

## Event risk heightens

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### Macro Update: Event risk heightens

- The biggest negative impact to Australia from the outbreak of swine flu may not be from the flu itself, but from any further dent to global economic growth and heightened market volatility.
- Next week's Victorian State budget will be a blueprint for how far governments are prepared to sacrifice their balance sheets to support growth. There is a risk of further State credit reviews in the period ahead.

### Interest Rate Markets: Yield curve back in steepening mode

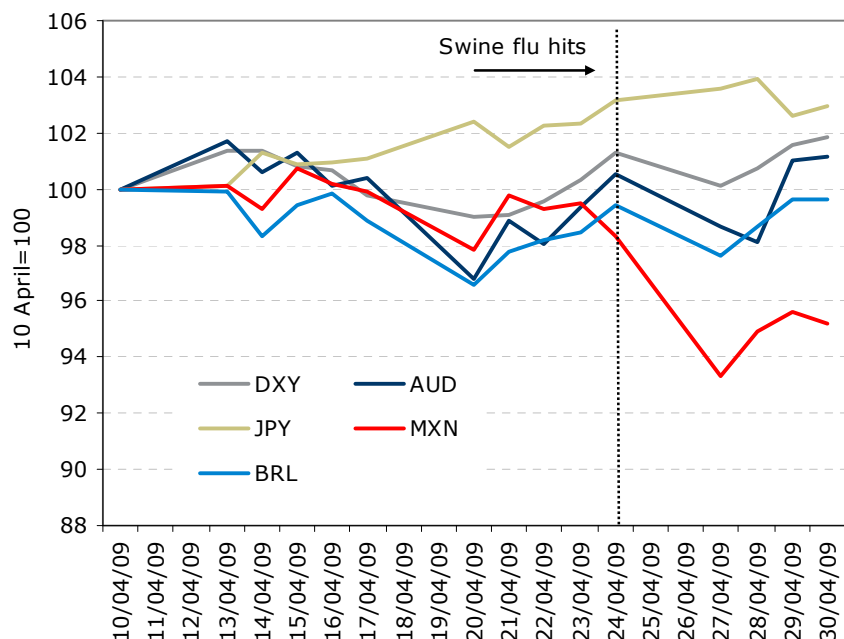
- Long-dated yields have risen more sharply than short-dated yields over the last week. This underlines that the curve is likely to remain steep over coming months.
- Local shorter-dated swap yields have fallen from recent highs over the past two weeks in light of these factors. They are now near levels we have previously discussed as opportunities to lock-in fixed rate funding.

### FX: What will the ECB bring to the party?

- Sentiment continues to turn on a dime and in turn so does the fortune of the AUD. This week it was swine flu, which boosted USD demand and caused AUD/USD to briefly flirt below 0.70. By today however, AUD/USD had rallied to as high as 0.73 in the overnight session.
- For the EUR, this week's big event is the ECB interest rate decision on 7 May in which the ECB is expected to cut the refinance rate to 1% and to announce the ECB's decision on moving towards quantitative easing (QE).

### Chart of the week

Figure 1: Swine flu has only a limited impact on markets so far



Source: Bloomberg

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## Macro Update: Event risk heightens

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### Swine flu the worst kind of event risk

The outbreak of swine flu is the last thing the global economy needs right now. Overnight the World Health Organisation (WHO) has raised the level of influenza pandemic alert to Phase 5 out of 6. This is now one step short of a full pandemic with the WHO advising that "*all countries should immediately activate their pandemic preparedness plans*". Three pandemics have occurred over the past century – the Spanish influenza (1918-19), the Asian influenza (1947-58) and Hong Kong influenza (1968-69). So far, 17 countries have confirmed or suspected cases of swine flu (in contrast to 37 countries affected by SARS), but deaths have been confined to Mexico and the US.

The WHO upgrade of the pandemic alert is of serious concern. Apart from the potentially devastating human consequences, this substantially increases the likelihood of severe disruptions to travel, and thus potentially trade and investment flows. Some countries have already suspended flights to Mexico to try to contain infection. Indeed, authorities' response to swine flu has been early, aggressive and co-ordinated. In Australia, this includes sweeping new quarantine powers to detain suspected infected people.

The SARS experience provides some blueprint for what might unfold. The economic impact of SARS was significant for the regions directly affected and is estimated to have cut nominal GDP growth by 0.5ppt in East and Southeast Asia from November 2002 to July 2003. But the flow on to Australia was relatively muted and mostly contained to the tourist sector, with short-term visitor arrivals falling 5% during this period. This barely caused a ripple to Australia's broader economy, including non-service exports, which continued to grow solidly.

Nevertheless, in contrast to SARS, the potential for a global flu outbreak has come at a terrible time for the global economy, with activity already very weak (especially tourism) and financial markets fragile. Trade and investment flows could be disrupted and heightened uncertainty is already dragging equity markets down and could weigh further on consumer and business spending decisions. Moreover, government resources are being diverted at a time when public spending is urgently required to support the broader economy.

If the risk of a pandemic escalates, the traditional safe havens of gold, US treasury bonds and the USD will be the only 'winners'. For Australia, the SARS experience suggests that the early response from authorities and the significant geographic distance from Mexico may limit the direct impact from the virus itself. But we would be far from immune from any deeper ramifications across financial markets (in particular the AUD would likely weaken sharply) or from another leg down in global growth. The risk to Australia would also substantially increase should the flu spread to Asia. For local policy-makers, it is the type of event risk that could see the RBA cut rates to 2.0% earlier than our year-end forecast.

### States to kick off the budget cycle – how bad will it be?

State governments kick off the annual budget cycle next week with the Victorian Budget to be delivered on May 5. This budget will be keenly watched as it will set a further blueprint for how much State governments are prepared to erode their budgetary positions to support their economies in light of the Commonwealth government offer to guarantee State government debt.

Queensland set the example early, suffering a ratings downgrade from AAA to AA+ after driving its budget into deep deficit and driving net debt significantly higher after the state maintained its significant capital works spending program

despite sharp falls in government revenues. The political fall-out from this approach has been limited, with the incumbent government retaining power in a snap election following the new budget figures. The 'cost' of the ratings downgrade has also not been as great as initially feared, largely because of the Commonwealth government's offer to guarantee State debt. This has improved liquidity and pushed down yields for semi-government debt, although spreads to Commonwealth bonds remains unusually wide to reflect uncertainty ahead of the Budget round and uncertainty about whether the States will opt to use the guarantee or not. There is only a 5bp fee differential between AAA and AA+ credit ratings to access the guarantee.

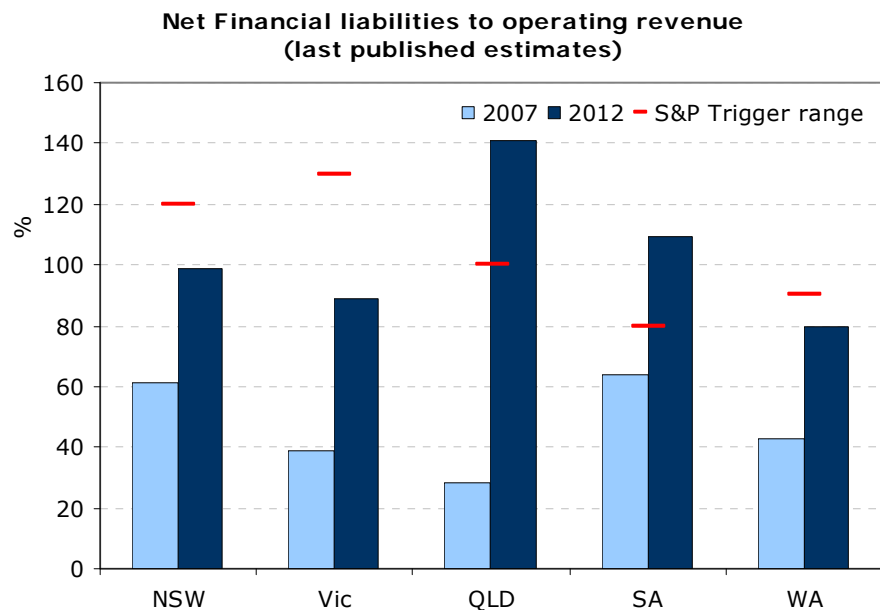
It seems assured that the significantly weaker economy will cause all of the States to fall into budget deficit in 2009-10 and beyond, although the hit to revenues may not be as sharp in Victoria, New South Wales and Tasmania as in the resource dependent Queensland and Western Australia.

Standard & Poor's have advised that a key determinant for ratings stability will be whether the States, faced with budget deficits, then decide to cut back on capital over absorbing additional debt. We see a reduced incentive for the States to cut spending to preserve their credit rating, given (a) the Commonwealth government-guarantee of State debt and (b) the need for expansionary, not contractionary, fiscal policy at this stage of the business cycle.

Figure 2 below suggests that even before the economic downturn deepened, New South Wales and South Australia were vulnerable to a credit review. Moreover, our analysis suggests that the deterioration in the 2009-10 budget position is big enough in both Victoria and Western Australia to push up net financial liabilities (as a share of operating revenues) to the ratings review 'trigger' level, although perhaps not as sharply or as soon as Queensland which is forecast to break trigger levels in 2010. There is thus a risk that other States will suffer a ratings review (or even downgrade), if not this year in the years to come.

If this eventuates, it would further link the quality of state government credit to that of the Commonwealth government-guarantee. This puts even more pressure on the Commonwealth to outline a credible debt reduction strategy, so as to not threaten its own credit rating, in its May 14 Budget.

**Figure 2: State Government 'trigger ranges' for rating reviews**



Source: Standard and Poor's and ANZ

### Data wrap

- **Private sector credit** rose just 0.1% in March as solid housing credit offset falls in business and personal credit.

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## Interest Rate Markets: Yield curve back in steepening mode

- Long-dated yields have risen more sharply than short-dated yields over the last week. This underlines that the curve is likely to remain steep over coming months.
- Local shorter-dated swap yields have fallen from recent highs over the past two weeks in light of these factors. They are now near levels we have previously discussed as opportunities to lock-in fixed rate funding.

### The yield curve has moved back into steepening mode

Long-dated yields have risen more sharply than short-dated yields over the last week. This underlines that the curve is likely to remain steep over coming months.

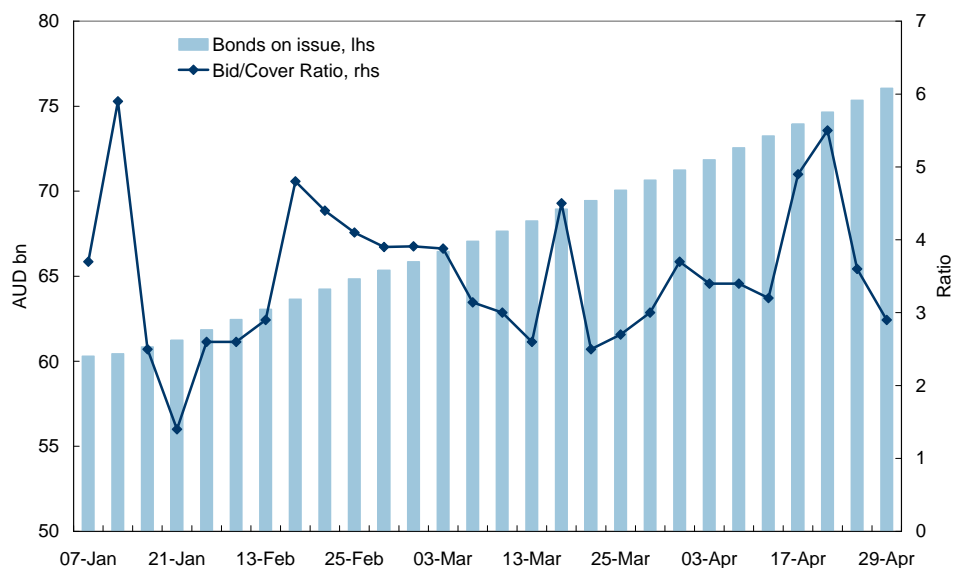
While we think the RBA will be on hold when the board meets next week, which might cap the upside beyond 120bps for the 3/10-year spread over coming days, we still feel that official cash rates are heading towards 2.0% later in the year. If the RBA stays on hold next week, this should weigh on near-term IB futures. However, we see current market pricing of a low in cash rates around 2.40% as offering some value for September and December bill futures.

Other factors have helped to push short-dated yields lower this week. Swine flu has been a reminder of the vulnerability of the global economy to fresh headwinds, despite more confidence that the US slowdown is starting to bottom.

Another driver has been the surprisingly dovish statement from the RBNZ regarding their unconditional commitment to keep rates at or below current levels until the end of 2010. The implications for Australia of New Zealand's economic conditions and policy settings are very limited. However recent AUD and NZD strength and higher market yields do highlight the tightening of financial conditions that both countries are experiencing, which argues there is more work ahead for monetary policy in both countries. Low official cash rates are set to anchor shorter-dated yields over coming months.

Different factors appear to be at work further out the curve. Better economic numbers and the extended rally for global stock markets have reduced flight-to-quality demand for bonds. Supply factors also appear to have been at work. The auction of the new April 2020 ACGB bonds this week met with lacklustre demand with a wide range of accepted bids and a relatively soft bid-to-cover ratio of 2.9 (Figure 3). Investor demand for longer-dated issues would not appear to be as strong for those at the front-end.

**Figure 3: ACGBs on issue and demand for increased supply**



Source: ANZ & Bloomberg

This is understandable ahead of the upcoming Budget round. Although there have been numerous leaks ahead of the Commonwealth Budget on May 12, risks are clearly for a significant deterioration in the underlying Budget balance over coming years. This would likely put upward pressure on the \$A200bn debt limit. Supply is only likely to increase from here. And State government budgets in coming weeks will also highlight a significant call on markets to fund infrastructure spending amid falling revenues.

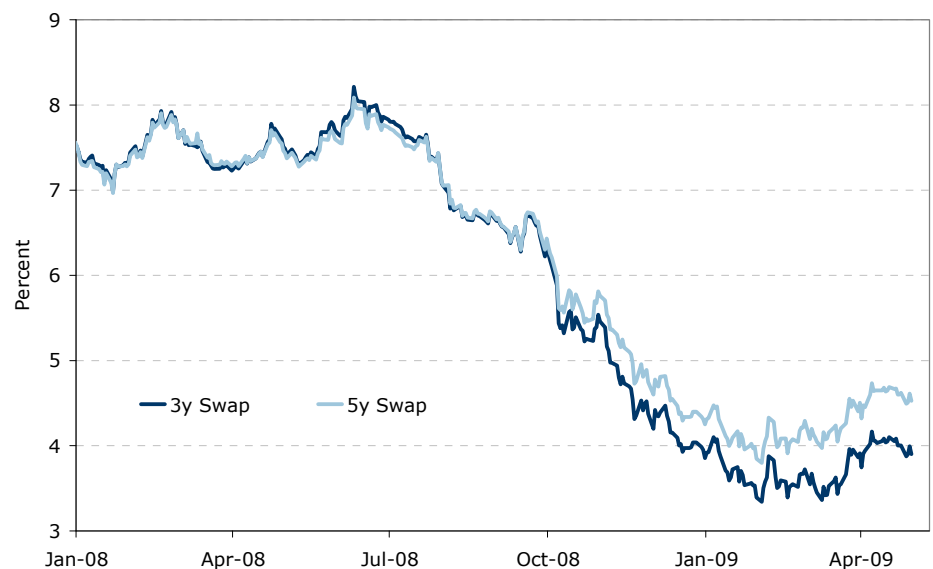
Finally, the yields on longer-dated US bonds have made a significant move higher despite ongoing purchases of Treasuries by the Fed as part of the quantitative easing policy. 10-year bond yields have moved above the key 3.05% level to 5-month highs while 30-year bond yields are back above 4.0% following the decision by the FOMC overnight not to extend quantitative easing (QE) plans announced last month to buy a total of \$US300bn of US Treasuries. The Fed has bought in excess of +\$50bn of Treasuries over the past month.

The move above 3.0% for 10-year yields poses a challenge for the Fed if the QE policy is designed to hold bond yields in ranges. Higher bond yields would represent an additional headwind to the economic recovery even though recent data suggests the worst of the slowdown may be behind us.

### Targets for shorter-dated swaps are back in play

Local shorter-dated swap yields have fallen from recent highs over the past two weeks in light of the factors discussed above (see Figure 4 below). These yields are now near levels we have previously discussed as opportunities to lock in fixed rate funding. Even though we think shorter-dated yields will be anchored by expected RBA rate cuts later in the year, we think it will be hard for the 3 and 5-year swap rates to make new lows. We have previously looked at the 3.70-3.90% level as a good opportunity for 3-year swaps. We would also see any move towards the area around 4.25% for 5-year swaps as providing a similar long-term hedging opportunity.

**Figure 4: Three-year and 5-year swaps**



Source: ANZ & Bloomberg

## FX: What will the ECB bring to the party?

### Recommendation

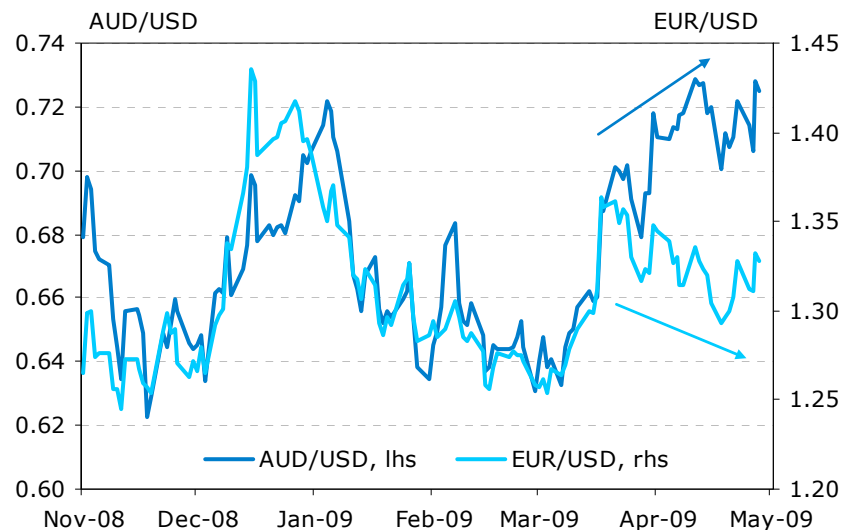
AUD trade remains within a narrow AUD/USD 0.70-0.73 range. AUD sellers may wish to take advantage of spikes above AUD/USD 0.7250; buyers can look to dips towards 0.6950. Beware of this week's busy US data roll-call, with personal spending, income and the ISM due late this week, and non-farm payrolls for April late next week. However, the highlight will be Monday's release of results of the US Federal Reserve's bank stress testing, an issue that has generated much speculation on the markets in recent weeks.

### Overview

Sentiment continues to turn on a dime and in turn so does the fortune of the AUD. This week it was swine influenza which triggered a turnaround in risk appetite and boosted USD demand – the AUD/USD briefly flirted below 0.70 but by today, with the World Health Organisation clarifying that many fewer deaths and recorded cases had occurred than what was being reported in the media, the AUD/USD rallied to as high as 0.73 in the overnight session. The news generated similar moves in the EUR, which recovered from a low of EUR/USD 1.2965 to trade close to 1.3350 overnight. But the question remains: can this strength be maintained?

For the EUR, this week's big event is the ECB interest rate decision on 7 May. In the press conference to follow, ECB President Trichet is expected to announce the ECB's decision on moving towards quantitative easing (QE). The market is expecting the ECB to cut the refinancing rate by 25bps to 1%; a 50bp cut would weigh heavily on the EUR, and combined with confirmation of a move to some sort of QE, could see the currency quickly push below EUR/USD 1.30 towards 1.2840. Over the past few weeks, ECB officials have been publicly debating both the appropriate base level of interest rates as well as "unorthodox policy measures" including QE. It is clear that the officials are deeply divided over the future direction of monetary policy in the Euro zone. With five more council member speeches due over the coming week having the potential to further cloud the outlook, any guidance and clarification from Trichet will be very welcomed.

**Figure 5: Will AUD/USD and EUR/USD divergence continue?**

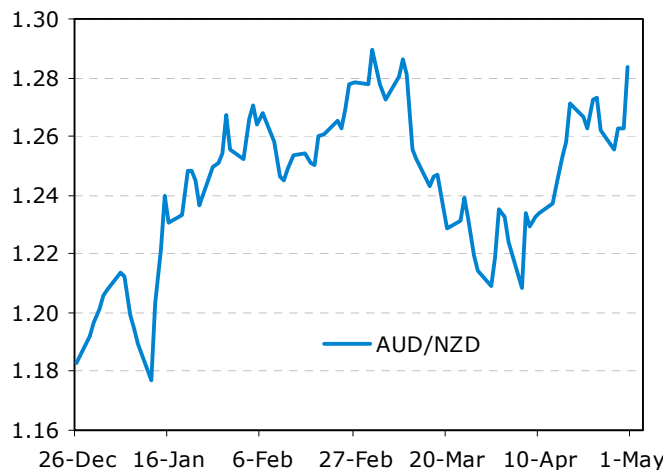
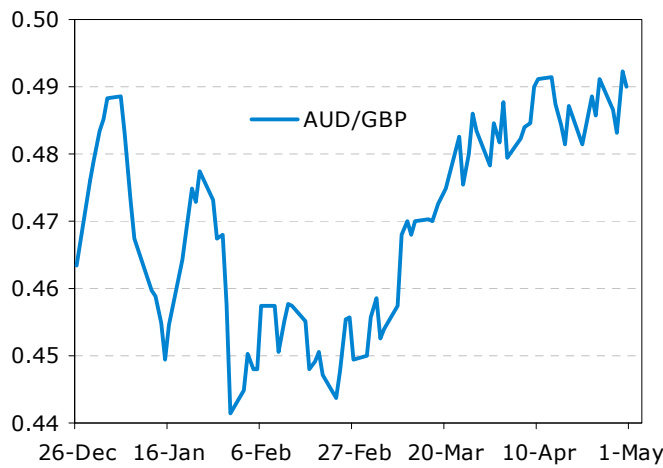
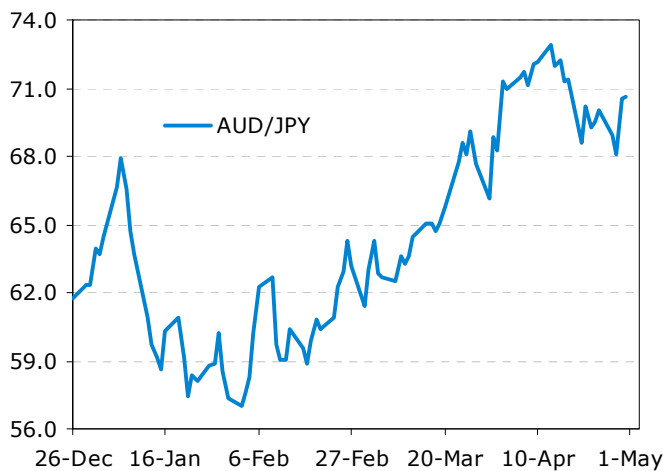
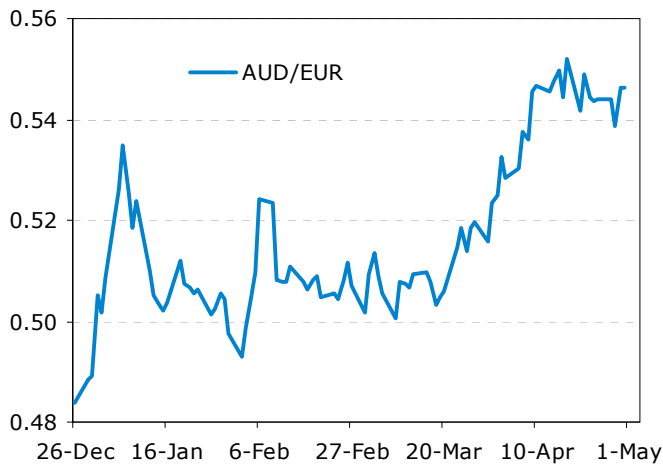


Source: ANZ, Bloomberg

A number of risk events are also on the horizon for the AUD. Apart from the US events covered above, an escalation in swine flu threat could see demand for the USD improve. Keep an eye on local events: both the RBA rate decision and the RBA's *Statement on Monetary Policy* will provide the latest insight on the near-term future of monetary policy in Australia. Worse than expected releases of retail sales, international trade and labour force data could trigger a sell off in the AUD/USD towards 0.7070 and then lower to 0.6950 if the negativity takes hold.

**AUD/USD Key levels: 0.6950 – 0.7330.** We will need to see a solid break below AUD/USD 0.6950 for a lower trend to emerge, while the upside target remains this year's high just shy of 0.7330.

## AUD cross view



### AUD/EUR Key levels: 0.5260 – 0.5550

- AUD/EUR has traded solidly above its 200-day moving average for the past three weeks, with the normally close relationship between movements in the EUR/USD and AUD/USD having broken down (see figure 5 above). With trade constrained within a tight AUD/EUR 0.5350-0.5550 trading range, a push below 0.5260 could signal renewed AUD weakness.
- The key risk event for the AUD/EUR this week will be the ECB rate decision on 7 May (see above). We will likely see remarks from a number of ECB officials prior to this date continue to have a big influence on market moves.

### AUD/JPY Key levels: 68.00 – 72.00

- The JPY has re-emerged as a global safe-haven currency as the world comes to grips with the threat of swine flu further hampering global growth. The JPY rose to a 5-week high against the USD at USD/JPY 95.63 but has since consolidated back above 97. Beware of Japanese employment and household spending data due out tomorrow.
- AUD/JPY continues to trade just below the 200-day moving average (currently at 71.34). An easing in the flu outlook could push the cross higher towards 72, while worse than expected outturns in the Australian economic data run next week could see it fall towards 68.

### AUD/GBP Key levels: 0.4780 – 0.4920

- The AUD/GBP remains in the basic trading range of 0.48 – 0.49 that has dominated since the beginning of April. Attempts to push higher have been quickly thwarted, and we need to see at least two consecutive closes above 0.4920 before such moves can be sustained.
- A better-than-expected result in the UK's April PMI data has the potential to support the GBP/USD and see the AUD/GBP head to the lower bound of its recent trading range. The BoE may announce an increase in its purchase of gilts as part of its QE program following its monetary policy meeting on 7 May; this would be a positive for the AUD/GBP.

### AUD/NZD Key levels: 1.2480 - 1.2850

- AUD/NZD pushed to a seven-week high to trade around 1.2850 today as the RBNZ not only cut interest rates by 50bp to 2.50%, but stated that rates would remain at this level or lower until the end of 2010.
- Today's levels are likely to be the limit of the current push higher on the cross. A worse than expected NZ Q1 unemployment outcome next week could see the AUD/NZD remain sticky above the 1.27 level for longer. If the RBA reflects the RBNZ's more aggressive move in its communications next week, this would have the potential to weigh on the cross.

## ANZ economic and financial market forecasts

Australian economic indicators	2007	2008	2009f	2010f
<b>Economic activity (annual % change)</b>				
Private final demand	6.0	3.9	-2.5	-2.5
Household consumption	4.3	2.1	-0.2	0.7
Dwelling investment	2.7	2.0	-6.6	9.1
Business investment	13.8	13.2	-7.5	-17.9
Public demand	2.8	5.0	3.1	5.2
Domestic final demand	5.4	4.1	-1.3	-0.7
Inventories (contribution to GDP)	0.6	-0.6	-0.2	0.2
Gross National Expenditure (GNE)	5.9	3.5	-1.4	-0.5
Exports	3.2	4.7	-4.9	0.2
Imports	11.5	10.6	-11.0	-6.0
Net Exports (contribution to GDP)	-1.8	-1.4	1.7	1.4
<b>Gross Domestic Product (GDP)</b>	<b>4.0</b>	<b>2.1</b>	<b>-1.0</b>	<b>0.7</b>
<b>Prices and wages (annual % change)</b>				
Inflation: Headline CPI	2.3	4.4	1.6	2.6
Underlying*	3.1	4.5	3.7	2.7
Wages	4.1	4.2	3.9	3.4
<b>Labour market</b>				
Employment (annual % change)	2.8	2.2	-0.3	-1.0
Unemployment rate (%)	4.4	4.2	6.1	8.1
<b>External sector</b>				
Current account balance: A\$ bn	-68.1	-50.1	-36.4	-42.6
% of GDP	-6.3	-4.2	-3.0	-3.5

\*Average of RBA weighted median and trimmed mean statistical measures.

Australian interest rates	Current	Jun 09f	Sep 09f	Dec 09f	Mar 10f	Jun 10f
RBA cash rate	3.00	2.75	2.50	2.00	2.00	2.00
90 day bill	3.08	2.65	2.30	2.30	2.30	2.35
3 year bond	3.44	3.25	3.20	3.05	3.40	3.60
10 year bond	4.57	4.35	4.30	4.15	4.30	4.40
3s10s yield curve	1.13	1.10	1.10	1.10	0.90	0.80
3 year swap	3.91	3.60	3.50	3.35	3.70	3.90
10 year swap	5.12	4.85	4.70	4.50	4.60	4.70
<b>International interest rates</b>						
RBNZ cash rate	2.50	2.25	2.25	2.25	2.25	2.25
NZ 90 day bill	2.86	2.70	2.70	2.70	2.70	2.70
US Fed funds note	0.25	0.25	0.25	0.25	0.50	1.00
US 2 year note	0.95	0.75	0.80	0.85	1.25	1.50
US 10 year note	3.12	3.50	3.55	3.55	3.75	3.90
Japan call rate	0.10	0.10	0.10	0.25	0.50	0.50
ECB refinance rate	1.25	1.00	0.50	0.50	0.75	1.00
UK repo rate	0.50	0.50	0.50	0.50	0.75	1.50

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

Foreign exchange rates	Current	Jun 09f	Sep 09f	Dec 09f	Mar 10f	Jun 10f
<b>Australia and NZ exchange rates</b>						
A\$/US\$	0.7341	0.66	0.63	0.59	0.56	0.57
NZ\$/US\$	0.5726	0.54	0.51	0.48	0.47	0.47
A\$/¥	71.71	69.30	68.04	64.90	64.96	66.12
A\$/€	0.5494	0.52	0.51	0.50	0.50	0.51
A\$/£	0.4930	0.45	0.43	0.40	0.37	0.37
A\$/NZ\$	1.2820	1.22	1.24	1.23	1.20	1.21
A\$/CA\$	0.8745	0.82	0.79	0.77	0.74	0.76
A\$/CHF	0.8302	0.79	0.78	0.77	0.77	0.80
A\$/CNY	5.009	4.51	4.31	4.04	3.83	3.90
A\$ Trade weighted index	59.70	56.29	54.25	51.49	49.41	50.00
<b>International cross rates</b>						
US\$/¥	97.70	105	108	110	116	116
€/US\$	1.336	1.28	1.24	1.18	1.12	1.12
€/¥	130.53	134	134	130	130	130
£/US\$	1.489	1.46	1.48	1.48	1.50	1.55
€/£	0.8974	0.88	0.84	0.80	0.75	0.72
US\$/CA\$	1.191	1.24	1.26	1.30	1.32	1.33
US\$/CHF	1.131	1.19	1.24	1.30	1.38	1.41
US\$ index	84.06	88.0	90.1	93.4	97.1	96.7
<b>Asia exchange rates</b>						
US\$/CNY	6.824	6.84	6.84	6.84	6.84	6.84
US\$/HKD	7.750	7.76	7.76	7.76	7.76	7.77
US\$/IDR	10584	12000	11900	11600	11600	11300
US\$/INR	49.84	52.00	51.00	51.00	50.00	50.00
US\$/KRW	1282.95	1500	1400	1450	1375	1350
US\$/MYR	3.5596	3.74	3.80	3.80	3.80	3.75
US\$/PHP	48.385	49.50	50.00	49.50	48.80	48.50
US\$/SGD	1.474	1.58	1.62	1.66	1.66	1.63
US\$/THB	35.25	36.50	37.50	37.00	36.50	36.00
US\$/TWD	33.15	35.20	36.00	36.00	35.50	35.50
US\$/VND	17783	17800	18100	18500	18500	18500
<b>Pacific exchange rates</b>						
PGK/US\$	0.354	0.32	0.32	0.35	0.35	0.36
FJD/US\$	0.454	0.43	0.42	0.40	0.39	0.39

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