

Sentiment versus fundamentals

12 March 2009

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

Macro Update: Mixed up

- Sentiment in equity markets improved this week, despite the data implying that the global downturn continues to deepen.
- Locally, official employment data continued to hold up in February. But with corporate profitability deteriorating we cannot see this trend continuing.

Interest Rate Markets: Bonds hold ranges while RBA easing looms

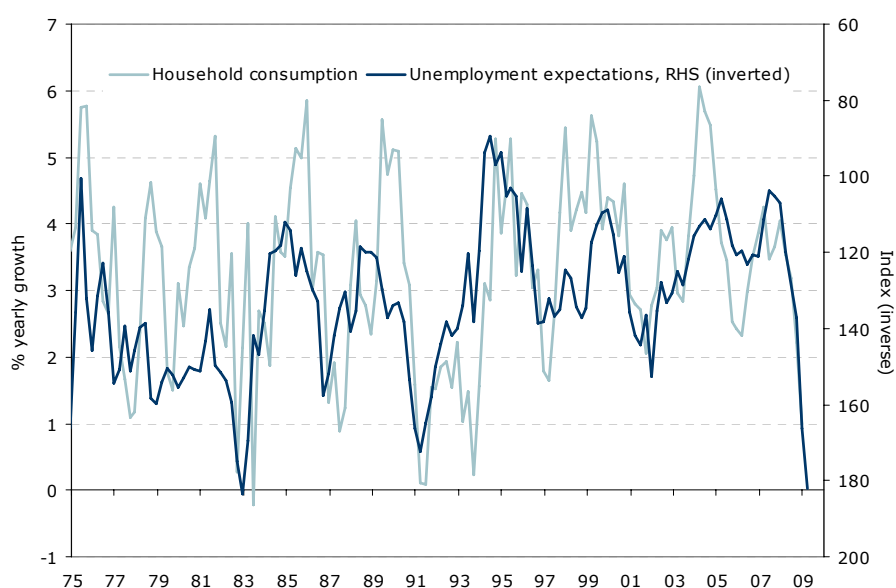
- Recent data have reinforced market expectations for the RBA to resume the easing cycle with a rate cut at its April 7 meeting. We have pencilled in a 25bp cut, but would not rule out a larger move.
- Increased Commonwealth bond issuance via AOFM tenders are going well, but we are starting to see some initial signs of moderating demand.

FX: Sentiment versus fundamentals

- The AUD remains in its trading range versus the USD, where buyers should take advantage of any moves below 0.6250 while sellers should look for rallies above 0.6480.
- Although the AUD is often viewed as benefiting in an environment of strong risk appetite, this week the support for AUD can only be called tepid. While a strong rally in equity markets has supported AUD/USD, the AUD has underperformed on most crosses.

Chart of the week

Figure 1: Unemployment fears will hinder consumer spending



Source: ABS and ANZ

Macro Update: Mixed up

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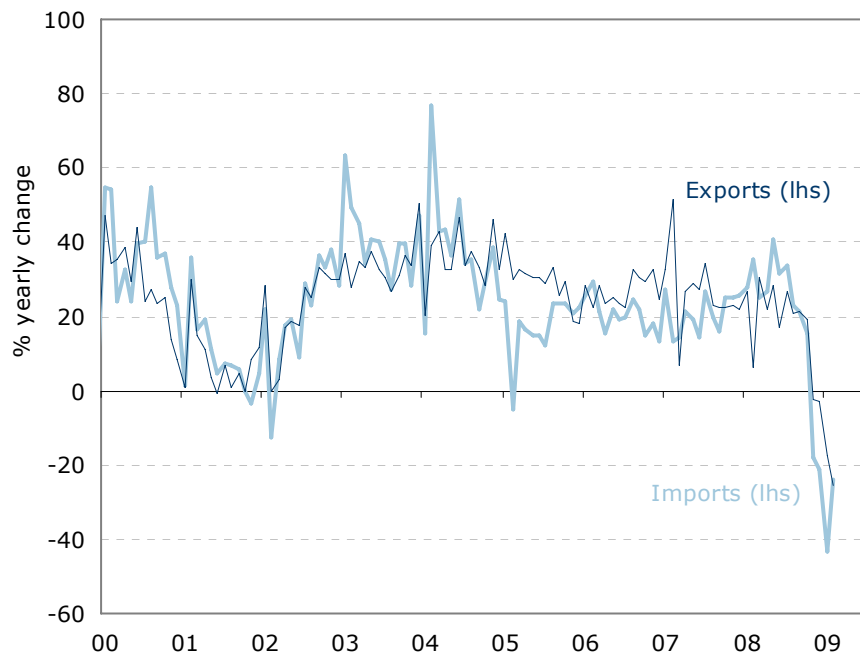
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Global economy: not yet bottoming

Despite the World Bank announcing that it is now forecasting the global economy to contract in 2009, global equity markets have rallied this week on news that two major US banks, Citigroup and JP Morgan, have been profitable for the first two months of 2009. For Citigroup at least, these are the first profits since late 2007 (ie. since the sub-prime crisis broke). The news has provided investors with some confidence that, as a result of massive government capital injections, the process of distressed bank balance sheet repair is now making good progress. Such balance sheet repair is essential to restoring the functioning of the global banking system, and thus prompting economic recovery. But with 'just' \$1.2 trillion of the estimated \$2.2 trillion of banking and insurance sector losses now declared, **we would hesitate in calling these individual banks' profit reports the end of the bad news.** For now, we expect confidence to remain low and high market volatility to persist.

Figure 2: Chinese trade data highlights the global economic distress



Source: Bloomberg and ANZ

Equity markets generally rally about six months before the economic recovery commences. **This week the global economic data implied that we may be some way from reaching the bottom of this deep economic downturn.** After suffering a sharp shock at the end of 2008, the collapse in global industrial production appeared to gather further momentum in early 2009. UK industrial production fell by 2.9% in January to be 12.8% lower than a year ago. Production in the UK's manufacturing sector has now shrunk by 6.4% in the three months to January, the biggest three month fall since records began in 1968. The news was also bad in Europe's major manufacturing economy, Germany. German factory orders plummeted a further 8.0% in January to be a massive 37.9% lower than a year ago, the biggest drop since German reunification in 1991. Declining global export demand is driving these catastrophic falls in global production. The continued deep downturn in global manufacturing will have further deep ramifications across global labour markets,

in turn extending the process of global consumer balance sheet readjustment and ultimately the global economic downturn.

This week's data from China highlighted that our trading partners in East Asia have also suffered tremendous damage from the sharp decline in global export demand. Chinese exports plunged 26% YoY in February, an acceleration from the 18% fall in December while imports fell by 24% YoY. Industrial production also disappointed, rising just 3.8% YTD YoY in February while Chinese retail sales growth fell to a 2-year low. That said, urban fixed asset investment jumped 26.5% YTD Yoy in January and February, which may be an early sign that China's large fiscal stimulus package is starting to work. But in the meantime the impact for Australian exporters is negative. This week Australian producers struck 44% declines in 2009-10 thermal coal contract prices. This makes a large 60-65% fall in coking contract prices likely.

Australia: Mixed signals

This week's poor global data clearly highlights the downside risks to our already pessimistic outlook for Australian corporate profits and business investment. It is thus imperative that consumer spending grows if we are to avoid further negative growth outcomes.

Indicators of future consumer spending were mixed this week. Consumer confidence remained at low levels and forward-looking indicators of employment continued to plummet, with both the ANZ Job Advertisements Series and the NAB Business Survey measure of employment intentions at levels worse than or as bad as during previous recessions.

In contrast, the official employment data continues to hold up surprisingly well, rising by 1.8K in February. This is not to say that labour market conditions are not weakening. The unemployment rate has risen from 3.9% to 5.2% in the past year, with the number of people looking for work growing more rapidly than actual job creation. Annual employment growth has weakened to 0.7% from 2.9% in February 2008. And there has been a trend shift away from full-time towards part-time jobs, which suggests downward pressure on household incomes. **But the adjustment in the labour market has so far been less pronounced than implied by the slowdown in economic growth.**

For policy makers, the relatively resilient employment outcomes as well as rising housing loan approvals (particularly for first home buyers) may provide some confidence that rate cuts, cash handouts and the increase in the first home owners' grant are helping to support the economy. But **we cannot see these positive employment outcomes continuing**, with falling corporate profits a strong incentive for businesses to cut back on labour costs. And with surveyed unemployment expectations at high levels it seems unlikely that consumer spending will save the day (see chart of the week). **ANZ continues to expect GDP will contract by around ½% in 2009 and that the unemployment rate will peak at around 7½% in 2010.**

Data wrap

- **The ANZ Job Advertisements Series** fell by 10.4% in February to be 39.8% lower over the year. Newspaper job ads were down 25.2% in February, taking the annual fall to 55.4%. Internet job ads fell 9.4% in the month.
- **The NAB Business Survey** showed a pick up in business confidence to -22 from -32, but a deterioration in actual business conditions to -20 from -11.
- The value of **housing finance approvals** rose by 2.3% in January, despite a 3.8% fall in lending to investors. The number of owner-occupier home loans rose 3.5%.
- **WBC-MI Consumer Sentiment** fell by 0.2% in March.
- **WBC-MI Consumer Inflation Expectations** fell slightly to 2.2% in March.
- **Employment** rose by 1.8K in February, with a sharp 53.85K drop in full-time employment offset by a 55.6K increase in part-time employment. The **unemployment rate** surged 0.4ppt to 5.2%, partly due to a higher participation rate which rose 0.2ppt to 65.5%.

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Interest Rate Markets

Bonds hold ranges while RBA easing looms. But lower cash rates and increased bond supply supports a steeper curve.

Recent data have reinforced market expectations for the RBA to resume the easing cycle with a rate cut at the April 7th meeting. We have pencilled in a 25bps cut, but would not rule out a larger move. In so far as today's labour force data are relevant for the RBA outlook, the sharp rise in the unemployment rate above 5% appear to be more consistent with trends globally and the clear evidence of a switch to part-time work from full-time suggest household incomes will come under pressure. Our job ads series point to further significant labour market weakness in coming months.

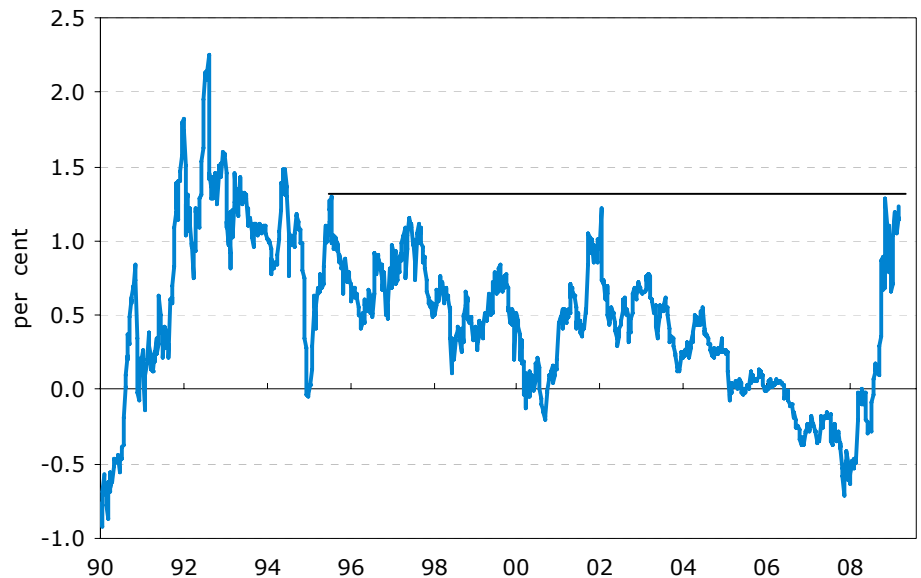
We will get some further insight into RBA thinking next week with Minutes from the last board meeting released on Tuesday. Several speeches from senior bank officials over the next two weeks will then help guide expectations.

While RBA growth forecasts are likely to be cut further in light of the GDP data last week there will be some relief for households with the next spending stimulus from the Government worth another 1% of GDP to hit bank accounts over the next couple of months. There could also be some scope for the scaling back of rate cut expectation should we see further signs of stabilisation across equity markets.

While the data have been weak on balance over the past week, the range-trade environment has been extended for bond yields over this period. Three-year bond yields have held to a 2.95%-3.45% range since early February while 10-year yields have held to a 4.00%-4.50% range since the end of January. Without a major shock, these ranges look likely to hold heading into the RBA board meeting.

Bonds have moved towards the lower part of these ranges this week to reflect expectations of imminent RBA rate cuts. Stock market weakness has also supported safe-haven demand to highlight how equities still look to be a key driver for other markets. But this has not been sufficient to push yields to new lows.

Figure 3: 3/10 curve



Source: ANZ & Bloomberg

The UK experience suggests a move to quantitative easing and large-scale purchases of Government bonds is required for yields to hit new lows for this cycle. The BoE purchased £2bn of Gilts overnight. Ten-year bond yields in the UK have fallen by around 60bps since the policy was announced last week.

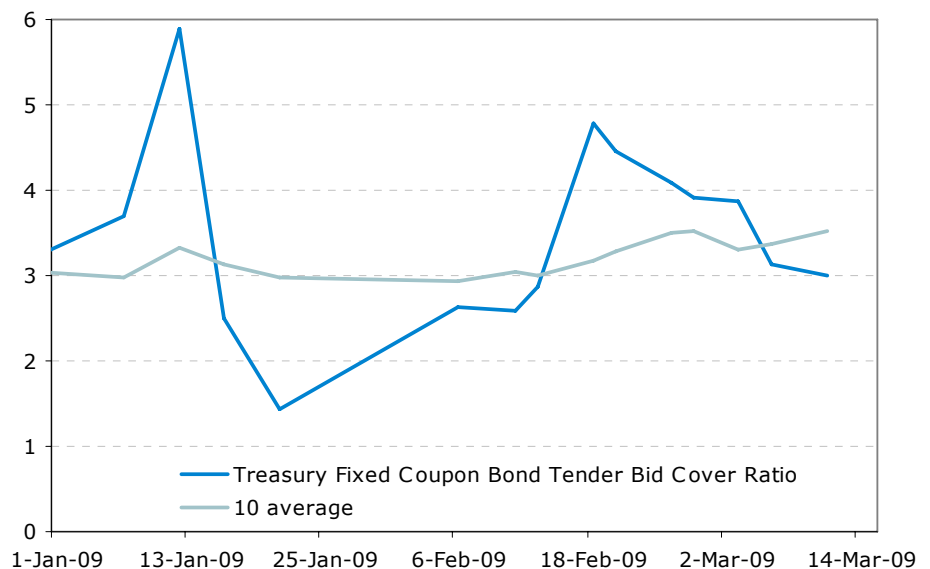
However, supply remains a constraint in the US as the US Treasury steps up issuance to fund stimulus measures there.

With shorter-dated yields anchored by further rate cut expectations, supply does help to explain curve steepening towards multi-year highs, at least in part – see Figure 3 above.

The spread between 3 and 10-year yields is at a month-high above 120bps and is threatening the 128bps high seen in early February. This is a significant level as this was also the high in 1995. We are still well below levels seen in 1992 when the curve hit 187bps in the midst of the last recession and an extended RBA rate cutting cycle that pre-dates the inflation targeting era.

Increased Commonwealth bond issuance via AOFM tenders are going well, but we are starting to see some initial signs of moderating demand in terms of the ratio of bids relative to the amounts being offered at tenders, or the bid/cover ratio – see Figure 4 - although a cover ratio of 3.0 is hardly a cause for concern at this stage.

Figure 3: The bid/cover ratio for AOFM tenders



Source: ANZ & Bloomberg

Note the dip in the bid/cover at the end of January was before the new borrowing target was announced. The high to low of bids accepted also appears to be widening a little in recent auctions.

Yesterday's tender was the 9th of the new borrowing program that aims to raise between \$22-24bn before the end of June. The AOFM has raised a total of \$5.9bn in bond issues since 6th Feb (\$8.1bn including T-Notes). If demand does moderate further for the longer-dated issues, this could add to curve steepening pressures if the RBA does meet market expectations with more front-loaded rate cuts.

Looking ahead to next week, the RBA board Minutes will provide some insight into how seriously further rate cuts were discussed considering the impending fiscal stimulus and the extent to which the weak GDP data was anticipated. If it was, did this challenge confidence in an economic rebound by the end of the year? Assistant Governor Edey is due to speak on Thursday. There are no major data due for release next week.

The Queensland state election will be held on 21st March. Considering the significant widening in Semi-government spreads following the recent downgrade of Queensland, markets will be looking for some clarity after the election regarding the Commonwealth's stance on direct or indirect support for the states in terms of funding costs and Capex spending to ease the burden on state finances at a time when revenues are being hit.

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FX: Sentiment versus fundamentals

Recommendation

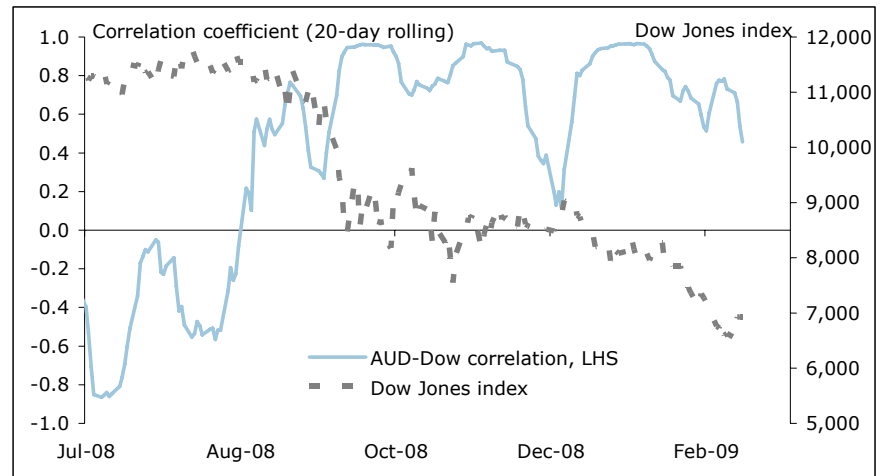
The AUD remains in its trading range versus the USD, where buyers should take advantage of any moves below 0.6250 while sellers should look for rallies above 0.6480. With actual volatility having fallen below implied volatility, short-dated options are now cheap relative to recent history. Sellers of AUD should take advantage of the swift decline in risk reversals seen in recent weeks to hedge their exposure to a further leg down in AUD/USD.

Overview

The 6% rally in equity markets this week has been supportive of the Australian dollar, which rallied from a low of AUD/USD0.6287 last week to a high of 0.6526 today. However, this was mainly due to a softening US dollar in what is being viewed as an improved environment for risk. Relative to EUR and JPY, the AUD has underperformed. As such, although the AUD is often viewed as benefiting in an environment of strong risk appetite, in this case the support for AUD can only be called tepid.

The relationship of the AUD to risk appetite is an important one to understand in the current environment. Our forecasts for the AUD/USD exchange rate are based on our fundamental economic forecasts. However, as documented previously, extreme highs and lows in risk appetite can cause the AUD/USD to trade at a 5-8 cent premium or discount to our estimate of fundamental fair value. At present, some market commentators are speculating that equity markets may have reached their lows for this cycle. We do not forecast equity market performance, but if this view is correct then this would imply a potential for AUD/USD to rise further, and trade at a premium to our estimate of fair value in the weeks ahead.

Figure 5: AUD is more hurt by a falling Dow than lifted by a rising one

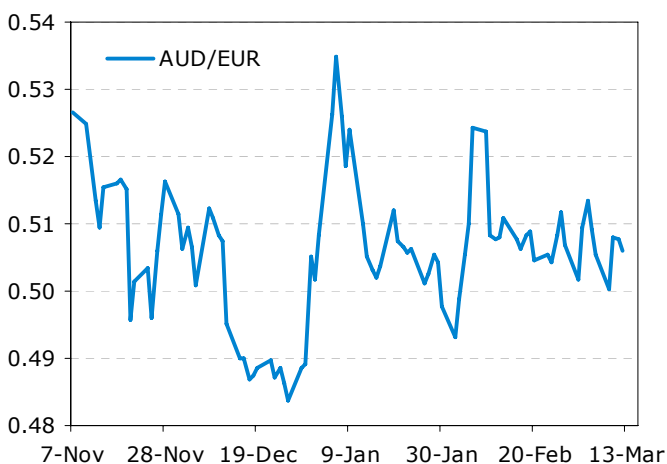
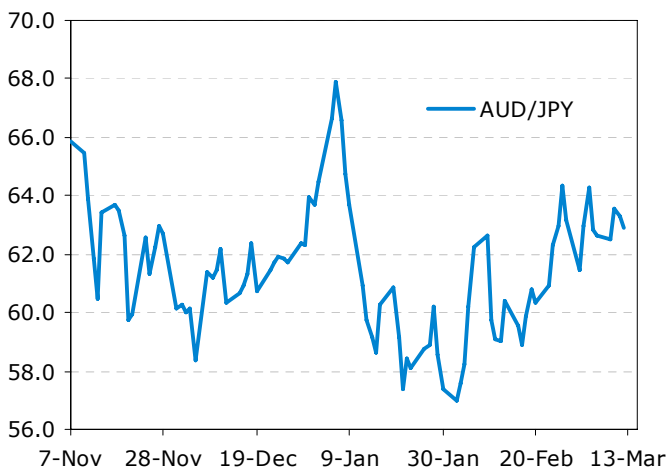
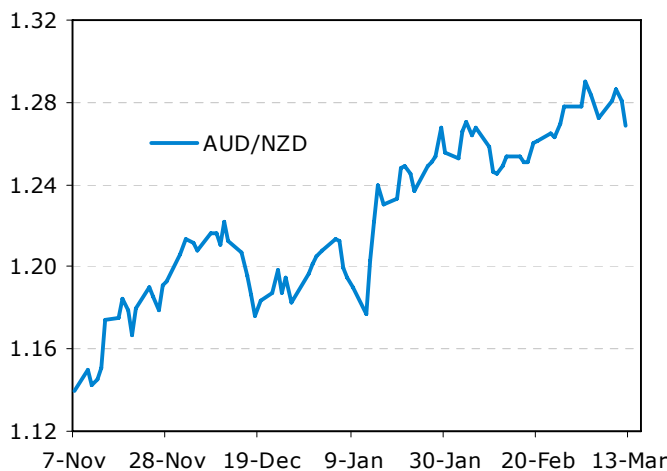
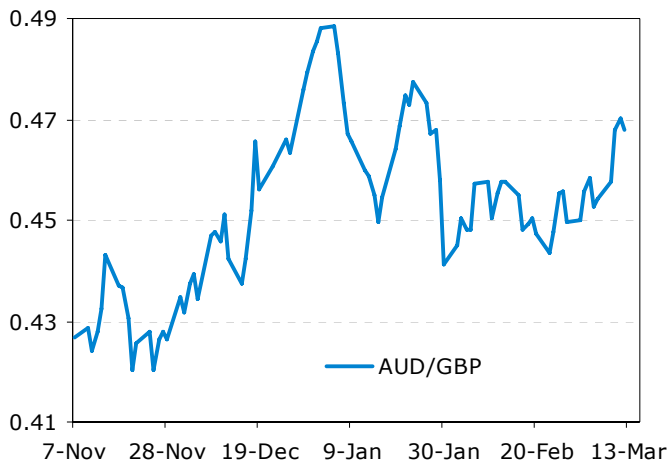


Source: ANZ, Bloomberg

However, equity market rallies may not be as positive for the AUD as some market participants believe. As we can see in the chart above, the AUD/USD tends to be highly correlated with the Dow Jones when the Dow is falling and the AUD/USD is weakening. When the Dow is rising, the relationship is not strong. The implication is that the AUD is heavily affected to the downside in a negative equity environment, but less supported to the upside when equity markets rally. The fact that AUD/USD is trading around our estimated fundamental fair value of AUD/USD0.6350 for March suggests that the equity market rally would have to gather significantly more strength to take AUD beyond the present topside resistance of AUD/USD0.6550.

AUD/USD Key levels: 0.6010 – 0.6550. The range for AUD risks moving lower. Significant upside resistance remains at 0.6550 (50% retracement between February's low and high), with support persisting but weaker at 0.6250.

AUD cross view



AUD/GBP Key levels: 0.4450 – 0.4800

- The GBP/USD sank to 1.3656 this week following news that Lloyd's bank had ceded control to the UK government. This propelled the AUD/GBP beyond last week's suggested upper level to 0.4734, a six-week high. However, further gains in the AUD/GBP should be capped below 0.4800, with the GBP/USD pushing higher towards the key 1.4040 level. There is strong support around AUD/GBP 0.4590, and then lower at 0.4450.
- Next week we'll see minutes from this month's RBA and BoE meetings, and UK unemployment numbers. These releases could provide some volatility in the cross.

AUD/NZD Key levels: 1.2540 - 1.2880

- The AUD continues to maintain strength versus the NZD, although this morning's 50bp cut to the overnight cash rate by the RBNZ saw the NZD/USD rally back above 0.5130 for the first time in two weeks. This has pushed the AUD/NZD to just below the key 1.2680 level, suggesting limited upside for now.
- After the strong push towards AUD/NZD 1.30, some consolidation can be expected. However, the medium-term outlook suggests that the cross will edge up above 1.30 as the NZ economy heads deeper into recession, keeping interest rates below those in Australia for the next six months.

AUD/JPY Key levels: 60.00 – 64.80

- AUD/JPY has traded in a tight 61.0 - 64.8 range over the past week, with moves higher capped below 64.8. The JPY has improved in recent sessions, and there is a risk of further JPY strength as we head into the end of Japan's fiscal year. This could weigh on the AUD/JPY over the coming weeks. Key upside resistance at 64.00, then 64.80, with downside support around 61.00 and 58.50.
- Next week's BOJ meeting is not expected to generate much excitement, with moves in the JPY to continue to be dictated by broader global risk appetite.

AUD/EUR Key levels: 0.5000 – 0.5160

- The AUD/EUR has dropped below the key 0.5070 level (50% retracement between Feb's high and low) on EUR/USD outperformance this week, and trade remains contained within a tight 1½ Euro cent range. The current upswing in the EUR/USD around 1.2850 looks unsustainable and is likely to head back below 1.2770.
- There are no obvious economic triggers for a radical move in the AUD/EUR on the horizon next week. Worse than expected Euro zone CPI, ZEW economic expectations and industrial production could return the cross back above 0.51 again.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008	2009f	2010f
Economic activity (annual % change)				
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
Gross Domestic Product (GDP)	4.0	2.1	-0.4	1.0
Prices and wages (annual % change)				
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
Labour market				
Employment (annual % change)	2.8	2.3	-0.2	-0.5
Unemployment rate (%)	4.4	4.2	5.7	7.4
External sector				
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	3.11	3.10	2.93	2.10	2.30	2.30
3 year bond	3.03	3.06	3.15	3.20	3.35	3.65
10 year bond	4.27	4.29	4.25	4.30	4.45	4.55
3s10s yield curve	1.24	1.23	1.10	1.10	1.10	0.90
3 year swap	3.42	3.42	3.50	3.50	3.65	3.95
10 year swap	4.81	4.84	4.65	4.65	4.75	4.85
International interest rates						
RBNZ cash rate	3.00	3.00	2.50	2.50	2.50	2.50
NZ 90 day bill	3.36	3.28	2.89	2.84	2.80	2.77
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.50
US 2 year note	0.99	1.01	0.85	0.95	1.25	1.50
US 10 year note	2.88	3.66	3.60	3.70	3.95	4.00
Japan call rate	0.10	0.10	0.10	0.10	0.25	0.50
ECB refinance rate	1.50	1.50	1.25	1.25	1.25	1.75
UK repo rate	0.50	0.50	0.50	0.50	0.50	0.75

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

Foreign exchange rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
Australia and NZ exchange rates						
A\$/US\$	0.6459	0.63	0.58	0.56	0.54	0.54
NZ\$/US\$	0.5119	0.50	0.45	0.43	0.41	0.42
A\$/¥	62.25	61.74	58.00	56.56	55.08	56.70
A\$/€	0.5042	0.50	0.48	0.50	0.49	0.50
A\$/£	0.4660	0.44	0.40	0.38	0.36	0.35
A\$/NZ\$	1.262	1.26	1.29	1.30	1.32	1.29
A\$/CA\$	0.8332	0.82	0.78	0.77	0.78	0.78
A\$/CHF	0.7468	0.76	0.73	0.75	0.76	0.77
A\$/CNY	4.419	4.31	3.97	3.83	3.69	3.69
A\$ Trade weighted index	54.90	54.05	50.39	49.39	47.88	47.95
International cross rates						
US\$/¥	96.4	98	100	101	102	105
€/US\$	1.281	1.25	1.20	1.12	1.10	1.08
€/¥	123.5	123	120	113	112	113
£/US\$	1.386	1.42	1.46	1.48	1.50	1.55
€/£	0.9242	0.88	0.82	0.76	0.73	0.70
US\$/CA\$	1.290	1.30	1.34	1.38	1.44	1.44
US\$/CHF	1.156	1.20	1.25	1.34	1.40	1.42
US\$ index	87.79	89.2	91.6	95.7	97.2	98.3
Asia exchange rates						
US\$/CNY	6.840	6.84	6.84	6.84	6.84	6.84
US\$/HKD	7.756	7.76	7.76	7.76	7.76	7.78
US\$/IDR	11981	12000	12000	11900	11600	11600
US\$/INR	51.74	49.00	49.00	48.00	48.00	47.00
US\$/KRW	1497	1500	1400	1400	1375	1350
US\$/MYR	3.69	3.64	3.74	3.80	3.80	3.80
US\$/PHP	48.32	48.50	49.50	50.00	49.50	48.80
US\$/SGD	1.532	1.54	1.58	1.62	1.66	1.66
US\$/THB	35.98	36.20	37.60	39.40	39.40	38.80
US\$/TWD	34.49	35.20	36.00	36.00	35.50	35.50
US\$/VND	17485	17500	17800	18100	18500	18500
Pacific exchange rates						
PGK/US\$	0.347	0.36	0.35	0.34	0.35	0.35
FJD/US\$	0.537	0.52	0.50	0.48	0.47	0.47

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