

## Putting risk back on the table

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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: Chinese green shoots benefiting Australia?

- Chinese imports of commodities have surged in recent months, providing support to Australian exports. However if China is currently building inventories for strategic reasons rather than to satisfy genuine demand needs, these trends could be reversed as stockpiles reach their limit. This poses another downside risk to Australian economic growth.
- A more balanced view from the RBA this week suggests the cash rate will be kept on hold for some months. However, we still believe there is room for the RBA to be disappointed about their view for economic recovery.

## Interest Rate Markets: Recent rise in yields will be difficult to sustain

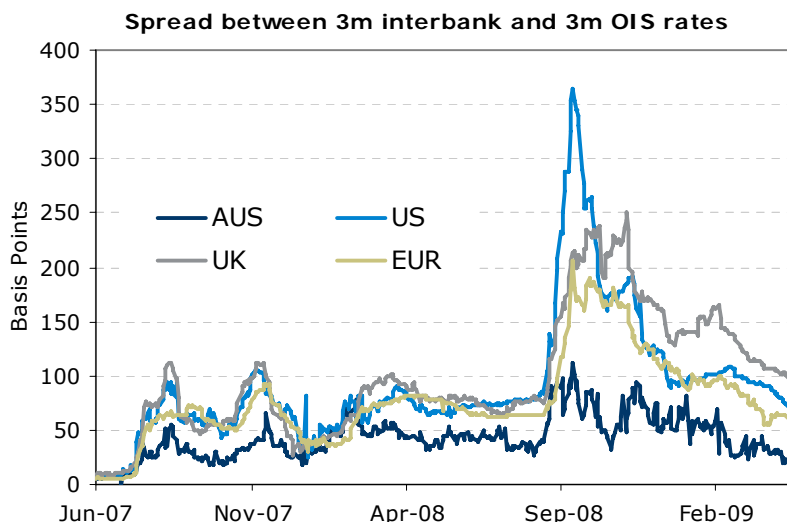
- Improved risk conditions have helped to push market yields to 6-month highs. 10-year Australian government bond yields are now more than 1% higher than at the end of 2008.
- We would need to see continued improvement in risk appetite and better than expected economic data for these higher levels to be sustained.

## FX: Market sentiment continues to outweigh fundamentals

- Improved sentiment around prospects for global recovery continues to benefit the AUD. But what has been surprising this week is the surge in the EUR and GBP despite continued poor economic fundamentals.
- The strong positive correlation between the AUD/USD and EUR/USD has been re-established, despite vastly different fundamentals. Yield advantage, proximity to China and prospects for a more dynamic recovery should still see AUD/EUR outperform over the medium-term.

## Chart of the week

**Figure 1: Improving credit conditions buoys confidence for global economic recovery**



Source: Bloomberg

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## Macro Update: Chinese “green shoots” benefiting Australia?

- Chinese imports of commodities have surged in recent months, providing support to Australian exports for the time being.
- However if China is currently building inventories for strategic reasons rather than to satisfy genuine demand needs, these trends could be reversed in coming quarters as stockpiles reach their limit, posing another downside risk to Australian economic growth.
- A more balanced view from the RBA this week suggests the cash rate will be kept on hold for some months. However, we still believe there is room for the RBA to be disappointed about their view for Australian economic recovery.

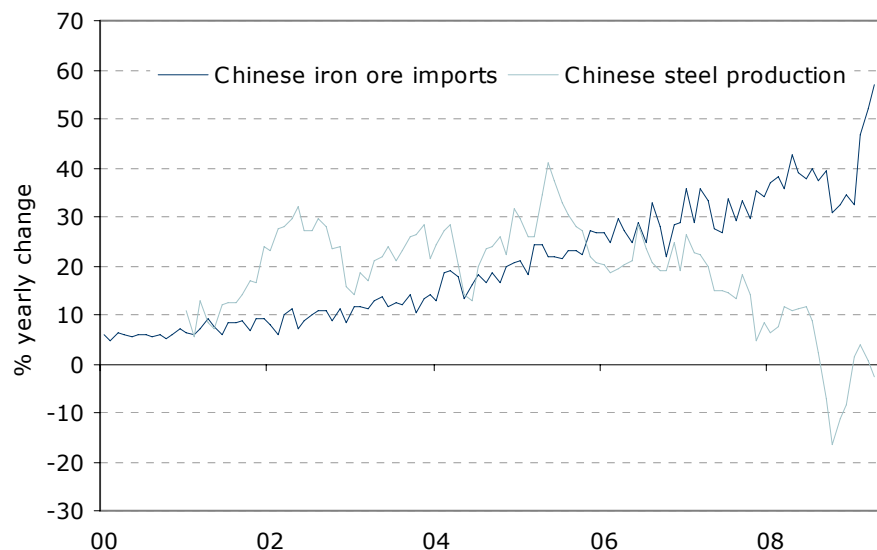
### Chinese imports of Australian resources surge

Driving improved market sentiment in recent months has been evidence of “green shoots” in some global economic data. Of particular importance to Australia has been a bounce back in some Chinese data over the past month. We expect the turn in the Chinese data has also lent some support to the AUD in recent weeks.

Commodity markets in particular have focused on a surge in Chinese imports of commodities. Chinese iron ore imports rose to a new high of 57mn t in April, a rise of 33.0% on a year earlier. Refined copper and copper products are also up an impressive 62% YoY to 399kt. While smaller in magnitude, Chinese coal imports have also risen to 5.72mn t, 67.3% higher than a year earlier. This has contributed to the rise in spot prices for iron ore and base metals in particular, with spot iron ore prices up 8% and copper prices up 48% since February.

Some of the pick up in Chinese iron ore imports is likely to be driven by stronger demand, largely stemming from the Chinese government’s 4 bn yuan stimulus package which is heavily geared towards infrastructure investment. However, there are concerns that much of the increased imports are being undertaken for strategic reasons. After all, growth in commodity imports have well outpaced industrial production (+7.3% YoY) and steel production (-2.8% YoY) in recent months (see Figure 2 below).

**Figure 2: Chinese steel production or chart of iron ore imports**



Source: ANZ, Bloomberg

It appears the Chinese may be taking advantage of low price levels to stockpile with inventories of both iron ore and steel in China now reportedly building. Iron ore port inventories have risen from a low of 58mt on February 13 to 705mt on

May 15, with industry estimates of another 20mt at steel mills. China's commodity purchases also have the benefit of reducing excess holdings of US\$. Australia has been a large beneficiary of these developments, with Chinese data showing imports of Australian iron ore have risen 53% in the past 4 months. This is consistent with Australian data showing a 79% increase in total exports to China over the same period (in non-seasonally adjusted value terms). Indeed Australian exports overall have managed to rebound a little, despite the sharp slowdown in global demand more broadly, with exports up 4.0% in February and holding at that level in March. This is helping to soften the slowdown in Australian economic growth.

If imports from China continue at this high level, it suggests that exports will provide more support to the Australian economy than currently forecast through 2009. But if China is indeed boosting bulk commodity imports for strategic reasons rather than to satisfy genuine demand, then this raises doubts about whether the current surge in exports to China can continue, and raises the possibility of a sharp fall in Australian exports later in the year. Given the large area needed to store such "bulk" commodities, congestion issues may soon start to limit the ability of such behaviour to continue. This is particularly the case given that Chinese steel mills have now reportedly been ordered to cut back production, which will limit the capacity of the Chinese to run down stock levels.

### Upbeat RBA suggests rates on hold for now, but risks lie ahead

The RBA has been relatively upbeat in recent communications. Minutes from the May Board meeting suggest that the RBA now sees the balance of risks as more balanced now, rather than tilted towards the downside. The RBA is increasingly confident that earlier policy stimulus (both monetary and fiscal) is gaining traction and that the rate of contraction in the global economy has started to ease. The Minutes specifically highlighted the rebound in Chinese production as a notable "green shoot" As such, the RBA expects that for Australia "*substantial growth (could) be expected to resume around the end of the year.*"

This more balanced view from the RBA suggests that monetary policy will be on hold for the next few months. However, we believe it is too early to call the end of the easing cycle in Australia. If a larger than expected pull-back in Chinese imports were to occur, this raises a further risk for the Australian economy in the second half of the year. And unfortunately, even if Australian exports to China were to hold at current levels, it is unlikely to help offset other challenges facing the economy in the second half of the year.

Business investment is set to contract by an average 5% per quarter, particularly in non-residential construction with the relevant building approvals down almost 50% over the past year. We also remain concerned about household spending as a rise in the unemployment rate picks up speed and the positive impetus from the latest round of cash handouts starts to wane. The fall in consumer confidence in May comes as a warning that sentiment remains fragile and households clearly remain concerned about the state of their finances and the economy.

With difficult economic times still ahead, there is still room for the RBA to be disappointed about their view for Australian economic recovery. As such, we retain the view that the cash rate will fall further by the end of the year.

### Data wrap

- **Minutes from the RBA's May Board meeting** in which it left the cash rate unchanged at 3% showed a further cut was considered. The Board now sees monetary policy settings as appropriate for the time being, although will continue to watch economic and financial developments closely for a change in the balance of risks.
- The **Wage Price Index** rose by 0.8% in Q1 to be 4.2% higher over the year.
- **WBC-MI Consumer Confidence** fell by 4.3% in May to 88.8.
- **MI Consumer inflation expectations** continued to ease to 2.3% YoY in May.
- **Motor vehicle sales** rose 0.9% in April although remain 20.3% down over the year.

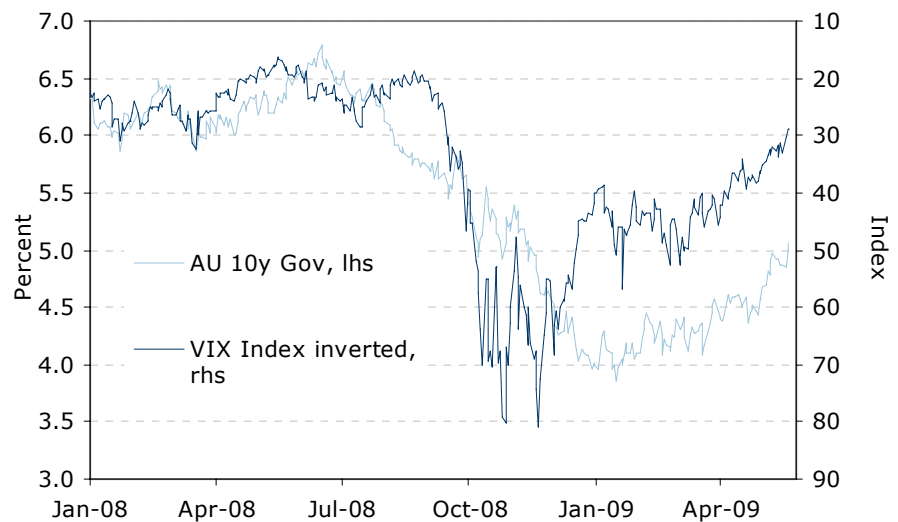
## Interest Rate Markets: Recent rises in yields will be difficult to sustain

- Improved risk conditions have helped to push market yields to 6-month highs. 10-year Australian government bond yields are now more than 1% higher than at the end of 2008.
- We would need to see continued improvement in risk appetite and better than expected economic data for these higher levels to be sustained.

### Market yields reach 6-month highs

The rise in market interest rates has been extended over the past week. The yield on Government ten-year bonds has risen above the psychological 5.0% level for the first time in 6-months while the 5-year swap rate is also at a 6-month high, also near 5% (Figure 3 below).

**Figure 3: ACGB 10-year yield and the VIX index**



Source: ANZ & Bloomberg

An improved run of global economic data and a clear improvement in risk dynamics across a range of indicators has undermined the demand for risk-free assets at a time when the supply of those assets is rising dramatically. US 10-year bonds yields appear to have sustained a break above the 3.0% level despite purchases of Treasuries by the Fed. Despite a 7pt fall overnight, US 10-year bond yields still remain comfortably above the key 3.0% even after the minutes from the Fed's April 28-29 meeting revealed some policy-makers thought a further expansion of quantitative easing may be necessary to avert a deeper US downturn (Figure 4 below).

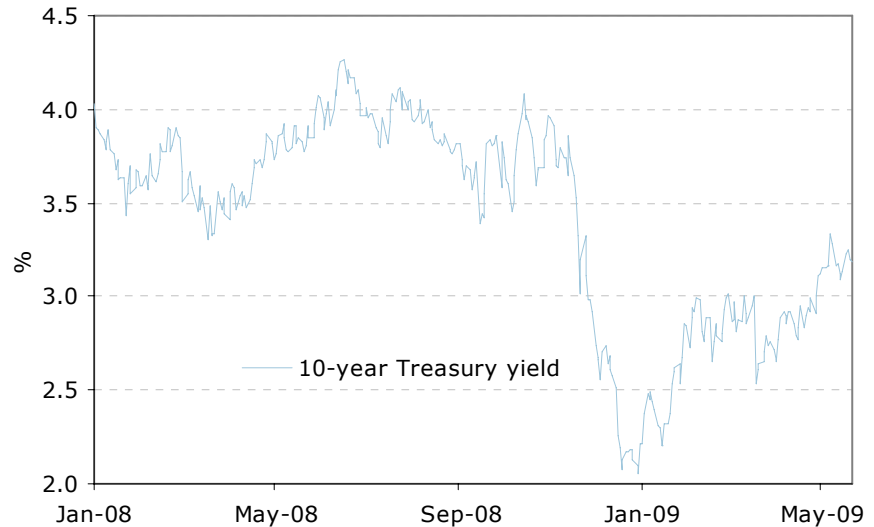
Figure 3 above highlights that the rise in the Australian 10-year yield has coincided with the sustained improvement in stock market sentiment. In the last week the S&P500 implied volatility index (VIX) has fallen below 30, the first time it has fallen below this key level since the worst of the financial crisis over October and November. The paring back of risk aversion has coincided with improved perceptions for prospects for global economic recovery. These factors have pushed Australian 10-year bond yields up over 1% from the lows seen at the end of 2008 despite further cuts in official cash rates.

Improved risk and credit conditions have also been highlighted by a continued narrowing of the spread between 3-mth BBSW rates and market expectations of official cash rates. This spread has narrowed to 20bps this week, the lowest level since January 2008. The Itraxx index of corporate credit default risk is also at the best level in 6-months.

Market expectations for future moves from the RBA are little moved this week with the minutes from the RBA's May meeting confirming that the RBA sees the risks to the outlook for both global and local economic growth as now being

more balanced. The futures market currently sees scope for just another 25bps cut in official cash rates from here.

**Figure 4: US 10-year Treasury yields**



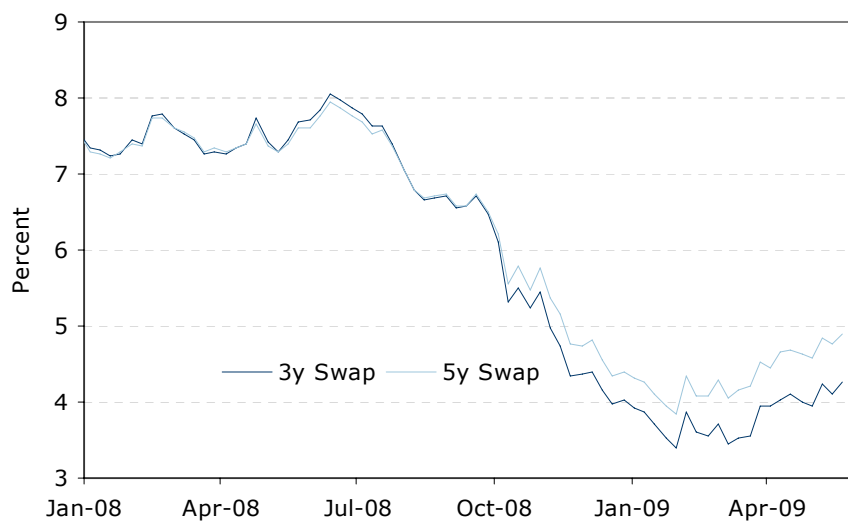
Source: ANZ & Bloomberg

**But it could be difficult for these gains to be sustained**

Clearly it is the momentum of the stock market rally and paring back of risk aversion across other markets that has helped to push local yields to levels that we had not anticipated in light of our view that the RBA will come back into play later in the year. But recent price action suggests further gains for yields will have to be dependent on further improvement in risk measures and positive surprises for economic data releases (noting that further improvement in the data is already priced in). There are also concerns that higher market yields represent a headwind for the economy in terms of higher borrowing costs.

We would still expect swap rates to head lower as the scope for easier RBA policy comes back into play later in the year. But given recent price action, we would now see less chance of a move below 4.5% on 10-year swaps (Figure 5).

**Figure 5: Three-year and 5-year swaps**



Source: ANZ & Bloomberg

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## FX: Market sentiment continues to outweigh fundamentals

### Recommendation

The wide trading range for the AUD/USD persists. Last night's failure to make a higher daily close despite improved global risk appetite and a weaker USD suggests this cross is vulnerable to some (mild) downward correction in the short-term. Natural sellers of AUD should continue to look to extend hedging duration at current levels above USD0.76.

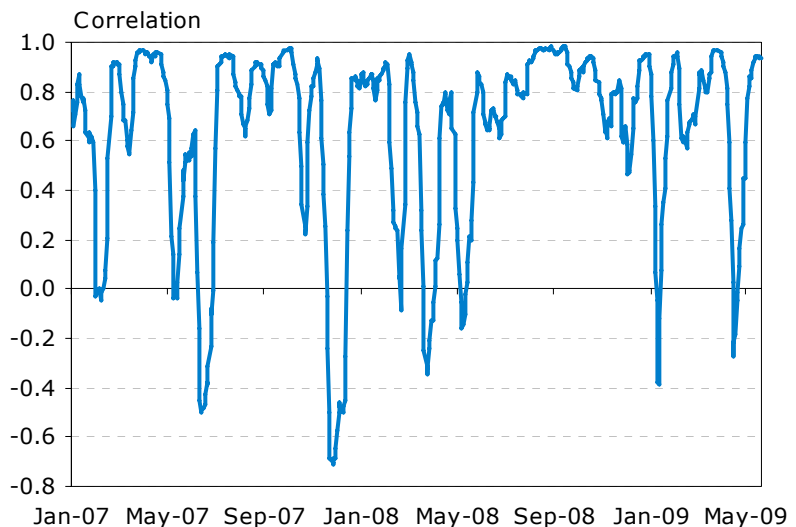
### Overview

Market sentiment continues to matter more in the current trading environment than economic fundamentals.

Case in point: despite the Euro-zone last Friday reporting a Q1 GDP outcome of -2.5% QoQ versus expectations for a smaller 2.0% decline (and with powerhouse Germany declining by 3.8% against expectations of a 3.0% fall), currency markets have barely blinked. After a brief dip lower on Monday, EUR/USD has rallied over 3 US cents in a move through the key 1.3750 level (38.2% retracement between the 2008 high and low). The strengthening upward momentum in the 50-day moving average could continue to push the EUR higher although we suspect strong technical resistance will be found at 1.3865.

The other strong movement this week has been in the GBP, which struck a fresh 5-month high against the USD and in the process easily pushed through its 200-day moving average. Markets have taken heart from the BoE's commitment to support economic recovery with the minutes from the last policy meeting revealing that Board members had discussed the possibility of expanding the Bank's quantitative easing program to £75bn instead of the £50bn that was agreed. This is despite the implication that UK yields will stay lower for longer.

**Figure 6: Correlation between AUD/USD and EUR/USD (20-day moving avg)**

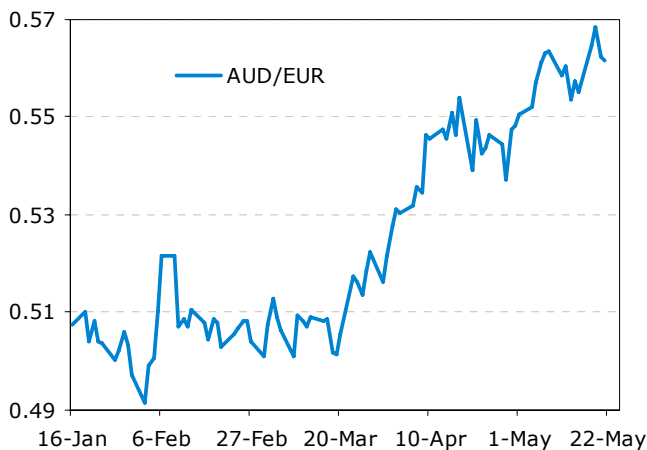


Source: ANZ, Bloomberg

These recent moves have seen the strong positive correlation between the AUD/USD and EUR/USD re-establish itself, despite the obvious differences that continue to emerge in the underlying fundamentals of the Australian and Euro zone economies. Not to ignore the apparent (and even surprising) durability of the global equity market rally, Australia's higher yield environment, aggressive fiscal stimulus and signs of recovery in China are lending good support to the AUD/USD. However, similar factors are not playing out in the Euro zone. National governments have been reticent to stimulate their economies to the extent that the Australian government has, while the ECB had failed to follow its US and UK contemporaries down the path of quantitative easing. We therefore still expect AUD/EUR to grind higher over the medium-term.

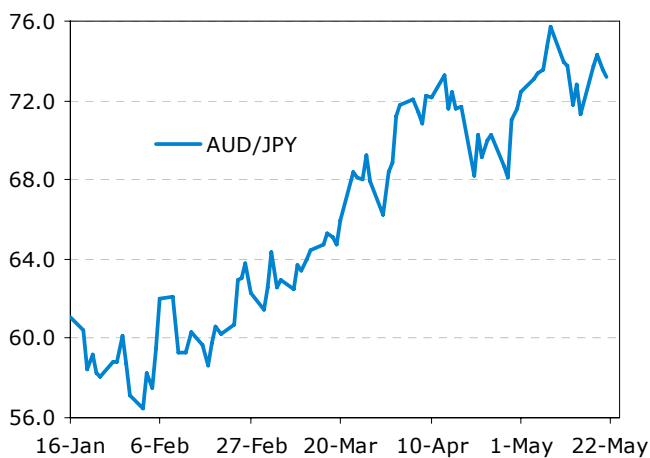
**AUD/USD Key levels: 0.7475 – 0.7930.** As highlighted in last week's view, the move above 0.7700 has opened up the possibility of a rise toward AUD/USD0.7930 (50% retracement level between the 2008 high and low). With trading ranges remaining wide, look for downside support above 0.7475.

## AUD cross view



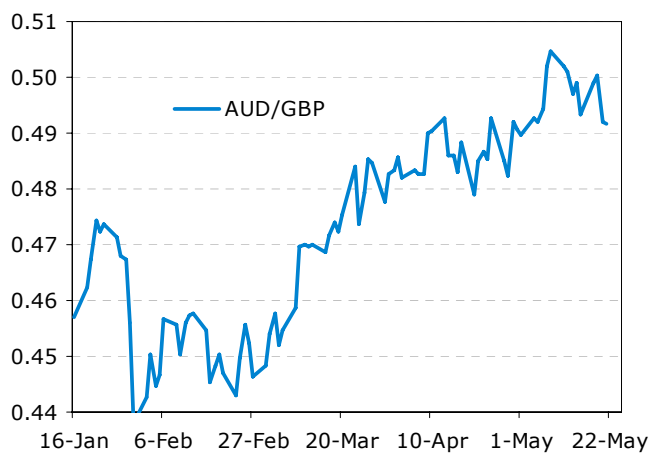
### AUD/EUR Key levels: 0.5360 – 0.5710

- AUD/EUR momentarily cracked the 0.57 level but failed to approach the May 7 high of 0.5713. This week's recovery on global equity markets has failed to give the EUR the same leg up as the AUD, although further signs of 'green shoots' in the Euro zone data flow next week could give the EUR the impetus it needs to push back through EUR/USD1.37 and subsequently weigh on the cross. Watch for the EU PMI release tonight and next week's confidence data.
- Longer-term, the outlook for the Euro zone is considerably more dire than Australia's, and as such the risk is for further AUD/EUR strength.



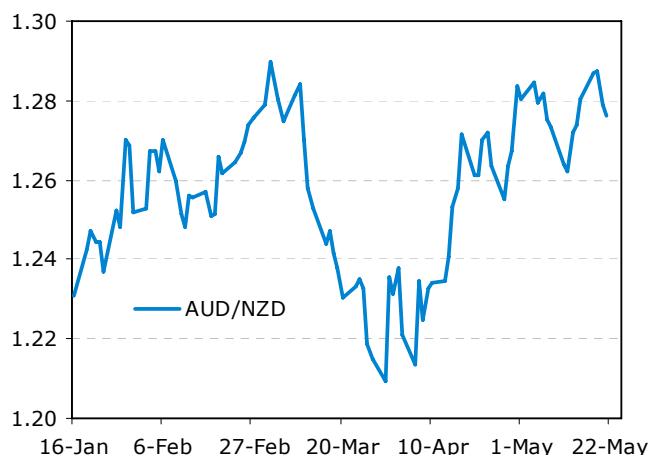
### AUD/JPY Key levels: 68.00 – 74.10

- While the JPY has re-emerged as a global safe-haven choice, USD/JPY continues to fail at the key 94.30 level. With the improvement in risk appetite boosting the AUD, AUD/JPY has settled back around 72 but is failing to sustain a rise above 74 (the key 38.2% retracement level between 2008's high and low). With little data due for release in Japan or Australia until late next week, beware of broad trends in equity market sentiment pushing the AUD/JPY around. Note that underlying momentum remains positive, with the cross trading comfortably above its 50-day moving average.



### AUD/GBP Key levels: 0.4790 – 0.5060

- The BoE's commitment to support the UK economy through QE policies has heartened the market and helped to support GBP/USD. With all MPC members voting to extend QE at the May board meeting, this has pushed GBP/USD above 1.57 for the first time in five months. The GBP has outperformed the AUD such that AUD/GBP has struggled to sustain moves above 0.50.
- A raft of key UK economic releases this week will be crucial; look for signs of deterioration in April retail sales data and Q1 GDP components to weigh on the GBP/USD. This would provide some short-term scope for AUD/GBP gains.



### AUD/NZD Key levels: 1.2490 - 1.2970

- This cross has failed to sustain a rally above 1.28 this week, with the improvement in risk appetite benefiting the NZD more than the AUD. While AUD/NZD remains decidedly range bound for now, July 2008's high of 1.2969 remains tantalisingly within reach. Indeed, with the 100-day moving average set to cross above the 50-day MA, the cross could be carried higher on momentum alone. Good support exists above 1.2590.
- The NZ trade balance is the key economic risk event for AUD/NZD early next week, before being overshadowed by the handing down of the NZ government budget.

## 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	-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
<b>Gross Domestic Product (GDP)</b>	<b>4.0</b>	<b>2.1</b>	<b>-0.9</b>	<b>0.6</b>
<b>Prices and wages (annual % change)</b>				
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
<b>Labour market</b>				
Employment (annual % change)	2.8	2.2	-0.3	-1.0
Unemployment rate (%)	4.4	4.2	6.1	8.0
<b>External sector</b>				
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	3.12	3.20	2.30	2.30	2.30	2.35
3 year bond	3.99	3.55	3.35	3.15	3.55	3.70
10 year bond	5.04	4.65	4.45	4.25	4.45	4.50
3s10s yield curve	1.05	1.10	1.10	1.10	0.90	0.80
3 year swap	4.24	3.90	3.65	3.45	3.85	4.00
10 year swap	5.46	5.15	4.85	4.60	4.75	4.80
<b>International interest rates</b>						
RBNZ cash rate	2.50	2.50	2.25	2.00	2.00	2.00
NZ 90 day bill	2.78	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	0.83	0.75	0.80	0.85	1.25	1.50
US 10 year note	3.18	3.50	3.55	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
<b>Australia and NZ exchange rates</b>						
A\$/US\$	0.7736	0.72	0.68	0.66	0.65	0.65
NZ\$/US\$	0.6064	0.54	0.51	0.48	0.47	0.47
A\$/¥	73.05	75.60	73.44	72.60	75.40	75.40
A\$/€	0.5615	0.56	0.56	0.55	0.55	0.56
A\$/£	0.4912	0.49	0.46	0.45	0.43	0.42
A\$/NZ\$	1.276	1.33	1.33	1.38	1.40	1.38
A\$/CA\$	0.8833	0.89	0.84	0.83	0.83	0.83
A\$/CHF	0.8512	0.86	0.84	0.86	0.90	0.92
A\$/CNY	5.279	4.92	4.64	4.51	4.43	4.43
A\$ Trade weighted index	62.30	61.23	58.85	57.40	56.89	56.65
<b>International cross rates</b>						
US\$/¥	94.4	105	108	110	116	116
€/US\$	1.378	1.28	1.22	1.20	1.18	1.16
€/¥	130.1	134	132	132	137	135
£/US\$	1.575	1.48	1.48	1.48	1.50	1.53
€/£	0.8748	0.86	0.82	0.81	0.79	0.76
US\$/CA\$	1.142	1.23	1.24	1.25	1.27	1.28
US\$/CHF	1.100	1.19	1.24	1.30	1.38	1.41
US\$ index	81.10	87.8	90.8	92.1	93.8	94.6
<b>Asia exchange rates</b>						
US\$/CNY	6.824	6.83	6.83	6.83	6.82	6.82
US\$/HKD	7.752	7.75	7.75	7.76	7.76	7.77
US\$/IDR	10369	11500	11900	11500	11500	11000
US\$/INR	47.49	52.00	51.00	51.00	50.00	50.00
US\$/KRW	1245.8	1400	1450	1400	1325	1300
US\$/MYR	3.528	3.70	3.75	3.75	3.70	3.65
US\$/PHP	47.23	49.50	50.00	49.50	48.80	48.50
US\$/SGD	1.457	1.58	1.60	1.62	1.63	1.61
US\$/THB	34.38	36.50	37.50	37.00	36.50	36.00
US\$/TWD	32.69	32.70	32.00	32.00	31.00	30.00
US\$/VND	17783	18300	18800	18800	19300	19300
<b>Pacific exchange rates</b>						
PGK/US\$	0.368	0.35	0.34	0.35	0.35	0.36
FJD/US\$	0.472	0.43	0.42	0.40	0.39	0.39

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