

Open partnerships
Open possibilities

Asian ALCO

October 2007

Amy Auster

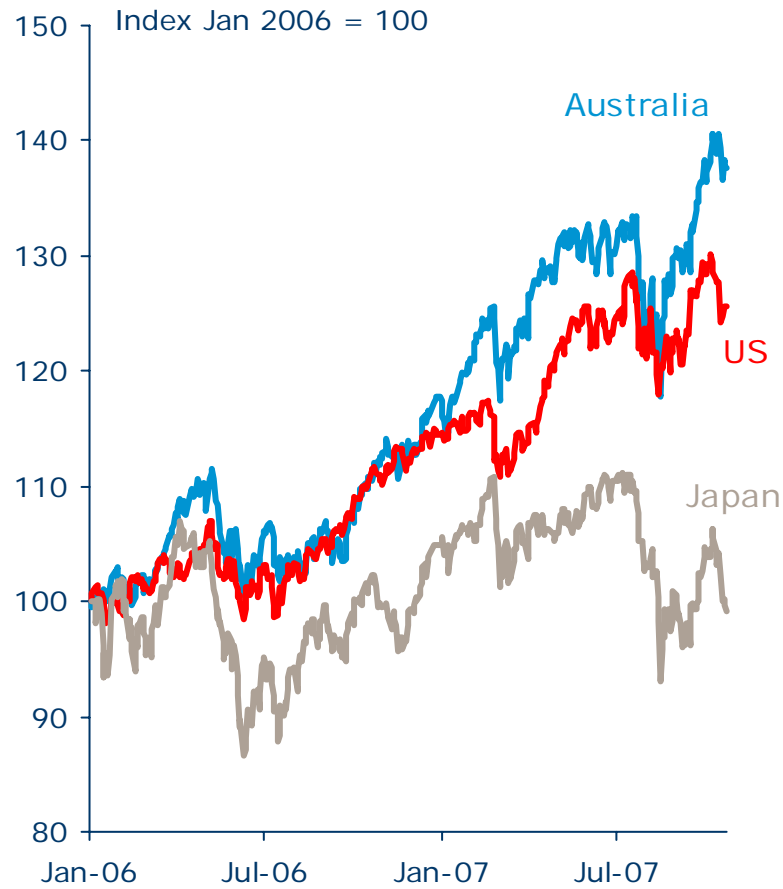
Economics@ANZ

Revisions to forecasts

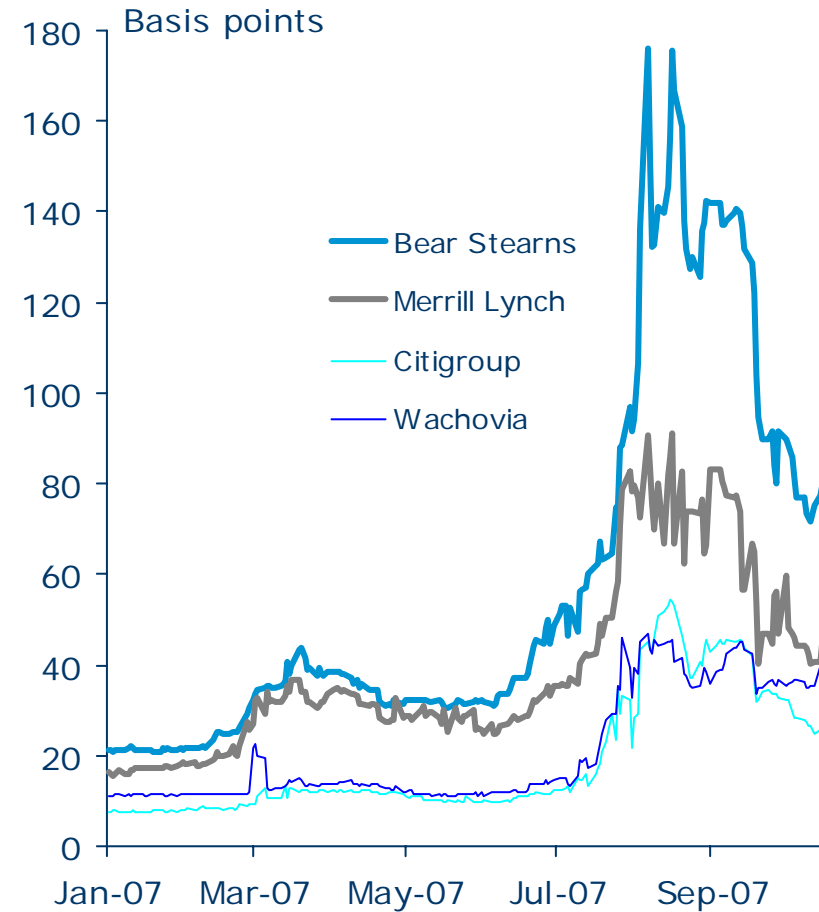
- > **Market now expecting Oct 31 rate cut; we may shift forecast to 4.25% trough**
 - We had shifted October rate cut to December on economic data and stable markets, but problems in credit markets are resurfacing with SIV issues
 - Fed action over next 6 months is finely balanced between market seizure, moral hazard and the actual evolution of inflation
- > **Diverging US vs global outlook reflects loss of US as global growth driver**
 - Global growth forecasts being downgraded, but we are forecasting 2008 global GDP growth at an above-trend 4.7% vs 5.0% this year
- > **Elsewhere, interest rates are flat or rising due to in part to food price inflation and it is too early to say whether food inflation is transitory**
 - Have just raised peak RBA rate by 50 bps to 7.25% as of May meeting
 - RBNZ on hold in our forecasts until early 2009
 - BOJ and ECB on hold; inflation data prevents cuts in ECB
 - PBOC on an upward trajectory with broad-based food inflation
 - Other Asian central banks tightening or holding policies steady
- > **Regulated currencies being adjusted upward by policymakers**
 - MAS has raised pace of S\$ appreciation and SBV has lowered rate of VND depreciation
 - Renewed pressure on CNY amid rumours of maxi-reval and HKMA intervenes
- > **US\$ weakness expected to remain a theme for next 6 months**
 - Primarily weak against EUR and commodity currencies
 - Asian currencies will strengthen, but A\$ to strengthen more on the cross rates

Equity markets tumbled last week amid reminder that CDO and RMBS issues are not fully resolved

Equity markets



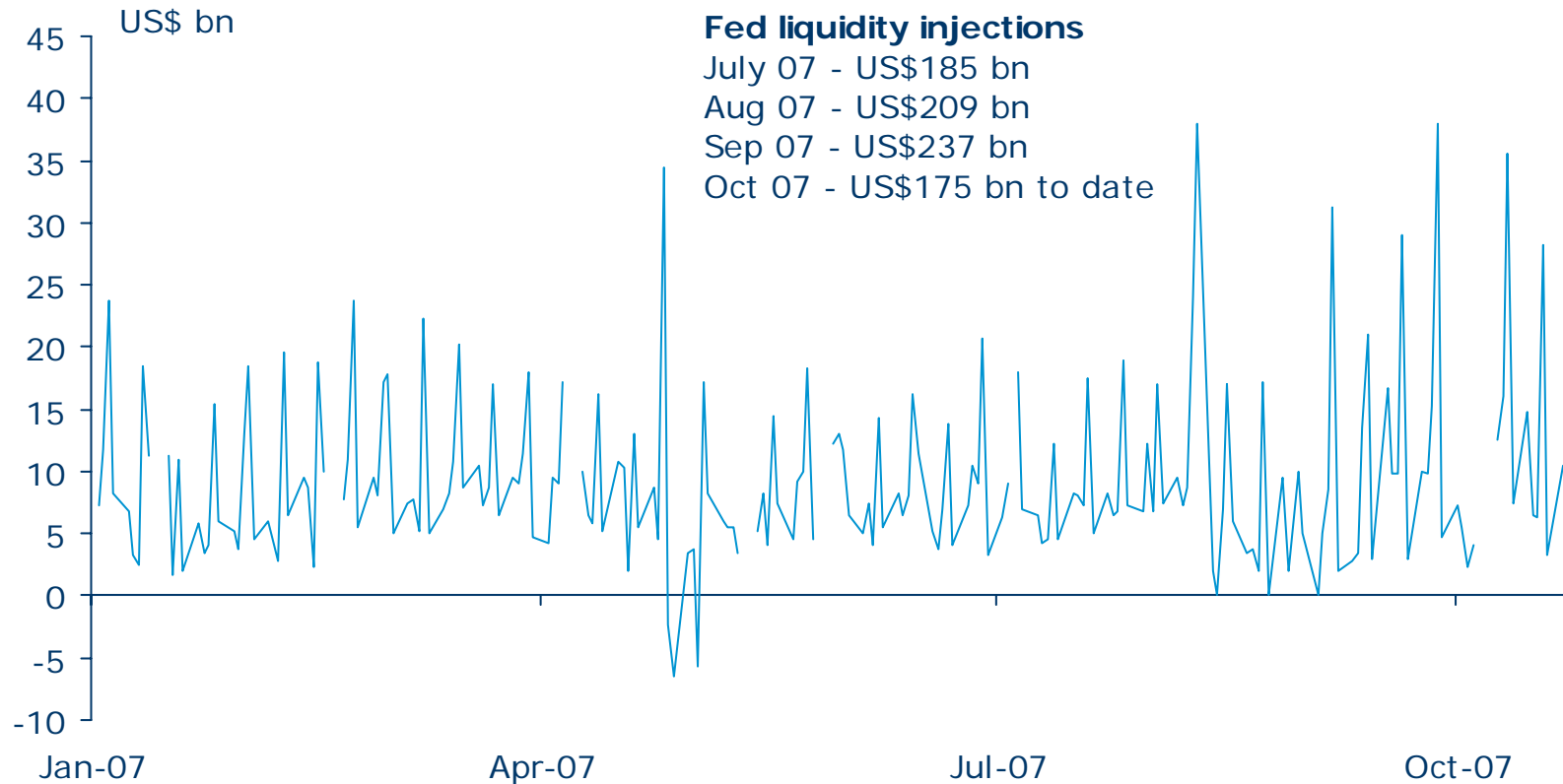
Credit default swaps



Source: Bloomberg and Economics@ANZ

The Fed remains active in the market, injecting another US\$24 bn last week

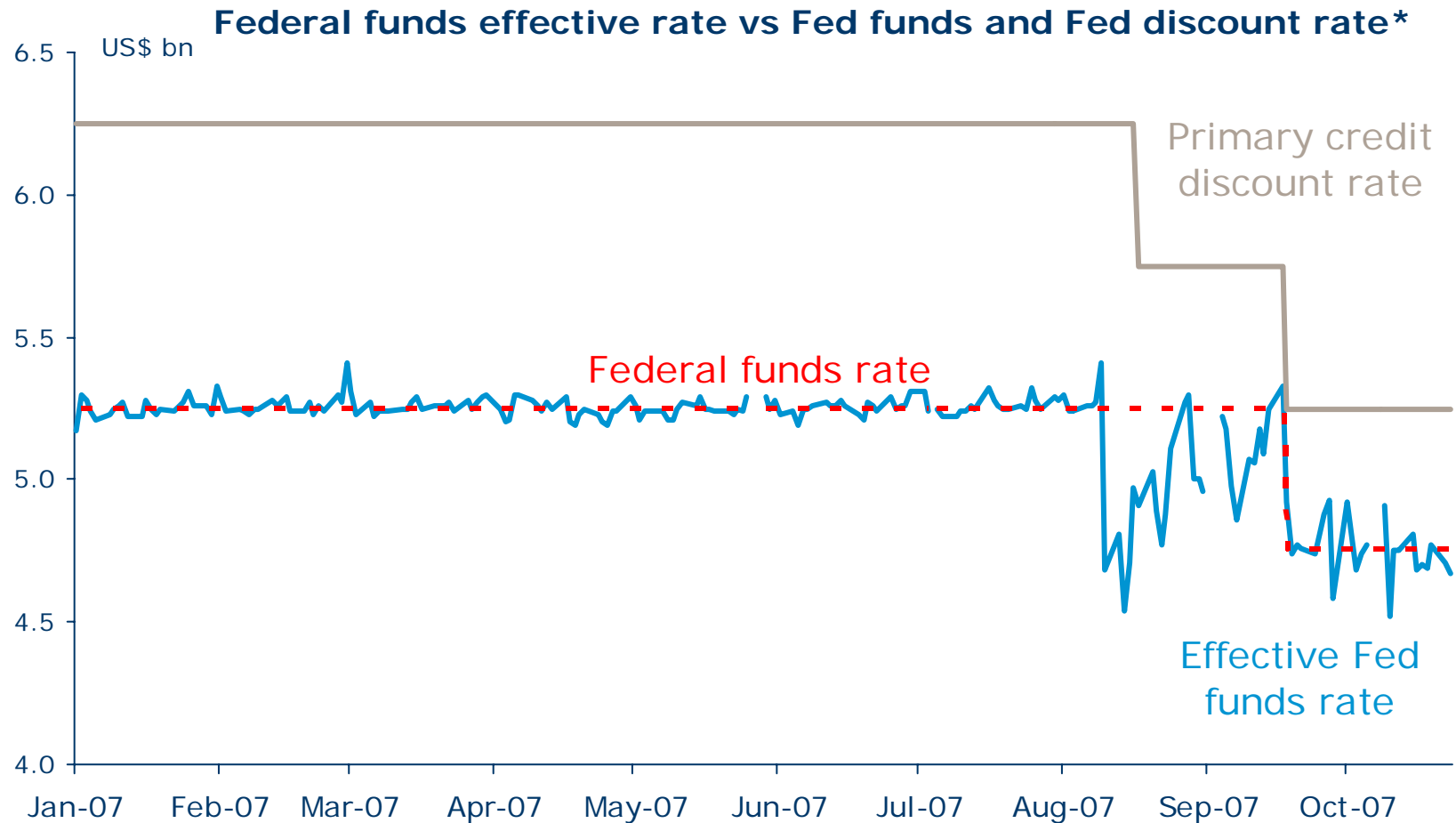
Daily summary of US Federal Reserve Open Market Operations*



**US Temporary Cash Added/Drained To/From Banking System by the US Federal Reserve*

Source: Bloomberg, Economics@ANZ

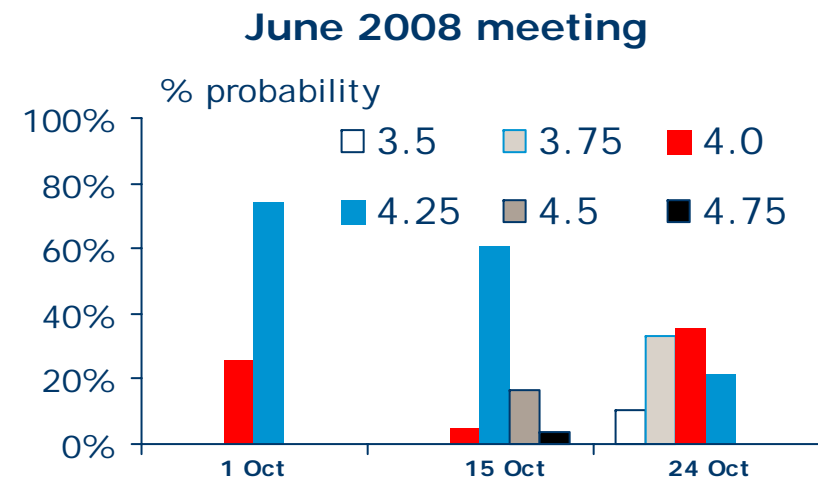
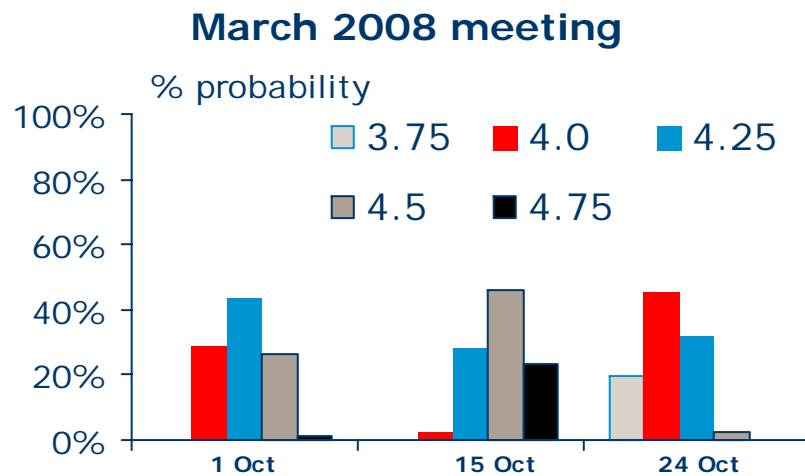
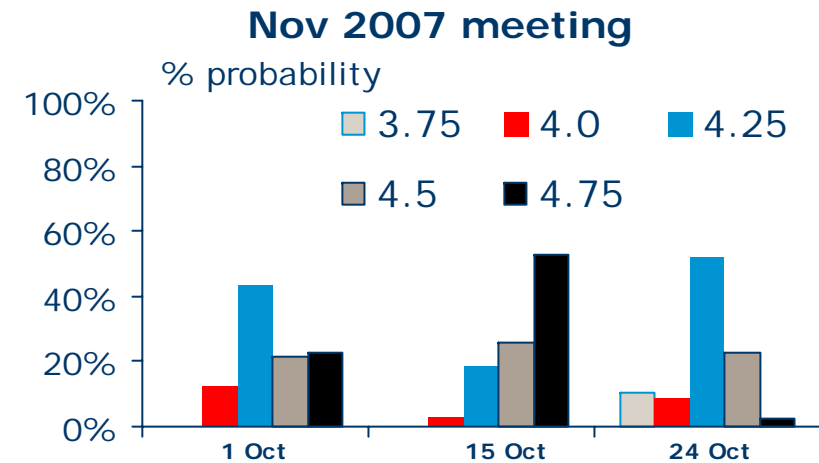
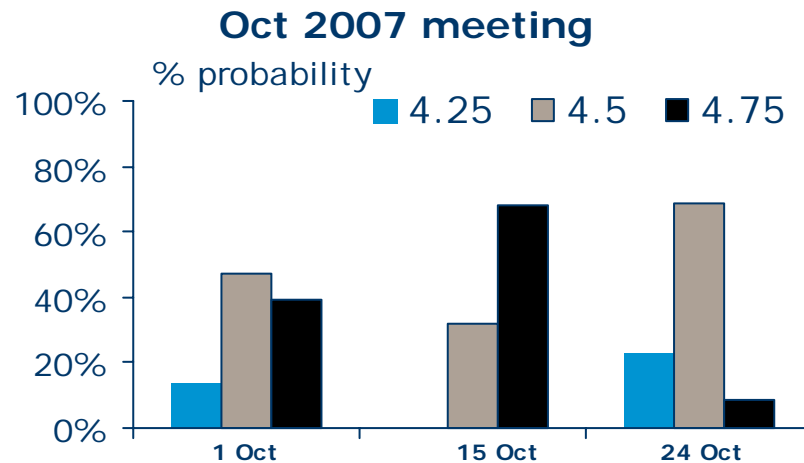
The effective Fed funds rate has remained below the Fed Funds rate since 16 October



*Effective rate is the volume-weighted average rate that the Fed funds trades through major brokers, as against the Fed policy rate

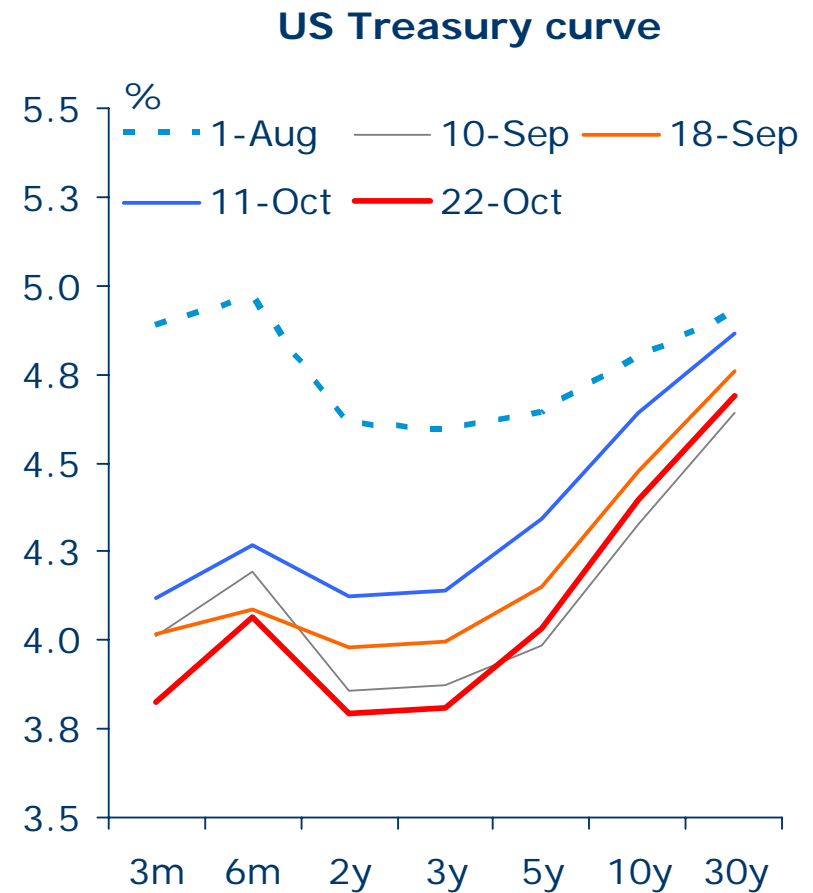
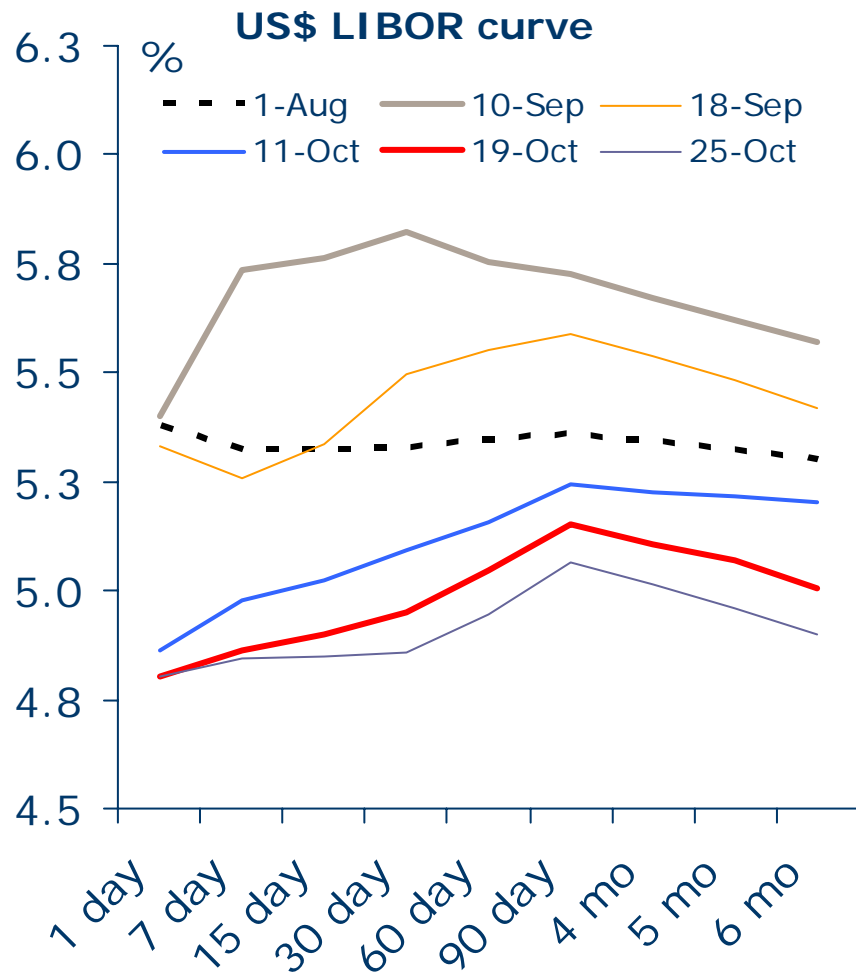
Source: Bloomberg and Economics@ANZ

Fed funds expectations shifting toward 4% trough



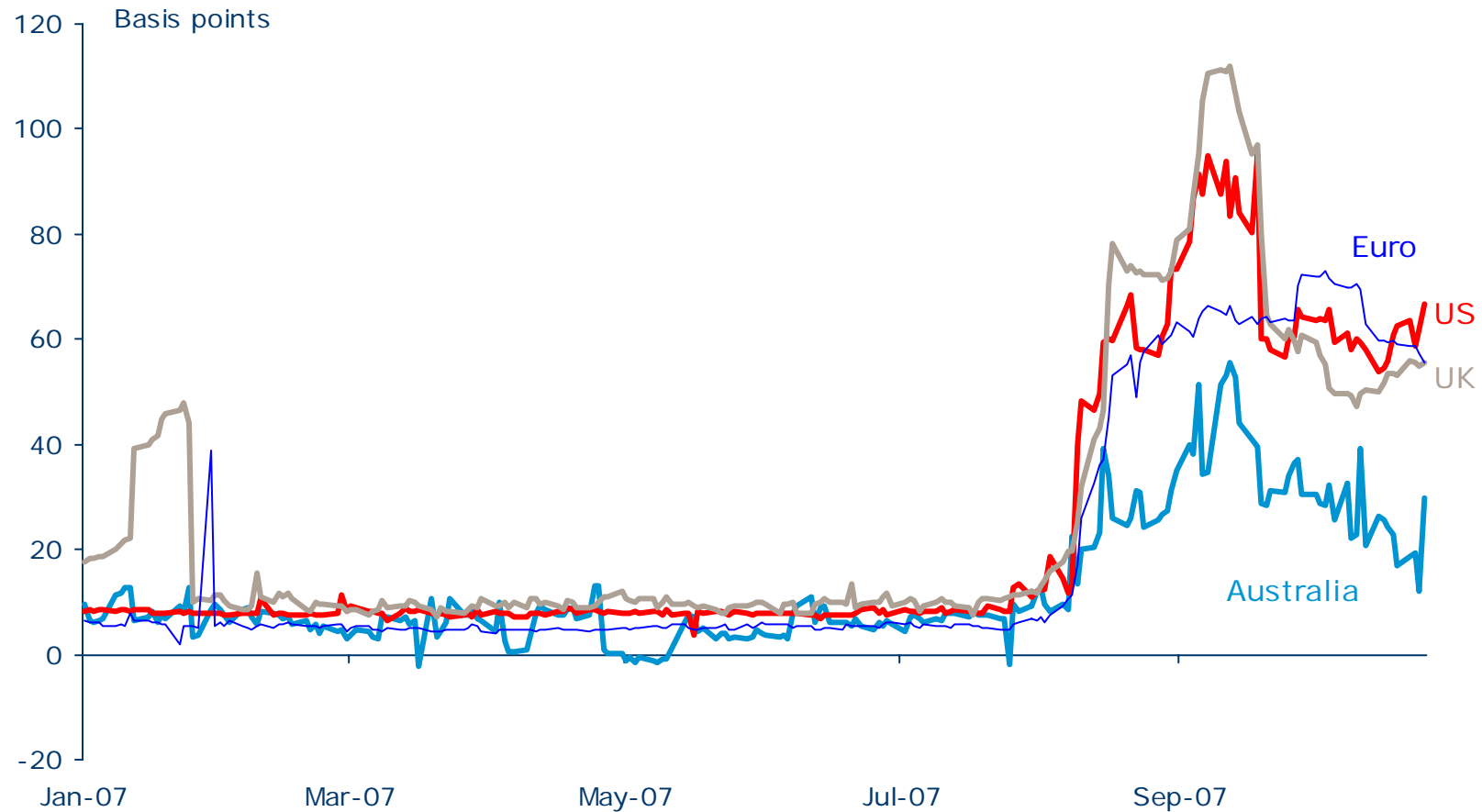
Source: Bloomberg and Economics@ANZ

Liquidity surge has forced short term rates to pre-August levels, and US\$ funding costs are down across the board



The price of risk is elevated despite falling risk-free rate and the credit curve has re-emerged...

Spread between 3-month interbank and 3-month OIS¹ rates

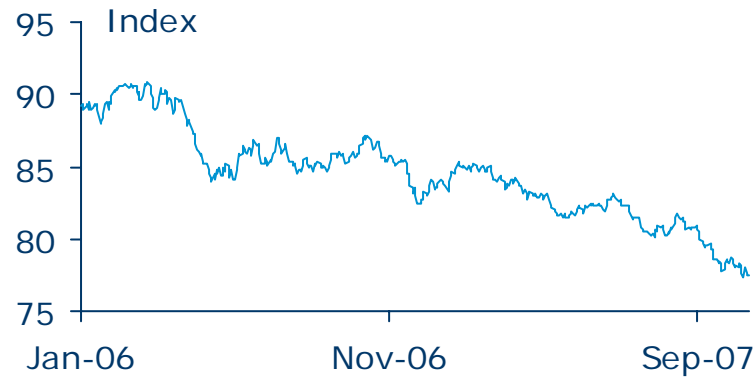


¹ Overnight indexed swap rate, a measure of market expectations of official policy rates

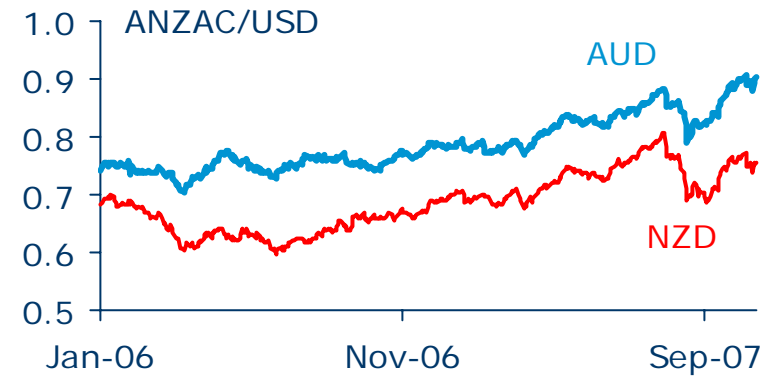
Source: Bloomberg and Economics@ANZ

But the US\$ keeps getting pummelled on expected rate differentials with an absence of flight to quality – Why?

USD broad currency index hits new lows



AUD and NZD rallying



EUR climbing higher

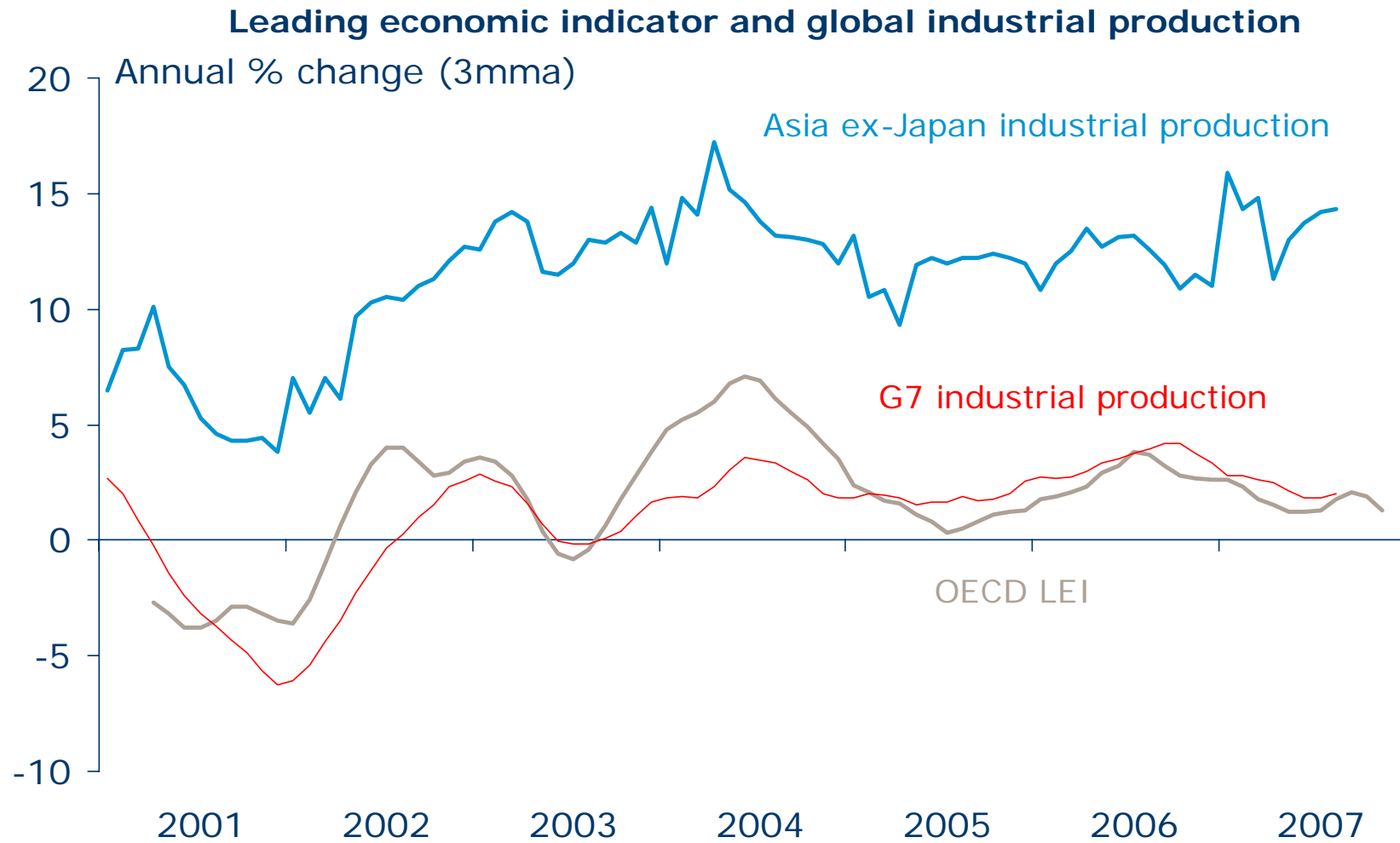


As is JPY



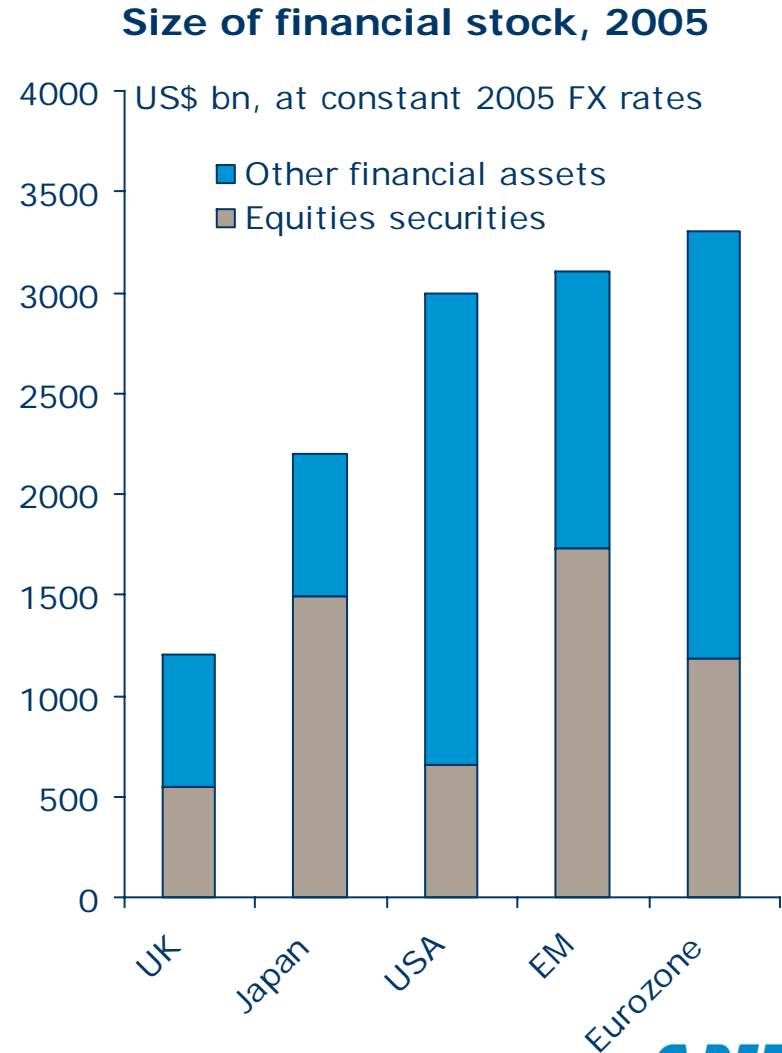
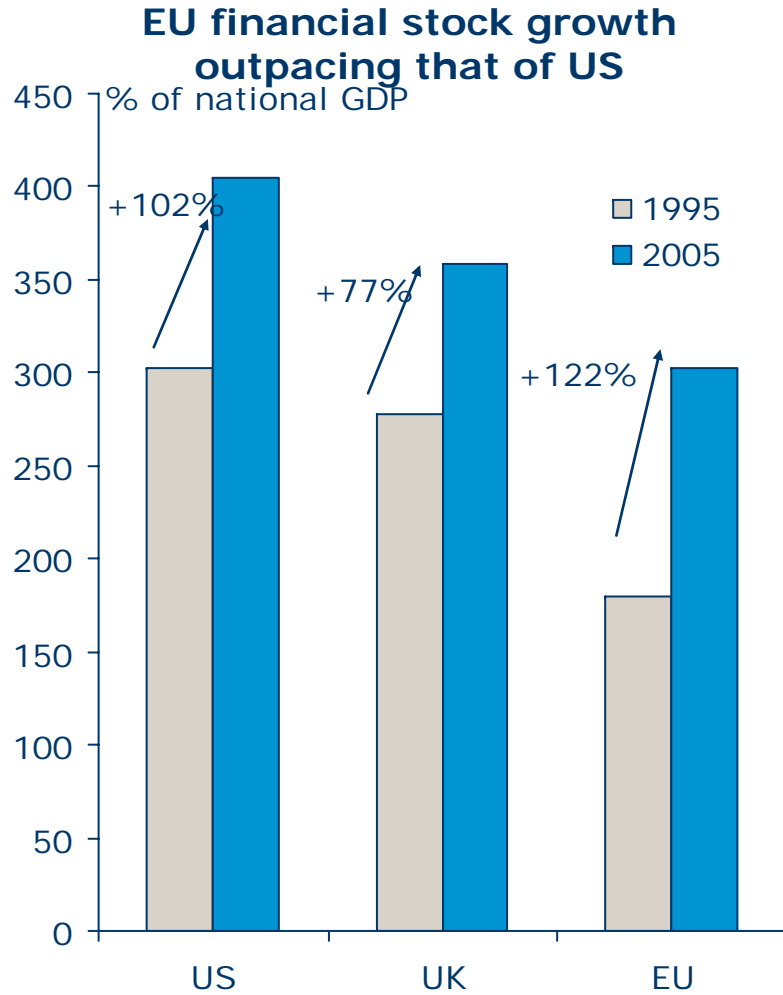
Source: Bloomberg and Economics@ANZ

Mainly because global growth prospects still good



Source: Datastream and Economics@ANZ

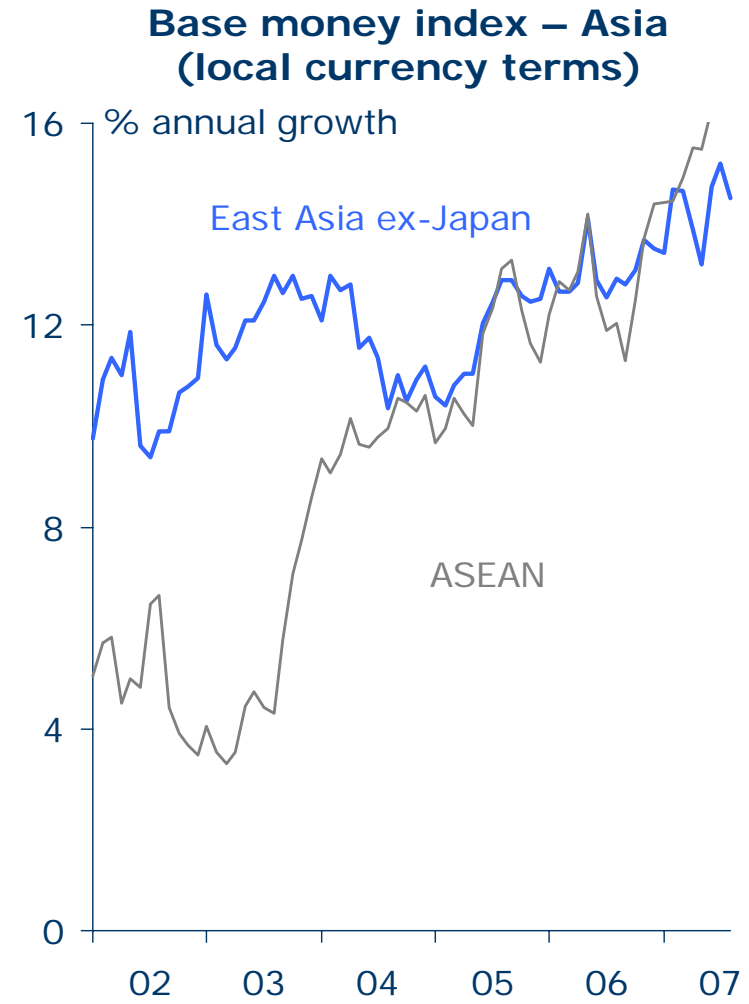
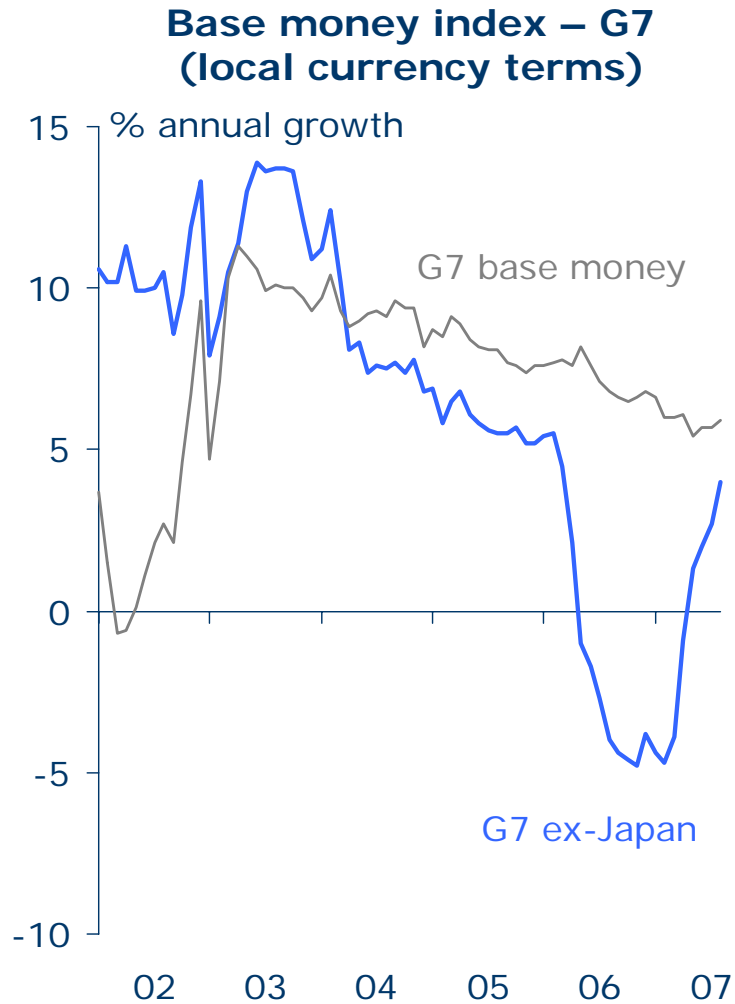
The growth of non-US financial assets offers a way to invest in the global growth story



Source: McKinsey Global Institute

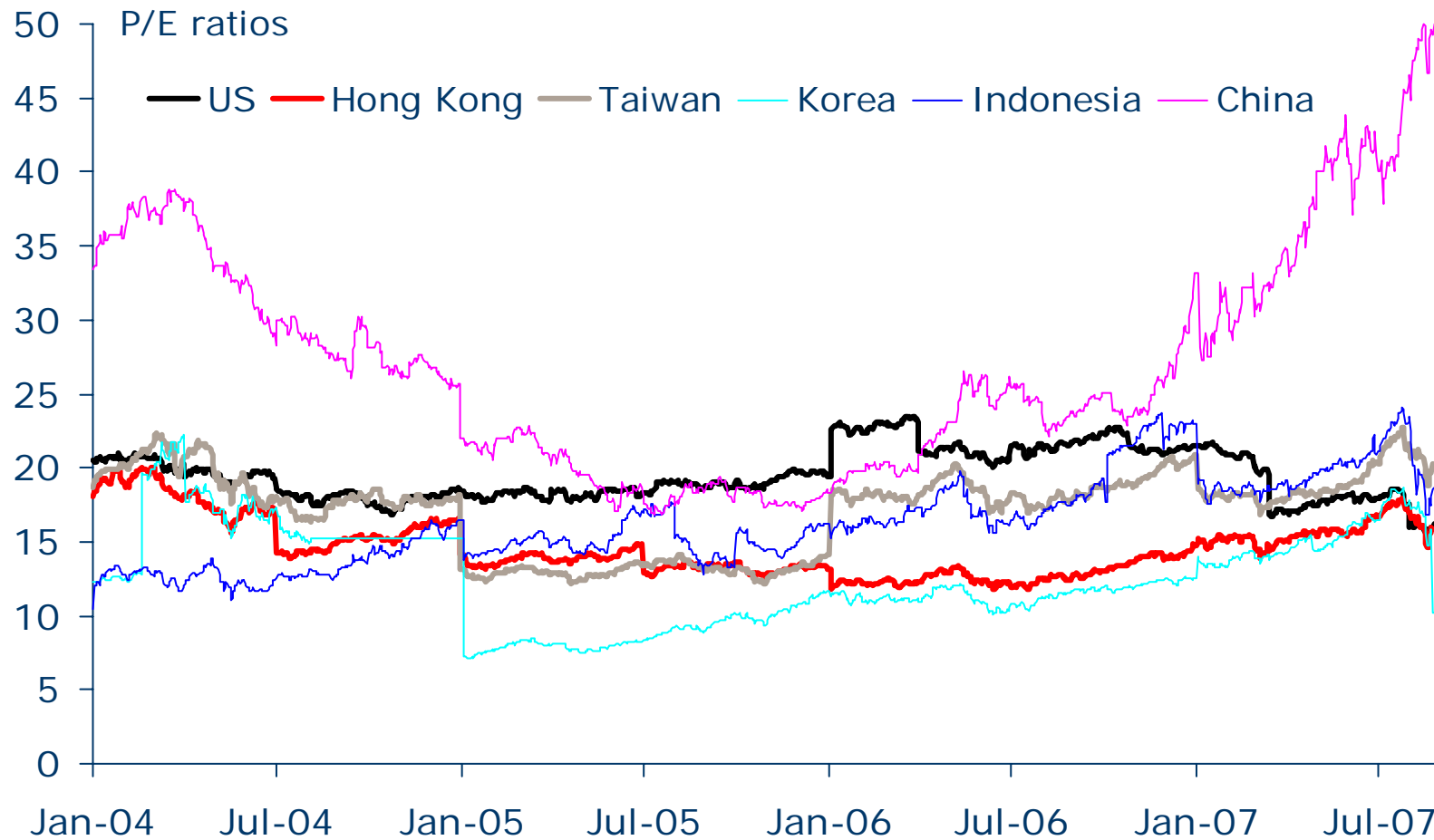


And until US bad loans written down, liquidity growth is accelerating again



In Asia, asset prices are strong, but not overvalued

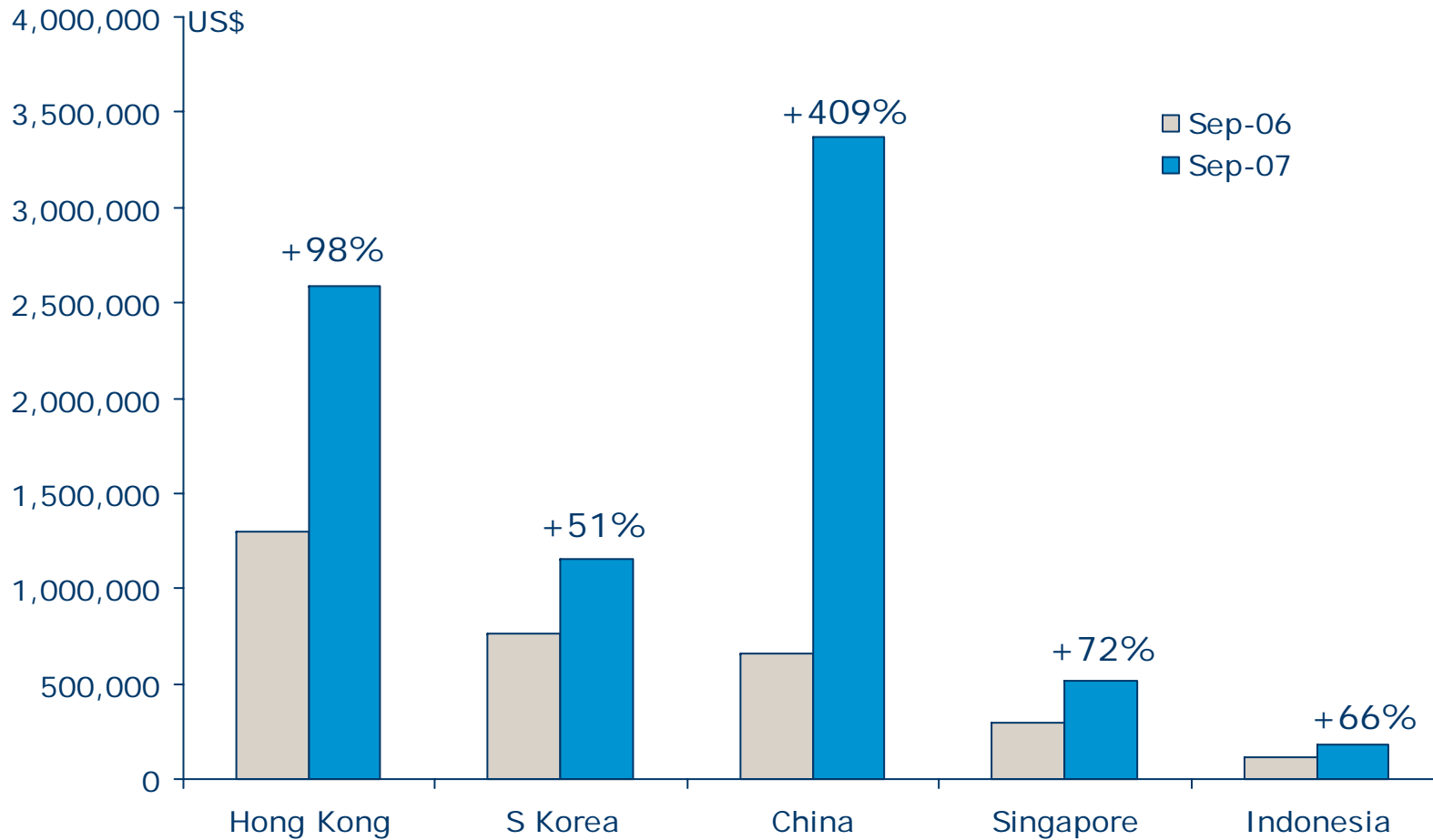
Only China's equity market shows an asset price bubble



Source: Bloomberg

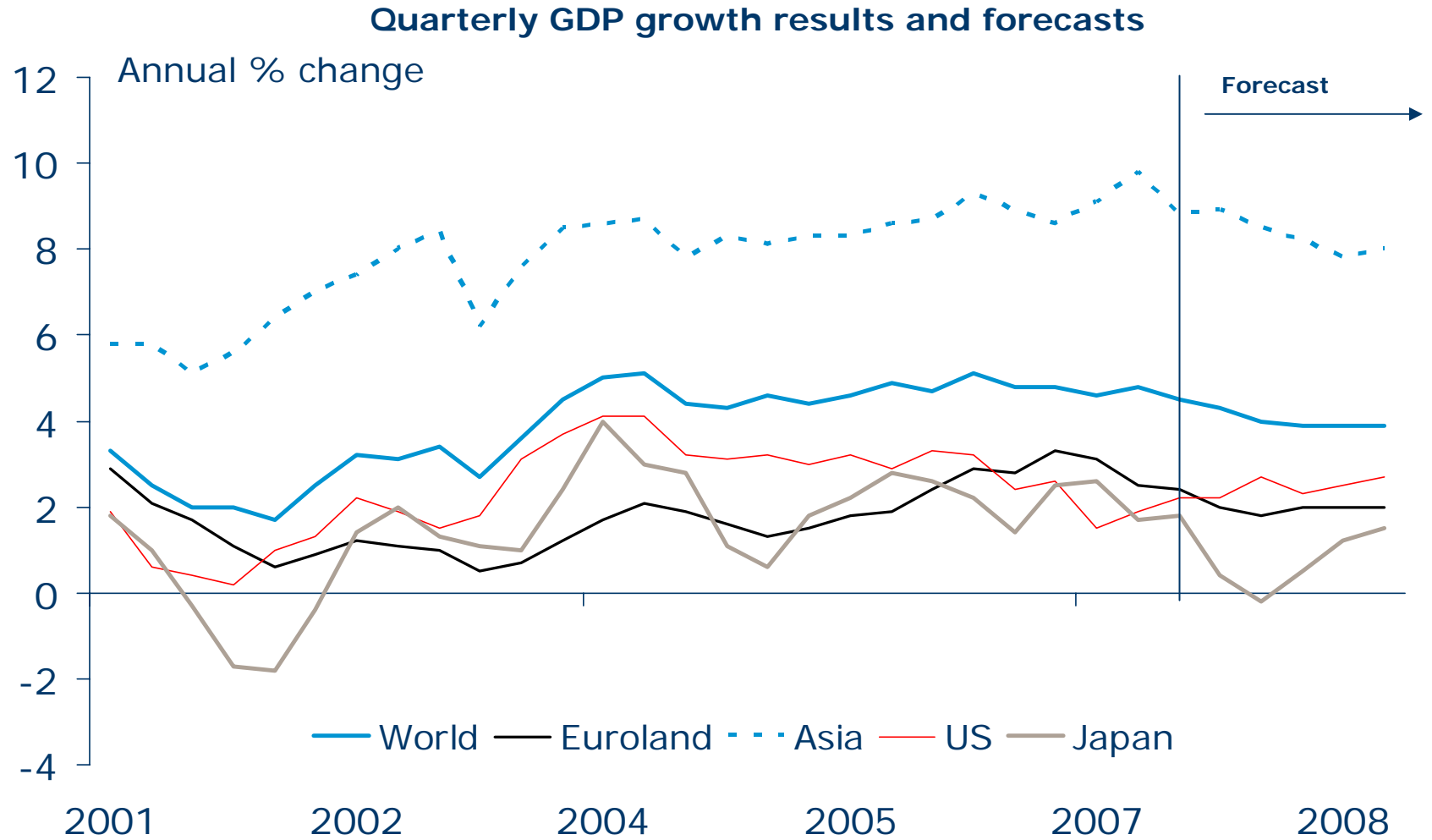
Asia financial flows arise from process of disintermediation as firms go for IPOs

Equity market capitalisation, US\$ terms



Source: Bloomberg, Economics@ANZ

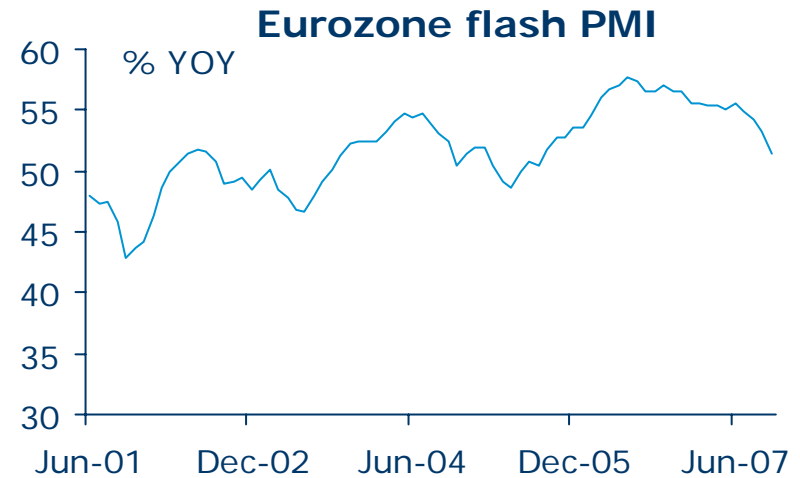
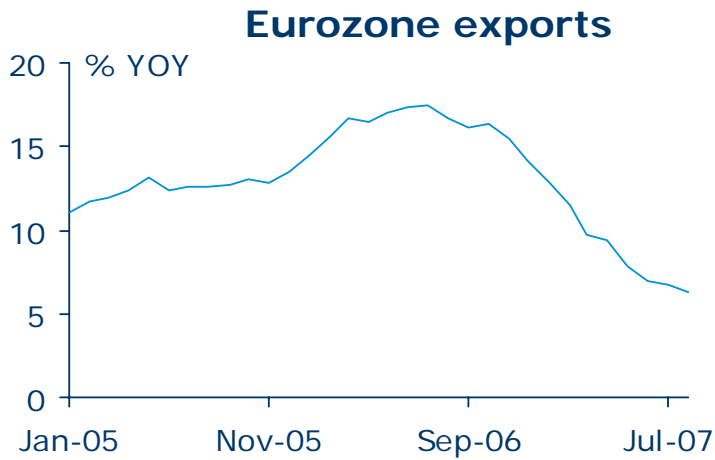
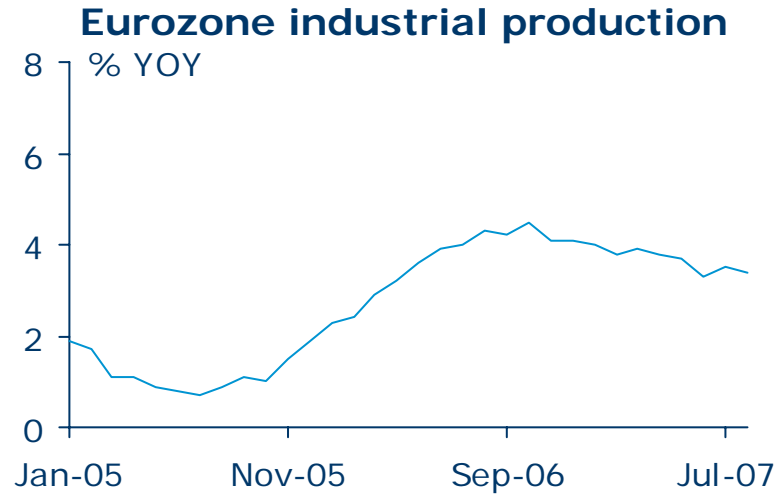
Global growth drivers are diverse so growth is above trend



Source: Datastream, Economics#ANZ



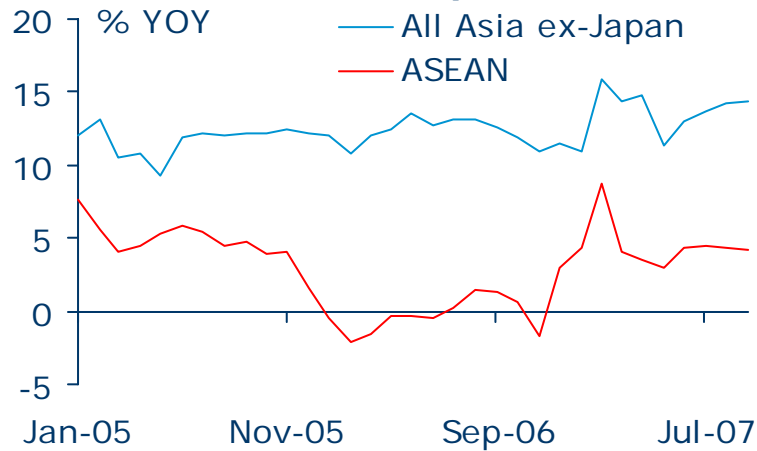
Signs that European growth is weakening – the main risk



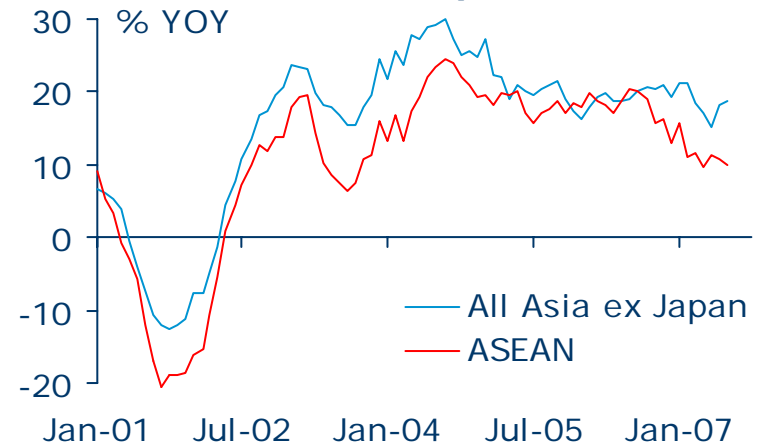
Source: Bloomberg and Economics@ANZ

Asia is still experiencing strong, but tempering, growth

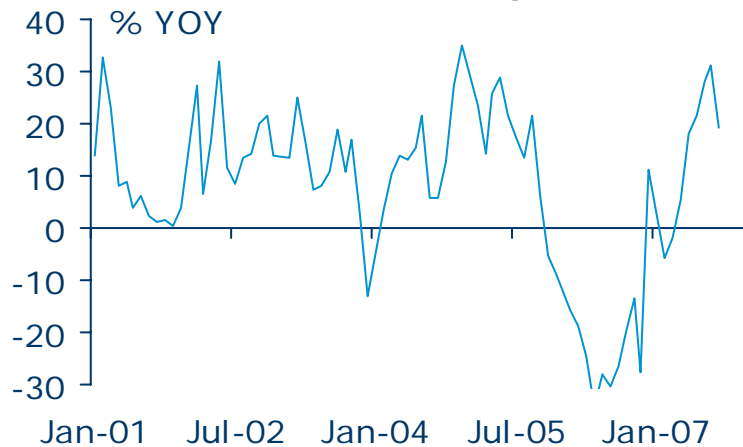
ANZ's Asia industrial production index



Asia exports

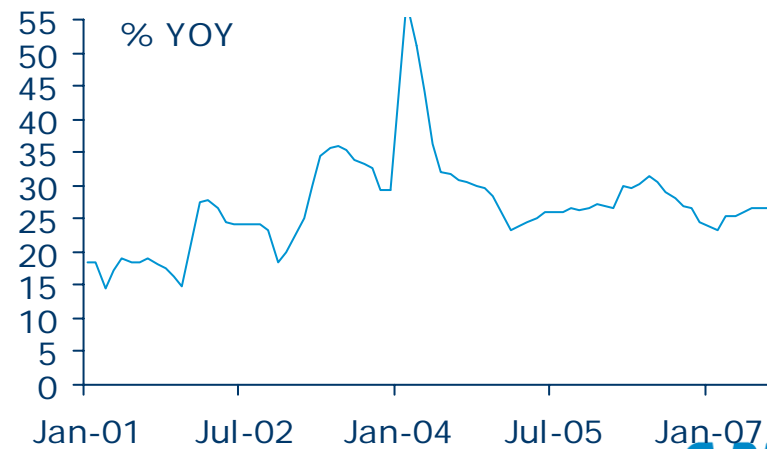


ANZ's ASEAN consumption index

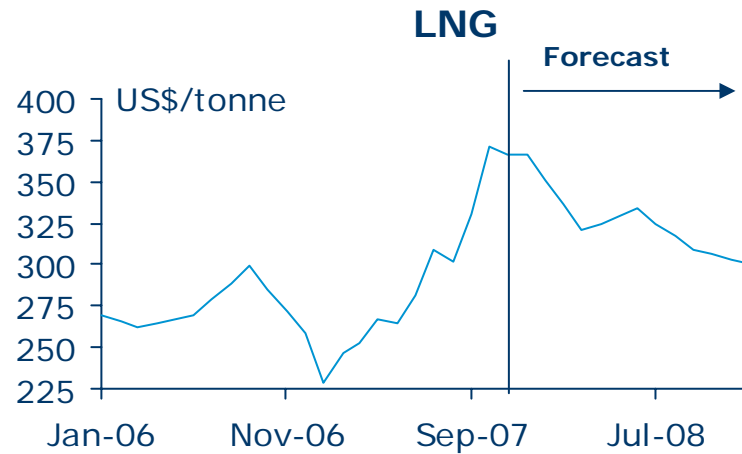
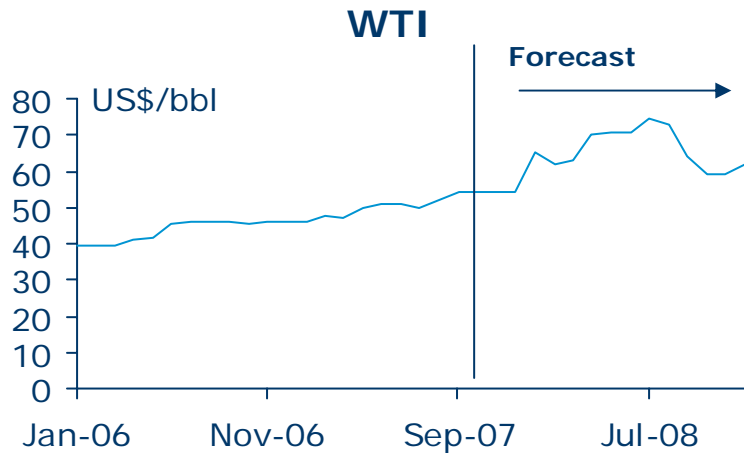
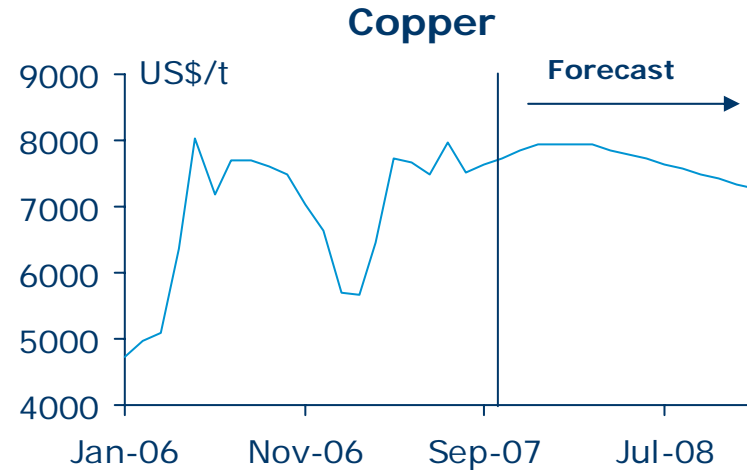
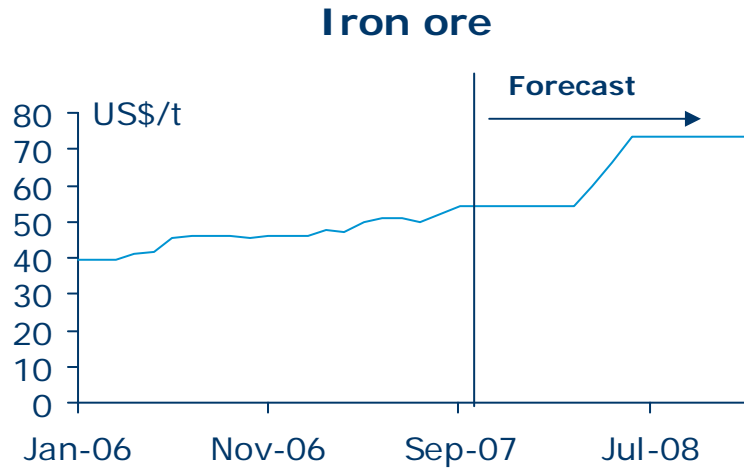


Source: Bloomberg and Economics@ANZ

China fixed asset investment

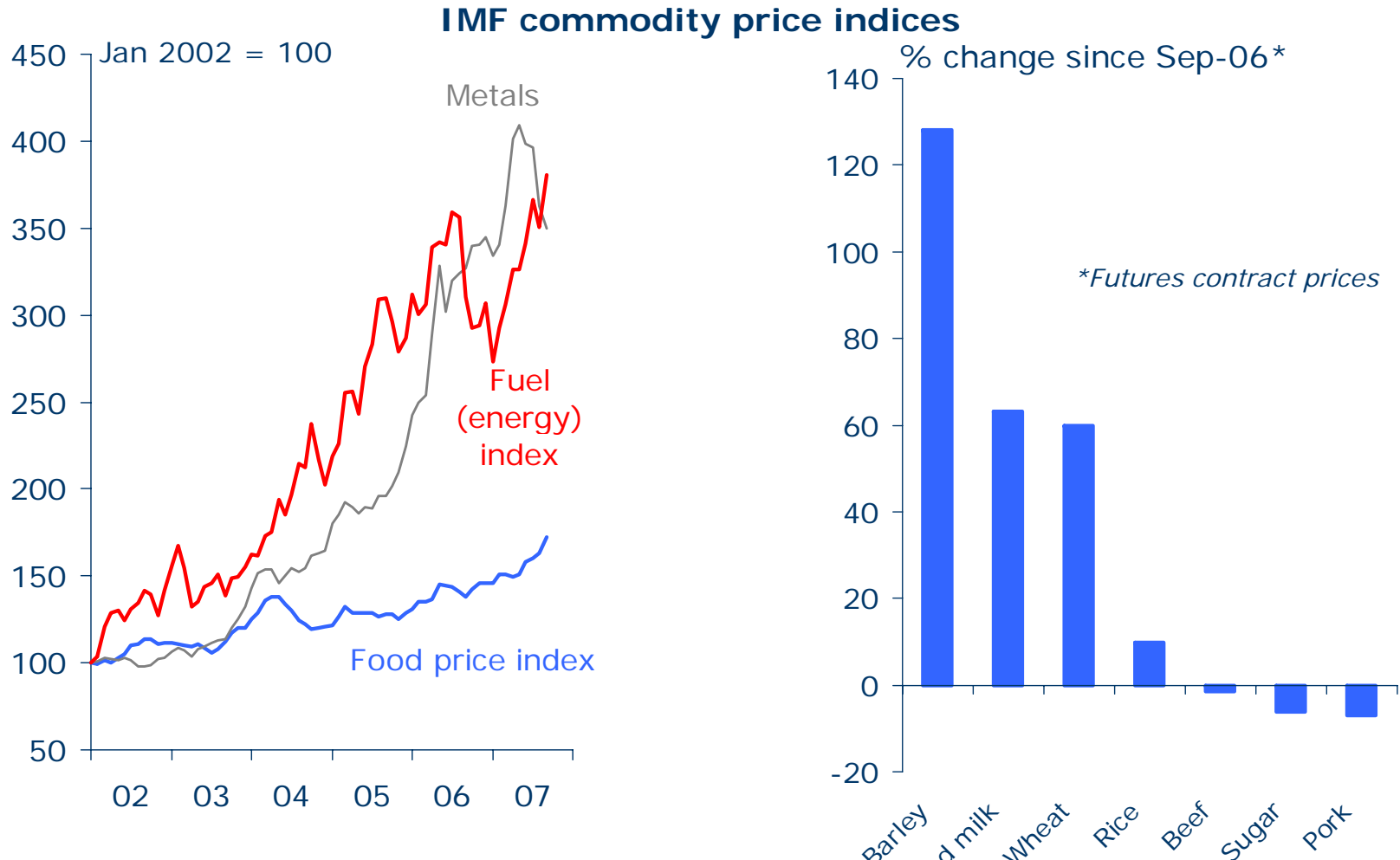


Which is why commodity prices remain elevated, and are forecast to remain strong



Source: Bloomberg and Economics@ANZ

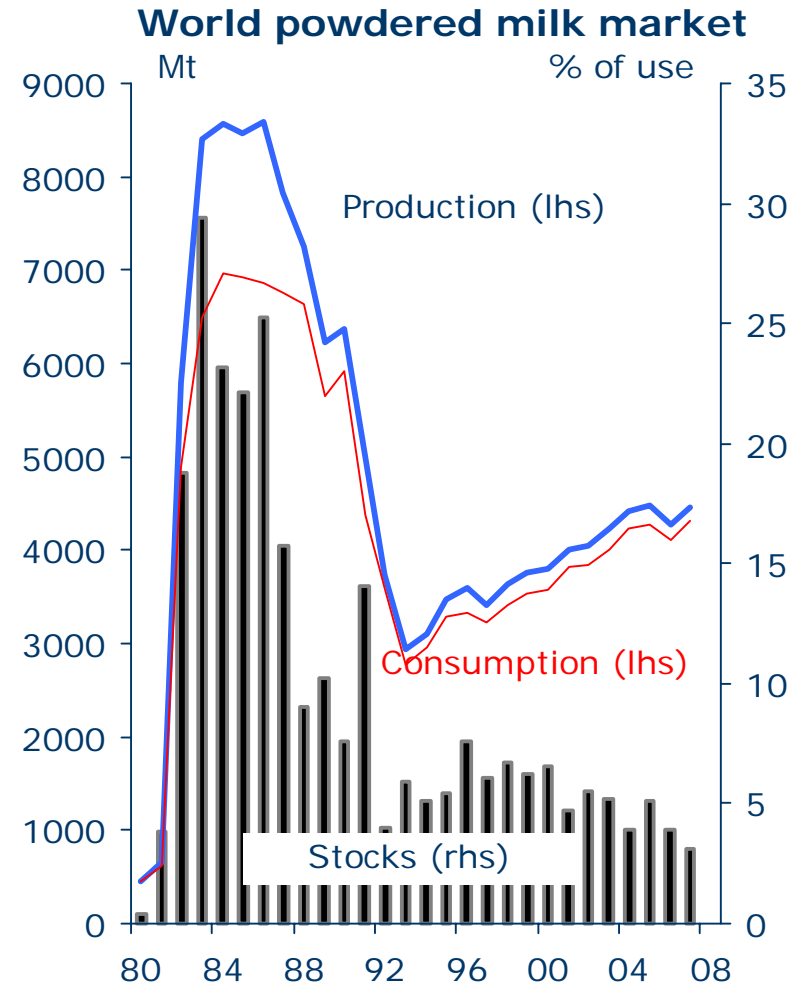
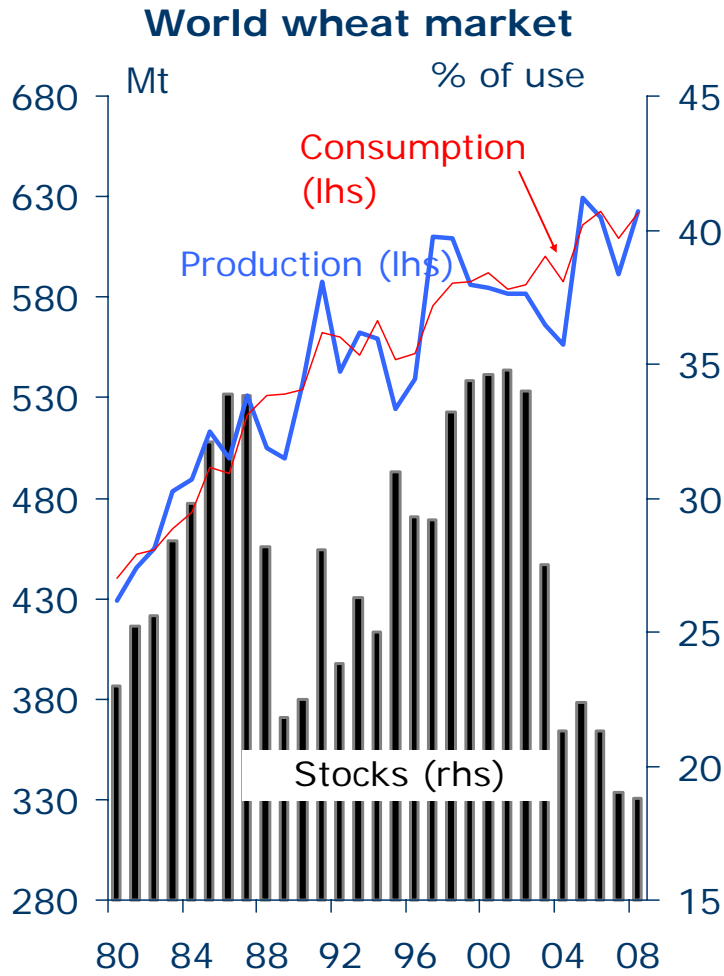
At long last, substantial second round inflationary effects from the boom in energy and base metals



Source: IMF and Economics@ANZ



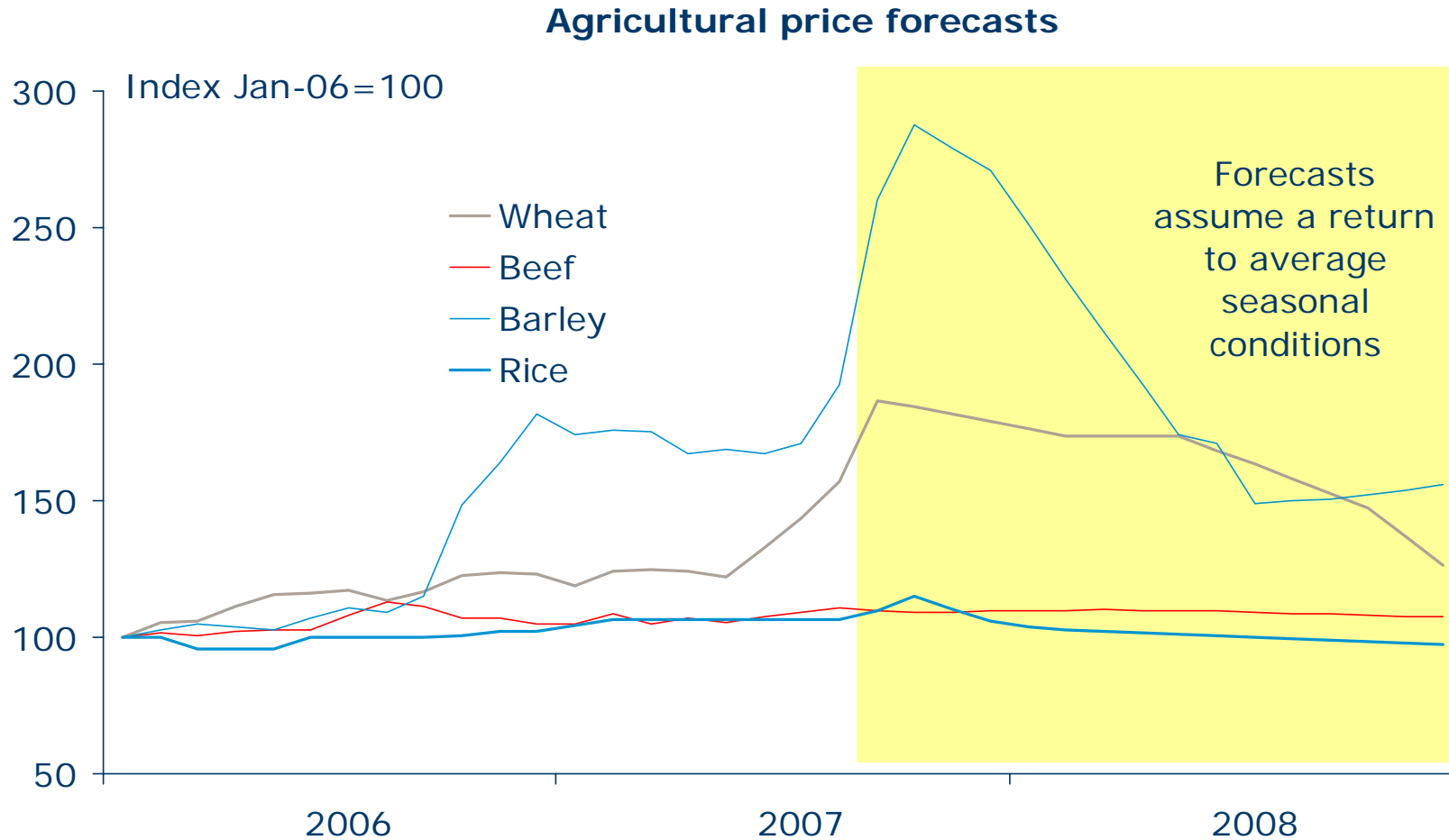
At the moment, food appears to be a capacity constraint



Source: Bloomberg, Reuters, Datastream and Economics@ANZ

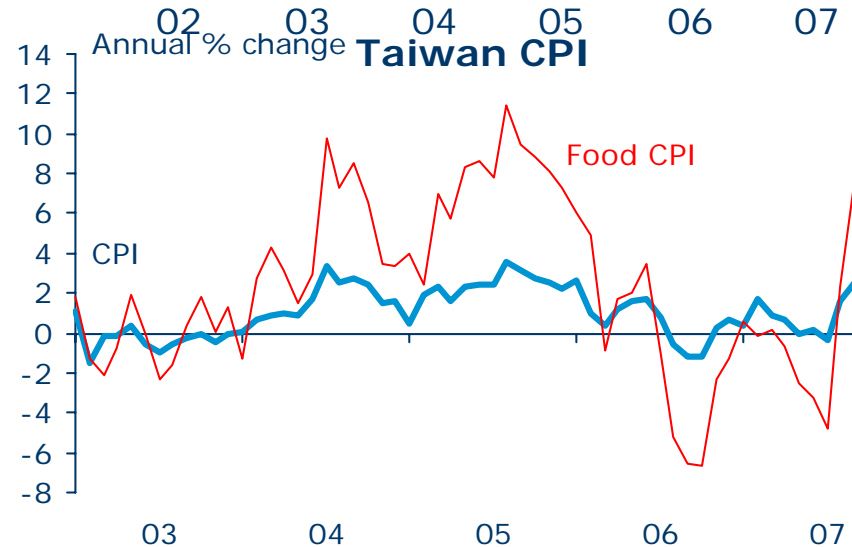
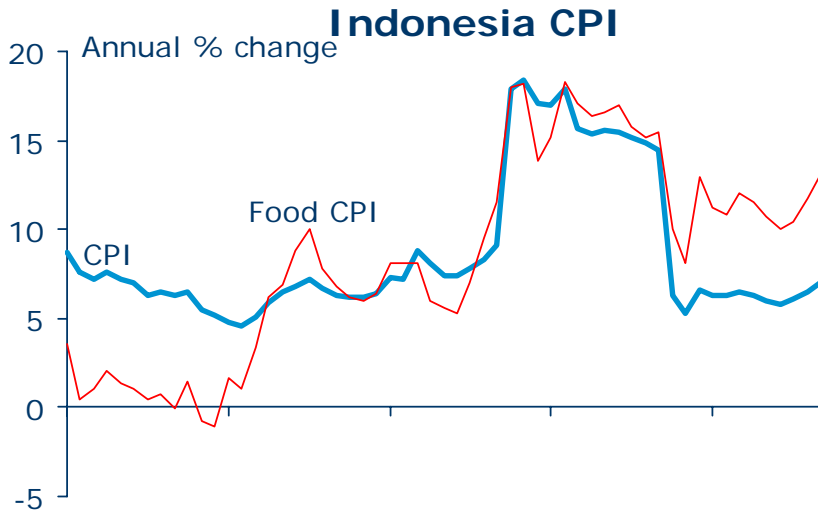
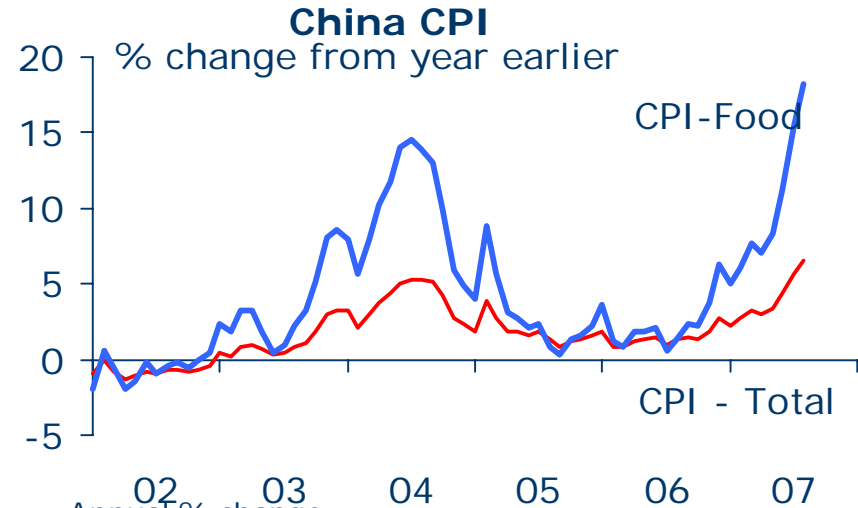
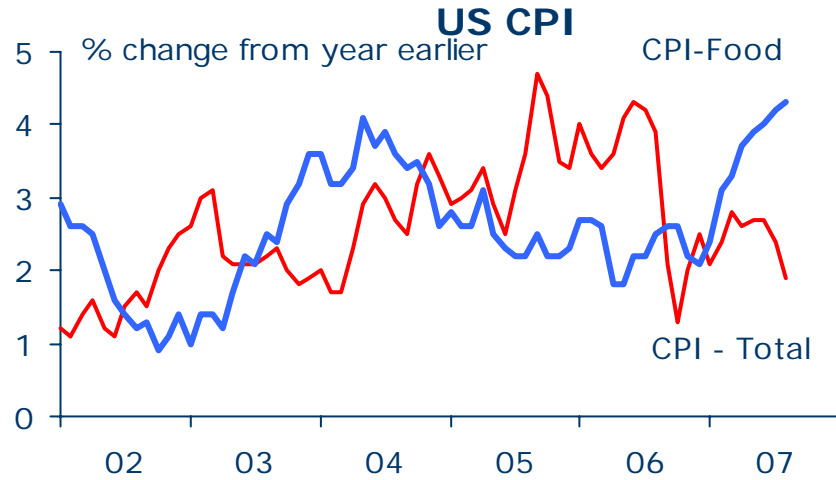


Ag-flation: praying for rain



Source: Datastream and Economics@ANZ

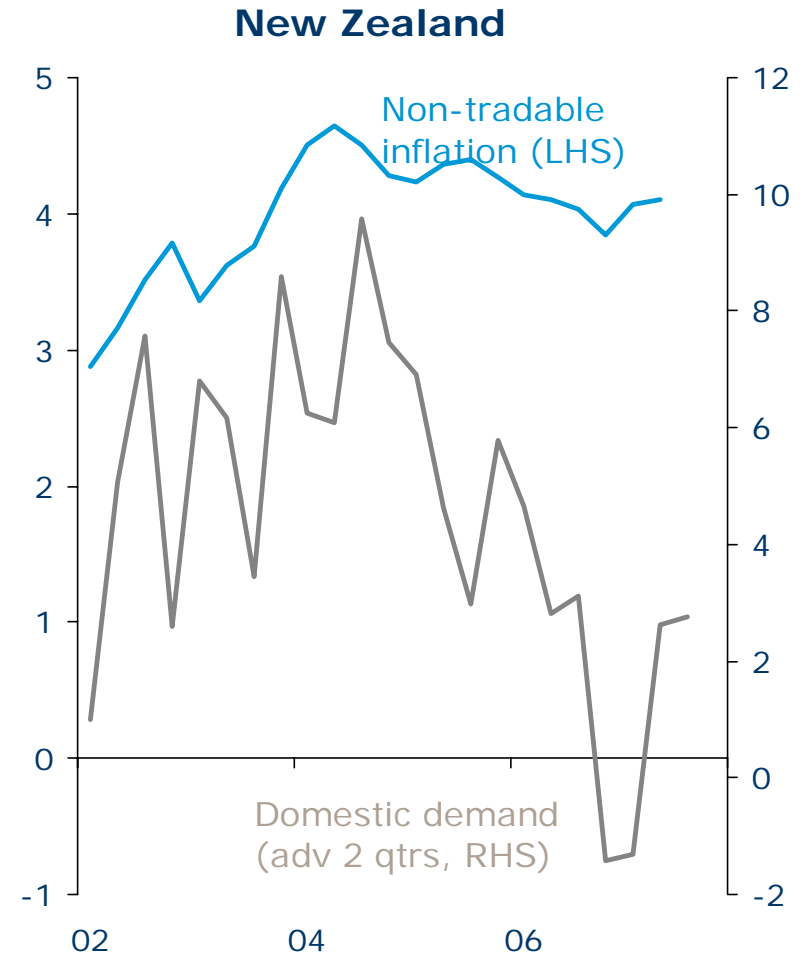
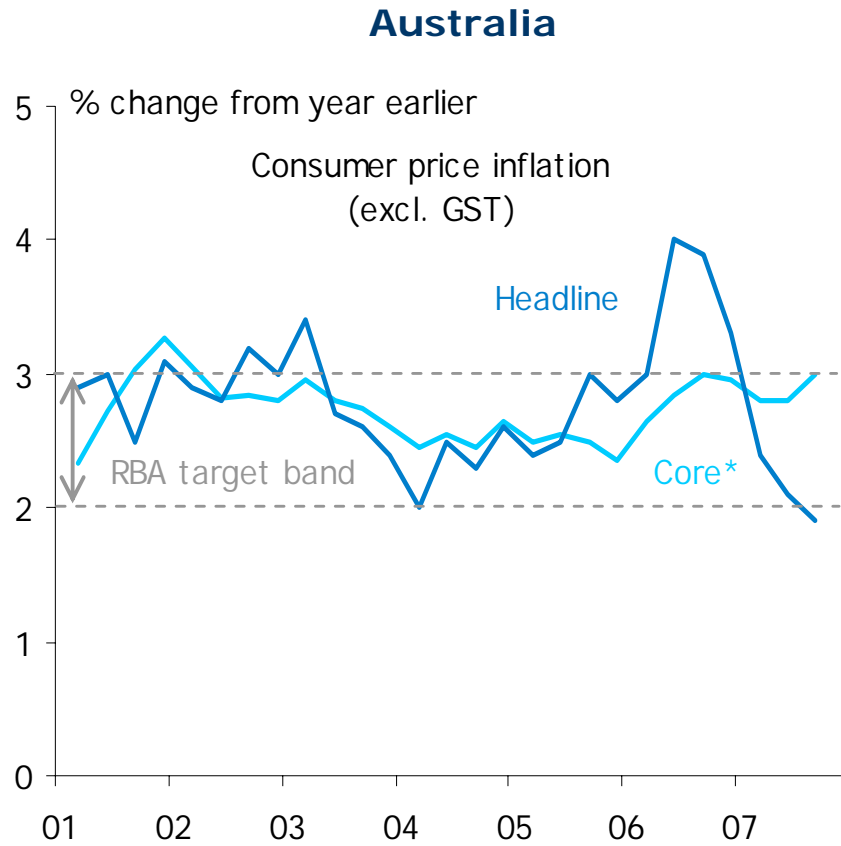
If not transitory, can central banks ignore food inflation?



Source: Bloomberg, Datastream and Economics@ANZ
Relationship Banking • Corporate Finance • Markets • Working Capital



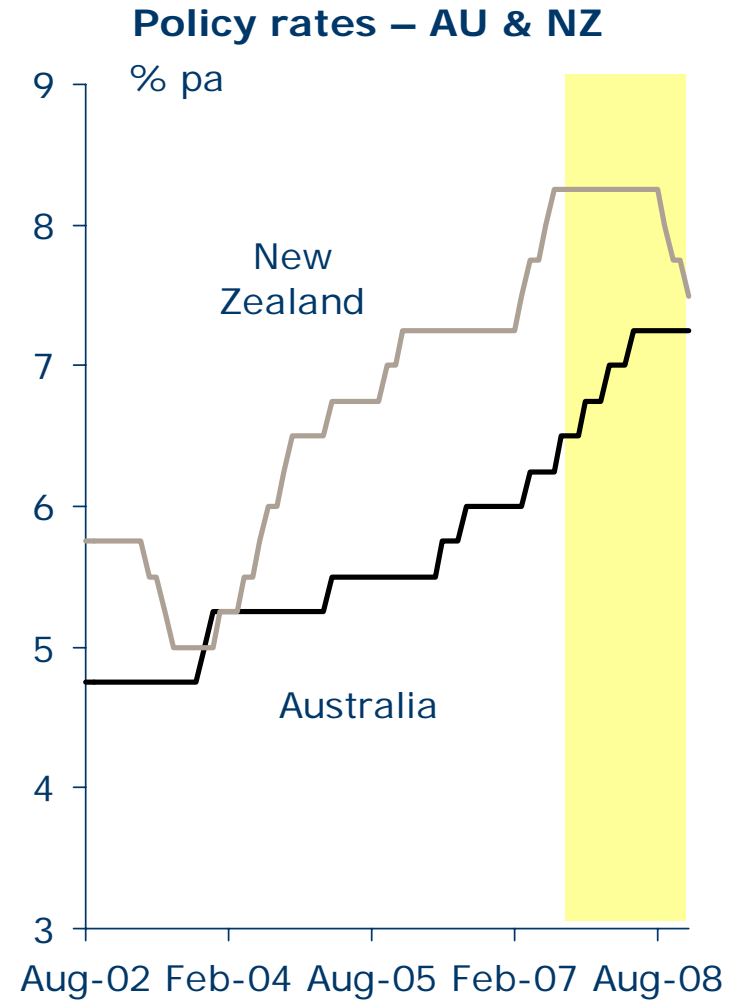
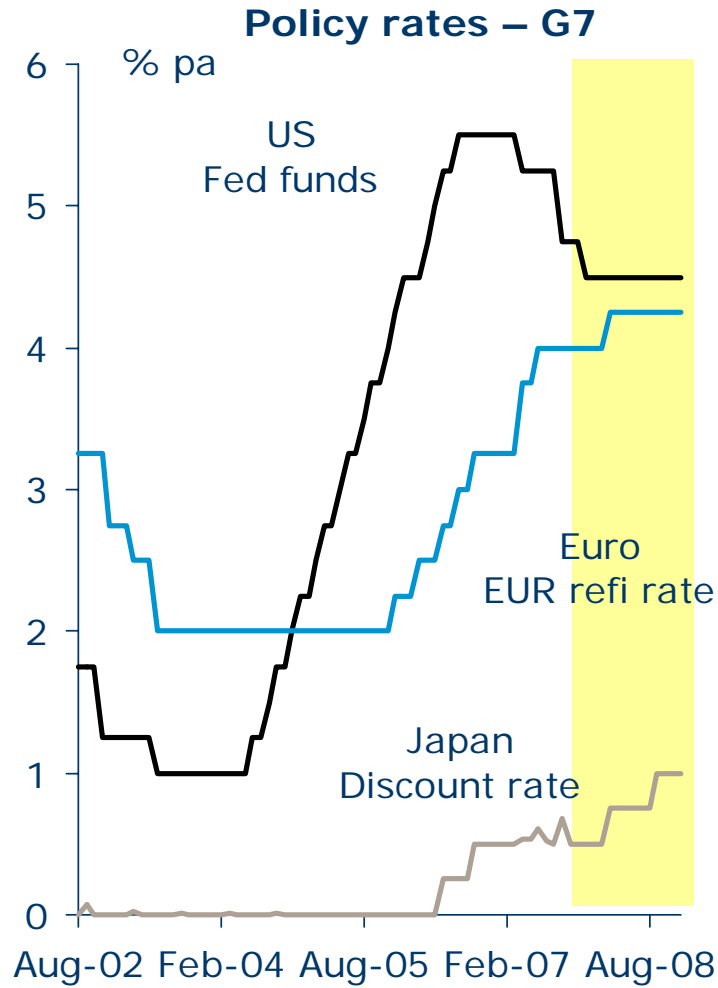
A\$ rates going up, NZ on hold with stubborn inflation



Source: ABS, Datastream and Economics@ANZ

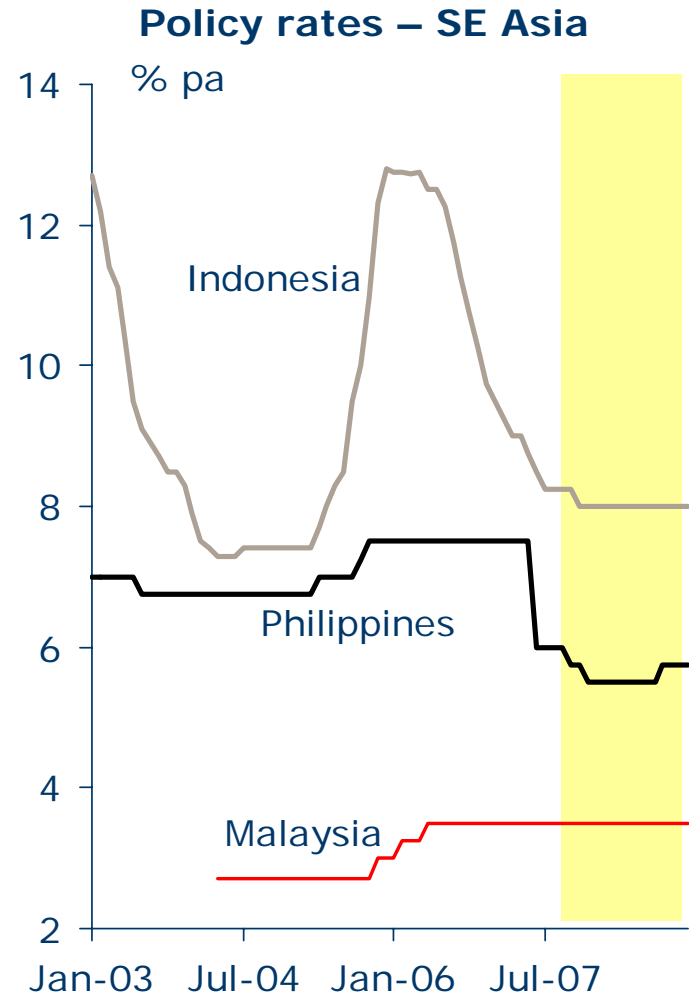
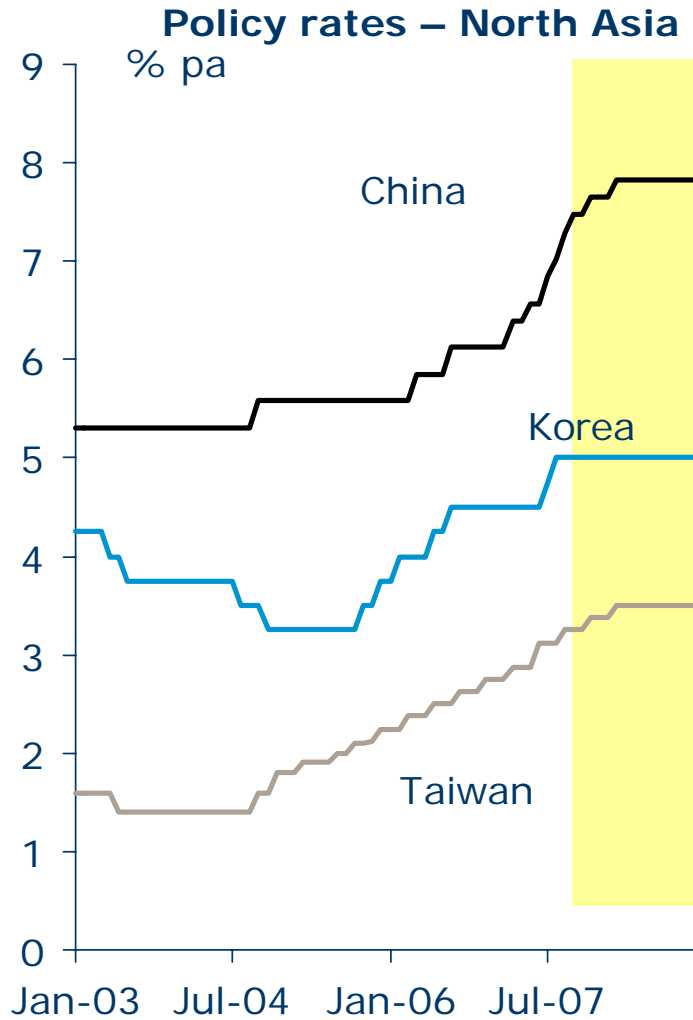


Prognosis: US is alone in monetary policy easing



Source: Bloomberg, Economics@ANZ

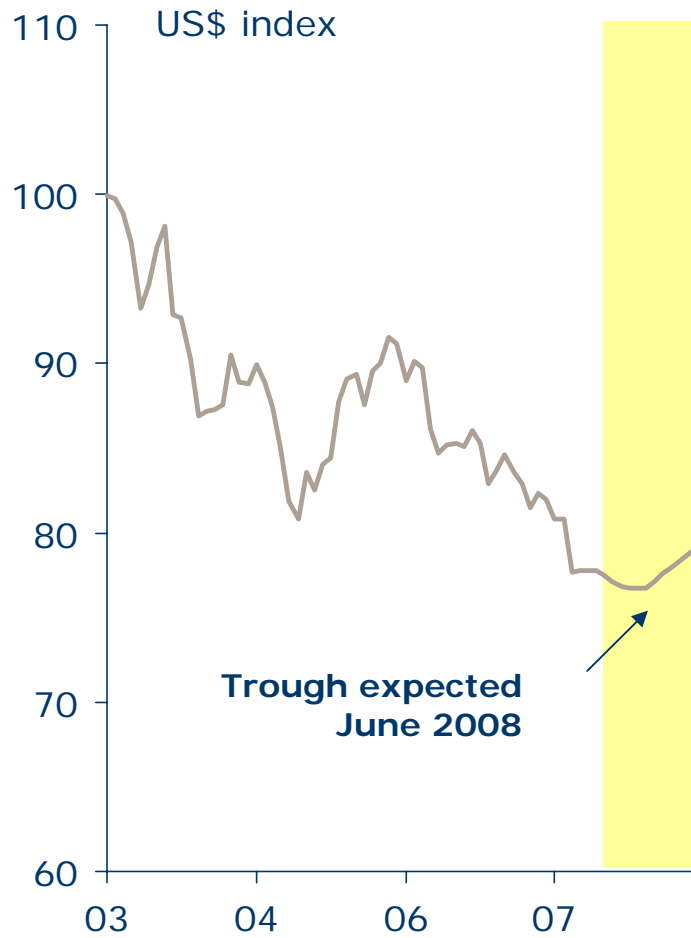
North Asia still tightening; SE Asia rate cuts now limited



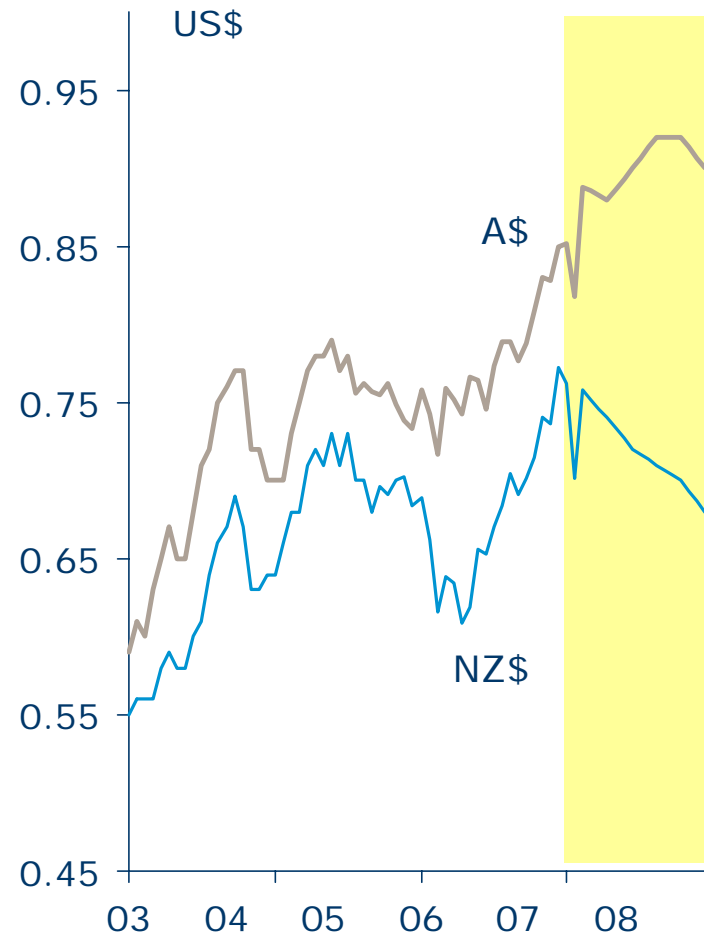
Source: Bloomberg, Economics@ANZ

US\$ weakness to remain a theme

US\$ broad index

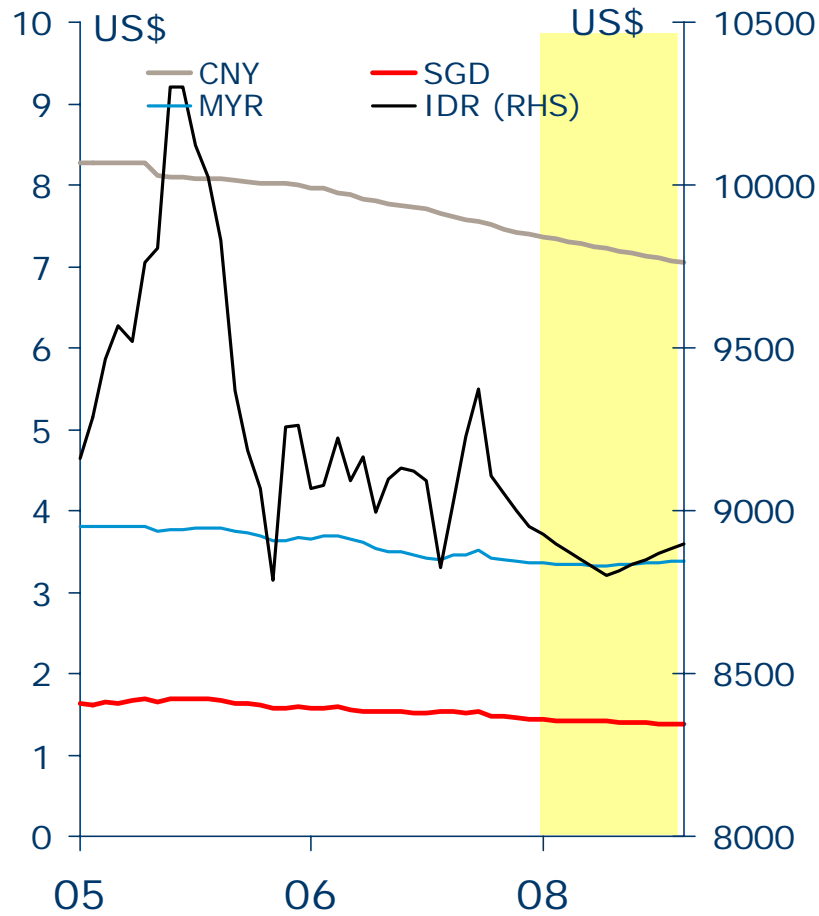


US\$ vs AUD and NZD

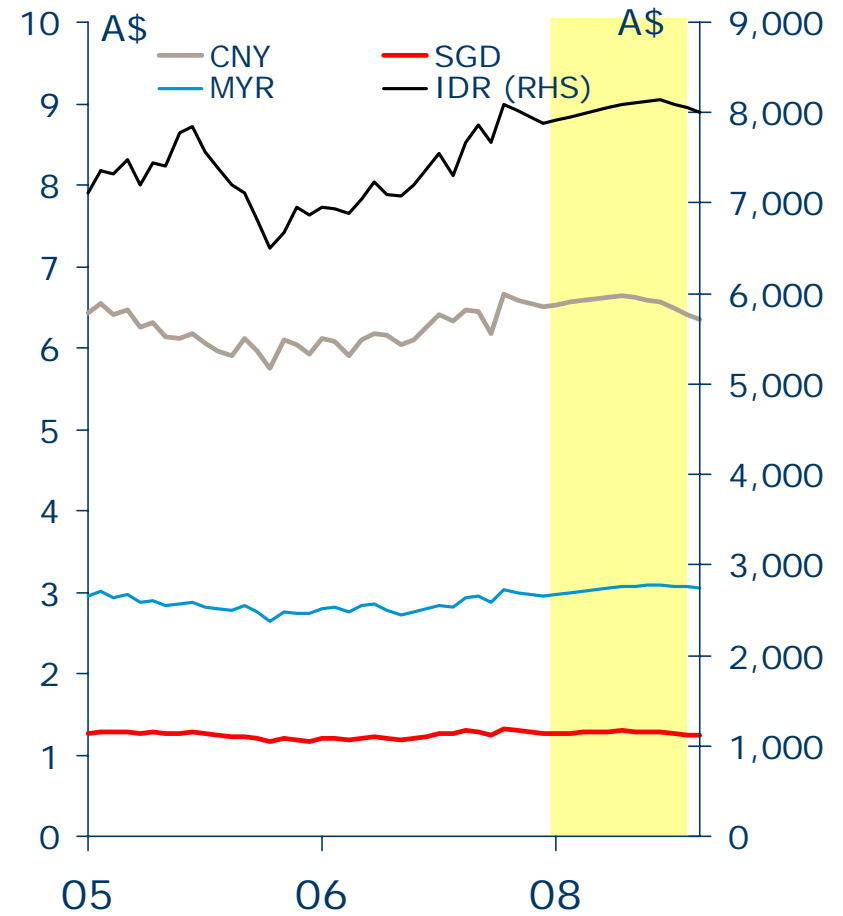


Asian currencies to strengthen vs US\$, but not vs A\$

US\$ vs strongest Asians

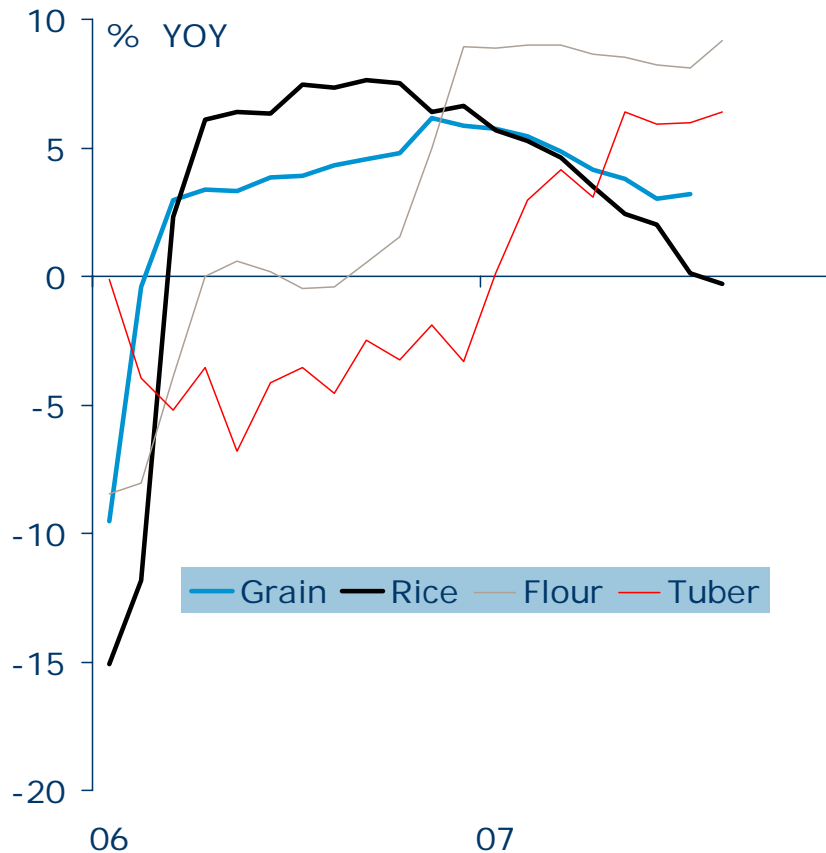


A\$ vs strongest Asians



Outlook for China

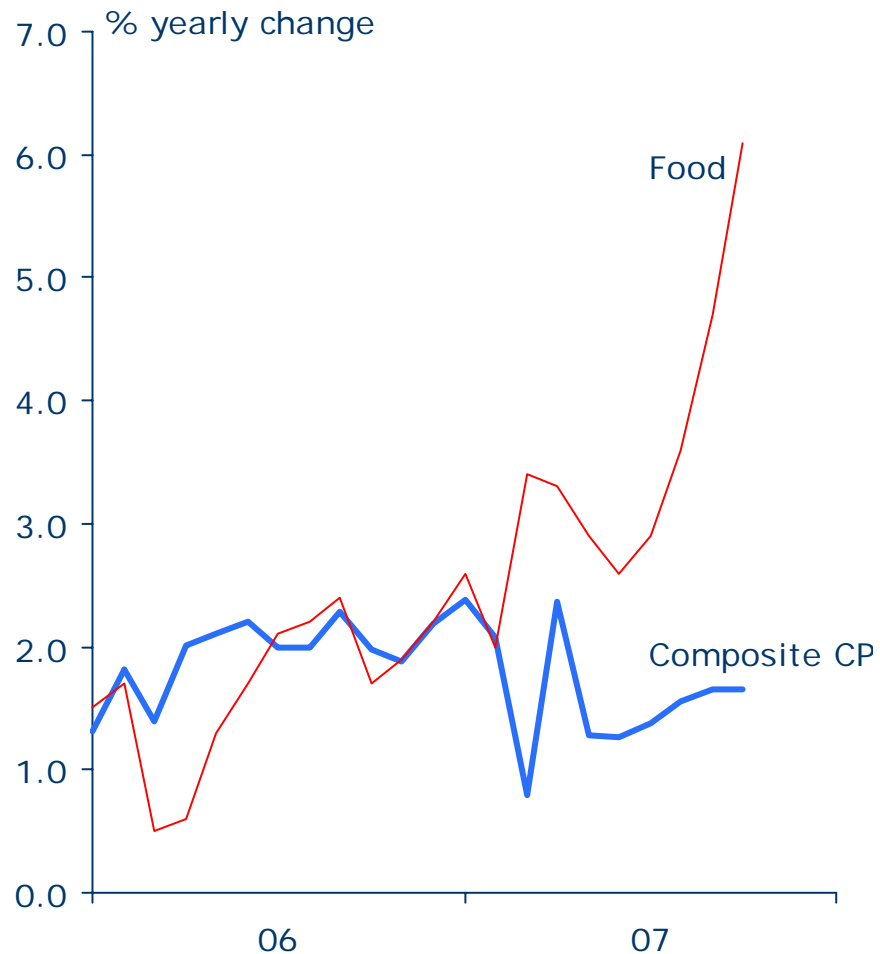
Food inflation is broad based



- > Growth was a strong 11.5% in Q3, but inflation tempered in September
 - Possibly massaged GDP figure as FAI, net exports and IP all accelerated in Q3
 - Our forecast is for a peak of 7.83% in 1-year lending rate by March 2008
- > Rate rises don't address major imbalances in the economy that are generating surplus liquidity remains
 - The government is very concerned about asset price bubbles in the stock and property markets
 - Longer term, the issue is the ROA of the banking system as investment is driving growth
 - Declining investment and rising consumption are policy goals, and are inflationary
 - Global Insight have downgraded their risk rating for China from 2.50 to 2.75
- > Conventional wisdom dictates CNY undervalued; how high do interest rates have to rise to keep US\$4 tr of deposits in the economy?

Outlook for Hong Kong

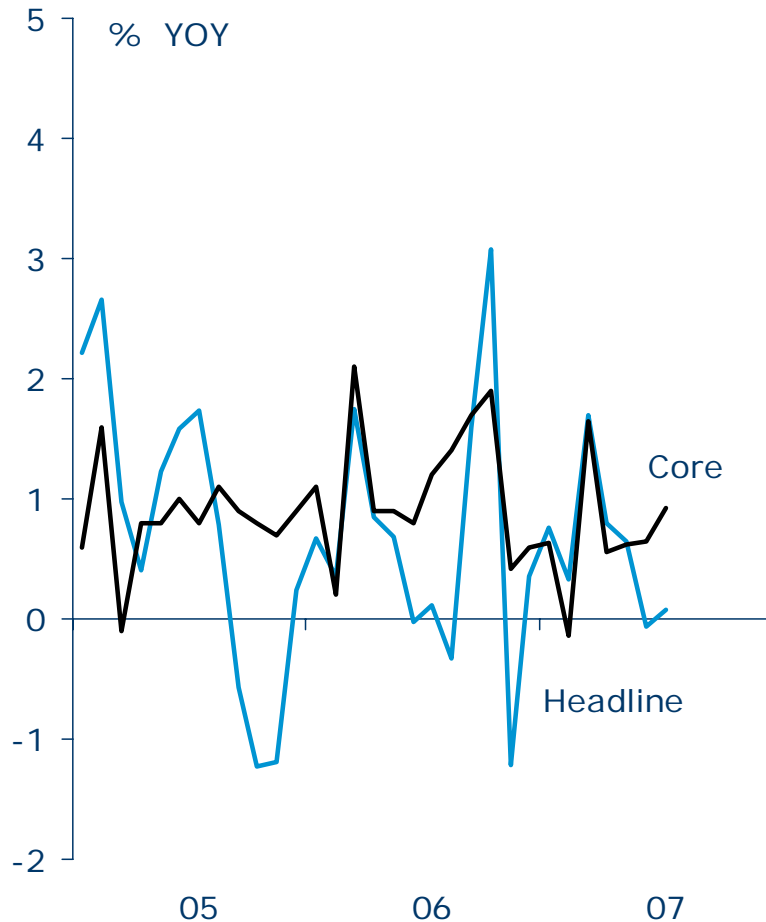
HK inflation needs higher rates



- > Hong Kong monetary policy is the most contentious call over next 2-3 years
 - Link with US monetary policy via currency peg clearly no longer appropriate
 - Loss of US\$ as world reserve currency has implications for local financial markets
 - HK the only economy where our EWI shows consistently rising risk assessment, stemming from liquidity measures and bond yields
- > Near term, expect HK market rates to rise versus US market rates
 - HK swaps finally reaching par with US for first time since SARS
 - Prime rate increasingly diverging from policy rate
- > Would make sense to fix HK to the G3 basket of currencies; how possible is such a move?

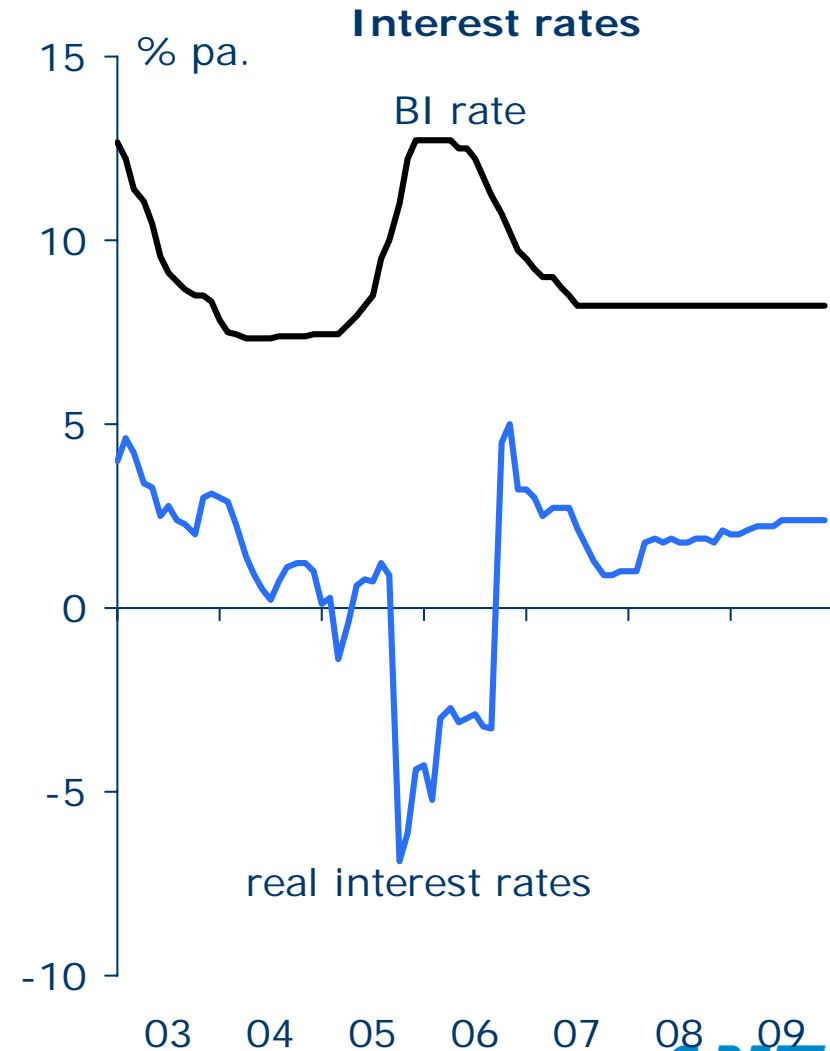
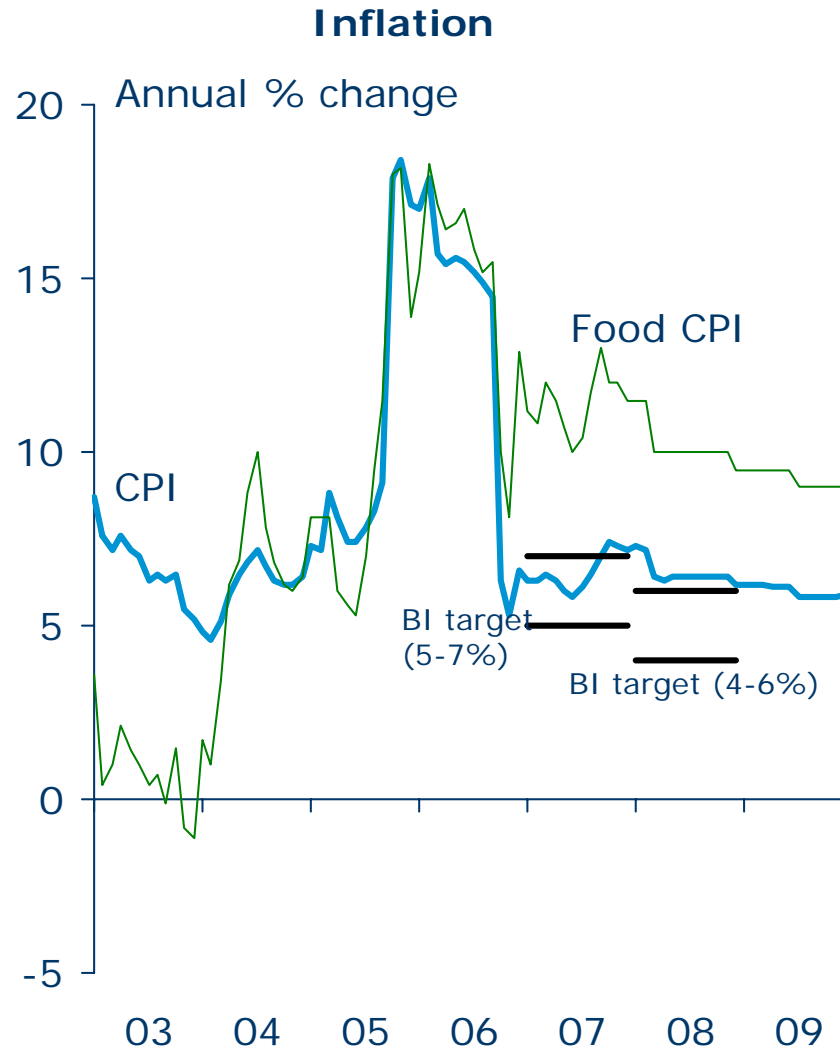
Outlook for Taiwan

Inflation at last?

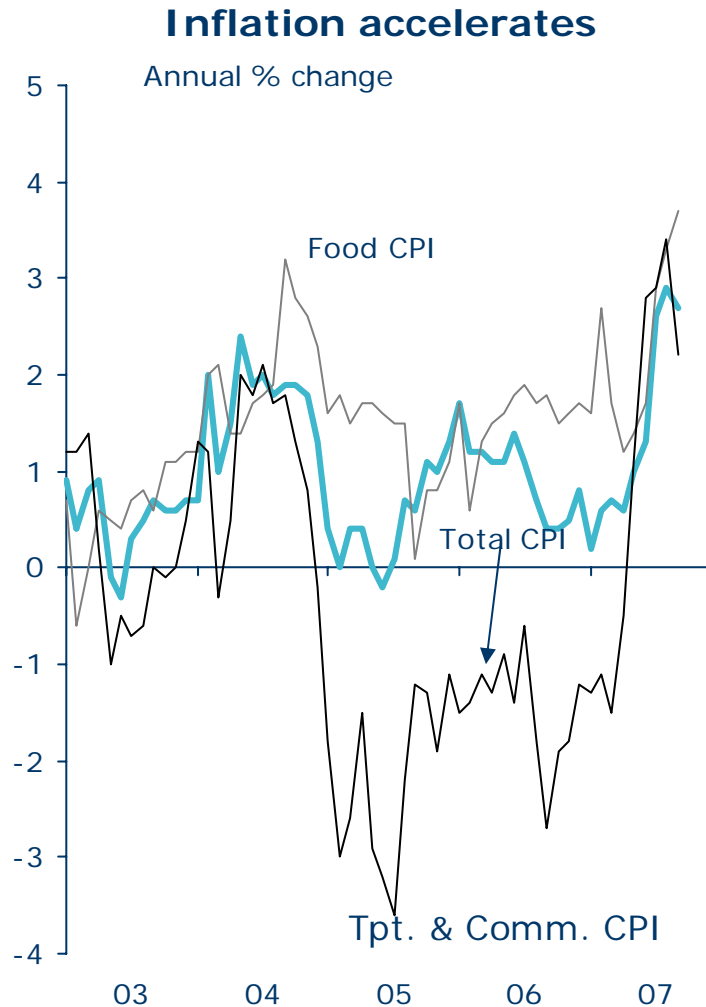


- > Falling business expenditure in US is a key risk to economic outlook
 - But export orders up 16% pa in August and September
 - GDP growth XX% in Q3
 - Inflation seems to be accelerating
- > We think CBC is still tightening
 - Forecast is for 13 bps rises in nextx 2 quarterly meetings, for a peak rate of 3.5% as of March 2008
- > However, rates not rising enough to make a different to weak currency forecast
 - NTD the only currency that is not expected to appreciate vs US\$ on a 6-9 month horizon
- > Upcoming electoral cycle to delay any substantial measures to address economy or advance pension reform

Indonesia risks overshooting CPI target – negative for rates, positive for IDR



Stronger growth and price pressures in Singapore prompt faster currency appreciation

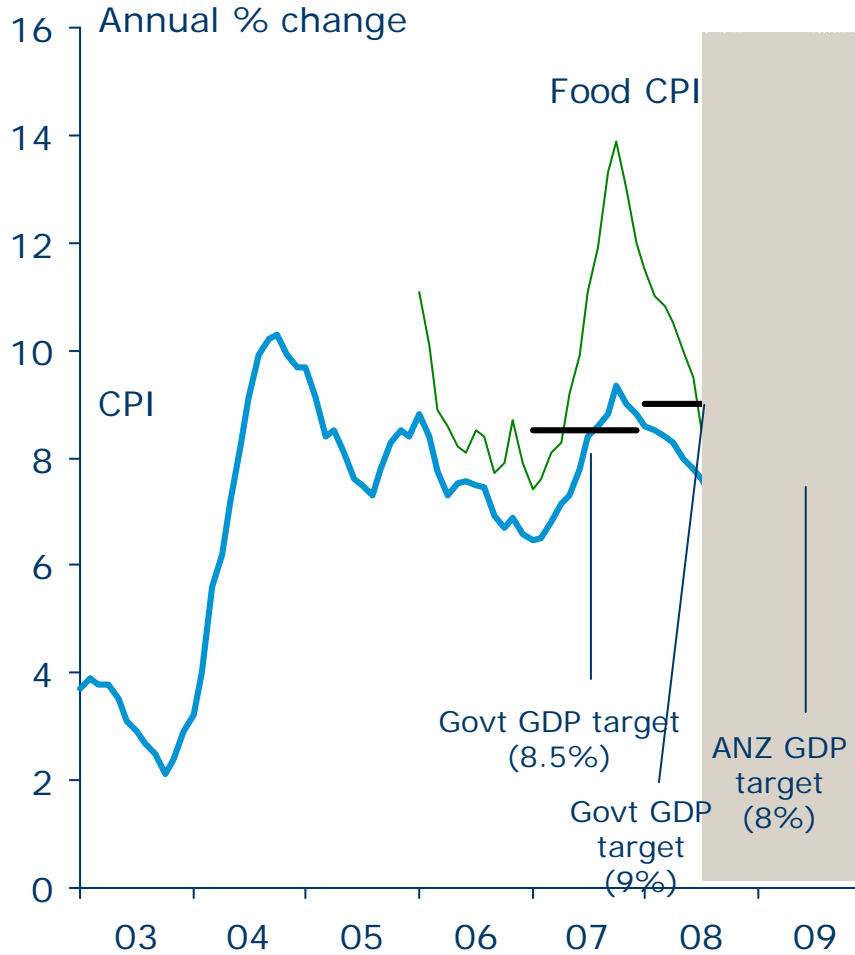


- > In its October Monetary Policy Statement, MAS continued with the policy of a modest and gradual appreciation of the S\$NEER policy band in the period ahead. However, it increased slightly the slope of the S\$NEER policy band – effectively allowing for a stronger appreciation of the SGD.
- > Triggers for this tighter stance
 - **Domestic price pressures.** CPI at 12 year highs, averaging 2.7% in July-September, with only about half of the increase attributed to GST hike.
 - **Tight labour market** (unemployment at 6-year low of 2.3% in June) and rising rental costs.
 - **Robust economic growth** with real GDP growth revised upwards to 8.3% in 2007 before moderating to 5.6% in 2008.
 - **External price pressures.** Higher oil and food prices.

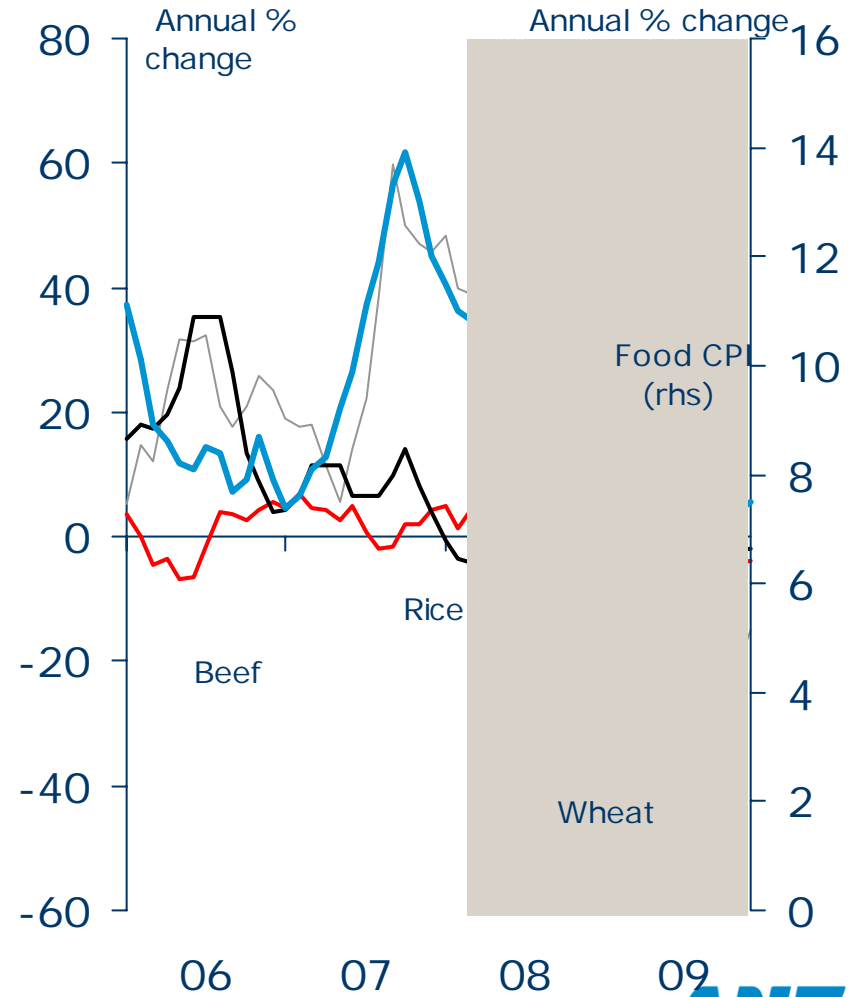
We think USD/SGD can peak below 1.40 over a 6-9 month horizon

Special mention for Vietnam, which adjusted pace of VND depreciation this month from 1% pa to 0.5% pa

Inflation just at target



Food a major driver



Source: Datastream, Bloomberg, Economics@ANZ



Regional financial market forecasts – A\$ under review

	Sept 2007	Oct 2007	Dec 2007	June 2008	Dec 2008
US Fed funds rate	4.75	4.75	4.50	4.50	4.50
RBA cash rate	6.50	6.50	6.75	7.25	7.25
Bank of Japan call rate	0.50	0.50	0.50	0.75	1.0
European Central Bank refi rate	4.0	4.0	4.0	4.25	4.25
US 10-year bond yield	4.59	4.40	4.60	4.70	5.35
US\$ - ¥	114.8	114.5	114	112	108
€ - US\$	1.4267	1.43	1.45	1.46	1.39
£ - US\$	2.047	2.05	2.06	2.05	1.99
US\$ - SwFr	1.16	1.16	1.15	1.14	1.20
AUD – US\$	0.8879	0.90	0.94	0.96	0.90
NZD – US\$	0.7579	0.76	0.77	0.74	0.68

Asia currency forecasts vs US\$

	Sept 2007	Oct 2007	Dec 2007	June 2008	Dec 2008
US\$ - ¥	114.8	114.5	114	112	108
US\$ - Yuan	7.506	7.449	7.397	7.22	7.04
US\$ - Won	915	915	915	912	920
US\$ - NT\$	32.67	32.69	32.80	32.80	33.0
US\$ - Rupiah	9,105	9,053	8,950	8,800	8,900
US\$ - Baht (onshore)	34.26	34.17	34.0	33.8	34.3
US\$ - HK\$	7.77	7.77	7.78	7.79	7.80
US\$ - Ringgit	3.41	3.39	3.35	3.33	3.38
US\$ - S\$	1.485	1.47	1.44	1.41	1.38
US\$ - Peso	44.90	44.30	43.0	44.0	46.0
US\$ - Dong	16,086	16,103	16,136	16,177	16,217
US\$ - Rupee	39.8	39.5	39.0	38.0	38.5

Asia currency forecasts vs A\$

	Sept 2007	Oct 2007	Dec 2007	June 2008	Dec 2008
AUD - ¥	101.93	103.68	107.16	107.52	97.20
AUD - Yuan	6.66	6.74	6.95	6.93	6.34
AUD – Won	813	828	860	876	828
AUD - NT\$	29.01	29.59	30.83	31.49	29.70
AUD - Rupiah	8,084	8,196	8,413	8,448	8,010
AUD – Baht (onshore)	30.42	30.94	31.96	32.45	30.87
AUD - HK\$	6.903	7.038	7.313	7.478	7.02
AUD - Ringgit	3.03	3.07	3.15	3.20	3.04
AUD - S\$	1.32	1.33	1.35	1.35	1.24
AUD - Peso	39.91	40.1	40.42	42.24	41.40
AUD - Dong	14,283	14,577	15,168	15,530	14,595
AUD - Rupee	35.31	35.77	36.66	36.48	34.65

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AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522
10th Floor 100 Queen Street, Melbourne 3000, Australia
Telephone +61 3 9273 6224 Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited
ABN 11 005 357 522
40 Bank Street, Canary Wharf, London, E14 5EJ, United Kingdom
Telephone +44 20 3229 2121 Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of NASD and SIPC)
6th Floor 1177 Avenue of the Americas
New York, NY 10036, United States of America
Tel: +1 212 801 9160 Fax: +1 212 801 9163

NEW ZEALAND by:

ANZ National Bank Limited
Level 7, 1-9 Victoria Street, Wellington, New Zealand
Telephone +64 4 802 2000

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