

23 April 2009

Aussie Rates Strategy

Uncomfortably high core inflation in Australia combined with QE overseas suggests inflation risks are not totally diminished from the global system.

While we are not seriously worried about inflation problems (deflation is probably the main inflation based tail risk), the proven inability of global central banks to accurately predict a recovery in the economy and thus to remove unconventional monetary policy measures in a timely way suggests some inflation risk premium will lurk in the back of investors minds.

For Australian rates markets this will have two immediate effects; to keep the RBA on hold for the next few months and to keep the curve steep.

Global Macro Strategy

We have seen the first genuine signs of a stabilisation in the global financial markets in recent months.

Equity markets have rallied and price volatility has declined as risk appetite has improved.

This has occurred despite continued poor 'news' flow. This suggests that the rally in risky asset markets is being driven by investors re-deploying cash on the basis of cheap asset valuations rather than a signal of a recovery in underlying cyclical fundamentals.

Authors:

Warren Hogan
Head of Australian Economics and Interest Rates Research
+61 2 9227 1562
Warren.Hogan@anz.com

Tony Morriss
Senior Rates Strategist, Australian Economics and Interest Rates Research
61 2 9226 6757
Tony.Morriss@anz.com

Daniel Bae
Global Markets, Analyst
+61 2 9227 1272
Daniel.Bae@anz.com

Our Vision:

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.

Figure 1: We favour a resumption of the steepening trend for Aus 3s10s curve



Source: ANZ & Bloomberg

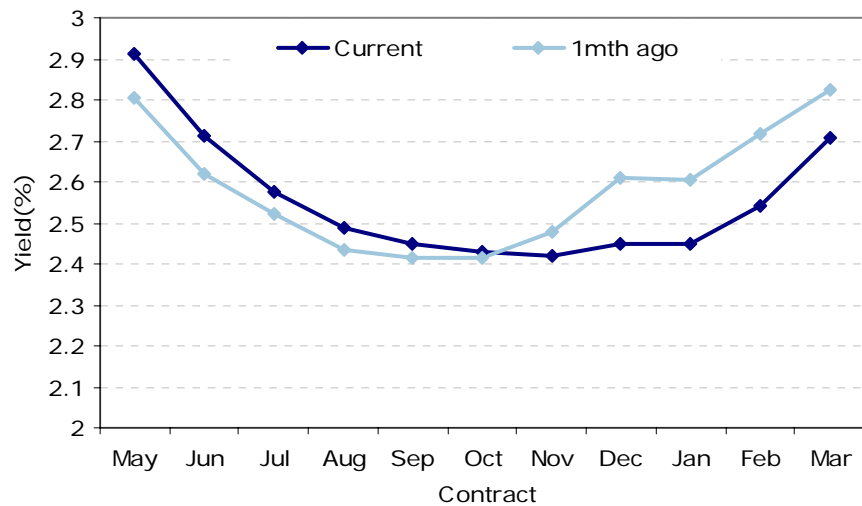
Aussie Rates Strategy

Warren Hogan
 Head of Australian Economics
 and Interest Rates Research
 +61 2 9227 1562
 Warren.Hogan@anz.com

Uncomfortably high core inflation in Australia combined with QE overseas suggests inflation risks are not totally diminished from the global system. While we are not seriously worried about inflation problems (deflation is probably the main inflation based tail risk), the proven inability of global central banks to accurately predict a recovery in the economy and thus to remove unconventional monetary policy measures in a timely way suggests some inflation risk premium will lurk in the back of investors minds. For Australian rates markets this will have two immediate effects; to keep the RBA on hold for the next few months and to keep the curve steep.

We think the RBA will keep rates steady next month and probably the month after. Indeed, the cash rate could be at 3% for six months. But it is not the low point. This economy faces substantial challenges ahead and unless inflation becomes a problem (which we doubt) the RBA will bring the short-rate down further. We are comfortable to forecast a 2% cash rate by year end. This suggests being short the front IBs and long further out. The right RBA trade now is bullish however. Not the very front numbers but rather the 1 to 3 yr sector. We stick to our view that the 1yr1yr will rally and likely set new lows later in the year.

Figure 2: 2% cash rate trough suggests being short the front IB and long further out



Source: ANZ and Bloomberg

The curve is in a clear flattening sequence in recent weeks as the global sell-off and shifting expectations for the RBA kick in. The flattening is almost over if the equity rally is almost over. Unlike the US the Australian curve will continue to exhibit some of the normal bull/steepening; bear/flattening characteristics given that there is still scope for cash rate reductions. We expect the curve to move back towards 130bp over the months ahead. We would put on steepeners below 90bp.

If the worst is ahead for the Australian economy and the RBA is likely to cut rates further then Australian rates should out-perform other dollar bloc countries. QE only partially offsets a super issuance program from the US Treasury. QE is not an Australian under-performance story but rather an out-performance story as the Australian borrowing requirement will be much less than in other dollar bloc countries. It looks like this process has begun. We are targeting 120bp by year's end.

Swap spreads appear to be drifting out in the 3yr sector after hitting a low in mid March. All our formal modelling tells us that swap spreads should be tighter. A large government borrowing program also favours some compressions. With the government likely to announce a much larger Budget deficit and thus a material upward revision to the issuance program we would look for swap spreads to contract over the next few weeks. Target a move back down to +30bp in 3yrs.

Global Macro Strategy: Too Early to Trade the Recovery

Warren Hogan

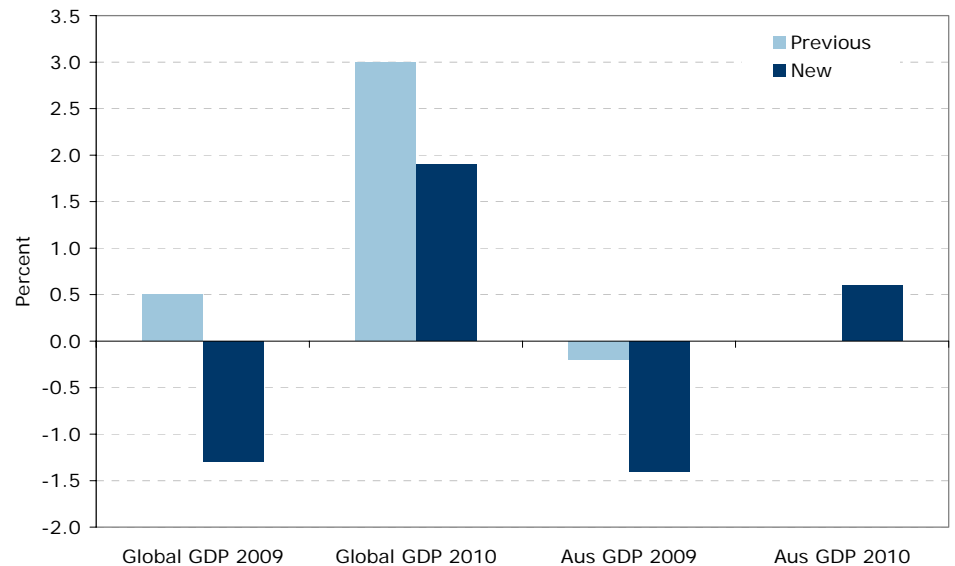
Head of Australian Economics
and Interest Rates Research
+61 2 9227 1562
Warren.Hogan@anz.com

We have seen the first genuine signs of a stabilisation in the global financial markets in recent months. Equity markets have rallied and price volatility has declined as risk appetite has improved. This has occurred despite continued poor 'news' flow. This suggests that the rally in risky asset markets is being driven by investors re-deploying cash on the basis of cheap asset valuations rather than a signal of a recovery in underlying cyclical fundamentals.

Even though improving investor risk appetite is encouraging, many challenges to corporate earnings and financial stability remain. We do not expect a sustained rally in risky asset markets from here although the recent rally may indicate that equity markets have now formed a long-term base.

Global growth prospects for 2009 have continued to be marked down. In March the IMF revised world economic forecasts for a fifth time since October 2008. The 2009 forecast for world GDP growth was revised from +0.5% to -1.3% between January and April. The world economy is expected to grow by 1.9% in 2010, still below the average rate of the past decade of around 3%.

Figure 3: Previous and Revised IMF GDP Forecasts

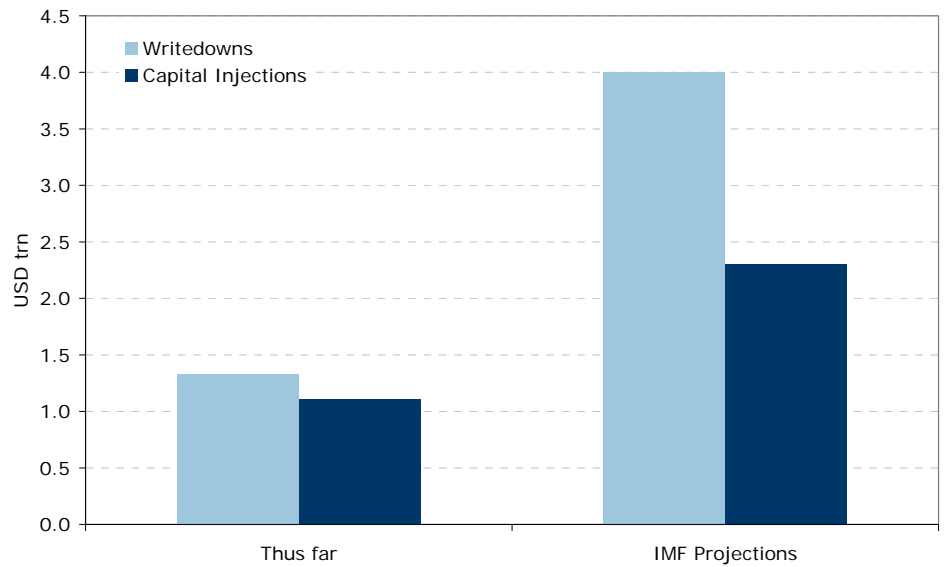


Source: ANZ and IMF

The latest assessments from the IMF highlight substantial risks still facing the global economy and markets. IMF estimates for total losses on securities and loans have been revised higher. Loss estimates from \$US originated loans and securities is now expected to reach \$US2.7trn, up from \$US2.2trn a few months ago. The IMF is now also estimating losses from European and Japanese originated exposures. These are expected to total \$US1.4trn taking total global losses across the financial system to over \$US4trn. Thus far loss and write-down announcements have total \$US1.2trn.

Unless the IMF estimates are wildly wrong, the potential for further write-downs and a new wave of financial distress and uncertainty to re-emerge appears quite high. If nothing else these estimates also imply significant further capital requirements for the financial system of as much as \$US1trn. While the use of public money to re-capitalise banks has been a critical element in stabilising the financial system, new capital demand of this magnitude may even be beyond the capacity of national governments.

Figure 4: IMF Projections for writedowns and capital injections by global financials



Source: ANZ and Bloomberg

As a primary necessary condition to be confident that the worst of the financial crisis is behind us, the US economy must stabilise. Many of the financial risks hampering the global financial system are related to the US economy. Further, the US is the most important source of demand in the world economy and thus a stable US economy is an important pre-condition for a global economic recovery. The evidence on the US economy through the first quarter of 2009 is mixed.

Bernanke's 'green shoots' are nothing more. Some early evidence of a reduction in the housing overhang can be easily disappointed particularly if house prices continue to fall. The US labour market remains weak, with the unemployment rate rising at a 5 percentage point annualised pace in recent months. Most forecasters have US unemployment 'peaking' above 10%. The best we can say is that in most sectors the rate of *deterioration* has stabilised.

In any case, the financial system remains fragile and the economies of the world weak. The recent bout of investor optimism appears to be highly vulnerable to further shocks. All this suggests to us that the bond market sell-off has probably run its course. We favour overweight governments and high grade credit and long duration. In the US we expect a bullish curve flattening.

Charts

Chart 1: AUS Bills/3s and Bills/10s curves

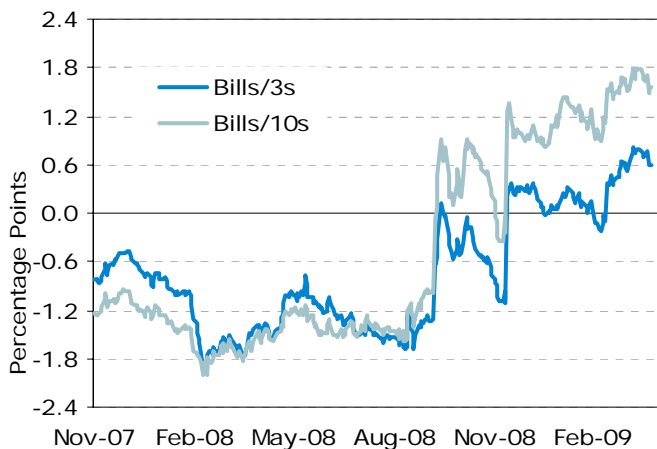


Chart 2: AUS-US 10-year spread

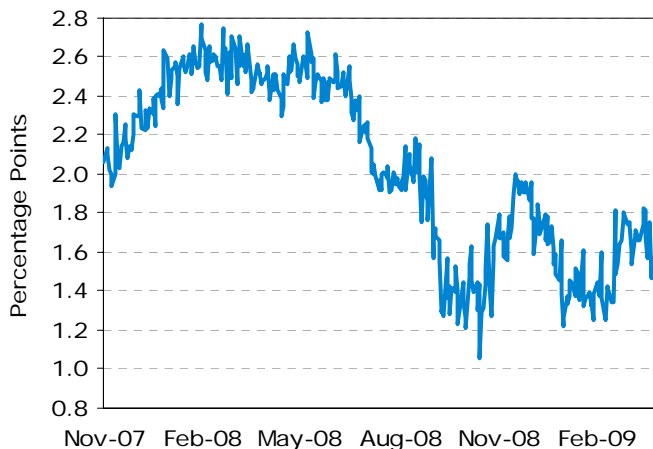


Chart 3: AUS 3-year semi-government spreads to bond

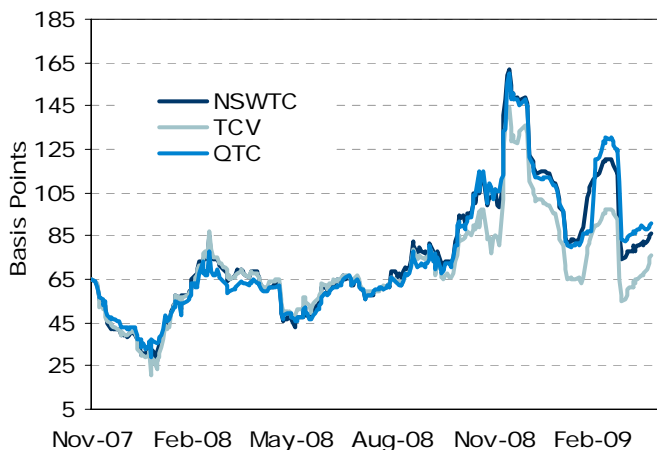


Chart 4: AUS 10-year semi-government spreads to bond

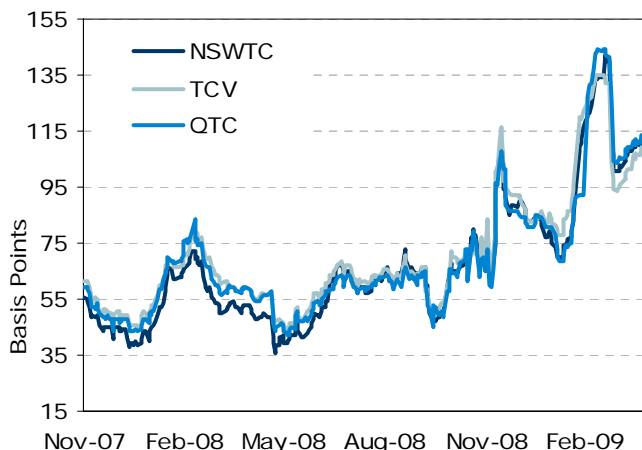


Chart 5: AUS swap curves

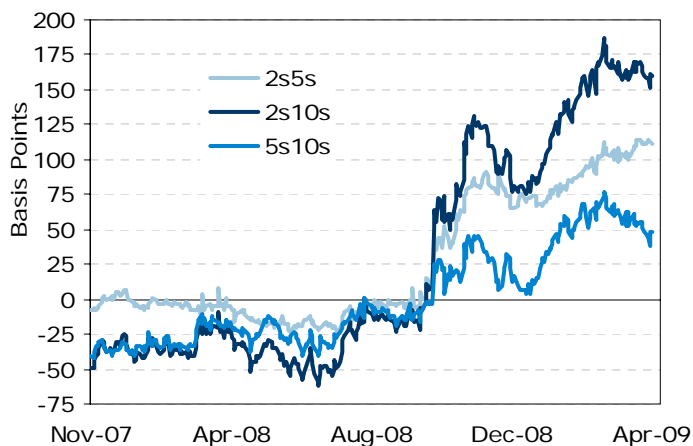


Chart 6: AUS swap yields



Interest Rate Forecasts

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10
United States						
Fed funds rate	0.25	0.25	0.25	0.50	1.00	1.50
3-month LIBOR	0.90	0.70	0.50	0.70	1.25	1.75
2-year bond	0.75	0.80	0.85	1.25	1.50	2.50
10-year bond	2.65	2.65	2.70	3.05	3.20	4.10
2s10s curve (bps)	190	185	185	180	170	160
Australia						
RBA cash rate	2.75	2.50	2.00	2.00	2.00	2.00
90-day bill rate	2.65	2.30	2.30	2.30	2.35	2.60
3-year bond	3.25	3.20	3.05	3.40	3.60	4.60
10-year bond	4.35	4.30	4.15	4.30	4.40	5.30
3s10s curve (bps)	110	110	110	90	80	70
10-year swap spread	50	40	35	30	30	55
New Zealand						
RBNZ OCR	2.25	2.25	2.25	2.25	2.25	2.75
90-day bill rate	2.70	2.70	2.70	2.70	2.70	3.48
2-year bond	3.49	3.50	3.45	3.65	3.83	4.56
10-year bond	4.35	4.30	4.25	4.65	4.80	5.50
Foreign Exchange						
AUD/USD	0.66	0.63	0.59	0.56	0.57	0.58
AUD/NZD	1.22	1.24	1.23	1.20	1.21	1.21
AUD/JPY	69	68	65	65	66	68
AUD/EUR	0.52	0.51	0.50	0.50	0.51	0.51
AUD/GBP	0.45	0.43	0.40	0.37	0.37	0.36
USD/JPY	105	108	110	116	116	118
EUR/USD	1.28	1.24	1.18	1.12	1.12	1.14
EUR/JPY	134	134	130	130	130	135
GBP/USD	1.46	1.48	1.48	1.50	1.55	1.60

Source: ANZ and Bloomberg

Contacts

ANZ Economics & Markets Research

Saul Eslake	Chief Economist	+61 3 9273 6251	Saul.Eslake@anz.com
Fiona Allen	Business Manager	+61 3 9273 6224	Fiona.Allen@anz.com

Australian Economics and Interest Rates Research

Warren Hogan	Head of Australian Economics and Interest Rates Research	+61 2 9227 1562	Warren.Hogan@anz.com
Katie Dean	Senior Economist	+61 3 9273 1381	Katie.Dean@anz.com
Tony Morriss	Senior Interest Rate Strategist	+61 2 9226 6757	Tony.Morriss@anz.com
Riki Polygenis	Economist	+61 3 9273 4060	Riki.Polygenis@anz.com
Dr. Alex Joiner	Economist	+61 3 9273 6123	Alex.Joiner@anz.com
Daniel Bae	Analyst	+61 2 9227 1272	Daniel.Bae@anz.com

Global Markets Credit Research

Jason Hill	Global Markets Credit Analyst	0434 312 356	Jason.Hill@anz.com
------------	-------------------------------	--------------	--

Commodity and Industry Research

Mark Pervan	Head of Commodities Research	+61 3 9273 3716	Mark.Pervan@anz.com
Julie Toth	Senior Economist	+61 3 9273 6252	Julie.Toth@anz.com
Doug Whitehead	Soft Commodity Strategist	+61 3 9273 6684	Doug.Whitehead@anz.com
Paul Deane	Rural and Regional Economist	+61 3 9273 6295	Paul.Deane@anz.com

Property and Financial System Research

Paul Braddick	Head of Property and Financial System Research	+61 3 9273 5987	Paul.Braddick@anz.com
Ange Montalti	Senior Economist	+61 3 9273 6288	Ange.Montalti@anz.com
Dr. Alex Joiner	Economist	+61 3 9273 6123	Alex.Joiner@anz.com
Stephanie Wayne	Research Analyst	+61 3 9273 4075	Stephanie.Wayne@anz.com

Foreign Exchange and International Economics Research

Amy Auster	Head of Foreign Exchange and International Economics Research	+61 3 9273 5417	Amy.Auster@anz.com
Amber Rabinov	Economist	+61 3 9273 4853	Amber.Rabinov@anz.com

Foreign Exchange and Interest Rates Research (London)

Tim Riddell	Currency and Interest Rate Strategist		Tim.Riddell@anz.com
-------------	---------------------------------------	--	--

Asian Economics Research (Singapore)

Paul Gruenwald	Chief Economist, Asia	+65 6419 7902	Paul.Gruenwald@anz.com
Tamara Henderson	Director, Currency & Rates Strategy	+65 6216 1845	Tamara.Henderson@anz.com
Ivy Tan	Associate Director, Credit Research	+65 6419 7914	Ivy.Tan@anz.com
Chang Wei Liang	Analyst, Economic Research	+65 6216 1838	WeiLiang.Chang@anz.com

New Zealand Economics Research (Wellington)

Cameron Bagrie	Chief Economist, New Zealand	+64 4 802 2212	Cameron.Bagrie@anz.com
Khoon Goh	Senior Economist	+64 4 802 2357	Khoon.Goh@anz.com
Philip Borkin	Economist	+64 4 802 2199	Philip.Borkin@anz.com
Steve Edwards	Economist	+64 4 802 2217	Steve.Edwards@anz.com
Kevin Wilson	Rural Economist	+64 4 802 2361	wilsonk1@anz.com
David Croy	Interest Rate Strategist	+64 4 802 2286	David.Croy@anz.com

Research and Information Services

Marilla Rough	Senior Information Officer	+61 3 9273 6263	Marilla.Rough@anz.com
Manesha Jayasuriya	Publications Coordinator	+61 3 9273 4121	Manesha.Jayasuriya@anz.com

Important Notice

Australia and New Zealand Banking Group Limited is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522

100 Queen Street, Melbourne, Victoria, 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

This document ("document") is distributed to you in Australia and the United Kingdom by Australia and New Zealand Banking Group Limited ABN 11 005 357 522 ("ANZ") and in New Zealand by ANZ National Bank Limited ("ANZ NZ"). ANZ holds an Australian Financial Services licence no. 234527 and is authorised in the UK by the Financial Services Authority ("FSA").

This document is being distributed in the United States by ANZ Securities, Inc. ("ANZ S") (an affiliated company of ANZ), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this document and wishing to effect transactions in any securities referred to herein should contact ANZ S, not its affiliates.

This document is being distributed in the United Kingdom by ANZ for the information of its market counterparties and intermediate customers only. It is not intended for and must not be distributed to private customers. In the UK, ANZ is regulated by the FSA. Nothing here excludes or restricts any duty or liability to a customer which ANZ may have under the UK Financial Services and Markets Act 2000 or under the regulatory system as defined in the Rules of the FSA.

This document is issued on the basis that it is only for the information of the particular person to whom it is provided. This document may not be reproduced, distributed or published by any recipient for any purpose. This document does not take into account your personal needs and financial circumstances. Under no circumstances is this document to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZ, ANZ NZ, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this document (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this document. If you have been referred to ANZ, ANZ NZ, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this document accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this document and are subject to change without notice. No part of the author's compensation was, is or will directly or indirectly relate to specific recommendations or views expressed about any securities or issuers in this document. ANZ, ANZ NZ, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

Where the recipient of this publication conducts a business, the provisions of the Consumer Guarantees Act 1993 (NZ) shall not apply.