

Recession

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For Economics & Markets Research to be the most respected, sought-after and commercially valued source of economics and markets research and information on Australia, New Zealand, the Pacific and Asia.

Macro Update: Recession

- We expect Australia will experience a mild recession in 2009. Dwelling construction and profits will be notably weak and an extended period softness in consumption expenditure looks likely.
- We are not forecasting Australia to follow the lead of the US and UK and enter what a severe economic recession.
- Nevertheless, the risk is that while the depth of the Australian downturn may be less than in the early 1990s, the duration may well be longer.

Interest Rate Markets: Yield curve pressures

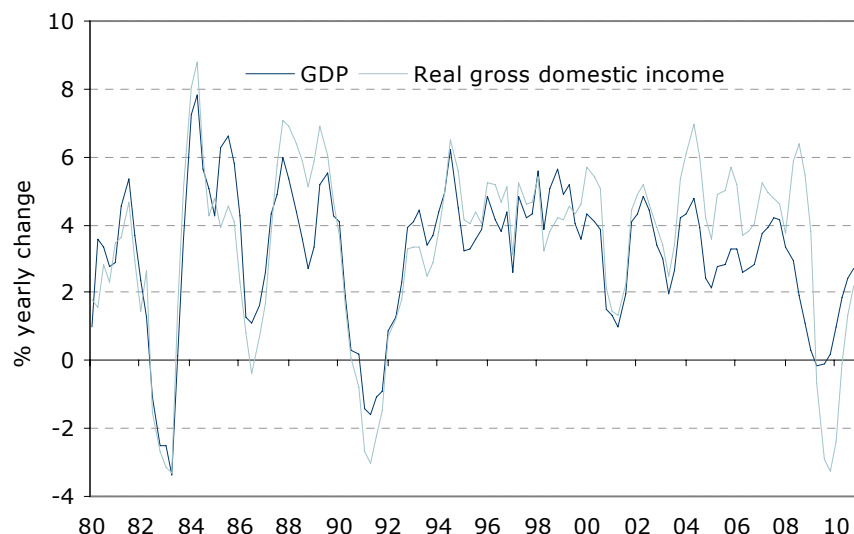
- We still expect the RBA will cut its official cash rate by 50bps next Tuesday, although the risk is clearly for a larger cut.
- While cash rates continue to head lower, steeper yield curves and some pressure on longer-dated yields have also become more apparent. Curve steepening means 10-year yields should continue to under perform even if we see a soft CPI number next week.

FX: USD rally continues

- The lagged effect of the financial crisis on the UK and Euro area has pressured these currencies and caused the USD rally to resume this week. The biggest story in currency markets was the GBP, which fell out of bed after the Royal Bank of Scotland reported a potential loss of £28 bn and the UK government announced a second assistance package for the troubled banking system.
- The AUD has swung violently to the downside this week. Poor data out of China and more negative corporate earnings releases could push AUD/USD temporarily below 0.6400, providing an opportunity for sellers of foreign currency.

Chart of the week

Figure 1: An income and growth recession



Source: ABS and ANZ

Macro Update: Recession

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A mild recession likely; but how long will it last?

The flow of new information continues to put downward pressure on our expectations for economic growth in Australia. It is now accepted wisdom that **the worst is ahead for the Australian economy**. But how bad will it get? Our assessment is that Australia will experience a mild recession in 2009. This will entail consecutive quarters of negative growth in real GDP, a number of quarters of contraction in real domestic incomes and a substantial increase in the unemployment rate. Real economic growth in Australia will be flat in 2009 as a whole, with notable weakness in dwelling construction and profits and an extended period of softness in consumption expenditure.

The revisions have also resulted in a slightly higher track for the unemployment rate, which we now expect to peak at around 7% in 2010. While substantial, a **peak to trough rise in the unemployment rate of just over 3ppts is still less than the rise seen following the recessions of 1982 and 1991**. Why? This is a consumer balance sheet event and a global financial shock. It is not a corporate-led recession. While corporate balance sheet pressures will intensify and labour shedding will be a hallmark of corporate life in 2009, the financial stresses in the economic system are not centred on corporate Australia, as it was in past recessions. What we are not expecting is widespread business failure – a key driver of surging unemployment in past cycles.

The big question for Australia is whether we follow the lead of the US and UK and enter what is increasingly looking like an economic depression characterised by a widespread credit crunch, surging unemployment and powerful deflationary forces in asset and product markets. We are not forecasting this outcome for Australia. Although under considerable pressure, **Australia's banking system is in a different position to the US and Europe** and monetary and fiscal policies have been more pre-emptive and so far more effective than in these other jurisdictions. Australia's natural rate of growth (from population) is still higher than the US and much higher than Europe and Japan.

In a world of increasing government prominence in economic life, Australia has an important advantage over many developed countries. **A very low government net debt position**. The general government gross debt is around 15% of GDP, well below levels in the US (66%) and UK (50%). Even if the Australian government must become more active in private markets, they have a strong balance sheet starting point.

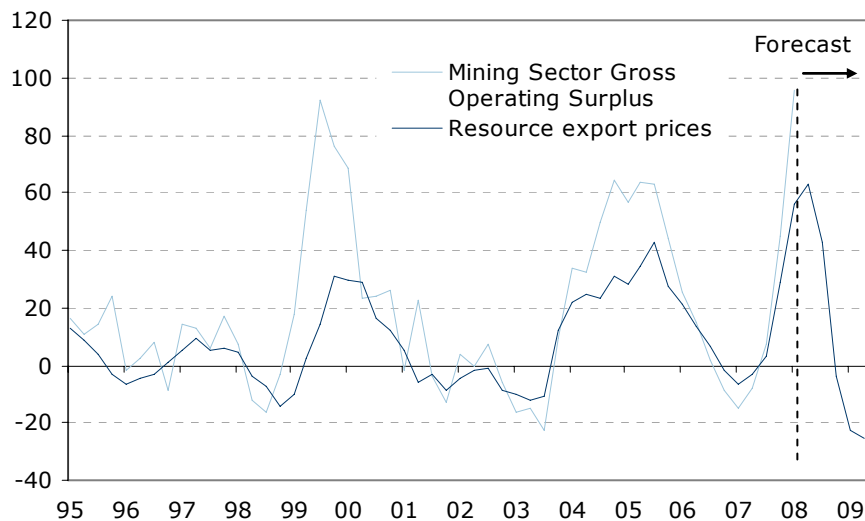
The flexibility of the A\$ helps as well, with the large depreciation witnessed since the middle of 2008 helping to boost local export revenues, subdue imports (eventually) and make the global funding task of Australian financial institutions a little easier (requiring less US dollars to meet \$A funding requirements).

Risks remain however. **Australia has a substantial dependency on global financial markets** for the financing of economic activity. While the government guarantees are assisting Australian banks accessing the global savings pool, this cannot be assured, particularly if a deteriorating economy and a worsening government financial position jeopardises investor confidence. A genuine crash in commodity markets would be a tremendous shock to the Australian economy after many years of boom; particularly as many firms based there planning on a commodity super-cycle. Business investment, infrastructure projects and government taxation revenues could all fall by more than expected.

Australia's household sector also faces an inevitable adjustment following a decade of cheap money and easy access to the global savings pool. **Consumption will be soft for many years as households repair balance sheets on the back of shifting asset values and changes to desired gearing levels.** How the labour market evolves going forward will be critical in determining the extent and duration of Australia's economic slowdown. In the near term, all forward-looking indicators point to further weakening, most notably the ANZ job ads series, within which the newspaper ads have fallen by more than 50% in a year, an outcome historically consistent with large and persistent increases in the unemployment rate.

The turn in Australian profits cycle is also one of the most startling, and damaging, characteristics of this downturn. Sharply weaker commodity demand will exert the biggest damage. We now expect A\$ resource commodity prices to fall by around 25% YoY by end-2009. On our estimates, these price falls as well as production cuts will drive a double-digit collapse in the ABS measure of mining profits in 2009 (see Figure 2).

Figure 2: Mining profits set for a double-digit decline



Source: ABS and ANZ

While mining accounted for around 30% of the growth in profits in 2008, it is the severity of the damage to the other 70% that will ultimately determine whether this profit cycle will be worse than the early 1990s recession. At that time, corporate non-financial profits fell by 15% YoY. For now, **we expect non-mining profits to fall by less than during the last recession, mainly because lower interest rates have provided considerable cost-relief for business.** Moreover, the debt-equity ratio of Australian businesses remains under 100% and well below a peak of more than 150% in the early 1990s. Lower oil prices are also easing cost pressures. Nevertheless, the downside risks to this view are many. Apart from a further deterioration in the real economy, the cost and availability of credit will be crucial in determining the pressures on business balance sheets. Our expectations for a further weakening in the A\$ could also be a tipping point for some importers as anecdotes suggest hedging has been at short-duration.

The shape and timing of a recovery in Australia is uncertain. As well as the functioning of the financial system, the shape of the global recovery (V versus U), the drivers of China's recovery, the extent of local household balance sheet consolidation and likely changes to the regulatory framework, will all be crucial determinants of the outlook over 2010 and beyond. **While the depth of the impending recession may be less than in the early 1990s, the duration may well be longer.**

Data wrap

- The **TDS/MI inflation gauge** fell by 0.2% in December, the third consecutive monthly fall and suggests headline CPI could be negative in Q4.
- **WBC/MI consumer confidence** fell 2.2% to 89.9pts in January.

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Interest Rate Markets: Yield curve pressures

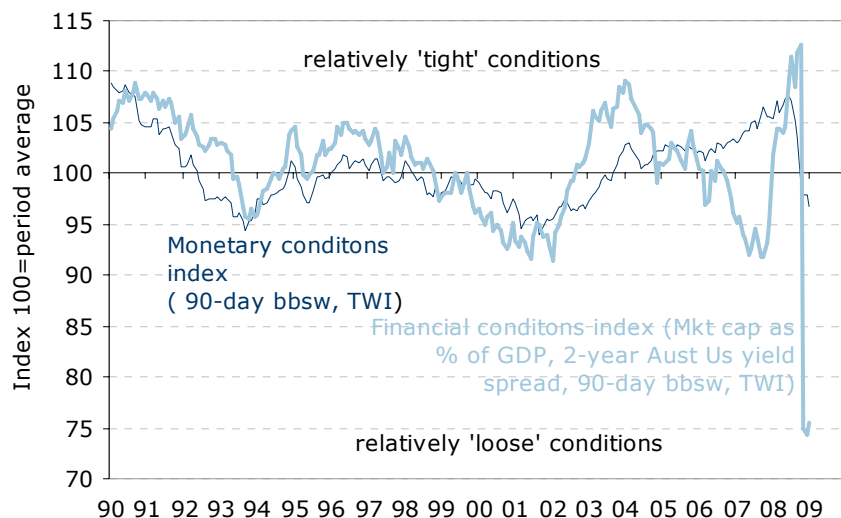
- There are a number of arguments for the RBA to take a less aggressive approach to easing policy in coming months; policy is already at stimulatory levels, further stimulatory fiscal policy looks on the way and the weaker A\$ is easing financial conditions.
- We expect the RBA will cut its official cash rate by 50bps next Tuesday, although the risk is clearly for a larger cut.
- While cash rates continue to head lower, steeper yield curves and some pressure on longer-dated yields have also become more apparent. Curve steepening means 10-year yields should continue to under perform even if we see a soft CPI number next week.

Overview

These are the arguments for the RBA to assume a less aggressive stance on policy easing in coming months:

- They have already taken policy to stimulatory levels with the sharp front-loading of rate cuts last year totalling 300bps. RBA Governor Stevens sounded relatively comfortable with this significant and timely response in his comments on December 9th.
- Fiscal policy has again come to the fore as the PM resumes work this week. A new fiscal boost ahead of the Budget looks increasingly likely and media reports suggest the Government is spending time on ways to support liquidity and borrowing to the corporate sector, even as some measures of credit stresses have improved.
- The 8% fall in the \$A's TWI over January has helped to keep financial conditions easy, even if the \$A is still above October lows. The economic challenges of 2009 will require lower rates, a weaker \$A and extended fiscal stimulus.
- As unemployment has only just started to head higher, the RBA might decide on a prudent policy strategy at this stage and save some "ammunition" to respond to unexpected weakness down the road. The case for extraordinarily low rates here is still weak as the local economy and banking sector remain in reasonable health, in contrast to some major overseas economies. The pricing of most mortgages from the cash rate means that monetary policy still remains effective.

Figure 3: Financial conditions index

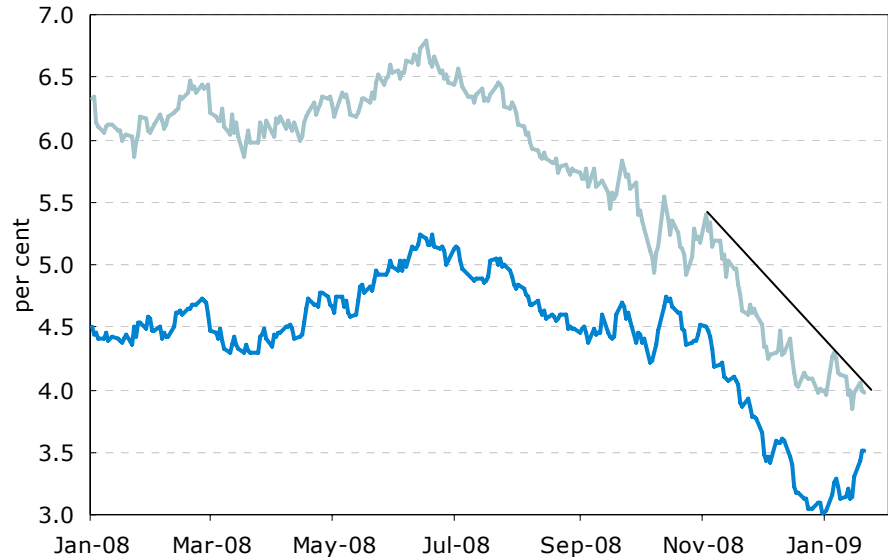


Source: Bloomberg and ANZ

We think a 50bps cut to 3.75% is more likely when the RBA meets on February 3rd, but the risk is clearly for a larger cut due to the deterioration in global economic conditions and weakness in domestic leading indicators. Either way, recent developments suggest that rates might need to stay lower for longer into 2010 to support economic recovery.

Steeper curves

Figure 4: UK and Australian 10-year yields



Source: ANZ and Bloomberg

While cash rates continue to head lower, steeper yield curves and some pressure on longer-dated yields have also become more apparent. The local rally for bonds remains in force, but the 3/10-year spread is once again approaching 100bps while longer-dated yields offshore have been rising.

The increasing nationalisation of the UK banking sector and pressure on public finances has seen UK 10-year yields rise over 50bps this week (see Figure 4 above). Rating concerns are likely to be a central theme across markets in coming months as Governments extend support to a broader range of economic and financial activity. We are clearly in better shape here. But curve steepening means 10-year yields should continue to under perform even if we see a soft CPI number next week.

Swap spreads have also continued to grind lower in Australia making the level of swap yields highly attractive for medium-term hedging. We expect increasing pay-side flow to materialise over the months ahead as corporation and households lock in low rates. This will limit the extent to which swap spreads can contract and in the absence of a significant further rally in government bond yields, may see a base form for Australian yields.

Longer term, the potential for a substantial increase in government debt issuance has materialised in Australia as the economic outlook deteriorates. Cyclical factors, most notably declining corporate profitability and prospects for higher unemployment, will push the normal operating budget into substantial deficit (as much as 2% to 3% of GDP) over the years ahead. The talk of the Government setting up a special purpose vehicle to help fill a funding gap left by offshore banks exiting the Australia market is likely to be partially funded through government bond issuance.

Surging government bond issuance will add to pressure on term yields to rise, thus strengthening the point that the current level of term interest rates is highly attractive.

This reinforces the view that current levels offer attractive opportunities to lock in longer-term hedging and funding.

FX: USD rally continues

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Recommendation

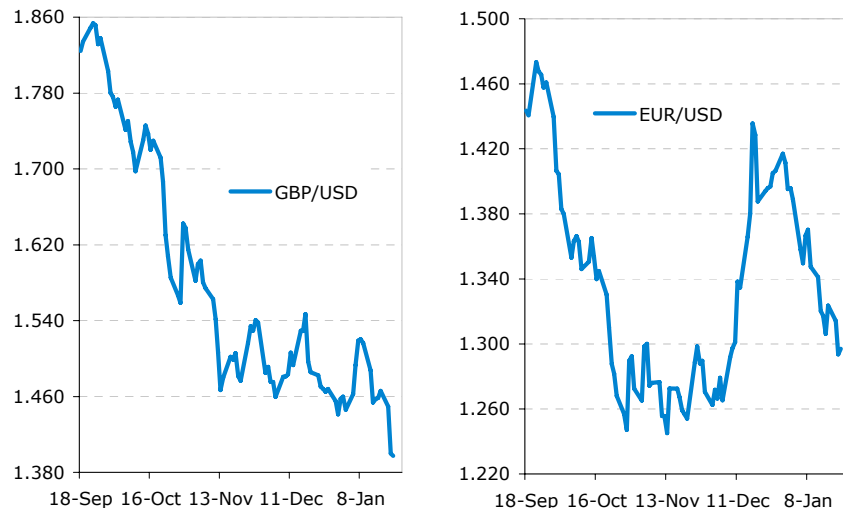
The AUD has swung violently to the downside this week. Poor data out of China and more negative corporate earnings releases could push AUD/USD temporarily below 0.6400, providing an opportunity for sellers of foreign currency. The forward discount has narrowed in recent months, but is still in exporters' favour.

Overview

The big story in currency markets this week was the GBP, which fell out of bed after the Royal Bank of Scotland reported a potential loss of £28 bn and the UK government announced a second assistance package for the troubled banking system. In the event, GBP/USD has fallen as much as 13 big figures from a Monday peak of 1.49 to 1.36, a level not seen since 1985.

As we foreshadowed last week, the lagged effect of the financial crisis on the UK and Euro area has pressured these currencies and caused the USD rally to resume. Though the EUR didn't suffer as much as the GBP in this week's carnage, EUR/USD has nonetheless retraced to below 1.30, a level last seen in mid-December. We think there is further downside for EUR/USD as the market comes to grips with the increasingly negative fundamental outlook; our end-March forecast remains EUR/USD1.25. The continued decline of the EUR is key to pushing up the USD, where we anticipate the USD's trade-weighted index could return from its present level of 85 to close to its November peak of 88.

Figure 5: The crisis catches up with GBP and EUR



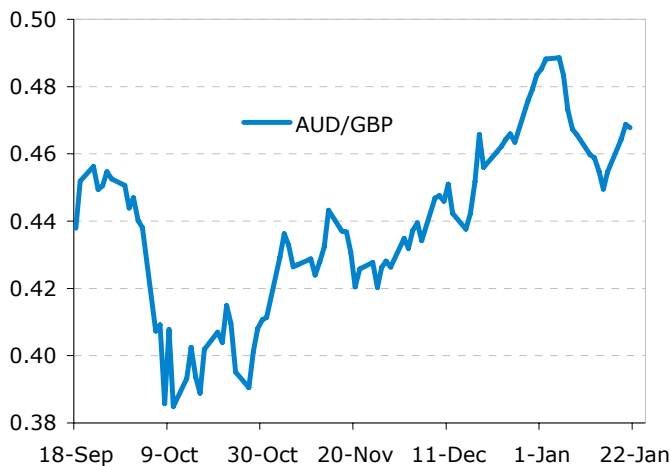
Source: Bloomberg

Though the AUD has also weakened versus USD, it has held in well on crosses and we expect this trend to continue. The trading range of AUD/EUR0.50-0.52 remains in play in the coming weeks. AUD/GBP has rallied back above 0.4700, and even AUD/CHF has held steady above 0.74 in this risk-averse environment.

Asian currencies may grab headlines in the coming days, as continued poor data flow will put increasing pressure on the authorities of managed currencies to allow their exchange rates to depreciate against the USD. Of particular note is SGD, after Singapore reported a severe 3.7% annual decline in GDP in the fourth quarter; we believe the currency could move toward USD/SGD1.54 from 1.50 at present. The Indian rupee and Taiwan dollar are two other currencies with potential for a more rapid depreciation against the USD. In the short-term we may see some USD selling out of Asia in advance of Chinese New Year - which begins on Monday - but in the longer term this trend is USD supportive.

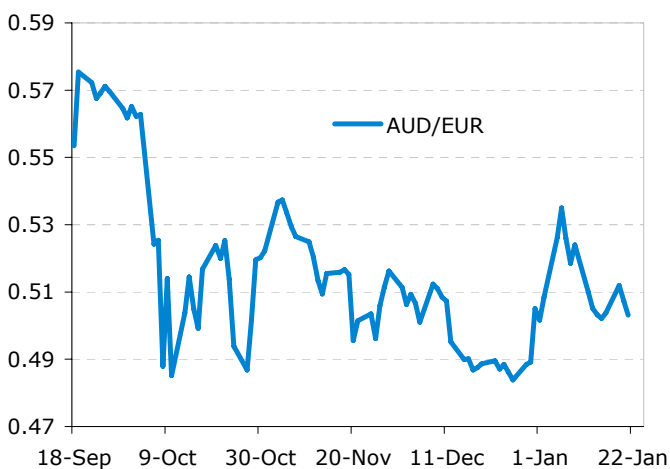
AUD/USD Key levels: 0.6400 – 0.6870. The AUD needs to get past 0.6870 to re-establish any base above 0.7000. There is strong support around 0.6400 to avoid moving back toward the October lows of 0.6009.

AUD cross view



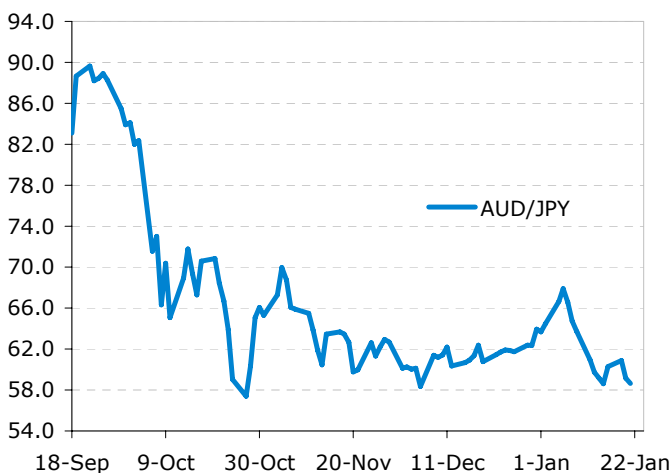
AUD/GBP Key levels: 0.4560 – 0.4790

- AUD/GBP broke temporarily above the key levels outlined last week, as the GBP/USD collapsed. The possibility is now for a somewhat higher trading range, if the GBP continues to grind lower.
- The bulk of GBP selling is probably done for now, but there are some key risks on the horizon. Fourth quarter GDP is published on Friday night, with the market projecting -1.2%. We also have some important earnings releases in the form of Royal Dutch Shell early next week.
- The market will next look ahead to the BOE meeting of 5 Feb, with another big cut expected.



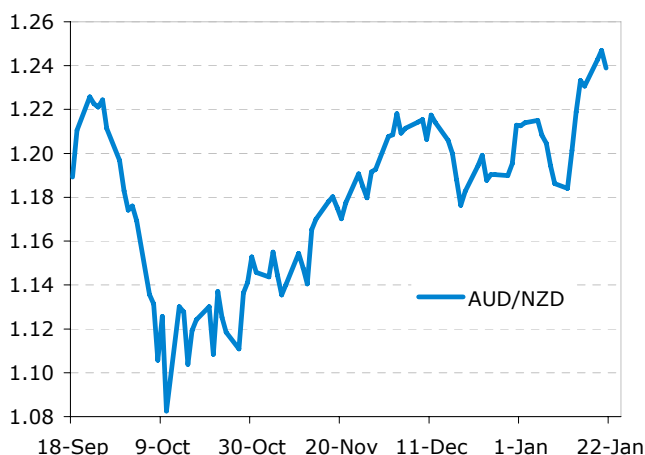
AUD/EUR Key levels: 0.4980 – 0.5260

- The trading range for AUD/EUR has stabilised as anticipated, despite ructions in the broad currency markets. The normally strong correlation between AUD/USD and EUR/USD is returning after falling apart in early January, suggesting that a range-bound AUD/EUR will once again become the norm.
- The data calendar for the Euro area is pretty light in the coming week. More direction may be taken from the equity markets, with some major German manufacturers reporting earnings and holding AGMs in the coming days.



AUD/JPY Key levels: 58.0 – 64.83

- Renewed risk aversion took USD/JPY back below 90 this week, briefly hitting a low of USD/JPY87.12. JPY should be held up around 88, however, given BOJ's recent intervention around this level. The BOJ announces its target rate today, but this is expected to remain unchanged and have little currency impact.
- A stronger JPY took AUD/JPY below 60 once again. Support now appears around the 58 level. With the USD/JPY expected to bottom out here, there is probably not all that much room for the cross to move lower in the near term.



AUD/NZD Key levels: 1.1940-1.230

- Last week we saw AUD/NZD as the key currency pair with potential to grind higher, and so it has to a short-term peak of AUD/NZD1.2521. Retracement has come after such a big rally, and 1.2440 now appears to be a resistance level. Support remains at 1.1940.
- There is certainly some downside risk to NZD/USD with the RBNZ set to meet on 29 November. The market is now anticipating a 100 bps cut to the cash rate to 4.0%. Though this would be the first time the RBNZ cash rate has fallen below that of the RBA since early 2000, this move is already largely priced into the AUD/NZD cross.

ANZ economic and financial market forecasts

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

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

Australian interest rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
RBA cash rate	4.25	3.50	3.00	3.00	3.00	3.00
90 day bill	3.61	3.85	3.75	3.70	3.75	3.75
3 year bond	2.89	2.80	3.25	3.35	3.60	3.95
10 year bond	4.08	4.00	4.25	4.25	4.40	4.75
3s10s yield curve	1.18	1.20	1.00	0.90	0.80	0.80
3 year swap	3.66	3.45	3.80	3.85	4.10	4.45
10 year swap	4.45	4.50	4.75	4.75	4.90	5.25
International interest rates						
RBNZ cash rate	5.00	3.50	3.25	3.25	3.25	3.25
NZ 90 day bill	4.14	3.79	3.60	3.52	3.50	3.50
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.50
US 2 year note	0.75	0.60	0.70	0.75	1.00	1.50
US 10 year note	2.54	2.90	3.20	3.75	3.80	4.20
Japan call rate	0.10	0.10	0.10	0.10	0.25	0.50
ECB refinance rate	2.00	1.50	1.25	1.25	1.25	1.75
UK repo rate	1.50	1.00	0.75	0.75	0.75	1.00

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

Foreign exchange rates	Current	Mar 09f	Jun 09f	Sep 09f	Dec 09f	Mar 10f
Australia and NZ exchange rates						
A\$/US\$	0.6642	0.63	0.58	0.56	0.54	0.54
NZ\$/US\$	0.5338	0.52	0.47	0.45	0.44	0.45
A\$/¥	59.40	61.74	58.00	56.56	55.08	56.70
A\$/€	0.5093	0.50	0.48	0.50	0.50	0.50
A\$/£	0.4751	0.43	0.41	0.40	0.39	0.39
A\$/NZ\$	1.244	1.21	1.23	1.24	1.23	1.20
A\$/CA\$	0.8338	0.76	0.70	0.69	0.70	0.71
A\$/CHF	0.7660	0.76	0.72	0.75	0.76	0.77
A\$/CNY	4.544	4.31	3.98	3.84	3.69	3.69
A\$ Trade weighted index	53.90	52.82	49.50	48.56	47.12	47.06
International cross rates						
US\$/¥	89.4	98	100	101	102	105
€/US\$	1.304	1.25	1.20	1.12	1.08	1.08
€/¥	116.7	123	120	113	110	113
£/US\$	1.398	1.46	1.43	1.41	1.40	1.40
€/£	0.9328	0.86	0.84	0.79	0.77	0.77
US\$/CA\$	1.255	1.20	1.20	1.24	1.30	1.32
US\$/CHF	1.153	1.20	1.24	1.34	1.40	1.42
US\$ index	85.82	87.8	90.6	95.3	98.1	98.7
Asia exchange rates						
US\$/CNY	6.838	6.84	6.86	6.86	6.84	6.84
US\$/HKD	7.760	7.76	7.77	7.80	7.80	7.80
US\$/IDR	11205	16000	14600	14200	13500	12400
US\$/INR	49.12	50.00	49.00	49.00	48.00	48.00
US\$/KRW	1372.925	1475	1500	1450	1400	1350
US\$/MYR	3.618499	3.60	3.64	3.74	3.80	3.80
US\$/PHP	47.53499	50.26	52.50	54.10	55.20	55.00
US\$/SGD	1.498	1.54	1.58	1.62	1.66	1.66
US\$/THB	34.94	35.80	37.60	39.40	39.40	38.75
US\$/TWD	33.58	34.00	35.20	36.00	36.00	36.00
US\$/VND	17480	17400	17800	18100	18500	18500
Pacific exchange rates						
PGK/US\$	0.373	0.37	0.37	0.36	0.35	0.35
FJD/US\$	0.546	0.53	0.51	0.49	0.48	0.48

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