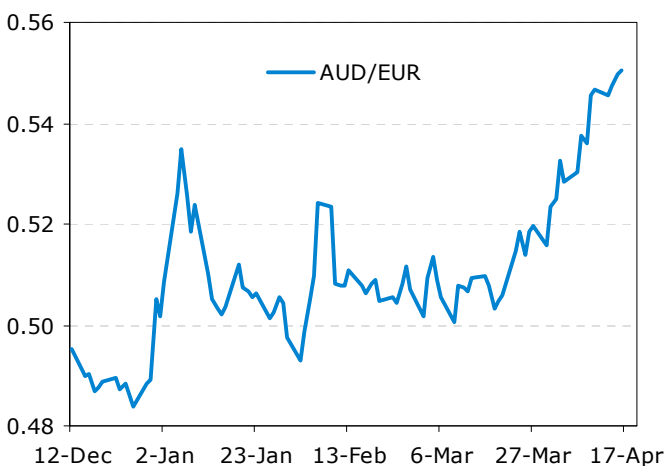
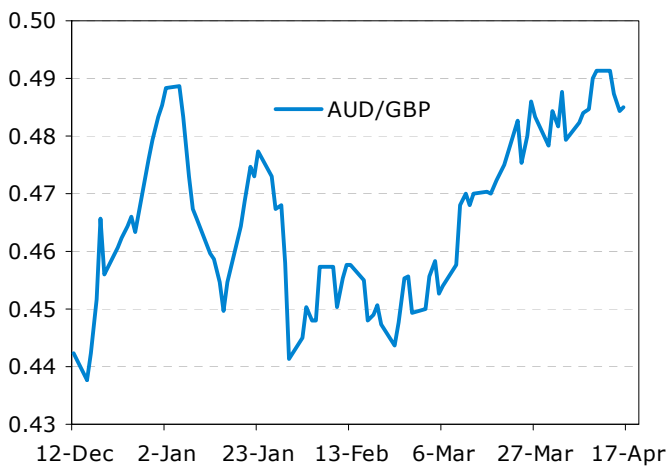
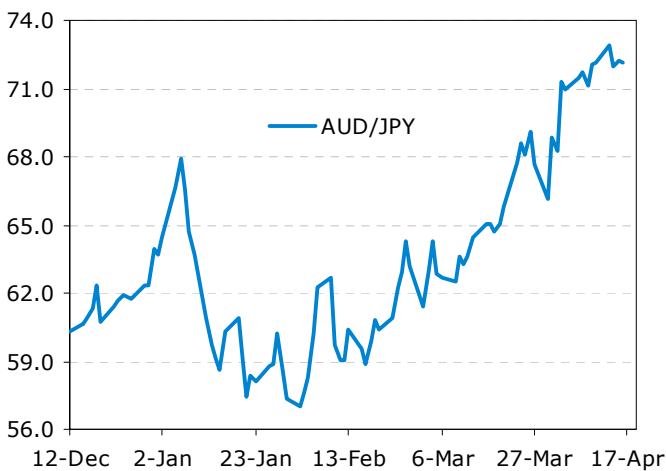
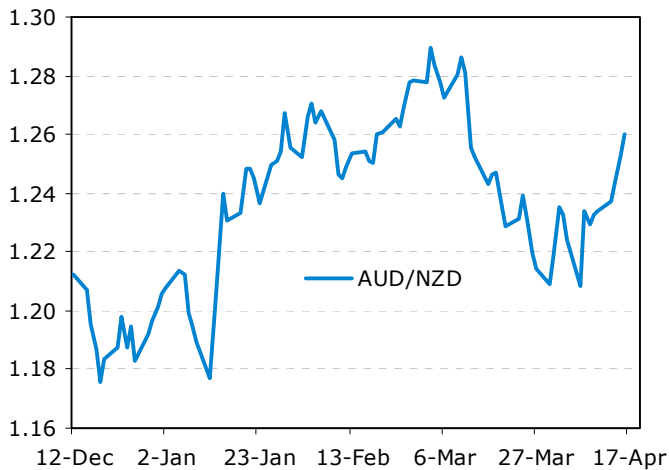


Source: ANZ, Bloomberg

So what can explain this recent divergence in performance between the two currencies? Unlike the AUD, the EUR has been unable to capitalise on the recent five-week surge on global equity markets and concurrent turn-around in risk appetite. The EUR/USD has traded in a downward channel over the past month since peaking at 1.3738 on 19 March. The key difference between these two currencies is that the market is anticipating a move by the ECB towards quantitative easing, in line with its compatriots the US Federal Reserve Bank and the Bank of England, in order to support spending in the rapidly slowing economy. Meanwhile, no such move is expected for the RBA, with Australia headed for a much better growth outcome in 2009 than most other developed economies. Look for the AUD/EUR to push towards 0.56 in the near-term, particularly if next week's Euro zone business confidence and manufacturing activity data print lower than expected. Good support exists above 0.5190 for moves to the downside.

AUD/USD Key levels: 0.7030 – 0.7475. AUD/USD has pushed through a key level at 0.7264. The next upside target is 0.7475 (38.2% retracement between 2008's high and low), with dips likely to be limited to 0.7030.

AUD cross view



AUD/NZD Key levels: 1.2250 - 1.2650

- AUD/USD broke back above 1.2390 this week, pushing through last week's suggested topside level at 1.2590 to touch just above 1.2650 this morning. The subsequent sell-off this afternoon is likely to persist towards 1.2490, and possibly lower to 1.2350.
- The release of the RBA's April board meeting minutes and a speech by Governor Glenn Stevens have the potential to move the cross around. However, the release of Q1 inflation data in both NZ and Australia next week are unlikely to make much impact given the current focus of monetary policy to support spending.

AUD/JPY Key levels: 68.30 - 74.00

- AUD/JPY rose as high as 73.49 this week, carried along by the continued surge on US equity markets, however the key 74 level remains elusive. Downside support persists around 70.30, and then lower at 68.90.
- The RBA events mentioned above are the key risk factors to the cross this week. The market is likely to look through Japanese consumer confidence data next week, although merchandise trade data for March could spark some interest, with a continuation of the recent trade deficit to weigh on the USD/JPY and provide support to the AUD/JPY.

AUD/GBP Key levels: 0.4650 - 0.4940

- The AUD/GBP was unable to sustain a break above the early January high of 0.4912 this week and has since petered to below 0.4850. Downside exists support at 0.4720, then lower at 0.4650.
- The UK Budget is to be handed down next week. Although the market consensus is for Chancellor Darling's November estimates of the budget deficit and public sector borrowing requirement to be significantly exceeded, expect the GBP (currently at a three-month high) to be sold-off in response. This could see the AUD/GBP breach 0.4940 and head towards 0.5080.

AUD/EUR Key levels: 0.5190 - 0.5606

- AUD/EUR has pushed to a six-month high above 0.55 this week, with the EUR unable to capitalise on the rally in global equities. With a move by the ECB towards quantitative easing more a question of "when" rather than "if," the EUR/USD will likely remain in its current downward trading channel, supporting a push towards the next key level at AUD/EUR0.5606.
- This week, the Euro zone ZEW survey of business sentiment and Purchasing Managers' Index for April are key releases to watch. Disappointing results could see the AUD/EUR head towards 0.5606. Good support exists above 0.5190.

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	3.00	2.75	2.50	2.00	2.00	2.00
90 day bill	3.07	2.65	2.30	2.30	2.30	2.35
3 year bond	3.55	3.25	3.20	3.05	3.40	3.60
10 year bond	4.48	4.35	4.30	4.15	4.30	4.40
3s10s yield curve	0.94	1.10	1.10	1.10	0.90	0.80
3 year swap	3.98	3.60	3.50	3.35	3.70	3.90
10 year swap	5.07	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	3.12	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	0.85	0.75	0.80	0.85	1.25	1.50
US 10 year note	2.77	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\$	0.71	0.66	0.63	0.59	0.56	0.57
NZ\$/US\$	0.58	0.54	0.51	0.48	0.47	0.47
A\$/¥	71.50	69.30	68.04	64.90	64.96	66.12
A\$/€	0.54	0.52	0.51	0.50	0.50	0.51
A\$/£	0.48	0.45	0.43	0.40	0.37	0.37
A\$/NZ\$	1.22	1.22	1.24	1.23	1.20	1.21
A\$/CA\$	0.88	0.82	0.79	0.77	0.74	0.76
A\$/CHF	0.82	0.79	0.78	0.77	0.77	0.80
A\$/CNY	4.88	4.51	4.31	4.04	3.83	3.90
A\$ Trade weighted index	59.00	56.29	54.25	51.49	49.41	50.00
International cross rates						
US\$/¥	100.13	105	108	110	116	116
€/US\$	1.33	1.28	1.24	1.18	1.12	1.12
€/¥	133.15	134	134	130	130	130
£/US\$	1.48	1.46	1.48	1.48	1.50	1.55
€/£	0.90	0.88	0.84	0.80	0.75	0.72
US\$/CA\$	1.23	1.24	1.26	1.30	1.32	1.33
US\$/CHF	1.15	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	6.84	6.84	6.84	6.84	6.84	6.84
US\$/HKD	7.75	7.76	7.76	7.76	7.76	7.77
US\$/IDR	10708	12000	11900	11600	11600	11300
US\$/INR	49.48	52.00	51.00	51.00	50.00	50.00
US\$/KRW	1330	1500	1400	1450	1375	1350
US\$/MYR	3.59	3.74	3.80	3.80	3.80	3.75
US\$/PHP	47.58	49.50	50.00	49.50	48.80	48.50
US\$/SGD	1.50	1.58	1.62	1.66	1.66	1.63
US\$/THB	35.38	36.50	37.50	37.00	36.50	36.00
US\$/TWD	33.77	35.20	36.00	36.00	35.50	35.50
US\$/VND	17779	17800	18100	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.34	0.32	0.32	0.35	0.35	0.36
FJD/US\$	0.46	0.52	0.50	0.48	0.47	0.48

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