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Authors:

Saul Eslake
Chief Economist

Warren Hogan
Head of Australian Economics and Interest Rate Research

Paul Gruenwald
Chief Economist, Asia

Tamara Henderson
Director, Currency and Rates Strategy, Asia

Mark Pervan
Head of Commodities Research

Katie Dean
Acting Head of Foreign Exchange and International Economics Research

Tony Morriss
Senior Interest Rate Strategist, Australia

Julie Toth
Senior Industry Economist, Australia

Riki Polygenis
Economist, Australia

Philip Borkin
Economist, New Zealand

Alex Joiner
Economist, Australia

Doug Whitehead
Soft Commodity Analyst

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GDP growth (%)	2008	2009(f)	2010(f)	2011(f)
Australia	2.2	0.1	0.5	3.1
New Zealand	-1.0	-2.6	1.5	4.6
United States	1.1	-2.7	1.8	2.5
Euro zone	0.8	-4.3	0.3	1.2
Japan	-0.7	-6.7	1.1	0.8
China	9.0	7.1	8.3	8.8
Other East Asia*	3.1	-1.8	3.8	4.6
World (PPP)	3.0	-1.3	2.9	3.7

*Asia excluding Japan & China

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Overview

Saul Eslake, Chief Economist

The worst seems to be over

It seems highly likely that the most severe phase of the economic downturn triggered by the global financial crisis has now passed. The global economy probably contracted further in the second quarter, but at a much less dramatic rate than in either of the preceding two quarters. And it is likely that quarter-on-quarter growth will turn positive during the second half of the year.

However we see no compelling reasons to alter our view that the recovery will be slow and fragile. Nor do we see any reasons to believe that the macro-economic policy settings which have succeeded in stabilizing the global financial system and arresting the downturn in global economic growth are instead likely to result in higher inflation. And although we believe it is important that central banks and governments devise and promulgate credible 'exit strategies' from the unorthodox positions that have been required to address the financial crisis and its aftermath, we do not see the need for such strategies to be implemented any time soon.

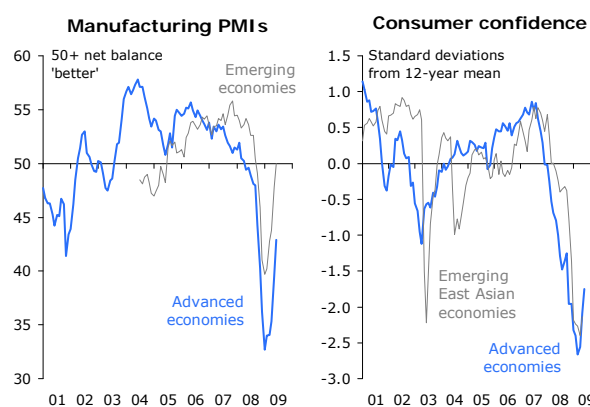
Global manufacturing cycle has bottomed ...

As we set out here three months ago, the substantial declines in household wealth resulting from the falls in share and housing prices (especially in the US and UK) and the abrupt falls in consumer and business confidence triggered by the collapse of Lehman Brothers prompted a dramatic decline in discretionary household and business spending beginning at the end of the third quarter of last year.

This in turn led to an abrupt and unanticipated increase in inventories, which the financial crisis made especially difficult to finance, and which thus led to an even sharper decline in production of 'big ticket' consumer and capital goods.

And given the globalized nature of the supply chains through which such goods are produced and distributed, this in turn led to a precipitous decline in international merchandise trade, dragging countries which had hitherto been little affected by the financial crisis in its initial stages into what thereby became a highly synchronized global economic downturn. Many of these countries, such as Germany, Japan, and other East Asian economies, have experienced larger contractions in economic activity than the US or the UK.

This very pronounced inventory cycle appears to have run its course, at least in Asia where industrial production rebounded smartly in the second quarter from extremely depressed levels in the first quarter. However it is less clear that this point has been reached in the US or Europe.



Sources: US Institute of Supply Management; Markit Economics; The Conference Board; Eurostat; Japan Economic & Social Research Institute; Thomson Financial Datastream; ANZ.

... but few signs of a recovery in demand

While production may be stabilizing around the world, there are few signs as yet of any self-sustaining recovery in global final demand. To be sure, targeted fiscal policy measures have lifted sales of motor vehicles in many countries. In some others (most obviously China), increased government spending and other measures have led to an upturn in construction activity. More broadly, combinations of tax cuts, direct cash payments, lower interest rates and a partial recovery in share markets have succeeded in preventing an ongoing slide in consumer spending.

These are all encouraging developments. However they don't amount to a self-sustaining recovery in household demand. More telling is the fact that consumer confidence remains close to two standard deviations below its long-term average in both advanced and emerging economies, despite some pick-up in the former from even more depressed levels earlier this year.

In the US and many European countries, a self-sustaining recovery in household demand simply requires more progress than has thus far been made in consolidating household balance sheets, and clearer signs than are evident to date that unemployment is close to peaking. On that score, the downward trend in initial claims for unemployment benefits in the US since mid-April is encouraging, but has hardly been of sufficient magnitude nor in place for long enough to warrant a conclusion that household spending is on the cusp of a sustained rebound. Nor is there any convincing evidence that household spending in emerging markets is about to start offsetting the shortfall in overall economic growth from substantially lower exports of consumer goods to advanced economies.

Hence it is important to global recovery prospects that fiscal and monetary policy settings retain their current unusually expansionary posture for an extended period. This appears to be well understood by most governments and central banks. The surprising thing is how poorly this is understood in some parts of the financial markets.

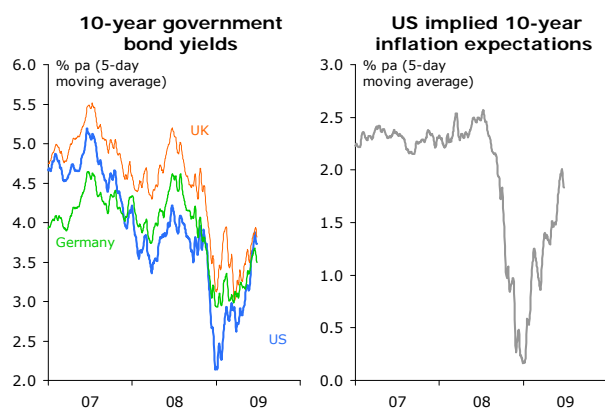
Inflation fears are egregiously misplaced

Government bond yields have risen since the end of 2008, by an average of around 90 basis points on G7 10-year bonds and by 150 basis points in the case of US 10-year bonds. Some have taken this as evidence that current monetary policy settings will inevitably fuel inflation, or as a sign that markets will have difficulty digesting the volume of debt that governments are now issuing (or both). The decline in the US dollar since early March has been widely interpreted in the same way, as presaging the inevitable loss (at some point) of the US currency's reserve status¹.

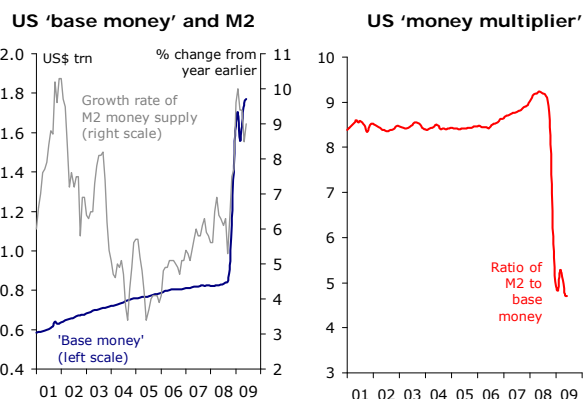
These trends are more sensibly interpreted as part of a 'return to normalcy' in global financial markets. In the months immediately following the collapse of Lehman Brothers, when risk aversion was at its most extreme levels, investors sought refuge in the US dollar (driving it up against all other currencies except the yen, which gained from the unwinding of 'carry trades') and in US government bonds (the yields on which fell by more than on other government bonds).

In late December last year, when the yield on US 10-year bonds dropped to almost 2%, bond market investors were implicitly expecting inflation of almost zero over the following ten years – which almost certainly incorporated an expectation of outright *deflation* for some of that period. This was a prospect that the Federal Reserve's adoption of 'quantitative easing' was explicitly designed to counter. The subsequent rise in US 10-year bond yields is almost entirely attributable to a recovery in inflation expectations towards 2% – exactly in line with the Fed's *de facto* inflation target.

The rise in US bond yields over the past six months is thus evidence of the *success* of the Fed's unorthodox policy actions, not a harbinger of failure.



Note: bond market inflation expectations are inferred from the spread between conventional and inflation-indexed bonds. Source: Bloomberg.



Source: US Federal Reserve

Another useful way of thinking about the Fed's response to the crisis is to recognize that the expansion in its balance sheet (from around US\$800bn before the Lehman's collapse to over US\$2trn since late last year), and the commensurate expansion in the stock of 'base money', has been required in order to offset the contraction in the banking system's capacity to create credit (from the base money supplied by the central bank) as a result of the crisis. This is illustrated by the near-halving of the US 'money multiplier' in the chart above.

Had the Fed been unwilling to expand its balance sheet in the way that it has, and assuming for the purpose of illustration that the 'money multiplier' had 'only' fallen from over 9 to (say) 6½ rather than 4¾ – then the M2 money supply would have declined by more than 20%. This is, of course, more or less what happened between 1930 and 1933, and which, as Milton Friedman (with Anna Schwartz) famously demonstrated, helped put the 'Great' into the Great Depression². It was also something which Ben Bernanke promised Milton Friedman on his 90th birthday that the Fed wouldn't do again³.

The Fed's 'quantitative easing' is no more likely to result in rapid inflation in the US nor a crash in the dollar's value, than did the similar strategy pursued by the Bank of Japan between 2001 and 2006 cause rampant inflation in Japan (it barely succeeded in ending deflation) or a steep fall in the yen (in fact the yen rose against the US dollar through this period).

More generally, it is almost impossible to envisage a significant acceleration in US inflation in the presence of so much spare capacity, both in the US and globally. Indeed, to the extent that the Obama Administration and Congress are willing and able to address seriously the fiscal position which now confronts the US (and that seems a more pressing challenge), the Fed may need to adopt a highly accommodative stance for longer.

¹ As examples, see the views attributed to Pimco founder Bill Gross ('Gross Says Diversify from Dollar as Deficits Surge', *Bloomberg*, 3 June 2009); *Gloom, Boom and Doom Report* author Marc Faber ('US Inflation to Approach Zimbabwe Level, Faber Says', *Forbes*, 2 June 2009), or (on any number of internet sites) to Jim Rogers (co-founder with George Soros of the Quantum Fund) and Euro Pacific Capital's Peter Schiff.

² Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton University Press, 1963), Chapter 7.

³ Ben Bernanke, 'On Milton Friedman's 90th Birthday' (8 November 2002) www.federalreserve.gov/boarddocs/speeches/2002/20021108/default.htm.

Australian Economic Outlook

Riki Polygenis

Overview

Despite receiving a significant shock in late 2008, the Australian economy has so far managed to circumvent the worst of the collapse in global demand and trade and has been the only advanced economy to avoid two consecutive quarters of negative growth in real GDP. Aggressive and pre-emptive monetary and fiscal policy has to date been effective in insulating many sectors, with household spending and housing demand responding positively. Exports have also been surprisingly resilient, largely driven by strong demand for bulk commodities from China. The business sector on the other hand is retrenching; corporate profits are falling sharply and debt and capital expenditure is being reduced.

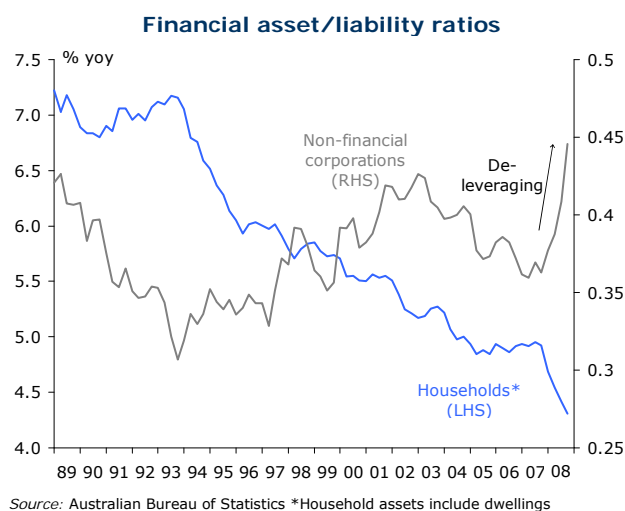
On current forecasts, GDP growth will be broadly flat in 2009, followed by anaemic growth of ½% in 2010 and a return to trend growth of 3¼% in 2011. With households spending and re-leveraging, but businesses consolidating, the severity of the downturn will ultimately be determined by the main link between the two – the labour market.

Business sector retrenches...

The Australian business sector has responded quickly to the disruptions to global growth and financial markets in late 2008 and early 2009. Production (as measured by GDP(P)) fell by 1.5% in real terms in the two quarters to March and the profits of private non-financial corporations contracted by 7.8% in nominal terms.

Corporate Australia entered the global recession from a stronger financial position than ahead of previous downturns, with profitability at a near record high as a share of GDP and gearing ratios low. But amidst tough demand conditions and heightened uncertainty, businesses are adjusting their behaviour to ensure financial resilience by curtailing discretionary expenditures, reducing debt levels and raising new equity. Business investment (excluding transfers) declined by 6.3% in real terms in the past two quarters, driven by falls in machinery and equipment investment, non-residential building and engineering construction. Business credit has also contracted, falling at a 5% annualised pace over the six months to May. This has resulted in a sharp increase in business financial assets as a proportion of liabilities – a de-leveraging (see chart to the right).

Business investment is expected to be a significant drag on growth for the next year, consistent with declines in surveyed investment intentions. Capital expenditure expectations from the NAB survey are at a much weaker level than during the early 1990s recession. And expectations using the broader ABS survey imply a 17% fall in investment in 2009-10 if the realisation ratio from 1991-92 is applied.



Certainly, government infrastructure investment will help to fill some of the gap, particularly if these projects get off the ground as quickly as the government has promised. However the expenditure levels proposed suggest it will not be large enough to offset declining business investment and overall gross fixed capital formation will fall.

... while households re-leverage

Like in the rest of the world, Australian household wealth fell sharply as equity markets plummeted to be down 8.6% over the year to Q1. But in contrast to corporate incomes, lower mortgage rates and direct payments from the Federal government have seen household disposable income rise by 6% over the year to March. This has allowed households to continue spending and borrowing (re-leveraging), whilst simultaneously increasing savings to help restore lost wealth. Real household consumption increased 0.3% in Q4 2008 and 0.6% in Q1 2009 and retail sales have so far increased by 1.3% in nominal terms in April and May. The key question for the economy going forward is whether this growth in spending can continue, particularly as the impact of the cash handouts starts to fade.

Evidence of household re-leveraging has been most evident in housing. Increased affordability from lower mortgage rates and greater federal and state government incentives for first home buyers has seen a sharp turnaround in housing finance approvals which have risen over 20% since the RBA commenced cutting interest rates in September. A record 38% of housing finance approvals (including refinancing) went to first home buyers in April, a development which is raising concerns about first home buyers overextending themselves.

Overall, median house prices have fallen by 4-5% over the year to Q1, however most measures suggest prices have strengthened from the month of March onwards. While areas of weakness will remain, particularly at the upper end of the market and in the mining states, shortages of housing due to record high population growth and weak building activity should keep a floor under house prices and act as a

buffer against substantial falls if unemployment proves higher than we are currently anticipating.

Labour market the key

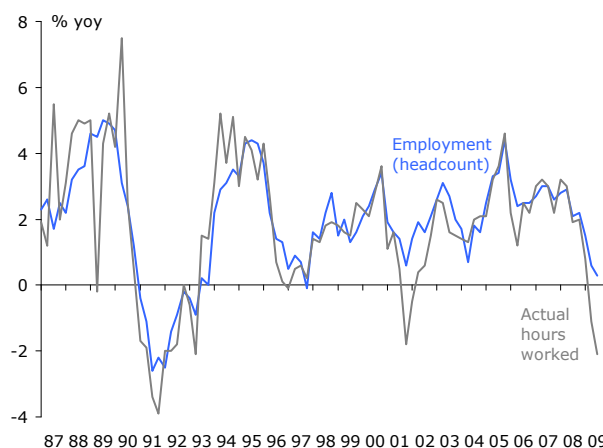
Labour market developments will ultimately determine the degree to which weakness in the business sector transmits back in household sector weakness. So far, developments have been encouraging. Employment has ground to a halt, growing at 0% in trend terms in May, but has not started to fall notably in absolute terms. This stands in contrast to the recessions in the early 1980s and early 1990s in which employment was down by over 1% at this stage in the cycle.

The relative resilience can partly be explained by the more pre-emptive nature of the policy response in this cycle which has been particularly beneficial for industries reliant on household spending. Employment in retail and hospitality increased by 15.3K and 10.1K over the six months to May. Together with employment gains in government-dominated sectors such as health (+49.3K), public administration (+28.2K) and arts and recreation (+15.7K), this helped to offset sharp employment falls in industries more exposed to weak global demand, commodity prices and lower business discretionary spending. Industries recording the largest employment falls in the same period include mining (-27.3K), manufacturing (-21.2K), rental and real estate services (-25.4K) and professional services (-16.3K).

A shift towards shorter working hours also helps to explain why employment has held up. Recent severe skill shortages are still fresh in the minds of employers and they are choosing to cut back on working hours rather than reducing labour levels altogether. Over the year to the May quarter, the number of hours worked economy-wide fell 2.1% whereas the number of employees (by headcount) rose 0.2% (see chart to the right). This has seen average working hours per person fall to 33.7, the lowest level since the data series commenced in 1984. This trend is also evident in the part/full-time employment split, with part-time employment rising by 72.6K in the six months to May whereas full-time employment fell by 83.1K. There is a limit to how far working hours can fall however, presenting a clear downside risk to outright employment levels.

Moreover, the fundamental drivers of labour demand including slower economic growth and the sharp fall in other forms of business spending foreshadow a much sharper labour market adjustment. Indeed all forward-looking employment indicators, including the ANZ job advertisements series and the employment component of the WBC/ACCI and the NAB Business Surveys all point to a fall in employment at least as pronounced as in previous recessions. We also remain particularly concerned about employment in the large employing retail and hospitality sectors (which together account for 18% of total employment) once cash handouts and tax cuts end.

Employers are cutting back on hours, not staff



Source: Australian Bureau of Statistics

On balance then, ANZ is forecasting employment to fall by 1½% over the year to the March quarter 2010. Nevertheless, we expect the fall in employment to be less severe than during the last two recessions in which the annual rate bottomed out at nearer to -3%. With labour force growth higher than in previous cycles (due to both strong population growth and high participation), the unemployment rate is expected to rise to 8% by mid 2010 from a low of 3.9% in February 2008 and the current rate of 5.7% (May 2009).

Net exports won't continue to save the day

While household spending has been a key support to growth in recent quarters, a strong contribution from net exports has been more influential. Net exports added a total of 3.9ppts to growth in Q4 2008 and Q1 2009. This can be partly attributed to a surprise rise in export volumes in Q1 (driven by strong agricultural exports and strong demand for raw materials from China). However the major contributor has been collapsing imports due to businesses running down inventories and the sharp depreciation of the A\$ in late 2008. Imports volumes fell a total of 14.6% in the past two quarters, adding a total of 3.5ppt to growth.

Net exports will not add to growth over the next year however. Most of our major trading partners excluding China remain mired in recession, and recent evidence suggests that Chinese stockpiling of bulk commodities is unlikely to continue in coming months as inventories reach physical limits. Amidst a backdrop of fragile global demand and the recent appreciation of the A\$, exports are thus likely to give back some recent gains in coming quarters and are unlikely to recover strongly until global growth returns to above-trend in 2011. Furthermore, imports will not continue their freefall. While domestic demand will remain weak as business investment contracts, the impact on imports will be offset in the near term by firms rebuilding stock levels at the now higher level of the A\$ after running them down heavily in the past two quarters.

New Zealand Outlook

Phillip Borkin

The New Zealand economy is rebalancing

New Zealand's growth model has been domestic-centric for the past two decades. This has been reflected in rapid debt accumulation, persistently large current account deficits, negative household saving rates and excess consumption as households benefited from the positive wealth effect of surging house prices. New Zealand has some of the largest (relative) external imbalances in the developed world, with a current account deficit and stock of net international liabilities at 8.5% and 98.3% of GDP respectively. Such imbalances have now been exposed given the structural shift in the pricing of risk around the globe. The New Zealand economy is now transitioning towards a more balanced model where greater importance is assigned to earnings, exports and savings.

This is a process that is well underway. Imports have collapsed (falling 8.6% in the March quarter and 6.5% in the December quarter) as they played catch-up to soft domestic demand over 2008. The current account deficit has fallen from a recent peak of 9% of GDP. Annual housing credit growth has eased to below 3%, a far cry from the double-digit rates of the decade prior. Credit card billings are now below levels of a year ago. There has been an upward shift in the pricing of risk around the globe. Credit criteria have been tightened. Retail interest rates have moved up, despite the RBNZ cutting the Official Cash Rate (OCR), owing to rapidly rising deposit rates. The incentives are shifting in favour of investors and savers, at the expense of borrowers. All are symptomatic of a wider de-leveraging dynamic across the economy, and growth is the sacrificial pawn in a de-leveraging environment.

However, it is a process that will take time and no doubt be intertwined with volatility. Unlike businesses, which can de-leverage or restore health to their balance sheets relatively quickly, a key differentiating aspect in this economic cycle is that the rapid debt accumulation over the previous decades has largely been a household phenomenon, and it is households that are facing the greatest need to de-leverage. When households de-leverage, they have only one lever to pull, namely reduced discretionary spending. Hence, household de-leveraging tends to take more time. On top of this, the weak global backdrop is hampering the ability of the tradable sector to pick up the growth baton that has been dropped by a de-leveraging domestic economy. Moreover, the NZ dollar remains stubbornly elevated (although we doubt for long). It is curtailing the ability of the export sector to assist in the rebalancing process.

This rebalancing theme weighs heavily on our economic assessment, impeding the economy's

ability to grow strongly over the forecast period and follow the normal pattern of strong upturns following recessionary periods (a so-called "V" shaped recovery). Nonetheless, we have still introduced a very pro-cyclical upswing from mid-2010 as pent-up demand, policy stimulus and the Rugby World Cup come to the fore. Strong net migration inflows are also influential. These dynamics need to be respected. But this forecast upturn will be short in duration (by historical standards) and needs to be read within the context of the deepest economic adjustment since the 1970's. We therefore expect the economy's transition and rebalancing process (including resource allocation) to extend beyond our forecast horizon of 3 to 4 years.

A bathtub shaped cycle – with waves

The economy is still in recession, or moving down one side of the bathtub. Forward indicators continue to point to an economy that is contracting, though the pace of contraction is moderating. The unemployment rate is rising rapidly and is set to continue heading higher into next year. Despite tax cuts and lower mortgage rates, consumer spending remains subdued as households increase their precautionary savings. Private consumption has now fallen for an unprecedented five consecutive quarters. Building consents are at levels not seen since the 1960s, and residential investment is down over 30% from its 2007 peaks. Business profitability has been under pressure and firms have been responding accordingly. Business investment has been cut back, falling 15% from a year ago – the steepest fall since the early 1990s.

But a base is now beginning to form. House sales are up 50% from their lows, as buyers respond to lower interest rates. We expect this to flow through to a sizeable recovery in building consents in the second half of 2009, and into actual residential construction activity late this year and early next year. Natural population growth is also providing underlying support to housing demand. Firms' own activity expectations from the National Bank *Business Outlook* survey – a leading indicator – is now back in positive territory. Consumer confidence is similarly back above the key 100 level, indicating that optimists once again outnumber pessimists. Net migration is running strong, with the last three months seeing an annualised gain of 26,400 people, representing a key source of upside support to the domestic economy. All are welcome.

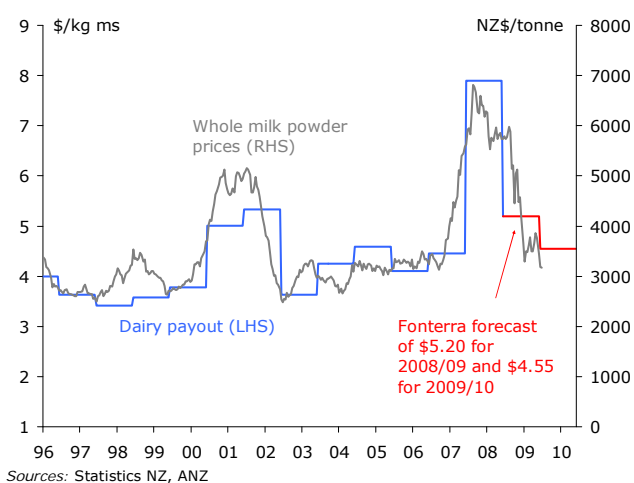
We expect forward momentum to be regained from late 2009. This partly reflects the bungy-cord dynamic at work, following what is likely to be seven successive quarters of contraction. We expect to see some FIFO (first in, first out) characteristics at work, with improved demand in the housing market driving a recovery in residential construction, and retail spending starting to recover as some confidence returns to consumers (but within the context of still low levels of activity). A rebuilding of

inventories following a large rundown is also expected to drive some of the early recovery.

We have pencilled in relatively sedate growth over H2 2009 to mid-2010, but we expect to see higher than normal inter-quarter volatility due to inventory adjustments and sectoral swings.

Stabilisation will mask heavy regional and sectoral disparities. 2008 was really an Auckland or upper North Island recession, as weak housing activity, retailing and a squeeze on discretionary income from rising essential costs (i.e. petrol and food prices) bit. There is still some intensity in these pockets but increased housing activity in Auckland is now outstripping other parts of the country. Petrol prices have fallen from over \$2.20 per litre to \$1.70, and food price inflation has eased. Conversely, collapsing manufacturing activity, weakening tourism flows and the big show-stopper – a lower forecast payout to the dairy sector – are set to impact heavily on tradable or export aligned regions. Rural land prices in particular are under significant pressure, and the flow-on effects from a tighter farming chequebook should not be underestimated. While the economy will be travelling along the bottom of the bathtub from the second half of 2009, but it will remain a bathtub with waves.

Dairy payout and whole milk powder prices

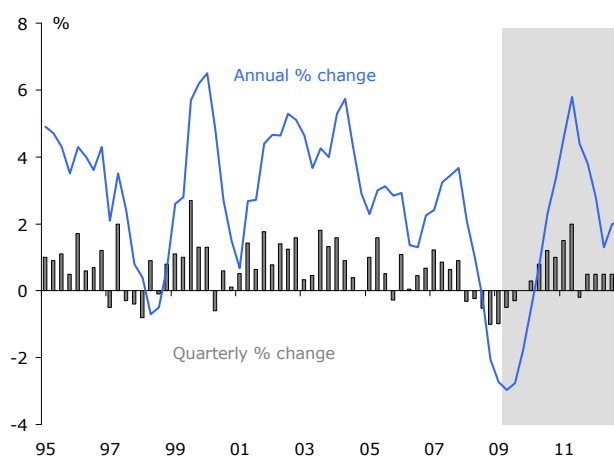


A recovery (of sorts)

While an overarching de-leveraging dynamic weighs heavily within our economic assessment – a transition that will take time – we nonetheless expect 2011 to be a boom year. As it becomes clear that the economy is on the mend, households and businesses will look to catch-up on spending that had been put off during the recession. The cyclical rebound in residential investment in particular is expected to be strong, with annual growth rising to over 20% by mid 2011. This looks strong on the face of it, but would still only see residential investment returning to the March 2008 level by the end of 2012. The Rugby World Cup in 2011 will easily be the largest sporting event New Zealand has hosted to date. Infrastructure-related

activity in the lead-up will buoy activity. The influx of Rugby visitors and their spending will also provide a good boost to the economy.

A large cycle (New Zealand GDP)



Sources: Statistics NZ, ANZ

However, unlike previous cycles, we have heavily tempered the length and magnitude of the cyclical recovery. Some post Rugby World Cup payback is likely in 2012 and we remain wary of structural aspects to this economic cycle.

Key financial market views

The RBNZ's job looks to be done with 575 basis points of stimulus already delivered in anticipation of tough times, the economy showing signs of stabilisation and credit markets improving offshore. Admittedly, financial conditions are tightening in other areas with fixed mortgage rates moving up and the NZ\$ remaining stubbornly elevated, but the reasoning behind both has little to do with monetary policy and the use of the OCR as a policy instrument, despite the obvious frustration of the RBNZ.

We expect the OCR to remain on hold until late 2010 before policy normalisation occurs. This is based on a cautious view about stabilisation in recent data around the globe, acknowledgement that this is a consumer de-leveraging story implying a drawn out adjustment process, the likelihood of increased use of non-traditional monetary policy mechanisms (such as regulation) and an expectation that inflation may be a concern in the future, but not yet.

We continue to envisage a weaker NZ\$ as forming a critical part of the rebalancing process for the economy. With the NZ\$/US\$ somewhat constrained by weak US\$ sentiment, a larger part of the adjustment may be borne by the AU\$/NZ\$. Not only are de-leveraging pressures more evident in NZ, but divergent economic performance, terms of trade levels and even interest rate expectations all favour the AU\$ over the NZ\$. We expect the AU\$/NZ\$ to rise to 1.37 by the end of this year.

Emerging Asia: China leads, but can the rest follow?

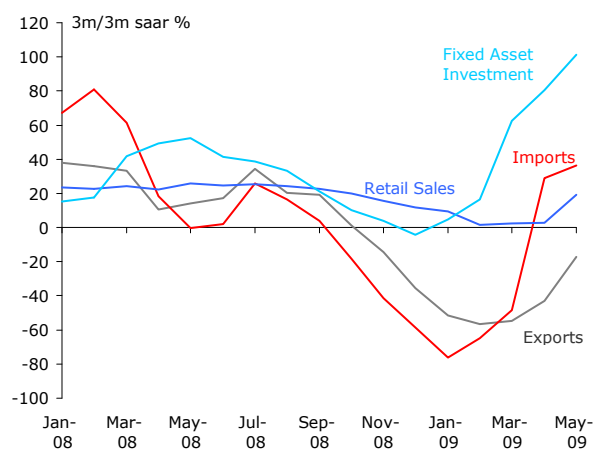
Paul Gruenwald and Tamara Henderson

With the worst of the crisis behind us, emerging Asia now begins the road to recovery. This will be neither swift nor uniform across the region. Restoring healthy growth will depend on: (i) demand momentum; (ii) export-dependency; and (iii) the likely effectiveness of fiscal policy. We see a risk of a slower than expected recovery reflecting a weak recovery of discretionary consumption globally.

As with many things, China appears to be a special case (and a large one at that, making up half the region's GDP). The authorities' stimulus plan is clearly bearing fruit as evidenced by a turnaround in a broad range of indicators spanning the financial sector, "soft" survey data, "hard" macroeconomic indicators, and sectoral data.

The latest data show that growth reached 2% QoQ in Q2 or 8% YoY, the pace desired by the authorities. This is a far cry from the final quarter of last year, when growth was estimated to have been zero. Measured on a momentum basis, the pick-up in activity is clear (see chart below).

Chinese activity indicators



Sources: ANZ Economics, CEIC

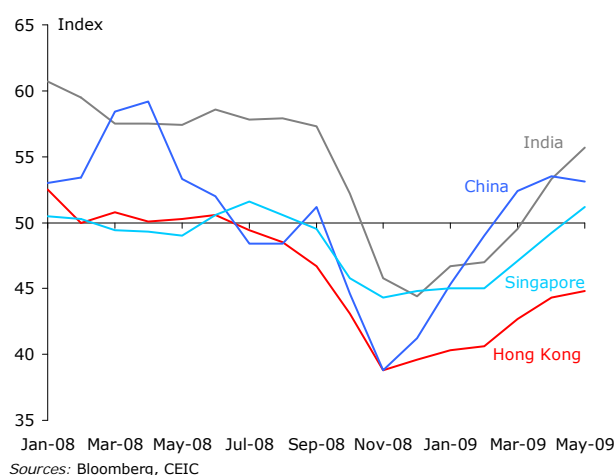
The "command" structure of the Chinese economy is well-suited to implementing a short-term stimulus plan. In essence, state-owned banks can be ordered to lend and state-owned enterprises can be ordered to produce. The downside is that credit quality and general resource allocation may suffer, although this appears to be a trade-off the authorities are willing to make to ensure economic and social stability.

The rest of Asia does not, to varying degrees, have a Chinese-style command economy. (Vietnam is probably the closest in terms of structure.) So growth will need to come from a combination of existing momentum, fiscal stimulus and foreign demand. It is important to note that the downturn in Asia was driven by sharply lower exports and

investment as well as declining consumption growth. So any recovery will need to be broad-based.

We currently see conflicting signs between the soft and hard data. The former (e.g., PMIs), based on surveys, suggest that the pace of activity is improving. The latter, based on the actual flow of goods and services, point to activity contracting at a slower pace, but show little sign of actual improvement. This conflict will in time have to be resolved, and our suspicion is that the relative optimism in the soft data may be in for a revision.

Emerging Asia PMIs



Sources: Bloomberg, CEIC

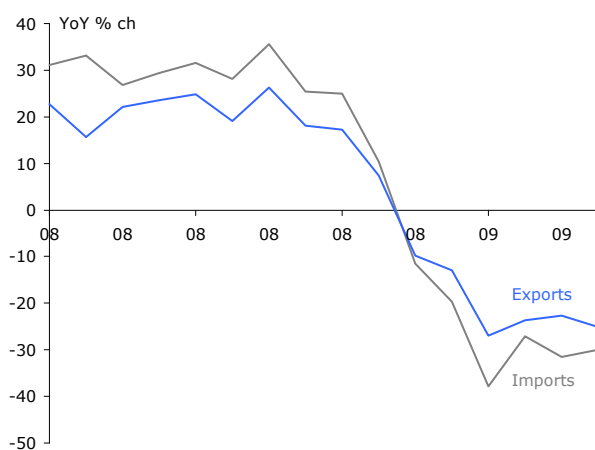
The effects of fiscal policy (ex-China) are showing up across parts of the region. (We think monetary policy loosening has run its course almost everywhere.) Korea and Indonesia are leading the pack in terms of the contribution to growth from public expenditure. Both economies posted solid Q1 outturns and appear to have good momentum. In other cases, such as Hong Kong and Malaysia, fiscal spending remains relatively modest. More generally, fiscal spending can provide some support to growth but is unlikely to generate a sizeable recovery in activity, particularly in the small and more open economies, where leakages into imports will be large.

Asia will not recover until foreign demand for the products it exports revives. As we saw last year, the region's limited ability to decouple from its export customers led to the sharp slowdown. Specifically, a recovery in Asia will require a resumption of discretionary spending by consumers in the US and Europe. This applies to China as well, where the ongoing recovery is imbalanced owing to the large, domestic oriented stimulus. Once this resumption in foreign demand and exports takes place we are likely to see a virtuous cycle including a recovery of investment in the export sectors and a rise in domestic consumption growth owing to a rise in employment and incomes as well as confidence effects.

Our projections are for a recovery to begin later this year and build gradually. Asia is unlikely to return to trend growth until 2011 in line with a normalisation

of durable consumer goods spending in the advanced economies. In term of numbers, we see the region's growth rising from 3¾% this year to 6½% in 2010 and 7% in 2011. Excluding China and India, Asia's growth will rise from -1¾% this year to 3¾% in 2010 and 4½% in 2011. The risks to this "U-shaped" profile are on the downside, and a slower recovery will result in a more "dragon boat-shaped trajectory.

Emerging Asia: Trade Developments



Sources: CEIC

Currencies and rates

Although the global economy is still sharply contracting, it is the nature of markets to focus on "second derivative" developments. As such, the emergence of "green shoots" from aggressive government stimulus measures and the perception that the "worst is behind us" have boosted investor tolerance for risk - lifting the currencies in emerging Asia (AXJ) in the process. This broad-based shift in sentiment makes us more bullish about AXJ currencies against the US dollar, although we acknowledge that setbacks are likely along the long road back to trend growth rates.

One such setback would seem to be quickly approaching, given the tendency for a pull-back in risk appetite during the summer months of the Northern Hemisphere - particularly the peak holiday period from mid-July to mid-August. Positioning also appears supportive of a pull-back in risk trades as there has been a re-accumulation of short US\$ positions, albeit not as extreme as at the end of last year, but sizeable nevertheless.

Using behaviour over the past five summers as a guide, the trimming of risk has been associated with a resurgence in US\$ strength and corresponding weakness in AXJ currencies. Within AXJ, the Taiwan dollar (TWD), Korean won (KRW), Indian rupee (INR) and Indonesian rupiah (IDR) have experienced the greatest amount of volatility on average during the past five summers. As such, for those investors that are unable to ride out summer volatility, we would suggest hedging against weakness in TWD, KRW, INR and IDR. For those investors that are able to ride out periodic pull-

backs in risk appetite, we would suggest using such retrenchments in risk trades as opportunities to lock in better levels to ride US\$-AXJ lower into 2010.

FX Market Performance – Summers (2004 – 2008)

	Total	Sep/ Aug	Aug/ Jul	Jul/ Jun
Volatility (VIX)	5.7%	-4.9%	15.6%	0.9%
US\$-DXY	0.4%	0.2%	1.4%	-1.2%
US\$-Asia (Avg)	-1.1%	0.6%	1.2%	-0.6%
US\$-INR	1.6%	0.8%	0.7%	0.1%
US\$-IDR	1.4%	0.9%	2.0%	-1.4%
US\$-MYR	1.1%	0.5%	1.1%	-0.5%
US\$-PHP	0.2%	0.6%	0.7%	-1.0%
US\$-SGD	0.3%	0.1%	1.4%	-1.1%
US\$-KRW	1.7%	0.6%	1.6%	-0.5%
US\$-TWD	2.5%	1.0%	1.2%	0.2%
US\$-THB	0.3%	0.1%	0.9%	-0.8%

Sources: Bloomberg, ANZ. Performance calculated on a mid-month basis.

In AXJ rates markets, our strategic bias remains for steeper curves generally. For the remainder of the year, the front-end of the curve should remain firmly tethered (if not headed lower as a result of further monetary stimulus in the cases of India, Indonesia and the Philippines), meaning that curve dynamics will be driven primarily by the longer tenors. Movements at the longer end of the AXJ curves will be hostage to perceptions about the strength of the recovery (encapsulating market assessments of inflation risk and supply risk as well).

Unfortunately, curve steepening trades have the disadvantage of substantial negative carry for funded investors. As such, we would prefer instead to take advantage of curve flattening opportunities offered by episodic disappointment about the pace of improvement in the global economy, seasonal (or otherwise) pullbacks in risk appetite, or basic consolidation of over-extended market exuberance.

That said, we would avoid tactical flatteners: (i) where the curve is relatively flat already (i.e. where the risk-reward trade-off is less advantageous, such as in Vietnam and Taiwan), (ii) where the market is more illiquid (i.e. Vietnam), (iii) where the overall steepening bias remains quite strong (i.e. Vietnam), and (iv) where yields and risk aversion tend to be positively correlated (i.e. Indonesia). Based on this set of criteria, we would prefer to implement tactical flatteners - as opportunities arise - along the local currency curves in Hong Kong, Korea and Singapore.

Foreign Exchange Outlook

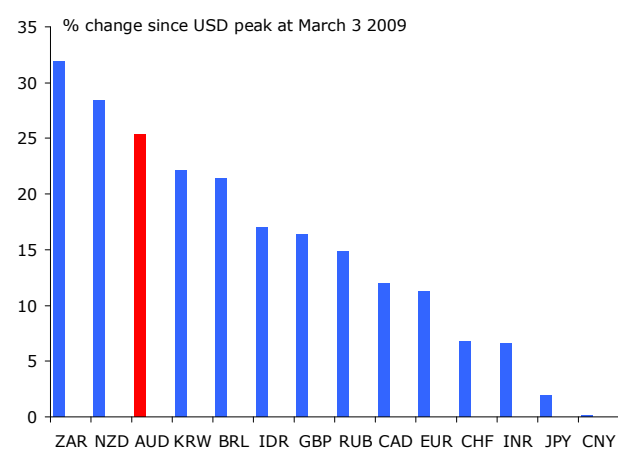
Katie Dean

Pricing out the worst case

The extraordinary monetary and fiscal stimulus that central banks and governments have delivered to the world economy appears to be working. Markets (and crucially banking systems) are repairing and global economic activity is stabilising. Financial markets have responded by pricing out the worst-case scenario, with equity markets and commodity prices rallying strongly. The US S&P is now up around 37% from its 2009 lows, while copper prices are up 66% and oil prices are up 110%.

For currency markets, the last quarter has seen a pronounced switch from defensive to pro-cyclical 'risky' assets. Safe-haven flows have moved out of the US\$, which has depreciated in broad currency terms by around 10% since its early-March peak. Commodity currencies and relatively higher-yielders, such as the A\$, but also the NZ\$ and the South African rand, have been the major beneficiaries. The A\$/US\$ has appreciated by 28% since early March, while the A\$TWI has risen 22%, the sharpest 16-week rise in its post-float history.

Pro-cyclical currencies like A\$ have risen strongly



Sources: Bloomberg and ANZ

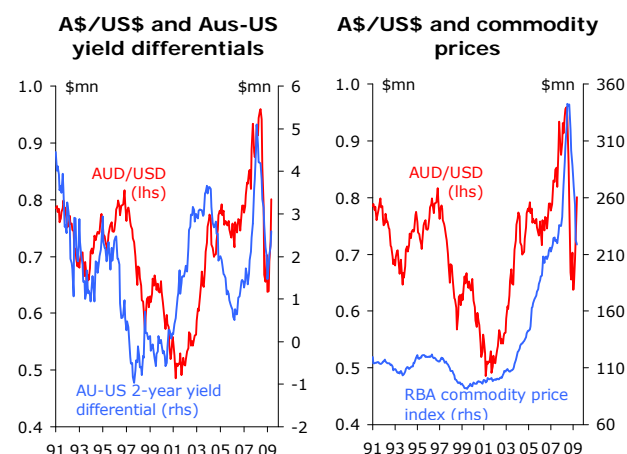
Reassessing fair value for the A\$

The speed and extent of the recent adjustment in the A\$ has taken many by surprise. Why, in the midst of the worst global recession in 70 years, is the A\$/US\$, one of the traditional harbingers of the global economic cycle, trading around 0.80, 10% above its post-float (26-year) average of 0.72?

Partly, this is a relative yield story. Commensurate with Australia's relatively stronger economic performance, Australian official interest rates are also relatively high, and thus attractive to those seeking positive yield. The first panel in the chart below shows that while the level of interest rates in Australia is close to historical lows, our relative yield differential with the US has widened sharply in recent months and, at around 2.9% for two-year yields, is around 0.3ppt (or around 13%) above its

post-float average. Likewise, despite the depth of the global recession, the level of commodity prices remains relatively high. Despite falling 57% from last year's peak, the RBA US\$ export commodity price index is still 68% higher than its post-float average (see chart below). Australia's terms of trade, even after a predicted fall of 20% in 2009, will still remain around 49% above its post-float average.

The drivers of A\$/US\$ are relatively high



Sources: Bloomberg, RBA, ANZ

Recent history also suggests an A\$ at current levels, while historically high, may well indeed represent only a minor deviation from current fair value. At around 0.80, the A\$/US\$ is trading right in the middle of its 2007-2009 range, spanning its peak of 0.9850 (when the local and global economy was booming in mid-2007) and trough of 0.6009 (in the wake of Lehman Brother's collapse in September 2008). If we hold the view that the A\$ will, as usual, lead the global economic cycle, and that global growth will return to trend by mid to late-2010, then an A\$/US\$ now at its recent mid-point (ie. trend) doesn't seem too out of place.

A long-term structural rise in A\$ equilibrium

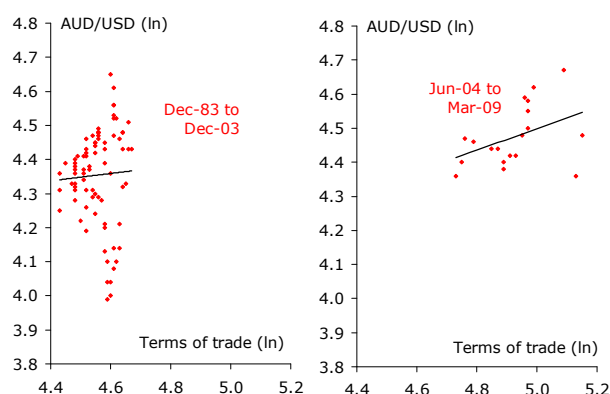
The behaviour of the A\$/US\$ throughout the financial crisis, in particular its failure to reach new lows and its subsequent rebound to above-average levels, strongly supports the view that, just as the US\$ is experiencing a long-term structural decline, the A\$ is experiencing a long-term structural rise. Our analysis suggests the post-1994 rise in Australia's commodity export prices has added up to 14pts to Australia's real effective average exchange rate and up to 9c to the nominal A\$/US\$ average real exchange rate. This implies that, so long as Australia's terms of trade remains higher than its pre-commodity boom (ie. pre-2004) level, as per our current forecasts for 2009 and 2010, the A\$/US\$ should trade around a higher equilibrium.

The argument can easily be made that any structural rise in the A\$ may be exaggerated over the coming decade. As we outlined last quarter, we see little medium-term threat to the US\$ as the world's reserve currency. The latest IMF data confirms that

US\$ reserve holdings are actually rising, from 64% of allocated reserves in 2007 to 65% in Q1 2009, although are still well below the peak of 71% held in 2001. But, once financial markets normalise, we do still expect the relative importance of US\$ reserve holdings, and with it the value of the US\$, to recommence its long-term, gradual, decline. Over the coming decade we expect to see more central banks diversifying out of currencies, potentially into commodities, and/or diversifying into non-G3 currencies. The A\$ is a beneficiary of both possibilities. Increased reserve holdings of commodities adds further upwards pressure to these prices, in turn giving the A\$ support as a commodity-currency. Moreover, in the absence of open and deep capital markets for most emerging currencies (particularly China), the A\$ offers a liquid and sound (ie. free-floating) proxy for exposure to these markets, and hence an attractive non-US\$ reserve alternative. This suggests the equilibrium for the A\$/US\$ could continue to drift higher for now.

A structural rise in the A\$/US\$

A\$/US\$ and the terms of trade



Sources: ABS, Bloomberg, ANZ

Identifying the short-term risks

In the short-term there are a plethora of risks facing the A\$ and broader currency markets. Two major risks to the outlook for the rest of 2009 include another sudden rise in risk aversion or an earlier than expected tightening of local monetary policy.

The likelihood of renewed risk aversion, albeit to levels well below recent peaks, underpins our current foreign exchange forecasts. The extent of the recent rally in financial markets, particularly in pro-cyclical currencies and commodity prices, suggests some risk that these markets have front-loaded pricing for the economic recovery.

The risk now is that while some markets have toyed with pricing for a V-shaped rebound, the reality is likely to be something more stuttering, with good news interspersed with bad, as global and especially G-3 activity faces an extended period of repair (see *Overview* on p2). In other words, while the second quarter of 2009 was about pricing out a worst-case scenario, we expect a stabilisation (rather than further strong momentum) in the economic data will

mean the third quarter is dominated by uncertainty over the *shape* of the global recovery.

This leaves markets, particularly pro-risk plays such as equities, commodities and the A\$, vulnerable to consolidation and reversal over the next 3 to 6 months. This reversal in the A\$ would be compounded should the RBA, as we are currently forecasting, be required to cut local interest rates again before year end. This would most likely see A\$/US\$ fall to a mid to low-70c range. A sustained fall below US\$0.70c would only appear likely in the event of a renewed shock to the global economic or financial system that prompted another round of 'depression' rather than 'recession' market pricing.

Under this scenario, there is scope for renewed (short-term) appreciation in the US\$, as higher volatility sparks safe-haven flows. The currently strong € would be a causality, and may indeed underperform A\$ should markets focus on Europe's relatively poor economic prospects or stresses in the European banking sector. Whilst a traditionally defensive currency, the ¥ should make up ground against most crosses, including the A\$, but may still struggle to post outright gains against a rising US\$ as Japan's all-important export sector remains soft. Asian currencies that would be most likely to suffer under a period of renewed risk aversion include the Korean won, Indonesian rupiah, Indian rupee and Taiwan dollar (see *Emerging Asia* p9-10).

On the upside, the A\$/US\$ could track higher towards 0.90 by year end should the Australian economy gain further momentum. Exports and business investment, which are both sensitive to the global cycle, are expected to be drags on growth in coming quarters. As such, further Australian recovery would be unlikely without further global momentum. Under this scenario, we could therefore see commodity prices rise further and central banks around the world tighten policy earlier than forecast. There is a risk that Australia, having had one of the strongest positive responses to interest rate cuts, could also be one of the first to raise official rates. Under this scenario, we would therefore expect the A\$ to not only rise against the US\$, but also to outperform on most major crosses.

Apart from the A\$, other pro-cyclical, commodity currencies, such as the Brazilian real and Canadian dollar, would be winners under this scenario. We would also expect to see emerging market currencies, across Asia and South America, lead the way. Local banking sector stresses, and regulatory and geo-political risk may however limit rises in emerging European currencies. The € and the £ would likely rise against a weaker US\$ while the ¥ may still struggle to find favour. The US\$ would be one of the great losers as, despite sustainable US economic recovery and thus higher US interest rates, safe-haven flows flee and the long-term decline in the US\$ accelerates.

Global Capital Markets

Warren Hogan and Khoon Goh

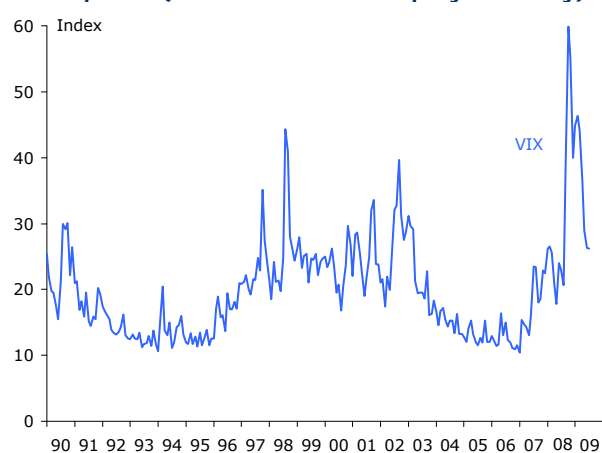
Risk of depression is priced out of financial markets

Global markets continue to repair amidst further evidence of global economic stabilisation in Q2 2009. Equity markets are now back to levels last seen in October 2008. The US S&P 500, at around 900, has risen approximately 30% from the lows reached in March of this year. Other developed economy markets have also rallied strongly, while emerging markets have performed even better. The MSCI Asia APEX 50 index has increased by almost 50% since the beginning of March.

Credit spreads have tightened from the historically wide levels seen late last year. High-grade credit performed strongly, initially as the risks of a systemic financial seizure receded. The initial rally in credit markets broadened as a more generalised decline in perceived default risk and improving confidence and liquidity allowed credit spreads to compress. Recent price moves in core debt and equity markets suggest investors have begun re-deploying cash as assets prices have fallen to historically attractive levels.

There has been a strong correlation across most of the major markets in recent months, indicative of increased speculative capital flows in global markets, again a sign of improving liquidity and confidence in the financial system. As equity markets and credit spreads have rallied, so too commodity prices have generally increased, money market pressures eased and broad measures of financial market volatility declined.

Market volatility declines as liquidity and confidence improve (VIX – index of US equity volatility)



Source: Bloomberg

As it stands, most markets are now back to levels seen in the immediate aftermath of the failure of Lehman brothers and the nationalisation of AIG in October 2008. This pricing dynamic, as noted by our Chief Economist in the introduction, suggests that as the risk of a deep and prolonged global downturn has declined, markets have moved back to pricing for a more orthodox global recession.

Will government deficits drive a new financial crisis?

The most tangible risk to the global economic outlook and the new found stability in global markets remains the funding of large public sector deficits. The government sector globally is now a large net borrower in global capital markets. This puts pressure on private households and corporations to become net savers. Thus far the process has been orderly. Yields on long-term government debt in the major markets have increased by around 150bps since the beginning of the year. At present the US 10-year government bond yield, at around 3.50% is about the right level given a near-zero overnight interest rate, zero growth, 2% inflation, and an expectation that the economy will return to an on-going positive growth and inflation trajectory over the medium-term.

It appears that the extra demand for funds from the public sector has simply taken up the slack from a decline in the demand for debt by the private sector in many economies. Deficits will get much worse before they get better. Any recovery in private demand for credit could see increased competition for a limited savings pool. Any hint that governments are 'crowding-out' private borrowers could undermine sentiment in financial markets and reinforce the negative consequences of rising interest rates on equity markets and private investment spending.

As risk appetite has improved, markets have largely been focused on the positive consequences of policy actions on economic activity and incomes. There is little doubt that increased fiscal stimulus, liquidity injections into financial systems and the provision of capital to banking institutions has played a strongly positive role in the past nine months. But there may well be negative consequences.

In the longer run, the moral hazard of bailouts will make containing excessive monetary growth a priority in the next economic expansion. In the short run, central banks will have a huge task working out at what time and in what sequence to extract extraordinary support and economic stimulus from the financial system. There is a long way to go before we can be confident that green shoots are taking hold. In the meantime, markets will remain volatile and vulnerable to adverse developments.

Australian interest rates head higher

A better than expected performance from the local economy and rising global term interest rates have seen Australian interest rates rise substantially in recent months. The 3-year swap rate has increased from around 3.40% in January to almost 5% currently. Long-term rates have risen just as much, from a low of 4.30% to now be up around 6%. The rise in government bond yields has been as severe. Markets have taken all expectations of further rate cuts out of the forward curve and have begun to price in substantial interest rate increases over the

medium term. The 1-year swap rate 2 years forward has increased from just over 4% to be at 6.25%. This expectation for 1-year rates is significantly higher than the current cash rate of 3% and the current 1-year rate of 3.5%.

Australian interest rates have risen by more than other markets. The yield spread between Australia and the US Treasury market highlights the point. The 10-year yield spread has increased to 200bp from a recent low of 120bp in January. The 5-year yield differential is out to 300bp. What is difficult to determine is whether the higher rates in Australia are the result of a stronger economy (and thus a pure expectation for higher short rates) or if the \$A market finding it difficult to absorb rising government bond supply.

The increase in government bond supply in Australia has been significant over the past six months and is expected to accelerate over the year ahead. Not only is the federal government increasing issuance, so too are state governments, with the largest issuers, NSW and Queensland confirming the take-up of the Commonwealth government guarantee. Total \$A government bonds on issue (State and Commonwealth) are expected to increase from around \$135bn in June 2008 to at least \$260bn by June 2010.

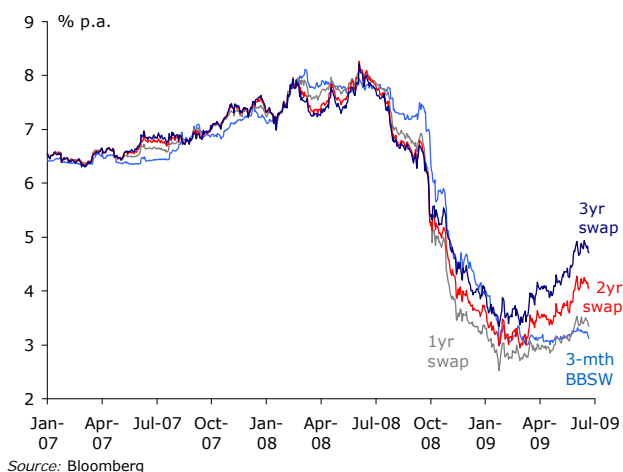
Our estimates have the total State sector coming to the capital market for almost \$20bn of new money in 2009-10 and the Commonwealth for a further \$60bn of new money. This is the largest public net borrowing requirement on record. Many indicators are telling us that the federal government is struggling to find end buyers for the bonds. Not only are our yield spreads to international markets widening, but physical government bonds are trading in the market at a discount to derivatives (also known as cheap to the futures basket). This suggests that market makers are holding the bonds rather than selling them down to end investors. It is likely that some of the increase in Australian bond yields reflects an emerging supply premium although most of the recent rise in rates is due to expectations of tighter monetary policy ahead.

The outlook for monetary policy hinges on the performance of the labour market. As noted in our overview of the Australian economy, employment has held up much better than expected. If this continues then the recent trend for rising consumer spending, higher mortgage demand and rising house prices will, in the presence of ongoing domestic inflation pressures, necessitate a reversal of some of the RBA's monetary stimulus. The current cash rate is set on an expectation that the unemployment rate will rise to around 7%-8%. If this doesn't look like happening then the cash rate will need to change.

This is the scenario that markets are now pricing for but which most economists are not expecting. If the labour market weakens then markets will be quick to remove rate hikes from the forward curve.

Whether or not the labour market will weaken enough to induce further rate cuts is difficult to determine, but we remain of the view that once falling employment comes through the effects on spending and confidence could be profound.

Australian market interest rates rise in anticipation of a recovery



NZ Rates Outlook: Backing the policymaker

We have no reason to doubt the RBNZ's commitment to keeping the official cash rate (OCR) at current or lower levels until the latter part of 2010. Inflation looks to be well tamed, and could even contain some downside risk should the currency remain stubbornly elevated. Outside of the housing market, we do not really see a rebound in other sectors. And the flow-on impact of a low dairy payout forecast for the 2009/10 season is yet to be felt.

Despite this, the market is not buying into the "on hold until late 2010" view. To some extent, this is normal market psychology. With the easing cycle seemingly over, the focus of attention has quickly turned to the timing of the tightening cycle. The massive disconnect between market pricing and the RBNZ's stated policy view creates opportunities. We expect the magnitude of this gap to narrow over time, with the market converging towards the RBNZ's view. While this implies value in going long outright, particularly in the March and June bank bill futures, we are wary of positioning and mortgage-related paying flows that could keep yields high in the near term. In the next few months, we expect rates to largely range trade.

Demand for New Zealand Government Bonds (NSGBs) has been generally good, which bodes well given the large increase in issuance over coming years. Standard & Poor's re-affirmation of New Zealand's AA+ sovereign credit rating, with an upgrade on the outlook to stable following the 2009 Budget, is also positive for bonds. However, the "downgrade premium" that had been priced into NZGBs, resulting in a wide NZ-US 10-year bond spread, continues to persist. This could partly reflect a lack of liquidity on the part of NZGBs. We expect this spread to eventually narrow.

Commodities Outlook

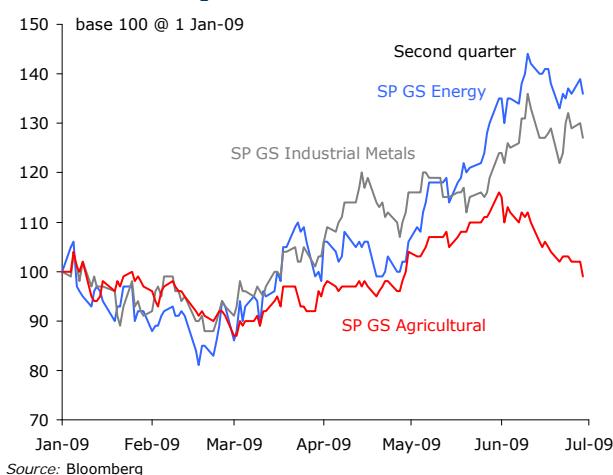
Mark Pervan and Doug Whitehead

From restocking to destocking

Commodity markets surprised on the upside in the second quarter of 2009, with participants underestimating the level of restocking occurring in China, and the positive influence of a weakening US\$. The speed of delivering government stimulus packages, particularly in China, also looked ahead of schedule, although the jury is still out on how effective these programs have been. Funds were prepared to take a very pre-emptive stand, looking at a horizon of improving economic demand and pricing-in the upside. The challenge for the coming quarter will be whether current high inventory levels will trigger a destocking phase in commodity markets, potentially coinciding with a rise in the US\$.

The strength of commodity markets has been impressive lately considering the current global recessionary backdrop. The benchmark S&P GS Commodity Index rose 25.6% in the second quarter – the third strongest quarterly gain in 30 years. The strongest gains were made in base metals, oil and oilseed markets. But not everything went up; gold and grain markets were flat to weaker, with falling risk aversion and rising supply conditions holding investors at bay.

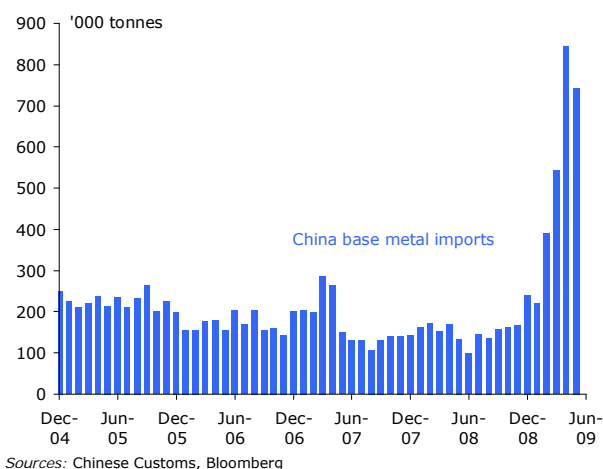
Major S&P GSCI Indices



Some of the factors which prompted the price gains in the second quarter may not be repeated in the next. China's huge 4 trillion yuan (US\$570 billion) government stimulus package pledged in response to the global financial crisis has been heavily infrastructure-based, artificially propping up Chinese commodity demand. The huge drop in prices in the second half of 2008 also prompted a jump in Chinese Government strategic buying – propping up prices to protect high-cost domestic suppliers. This had a positive impact on the commodity market, but the big positive kicker came from the wide arbitrage window which developed between higher-priced Chinese commodities and lower-priced offshore

commodities, fuelling a huge jump in Chinese imports.

Chinese Base Metal Imports



The risk for the coming quarter is that Chinese commodity imports will revert back to normal levels, at around 60-70% below the current level. Commodity price differentials have now narrowed to a point where there is little incentive for Chinese traders to import more material. In fact, there is a risk that the recent flood of Chinese imports has not been consumed and that if domestic prices fall below offshore prices, the material could be re-exported. This would dovetail with a seasonal slowdown in demand when northern hemisphere consumers destock inventories through the slow summer vacation period. Chinese strategic buying, which helped create the arbitrage window, has also diminished and is unlikely to return until prices retreat.

The current quarter should usher in choppy to lower commodity prices, with China absorbing the strong influx of supply of the past quarter. A consolidation or pull-back in fully-priced financial markets may also create support for the US\$ as a safe-haven play – creating an additional drag on commodity prices. The energy and industrial metal markets look to have the greater downside risk, with agricultural markets already testing the previous quarter lows. Precious metals, particularly gold, should hold up better as safe-haven buying returns, but a firmer US\$ will hold back better gains. The risk on the upside, as we saw in the second quarter, is that funds are prepared to see through the current weak fundamentals and focus (or price-in) the upside of improving economic demand in 2010. We think this will be a bigger positive factor in the fourth quarter.

Base metals look overbought

Base metal prices have benefited from Chinese strategic buying and the wide arbitrage window between Shanghai and LME metal prices over the past quarter. This is diminishing and so to is the market upside in the near term. A seasonal slowdown in demand will also cool sentiment. Aluminium and lead look most at risk, with higher

prices over the past quarter accompanied by higher supply. The anomaly looks to be partly based on fundamentals such as improving automobile sales (propped up by temporary government assistance in Europe) - and partly based on structural factors, with a high proportion of the supply gains (particularly in aluminium) supposedly locked away in financing and warehousing deals (which could be unwound at any time). Copper should be the best of the bunch, with falling treatment charges flagging ongoing tight LME supply conditions.

Oil to lead the economic recovery

Oil should track lower in line with all base metals, but the downside period should be shorter. A supply disruption premium should be built in for the US hurricane season (June to November) which will lead into the end-of-year pick-up in winter heating oil demand. Oil also appears to be the preferred commodity play for the recovery in global economic activity. This may work both ways. A fair bit of future demand improvement has already been priced-in. If conditions don't improve soon, the market may need to pull-back the recovery premium. On the flipside, as we move closer to a sustained recovery, further (long) investment demand will move into the market.

Gold will re-emerge as a safe-haven play

Gold is holding up well despite a period of easing risk aversion over the past quarter. This may now play in its favour, with a potential rise in risk aversion possible as we enter an uncertain third quarter outlook. The test will be whether gold can track higher with a rising US\$, which will accompany as a safe-haven play. We saw a positive relationship in the first quarter (higher gold and a higher US\$), but it broke down in the second quarter. A falling VIX index (a measure of option volatility on the S&P500) suggests heightened risk aversion is still to appear. If this measure continues to ease, then gold's upside will be limited.

Bulks need to digest

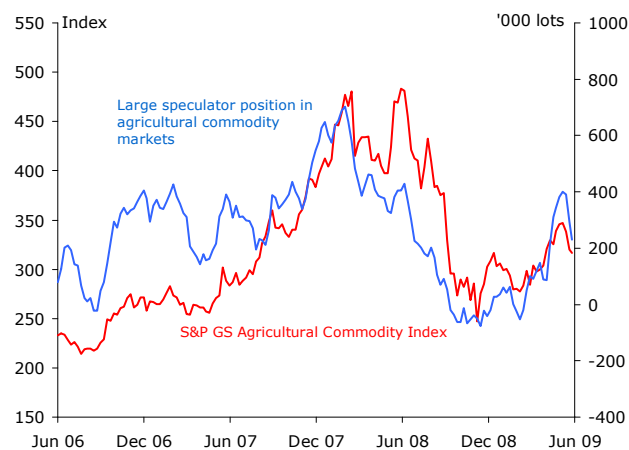
Bulk markets look vulnerable to a pull-back from the recent surge in Chinese imports. Encouragingly the downside risk should be limited, with price gains over the past quarter nowhere matching the gains in China's import demand. Focus should switch from a congested freight market to very high port and consumer stockpiles which should dampen the short term mood as destocking kicks in. Ironically, a forecast cooling freight market will eventually be a positive signal for the bulks, particularly thermal coal, as it restores a CIF (total delivered price) discount to higher priced Chinese coal. The high cost of Chinese coal and iron ore supply will also keep a high floor on seaborne bulk prices.

Agricultural Commodities

Agricultural commodities initially benefited from renewed investment appetite amongst the fund

community in the second quarter of 2009. The rally in Agricultural commodity markets mirrored that of equity markets and the wider commodity complex, with the correlation between outside and agricultural markets reaching extremely high levels. However fundamentals for a number of the agricultural commodities have deteriorated throughout June, prompting swift liquidation of long side positions by speculative investors in a number of key markets.

S&P GS Agricultural Commodity Index and speculative positions



Sources: Bloomberg, CFTC

Supply outlooks have improved

Supply side dynamics are looking less bullish than at this time last quarter. In the coffee market, the Brazilian harvest has begun, resulting in an increased supply of mid range quality beans. While the high-end Arabica market remains tight, the substitution of Mild varieties for Brazilian Naturals and the drawdown of warehouse stocks should meet immediate demand needs. In wheat, the Northern hemisphere harvest is in progress, with early production figures mostly in line with or above market expectations. While the supply outlook has improved, the downside risk is likely to be limited, as prices approach the lower end of targeted ranges, having retraced nearly all of last quarter's gains.

Oilseed markets to out perform grains

The major focus for the agriculture markets has shifted to the new Northern Hemisphere summer crops and particularly the corn and soybean crops. US soybean supplies have reached extremely tight levels, with the stocks/usage ratio for the end of the 2008-09 crop forecast to reach just 3.6%. While 2009-10 soybean acreage suggests a substantial increase in production, the supply scenario remains extremely susceptible to adverse weather events over the growing season, which could see production expectations fall and prices surge higher in order to ration demand. Conversely in corn, recent revised acreage estimates have alleviated concerns about tight market conditions throughout 2009/10. As a result, we see oilseeds and oilseed product prices outperforming the grain markets throughout the second half of 2009-10.

International Economic Growth Forecasts

GDP	2008	2009(f)	2010(f)	2011(f)	2012(f)
US	1.1	-2.7	1.8	2.5	3.6
Japan	-0.7	-6.7	1.1	0.8	2.8
Germany	1.3	-5.9	0.4	1.3	1.8
France	0.7	-2.4	0.8	1.2	2.0
Italy	-1.0	-5.3	0.2	0.2	1.4
UK	0.7	-3.8	0.7	1.5	2.9
Canada	0.4	-2.4	1.0	2.2	3.8
G7	0.6	-3.8	1.3	1.8	3.0
Spain	1.2	-3.2	-0.2	1.6	1.3
Euro zone	0.8	-4.3	0.3	1.2	1.7
Australia	2.2	0.1	0.5	3.1	3.6
New Zealand	0.2	-2.6	1.5	4.6	2.1
Developed countries	0.7	-3.7	1.1	1.8	2.9
China	9.0	7.1	8.3	8.8	10.7
Korea	2.2	-2.9	2.8	3.5	5.1
Taiwan	0.1	-5.4	3.9	4.2	4.5
Indonesia	6.1	3.9	5.1	4.8	5.2
Thailand	2.6	-3.1	4.3	4.3	5.0
Hong Kong	2.4	-6.7	2.6	4.5	4.2
Malaysia	4.6	-1.9	3.2	5.1	5.7
Singapore	1.2	-7.5	2.9	5.0	5.5
Philippines	4.6	0.5	2.2	4.4	4.2
Vietnam	6.2	4.3	6.3	7.4	6.5
East Asia excl. Japan & China	3.1	-1.8	3.8	4.6	5.2
East Asia excl. Japan	6.7	3.7	6.6	7.3	8.7
India	7.3	4.9	6.6	7.7	7.6
South Asia	7.0	4.5	6.2	7.1	7.3
Eastern Europe	5.1	-3.5	1.8	3.6	4.6
Latin America	4.2	-2.1	2.3	2.6	4.0
Emerging countries	5.8	1.5	4.9	5.7	6.9
World (PPP)	3.0	-1.3	2.9	3.7	4.8

Australian and New Zealand Economic Forecasts

	Annual % change (period average)				Quarterly % change			
	2008	2009 (f)	2010(f)	2011 (f)	Jun-09(f)	Sep-09(f)	Dec-09(f)	Mar-10(f)
Australia								
GDP	2.2	0.1	0.5	3.1	0.0	-0.1	-0.1	0.1
Household consumption	2.2	1.0	1.2	2.9	0.3	0.0	0.0	0.3
Dwelling investment	2.5	-6.8	8.4	10.3	-2.2	1.5	3.0	2.8
Business investment [^]	13.5	-10.1	-13.9	1.0	-3.8	-4.9	-5.3	-3.8
Public demand [^]	5.5	2.4	6.7	4.2	0.5	1.5	1.8	1.9
<i>Domestic final demand</i>	4.4	-1.1	0.5	3.4	-0.5	-0.4	-0.2	0.2
Net Exports (cont. to growth)	-1.5	2.5	-1.0	-0.9	-0.6	-0.4	-0.4	0.1
Inflation: Headline CPI	4.4	1.8	2.4	2.0	0.5	0.8	0.6	0.8
Core	4.5	3.7	2.7	2.2	0.8	0.7	0.7	0.7
Wages (Wage Price Index)	4.3	3.6	3.2	3.6	0.8	0.8	0.7	0.8
Employment	2.2	-0.3	-0.7	2.0	-0.3	-0.4	-0.5	-0.4
Unemployment rate (%)	4.3	6.1	7.8	7.6	5.8	6.4	7.1	7.7
Current account balance (A\$ bn)	-51.0	-42.6	-65.5	-73.0	-9.6	-12.9	-15.4	-15.1
(% of GDP)	-4.3	-3.6	-5.4	-5.6	-3.2	-4.4	-5.2	-5.0
New Zealand								
GDP	0.2	-2.6	1.5	2.1	-0.5	-0.3	0.0	0.3
Inflation: Headline CPI	4.0	1.9	2.1	2.7	0.6	0.5	0.5	0.3
Wages	5.0	3.8	1.6	1.5	0.8	0.5	0.4	0.4
Employment	0.6	-1.6	-1.0	2.2	-1.0	-0.9	-0.4	-0.2
Unemployment rate (%)	4.2	6.0	7.7	7.4	5.6	6.4	7.0	7.5
Current account balance (NZ\$ bn)	-16.0	-8.9	-9.4	-10.5	-1.9	-2.1	-2.2	-2.3
(% of GDP)	-8.9	-5.0	-5.2	-5.4	-4.3	-4.8	-5.0	-5.3

[^] Excluding second-hand asset sales

Financial Market Forecasts

	Annual (period end)				Quarter (period end)			
	2008	2009(f)	2010(f)	2011(f)	Jun-09	Sep-09(f)	Dec-09(f)	Mar-10(f)
Interest rates (% p.a.)								
<i>Australia</i>								
Cash rate	4.25	2.50	2.75	4.75	3.00	3.00	2.50	2.50
3-year bond rate	3.07	4.05	4.85	5.20	4.56	4.05	4.05	4.15
10-year bond rate	3.99	5.25	5.55	5.40	5.52	5.35	5.25	5.25
<i>New Zealand</i>								
Official cash rate	5.0	2.5	3.0	5.5	2.5	2.5	2.5	2.5
10-year bond rate	4.6	5.6	6.3	6.7	6.0	5.8	5.6	5.7
<i>United States</i>								
Fed funds rate	0.25	0.25	0.75	2.75	0.25	0.25	0.25	0.25
3-year bond rate	0.76	1.00	2.25	4.00	1.11	1.10	1.00	1.25
10-year bond rate	2.21	3.50	4.35	5.00	3.53	3.50	3.50	3.75
<i>Europe</i>								
ECB refinance rate	2.50	0.75	1.25	2.50	1.00	0.75	0.75	0.75
BoE repo rate	2.00	0.50	1.00	2.25	0.50	0.50	0.50	0.50
Exchange rates								
A\$/US\$	0.70	0.73	0.80	0.80	0.81	0.76	0.73	0.76
NZ\$/US\$	0.58	0.55	0.56	0.61	0.64	0.58	0.55	0.54
A\$/¥	63.68	73.00	89.60	94.40	77.70	74.48	73.00	74.48
A\$/€	0.50	0.56	0.61	0.60	0.57	0.56	0.56	0.56
A\$/£	0.48	0.46	0.49	0.49	0.49	0.48	0.46	0.48
A\$/NZ\$	1.21	1.33	1.43	1.31	1.25	1.31	1.33	1.31
US\$/¥	90.6	100.0	112.0	118.0	96.4	98.0	100.0	98.0
€/US\$	1.40	1.30	1.32	1.34	1.40	1.35	1.30	1.35
A\$TWI	55.60	60.05	65.83	64.80	64.70	62.35	60.05	62.35

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
Tony Morriss	Senior Rates Strategist	+61 2 9226 6757	Tony.Morriss@anz.com
Julie Toth	Senior Economist, Industry	+61 3 9273 6252	Julie.Toth@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
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Commodity and Industry Research

Mark Pervan	Head of Commodity and Industry Research	+61 3 9273 3716	Mark.Pervan@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
Natalie Robertson	Commodity Research Analyst	+61 3 9273 3415	Natalie.Robertson@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
Liam Getreu	Research Assistant		

Foreign Exchange and International Economics Research

Katie Dean	Acting Head of FX and International Economics Research	+61 3 9273 1381	Katie.Dean@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 6216 1814	Paul.Gruenwald@anz.com
Tamara Henderson	Director, FX & Rates Strategy	+65 6419 7930	Tamara.Henderson@anz.com
Yeo Han Sia	Associate Director, FX and Rates Strategy	+65 6419 7943	HanSia.Yeo@anz.com
Franklin Poon	Economist, North East Asia	+852 3929 5340	Franklin.Poon@anz.com
Chang Wei Liang	Analyst, Economic Research	+65 6216 1918	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

Research and Information Services

Karen Crothers	Head of Research and Information Services	+61 3 9273 6265	Karen.Crothers@anz.com
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 FINRA [www.finra.org] and SEC)

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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