

State revenues in freefall, as deficits blow out

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Macroeconomic Update: state government revenues crash, deficits blow out

- The Queensland and New South Wales State Budgets released this week confirmed a significant deterioration in their underlying budget positions.
- The gross borrowing requirements of Australia's Commonwealth and State governments in 2009-10 will reach a record \$132.5bn in nominal terms.
- Taking into account pre-funding and re-funding, net demand for new money from the capital markets by the Australian public sector (ex. local government) will be \$79.5bn, or approximately 7% of national GDP.

Interest Rate Markets: pressures abate but downside risks remain strong

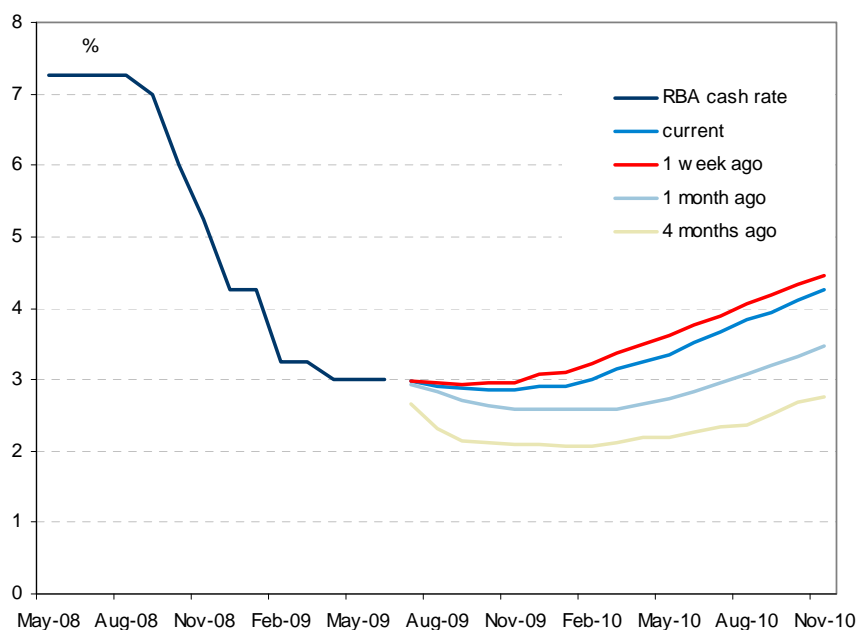
- Upward pressure on market rates appears to have abated, at least for now.
- The policy outlook should help to anchor short-dated yields.
- Despite moves over the past week, there remain significant downside risks to market pricing for the RBA cash rate.

FX: Consolidation in metals prices an AUD risk

- Although the AUD/USD has reversed last week's surge to above 0.81, it remains settled in its higher 0.7850 – 8250 trading range.
- Look to a continued correction in base metals prices this week to limit any moves higher in the AUD/USD.

Chart of the week

Figure 1: Australian interbank cash rate futures



Source: Bloomberg

Macroeconomic Update: state government revenues crash, deficits blow out

The Queensland and New South Wales State Budgets were released this week, confirming the significant deterioration in the underlying budget positions of these States. NSW is expected to record a deficit of \$1.3bn in 2008-09, improving to a deficit of \$1bn in 2009-10. A small surplus is expected in 2011-12. The Queensland cash deficit is expected to rise to \$7.5bn in 2009-10. A surplus for Queensland is not anticipated before 2016-17. (For more detail on the State Budgets, see our reports on each state budget, released this week).

With the last of the major state government budgets for 2009-10 released, we can now estimate a total borrowing program for the major public sector issuers across Australia. Each issuer entity produces a borrowing program. We have attempted to provide a harmonised overview of the various programs in Table 1. The notes below the table outline some of our assumptions.

Table 1: Harmonised Borrowing Program of Australian Public Sector, 2009-10

\$A bn	Gross Borrowing Req.	Less Pre-Funding	Effective Gross Borrowing Req.	Less Maturities	Net Borrowing Req.
NSW	15.4	5.0	10.4	5.5	4.9
VIC	5.6	0.8	4.8	1.0	3.8
QLD	33.0	10.4	22.6	18.1	4.5
WA	6.0	0.0	6.0	2.4	3.6
SA	5.0	0.6	4.4	2.7	1.7
NT	0.6	0.0	0.6	0.4	0.2
Total Semi-Gov*	65.6	16.8	48.8	30.1	18.7
Clth Gov	66.9	0.0	66.9	6.1	60.8
Total Govt	132.5	16.8	115.7	36.2	79.5

* Tascorp program not available.

Assumptions: Some borrowers provide details of changes in money market funding programs while others focus on term borrowings. This will affect the comparability of gross numbers but should not affect net funding or net call on markets calculations. These calculations provide no insight into the term structure of new funding. Some authorities may need to focus new issuance in longer term securities due to shortened current funding profiles. QLD: Maturities include CP and are net of customer debt retirement. Pre-funding includes both "pre-funding of benchmark bond maturities" and "funding in advance of customer borrowings." VIC: The use of "internally generated funds" to meet the borrowing requirement has been factored in via a lower gross borrowing program. Pre-funding figure is an ANZ estimate. Other states have provided formal guidance on this. These numbers are total funding requirements and will not match up directly to \$A bonds outstanding. For example, QTC has \$13bn of \$A benchmark bonds maturing in 2009-10 and is expected to only issue around \$A11-13bn of \$A bonds, with the other half of the borrowing program coming from CP and MTNs's.

The gross borrowing requirement of the Commonwealth and State governments in 2009-10 will be \$132.5bn. In nominal terms this will be a record borrowing requirement for the Australian public sector. Some of the larger states have partially pre-funded this requirement in the current financial year, which brings the effective gross borrowing requirement down to \$115.7bn.

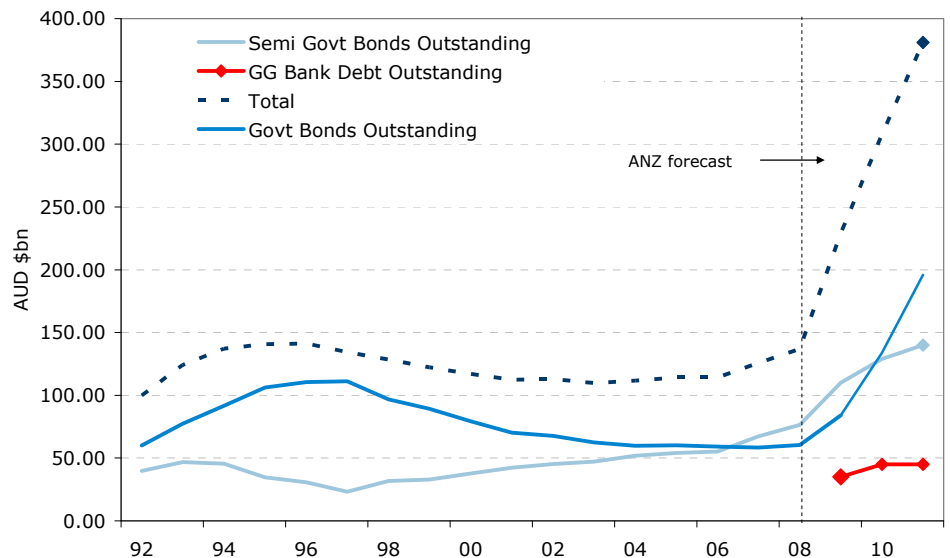
A large part of this borrowing requirement is the re-financing of past borrowings that mature in the coming financial year. By taking this into account, we can calculate that the net borrowing requirement (that is, the demand for new money from the capital markets by the Australian public sector, ex. local government) will be \$79.5bn, or approximately 7% of national GDP.

This large government borrowing requirement raises a range of questions, not least, where will the money come from? A sudden increase in the public borrowing requirement will be funded by either an equal reduction (increase) in private sector borrowing (saving) or an increase in our current account deficit. In the United States the large increase in public borrowing requirements is being more than offset by a decline in private sector borrowing from both corporations and households. (In fact, the US current account deficit has begun to contract).

For Australia, much of the increase in public borrowing has, thus far, been matched by a softening in corporate and household borrowing growth, although total private credit is still expanding. Will private sector credit continue to expand in the face of rising public sector borrowing requirements? Or will our reliance on offshore savings increase, pushing out our current account deficit? This is a key uncertainty facing the economy over the year ahead.

In any case the number of government, semi government and government guaranteed bank bonds on issue in Australia is expanding rapidly at present. Figure 2 highlights our projections for \$A government bonds on issue over the next three years. After running at just over \$A100bn for most of the decade, the total number of bonds on issue, across these three sectors, is projected to rise to \$A400bn by June 2012.

Figure 2: \$A Government, semi Government and Government Guaranteed Bank Bonds on Issue



Source: Bloomberg and ANZ.

The great bulk of new issuance is by the Commonwealth, with a net borrowing requirement of around \$60bn, while NSW, Victoria, Queensland and Western Australia make up another \$17bn of new borrowing. The relatively large Commonwealth borrowing requirement is likely to put relatively more pressure on the borrowing rates for the Commonwealth compared to both the States and the swap curve. Semi-government yield differentials to the Commonwealth have been declining in recent months in line with improving credit conditions more generally and the offer of a Commonwealth guarantee of State Borrowing (which Queensland has confirmed that it will take up, once the Guarantee is passed through Federal Parliament).

Data wrap

- **Dwelling commencements** fell by 4.0% in Q1 after declining by 11.5% in Q4.
- **Minutes from the RBA's June Board meeting** showed that while the RBA is comfortable with current settings, it still retains a soft easing bias (see Interest Rate Markets section below).

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Interest Rate Markets: pressures abate but downside risks remain strong

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- The policy outlook should help to anchor short-dated yields.
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Upward pressure in markets abating, for now

Many of the factors that helped to push market interest higher in recent weeks appear to have matured. Market yields have stopped rising and there is scope for some modest correction lower, particularly at the front-end of the curve.

Factors that are now working to limit the rise in market yields:

- Stock markets are now moving into consolidation after a period of rallying, on the hope that a relatively strong economic recovery is at hand. The downgrade of 18 US banks overnight is a reminder that there are still some serious challenges ahead. Measures of risk aversion have moved higher and credit spreads have moved out again.
- Policy-makers have been more vocal in saying recovery will take a long time and there are still challenges ahead, notably from senior officials at the US Federal Reserve, the BOE and IMF.
- Soft core inflation data from the US overnight and the drop in US industrial capacity to a record low are reminders that there is little threat of a sustained break higher for inflation or pressure for the Federal Reserve to lift rates anytime soon.
- Higher bond yield and petrol prices are natural headwinds to recovery. US mortgage rates have rising in recent weeks, while the pressure on borrowing costs is again a political issue here.

There are still uncertainties that might limit the scope for market rates to fall, especially at the longer end. The status of the \$US as the global reserve currency is a little more uncertain these days. The BRIC (Brazil, Russia, India and China) countries met this week and sent mixed signals on their support for the dollar retaining its status as the leading reserve currency.

Figure 3: 2 and 5-year swap yields



Source: ANZ & Bloomberg

Also, the supply of US bonds continues apace with the US Treasury set to issue a new round of bonds next week. The local market had to digest a range of important news here this week from state Budget developments. This might help to explain why a tender of 2019 ACGB bonds here yesterday attracted the weakest bid/cover of any tender since early January.

We could at least expect some clarity around the Fed's approach to quantitative easing following the FOMC meeting next week.

Figure 3 above illustrates how far local swap yields have risen as part of the normalisation of global markets over the past couple of weeks, but just how far they remain below the highs seen only a year ago. Five-year swaps have stalled around 5.5% while 2-year swaps have held below 4.30%. We have now clearly seen a low on yield so any correction lower is likely to offer attractive hedging levels. Figure 3 also shows how the steepening of the yield curve has pushed longer-dated rates higher relative to the front-end as these are being anchored by the steady rate stance of the RBA and mild easing bias.

As there are few major data due for release next week we are likely to take our lead from offshore events, such as the FOMC meeting and bond auctions and, of course, developments in the stock markets that impact the demand for safe-haven assets.

Market underestimating risk of further RBA easing

Minutes from the RBA's June meeting confirmed that the RBA would be comfortably on hold in coming months. Board members appear confident that current monetary policy settings are appropriately calibrated to foster sustainable growth or low inflation, at least "for the time being" and view the risks to the forecasts as more balanced rather than being tilted to the downside.

At the same time, the RBA also restated its soft easing bias *"Board members did not see a pressing case for any further action at this meeting, through they viewed the inflation outlook as affording scope for some further easing of monetary policy, if that were to be needed to support demand at a later stage."* Together with the broader global factors weighing on market sentiment, this served to dampen rate hike expectations in Australia over the past week.

Nevertheless interbank futures markets are still pricing in 100bp of hikes to almost 4% by September 2010 (commencing in early 2010), compared with more than 125bp of cuts to over 4.25% last week. In our view, there are considerable downside risks to this view.

While recent "greenshoots" in the Australian macroeconomic data are encouraging, particularly those relating to retail spending and residential building activity, we are mindful of the significant economic risks remaining over the next 12 months. It is not clear whether Australia is simply enjoying a delayed reaction to the global downturn with longer lags than we had been anticipating, or whether fast and aggressive monetary policy action has limited the magnitude of the downturn Australia will experience.

We hope that it is the latter, but remain mindful of the significant negative economic influences yet to play out, including the sharp fall in nominal incomes from the unwinding of the terms of trade boom and rising unemployment. As such, we still see further rate cuts in late 2009 as the most likely outcome and believe rate hikes are highly unlikely until late in 2010, when the domestic economic recovery has become well entrenched and the unemployment rate has stopped rising.

FX: Consolidation in metals prices an AUD risk

Recommendation

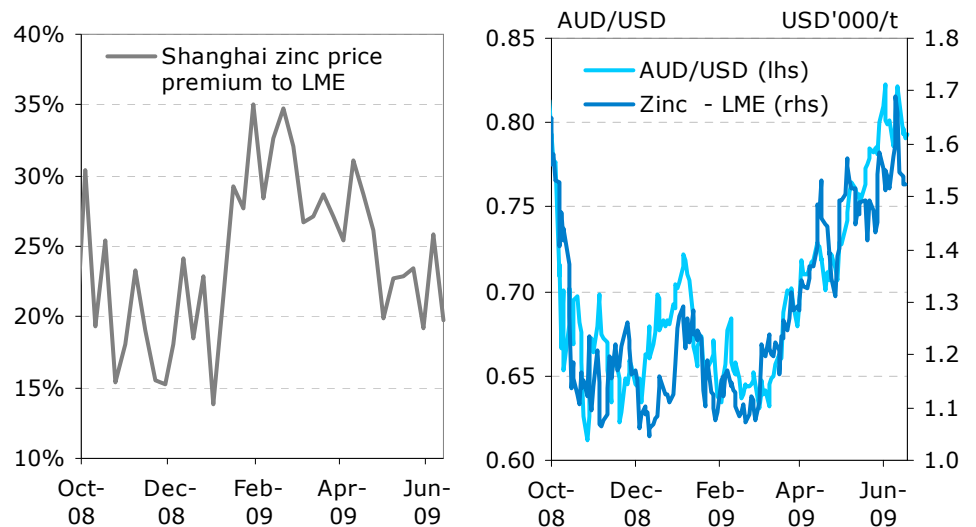
Although the AUD/USD has reversed last week's surge to above 0.81, it remains settled in its higher 0.7850 – 8250 trading range. Look to a continued correction in base metals prices this week to limit any moves higher in the AUD/USD. In a subdued week for local economic events and data, the US Federal Reserve's policy meeting is the key risk event for currency markets. AUD sellers could look to take advantage of moves above 0.81, while AUD buyers may wish to be poised for moves below 0.79.

Key Risks

In last week's FX note, we discussed the significant upgrade made to our AUD/USD outlook, albeit with a period of weakness in H2 2009. This week, we focus on one of the major downside risks to the AUD/USD in the short-term – a consolidation in base metals prices.

Since the beginning of the year, base metals prices have attracted an increasing premium in the Chinese market as compared to the London Metals Exchange, due to strong Chinese domestic demand relative to the rest of the world. For copper, aluminium and zinc, the average premium paid on the Shanghai Exchange rose from around 9% at the start of 2009 to over 30% at their peak, and have since declined to below 20%. Pricing signals indicate that this easing in premium is likely to persist in the short term, suggesting that Chinese restocking could slow. The narrowing in premium paid is also seeing a consolidation in prices, and in turn, is weighing on the AUD/USD. Note that over the past week, the downward trend in the AUD/USD from a peak close to 0.8250 to below 0.80 (with dips towards 0.7850) has been accompanied by declines of 4½% to 10% in base metal prices.

Figure 4: Moves in AUD/USD heavily influenced by base metals prices

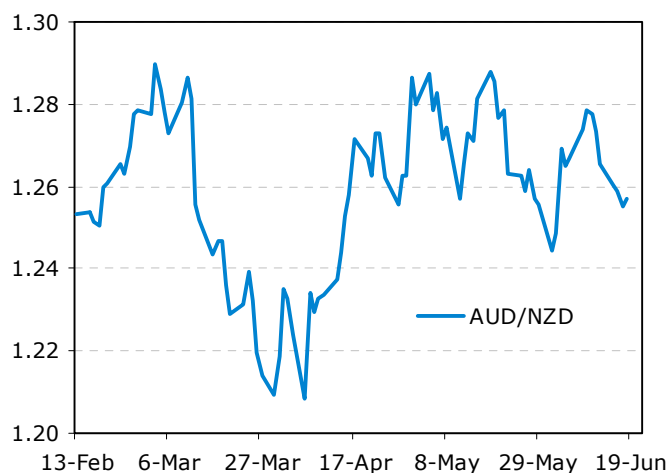
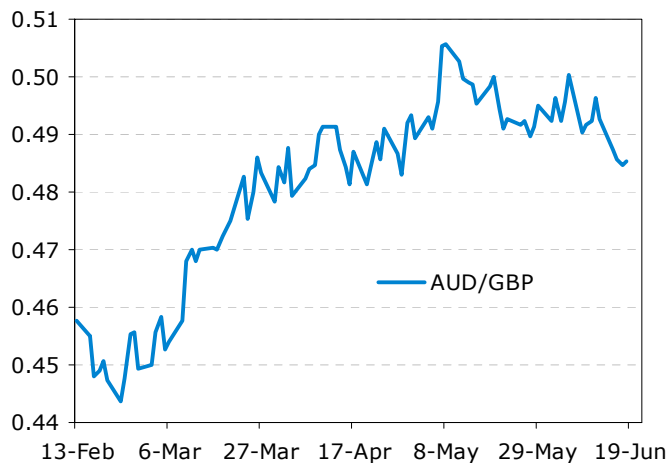
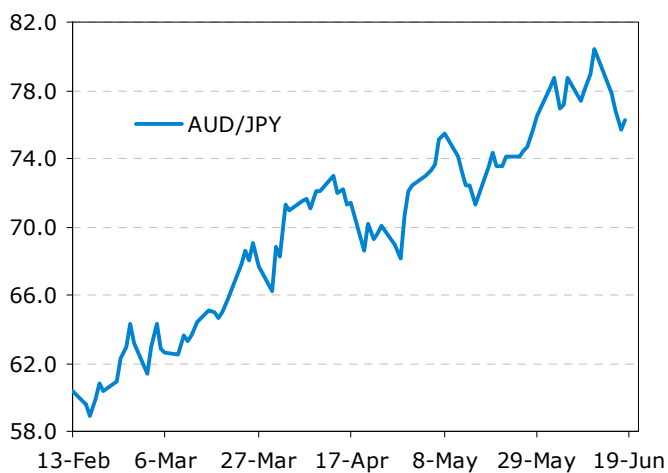
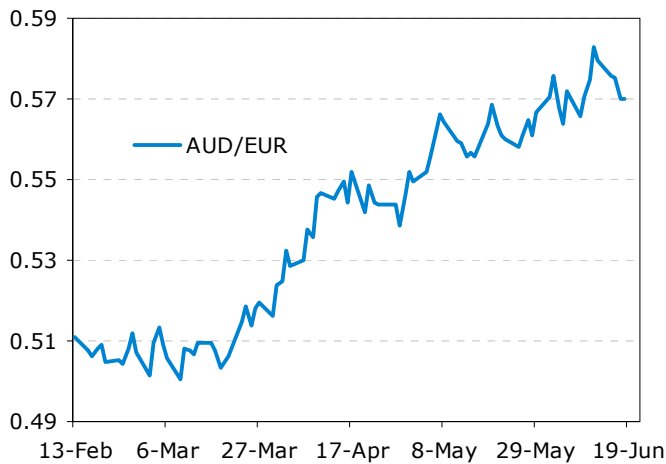


Source: ANZ, Bloomberg

What this means for the AUD over the coming months is that a slowing in Chinese base metals demand could act to slow or even limit further base metals price gains, and thus cap any upside potential for the AUD to move above recent peaks. Note that commodity markets are similar to currency markets in that prices tend to move on signals rather than actual changes in the real economy. For instance, the doubling in crude oil prices over the past four months has coincided with no material improvement in oil demand. Thus while the recent run-up in commodity prices (and the AUD/USD) have moved over the past few months to factor in more positive signs of stabilisation in the global economic environment, some pull-back can be expected in anticipation of hard evidence of a recovery toward the end of the year. Overall, we expect the AUD/USD to trough at 0.73 in the second half of the year before grinding higher to return to 0.80 by the end of 2010 as the global economy slowly recovers.

AUD/USD Key levels: 0.7750 – 0.8250. Another move towards 0.8250 failed to hold this week, and downside moves have been limited to 0.7850. This week should see the 0.8250 cap persist, with solid downside support at 0.7750.

AUD cross view



AUD/EUR Key levels: 0.5610 – 0.5830

- AUD/EUR's rise took a breather this week as the dip in commodity prices and equities weighed on AUD. However, upward momentum persists and we continue to target AUD/EUR to reach above 0.59 in the medium term. Next week, a sustained break below 0.5610 could see the cross head towards 0.5475, while moves higher are likely to be capped below last week's high at 0.5829.
- Worse than expected Euro zone June purchasing managers' data to be released on Tuesday could weigh on the EUR and push AUD/EUR towards 0.5830. Also beware of current account and industrial new orders data for April.

AUD/JPY Key levels: 74.0 – 79.5

- AUD/JPY finally broke through our topside target of 79.5 late last week to come within reach of 80.5 as AUD/USD had another crack at 0.8250. Recent sessions however have seen AUD/JPY ease back to around 76. The one-month moving average is beginning to look a little topy and our forecasts suggest that the cross could move sideways to slightly higher over the weeks. Good downside support remains at 74.
- While a raft of activity and prices data is due out in Japan over the coming week, the key reads will be Wednesday's May trade report, and Friday's inflation numbers.

AUD/GBP Key levels: 0.4810 – 0.4980

- The latest burst in AUD/GBP strength appears to have petered out for the moment, and the cross has declined to around 0.4840, below last week's downside target. The one-month moving average has clearly turned lower as AUD/USD catches its breath while GBP/USD pushes sideways. Concerns regarding the UK political environment have not made a significant dent in the GBP's recovery, although a short-term recovery in the USD could limit further gains over the second half of 2009.
- Watch out for UK retail sales data tonight and house price data next week to potentially generate some volatility in AUD/GBP.

AUD/NZD Key levels: 1.2460 - 1.2900

- AUD has lost ground against all of the major crosses this week, including NZD. AUD/NZD has repeatedly failed to break back above 1.29 since late April's 2009 high, and upward momentum looks exhausted for now.
- Next week's key risk event is the NZ Q1 GDP report. NZ has already suffered four consecutive quarters of economic contraction, and this trend is expected to have continued in Q1 with a quarterly fall in GDP of 1.5% forecast. A worse than expected result could weigh heavily on the NZD and see AUD/NZD take another run up towards 1.29. Good downside support exists at 1.2460.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	4.1	-2.0	-1.5
Household consumption	4.3	2.2	0.9	0.9
Dwelling investment	2.7	2.5	-6.8	8.4
Business investment	13.8	13.8	-9.3	-13.7
Public demand	2.8	5.3	2.1	6.6
Domestic final demand	5.4	4.4	-1.1	0.3
Inventories (contribution to GDP)	0.6	-0.6	-0.2	0.3
Gross National Expenditure (GNE)	5.9	3.8	-1.3	0.6
Exports	3.3	3.9	-1.5	-3.3
Imports	11.4	10.3	-11.9	0.7
Net Exports (contribution to GDP)	-1.7	-1.5	2.6	-0.8
Gross Domestic Product (GDP)	4.0	2.3	0.0	0.4
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	1.7	2.2
Underlying*	3.1	4.5	3.7	2.7
Wages	4.0	4.3	3.6	3.2
Labour market				
Employment (annual % change)	2.8	2.2	-0.3	-0.9
Unemployment rate (%)	4.4	4.2	6.2	8.0
External sector				
Current account balance: A\$ bn	-67.7	-51.0	-41.2	-62.6
% of GDP	-6.2	-4.3	-3.5	-5.1

*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	3.00	2.50	2.00	2.00	2.00
90 day bill	3.26	3.20	2.30	2.30	2.30	2.35
3 year bond	4.53	4.15	4.10	4.00	4.20	4.30
10 year bond	5.59	5.65	5.50	5.20	5.30	5.30
3s10s yield curve	1.06	1.50	1.40	1.20	1.10	1.00
3 year swap	4.91	4.50	4.40	4.30	4.50	4.60
10 year swap	6.07	6.15	5.90	5.55	5.60	5.60
International interest rates						
RBNZ cash rate	2.50	2.50	2.25	2.00	2.00	2.00
NZ 90 day bill	2.82	2.85	2.43	2.35	2.35	2.35
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.25
US 2 year note	1.35	1.35	1.10	1.00	1.25	1.50
US 10 year note	3.93	4.76	3.85	3.70	3.75	3.90
Japan call rate	0.10	0.10	0.10	0.10	0.10	0.10
ECB refinance rate	1.00	1.00	0.75	0.75	0.75	0.75
UK repo rate	0.50	0.50	0.50	0.50	0.50	0.50

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\$	0.8094	0.78	0.76	0.73	0.74	0.76
NZ\$/US\$	0.6360	0.64	0.58	0.55	0.54	0.54
A\$/¥	79.27	76.44	79.80	73.00	77.70	82.08
A\$/€	0.5770	0.57	0.60	0.58	0.59	0.60
A\$/£	0.4934	0.49	0.49	0.48	0.47	0.49
A\$/NZ\$	1.273	1.22	1.31	1.33	1.37	1.41
A\$/CA\$	0.8943	0.88	0.87	0.88	0.87	0.87
A\$/CHF	0.8725	0.87	0.87	0.82	0.86	0.85
A\$/CNY	5.531	5.33	5.19	4.99	5.05	5.18
A\$ Trade weighted index	64.90	63.14	62.86	59.69	60.54	62.94
International cross rates						
US\$/¥	97.9	98	105	100	105	108
€/US\$	1.403	1.38	1.26	1.25	1.26	1.26
€/¥	137.4	135	132	125	132	136
£/US\$	1.640	1.58	1.55	1.53	1.56	1.56
€/£	0.8551	0.87	0.81	0.82	0.81	0.81
US\$/CA\$	1.105	1.13	1.15	1.20	1.18	1.15
US\$/CHF	1.078	1.12	1.14	1.12	1.16	1.12
US\$ index	79.98	81.4	87.0	87.2	87.1	87.2
Asia exchange rates						
US\$/CNY	6.834	6.83	6.83	6.83	6.82	6.82
US\$/HKD	7.752	7.75	7.76	7.76	7.76	7.76
US\$/IDR	10065	10750	10250	9750	9500	10500
US\$/INR	47.44	50.00	48.50	48.00	47.00	47.50
US\$/KRW	1250.25	1325	1225	1150	1100	1225
US\$/MYR	3.5025	3.60	3.60	3.55	3.50	3.50
US\$/PHP	47.67599	48.50	49.00	48.00	48.00	47.00
US\$/SGD	1.451	1.52	1.53	1.52	1.51	1.51
US\$/THB	34.08	35.50	36.00	35.50	35.00	35.00
US\$/TWD	32.74	32.70	32.00	31.50	31.00	31.00
US\$/VND	17795	17800	18500	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.374	0.32	0.32	0.35	0.35	0.36
FJD/US\$	0.482	0.43	0.42	0.41	0.40	0.40

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