



Outlook 2013

Slow but steadier growth

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No drama for bonds

In the context of a firmer but unspectacular global economic recovery in 2013, bond markets look unlikely to collapse, but this does not mean a lack of better opportunities elsewhere.

At the start of a new year, it is often worth taking a step back from the noise and looking instead at the big picture.

In ANZ, this exercise, referred to as a "Secular Review", is deemed critical to any assessment of market opportunity. Understanding whether a market is in a secular bull or bear phase dictates the optimal investment style and approach to risk taking.

The concept of secular bulls and bears is based on an appreciation of the psychological mood swings driving investment decisions. At the start of a secular bull market, investors are cautious because they are mindful of the previous bear market. This caution gradually dissipates as the market consolidates, eventually reaching a peak of over-optimism and herd buying. At this point, poor investment decisions are made, the market corrects significantly and the secular bull market is replaced by a secular bear.

The question taxing analysts at this time is whether 2013 will mark the end of the secular bull market in bonds. However, there is little to suggest that this will happen. We see G3 monetary policies staying accommodative for an extended period, possibly to 2015 or beyond. These policies are judged to be working and going forward, can be expected to help calm market nerves. Meanwhile, the 2013 outlook is for a steadier global growth profile, even if GDP numbers do not reach much higher than in 2012.

However, while the bull market in bonds may persist, it is worth pointing out that the transition from secular bulls to secular bears can take years, if not decades, and the ideal entry and exit points may be well before the end of each phase. In this case, not only is the bond bull market in reasonable shape, the volatility associated with high yields and corporates may even start to ease.

However, with this may also come a fall in bond returns, and a corresponding lift in equity returns, fuelled by a combination of modestly stronger growth momentum and anchored G3 central banks. The message for Asian investors who have become enamoured with their bond investments, is that it may be time to adopt a more balanced portfolio, even ahead of a dramatic turnaround in the bond market.

ANZ takes this opportunity to wish all its clients good health, wealth and happiness in the year ahead.

Bret Packard

Managing Director Wealth Asia
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Economic Overview

Building momentum

The fragile global economic expansion of the past three years could be making way for more resilient growth in 2013. This hinges on the momentum in US and China continuing to build, with Europe and Japan dragged along. Meanwhile, there appears to be room in Asia for upside surprises.

GDP Growth Forecasts (%)

	2012F	2013F
World	2.3	2.8
G7	1.4	1.6
US	2.1	2.5
Euro zone	-0.5	0.0
Japan	2.0	1.4
China	7.8	8.1
Asia Pac ex Japan	6.1	6.8

Source: ANZ Economics & Markets Research, Dec 2012.

US: Fiscal woes a near term cliff-hanger

The fiscal situation is likely to be the greatest challenge for the US economy in 2013. While the budget deal passed in early January suggests that significant fiscal tightening would not occur in 2013, fiscal policy would be contractionary, nonetheless. The US government has also reached its statutory budget debt limit. An inability to raise the debt ceiling further could lead to a default in the worst case. Longer term, US public debt could rise to unsustainable levels if current policies remain in place.

Spotlight

Can the tension between politics and economics be resolved?

The global economy appears to be regaining some strength. However, for this to be sustainable requires the G7 political elite to commit to reviving economic activity.

Around the world, political and economic priorities seem less aligned than we might expect. Going forward, politics threaten to derail the budding recovery we are witnessing in key global markets.

The end of 2012 brought with it a cyclical, albeit modest, rebound in the US and China. Inventories have run down, and companies are looking to restock, potentially triggering a lift in industrial activity. These companies are nervous however about the impact of the impending US fiscal cliff.

If adequately addressed, economists agree that the fiscal cliff, that is, tax and spending cuts due to take effect this year, could shave a few points off the US's GDP numbers, but the impact would stop short of a full blown recession. Yet, the possibility remains that the Democrats and Republicans will continue with the brinkmanship displayed so far.

Meanwhile, in Europe, the Spanish government remains reluctant to activate the ECB's OMT (Open Market Operations) programme, for fear of having to give up

some of its sovereignty. Given Spain's unsustainable debt levels, the risk of further financial distress in Spain could continue to weigh on the eurozone's broader prospects. Compounding this is the likelihood that, with elections around the corner for Germany, Angela Merkel will take a harder line in her negotiations with her European neighbours.

Similarly in Asia, political bickering has stalled reforms in India and halted business investment. This has pushed India's 3Q12 growth to a 3-year low of 5.3%, and worsened its fiscal accounts. These developments are potentially putting India's investment grade credit rating at risk.

It appears that 2013 will continue to be marked by the battle of political versus economic agendas. To date, there seems to be a degree of complacency that politicians will eventually do what is needed to avert an economic crisis. In the US's case, this probably means an extension of tax breaks and fiscal spending. However, we see room for disappointment in this regard, and warn that without clear signals, markets may stay volatile in the short term.



We believe that a deal will eventually be struck to resolve both short term and long term fiscal issues, but not without plenty of intrigue along the way. While a severe fiscal crunch has been averted, protracted negotiations surrounding the debt ceiling between the two parties may continue to weigh on confidence and be a source of volatility for financial markets.

Housing and business investment is also vital to the 2013 outlook. A continued broadening out of the housing recovery could result in sizeable positive spill-over to other areas of the economy, especially consumption. In addition, assuming a pick up in business investment as worries over global growth and the fiscal situation abate, the US recovery has the potential to consolidate. We expect the US economy to grow by 2.5% in 2013 with the possibility of heading higher should there be a satisfactory resolution to the fiscal issues.

Europe: Improving but still dim

We expect the Eurozone to emerge from recession in 2013 but growth will be sluggish at best. While stronger external demand from US and China will likely help to lift momentum marginally, the headwinds to growth remain challenging.

Continued fiscal contraction and the potential of a financial calamity in the peripheral states should not be dismissed, although the latter has been tempered by the ECB's Open Market Operations (OMT) programme.

Political risks also cannot be ruled out, with Germany's federal election likely to be held in September 2013. Meanwhile, the outlook for France is worrying, with only timid reforms announced so far.

That said, the periphery is undergoing positive albeit gradual structural changes leading, for example, to more competitive labour costs. We expect Spain to trigger the ECB's OMT in the new year, which could actually be positive for risk sentiment as the markets will see this as a further erosion of Eurozone tail risks. After contracting by around 0.5% in 2012, we expect Eurozone growth to be flat this year.

Japan: Exports and politics hold the key

After a discouraging 2H12, possible political and leadership changes in Japan herald more stimulatory fiscal and monetary policies ahead, potentially boosting growth prospects. Meanwhile, on the trade front, we see a cyclical improvement in export demand to be a positive for Japan.

With the Liberal Democratic Party once again returned to power, and Shinzo Abe becoming the new prime minister, some liquidity injections can be expected. Mr Abe has been a particularly vocal advocate of more aggressive moves by the Bank of Japan (BoJ) to end deflation and support growth. In fact, both parties are now in favour of additional stimuli, although spending is likely to be limited by the government's high debt levels. We expect Japan's economy to grow by a little over 1% in 2013.

Economic Overview

Australia: Managing the transition

The key question for Australia in 2013 is whether the non-mining sectors, in particular housing, consumption and investment, can offset the drag from the slowdown in mining investment. In recent months, cost increases, the high AUD, lower commodity prices and the continuing uncertainty over the global economic backdrop have resulted in the cancellation and deferral of major resource projects. We expect mining investment to peak in 3Q13.

Correspondingly, the unemployment rate is expected to rise to 5.75% by mid 2013, with the risk that it could reach a high of 6% as labour demand in the mining sector continues to ease amid strong population growth. Our 2013 GDP forecasts for Australia stand at 2.75%, marginally below trend growth. Given still-contained inflationary pressures, this is likely to incline the RBA towards an easing bias over the course of the year.

Emerging Asia: A gentle rebound

The modest rebound in export growth, led by China, has started to spill over into the rest of Emerging Asia. A number of indicators, such as orders versus inventories, suggest that the slide in activity in 2012 has bottomed out, and the region is set to recover gently over the course of 2013.

In fact, a stronger recovery in exports will help the more open economies such as Korea, Taiwan etc outperform their ASEAN counterparts. This is not to suggest that a V-shaped recovery is imminent. This is unlikely until Europe, Asia's largest trading partner, is able to restore its import momentum.

On the interest rate front, we expect most Asian central banks to stay on hold in the new year as growth picks up. Fiscal policy stimulus may continue to be used sparingly across the region as governments focus on safeguarding their fiscal sustainability. With the exception of India, the fiscal profile across Emerging Asia remains healthy.

China: Cautiously optimistic

China's economic outlook in 2013 appears mildly positive on the back of proactive fiscal policy and accommodative monetary policy. Notably, growth momentum has started to accelerate since 3Q12. The stable political outlook also suggests more proactive fiscal spending in the new year, such spending having lagged for most of 2012, but picking up again in 3Q12.

In addition, the large infrastructure projects approved by the Chinese government in May are likely to kick in and provide an uplift to relevant sectors over the next two to three months. In fact urbanisation, as affirmed by premier in waiting Li Keqiang, is expected to be a major driver of growth going forward.

However, we would caution against an overly bullish view of China's growth prospects. The new leadership is looking for a stable, rather than overly impressive, growth profile. We expect GDP growth to average 8.1% yoy in 2013.

On the downside, inflation could be a risk, although we expect this to become a significant concern only in 2H13. However, there is no room for complacency. Moderately higher global commodity prices as well as rising food inflation could push China's inflation to as high as 4% in 2013.

Longer term, we think the Chinese Communist Party has plans to lower tax rates for corporates and the middle income group, as well as cut import tariffs, in order to drive consumption. The formation of a nation-wide pension scheme will also help to boost labour mobility and urbanisation.

Furthermore, in an attempt to ease the credit constraints facing the small and medium sized enterprises, we can expect further liberalisation of interest rates targeted at instilling greater competition among China's financial institutions.

Asia Pacific ex Japan GDP Growth Forecasts (%)

	2012F	2013F		2012F	2013F
Asia Pacific ex Jap	6.1	6.8	Malaysia	5.5	5.2
Australia	3.6	2.8	Philippines	6.1	5.4
China	7.8	8.1	Singapore	1.6	3.0
Hong Kong	1.5	3.9	South Korea	2.2	3.9
India	5.6	7.0	Taiwan	1.7	3.0
Indonesia	6.3	6.6	Thailand	5.8	5.4

Source: ANZ Economics & Markets Research. Dec 2012.

Selective buying

2013 is likely to be marked by further green shoots on the global macro landscape, with the prospect of a hard landing in the US and China starting to recede. But a near term shopping spree is not on the cards, as investors await news on the fiscal cliff.

US: Near term volatility point to high quality stocks

After three years of reasonably consistent outperformance, the near term headwinds for US equities are rising. Following several years of above-trend revenue growth and impressive productivity gains, margins have become elevated and now appear vulnerable. It appears that downgrades to the 10% earnings forecast for 2013 cannot be ruled out. Add to this the uncertainty over the fiscal cliff negotiations and the market's relatively rich valuations, and the market appears to have sources of disappointment aplenty over the next quarter.

That said, the safe haven status of the USD could support total returns for Asian investors. Meanwhile, the pick up in the US housing market is much welcomed and a broader housing recovery could lift the outlook for US financials. Longer term, the US's rising self-sufficiency in energy and signs of a potential recovery in business spending will help underpin US equities as a core allocation in investment portfolios.

Spotlight

Europe: Prepare to be surprised

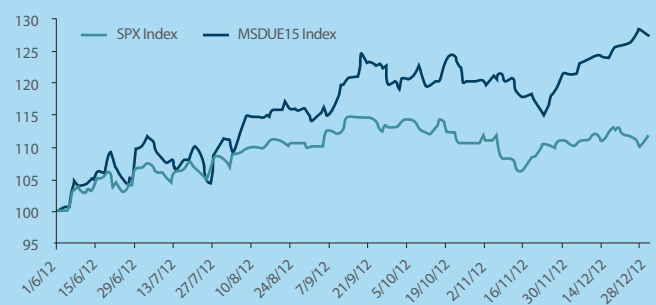
A transition of focus from austerity to growth could be just the catalyst that the European market needs to turn around

The formula for a rewarding equity investment, according to the experts, can be summed up as: a potential for positive surprises, still sceptical investor sentiment, and cheap valuations. If that is indeed true, then the European equity market fits the bill nicely.

For now, the mass of global investors still seem wary of European stocks. Elevated sovereign debt levels in the periphery continue to pose a structural challenge for the region. Meanwhile, the outlook for the European economy and the latest activity indicators are far from encouraging. The overall Euro Area unemployment rate continues to rise (11.7% in October), led by the alarming rise in youth unemployment (23.9%). Even the core economies are not immune, with labour conditions and retail sales figures in Germany starting to deteriorate.

However, the Eurozone appears to be past its point of extreme bearishness. Looking back, the low seems to have been reached in June 2012, before the ECB launched its Open Market Transactions (OMT) programme. The programme has done much to reduce the potential tail risk in the market, by effectively providing a backstop to the peripheral sovereign bond market. Since then, the MSCI Europe has outperformed the S&P 500 in USD terms (see chart). With valuations trading at a 12-month forward PER of 10x and a price to book ratio of 1.2x, Eurozone markets are still attractively valued, but no longer as cheap as they once were.

Performance of S&P 500 vs MSCI Europe (Jun 2012 - Dec 2012)



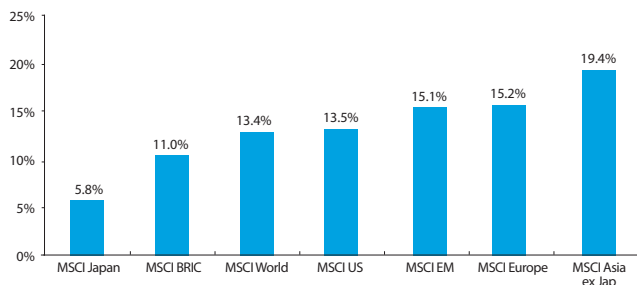
Source: Bloomberg. ANZ, December 2012. In USD terms. Past performance is not a guarantee of future returns.

Going forward, it may not take a substantial push to get investors back into European stock markets. Even small conciliatory steps taken by European policymakers towards a growth-over-austerity agenda could do wonders for sentiment. Given the decline in borrowing and labour unit costs, some support for corporate earnings can already be expected in the months ahead.

In the short to medium term, the subdued domestic growth prospects and expectations of further deleveraging in the European banking system suggests that the road to profits will not be a smooth one. Nevertheless, while not for the faint-hearted, we believe that longer term investors with a selective tilt towards export-oriented European stocks will be rewarded.

Equities

Regional Equity Market Returns (2012)



Source: Bloomberg, ANZ. Returns are in USD terms. Past performance is not a guarantee of future returns. As of 31 Dec 2012.

Japan: May disappoint again

The surprise outperformance of the Japanese market since November 2012 has stirred investor interest. This time around, the possibility of radical reforms is responsible for driving the market's gains. Japan's new prime minister, Shinzo Abe, has called for the Bank of Japan to increase its inflation target through unlimited quantitative easing. The upcoming change in membership at the Bank of Japan in early 2013 could also see the adoption of a more dovish stance. Optimists point to a potential end to deflation, accompanied by a weakening Yen, as key factors in Japan's favour.

On the other hand, Japanese banks could incur losses on their holdings of Japanese Government Bonds (JGBs) if easing deflationary pressures cause bond yields to rise. The return of inflation must be accompanied by stronger economic growth for a positive net impact on the banks and the market as a whole. Nevertheless, until we see BoJ actively pursue more aggressive monetary policy, investors hoping for a re-rating of the Japanese market may be disappointed yet again.

Emerging Markets: Brightening prospects

Following the smooth leadership handover and improving economic data in China, the prospects for the Emerging Markets (EM) appear brighter. EM equities underperformed global equities over the past two years but have recently been showing signs of a turnaround. From a valuation perspective, EM equities are trading at around their average levels relative to the world, although this still represents a discount for a region that is expected to grow its earnings faster than the developed world.

However, investors will need to be selective. While China's economy does seem to be on a firmer footing, the picture is looking less positive from an economic/earnings perspective with ongoing softness and disappointment in India and Brazil. We continue to favour Asia ex Japan within the EM region.

Asia In Detail

China: Earnings bottoming

We continue to be slightly positive on the Chinese equity market. With Chinese industrial profits rising 20.5% in October, up from 7.8%yoy in September, earnings could be bottoming out. Meanwhile, valuations remain inexpensive (9.1x 2013PER). Finally, given that current market consensus does not appear to include any major policy reforms from China's new leaders in the near term, an announcement to the contrary could be a positive surprise and potentially lift investor sentiment.

Taiwan: Aggressive forecasts

With the technology sector accounting for almost 55% of the index, a cyclical recovery in the global economy is critical for the market and investor sentiment. While recent economic activity indicators have been encouraging, the consensus earnings forecasts for 2013 of 24.4% (vs 10.7% for the region) seem aggressive. Any possibility of a downgrade in earnings could dampen the market.

South Korea: Attractively valued

A more benign global macro outlook and unchallenging valuations (2013F PER of 8x) are key positives for Korea going forward. We may see greater fiscal policy supporting growth after the December elections are out of the way. Finally, barring a sharp rise in global risk aversion, we expect the KRW to appreciate gradually as Korea's current account balance improves. Further gains for the won are likely to make Korean assets appealing to foreign investors.



India: Neutral, for now

Fair valuations and the potential for rate cuts as inflation peaks are positives for the Indian market. However, it is likely that politics would dominate investor sentiment in the near to medium term. The government's ability to push through reforms (e.g. allowing Foreign Direct Investments in the retail sector etc) and jumpstart the private investment cycle are critical to India's future growth prospects. It is also imperative that the government keeps to its fiscal roadmap in order to retain India's investment grade rating. We remain neutral for now, preferring to see actual policy implementation before turning more constructive.

Singapore: Potential earnings upside

We are marginally constructive on the Singapore market. An improving global backdrop could lend further support to the Singapore market and offer some upside to earnings. In addition, the market does not look expensive. However, inflation is a risk which we will be watching closely. Higher costs could hurt competitiveness and weigh on corporate earnings going forward.

ASEAN: Be selective

Following the outperformance of the ASEAN markets in 2012, it would not be surprising to see investors rotate out of these markets to the more attractively-valued cyclical markets within Asia, especially if economic momentum continues to gain traction. Philippines continues to stand out in terms of macro fundamentals and investor sentiment could be further boosted should the country's credit rating be lifted to investment grade status. That said, as valuations look rich, we would prefer to gain exposure on dips. Over in Indonesia, our concerns over the rupiah (see currency section) lead us to remain relatively cautious on the equity market. In addition, proposed hikes in electricity tariffs and gasoline prices could worsen Indonesia's inflation outlook in 2013.

Fixed Income

Lower returns

New lows in bond yield in many developed markets are intensifying concerns over bubble-like conditions. While we believe that the environment remains bond-friendly in the medium term, returns are expected to be subdued.

Developed Market Sovereigns: Investors seek fiscal credibility

The meagre yields provided by developed market sovereigns appear to offer little protection against inflation. This is unlikely to change in the medium term as we see G3 central banks maintaining an accommodative monetary policy for an extended period, with scope for policy to be eased further.

Not surprisingly, fiscally sound sovereigns such as Australia and New Zealand which offer relatively higher yields

continue to attract investors. Over in Australia, recent data suggests that the overall investment outlook may be weaker than previously thought, given sharp downward revisions in mining companies' investment intentions for 2013. The potential drag on growth supports the case for further RBA easing, a positive development for bonds. ANZ expects a further 100 basis points of rate cuts over the course of 2013. However, Australian fixed income's stellar run over the last three years point to lower prospective returns.

Spotlight

US Corporates: Quality rules

Factors underpinning the US bond rally are expected to remain intact in 2013. However, investors should avoid over-reaching for yield.

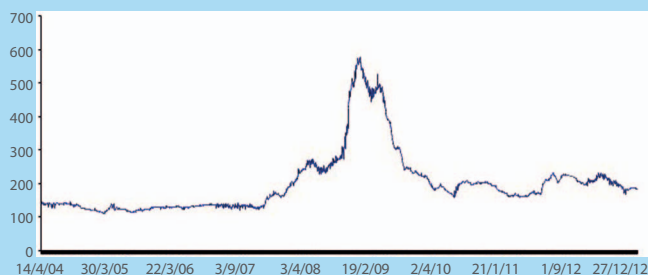
While the US fiscal cliff is expected to shave about 1.5-2% off the US economic growth in 2013, the US housing recovery appears to be underway. A stronger housing and economic recovery is possible once the large overhang of housing inventory and still-restrictive bank lending standards are addressed. On balance therefore, we expect the US to avoid a recession in 2013, but growth is likely to be subpar.

This implies a continuation of the Fed's monetary accommodative policy and benign conditions for US corporate bonds. However, in our opinion, the scales are still tilted towards the higher quality sector. The Fed's latest asset purchase programme targeting Mortgage Backed Securities (MBS) is more likely to benefit high grades.

We would draw investors' attention to the evolution of the bond market during the Fed's QE1 programme. At the time, the Fed's increased ownership of mortgage-backed securities caused domestic money market funds to reduce their holdings correspondingly. They shifted their investments instead to other US fixed income assets, in particular high quality US corporate bonds. However, investment grade credit spreads have narrowed significantly (see chart), and investors should expect future upside to be more muted.

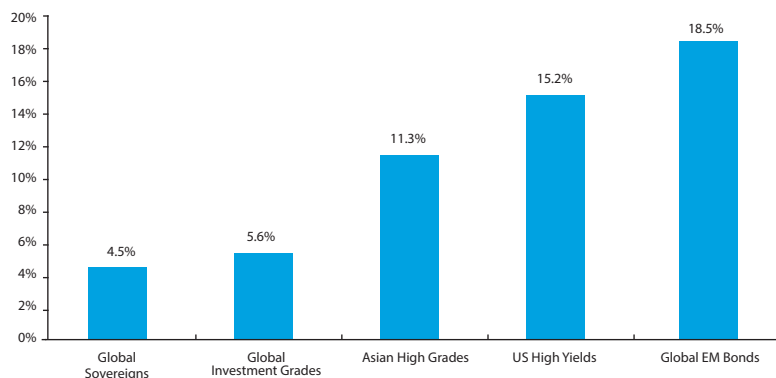
Furthermore, our expectation of a slowly improving economy, if realised, will pave the way for stronger spending and rising inflation. Faced with these developments, bond markets are likely to start to price in the risk of higher rates. The risk of a rise in bond yields is a warning to investors to also avoid over-extending the duration of their bond portfolios, given the greater impact on long dated bonds.

US Investment Grade Credits - Spread over Treasury (Apr 2004 - Dec 2012)



Source: Standard & Poor's Global Fixed Income Research. As of Dec 2012. Past performance is not a guarantee of future returns.

Global Bond Market Returns (2012)



Source: Bloomberg, ANZ. Returns are in USD terms. Past performance is not a guarantee of future returns. As of 31 Dec 2012.

On a related note, the high foreign ownership of Australian government bonds (72.2% as of 3Q12) leaves the market vulnerable to any sharp movements in the AUD. We believe that widespread selling is unlikely unless yield differentials fall sharply.

Given that 2-year yields are below Australia's official cash rates, we also foresee global investors turning their attention to higher yielding Sovereign Supra Agency (SSA) papers, semis and corporate debt. That said, any potential gains may be partially offset by a weaker AUD should the RBA lower rates more than expected.

We expect New Zealand sovereign bonds to outperform other G10 sovereign bonds. Recent headlines appear to be focused on the stimulus associated with the Christchurch rebuild, and away from the country's fiscal policy outlook. In fact, fiscal contraction is expected to be a major drag on New Zealand's growth over the coming few years, with local government spending also set to be sharply curtailed.

These dynamics, coupled with a still-healthy housing market and contained inflationary pressures are likely to keep the RBNZ on hold. This sets a favourable backdrop for New Zealand bonds, while potentially underpinning the NZD.

Developed Market Corporates: More limited yield compression going forward

The anchoring of sovereign bond yields by their respective central banks is expected to continue to support the corporate bond segment, as investors maintain their search for higher-than-cash rates.

However, as we start 2013, the re-allocation to corporate bonds and the corporate bond spread compression to the sovereign market is appearing mature. While we expect G3 central banks to hold accommodative policy for a sustained period, high grade corporate bond returns may ease through the year, accompanied by a reduction in returns volatility.

At the same time, potential changes to global banking regulations are raising the risks of holding high yield bonds. These regulations are expected to result in further liquidity squeezes in the secondary bond market and could deteriorate further during periods of market stress. In such instances, high yield bonds are likely to be more vulnerable.

Therefore, while the steady decline in bond yields over the last 12-18 months has had bond investors shifting further down the credit curve, the incremental yield offered by high yield bonds may look less attractive after factoring the probability of default and the lack of liquidity.

Emerging Market Debt: More upside possible

In our 2012 annual outlook report, we highlighted Emerging Market Debt (EMD) as an asset class deserving of more investor attention. Since then, this sector has returned about 18% and despite this impressive showing, we believe that there is room for the rally to continue.

The EMD universe, which includes Asian fixed income, has enjoyed ratings upgrades on the back of improving fiscal balances, debt levels and inflation outlooks. In fact, 70% of total outstanding EM corporate bonds are rated investment grade, up sharply from less than 40% in 2000.

Going forward, opportunities for further credit upgrades hold the key to the sector's upside potential. Our medium term view of EM currencies as beneficiaries of a weaker USD also suggests continued demand for this sector. However, it is this external demand that puts EMD at risk of capital outflows, albeit amid the faster pace of domestic participation through local pension and insurance funds.

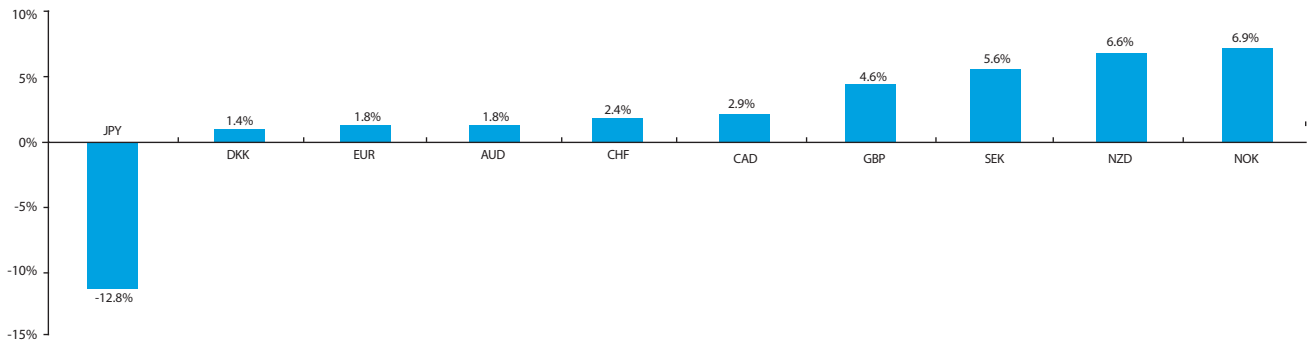
Investors may therefore not want to view EMD as a traditional defensive asset within a balanced portfolio. Although this sector can act as a lower volatility replacement for other risk assets, various idiosyncratic risks exist, including political and economic uncertainties. Recent developments in Argentina, where the threat of default has resurfaced, serve as a timely reminder that investors will need to be selective and diversified within this space.

Currencies

USD under pressure

Our weaker USD outlook does not imply a lift for all other currencies. While the KRW, RMB and PHP stand out in terms of upside potential, the AUD and NZD are unlikely to rise much from current levels, unless a dollar crisis materialises.

G10 Currency Returns (2012)



Source: Bloomberg, ANZ. Returns are against the USD. Past performance is not a guarantee of future returns. As of 31 Dec 2012.

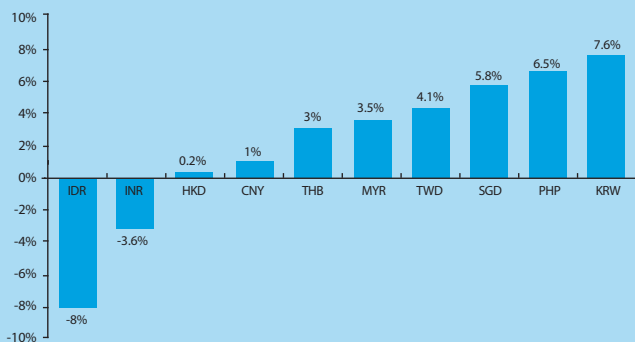
Spotlight

Asia's turn to shine

We expect Asian currencies to be buoyed in 2013 by fresh capital inflows, as investors seek to capitalise on the region's economic recovery. However, our outlook is not uniformly positive.

Despite Asia's disappointing economic numbers in 2012, the region's currencies still managed to generate gains of between 1% to 7%. The story was a familiar one – investors sought out yield and real returns amid the globally depressed interest rate environment.

Performance of Asian Currencies (2012)



Source: Bloomberg, ANZ. Returns are against the USD. Past performance is not a guarantee of future returns. As of 31 Dec 2012.

Going forward, we expect capital to continue to flow into the region as growth recovers. This will help buoy Asian currencies in 2013, especially given the slim chance of rate cuts. If Asian policymakers were slow to ease during the 2012 slowdown, they will be even less inclined to do in a growth cycle. In addition, the fiscal outlook for most Asian economies remains healthy. Barring India, Asian policy makers were largely conservative spenders throughout the economic slowdown.

The KRW shows particular strengthening potential given its high yields, strong credit rating and large current account surpluses. There is also scope for further PHP upside on the back of strong remittances flow and strong growth in the Business Process Outsourcing (BPO) sector. Our 2013 year end targets for USDKRW and USDPHP are 1040 and 40.2 respectively. The SGD is likely to remain a sought after currency, although central bank policy could limit its gains. We see the USDSGD heading towards 1.19 by the end of 2013.

Investor interest could also resume for the Chinese RMB, along with improving economic prospects. Foreign currency deposits were amassed on the mainland during 2012, amid fears of RMB depreciation. We would expect this trend to reverse in 2013, lending further support to the currency. That said, while the People's Bank of China is loosening its grip on the currency, they are unlikely to tolerate excessive RMB appreciation, given the still-nascent recovery in exports. On balance, we expect the RMB to appreciate to 6.10 by the end of the year.

Nor is the picture equally rosy for all Asian currencies. The IDR, for example, while forecast to stage a partial recovery after falling by some 6% in 2012, is still expected to be constrained by its poor balance of payments. In addition, caution may prevail given Indonesia's stalled economic reform process, with the focus now shifting to the 2014 presidential election. The USDIDR is forecast to end 2013 at around 9500.



USD: Safe haven allure diminishing

In the near term, the USD may still outperform some of the other major currencies due to better fundamentals. However, we caution that the greenback's safe haven status may become less appealing to investors as the US recovery broadens out in 2013.

There are several reasons for this. Firstly, short term yields in the US are likely to stay anchored for an extended period, making short term Treasuries an unattractive venture. Secondly, even if long end bond yields were to rise, the fear of capital losses resulting from bubble conditions may dwarf the carry on the bonds. Thirdly, the sharp increase in post-GFC foreign ownership of US Treasuries is thought to stem from investors' desire to preserve their portfolio liquidity during this period of global deleveraging. Such concerns are expected to diminish going forward.

Euro: Range bound

The EUR is expected to follow a narrow trading range in the New Year as contrasting dynamics play out against each other. Internal stresses in Europe remain material, with France emerging as the latest source of risk in this embattled region. On the bright side however, the Eurozone's gradually improving balance of payments, with a trade surplus now approaching 2% of GDP from flat a year ago. The potential for the USD to come under pressure adds to the EUR's fine balance of upward and downward pressures.

Our year end forecast for the EURUSD is 1.31, but a stronger global environment could see the common currency strengthening to 1.35. Conversely, should global conditions deteriorate, a re-test of the 1.20 level cannot be ruled out.

JPY: Likely to stay attractive

In a world of almost uniformly challenging fundamentals, aggressive and radical domestic monetary easing will be needed to weaken the yen further. We have our doubts that this is indeed forthcoming.

At the same time, we note that domestic institutional investors have become net yen buyers. Rising payouts from the Government Pension Fund and recent announcements from Japanese companies suggest that the domestic demand for yen is likely to remain strong. As such, we see the USDJPY moving towards 78 by year end.

AUD: Possible RBA intervention

The AUD's strength this past year has been underpinned by central bank diversification and Foreign Direct Investment flows. However, some of that support may ease as we approach a peak in the mining investment pipeline, anticipated in 3Q13.

Meanwhile, employment growth in currency-sensitive sectors such as retail, manufacturing and tourism, has been decidedly soggy of late. Given the RBA's focus on the labour market, we would not rule out the possibility active central bank intervention to weaken the currency, especially if unemployment rates appear to be trending up. Our end 2013 forecast for the AUDUSD stands at 1.05.

Currencies

NZD: Diverging from the AUD

While high interest rates, attractive bond yields, reasonable growth prospects and low levels of government debt were factors common to both the AUD and NZD, a divergence in paths may emerge this year.

In particular, there is a smaller chance of the RBNZ easing rates, given the stimulus coming from the Christchurch rebuild and robust home prices in Auckland. Both are long term positives for economic growth and capital inflows. In fact, the new RBNZ Governor has all but ruled out active intervention in the currency market, unlike in Australia where this has been raised as a potential weapon against unemployment.

Furthermore, foreign ownership of NZ government bonds, now at 62%, is lower than the 76% foreign ownership of Australian sovereigns, giving NZ the capacity to soak up new offshore demand. This suggests that the AUD/NZD cross rate could head lower during the course of the new year.

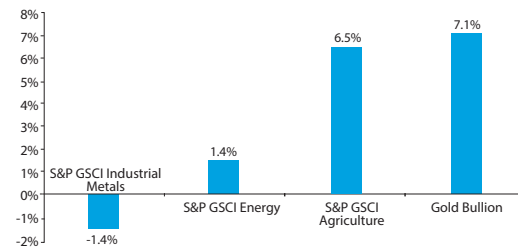
In the near term however, developments relating to NZ's current account and domestic economy pose some risk to the NZDUSD. We are also mindful of the potentially unfavourable outcome arising from the US fiscal cliff negotiations, which could trigger a broad flight to safety. This said, we remain sanguine on the medium term outlook and see the NZDUSD heading to 0.84 by year end.

First half volatility

The new Chinese leadership's commitment to growth is likely to underpin commodity demand throughout the year. At the same time, shifting expectations of global growth prospects may create periods of volatility, especially in the first half of the year.

The commitment by China's new leadership to 7-8% growth per year over the medium term, plus an ambitious housing program of six million new public units, is likely to underpin commodity demand in 2013 and beyond. At the same time, uncertainties over the pace of global growth looks set to dampen sentiment.

Commodity Returns (2012)



Source: Bloomberg. ANZ. Returns are in USD. Past performance is not a guarantee of future returns. As of 31 Dec 2012.

Spotlight

Is this the end of the commodity super-cycle?

Despite the waning enthusiasm for the commodities sector, the outlook for 2013 may not be as bad as some fear, especially if China achieves its growth forecasts.

The flat-lining of the S&P GSCI Index (a measure of general commodity price movements) in 2012, not to mention the sector's lacklustre performance in the preceding four years, has finally caused commodity bulls to retreat. Some analysts are even predicting an extended period of bearish sentiment and falling prices.

In fact, the commodities market has become more complex and difficult to forecast. In the five years to 2007, the sector's 15% p.a. returns had investors pounding at the door. Despite subsequent softness, total assets under management in commodities increased almost three-fold from 2008 to end-September 2012, according to Barclays Capital.

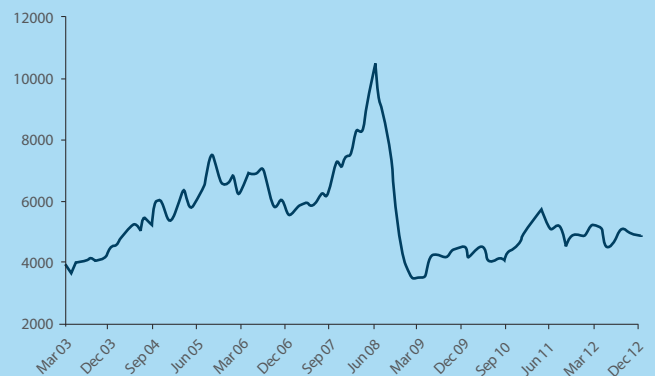
Not surprisingly, this was accompanied by a proliferation of instruments offering investors a variety of ways to gain exposure to the commodity markets. Investors were spoilt for choice: from commodity based indices, ETFs and equities to physical commodities and futures. To add further spice to the market was the reportedly high level of speculative activity. This not only drove up volatility and but also disrupted long term investment strategies.

Now, with the Chinese economy on a firmer footing, and urbanisation expected to be a key growth driver going forward, the demand for commodities may well supported.

However, investors looking for the supersized returns of the past will be disappointed. Not only are demand dynamics shifting – take for example the US's increasing energy sufficiency and the higher demand for cars in China – but supply factors are also looking increasingly complex.

Recent developments in the agricultural market are a good illustration of this, with higher output likely to depress prices in 2013, despite last year's drought-induced shortages. Against this ever-changing backdrop, investors will be required to exercise even greater discretion when choosing their commodity investments going forward.

S&P GSCI Index (Feb 2003 - Dec 2012)



Source: Bloomberg. ANZ. In USD terms. As of December 2012. Past performance is not a guarantee of future returns. The S&P GSCI Index is a measure of general commodity price movements and inflation in the world economy.



Oil: Firmer prices expected in 2013

Energy prices are likely to be firmer in 2013, supported by lingering supply tension in the Middle East. However, we would expect price gains to be skewed towards the latter part of the year, along with better global growth momentum.

That said, prices look oversold at current levels and investors may wish to take steps to front run the better growth prospects expected in the second half of the year, while keeping their expectations relatively modest.

The ramp up of unconventional oil supplies in the US could limit the upside in prices, as would a potential return of Iran's oil exports. Balancing out these conflicting forces, ANZ analysts expect Brent and WTI to reach US\$119/bbl and US\$103/bbl by December 2013 respectively.

Base metals: Higher inventories may weigh on copper

Copper prices could be held back when production at the Escondida plant in Chile resumes to around 1 million tonnes annually, which amounts to 7% of global mine production. According to ANZ analysts, China's smelting production, which rose to a record high of 520,000 tonnes in October 2012, may continue to be ramped up, potentially tipping the global copper market into a surplus of around 200,000 tonnes in 2013.

The picture for Aluminium is equally subdued given rising stock piles and oversupply conditions. While prices are likely to see some support from improving demand, the undisciplined production of Chinese players who enjoy subsidised energy costs, would remain a drag on the market.

Bulks: Likely to underperform

Whilst bulks prices are expected to be higher in 2013, they are likely to underperform other commodities. This is because of the current high levels of inventories as well as the poor profitability of the key end users. However, these pressures may abate in the second half of the year, as demand conditions become more favourable.

In particular, China's struggling steel mills would be a dampener on the iron ore and coking coal markets. The mills have already rebuilt their iron ore supply and would need to see an improvement in steel prices before accepting higher raw material prices.

As for coking coal, prices are coming off a high base in early 2012 and increased competition from Mongolia would be a drag on prices. In addition, China's domestic supply has rebounded after heavy consolidation over the past three years. That said, prices look oversold and reports of production cutbacks from Australia, the largest seaborne supplier, should see quarterly contract prices for coking coal improve over the next 12 months.

Finally, high Chinese supply would weigh on thermal coal prices in 2013, with the high stockpiles at the power plants and slower demand accentuating the overhang. However, stronger Chinese growth in second half of the year could see better prices emerging. Import demand from India may also rise on the back of a stronger rupee.

Precious metals: A relatively favourable outlook

We expect gold prices to reach near record highs in 4Q13, supported by central bank buying and Chinese demand. Our 2013 year end forecast for gold stands at US\$1890/oz. China has surpassed India as the world's largest gold consumer in 2012, and physical demand should remain robust, especially if real interest rates in China continue to fall.

On the other hand, India's demand for gold would continue to be constrained after the government raised import duties earlier in 2012. As a result, we expect to see Indian gold imports fall from a record 967 tonnes in 2011, to about 700 tonnes in 2013.

Silver prices should also benefit from improving industrial demand. However prices could be volatile as the further interest and development of the silver ETF market and higher implied volatility could encourage more short term speculative demand, especially from Chinese investors. We see silver prices ending 2013 around US\$37/oz.

Finally, supply dynamics look favourable for platinum and palladium. A repeat of the strike action of 2012 could exacerbate the supply deficit for platinum. Palladium supply could also be squeezed as the sales of Russian stockpiles potentially come to an end in 2013.

Agriculture: To contend with greater supply

Prices of agricultural commodities had been buffeted by major supply shocks in the last 12 months, which have a low likelihood of being repeated. For example, the severity of the drought in the US corn belt in 2012 was a one in thirty year event. Therefore, as yields rebound, higher production is expected to lead to lower prices. At the same time, global stocks of cotton and sugar are continuing to grow, potentially capping prices well below the highs reached over the last three years. Prospects of lower cotton and sugar prices could in turn prompt growers to switch to grain and oilseed, further increasing output.

Forecasts

Policy Rate Forecasts (%)

	Current 7 Dec 12	Mar – 13	Jun – 13	Sep – 13	Dec – 13
US	0.25	0.25	0.25	0.25	0.25
Euro zone	0.75	0.50	0.50	0.50	0.50
Japan	0.10	0-0.10	0-0.10	0-0.10	0-0.10
UK	0.50	0.50	0.50	0.50	0.50
Australia	3.00	2.75	2.50	2.25	2.00
New Zealand	2.50	2.50	2.50	2.50	2.50
Emerging Asia					
China	6.00	6.00	6.00	6.25	6.25
HK	0.50	0.50	0.50	0.50	0.50
India	8.00	7.75	7.50	7.25	7.25
Indonesia	5.75	5.75	6.00	6.25	6.25
Malaysia	3.00	3.00	3.00	3.25	3.25
Philippines	3.50	3.50	3.50	3.50	3.50
Singapore	0.38	0.38	0.38	0.39	0.39
South Korea	2.75	2.75	3.00	3.00	3.25
Taiwan	1.875	2.000	2.125	2.250	2.375
Thailand	2.75	2.75	2.75	3.00	3.00
Vietnam	10.00	9.00	9.00	9.00	9.00

Source: ANZ, relevant central banks, Bloomberg. As of Dec 2012.

Foreign Exchange Rate Forecasts

	Current 7 Dec 12	Mar – 13	Jun – 13	Sep – 13	Dec – 13
Majors					
A\$/US\$	1.05	1.05	1.05	1.05	1.05
NZ\$/US\$	0.83	0.84	0.84	0.84	0.84
US\$/¥	82.4	78.0	78.0	78.0	78.0
€/US\$	1.30	1.29	1.29	1.30	1.31
£/US\$	1.61	1.61	1.61	1.61	1.61

Source: Bloomberg, ANZ. As of Dec 2012.

	Current 7 Dec 12	Mar – 13	Jun – 13	Sep – 13	Dec – 13
Asian currencies					
US\$/CNY	6.23	6.25	6.20	6.15	6.10
US\$/IDR	9649	9750	9700	9600	9500
US\$/INR	54.1	51.5	51.0	50.5	50.0
US\$/KRW	1096	1070	1060	1050	1040
US\$/MYR	3.05	3.05	3.04	3.03	3.02
US\$/PHP	40.9	40.5	40.4	40.3	40.2
US\$/SGD	1.22	1.21	1.20	1.20	1.19
US\$/THB	30.70	31.40	31.20	31.00	30.8
US\$/TWD	29.10	29.40	29.40	29.30	29.20
US\$/VND	20840	21300	21500	21500	21500

Commodity Price Forecasts

	Unit	Mar – 13	Jun – 13	Sep – 13	Dec – 13
Base Metals					
Aluminium	US\$/lb	0.94	1.00	1.04	1.06
Copper	US\$/lb	3.75	3.90	4.00	4.05
Nickel	US\$/lb	8.10	8.40	8.90	9.40
Zinc	US\$/lb	0.94	0.98	1.02	1.04
Lead	US\$/lb	1.04	1.05	1.06	1.07
Precious Metals					
Gold	US\$/oz	1820	1850	1870	1890
Platinum	US\$/oz	1690	1820	1835	1860
Palladium	US\$/oz	700	760	780	800
Silver	US\$/oz	35.0	35.5	36.0	37.0
Energy					
WTI Nymex	US\$/bbl	96	100	101	103
Brent	US\$/bbl	118	120	118	119
Agriculture					
Corn	US\$/bu	784	795	671	653
Wheat	US\$/bu	908	888	819	777
Soybeans	US\$/bu	1500	1450	1350	1300
Sugar	US\$/lb	20	19	20	21
Cotton	US\$/lb	80	79	78	82
Palm Oil	MYR/t	2700	2800	2900	2900

Source: ANZ. As of Dec 2012. Forecasts are average prices for the quarter.

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