

Central banks at the crossroads

28 May 2009

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For ANZ Economics & Markets Research to be the most respected, sought-after and commercially valued source of economics and markets research and information on Australia, New Zealand, the Pacific and Asia.

Macro Update: Expectations confirmed

- Some unfortunate shocks have hit the economy this week. Sharp rises in term rates will potentially impede the transmission of monetary policy while the outbreak of influenza strain H1N1 will hurt confidence and activity.
- Meanwhile, this week's poor CAPEX survey confirms the downturn in business investment is only just beginning.
- Next week's economic data is likely to confirm the Australian economy is in recession with Q2 GDP expected to show a small contraction.
- This would be broadly in line with policy-makers expectations, so we continue to expect the RBA will stay on hold next week. Nevertheless, these downside risks should keep the RBA on an easing bias.

Interest Rate Markets: Curves steepen sharply

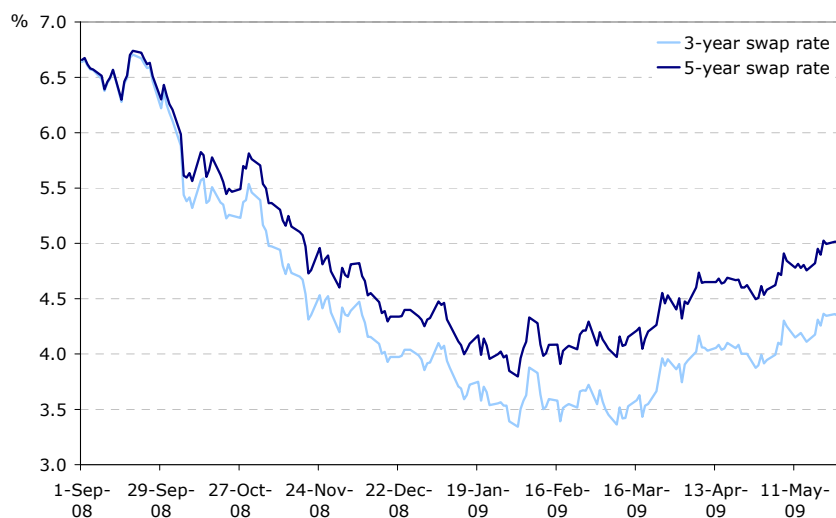
- Yield curves have steepened sharply in response to increased concerns over the sustainability of public finances.
- Local yields have matched the sharp rise for US Treasury yields. But we would expect the AUS-US 10-year bond spread to narrow.

FX: Next week key for medium term direction

- Recent USD weakness and AUD strength reversed overnight, and if this continues AUD/USD is subject to downside pressures.
- While our bias is that buyers of AUD should wait for better levels, we are at a crucial turning point. Technical levels discussed below should be watched carefully – if close to being breached, buyers may want to look at taking out additional cover.

Chart of the week

Figure 1: Australian swap rates at six-month highs



Source: Bloomberg

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Macro Update: Expectations confirmed

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Some unfortunate shocks

Last week we highlighted the concerns about the sustainability of the sharp rise in Chinese commodity import demand which has been providing good short-term support to Australian exporters. This week we have seen further threats to any continuation of the recent stabilisation in local economic activity, in the form of sharply higher term yields as well the arrival to Australia of swine flu, or influenza strain H1N1.

Influenza strain H1N1 has hit Australia. There are currently over 100 reported cases with warnings that it could possibly infect 10 to 20% of the total population over winter. Measures being taken to try to contain the spread of the influenza include quarantining infected persons and persons who have possibly been exposed to infection. This has seen schools and some businesses shut. At this stage, these closures have not been so widespread as to impact aggregate activity. But nevertheless, there is now a rising concern that travel and tourism as well as discretionary retail, hospitality and entertainment industries will all feel some negative affect as people bunker down at home. That said, the telecommunications and in particular the pharmaceuticals industries are likely to benefit.

Overall, the drag on the economy will be negative. While the magnitude will be small (and so not noticeable at this stage), it could potentially increase sharply should the number of influenza cases rise to the 'extremes' now being predicted.

Policy helping households, not businesses

Now to term rates. As outlined in the *Interest Rate Update* on p4, heightened concerns about government bond supply have prompted a significant increase in global bond yields. This has seen the Australian 3-year swap rate hit a 6-month high of 4.42% this week, a rise of around 110bp from its mid-February low. The 5-year swap rate has increased a similar amount to be at 5.055% today (see *Chart of the week* on p1).

The sharp rise in local term rates is a notable impediment on the transmission of monetary policy in Australia. As RBA Deputy Governor Ric Battellino noted in a speech this morning, despite aggressive policy interest rate cuts, corporate lending rates in Australia still remain above the 10-year average rate (Figure 2). In contrast, variable mortgage rates are around 1.7% below 10-year average rates. While households are receiving policy relief, this highlights the continued vulnerability of the Australian business sector to the current challenging environment. We continue to worry that the worst is yet to come for this sector, and as such unemployment.

Figure 2: Non-financial Corporate Bond Yields

	Maturity	Current rate	10-year average rate	Deviation from average
Australia	1-5 years	7.29	6.62	0.67
US	5-10 years	6.59	6.26	0.34
UK	5-10 years	7.04	6.43	0.61

Source: RBA

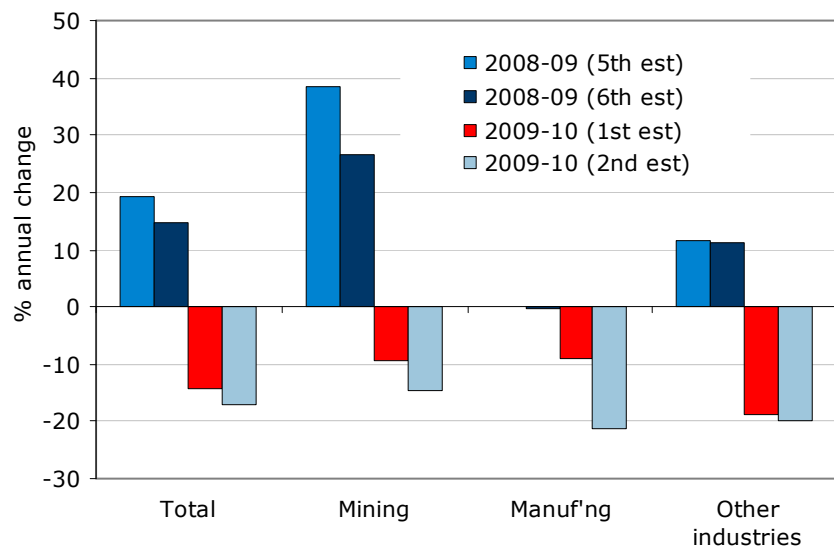
The business investment cycle turns

This week confirmed the long-expected downturn in business investment is commencing. Capital spending fell 8.9% in Q1, right at the bottom of expectations, with equipment, plant and machinery tumbling by 10.8%, the biggest quarterly fall since the survey began in 1987. The construction work done survey meanwhile showed that private non-residential activity fell by 6.3% with private engineering activity falling 6.1%.

After showing surprising resilience last quarter, the ABS CAPEX survey showed that investment intentions for the year ahead have been marked down sharply. Spending plans for 2009-10 were revised down by around 10% in the last three months as reduced demand and more difficult financing conditions reduce appetite (and perhaps ability) for investment expansion, at least for now. Figure 3 below shows investment intentions were marked down across all major industries.

Average 5-year realisation ratios would imply investment spending will be flat in 2009-10 but 'recessionary' scenarios, which are likely to be more appropriate in the current context, imply business investment could fall by around 20% next financial year. This is broadly in line with our expectations, and is also unlikely to be different from the RBA's internal forecasts. Hence, while there is nothing 'new' in this week's CAPEX survey and so no trigger for a rate cut next week, it does confirm the challenges facing the Australian economy in the second part of this year. With rising term rates negatively impacting businesses further, this should be enough to see the RBA maintain an easing bias in the months ahead.

Figure 3: Expected investment expenditure*



Source: ABS and ANZ *2008-09 expected investment implied from average 5-year realisation ratio. 2009-10 expected investment implied from 1991-92 realisation ratio.

Recession expected to become 'official'

As these storm clouds to growth gather, next week's (heavy) data flow is expected to confirm the Australian economy is in recession. Q1 GDP will be released on Wednesday and at this stage we expect another contraction in growth, albeit of 0.2% which is below Q4's 0.5% decline. Falling business and dwelling investment as well as weaker employment and profits is likely to offset higher consumption (thanks to policy stimulus) and a boost from net exports.

Data wrap

- The **WBC leading index** rose 0.3% in March, the first rise in seven months.
- **DEWR skilled vacancies** fell 7.0% in May, the 18th consecutive monthly fall.
- **Construction work done** fell 3.7%, led by sharp falls private engineering and non-residential work done.
- **Private capital expenditure** fell 8.9%. Investment intentions for 2009-10 were revised down by around 10%.

Interest Rate Markets: Curves steepen sharply

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- Yield curves have steepened sharply in response to increased concerns over the sustainability of public finances.
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Yield curves steepen

There has been a significant rise in longer-dated yields over the past week as concerns over the sustainability of public finances has come to the fore. US 10-year yields are now up by nearly 1.7% from the lows seen at the end of last year and are at their highest level since November 17. The difference between US 2-year and 10-year yields is at the widest level on record (2.75%) as shorter-dated yields are being anchored by extraordinary low official cash rates.

Local bond yields have followed a surprisingly similar path to the lead being set in the US. The yield on the 10-year ACGB bond is at the highest level since last October touching 5.5%. The spread between AUS 3 and 10-year yields is at 132bp, levels not seen since May 1994.

With home loan rates priced of the long end of the curve, the rise in bond yields could serve to push up US mortgage rates. This may threaten the tentative signs of a bottoming out in the US housing sector. Petrol prices are also rising with the rally in oil prices to 6-month highs above \$US63 a barrel. These factors represent additional headwinds for US households that will weigh on the scope for a strong economic rebound later in the year.

The sell-off in US Treasuries has taken place despite some positive market developments in recent days. There has also been strong investor demand for the 2 and 5-year bond auction this week with good bid/cover ratios and notably strong demand from "indirect" bidders such as foreign central banks. And Moodys Investors Services has reaffirmed the AAA rating of the US despite the significant deterioration in US public finances.

Concerns over the diversification of global central bank reserves away from the USD appear to be a key driver in the sell-off this week. But the AUS-US bond spread has yet to narrow markedly despite the continued rise of the AUD as part of this theme.

The historic nature of this steepening of yield curves can be seen in the chart below.

Figure 1: The AUS and US yield curves



Source: ANZ & Bloomberg

US yield curve steeper than 1990's recession

The move to a new record high for the US curve is particularly striking as this takes the 2s10s spread beyond what was seen in the early 1990s recession. While higher borrowing costs are another headwind for households and the corporate sector, this will aid in the recapitalisation of the banking system as banks borrow relatively less expensive short-term funds while lending funds at higher rates over longer maturities.

For Australia, the curve is at the highest level in over 16 years, but is not yet at the extremes seen during that early 90s downturn, which was around 190bps. To reach such levels, we would probably have to see RBA rate cuts come back into focus later in the year while long-term yields continue to sell-off. But outright yields above 5.5% look attractive.

The weak CAPEX data released today supports our expectation for a negative GDP release next week and highlights how a downturn in investment will be a key drag on growth later in the year. We also expect a significant weakening in the labour force over coming months to highlight that the risks on monetary policy remains clearly skewed to the downside. This raises the prospect the yield curve could steepen further and a revisiting of a 1990's recession-type curve can not be ruled out.

Further issuance may be an issue

Supply will continue to be an issue for US bond markets as bond tender programs continue to rise. The US Treasury will be issuing a total of \$US102bn of bonds this week with the \$US26bn 7-year notes auction tonight.

This should support some narrowing in the AUS-US 10-year spread. Australian bonds have surprisingly sold off in line with the sharp rise in longer-dated US bond yields. This is despite less concern around over supply in the Australian market.

This particularly sharp rise in US bond yields also poses a major challenge for the Fed's policy of quantitative easing. Will they now step up the purchases of Treasuries to stop bond yields rising further? This could limit the narrowing of the AUS-US spread in the near-term, but such purchases would most likely only have a temporary impact as we have seen with current QE policies.

With the likelihood that the yield curve will remain at historically higher level, it is now unlikely that we will see 10-year yields below 4.5% as we previously thought. But we still expect yields to get back below 5.0% in coming months while 3-years should head back towards 3.5%. We are still expecting the AUS-US spread to head back under 150bps from current levels around 180bps.

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FX: Next week key for medium term direction

Recommendation

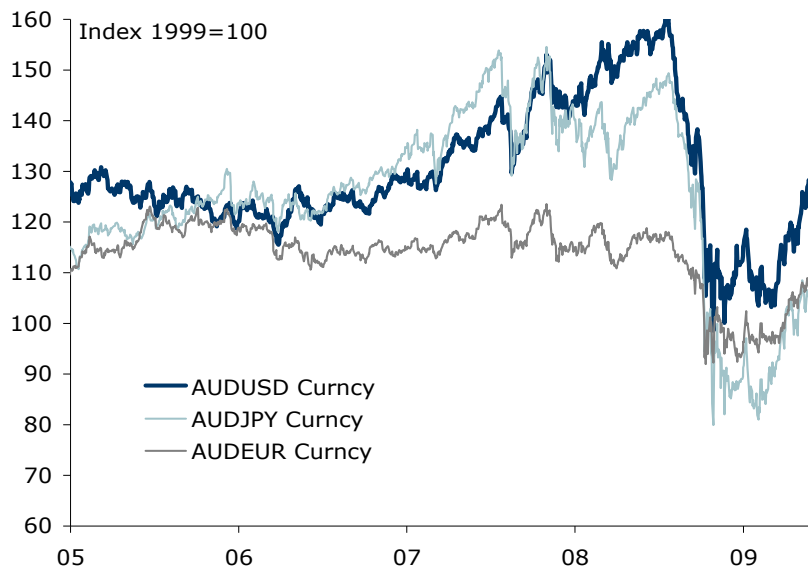
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Overview

Over the past few weeks, the main driver for the AUD has been a weakening USD. The broad USD trade-weighted index has fallen precipitously from 84.87 at the start of this month to a low of 79.8 on 23 March. It is in this context that AUD/USD rose to a post-September high of 0.7891 this past week. Though this rise in the benchmark AUD/USD makes the AUD seem strong, the AUD has not outperformed on key crosses, remaining with a trading range of AUD/EUR0.5560 – 0.5560 and AUD/JPY73-75 this week.

Looking at the bigger picture, the AUD/USD is now 6% above its long-term average since the 1982 float (on a nominal basis). However, AUD/JPY and AUD/EUR are both 5% below their long-term averages (taken since the 1999 which represents the last JPY collapse and the introduction of the EUR). If looking just at the period since 1999, AUD/USD is now 13% against that 10-year average.

Figure 1: AUD strong versus USD, but not on crosses



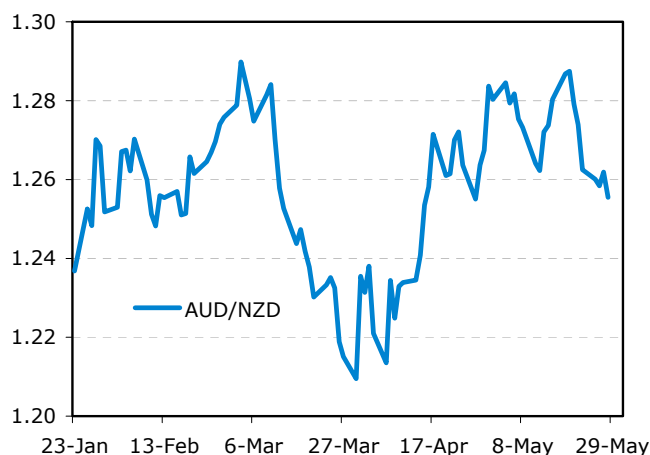
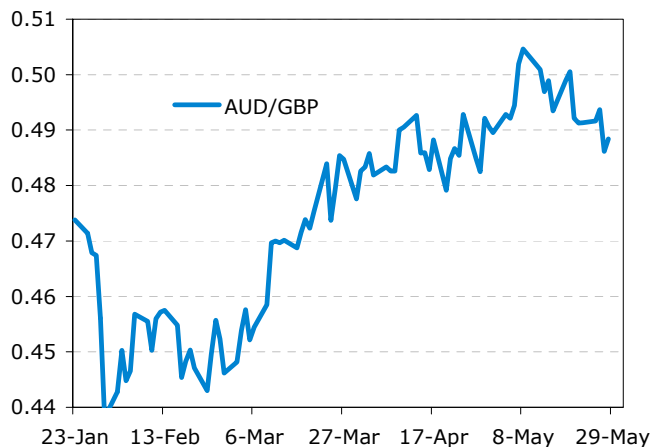
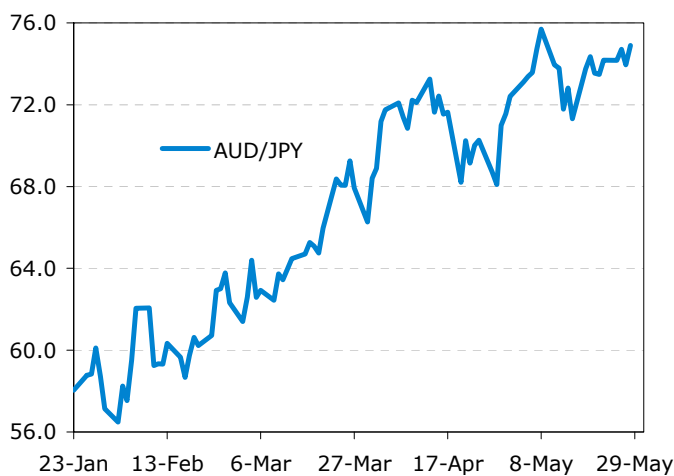
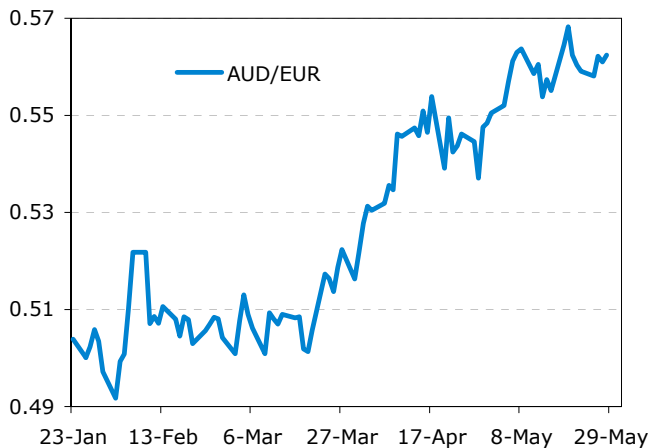
Source: ANZ, Bloomberg

The coming week is going to be a crucial test for the USD – and by extension the AUD’s performance against the G3 currencies – as we have the RBA, ECB, BOE and BoC all meeting in the week ahead. Market dynamics are also becoming interesting as the USD strengthened overnight in response to surging long-term US Treasury yields. Our medium-term forecasts are based upon on the view that the USD will gradually recover against the EUR, JPY and GBP over the coming 12-18 months - as such, we believe that the USD weakness we saw overnight is the start of a more enduring retracement. However, an extension of USD weakness would threaten that view and potentially a substantial forecast revision.

From a technical perspective, a weekly close above the following levels would cause us to re-evaluate our broad USD forecasts: EUR/USD above 1.43; GBP/USD above 1.62 and USD/JPY below 93.5. The key level for AUD/USD remains 0.7930. If we do significantly revise our medium-term forecasts in the direction of a weaker USD, this argues for a further upgrade to our AUD/USD forecast.

AUD/USD Key levels: 0.7475 – 0.7930. The pivot point of 0.7700 would open up room for further downside toward 0.7600, then 0.7475. Key resistance remains at USD0.7930 (50% retracement level between the 2008 high and low).

AUD cross view



AUD/EUR Key levels: 0.5530 – 0.5710

- AUD/EUR underperformed the AUD/USD slightly this week, failing to reach a new high after last week's spike. AUD/EUR remains just below the bottom of its long-term trading range of 0.5700-0.6300, and around the level where AUD/EUR collapsed in October 2008.
- European data has been mixed, with the German IFO survey underwhelming. German unemployment tonight and next week's ECB meeting will be a key event. Some ECB officials have suggested this week the ECB could still cut rates, and others have suggested the ECB could expand its covered bond purchase program.

AUD/JPY Key levels: 67.50 – 75.30

- USD/JPY strength has kept the AUD/JPY capped at 75 despite rallying equity markets, falling volatility and evidence of increased risk appetite. A weaker JPY could lead the AUD/JPY to break these key levels but with AUD also being mainly driven by USD weakness our bias is that AUD/JPY will remain capped by recent highs.
- Upcoming data releases out of Japan include April CPI and industrial production – a key indicator of global IP trends. However, global risk appetite and the fortunes of the USD are likely to remain the main drivers of JPY.

AUD/GBP Key levels: 0.4790 – 0.5050

- GBP/USD has been a surprising outperformer, rising briefly to a post-October high just above 1.60 this week. This underlines the extent of USD weakness, as GBP rallied in the face of S&P putting the UK's sovereign rating on negative outlook, and all indications that the BOE will keep rates low and expand QE for the foreseeable future. AUD has significantly underperformed GBP over the past week – this trend is likely to remain.
- There are no key data out over the next several days. The BOE meets late next week with no rate cut expected, but potential extension of QE on the table.

AUD/NZD Key levels: 1.2490 - 1.2700

- The release of a conservative budget out of NZ today prompted S&P to raise its outlook on the sovereign long-term foreign currency rating from "negative" to "stable". This has removed a cloud hanging over NZD, and prompted NZD/USD to rally by 60 points today from 0.6130 to 0.6190, opening up a possible extension toward 0.6315.
- The S&P announcement puts significant downside pressure on the AUD/NZD cross, as the NZD may continue its rally. A move below 1.2490 risks a fall back toward 1.2200.

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	-1.8
Household consumption	4.3	2.1	0.4	1.0
Dwelling investment	2.7	2.0	-6.5	9.0
Business investment	13.8	13.2	-9.7	-15.9
Public demand	2.8	5.0	2.0	5.8
Domestic final demand	5.4	4.1	-1.5	-0.1
Inventories (contribution to GDP)	0.6	-0.6	-0.7	0.8
Gross National Expenditure (GNE)	5.9	3.5	-2.2	0.8
Exports	3.2	4.7	-4.9	-1.3
Imports	11.5	10.6	-12.2	1.8
Net Exports (contribution to GDP)	-1.8	-1.4	2.0	-0.6
Gross Domestic Product (GDP)	4.0	2.1	-0.9	0.6
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	4.1	4.2	3.8	3.4
Labour market				
Employment (annual % change)	2.8	2.2	-0.3	-1.0
Unemployment rate (%)	4.4	4.2	6.1	8.0
External sector				
Current account balance: A\$ bn	-68.1	-50.1	-52.2	-77.4
% of GDP	-6.3	-4.2	-4.4	-6.5

*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	3.00	2.50	2.00	2.00	2.00
90 day bill	3.18	3.20	2.30	2.30	2.30	2.35
3 year bond	4.14	3.95	3.65	3.60	3.80	3.80
10 year bond	5.43	5.45	5.05	4.80	4.90	4.80
3s10s yield curve	1.29	1.50	1.40	1.20	1.10	1.00
3 year swap	4.37	4.30	3.95	3.90	4.10	4.10
10 year swap	5.82	5.95	5.45	5.15	5.20	5.10
International interest rates						
RBNZ cash rate	2.50	2.50	2.25	2.00	2.00	2.00
NZ 90 day bill	2.79	2.85	2.43	2.35	2.35	2.35
US Fed funds note	0.25	0.25	0.25	0.25	0.50	1.00
US 2 year note	0.97	1.00	0.90	0.85	1.25	1.50
US 10 year note	3.74	3.75	3.65	3.55	3.75	3.90
Japan call rate	0.10	0.10	0.10	0.25	0.50	0.50
ECB refinance rate	1.00	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\$	0.7771	0.72	0.68	0.66	0.65	0.65
NZ\$/US\$	0.6174	0.54	0.51	0.48	0.47	0.47
A\$/¥	74.95	75.60	73.44	72.60	75.40	75.40
A\$/€	0.5624	0.56	0.56	0.55	0.55	0.56
A\$/£	0.4882	0.49	0.46	0.45	0.43	0.42
A\$/NZ\$	1.258	1.33	1.33	1.38	1.40	1.38
A\$/CA\$	0.8726	0.89	0.84	0.83	0.83	0.83
A\$/CHF	0.8498	0.86	0.84	0.86	0.90	0.92
A\$/CNY	5.305	4.92	4.64	4.51	4.43	4.43
A\$ Trade weighted index	62.80	61.23	58.85	57.40	56.89	56.65
International cross rates						
US\$/¥	96.5	105	108	110	116	116
€/US\$	1.382	1.28	1.22	1.20	1.18	1.16
€/¥	133.3	134	132	132	137	135
£/US\$	1.592	1.48	1.48	1.48	1.50	1.53
€/£	0.8681	0.86	0.82	0.81	0.79	0.76
US\$/CA\$	1.123	1.23	1.24	1.25	1.27	1.28
US\$/CHF	1.094	1.19	1.24	1.30	1.38	1.41
US\$ index	81.02	87.8	90.8	92.1	93.8	94.6
Asia exchange rates						
US\$/CNY	6.828	6.83	6.83	6.83	6.82	6.82
US\$/HKD	7.753	7.75	7.75	7.76	7.76	7.77
US\$/IDR	10363	11500	11900	11500	11500	11000
US\$/INR	47.93	52.00	51.00	51.00	50.00	50.00
US\$/KRW	1268.9	1400	1450	1400	1325	1300
US\$/MYR	3.524	3.70	3.75	3.75	3.70	3.65
US\$/PHP	47.634	49.50	50.00	49.50	48.80	48.50
US\$/SGD	1.456	1.58	1.60	1.62	1.63	1.61
US\$/THB	34.44	36.50	37.50	37.00	36.50	36.00
US\$/TWD	32.64	32.70	32.00	32.00	31.00	30.00
US\$/VND	17793	18300	18800	18800	19300	19300
Pacific exchange rates						
PGK/US\$	0.371	0.35	0.34	0.35	0.35	0.36
FJD/US\$	0.474	0.43	0.42	0.40	0.39	0.39

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