

Green shoots putting down roots?

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Macro Update: Stimulating the stabilisation

- This week's stronger than expected data suggests expansionary monetary and fiscal policy is helping to stabilise the economy. This could keep the RBA on hold for at least a number of months.
- Tuesday's budget is expected to provide further policy stimulus, most likely through increased infrastructure investment. Higher spending, but mainly weaker revenues could see the biggest budget deficit in 50 years.

Interest Rate Markets: Medium-term outlook

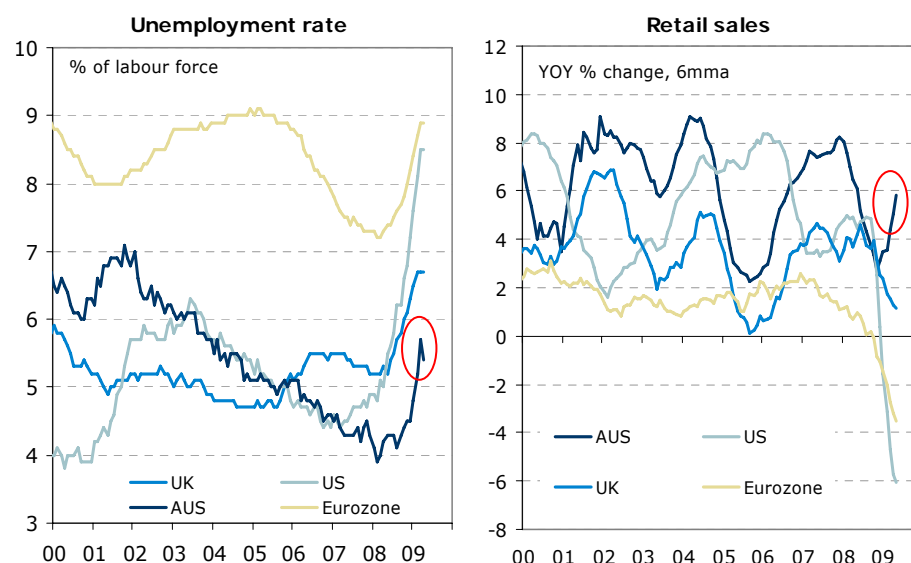
- Global interest rate markets will remain caught between the negative effects of rising long-term inflation expectations and increased government bond supply and the positive influence of low policy rates and on-going economic fragility and falling inflation.
- We expect the Australian economy will disappoint RBA expectations for a recovery by year-end. This will be a trigger for further RBA rate cuts by the end of the year. This should keep short-term bond and swap rates anchored.

FX: Upgrade of forecasts

- There is about an equal probability for the AUD/USD shoot higher toward 0.7610 and 0.7800 in the coming sessions – or to collapse toward 0.7375 and 0.7240.
- We have revised up the trough in our forecast track, such that AUD/USD weakens gradually toward 0.64 around year-end. Should the EUR rally resume past 1.3500, we would have to reassess our outlook for the AUD, and potentially shift to a strengthening medium-term trend.

Chart of the week

Figure 1: Australian data surprises on the upside, and outperforms the rest of the world (for now)



Source: ABS and ANZ

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Macro Update: Stimulating the stabilisation

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Data flow supports *temporary* pause by the RBA

The RBA again kept interest rate cuts on hold at their May meeting. In making the decision the RBA stated that domestic monetary and fiscal policy settings will "*provide significant support to domestic demand over the period ahead*". The RBA has also become more optimistic about the global growth outlook, especially China, and is pleased to see the improvement in financial markets.

Most of the data released this week supported the view that expansionary policy in Australia is working, at least for now (see *Data Wrap* below for details). The strength of retail sales and labour force numbers genuinely shocked the market and building approvals and the trade balance in March were also significantly stronger than expected. Indeed, the strength of retail sales and the trade balance suggest there is now a chance that Australia can avoid a negative quarter of GDP growth in Q1. However, given expected falls in inventories and building approvals we are not going to make that call just yet.

No doubt, it was a good data week. This shows that the Australian economy is proving more resilient in the midst of the global downturn, perhaps mainly due to aggressive policy support. But we are not prepared to call this the start of the recovery. We still believe there are considerable challenges ahead. Plenty of forward indicators show the environment remains fragile at best. ANZ job ads are wallowing at near record lows, the full impact of lower commodity prices is yet to hit exports and business investment is only just beginning to turn (in what could be a very long cycle). As such we still believe the RBA will need to continue to cut interest rates further later in the year.

Budget deficit could be the worst in 50 years

The Government is expected to deliver further stimulus to the economy when it delivers the 2009-10 budget next Tuesday. That said, a sharp deterioration in government revenues as a result of weaker economic growth will impose a limit on the government's ability to increase its 'discretionary' spending.

We expect that the starting point for the 2009-10 has deteriorated significantly since February's Budget update. Even before any new policy announcements are taken into account, a weaker economy is expected to drag the 2009-10 Budget starting point into deficit of around 4% to 4.5% of GDP. This is worse than the largest deficit (4.1% of GDP) in the last recession (1992-93).

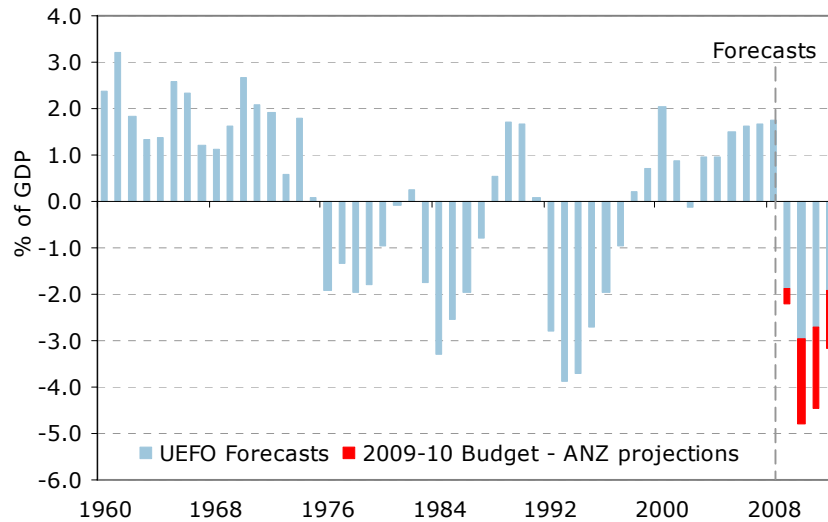
We suspect the government will be reluctant to push its deficit too far beyond the worst experience of the 1990s. Indeed, financial discipline is vital to protect the Government's prized AAA credit rating. As such, we expect a range of permanent spending decisions will need to be offset by permanent savings in order to show that the budget can return to balance as the economy recovers. Increases in pension rates therefore may be offset by greater means testing for other benefits (such as childcare and family tax benefits).

Further discretionary stimulus measures are however required to support this economy through the global recession. The Government must balance these counter-cyclical policy priorities with medium-term productivity enhancing objectives (and financial responsibility). As such, we suspect the biggest policy stimulus announcements are likely to be focussed on further increases in infrastructure investment.

We suspect the net impact of new policy decisions will be the order of \$15 to \$20 billion (over the next four years). On our estimates, this would take the 2009-10 budget deficit to \$57bn, or 4.8% of GDP. This would be the biggest

budget deficit in over 50 years. That said, it would still be low by global standards. The US budget deficit for example is projected to be 13.1% of GDP this year while the UK's deficit projection is 12.3% of GDP for 2009-10.

Figure 2: Possibly the biggest deficit in 50 years



Source: Commonwealth Treasury and ANZ

A gradual recovery in the Australian economy and a wind-down of government stimulus spending should see the budget deficits improve to around 3.0% by 2011-12. In the absence of another 'once in a generation' commodity boom, the budget may struggle to return to balance before 2014-15 at the earliest.

This will increase the government's net debt burden significantly. On our projections, government net debt could rise from February's UEFO estimate of 5.2% of GDP (around \$70bn) in 2011-12 to, as a worse case, about 10% of GDP (\$130bn) by 2012-13. Again, this is low by global standards and is also low by historical Australian standards with net debt peaking at 18.5% of GDP in 1995-96.

Despite a significant deterioration in its balance sheet, we do not expect Tuesday's budget to cause any concern over the Government's AAA credit rating. Australia's medium-term economic prospects remain sound and, in the interests of fiscal transparency, the government is expected to outline a credible exit strategy for reducing its debt burden, albeit over an extended time period (of around 10 years).

Data wrap

- **ANZ Job ads** fell 7.5% in April, with internet down 8.1% but newspaper ads up 3.1%.
- The **AiG services index** improved to 36.5 in April up from 30.4 in March.
- The **MI/TDS inflation gauge** showed that price growth was flat in April.
- Seasonally adjusted estimates of **VFACTs car sales** declined 4.0% in April.
- **ABS House prices** eased 2.2% in Q1, an annual fall of 6.7%, in contrast with the RP measure released last week which showed a 1.5% quarterly rise.
- **Building approvals** rose 3.5% March, down 16.5% in the year.
- The RBA left **official cash rates** on hold at 3% at their May meeting.
- March **retail sales** unexpectedly rose 2.2% in March, 6.3% higher than March 2008. **Retail sales volumes** rose a solid 1.0% in Q1.
- The **trade surplus** improved to \$2.5bn due primarily to weaker imports.
- **Employment** in April rose 27K. The **unemployment rate** fell to 5.4% as the participation rate eased to 65.4%.

Interest Rate Markets: Medium-term outlook

- Global interest rate markets will remain caught between the negative effects of rising long-term inflation expectations and increased government bond supply and the positive influence of low policy rates and on-going economic fragility and falling inflation.
- We expect the Australian economy will disappoint RBA expectations for a recovery by year-end. This will be a trigger for further RBA rate cuts by the end of the year.

Contrasting forces to keep global rates range bound

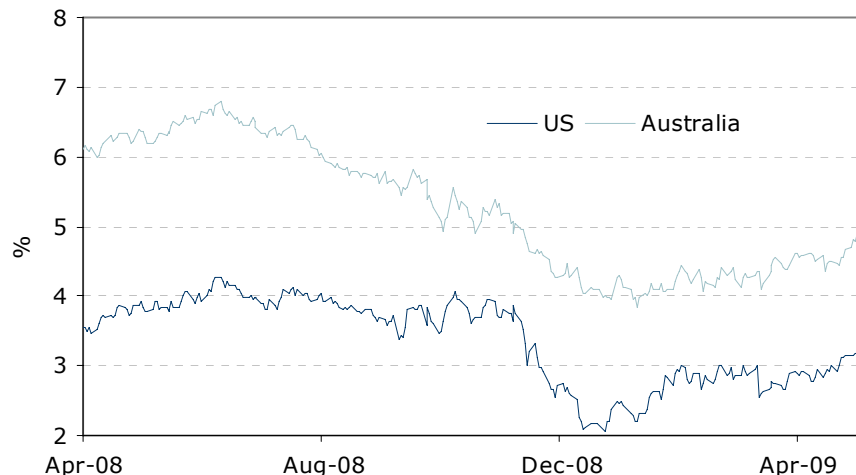
Short-term interest rates are expected to remain at or below current levels for the foreseeable future. While there are some early signs of stabilisation in the world's key economies, economic growth will remain weak right through 2010 according to both the IMF and ANZ forecasts.

Abnormally large government borrowing programs represent the main upside risk to low and stable term interest rates. A sudden increase in government bond issuance should put upward pressure on term rates across the curve (ie. a parallel shift up).

The Fed and the BoE have initiated Quantitative Easing (QE) partly to contain upward pressure on terms rates associated with large government borrowing programmes. QE however has increased concerns around the long-term inflation outlook given that central bank balance sheet expansion is seen as effectively 'printing money'. This is having the effect of steepening the term yield curves (2/10yrs) of the major markets.

The result of these pressures (low and stable cash rates, increased government borrowing and QE) has been a bearish steepening of the yield curves across the major markets. This has resulted in term rates that are much higher than money market rates and therefore yield steep curves from 3mths to 2yrs. Improving risk appetite and better than expected economic data in recent weeks has exaggerated the process recently.

Figure 3: 10-year bond rates are well off their lows



Source: Bloomberg and OIS

In the latest policy announcements the Bank of Canada and the RBNZ have indicated explicitly that policy rates will remain low for over a year in an attempt to contain any upward pressures on term rates.

Interest rate markets will be caught between the negative effects of rising long-term inflation expectations and increased government bond supply and the positive influence of low policy rates and on-going economic fragility and falling inflation. As such, we are forecasting global rates to remain broadly range bound over the

remainder of 2009. For example we expect the US Treasury 10yr Note to yield between 2.5% and 3.5% for the next 6 to 12 months.

A disappointing economy to keep the RBA in the game

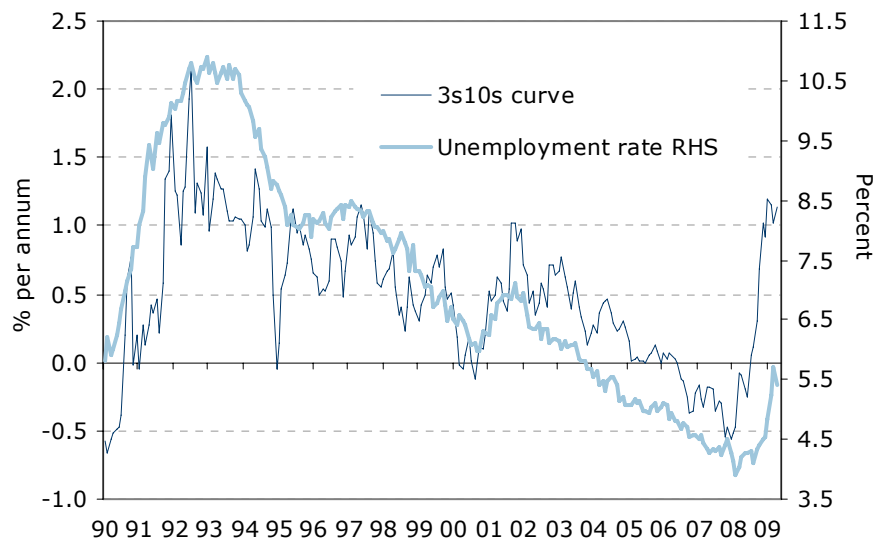
Market expectations for the RBA have recently swung away from near-term easing. In the process the market has pushed up expectations for the terminal cash rate from a low of around 2% in February to around 2.75% currently.

ANZ expects further economic weakness to emerge over the second half of 2009 as employment weakens. Most of the increase in the unemployment rate thus far has been due to rising participation and labour force growth. Employment growth has been remarkably resilient with the main factor being a shift away from full-time employment towards part-time, although this was partly reversed in today's surprisingly strong employment data.

All the major forward indicators of the labour market, including the ANZ Job Ads series, suggest that employment will contract by at least 1.5% over the year ahead. On this basis the unemployment rate will rise steady from the current 5.4% to around 8% by the second half of 2010.

At present the RBA expects a recovery in the economy over the second half of 2009. In contrast, we expect the economy to disappoint as employment growth slows. This will be a trigger for further easing over the second half of this year. We expect a low point for the RBA cash rate of around 2% by the end of the year.

Figure 1: A further rise in the unemployment rate will keep pressure on the 3s/10s yield curve



Source: Bloomberg, ABS and ANZ

Shifting RBA expectations and rising global term rates have seen the Australian 10 year (govt) rate rise 90bp over the past 3 months. In the process the 3/10yrs yield curve has steepened back above 100bp. We expect the yield curve to remain steep (6mth range: +90bp to +130bp) as further rate cuts keep short-term bond and swap rates anchored (or even allow these rates to move lower).

We expect further compression in sovereign spreads in \$A over the next 3 to 6 months although the extent of compression is unclear and will largely be determined by the stability of the broader financial markets. The focus of new money issuance will be from the Commonwealth followed by the States then the Banks.

FX: Upgrade of forecasts

Recommendation

None – avoid hasty reactions in this highly volatile, uncertain environment. There is about an equal probability for the AUD/USD shoot higher toward 0.7610 and 0.7800 in the coming sessions – or to collapse toward 0.7375 and 0.7240. Tonight’s ECB meeting has massive implications for the broad FX markets, with the potential for EUR to collapse if the ECB aggressively cuts rates or moves toward quantitative easing. Technically, the weekly close for AUD/USD tomorrow is crucial. We have tweaked our medium-term AUD forecasts higher, but will review them again Monday when event risk has settled.

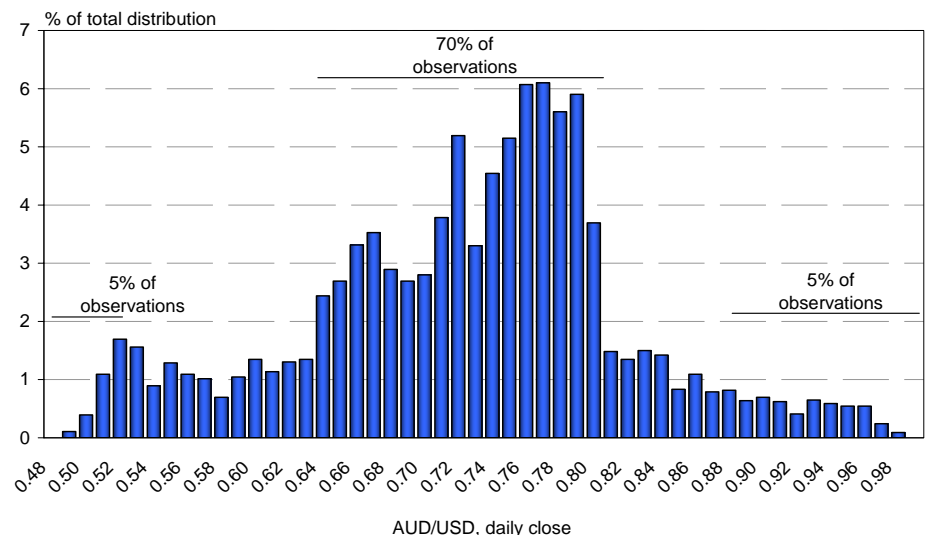
Overview

The AUD has seen a massive rally, pushing up from a low of AUD/USD 0.6990 on 28 April to a high of 0.7562 today. On the way, it has smashed through what had previously been strong resistance at 0.7250-80, managed a weekly close above 0.7300 and taken out the key 0.7475-0.7500 area that represented an important retracement level dating from the AUD’s 2008 fall and measured rebound.

As we have been foreshadowing in recent publications, a high weekly close and move for AUD/USD above 0.7350 are strong technical signals that must be respected. While we still believe that the AUD will weaken against the USD over the coming 12-18 months, the fact that the AUD/USD continues to make higher highs and higher lows suggests that there is less than a 50% probability that the AUD/USD will fall to a new low below AUD/USD 0.62 over this cycle. We have therefore revised up the trough in our forecast track, such that AUD/USD weakens gradually toward 0.64 around year-end.

Many observers now argue that positive investor sentiment and the equity market rally will cause the AUD/USD to strengthen further. This may prove true in the short term. However, we are hesitant to forecast a stronger AUD/USD over 12-18 months for two main reasons. First, that it would be extremely unusual for the AUD/USD to trade well above its long-term average through the worst global recession since at least World War II. As the chart below shows, 70% of daily closes have been in a range of AUD/USD 0.64 – 0.80 since 1983 float.

Figure 2: AUD/USD distribution of daily closes since 1 Jan 1984

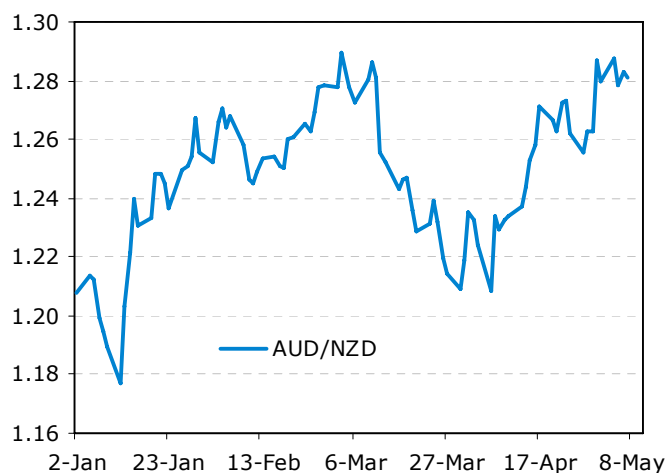
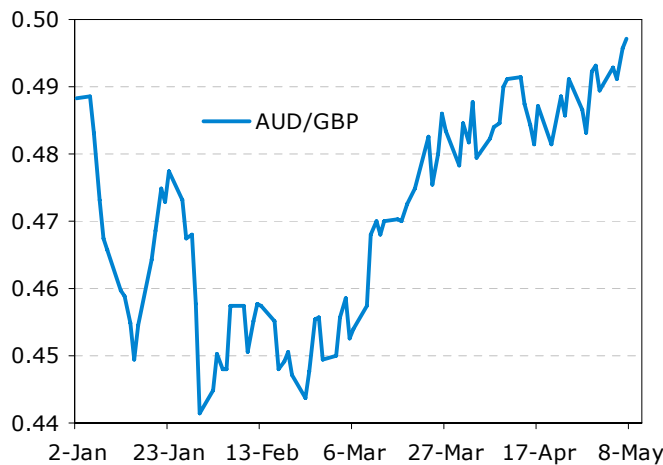
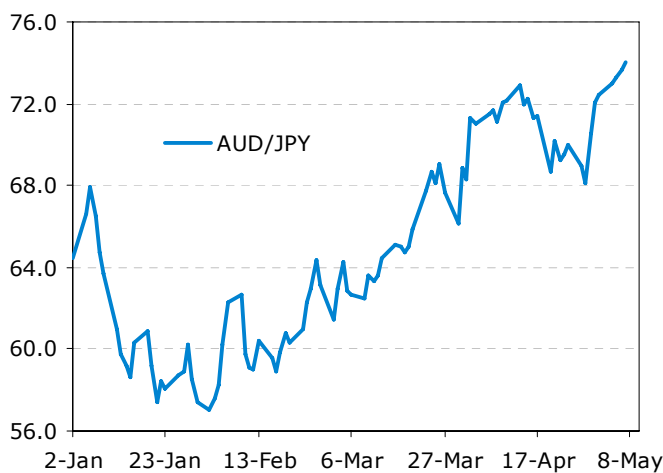
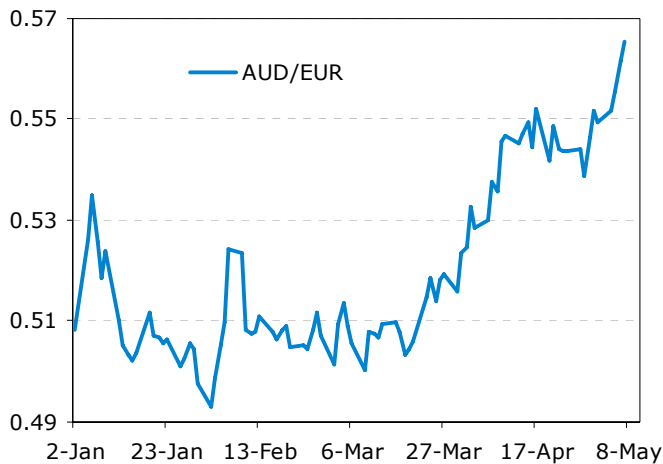


Source: ANZ, Reuters

Second, the AUD is at present strong against what is still a weak USD – where the USD trade-weighted index is 15% below its long-term average. If the “reflation” trade continues on more positive economic prospects – led by the US – then the USD should rally in the months ahead as prospects for the Fed to raise rates increase. Though the AUD/USD looks to be strong now, on other crosses such as AUD/EUR and AUD/JPY, the AUD is still weak relative to long-term averages. Thus the ECB’s actions tonight are a crucial piece of information.

Should the EUR rally resume past 1.3500, we would have to reassess our outlook for the AUD, and potentially shift to a strengthening medium-term trend.

AUD cross view



AUD/EUR Key levels: 0.5330 – 0.5650

- AUD/EUR has appreciated around 13% since the rally on global stock markets and recovery in risk appetite took off in early March. Trading close to the 61.8% retracement level between 2008's high and low, the cross needs to be able to persist at current pricing in order to see a push higher towards AUD/EUR0.5870. Good support exists around 0.5330.
- The key risks to this cross are to the downside, with tonight's awaited ECB meeting the top of the list. However, next week's Q1 GDP release in the Euro zone could provide support for the cross if a disappointing growth number is released.

AUD/JPY Key levels: 68.50 – 74.00

- The 3½-week rally in the JPY has come to an end, with USD/JPY heading back above 98 (and as high as 99.5). With the AUD/USD pushing higher this week on the back of ever improving risk appetite and an abatement in swine-flu fears, this has seen the AUD/JPY rebound to a 7-month high of 74.63.
- The key risk events for this cross are global; beware of tonight's ECB rate decision and press conference (where any indication of a move to quantitative easing will weigh on the AUD/JPY), and tomorrow night's US payroll release (a further slowing in job losses is also likely to push the AUD/JPY lower).

AUD/GBP Key levels: 0.4780 – 0.4990

- The AUD/GBP rallied to a 12½-year high of 0.49914 this week. The next major level higher is the 1996 peak of 0.5325, but with the significant downside risk to the AUD/USD of the ECB moving to quantitative easing at tonight's meeting, this could quickly push the AUD/GBP back below 0.49 and towards the key support at 0.4780.
- Keep your eye on UK industrial production and employment data for March due out next week; these figures will be a good lead into the Q1 GDP release due the following week. A disappointing result, particularly in the IP numbers, could weigh on the GBP and lend support to the AUD/GBP.

AUD/NZD Key levels: 1.2560 - 1.2940

- The stark difference in the monetary policy stance of the Australian and New Zealand central banks is keeping the AUD/NZD well supported around 1.28. While the RBNZ has stated that rates will remain at or below 2.50% until then end of 2010, the RBA is expected to keep rates on hold at 3% for at least the next few months.
- Key risk events over the coming week are global (see AUD/JPY comment). Any likely downside moves are likely to be more amplified for the NZD/USD than the AUD/USD, which could see the AUD/NZD continue to trade in excess of 1.27.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	3.9	-2.5	-2.5
Household consumption	4.3	2.1	-0.2	0.7
Dwelling investment	2.7	2.0	-6.5	9.0
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	-1.3	-0.7
Inventories (contribution to GDP)	0.6	-0.6	-0.2	0.2
Gross National Expenditure (GNE)	5.9	3.5	-1.4	-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	-1.0	0.7
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	1.6	2.6
Underlying*	3.1	4.5	3.7	2.7
Wages	4.1	4.2	3.9	3.4
Labour market				
Employment (annual % change)	2.8	2.2	-0.3	-1.0
Unemployment rate (%)	4.4	4.2	6.1	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	3.12	2.65	2.30	2.30	2.30	2.35
3 year bond	3.87	3.25	3.20	3.05	3.40	3.60
10 year bond	4.90	4.35	4.30	4.15	4.30	4.40
3s10s yield curve	1.03	1.10	1.10	1.10	0.90	0.80
3 year swap	4.24	3.60	3.50	3.35	3.70	3.90
10 year swap	5.35	4.85	4.70	4.50	4.60	4.70
International interest rates						
RBNZ cash rate	2.50	2.25	2.25	2.25	2.25	2.25
NZ 90 day bill	2.91	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	0.96	0.75	0.80	0.85	1.25	1.50
US 10 year note	3.19	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	1.00	0.50	0.50	0.75	1.00
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\$	0.7517	0.70	0.68	0.65	0.64	0.64
NZ\$/US\$	0.5878	0.54	0.51	0.48	0.47	0.47
A\$/¥	74.24	73.50	73.44	71.50	74.24	74.24
A\$/€	0.5663	0.55	0.55	0.55	0.57	0.57
A\$/£	0.4967	0.47	0.46	0.44	0.43	0.42
A\$/NZ\$	1.2790	1.30	1.33	1.35	1.38	1.36
A\$/CA\$	0.8779	0.86	0.84	0.81	0.81	0.82
A\$/CHF	0.8551	0.83	0.84	0.85	0.88	0.90
A\$/CNY	5.127	4.78	4.64	4.44	4.36	4.36
A\$ Trade weighted index	61.60	59.56	58.76	56.66	56.37	56.01
International cross rates						
US\$/¥	98.77	105	108	110	116	116
€/US\$	1.327	1.28	1.24	1.18	1.12	1.12
€/¥	131.09	134	134	130	130	130
£/US\$	1.513	1.48	1.48	1.48	1.50	1.53
€/£	0.8788	0.86	0.84	0.80	0.75	0.73
US\$/CA\$	1.168	1.23	1.24	1.25	1.27	1.28
US\$/CHF	1.138	1.19	1.24	1.30	1.38	1.41
US\$ index	84.21	87.8	89.9	93.0	96.7	96.5
Asia exchange rates						
US\$/CNY	6.823	6.83	6.83	6.83	6.82	6.82
US\$/HKD	7.750	7.75	7.75	7.76	7.76	7.77
US\$/IDR	10403	11500	11900	11500	11500	11000
US\$/INR	49.46	52.00	51.00	51.00	50.00	50.00
US\$/KRW	1262.40	1400	1450	1400	1325	1300
US\$/MYR	3.5270	3.70	3.75	3.75	3.70	3.65
US\$/PHP	47.575	49.50	50.00	49.50	48.80	48.50
US\$/SGD	1.472	1.58	1.60	1.62	1.63	1.61
US\$/THB	34.99	36.50	37.50	37.00	36.50	36.00
US\$/TWD	33.16	32.70	32.00	32.00	31.00	30.00
US\$/VND	17767	18300	18800	18800	19300	19300
Pacific exchange rates						
PGK/US\$	0.358	0.35	0.34	0.35	0.35	0.36
FJD/US\$	0.461	0.43	0.42	0.40	0.39	0.39

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