

Solid economy heads into a tough 2009

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Macro Update: Holding up, for now

- Australia should post one of the strongest Q4 GDP results in the OECD. Our current forecasts are for GDP growth to be flat in the quarter.
- But a weaker commodity price outlook has caused us to markdown our 2008-09 and 2009-10 Australian economic forecasts.
- The end of the commodity boom means Australian State economies are rapidly desynchronising.

Interest Rate Markets: Australian yields drift higher, state yields sharply widen

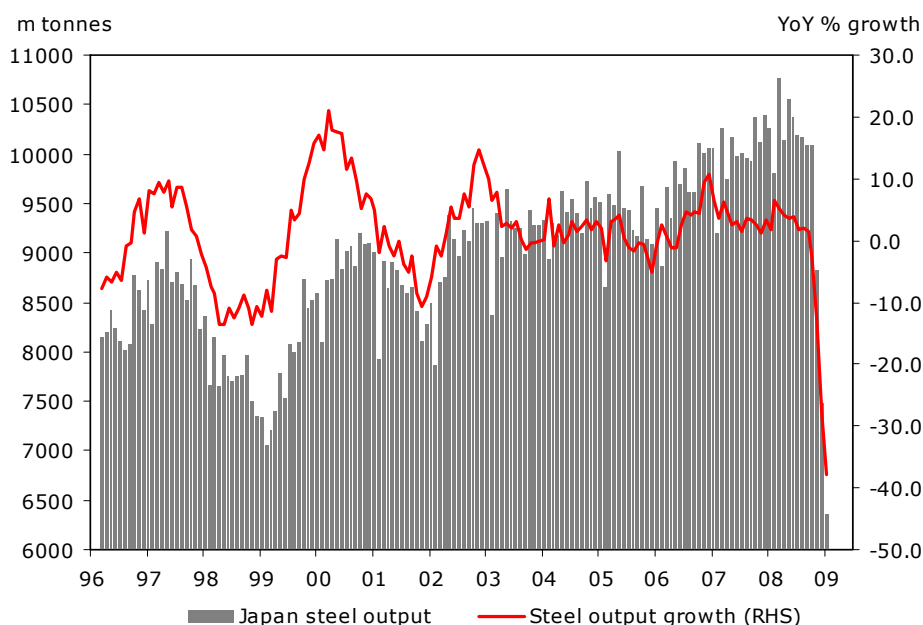
- Global interest rate markets remain in a trading pattern influenced by weak economic and deflationary forces on the one hand and a surge in government bond supply on the other.
- In Australia term rates have drifted higher over the week but remain well supported. Yet the big news for Australian rate markets this week was the downgrade of the State of Queensland last Friday evening.

FX: Markets falling out of bed with the Yen

- The RBA cash rate and GDP announcements next week will keep the market on its toes. AUD sellers should look for opportunities above AUD/USD0.6620; buyers should target dips below 0.6330.
- The JPY has progressively lost its safe-haven status over the past few weeks as the market comes to grips with the perilous circumstances of the Japanese economy.

Chart of the week

Figure 1: Steel output in Japan has collapsed



Source: Bloomberg and ANZ

Macro Update: Holding up, for now

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- But a weaker commodity price outlook has caused us to markdown our 2008-09 and 2009-10 forecasts.
- Australian State economies are rapidly de-synchronising.

Australian data surprises on the upside

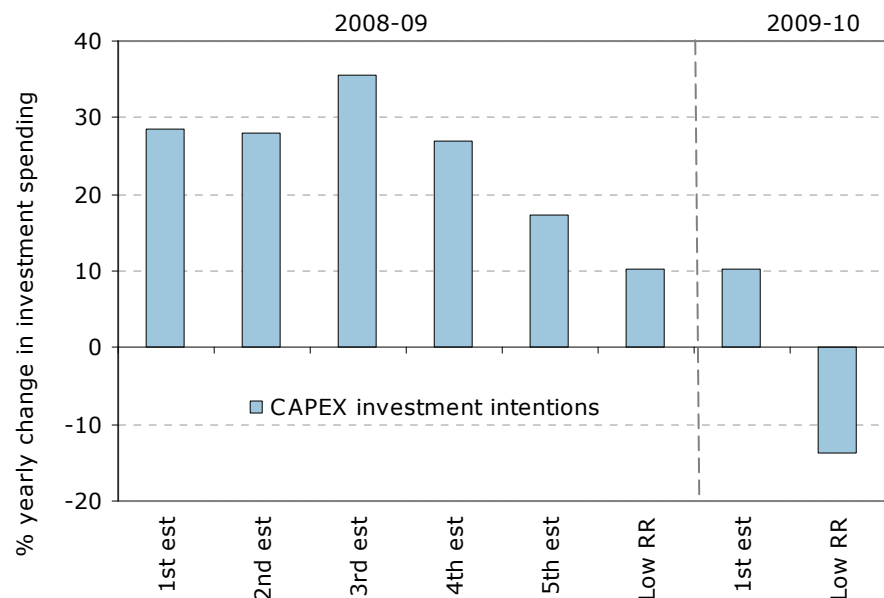
Local data surprised on the upside this week (see data wrap below). Of greatest surprise was the resilience of business investment in Q4. While the rest of the world was falling apart, Australian firms pressed on with investment spending, supported by a strong amount of work in the pipeline.

This is good news for next week's Q4 GDP. We can't yet be confident that growth was positive; Monday's company profits and inventories data will provide the final crucial pieces of the puzzle. But we have now seen enough positive data (business investment, retail) to be sure that Australia will post one of the strongest Q4 outcomes in the OECD. Our forecast for Australia remains for broadly flat quarterly growth, in contrast to the G7 average so far of -2.0%.

Nevertheless, today's CAPEX survey indicated that while actual spending was strong in Q4, expected investment spending continues to be marked down. Figure 2 shows that projected 2008-09 investment spending has fallen from a peak of 35% growth to around 17%. This is still a robust projection. The first read for investment spending in 2009-10 is also robust, implying growth of around 10%. This suggests many planned projects in 2008-09 are being deferred rather than completely scrapped.

That said, these estimates are based on average 5-year realisation ratios, which may be biased up by Australia's strong economic performance over this period. If we use realisation ratios from the early 1990s recession, the survey tells a very different picture, implying investment growth of around 10% this financial year and a fall of more than 10% next financial year. Our own forecasts are more in line with the latter scenario.

Figure 2: Investment intentions have been marked down



Source: ABS and ANZ. Estimates based on average 5-year realisation-ratios. Low RR (low realisation ratio) is the 1991-92 realisation ratio.

The outlook dims

While local short-term data has surprised on the upside, global data continued to come in worse than expectations. For Australia, the most notable release this week was a blow out in the Japanese trade deficit, with exports collapsing by a

record 45.7% YoY. Our chart of the week (p1) highlights the sudden collapse in Japanese steel production, which has fallen by an unprecedented 38% YoY.

The deepening downturn in the economy of Australia's major export destination will have significant ramifications for our local economy. We have downgraded our outlook for 2009-10 contract coking coal prices to -65% from -50%. We also now expect further falls in these contract prices over 2010-11 (our previous forecast was for a price rollover). The volume of coking coal exports are now forecast to fall by around 10% this year.

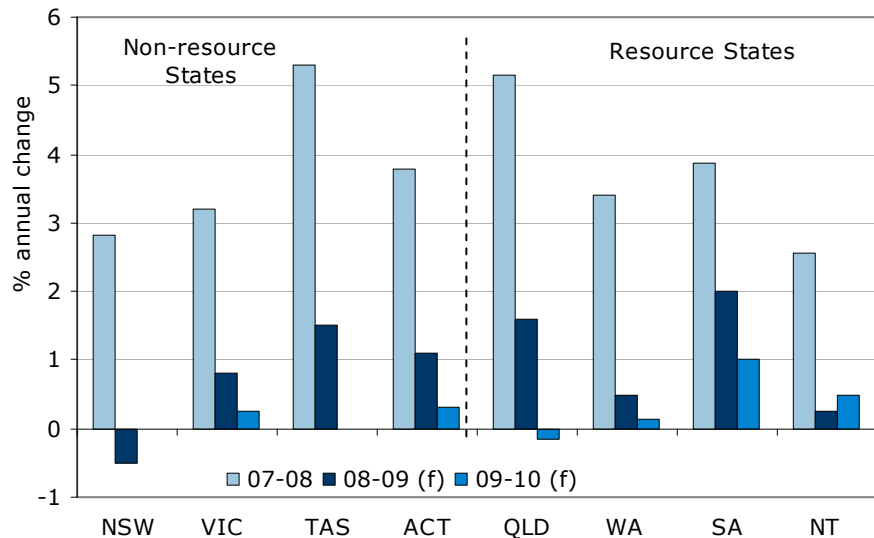
It's not all bad news on the export commodity front however. Recent better demand out of Asia has seen us upgrade our outlook for iron ore contract prices (to -35% in 2009-10 from -50%). We have also upgraded our forecasts for gold which we expect to move towards US\$1200/oz on safe-haven buying. Nevertheless, the downgrade to coking coal has negatively impacted our aggregate terms of trade view. We now expect the terms of trade to fall over 2009-10 and 2010-11.

As a result of this negative impact on national income, we have again downgraded our outlook for the Australian economy. Despite a relatively resilient December quarter, we now expect GDP growth in 2009 as a whole to suffer a small contraction, or around ¼ppt. The projected recovery in 2010 is also now likely to be more subdued, with growth of just 1¼ppt likely, as continued poor exports and investment offset a tentative recovery in housing.

States resynchronising

Last week's Standard & Poor's downgrade of the State of Queensland highlights the vulnerability of Australia's resource regions to the global economic cycle. Just as the past six months has seen the resynchronisation of Asian and G7 economic growth, so the coming year will see the convergence of Australia's different State economies. After outperforming the rest of the nation, Queensland and Western Australia are now experiencing the sharpest slowdowns and are likely, along with New South Wales, to suffer the weakest economic growth of all the States in 2009-10 (Figure 3).

Figure 3: State economies are rapidly converging



Source: ABS and ANZ

Data wrap

- The **wage price index** rose 1.2% in Q4 (4.3% YoY), largely in historical response to Australia's strong labour market. **Average weekly earnings** were also strong, rising 1.4% QoQ and 4.2% YoY.
- **Construction work done** unexpectedly rose 1.7% in Q4.
- **Capital expenditure** unexpectedly rose 6.0% in Q4, driven by a 12% rise in buildings and structures and a 1.0% increase in equipment & machinery.

Interest Rate Markets

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Rates markets buffeted by weak economy, deflationary forces and burgeoning supply

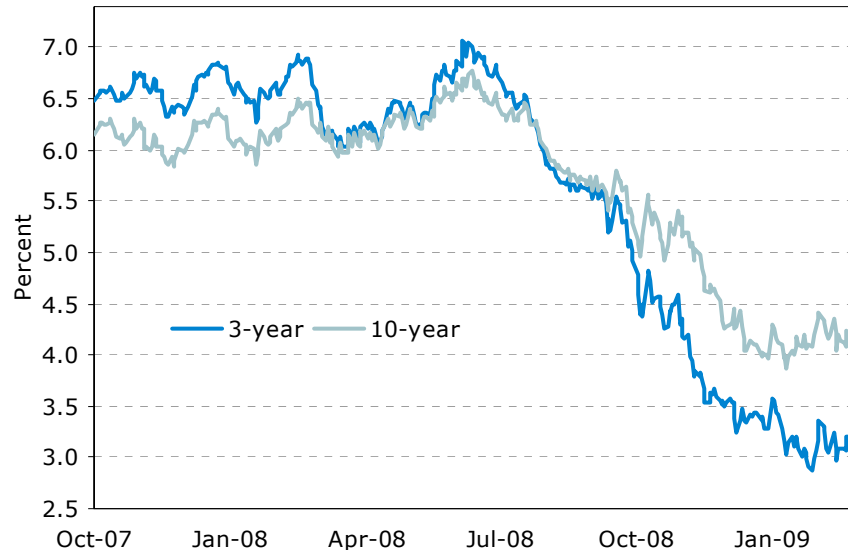
Global interest rate markets remain in a trading pattern influenced by weak economic and deflationary forces on the one hand and a surge in government bond supply on the other. Rising supply in the US treasury market seems to be winning out with term yields testing recent highs. The US 10yr T-Note is flirting with the early February yield level of 3%, after reaching a low 2.06% in late December last year. This uptrend in US yields comes despite still weak economic data and a new low for equity markets this week.

While US rates markets will remain pressured by large volumes of new supply from the US government, we are not expecting a sustained upward move for yields. Bond yields are most likely in the process of defining a trading range which we expect to hold through much of the first half of 2009. We may well be near the top of that range in yield terms at around 3% for the 10yr. If indeed this is the case then we could identify the 2% to 3% range as likely to hold for the next six months.

Australian yields drift higher, state yields sharply widen

In Australia term rates have drifted higher over the week but remain well supported. The 3yr government bond yield is currently around 3.25% (swap rate at around 3.65%). Government bond tenders, which are now held each Wednesday and Friday, have been well received. Tenders continue to achieve strong bid-cover ratios and small tails. Despite supply concerns in the US, there appears to be no such problems for the Commonwealth government as yet.

Figure 4: Australian government bond yields



Source: Bloomberg and ANZ

The big news for Australian rate markets this week was the downgrade of the State of Queensland last Friday evening. Standard and Poor's reduced the credit rating from AAA to AA+ (outlook stable) following the release of the Queensland Government's latest economic and fiscal update. The Queensland government's latest fiscal update, not unlike the Commonwealth government's revised numbers early this month, highlights a substantial deterioration in the government financial position in recent months.

For S&P, the recent deterioration in the budget position combined with an on-going commitment to capital expenditure and a larger borrowing program means that the Queensland Government's fiscal outlook is inconsistent with a AAA

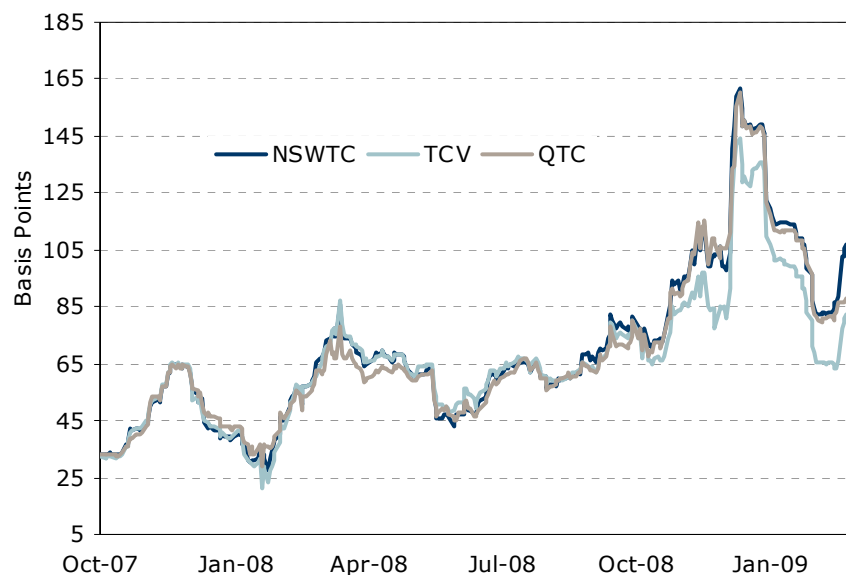
rating. The semi-government bond market has been impacted heavily with spreads to bond and swap moving wider rapidly.

And not only has QTC bonds been impacted. All semi government bonds are wider. Indeed, semi-government bonds are now yielding more than equivalent maturity government guaranteed bank paper when just a week ago these bonds generally had a yield around 25bp to 25bp lower than the government guaranteed banks.

Market pricing suggests all States are now being priced as a tangible risk of downgrade in the period ahead. With other states unlikely to report updated financials before the annual budget rounds in May/June, the market will continue to price a downgrade risk into the other states. State Government bonds now yield around 110bp to 130bp over the Commonwealth, which represents a significant yield pick-up on bonds that still represent a trivial default risk.

Apart from the financial pressure higher borrowing costs places on the States, those with large borrowing programs will be challenged to raise large quantities of money in such difficult market conditions. While the Federal government has historically resisted efforts to support State borrowing requirements, the potential for a significant retrenchment of State government spending and investment plans may coax Federal politicians into action.

Figure 5: 3-year Semi-Government bonds



Source: Bloomberg and ANZ

Rate of RBA cuts to slow, but continue

The market focus will now shift to next week's RBA meeting with a wide range of opinions on the likely outcome circulating in markets. If last week's testimony is any guide, it would appear that the RBA feels they are well ahead of economic developments and can now sit back and observe how the economy and markets react to recent stimulus. This is the 'pause' view and all else being equal appears to be the strategy favoured by the leadership of the RBA at present.

The other view is that the RBA needs to keep easing. The shocking growth and export numbers out of northeast Asia in recent weeks, in particular the collapse in Japanese exports, could be seen as genuinely new information that requires a further downward revision to Australia's growth outlook.

We expect a 25bp cut, as a compromise between leaving some rate cuts for later whilst continuing to provide fresh stimulus in the system.

FX: Markets falling out of bed with the Yen

Recommendation

The RBA cash rate and GDP announcements next week will keep the market on its toes. AUD sellers should look for opportunities above AUD/USD0.6620; buyers should target dips below 0.6330.

Overview

Last week the focus was on the decline of the EUR, this week it's the JPY's turn. The JPY has progressively lost its safe-haven status over the past few weeks as the market comes to grips with the perilous circumstances of the Japanese economy. The release of worse than expected GDP data showing that the economy contracted 3.3% in the December quarter convinced the market that the outlook for Japan was as bad, if not worse, than that for the US. The resulting sell-off has seen the JPY sink to USD/JPY97.87, its lowest level against the USD in over three months. The JPY has also been hit on the major crosses, although ultimately the currency's weakness has been driven by a broad rally in the USD. ANZ forecasts this trend to continue, with the USD/JPY to reach 102 by year's end and 112 by the end of 2010.

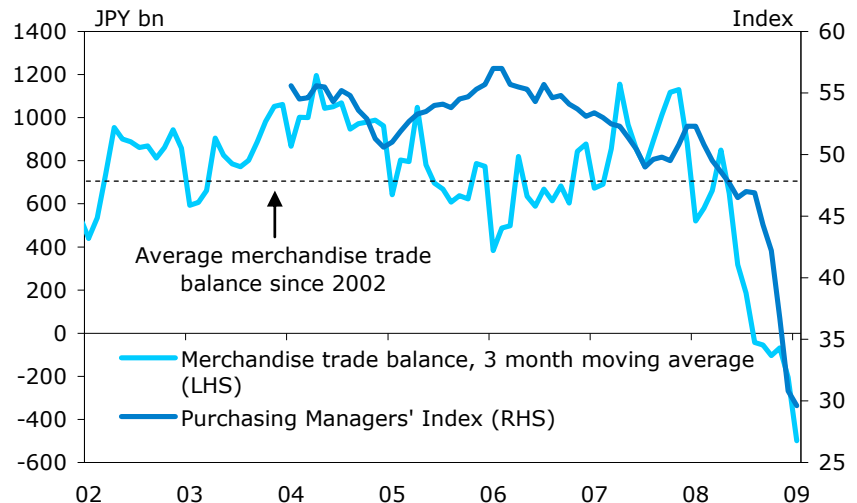
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Figure 6: Japanese export and manufacturing activity have plummeted



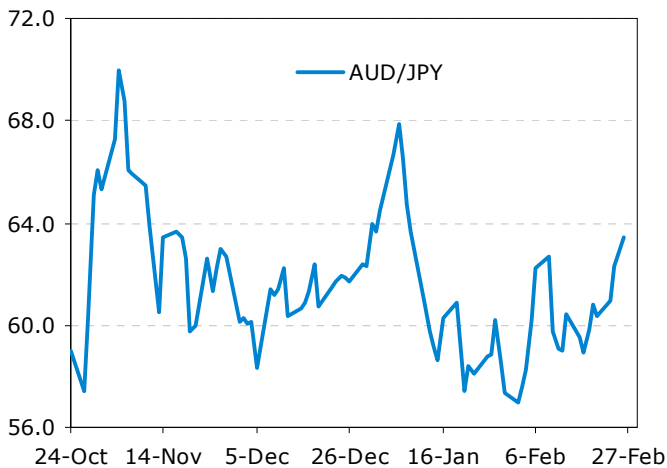
Source: ANZ & Bloomberg

The collapse in global demand and commodity prices has taken a sledge hammer to the Japanese economy, and to its manufacturing sector in particular. Accustomed to an average merchandise trade surplus of over JPY700 bn since 2002, the January trade deficit of almost JPY1 tr, driven by a 46% plunge in exports from a year earlier, indicates how little refuge the economy, and JPY in turn, can provide from the turmoil in the global financial markets. Combined with disappointing outcomes in high frequency economic indicators such as the Purchasing Managers' Index, this suggests that the recession will be deep and protracted. We forecast the economy will contract 3.8% in 2009.

In such an environment, the outlook for yield, and in turn, the JPY, is negative. Strong demand for USD flows will continue to see a depreciation in the JPY in the coming quarters, while the relatively more positive outlook for the US and European economies (with a shallower contraction and faster recovery expected) is likely to also weigh on the JPY.

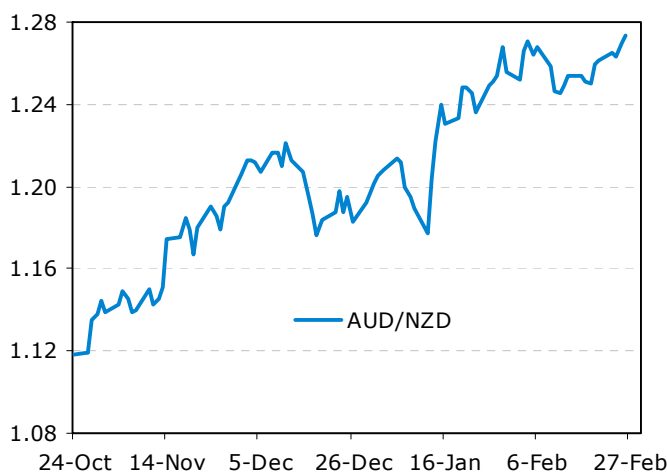
AUD/USD Key levels: 0.6250 – 0.6710. Tight range trading has persisted, with the AUD/USD grinding higher off a base around 0.6350. The strong correlation between the AUD and moves in equity markets has broken down in recent weeks, with the negative performance on the Dow not fully reflected in AUD/USD trading. Resistance has formed at 0.6550, with a sustained break likely to take the AUD/USD towards 0.6620. Downside support remains at the 2 February low of 0.6250.

AUD cross view



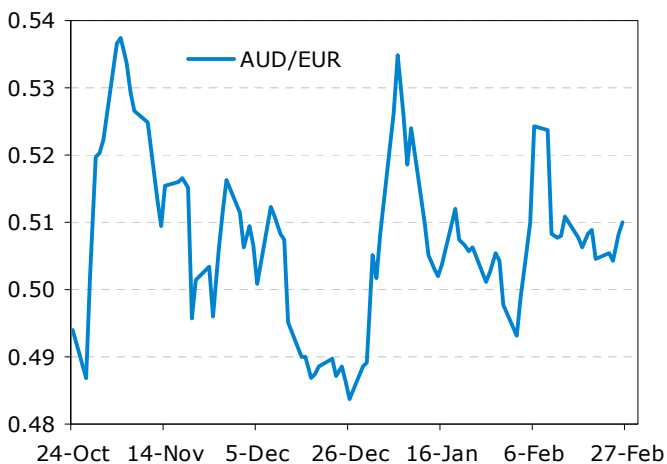
AUD/JPY Key levels: 58.50 – 68.00

- JPY weakness against the USD has boosted the AUD/JPY beyond last week's suggested topside level to a seven-week high of 63.70. Disappointing Japanese trade data released this week was another nail in the coffin to end the JPY's strong run since mid 2008. Further JPY weakness could see a break higher by the AUD/JPY to retest the 66.7 retracement level. Short-term support remains at AUD/JPY61.00 and then lower at 58.50.
- Consolidation around USD/JPY96 is possible before the next leg of JPY weakness takes hold to send the USD/JPY to 98 by the end of March.



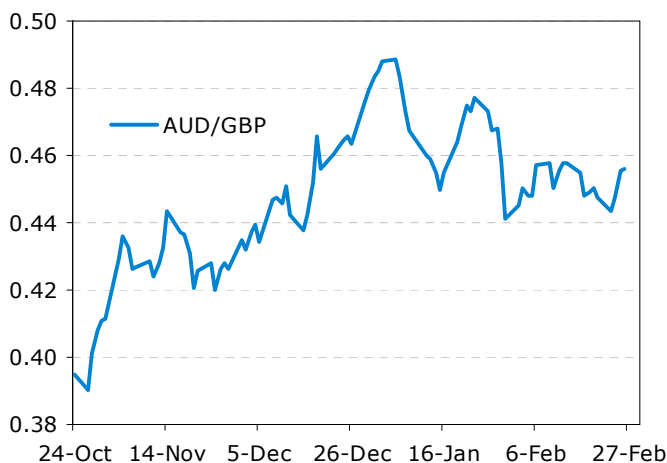
AUD/NZD Key levels: 1.2420-1.2810

- There have been few developments in the technical outlook for either the AUD/USD or NZD/USD over the past week. However, market sentiment has been more supportive of the AUD/USD, particularly due to its liquidity and the relatively more downbeat outlook for the NZ economy. This has driven the AUD/NZD higher to break above a key level at 1.2690, with the late-January high of 1.2810 the next test.
- Strong support remains at AUD/NZD1.2560, with a break lower likely to be capped above 1.2420.



AUD/EUR Key levels: 0.4980 – 0.5160

- Trading in a tight range, the AUD/EUR has ground towards a key resistance level at 0.5110. Good support remains above 0.5010, although a break lower from current levels could see the cross head towards 0.4980.
- Next week's ECB rate decision will mark a crucial point in EUR/USD trade next week. Markets are expecting a 50 bp cut to take the refinancing rate to 1.5% following February's decision to pause. Similar to our view on the JPY, we expect the EUR to weaken further through the year, with a commensurate decline in the AUD to keep the AUD/EUR broadly stable in 2009.



AUD/GBP Key levels: 0.4360 – 0.4600

- Expect some pull back in the GBP/USD over coming sessions following a sharp 4 US cent dip this week. AUD/GBP has surged above 0.4550, and could head towards the mid-month high of 0.4600 if the current rally is sustained. However, consolidation is the more likely option, with good support at AUD/GBP0.4420.
- The market is expecting the BoE to cut rates by 50 bps to 0.50% at its meeting next week. With virtually no ammunition left in its monetary policy arsenal, expect more talk around 'quantitative easing' measures in the Governor's statement in order to support the UK economy.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008f	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	3.8	-1.3	-0.4
Household consumption	4.3	2.2	0.4	1.1
Dwelling investment	2.7	1.6	-3.0	11.9
Business investment	13.9	12.7	-5.1	-10.0
Public demand	2.7	5.8	5.6	6.0
Domestic final demand	5.4	4.2	0.2	1.1
Inventories (contribution to GDP)	0.6	-0.2	-0.1	0.0
Gross National Expenditure (GNE)	5.9	4.0	0.1	1.1
Exports	3.3	3.9	-7.1	0.4
Imports	11.4	11.0	-5.0	1.0
Net Exports (contribution to GDP)	-1.7	-1.7	-0.3	-0.1
Gross Domestic Product (GDP)	4.0	2.3	-0.3	1.2
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	2.8	3.0
Underlying*	3.1	4.5	3.3	2.8
Wages	4.1	4.2	3.8	3.5
Labour market				
Employment (annual % change)	2.8	2.3	0.0	-0.3
Unemployment rate (%)	4.4	4.2	5.5	7.0
External sector				
Current account balance: A\$ bn	-68.2	-51.1	-56.6	-83.9
% of GDP	-6.3	-4.3	-4.6	-6.8

*Average of RBA weighted median and trimmed mean statistical measures.

Australian interest rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
RBA cash rate	3.25	3.00	2.75	2.50	2.50	2.50
90 day bill	3.16	3.45	2.80	2.80	2.80	3.15
3 year bond	3.21	2.55	2.75	2.85	3.15	3.65
10 year bond	4.25	3.90	4.15	4.15	4.25	4.55
3s10s yield curve	1.03	1.35	1.40	1.30	1.10	0.90
3 year swap	3.64	3.15	3.20	3.35	3.65	4.15
10 year swap	4.75	4.40	4.60	4.65	4.75	5.05
International interest rates						
RBNZ cash rate	3.50	2.75	2.50	2.50	2.50	2.50
NZ 90 day bill	3.25	3.04	2.85	2.77	2.75	2.75
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.50
US 2 year note	1.07	0.60	0.70	0.75	1.00	1.50
US 10 year note	2.91	2.90	3.20	3.75	3.80	4.20
Japan call rate	0.10	0.10	0.10	0.10	0.25	0.50
ECB refinance rate	2.00	1.50	1.25	1.25	1.25	1.75
UK repo rate	1.00	1.00	0.75	0.75	0.75	1.00

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.

Foreign exchange rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
Australia and NZ exchange rates						
A\$/US\$	0.6500	0.63	0.58	0.56	0.54	0.54
NZ\$/US\$	0.5113	0.50	0.45	0.43	0.41	0.42
A\$/¥	63.63	61.74	58.00	56.56	55.08	56.70
A\$/€	0.5101	0.50	0.48	0.50	0.49	0.50
A\$/£	0.4557	0.44	0.40	0.38	0.36	0.35
A\$/NZ\$	1.271	1.26	1.29	1.30	1.32	1.29
A\$/CA\$	0.8151	0.76	0.70	0.69	0.70	0.71
A\$/CHF	0.7601	0.76	0.73	0.75	0.76	0.77
A\$/CNY	4.444	4.31	3.97	3.83	3.69	3.69
A\$ Trade weighted index	55.10	53.62	50.30	49.40	47.94	48.01
International cross rates						
US\$/¥	97.9	98	100	101	102	105
€/US\$	1.274	1.25	1.20	1.12	1.10	1.08
€/¥	124.7	123	120	113	112	113
£/US\$	1.426	1.42	1.46	1.48	1.50	1.55
€/£	0.8934	0.88	0.82	0.76	0.73	0.70
US\$/CA\$	1.254	1.20	1.20	1.24	1.30	1.32
US\$/CHF	1.170	1.20	1.25	1.34	1.40	1.42
US\$ index	87.77	88.2	90.4	94.7	96.3	97.6
Asia exchange rates						
US\$/CNY	6.839	6.84	6.84	6.84	6.84	6.84
US\$/HKD	7.754	7.76	7.77	7.80	7.80	7.80
US\$/IDR	12025	11350	11500	11900	11600	11600
US\$/INR	50.15	49.00	49.00	48.00	48.00	47.00
US\$/KRW	1517.25	1375	1400	1400	1375	1350
US\$/MYR	3.673	3.64	3.74	3.80	3.80	3.80
US\$/PHP	48.215	47.50	48.50	49.30	49.50	49.50
US\$/SGD	1.534	1.54	1.58	1.62	1.66	1.66
US\$/THB	35.97	35.80	37.60	39.40	39.40	38.80
US\$/TWD	34.82	34.20	35.20	36.00	36.00	35.50
US\$/VND	17483	17500	17800	18100	18500	18500
Pacific exchange rates						
PGK/US\$	0.352	0.37	0.36	0.36	0.35	0.35
FJD/US\$	0.536	0.52	0.50	0.48	0.47	0.47

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