

Larger and faster rate cuts

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Macro Update: Budget deficits unavoidable

- The Australian government now faces an extended period of budget deficits, with the risk that we could see a worse peak to trough deterioration in the budget deficit than in previous recessions.
- New policy measures are being developed to try and address the vulnerabilities Australia's commercial property sector.

Interest Rate Markets: Larger and faster rate cuts

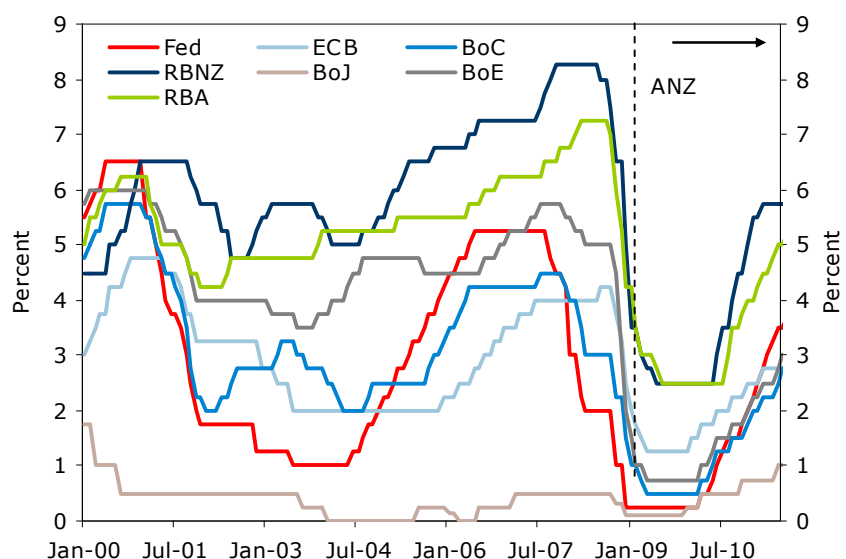
- The deteriorating global and domestic economic environment will prompt further large rate cuts from the RBA. We expect a 75bp reduction next week with the cash rate to ultimately hit a low of 2.5% by Q3.
- Expectations for faster rate cuts have seen front-end bond yields continue to fall over the past week, but longer-dated yields have lagged the move, highlighting the theme of continued yield curve steepening.

FX: Further AUD upside limited

- The AUD has ground higher over the week. The key short-term risks lie around US activity data due out tonight and tomorrow, where worse than expected releases have the potential to stoke another surge in global risk aversion and put downward pressure on the AUD.
- Longer term, changes to our Australian interest rate forecasts highlight the risks to our AUD/USD forecasts. While we believe our current forecast (already at the low end of consensus forecasts) remains valid, the major risk in 2009 is that it could fall below the expected trough of 0.54, and that this trough could occur earlier than the expected December 2009 outcome.

Chart of the week

Figure 1: Global interest rates continue on a downward trajectory



Source: Bloomberg and ANZ

Macro Update: Budget deficits unavoidable

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Vulnerabilities in commercial property

In the last week the government has announced the establishment of a \$4bn Australian Business Investment Partnership (ABIP) with the four major Australian banks. The government will contribute \$2 billion and each of the four major banks will contribute \$500 million to the Partnership. This scheme is designed to temporarily fill the 'funding gap' that could be left by the potential withdrawal of foreign banks from *existing* (not new) commercial property projects. The government claims this initial \$4 billion could be extended via the issuance of Government guaranteed debt to create up to \$30 billion of loanable capital. The government reportedly wants the ABIP to commence in March, although the details of the scheme are yet to be finalised.

Without details, it is difficult to judge how successful and appropriate the scheme will be. What we do know however is that the potential withdrawal of foreign bank funding from commercial property could potentially have deep and painful ramifications across the sector and the broader economy. Foreign banks account for around 28% (or \$45bn) of total lending to the sector. The potential withdrawal of almost of this lending, without policy intervention, would most likely cause a significant increase in the cost of funds for those projects directly affected. In a worse-case scenario, it could prompt a fire sale of projects previously funded by foreign banks. This would have significant implications for prices across the sector.

At the moment there is a stand-off between buyers and sellers in Australian commercial property. CBD prime office property prices are estimated to have fallen by around 20% since the peak in the December quarter 2007¹, although this estimate is based on a very limited number of transactions. In the last recession, prime office property prices collapsed by around 40%. However this price correction was largely driven by oversupply in the sector with vacancy rates of between 13-31% across capital cities. In contrast, the demand-supply balance is now more sound; the current national vacancy rate is just 3%. Nevertheless, this time around the sector faces the risk not just of the potential withdrawal of foreign bank funding, but also the possibility that the local banking sector tightens lending criteria for commercial property as the broader economy deteriorates. In this case, the 1980s/90s price drop of 40% may yet prove a useful benchmark, despite the different dynamics driving the shock (ie. a credit event versus oversupply).

Budget deficits as far as the eye can see!

Forget the debate over whether we will experience a Budget deficit. That is a done deal. The debate is the extent to which the Government should utilise the financial capacity of the Commonwealth of Australia to offset the impact of the global economic slump now underway. The past three recessions have seen a peak to trough deterioration in the Budget position of between 3.5% and 5.5% of GDP. If this normal cyclical pattern is observed in the current downturn, the Budget could be expected to deteriorate from a peak surplus of around 1.7% of GDP in 2007/08 to a deficit of around 2.5% to 3% of GDP within a few years. This implies that the Government will be running deficits of around \$30bn or more beyond 2009/10.

This process is already well advanced. On the Government's latest estimates from the Mid-Year Economic and Fiscal Outlook (MYEFO) released last November, the expected Budget surplus for the current year (2008/09) has shrunk from an originally estimated \$22bn to \$6bn, largely the result of the \$10.4bn fiscal package but also due to weaker economic growth forecasts

¹ Based on data from JLL

underpinning the calculations. Just 10 weeks later, these economic projections look too optimistic. Leading indicators of domestic spending have slumped while the news flow out of our major trading partners has gone from bad to worse.

Employment is a critical variable in determining Budget outcomes due to the dual impact on personal income tax collections and transfer payments. Most forecasters are expecting the unemployment rate to rise from a low of 3.9% in 2008 to around 7% in 2010, but there are considerable risks to these forecasts. Furthermore, over the past five years the commodity boom has increased the Government's reliance on income taxes from resource companies. If the profits of mining companies slump in line with the global economy, this will take a huge chunk out of the Government's revenues. So while we are expecting a mild recession by Australian standards, expectations for the Budget position should be less optimistic. If indeed the looming recession turns out to be worse than anticipated and the demand for our commodity exports remains subdued for an extended period, we could see a worse peak to trough decline in the Budget position than in previous recessions.

Also portending a rapid and substantial deterioration in the Budget position is more pre-emptive and activist approach to fiscal policy from the current Government. Not only has it executed the fiscal stimulus package late last year, it has increased funding for State and Local Governments. It has played an active role in guiding industry support, such as motor vehicle financing and support for the credit quality of the banking system. More direct fiscal stimulus will surely come with rumours circulating of another substantial announcement within days. This approach would be consistent with the emerging view amongst policymakers the world over of the importance of fiscal policy in offsetting the worst of the downturn when that downturn has at its root cause an impairment of the financial system. Put simply, monetary policy is unable to tackle this downturn alone.

Budget deficits mean issuing bonds and increasing the public debt. This will keep the Australian Office of Financial Management (AOFM) busy. This is the arm of Treasury charged with managing the Commonwealth Government's activities in financial markets. This is where the good news starts. First of all, the government has a strong starting point. Government net debt is -3.9% of GDP depending on how you measure it. This is well below the peak in the mid 1990s of 18.4% and low compared to countries such as the USA, Germany and the UK which have net debt levels of between 40% and 60% of GDP.

The Government can afford to run Budget deficits for some years and still only get up to levels comparable to our peers. As such, the Government credit rating, all important in a period of rising bond issuance and extensive Government guarantees for the banking system, is unlikely to be under serious threat.

Helping too is a modest financial buffer built up in recent years. We estimate the Government has around \$15bn on deposit with the RBA, which could be deployed into the funding of a deficit. The Building Australia fund and the Higher Education Endowment fund add up to just over \$15bn as well. With this buffer, the AOFM is unlikely to have to flood capital markets with Government bonds to fund the Budget deficit. But once Budget deficits set in, they are hard to get rid of and eventually a large fiscal deficit will result in a large call on the private sector savings pool by the public sector.

Data wrap

- The final stage **producer price index** increased by 1.3% in the December quarter. The rise was driven by import prices (+14.8%) due to the lower A\$, while domestically-sourced prices fell by 0.5% owing to lower energy costs.
- The **consumer price index** fell by 0.3% in Q4, taking the annual rate down to 3.7% from 5.0%. Lower petrol prices were the main driver, although inflation did ease more broadly, with underlying inflation easing to 0.75% QoQ from 1.25% QoQ last quarter.
- The **NAB Business Survey** showed an improvement in confidence and conditions in December, albeit off record lows in November. Business confidence rose by 10pts to -20 and business conditions improved 11pts to -6.

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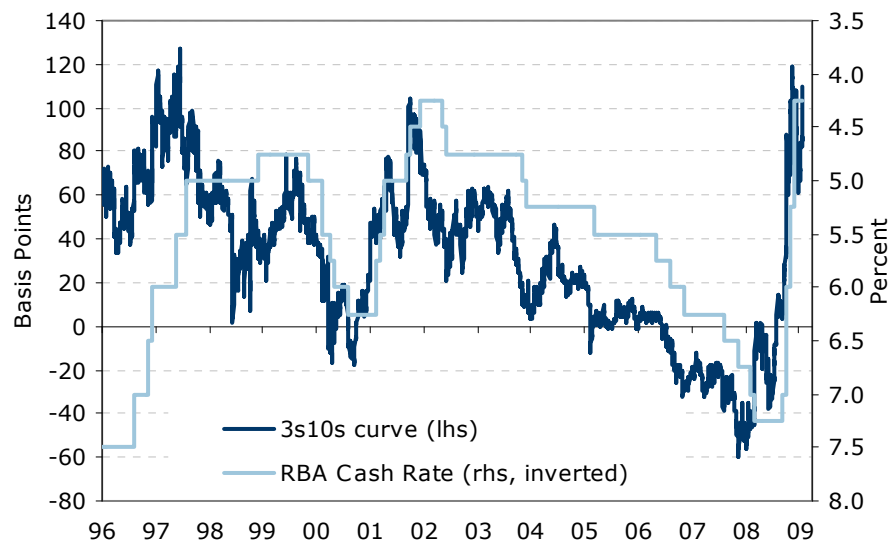
Interest Rate Markets: Larger and faster rate cuts

- The deteriorating global and domestic economic environment will prompt further large rate cuts from the RBA. We expect a 75bp reduction next week with the cash rate to ultimately hit 2.5% by Q3.
- Expectations for faster rate cuts have seen front-end bond yields continue to fall over the past week, but longer-dated yields have lagged the move, highlighting the theme of continued yield curve steepening.

Central banks stress the deterioration in the global environment

The confirmed peak in local inflation this week appears to provide little constraint on the RBA resuming a more aggressive approach to easing monetary policy. This now looks to be the "path of least regret" for policy-makers facing a broad and intense downturn in global activity. And pressure for the curve should remain to the upside while the RBA remains in easing mode (see Figure 2).

Figure 2: The easing cycle keeps the focus to the upside



Source: ANZ and Bloomberg

Expect the deterioration in the outlook for world growth to feature more prominently when the rate cut is announced next week. RBA board member McKibbin said the severity of the global economic downturn has exceeded expectations in comments last Friday while the FOMC statement overnight highlighted that *"global demand appears to be slowing significantly."* The worsening international outlook was central to the RBNZ's decision to cut rates by a larger than expected 150bps earlier today. The likelihood of another 1 per cent cut to cash rates here has increased in light of the big cut in NZ although we think there is more of a case for a 75bp cut. Indeed, market risk is for the RBA not to cut by 1% and refrain from confirming market expectations for further significant cuts in coming months.

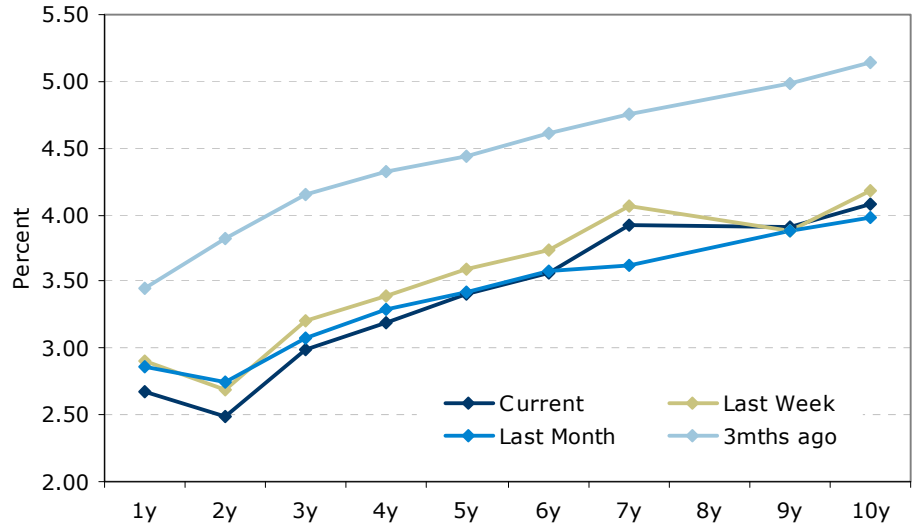
Either way, with Australia to experience a (mild) recession in 2009 and barely 2% growth in 2010, the challenges confronting the economy argue for lower rates, a weaker currency and further fiscal support in coming months. We now see the cash rate heading to 2.5% by Q3.

A more aggressive stance from the RBA might see more of a rally in term-rates in the near-term, but we remain cautious on how far this can go with 2.0% cash rates by the middle of the year almost fully factored into current market pricing. At some point the strategy of saving some policy flexibility to ensure a recovery eventually takes hold or address unexpected weaker economic outcomes must feature in communication from the Bank.

Bond yields at the front of the yield curve have continued to fall over the past week as market expectations have moved to expect larger and faster rate cuts. Three-year yields are below 3.0%, but longer-dated yields have lagged the

move, highlighting the major theme of continued steepening for yield curves. While expectations for rate cuts have driven shorter-dates lower, longer-dated yields have held up on the expectation for increased Government supply and rising longer term inflation risks. Ten-year yields have not posted new lows this week and are even above month-ago levels (see Figure 3).

Figure 3: The yield curve – lower and steeper

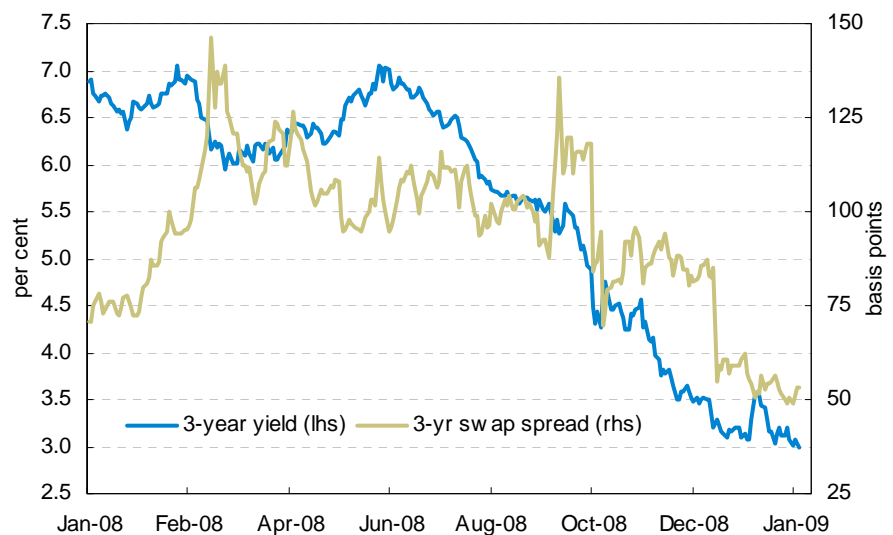


Source: ANZ & Bloomberg

Conditions for swap rates remain favourable on the back of continued demand for yield during this easing cycle. The new focus on further measures to foster improved credit conditions and the operation of the credit function in banking systems is also favourable. Plans to support lending to commercial property and broader syndicated loans are being developed while the BoE is also refining details of how to support syndicated loans in the UK.

A key development this week has been increased speculation that the Federal Deposit Insurance Corporation in the US will take on the role of creating a “bad bank” to take on toxic assets from banks. While the details of how this might work could prove problematic, this is a significant development from US authorities that shifts primary focus from liquidity operations to addressing core issues that continue to generate uncertainty for markets. Stock markets have responded very positively to this news despite the shocking run of economic data of late to help continued narrowing of credit spreads. Any further news on this issue could be the main story for global markets next week while domestic focus remains squarely on the RBA.

Figure 4: Yields and swap spreads head lower



Source: ANZ and Bloomberg

FX: Further AUD upside limited

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Recommendation

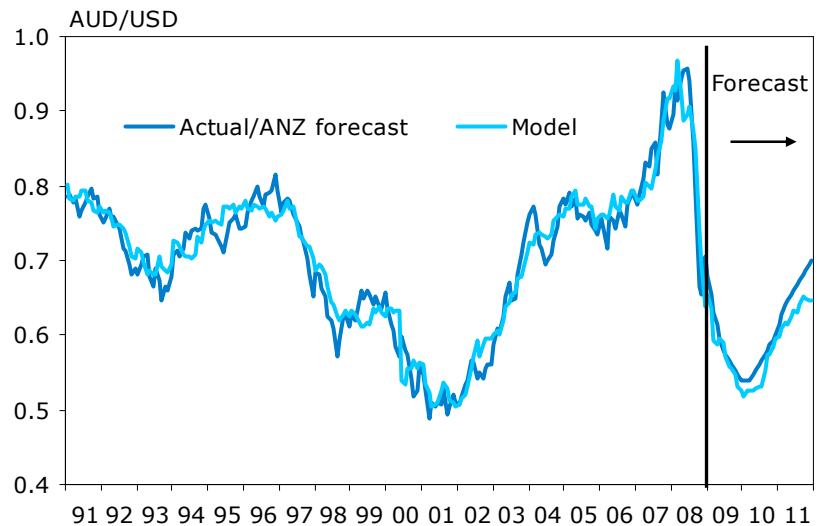
The AUD has ground higher over the week. The key short-term risks lie around US activity data due out tonight and tomorrow, where worse than expected releases have the potential to stoke another surge in global risk aversion and see the AUD/USD dip towards 0.6420, and AUD/EUR to below 0.5000.

Overview

The AUD's New Year boost is over, with a lower trading range of AUD/USD 0.6350-0.6800 established over the past two weeks. A re-emergence of risk aversion, with the focus returning to ructions in financial markets, has seen the AUD struggle to maintain a breach above AUD/USD 0.6700.

The return of financial market concerns, combined with further downgrades to both the global and domestic economic outlook, have prompted ANZ to revise its Australian interest rate expectations lower (please refer to the *Interest Rate Markets* article for further details). Although we feel that our current AUD forecast (already at the low end of consensus forecasts) remains valid, the downside risks to this forecast have become more pronounced.

Figure 1: AUD/USD set to move lower in 2009



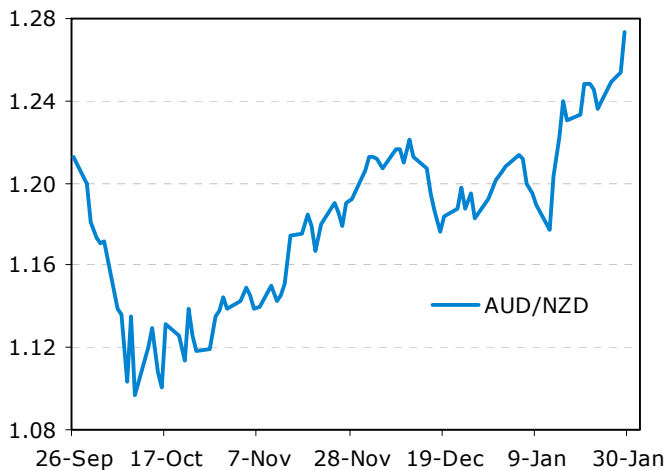
Source: ANZ & Bloomberg

The major risk to the AUD/USD forecast in 2009 is that it could fall below the expected trough of 0.54, and that this trough could occur earlier than the expected December 2009 outcome. Either of these outcomes could occur if commodity prices, having already fallen to 2005 levels since their July 2008 peak, take another significant leg downwards. On our current commodities and interest rate estimates, our fair value model suggests that the AUD could dip as low as 0.5150 by January 2010.

In the short term, no market moving data will be released in Australia over the coming days, so the RBA rate decision next week will be the key domestic event with the potential to move the AUD. A smaller than expected 75bp cut to the cash rate could see the AUD push higher, particularly against the NZD and GBP. There is also some risk around activity data due for release in the US. Worse than expected reads on tonight's December durable goods orders and tomorrow's Q4 GDP numbers and December Purchasing Managers' survey would likely weigh on the AUD. The AUD/USD could fall towards 0.6420, while the AUD/EUR could dip below 0.5000, and the AUD/JPY to under 58.20.

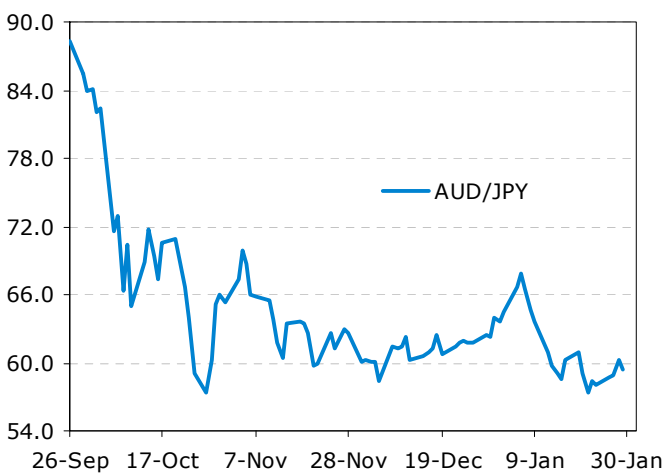
AUD/USD Key levels: 0.6420 – 0.6840. The AUD has struggled to maintain a break above 0.6680, and needs to do so in order to retest the psychologically important 0.7000 level. There remains strong support at 0.6420.

AUD cross view



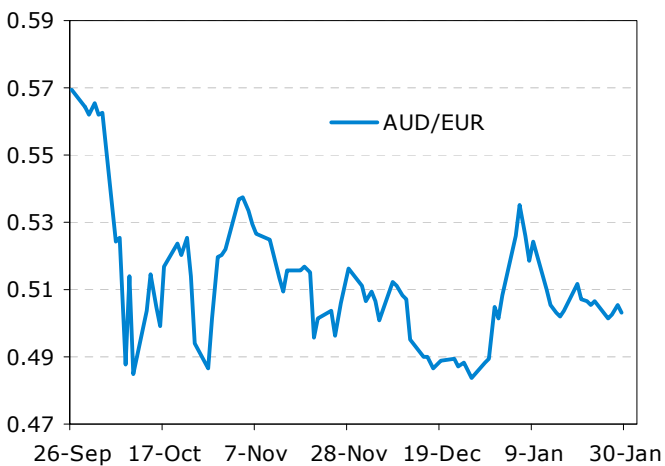
AUD/NZD Key levels: 1.2370 – 1.2970

- The AUD has surged against the NZD over the past week, climbing as high as AUD/NZD1.2750 following a bigger than expected 150bp cut to the RBNZ cash rate to 3.50%. However, we see this as a short-term rally, with the AUD/NZD expected to be capped below the previous peak of 1.2970 reached in July 2008.
- Over the coming week, the AUD is likely to be dragged lower by the NZD, and on speculation that the RBNZ's larger than expect rate cut may influence the RBA's decision when it meets next week. Key support lies at AUD/NZD1.2370.



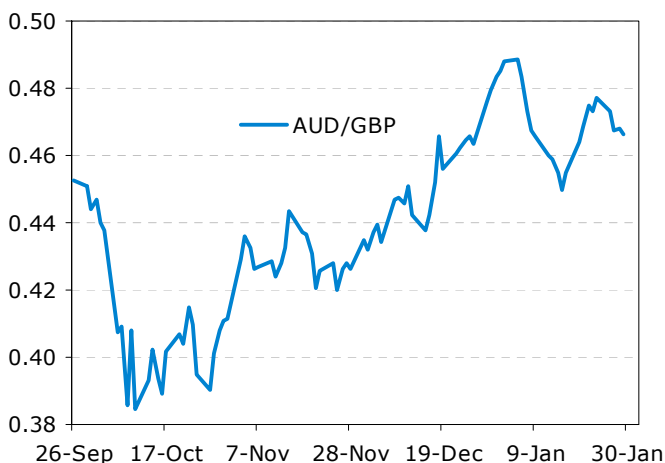
AUD/JPY Key levels: 58.20 – 62.20

- The USD/JPY was range-bound around USD/JPY89 for much of this week, before this morning's FOMC statement boosted the USD above 90.50.
- The AUD outperformed the JPY this week, pushing higher to test the key level at AUD/JPY60.40. Weaker than expected US and Japanese data released later this week would likely weigh more on the AUD than the JPY, and we could see the AUD/JPY test 58.20 – particular attention should be paid to the Japanese industrial production and inflation numbers, and US GDP and Purchasing Managers' survey data.



AUD/EUR Key levels: 0.4990 – 0.5150

- The trading range for the AUD/EUR has maintained stability, remaining within 0.4990-0.5100 this week. The cross rate is currently trading above the key 0.5040 support, and needs to push higher to test the next level at 0.5150. Downside support exists at 0.4990.
- The risks to the EUR are to the downside over the coming week. A weaker than expected January flash inflation result of 1.4% could see the EUR/USD dip below 1.30. An unexpected cut in interest rates at the ECB's February meeting would also weigh on the EUR.



AUD/GBP Key levels: 0.4550 – 0.4770

- The AUD/GBP ground lower over the week as the GBP/USD bounced back to around 1.4200 from last week's rapid decline to a 25-year low of 1.3506.
- Now that a 'technical recession' of two consecutive quarters of negative growth has been established in the UK, the BOE will likely meet forecasters' expectations to cut the repo rate by 50bps to 1% next week. The risk is that a larger cut could occur, and this could see the AUD/GBP trade up to 0.4770, although a rebound towards the early January peak above 0.4940 seems unlikely.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008f	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	3.7	-0.8	1.4
Household consumption	4.3	2.2	0.6	1.4
Dwelling investment	2.7	0.9	-4.2	17.8
Business investment	13.9	12.4	-3.2	-4.5
Public demand	2.7	5.7	3.7	2.4
Domestic final demand	5.4	4.1	0.2	1.6
Inventories (contribution to GDP)	0.6	-0.2	-0.1	0.0
Gross National Expenditure (GNE)	5.9	4.0	0.0	1.6
Exports	3.3	4.6	-3.2	3.1
Imports	11.4	11.8	-2.4	1.3
Net Exports (contribution to GDP)	-1.7	-1.7	-0.1	0.3
Gross Domestic Product (GDP)	4.0	2.3	0.1	2.0
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	3.0	3.0
Underlying*	3.1	4.5	3.5	2.8
Wages	4.1	4.2	3.6	3.5
Labour market				
Employment (annual % change)	2.8	2.3	-0.1	-0.2
Unemployment rate (%)	4.4	4.2	5.4	6.8
External sector				
Current account balance: A\$ bn	-68.2	-53.7	-72.6	-88.8
% of GDP	-6.3	-4.5	-6.0	-7.1

*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	4.25	3.00	2.75	2.50	2.50	2.50
90 day bill	3.38	3.45	2.80	2.80	2.80	3.15
3 year bond	2.97	2.55	2.75	2.85	3.15	3.65
10 year bond	4.08	3.90	4.15	4.15	4.25	4.55
3s10s yield curve	1.11	1.35	1.40	1.30	1.10	0.90
3 year swap	3.51	3.15	3.20	3.35	3.65	4.15
10 year swap	4.41	4.40	4.60	4.65	4.75	5.05
International interest rates						
RBNZ cash rate	3.50	3.00	2.50	2.50	2.50	2.50
NZ 90 day bill	3.78	3.42	2.94	2.84	2.76	2.75
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.50
US 2 year note	0.91	0.60	0.70	0.75	1.00	1.50
US 10 year note	2.69	2.90	3.20	3.75	3.80	4.20
Japan call rate	0.10	0.10	0.10	0.10	0.25	0.50
ECB refinance rate	2.00	1.75	1.25	1.25	1.25	1.75
UK repo rate	1.50	1.00	0.75	0.75	0.75	1.00

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

Foreign exchange rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
Australia and NZ exchange rates						
A\$/US\$	0.6602	0.63	0.58	0.56	0.54	0.54
NZ\$/US\$	0.5176	0.52	0.47	0.45	0.44	0.45
A\$/¥	59.36	61.74	58.00	56.56	55.08	56.70
A\$/€	0.5035	0.50	0.48	0.50	0.50	0.50
A\$/£	0.4662	0.43	0.41	0.40	0.39	0.39
A\$/NZ\$	1.276	1.21	1.23	1.24	1.23	1.20
A\$/CA\$	0.8041	0.76	0.70	0.69	0.70	0.71
A\$/CHF	0.7619	0.76	0.72	0.75	0.76	0.77
A\$/CNY	4.515	4.31	3.98	3.84	3.69	3.69
A\$ Trade weighted index	54.50	52.65	49.34	48.41	46.97	46.91
International cross rates						
US\$/¥	89.9	98	100	101	102	105
€/US\$	1.311	1.25	1.20	1.12	1.08	1.08
€/¥	117.9	123	120	113	110	113
£/US\$	1.416	1.46	1.43	1.41	1.40	1.40
€/£	0.9261	0.86	0.84	0.79	0.77	0.77
US\$/CA\$	1.218	1.20	1.20	1.24	1.30	1.32
US\$/CHF	1.154	1.20	1.24	1.34	1.40	1.42
US\$ index	84.80	87.7	90.5	95.1	98.0	98.6
Asia exchange rates						
US\$/CNY	6.844	6.84	6.86	6.86	6.84	6.84
US\$/HKD	7.758	7.76	7.77	7.80	7.80	7.80
US\$/IDR	11330	16000	14600	14200	13500	12400
US\$/INR	48.89	50.00	49.00	49.00	48.00	48.00
US\$/KRW	1369	1475	1500	1450	1400	1350
US\$/MYR	3.5975	3.60	3.64	3.74	3.80	3.80
US\$/PHP	47.130	50.26	52.50	54.10	55.20	55.00
US\$/SGD	1.505	1.54	1.58	1.62	1.66	1.66
US\$/THB	34.92	35.80	37.60	39.40	39.40	38.75
US\$/TWD	33.70	34.00	35.20	36.00	36.00	36.00
US\$/VND	17477	17400	17800	18100	18500	18500
Pacific exchange rates						
PGK/US\$	0.379	0.37	0.37	0.36	0.35	0.35
FJD/US\$	0.544	0.53	0.51	0.49	0.48	0.48

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