

## No escaping the global storm

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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: A tough year ahead

- GDP data showed that Australia suffered a substantial shock from the global downturn in the December quarter.
- The sharp fall in corporate profitability and evidence of distress in the manufacturing sector does not augur well for employment and business investment.
- We now expect Australian GDP to contract by 0.5% in 2009, followed by a very mild 1% recovery in 2010.

### Interest Rate Markets: RBA to ease in April; don't rule out a 50bp move

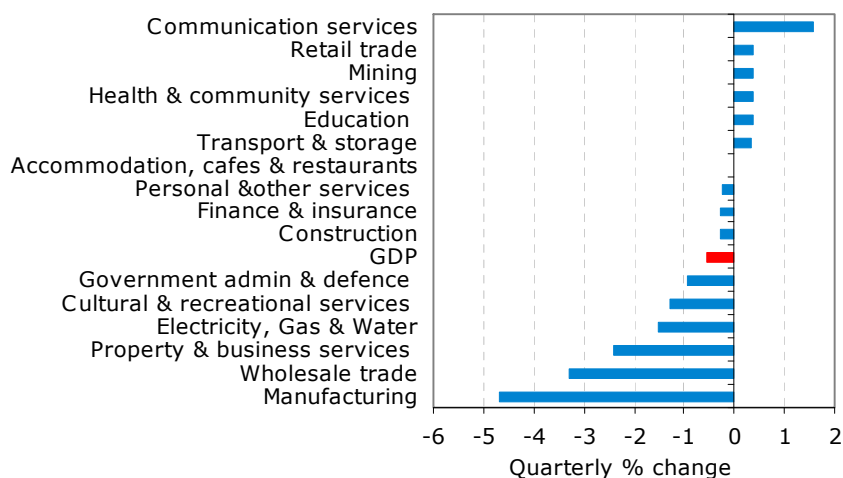
- We expect the Australian cash rate to hit a terminal rate (low point) of 2% by the end of 2009 (our previous forecast low was 2.5%).
- The economy looks like it is in recession and the worst of the fall-out from the international financial crisis is still to come. We expect the RBA will respond with another 50bp of rate cuts by mid year. This may come in the form of single 25bp moves in April and May. There is however, a tangible risk of a 50bp cut in April if the situation deteriorates further.

### FX: Downside risk for the AUD increases

- Employment data in both the US and Australia will be crucial for FX markets this week, while the upcoming New Zealand interest rate decision will keep the AUD/NZD cross volatile.
- The AUD's fundamental medium-term story has taken a decided dip south. The risk is that the sub-0.50 lows of 2001 could be retested late in 2009, and that the AUD's subsequent recovery could be slower than currently forecast.

### Chart of the week

Figure 1: Few industries were resilient in Q4



Source: ABS and ANZ

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## Macro Update: A tough year ahead

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- The sharp fall in corporate profitability together with evidence of distress in the manufacturing sector does not bode well for employment and business investment.
- We now expect Australian GDP to contract by 0.5% in 2009, followed by a very mild 1% recovery in 2010.

### Australian business sector looking increasingly vulnerable

GDP data showed that Australia suffered a substantial shock from the global downturn in the December quarter. Real GDP fell by an unexpectedly large 0.5% in the December quarter, following marginal growth of 0.1% in the September quarter. **The non-farm economy is in recession**, contracting by 0.2% and then 0.8% in the September and December quarters.

Not only did this economic contraction come at an earlier point in the downturn than expected, but **the data emphasized some key areas of vulnerability in the Australian economy, particularly in the business sector**. This has prompted us to revise down our economic growth forecasts even further.

**Of key concern was the level of distress in the manufacturing sector** which still represents 10% of the economy. Manufacturing production dropped sharply in the quarter, as evidenced by a 4.7% drop in gross value added in the quarter (see Chart of the Week on the front page). Instead, manufacturers chose to run down inventories, with manufacturing inventories falling a massive \$2.1bn.

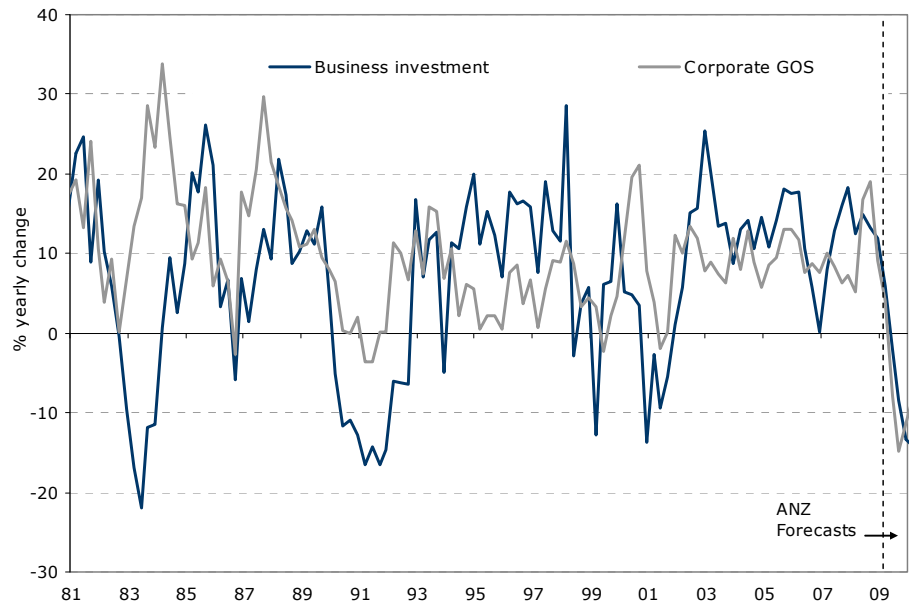
While some have argued that the huge run down in inventories will help to avoid further large falls in production, we are sceptical. Surveys show that the local manufacturing sector is at the forefront of this economic downturn and reports of local factory closures suggest **production in this sector will contract further this year**. We also don't subscribe to the view that the sharp drop in inventories was unintentional and hence will be unwound. Manufacturing stocks have now fallen for three consecutive quarters and experience from previous recessions suggests this can continue for many quarters to come. Hence, while inventories may well add to economic growth next quarter (because any run-down in stocks is likely to be smaller than in Q4), this is likely to be offset by further contractions in production.

The second major concern was the sharp **deterioration in corporate profitability** in the quarter of 5.4% (as measured by the corporate gross operating surplus). Not only was the fall in profits broad-based across industries, but this has occurred prior to the sharp adjustment in mining profits that we know will come following the re-setting of iron ore and coal contract prices from April onwards. It now seems that corporate profits will fall by a total of over 20% between the September quarter 2008 and the December quarter 2009.

**The more difficult outlook for corporate profits does not augur well for business investment and employment (see Figure 2 below)**. We are now expecting business investment to fall by 4.7% in 2009 and for the unemployment rate to rise to 6½% by the end of 2009 and to 7½% by mid 2010. However, we still don't envisage the correction in business investment and employment to be as severe as in previous recessions. This is for two key reasons. Firstly, businesses entered this global downturn from stronger balance sheet position, with gearing ratios lower and interest cover ratios higher. And secondly, businesses have received greater interest rate relief thanks to aggressive rate cuts from the RBA, even if this has been offset to some degree by higher risk premiums and more difficult funding conditions. As such, we do not anticipate the imperative to reduce labour and investment costs urgently to be as great as in the 1990s recessions when the unemployment rate rose by 5.3ppt from peak to trough (our current forecast is for a 3.6ppt increase) and where business investment fell by 47% from peak to trough. **Nevertheless, a**

**sharper adjustment in the business sector is now the biggest risk facing Australia over the next twelve months.**

**Figure 2: Lower corporate profitability to weigh on business investment**



Source: ABS and ANZ.

News on the building sector was not much better. **The sharp fall in building approvals in January confirmed that dwelling investment and non-residential construction will be a significant drag on growth throughout much of 2009.** Non-residential building approvals have more than halved over the past year in value terms and the number of residential building approvals has fallen by a third.

The other key takeaway from this week's GDP data was evidence that **we cannot rely on household consumption to drive economic activity in the short term.** The sharp improvement in household disposable income and savings in Q4 is a positive story longer term as it means households will be more resilient to the coming rise in the unemployment rate and any other economic shocks. But with confidence shattered and the prospect of unemployment a key concern, we cannot expect households to increase their levels of spending and to drive growth through 2009.

So with household consumption growth weak, and business investment and dwelling investment to contract sharply, **we now expect economic growth to fall by 0.5% over the course of 2009 followed by anaemic 1% growth in 2010.**

#### Data wrap

- **Real GDP** contracted by 0.5% in the December quarter 2008, to be just 0.3% higher in YoY terms.
- **Retail sales** rose 0.2% in January following a 3.8% increase in December. The increase was largely driven by food and cafes and restaurants retailing.
- **The TD Securities Inflation Gauge** rose by 0.7% in February (3.1% YoY) largely driven by higher petrol prices and other seasonal increases.
- The **AIG Performance of Manufacturing Index** fell sharply to 31.7 in February from 36.6 in January. The **Performance of Services Index** fell even more sharply to 32.2 in February from 41.0 in the previous month.
- The Business Indicators Survey showed a 6.5% fall in **company gross operating profits** and a 1.9% drop in **inventories** in Q4.
- The RBA left the **cash rate** unchanged at 3.25% at its March Board Meeting.

## Interest Rate Markets

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- We expect the Australian cash rate to hit a terminal rate (low point) of 2% by the end of 2009 (our previous forecast low was 2.5%). Although the RBA left rates unchanged this week, we expect further near term rate cuts on the back of weaker global data and the surprisingly weak Q4 GDP data. Financial fragility will add to the case for another cut in April.
- The economy looks like it is in recession and the worst of the fall-out from the international financial crisis is still to come. We expect the RBA will respond with another 50bp of rate cuts by mid year. This may come in the form of single 25bp moves in April and May. There is however, a tangible risk of a 50bp cut in April if the situation deteriorates further over the month ahead.

### RBA to ease in April; don't rule out a 50bps move

Recent global economic data suggests an even more substantial contraction in global industrial production is in process. A slump in key north Asian economies does not bode well for our exports to these markets over the year ahead. As mentioned last week, we have revised down our forecasts for Australia's export prices and volumes for both 2009-10 and 2001-11.

**Figure 3: Swaps and the cash rate**



Source: ANZ and Bloomberg

The economy looks like it is entering recession and the worst of the fall-out from the international financial crisis is still to come. We expect the RBA will respond with another 50bp of rate cuts by mid year. This may come in the form of single 25bp moves in April and May. **There is however, a tangible risk of a 50bp cut in April if the situation deteriorates further over the month ahead.**

Although the RBA may cut by 50bp in April we believe the period of out-sized rate cuts is now behind us. The cash rate is now 3.25% compared to our assessment of the neutral rate of somewhere between 5% and 6%. It is the RBA's practice to be more conservative in their policy adjustments the further the cash rate is from neutral (both on the upside and downside). Thus we expect rate adjustments to be more measured; we favour movements of 25bp.

The pace of easing will become more gradual. Past fiscal and monetary stimulus is showing up in the data (retail sales, consumer confidence, housing finance, auction clearance rates). Although the underlying momentum of economic activity is downwards, a 3.25% cash rate is already set for a weak economy. **The trigger for further rate cuts is likely to be either evidence that past policy actions are not working to arrest the slide in demand in the**

**economy (renewed weakness in retail sales, demand for credit) or a more explosive rise in unemployment than is currently projected.**

Given the uncertainty around these factors we are characterising our forecast path for rates as a guide that will be adjusted as new information comes to light. We have another 25bp rate cut in May, followed by 25bp a cut every other month through to November. At this stage the main risk appears to be for a longer 'pause' that keeps the cash rate steady through the State and Federal Budget period (May/June) which would then be followed by a new phase of easing over the second half of 2009.

### Market expectations

Money markets have a terminal rate of just below 2.2% priced in for November 2009. Most of the anticipated easing from current levels is priced into the next few months with the market factoring in a 39bp cut for April (a cash rate of 2.86%) and 97bp in total by August.

We view the primary risk to our forecasts, market pricing and market expectations as lower rates. The Bank of Canada, ECB and BoE cut rates this week by 0.5%. Official interest rates in Canada and the UK now stand at 0.5% and the BoE has announced a large expansion of the money supply by buying Government and corporate debt – quantitative easing.

**It will be important for Australia to maintain some interest rate premium to the rest of the world** in order to effectively attract the necessary foreign debt capital required to fund our current account deficit.

Australia's cash rate has, on average, been set about 175bp above the US Federal Funds rate since the early 1990s. It is interesting to note that when the Australian cash rate was on par or below the funds rate in the late 1990s, we saw a period of sustained currency weakness soon after. If G-10 rates trough at somewhere between zero and 0.5% on average then Australia's cash rate could go as low as 1.5%.

### Outlook for borrowers

All of the above means that terms yields are unlikely to rise much in current conditions, even if the RBA is only likely to move in incremental steps from here after such an aggressive easing cycle in the previous 5 months. We are not convinced that yields will necessarily hit new lows over this period considering rising Government supply to fund the stimulus and the mature phase of this easing cycle, but there will clearly be opportunities to lock in longer-term borrowing costs at favourable rates once the RBA comes back into play (see Figure 3 above).

Recent lows for swap rates were posted in February. The 2-year swap dipped to 2.93% while the 5-year rate hit 3.75%. The steepening of the yield curve can also be inferred from Figure 3 above. The curve is likely to remain steep while the market expects the RBA to maintain an easing bias. **So we would recommend setting targets near previous lows around 3.0% and 4.0% respectively to fix longer term funding before there are clearer signs of stabilisation in the major economies and asset markets.**

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## FX: Downside risk for the AUD increases

### Recommendation

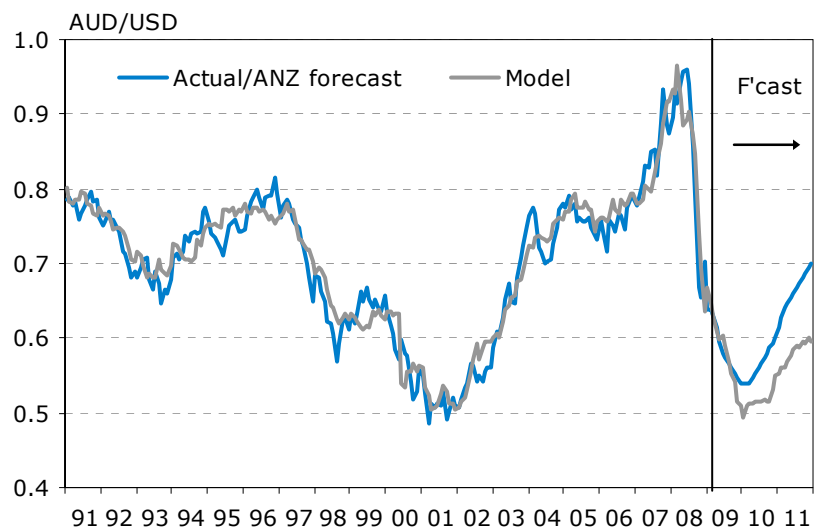
Currency markets are braced for another round of dismal employment numbers due to be released this week. The risk of better than expected US non-farm payrolls tonight or a rise in the Australian employment numbers on Thursday could stimulate short-term rallies. Buyers should take advantage of any moves below 0.6250, while sellers should look for rallies above 0.6480.

### Overview

Range trading has been a persistent theme for the AUD/USD in 2009, albeit with a progressive downward trend. This week was no exception, with a 0.6285 - 0.6530 band observed. The AUD took a beating from a worse than expected Q4 Australian GDP result, although reports of a second Chinese fiscal stimulus package encouraged new hope about the economic outlook and drove a 2½ US cent rally. However, heightened concerns about the health of the US financial sector have since sent the US equity market sharply lower, with a subsequent rise in risk aversion pushing the AUD/USD below 0.64.

Although short-term volatility has tended to cloud the broad direction of the AUD/USD, the fundamental medium-term story has taken a decided dip south. With the Australian economy unable to escape the downward drag of the global environment and now verging on official recession, we have lowered our expectations for interest rates in 2009 and beyond (see *Interest Rate Markets* piece on previous pages). Further, the track for commodity prices, particularly for hard resources, is now forecast to be lower in light of persistent declines in global demand. These developments imply important downside bias to our outlook. The risk is that the sub-0.50 lows of 2001 could be retested late in 2009, and that the AUD's subsequent recovery could be slower than currently forecast.

**Figure 4: The AUD/USD could retest 2001 lows**

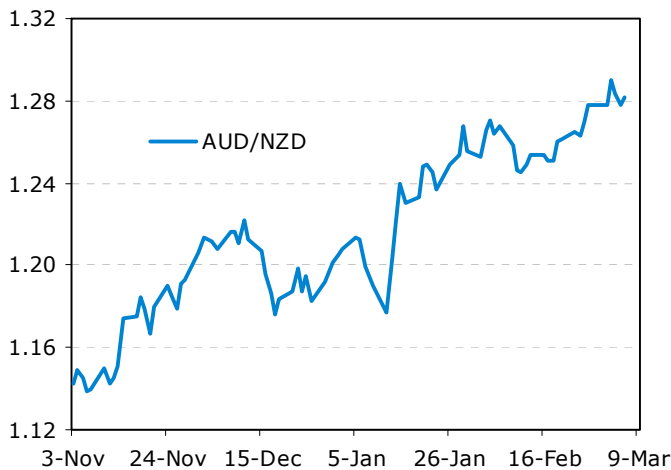


Source: ANZ, Bloomberg & RBA

This week also saw a continuation of the strong USD story, with the USD Index rising to a three-year high. This helped to support the AUD on the major crosses, although some consolidation has since developed. Against the NZD, the AUD reached a seven-month high of AUD/NZD1.2936, with the NZD pushed below the psychologically important NZD/USD0.50 level. However, recent moves in the AUD/NZD could retrace next week if New Zealand monetary policy is eased by less than the 75 bps expected by the market.

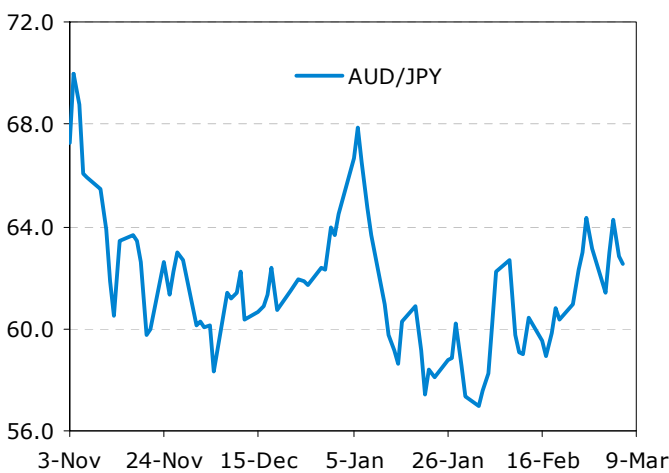
**AUD/USD Key levels: 0.6010 – 0.6550.** Range trading for the AUD has taken another leg south. Significant upside resistance remains at 0.6550 (50% retracement between February's low and high), with the currency unable to sustain any break above this level over the past two weeks. Good support persists at 0.6250, with the October low of 0.6010 forming the major floor.

## AUD cross view



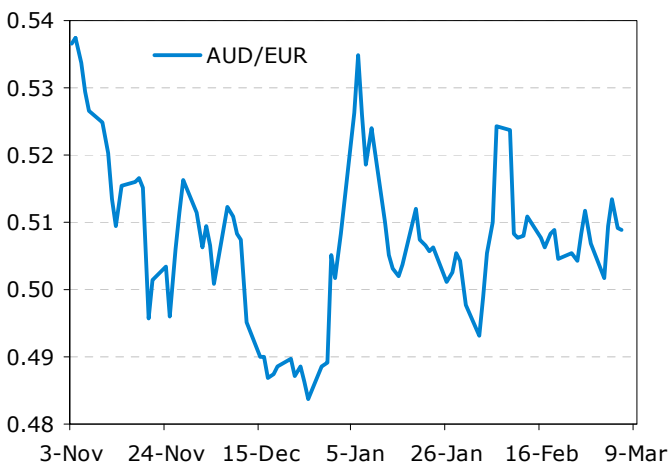
### AUD/NZD Key levels: 1.2580-1.2970

- The AUD/NZD broke above last week's suggested levels, reaching a seven-month high of 1.2936. The cross is likely to remain above 1.27 through the coming week, with the NZD/USD now struggling to keep its head above the 0.50 level.
- Volatility in the AUD/NZD could spike on Thursday, with the RBNZ scheduled to hand down its OCR decision and employment numbers due out in Australia. Note that little ground lies between current trading levels and the July 2008 high of AUD/NZD 1.2970 - we expect the cross to punch through this level in the medium term.



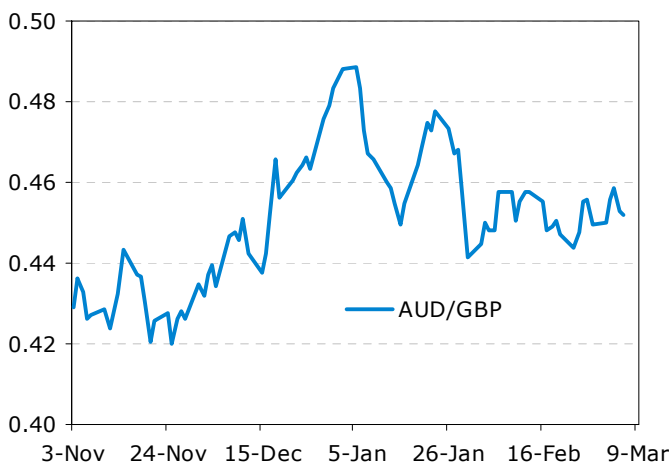
### AUD/JPY Key levels: 60.00 – 65.30

- The JPY's move out of favour as an alternative safe-haven currency of choice continues, with the USD/JPY weakening this week to beyond our end-March target of 98. The move has supported the AUD/JPY, remaining above the 50% retracement level of 61.9 between 2009's peak and trough.
- A push higher for the AUD/JPY to above last week's peak of 64.30 is possible, but it is difficult to see a return to the January top of 68.30 given the current downtrend in the AUD/USD and consolidation in the USD/JPY after depreciating by around 5½% over the past two weeks.



### AUD/EUR Key levels: 0.4980 – 0.5160

- AUD/EUR trading remains in a tight range. A dip below the 0.5030 support level and towards Tuesday's low of 0.5002 could eventuate if we receive worse than expected Australian employment numbers next week. The cross has struggled to maintain rallies above 0.5130, so any topside moves are likely to be capped below 0.5160.
- With ECB President Trichet leaving the door open for further policy rate cuts following last night's 50 bp reduction to 1.50%, the likelihood of continued falls in the EUR/USD has increased. This will help maintain support for the AUD/EUR.



### AUD/GBP Key levels: 0.4410 – 0.4590

- Recent trading sessions have seen the GBP extend last week's fall against the USD. These moves helped to support the AUD/GBP and keep it within the upper part of last week's suggested key levels. Solid support persists at 0.4410, and topside resistance at 0.4590 (50% retracement from the 26 January high).
- A worse than expected January UK industrial production result next week could weigh further on the GBP/USD. Such a result would bode well for the AUD/GBP and may encourage a break above the key 0.4590 level.

## ANZ economic and financial market forecasts

Australian economic indicators	2007	2008	2009f	2010f
<b>Economic activity (annual % change)</b>				
Private final demand	6.0	3.9	-1.9	-0.7
Household consumption	4.3	2.1	-0.4	0.9
Dwelling investment	2.7	2.0	-5.1	11.2
Business investment	13.8	13.2	-4.7	-10.5
Public demand	2.8	5.0	3.3	5.2
Domestic final demand	5.4	4.1	-0.7	0.7
Inventories (contribution to GDP)	0.6	-0.6	-0.3	0.2
Gross National Expenditure (GNE)	5.9	3.5	-1.0	0.8
Exports	3.2	4.7	-4.2	0.4
Imports	11.5	10.6	-6.9	1.0
Net Exports (contribution to GDP)	-1.8	-1.4	0.8	-0.1
<b>Gross Domestic Product (GDP)</b>	<b>4.0</b>	<b>2.1</b>	<b>-0.4</b>	<b>1.0</b>
<b>Prices and wages (annual % change)</b>				
Inflation: Headline CPI	2.3	4.4	2.8	2.8
Underlying*	3.1	4.3	2.7	2.8
Wages	4.1	4.2	3.9	3.4
<b>Labour market</b>				
Employment (annual % change)	2.8	2.3	-0.2	-0.5
Unemployment rate (%)	4.4	4.2	5.7	7.4
<b>External sector</b>				
Current account balance: A\$ bn	-68.1	-50.1	-52.9	-79.5
% of GDP	-6.3	-4.2	-4.4	-6.5

\*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	3.25	2.75	2.25	2.00	2.00
90 day bill	3.33	3.32	2.93	2.10	2.30	2.30
3 year bond	3.13	3.22	3.15	3.20	3.10	3.65
10 year bond	4.28	4.40	4.25	4.30	4.20	4.55
3s10s yield curve	1.14	1.18	1.10	1.10	1.10	0.90
3 year swap	3.52	3.57	3.50	3.50	3.40	3.95
10 year swap	4.78	4.85	4.65	4.65	4.50	4.85
<b>International interest rates</b>						
RBNZ cash rate	3.50	3.50	2.50	2.50	2.50	2.50
NZ 90 day bill	3.16	3.86	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	0.90	0.95	0.85	0.95	1.00	1.50
US 10 year note	2.83	3.69	3.60	3.70	3.70	4.00
Japan call rate	0.10	0.10	0.10	0.10	0.25	0.50
ECB refinance rate	1.50	2.00	1.25	1.25	1.25	1.75
UK repo rate	0.50	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
<b>Australia and NZ exchange rates</b>						
A\$/US\$	0.6419	0.63	0.58	0.56	0.54	0.54
NZ\$/US\$	0.5011	0.50	0.45	0.43	0.41	0.42
A\$/¥	63.20	61.74	58.00	56.56	55.08	56.70
A\$/€	0.5108	0.50	0.48	0.50	0.49	0.50
A\$/£	0.4531	0.44	0.40	0.38	0.36	0.35
A\$/NZ\$	1.281	1.26	1.29	1.30	1.32	1.29
A\$/CA\$	0.8251	0.82	0.78	0.77	0.78	0.78
A\$/CHF	0.7503	0.76	0.73	0.75	0.76	0.77
A\$/CNY	4.390	4.31	3.97	3.83	3.69	3.69
A\$ Trade weighted index	54.70	54.05	50.39	49.39	47.88	47.95
<b>International cross rates</b>						
US\$/¥	98.5	98	100	101	102	105
€/US\$	1.257	1.25	1.20	1.12	1.10	1.08
€/¥	123.7	123	120	113	112	113
£/US\$	1.417	1.42	1.46	1.48	1.50	1.55
€/£	0.8870	0.88	0.82	0.76	0.73	0.70
US\$/CA\$	1.286	1.30	1.34	1.38	1.44	1.44
US\$/CHF	1.169	1.20	1.25	1.34	1.40	1.42
US\$ index	89.11	89.2	91.6	95.7	97.2	98.3
<b>Asia exchange rates</b>						
US\$/CNY	6.841	6.84	6.84	6.84	6.84	6.84
US\$/HKD	7.758	7.76	7.76	7.76	7.76	7.78
US\$/IDR	12060	12000	12000	11900	11600	11600
US\$/INR	51.77	49.00	49.00	48.00	48.00	47.00
US\$/KRW	1576	1500	1400	1400	1375	1350
US\$/MYR	3.73	3.64	3.74	3.80	3.80	3.80
US\$/PHP	48.63	48.50	49.50	50.00	49.50	48.80
US\$/SGD	1.553	1.54	1.58	1.62	1.66	1.66
US\$/THB	36.23	36.20	37.60	39.40	39.40	38.80
US\$/TWD	34.93	35.20	36.00	36.00	35.50	35.50
US\$/VND	17479	17500	17800	18100	18500	18500
<b>Pacific exchange rates</b>						
PGK/US\$	0.340	0.36	0.35	0.34	0.35	0.35
FJD/US\$	0.529	0.52	0.50	0.48	0.47	0.47

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