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GDP growth (%)	2007	2008(f)	2009(f)	2010(f)
Australia	4.0	2.3	0.1	2.0
New Zealand	3.2	0.4	-1.9	2.5
United States	2.0	1.4	-1.6	2.0
Euro zone	2.6	1.0	-1.2	0.7
Japan	2.4	0.1	-1.5	1.0
China	11.8	9.1	6.9	8.5
Other East Asia*	6.0	4.1	0.4	4.4
World (PPP)	4.8	3.3	1.0	3.3

*Asia excl. Japan & China

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Overview

Saul Eslake

A grim outlook for the world economy

Near-term prospects for the world economy are, in a word, grim. Economic activity in the 'industrialized world' will contract by around 1½% in 2009, the first such full-year decline since the end of World War II. Growth in developing and emerging economies will slow from an average of 7½% per annum over the past five years to around 4% this year. As a result, growth in the global economy is likely to average about 1% this year, on par with the outcome in 1982 (when developing economies accounted for a much smaller proportion of global GDP than they do today) as the weakest in the post-war era.

The downward momentum in the global economy intensified dramatically in the final quarter of last year, as goods producers moved aggressively to cut unwanted inventories and production. This led, in turn, to a dramatic slump in trade flows and in commodity prices. And although the most recent business surveys contain hints that the downturn in global manufacturing may have passed its most intense point, the pace of job-shedding appears to have picked up substantially since the turn of the year. This will add to the downward pressure on household spending already stemming from falling asset prices.

Financial crises such as that which began in mid-2007 are typically associated with 'profound declines in output and employment'¹. Thus, despite substantial reductions in official interest rates (in many cases to record lows), other wide-ranging steps by central banks to provide additional support to financial markets, and the prospect of significant fiscal measures to support growth, the downturn in the global economy is likely to continue at least through the first half of the year. And the subsequent recovery, when it eventually begins, will be hesitant and vulnerable to setbacks. Thus we expect global growth to average a well below trend 3¼% in 2010.

The global financial crisis is not over yet

In some respects, financial markets have reacted with surprising equanimity to the relentless tide of grim economic news in recent months. In particular, equity markets have, for the most part, remained above the lows set on 20 November last year (Australia has been an exception). This suggests that a considerable amount of bad news has already been 'priced in' by investors.

¹ A brief but comprehensive summary of the consequences of financial crises in advanced and emerging economies is provided by Carmen M. Reinhart and Kenneth S. Rogoff, 'The Aftermath of Financial Crises', Paper presented to the American Economic Association, 3 January 2009, available at <http://www.economics.harvard.edu/faculty/rogoff/files/Aftermath.pdf>.

Additionally, the spread between Libor rates (the rates which banks pay for short-term borrowings in wholesale markets) and market expectations of official cash rates have continued to narrow, even in the face of renewed concerns about the health of American and British banks.

However, it would be premature to conclude that the global financial crisis is now 'over', or even that the end is in sight. Rather, a more realistic assessment is that it has moved into a new phase.

The IMF has recently raised its estimate of the total losses which will eventually be incurred on US-originated assets by banks and other financial institutions from \$US1,400bn last October to \$US2,200bn². This compares with losses announced to date totalling just over US\$1,000 bn. Nearly all of these losses have been on mortgages or mortgage-backed securities. However, most of the upward revision to the estimate of likely total losses comes from expected losses on corporate and commercial real estate securities, and from bank loans to businesses, as a result of the deteriorating economic outlook.

Government guarantees of banks' wholesale borrowings appear to have staved off the *liquidity* crisis which brought the global banking system to the brink of collapse in the aftermath of the failure of Lehman Brothers in September last year, although the premium over official cash rates being paid by banks for wholesale funds remains high by pre-July 2007 standards. And the assortment of special facilities spawned by the US Federal Reserve has induced a resumption of activity in some of the debt securities markets (notably that for short-term commercial paper).

However it is becoming increasingly clear that the *ad hoc* injections of government capital into banks (thus far amounting to US\$380bn out of a total of US\$826bn in new capital raised since July 2007) have not been sufficient to allay doubts about the *solvency* of many banks.

American and European banks themselves clearly remain uncertain about the adequacy of their capital, as evidenced by their continued accumulation of cash in their accounts at central banks in preference to extending credit to businesses and households. If the IMF's estimates of the eventual total of write-downs on loans and securities is correct, banks will need to raise as much new capital again as they have done since July 2007.

Yet banks are unlikely to be able to raise anywhere near this amount from investors who are even more uncertain than current bank managements about the true state of bank balance sheets.

² IMF, *Global Financial Stability Report Market Update*, 28 January 2009; available at <http://www.imf.org/external/pubs/ft/fmu/eng/2009/01/pdf/0109.pdf>.

The financial crisis will not be 'over' until confidence (on the part of both bank executives and financial markets more broadly) in the solvency of banks has been restored.

Hence the seeming inevitability of further large calls on US and European taxpayers' funds, either for fresh capital injections into banks, or to establish agencies (so-called 'bad banks') to absorb impaired (or 'toxic') assets (as has been done in the aftermath of banking crises in many countries in the past).

This is no ordinary recession ...

The term 'recession' was coined in the aftermath of World War II as a way of describing the downturns in business activity that would inevitably result from periodic attempts to contain inflationary pressures (usually through monetary policy) in the context of a longer-term commitment to maintain full employment, without re-awakening the fears of a return to the 'Great Depression' which haunted the generation who lived through it.

The word 'depression' was then reserved for history, and has since generally taken on the sense of describing a recession of unusual depth or length, of which there have been few if any instances in the Western world at least since the 1930s.

However the difference between a 'recession' and a 'depression' is not one of degree or duration. Rather, what distinguishes a depression from a recession are its causes and its consequences. Before World War II, depressions typically resulted from boom-bust cycles in asset prices and bank failures (or from non-economic causes such as wars, natural disasters or major population outflows). And they were characterized not only by shrinking economic activity but also by deflation – that is, persistent across-the-board declines in the general level of prices.

This appears to be a more accurate description of the forces now shaping the trajectory of the global economy than those which have shaped the typical post-war recession. There is no doubting the role played by falling asset prices and bank failures in bringing on the present downturn. And there is an increasing risk of deflation, especially in those countries whose currencies have appreciated during the financial crisis.

... and so extra-ordinary policies are needed

A depression does not have to be 'great' in order to be a depression. The Great Depression of the 1930s was so severe because governments and central banks were slow to respond to the forces which brought it on, and instead initially compounded them by raising interest rates and taxes, cutting government spending and increasing barriers to trade.

It would be a mistake to believe that the responses to a typical post-war recession will be sufficient to deal with the current episode.

In an environment of very low inflation (or even deflation), when the 'spreads' between official interest rates and the interest rates actually paid by borrowers are unusually wide, and when households and businesses are seeking to reduce leverage, record low interest rates are likely to prove relatively ineffective by themselves in reviving economic activity. Central banks will thus need to continue to use other, less conventional methods to support economic activity, including expanding their own balance sheets to by-pass impaired financial systems.

And in an environment where the effectiveness of monetary policy is likely to be thus constrained, fiscal policy must, of necessity, play a much greater role in supporting and reviving economic activity than has been customary in recent decades. Most industrialized economies will incur large budget deficits in 2009 and for some years thereafter, as the result of conscious decisions to increase government spending or to cut taxes, as well as due to the operation of so-called 'automatic stabilizers'; and government indebtedness will rise, in some cases sharply.

Although contrary to the prevailing conventional wisdom of the past three decades, these policy responses are, in general, appropriate for the highly unusual circumstances in which most governments and central banks now find themselves.

Eventually, governments and central banks will need to determine when, and how quickly, to unwind these measures, lest they end up resulting in undesirably high inflation or new sources of persistent imbalances. But such concerns should not be used as an excuse for inaction now.

Australia is not immune

Australia's economy showed considerable resilience in the face of the global downturn during 2008, partly because its banking system and housing markets showed few of the stresses which have been so prominent in the US and Europe, and partly because of the income gains which continued to accrue from earlier sharp increases in commodity prices.

However the abrupt decline in commodity prices since last July, the sharp fall in household wealth and its impact on household borrowing and spending, tightening in the availability of credit and the lagged effects of the steep downturn in the global economy, seem likely to induce a recession in Australia this year. There is less risk of deflation in Australia than in many other countries, in part because of the large fall in the A\$. Like their counterparts overseas, Australian policy-makers will need to act boldly.

Australian Economic Outlook

Katie Dean and Warren Hogan

- Australia will fall into a mild recession in 2009.
- Adjustment in the resources sector and the labour market remain key downside risks.
- The RBA is likely to cut its cash rate to below 3%. The government budget looks set to fall into substantial deficit for the foreseeable future.

The worst lies ahead

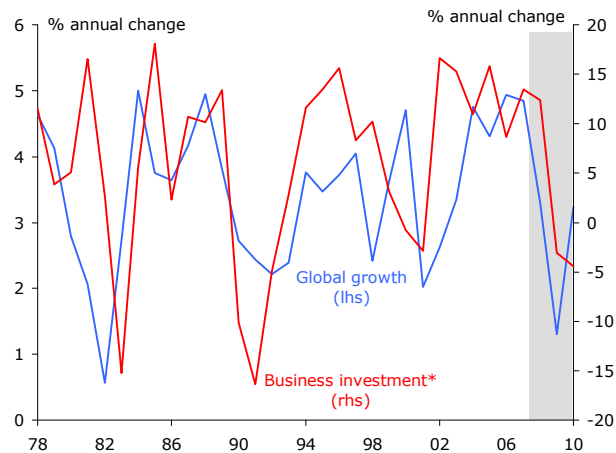
The flow of new information continues to put downward pressure on our forecasts for economic growth in Australia. We now expect Australia will experience a mild recession in 2009. This will entail consecutive quarters of negative growth in real GDP, a full year contraction in real domestic incomes and 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 and exports.

Although Australia ended 2008 on a better footing than most other economies, the worst lies ahead. The greatest damage will be wrought by the end of the commodity boom. Global commodity prices have now fallen 54% from the mid-2008 peak. But the biggest impact to Australian export earnings will not come until 2009-10, when the new contract prices for Australia's bulk coal and iron ore commodities (25% of total exports) are in place. Negotiations are currently underway for these contract prices and we anticipate price declines of around 50% to be agreed for iron ore, coking and thermal coal. Such sharply lower prices, which will apply from Apr-09 to Mar-10, will have deep ramifications across the broad economy. They will drive a significant reversal in the terms of trade, which are now expected to fall by around 15% over the coming year. We expect this will cause double-digit declines in aggregate mining profits and a sharp turn in national income growth. Having peaked at 6.4% YoY in Q3 2008, real gross domestic income is now expected to *decline* by around 3% by end-2009.

The end of the resources boom will significantly impact exports, investment and employment. Surveyed investment intentions remained strong throughout 2008, pointing to 12% investment growth in 2009 even after applying historically low realisation ratios. However this was overwhelming centred in mining. At least some of these planned mining investment projects will be deferred and in some cases cancelled. This is in response to not only the deteriorating demand outlook but also tighter financing conditions. These two factors are also likely to significantly impact investment plans across the non-mining sector. Just as it has in each previous global recession over the last 40 years, aggregate business investment in Australia is likely to decline in 2009. We expect this contraction will

deepen as 2009 progresses, as few new projects commence as existing projects are completed.

Business investment will decline with global growth



Sources: Australian Bureau of Statistics, ANZ, *Ex second-hand asset sales

Having returned to surplus in late 2008, Australia's trade balance is set to fall back into deficit this year, not only as export prices fall but as export volumes also decline. Falling global demand has already served the resource sector an almighty shock with export volumes of iron ore and coal plunging by 24% and 15% respectively in November. We now anticipate resource export volumes to fall by a further 10% in the coming year. This will cause total exports to fall by at least 3% in 2009, the biggest decline since 1983. Unfortunately, as recent local mine closures highlight, there are still downside risks to this sombre view.

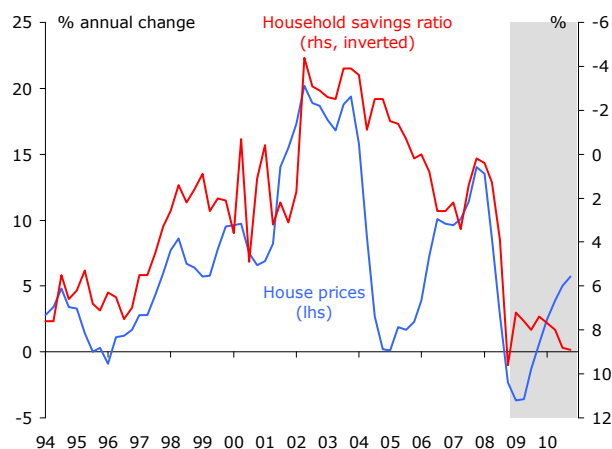
It's a household story too

As well as the end of the commodity boom, the downturn in the Australian economy is being driven by household balance sheet adjustment. Australian household net worth appears to have fallen by nearly 10% over 2008. This is the biggest decline in household wealth in our 20-year history of the series and was largely driven by the 43% decline in the Australian share market. This sharp fall in household wealth, a rising unemployment rate and heightened uncertainty over job prospects and possible further falls in asset prices, are together likely to swamp the positive impact to households from lower interest rates and fiscal stimulus.

The balance sheet adjustment is predictable in these circumstances, with households increasing their savings and cutting back their borrowings. Personal credit growth is now declining in yearly terms, slowing to a 26-year low of -3.3% by end-2008. Mortgage equity withdrawal (borrowing against the value of a house to fund expenditure) has been reversed as households seek to reduce rather than take on additional debt. Unsurprisingly, the household savings rate has already turned sharply positive and is likely to remain high for some time. This process will crimp consumer spending above and beyond what 'normal' factors (slowing income growth as unemployment rises) would suggest. It

also reduces the sensitivity of household spending to lower interest rates. We expect these factors will cap household consumption growth at below trend rates not just for 2009 but also for much of 2010.

House prices a key risk for households



Sources: Australian Bureau of Statistics, ANZ

A significant downside risk to the household sector is the housing market and in particular house prices. New housing investment will contract this year with heightened uncertainty and tighter financing conditions severely affecting building approvals towards the end of 2008. Yet despite these factors, Australian house prices have remained relatively resilient. While some further modest price falls are likely, we maintain that Australia looks well-placed to avoid a US-style house price collapse.

Aggressive RBA rate cuts have significantly improved housing affordability and should see the household debt service ratio almost halve from 14% in mid-2008 to around 7% by late-2009. Moreover, mortgage default rates remain well below 1.0% and the number of 'forced sellers' remains low. Indeed, housing finance approvals have improved in recent months, buoyed in part by the increase in the first home owners' grant. With Australia's housing shortage set to be exacerbated by a fall in new residential building activity in 2009, an extended period of low interest rates could well prompt a solid recovery in housing investment, and a stabilisation of house prices, in 2010. The main risk to this relatively benign view however is the labour market.

Unemployment will rise, but how far?

A slower economy saw the unemployment rate rise gradually from 3.9% to 4.5% over 2008. As the economy contracts, the unemployment rate will rise more quickly from here, to reach around 6% at the end of 2009 and peak at around 7% in 2010. While substantial, a peak to trough rise of just over 3ppts in the unemployment rate 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 they were in past recessions. What we are not expecting is widespread business failure – a key driver of surging unemployment in past cycles.

Nevertheless, the industry composition of the labour market highlights the risk that unemployment could rise more quickly than we anticipate. While mining accounts for under 2% of total jobs, more than 50% of Australian workers are employed in retail, property and business services, manufacturing and construction. After mining, these sectors are the most cyclical and vulnerable to the worsening economic downturn. Poor labour productivity growth in recent years also leaves the workforce vulnerable to deep cuts as output slows further.

Disinflation, not deflation

As expected, slower demand and asset price depreciation has seen Australian inflationary pressures dissipate. Lower petrol prices and discounting saw headline inflation ease to 3.7% YoY in the December quarter 2008. Underlying inflation eased to 4.4% YoY. Going forward it seems likely that the dampening impact on prices from weaker demand conditions will more than outweigh the upward pressure from a weaker A\$. We now expect underlying inflation to return to within the RBA's 2-3% target band by the end of 2009.

The return of the deficit

As growth continues to slow, further aggressive policy action is assured. We now expect the RBA will cut its official cash rate to a fresh all-time low of 2.5% in 2009. A continued pro-active approach from the government, including a bring-forward of income tax cuts and further measures to try and protect jobs and spur investment, also looks highly likely. A counter-cyclical fiscal response is entirely appropriate given the counter-factual; the risk of a protracted recession. But this likely substantial increase in government spending will put further strain on government finances that are already being hit from a significant cut to resource company tax revenues. The past three recessions have seen a peak to trough deterioration in the Budget position of between 3.5% and 5.5% of GDP. If this normal cyclical pattern is observed in the current downturn, then the Budget could be expected to deteriorate from a peak surplus of around 1.7% of GDP in 2007/08 to a deficit of around 2.5% to 3% of GDP within a few years. This implies that the Government will be running deficits of around \$30bn or more beyond 2009/10.

We expect an aggressive policy approach will sow the seeds of eventual recovery. However, the factors dragging growth lower – the end of the resource boom and household balance sheet adjustment – will take time to play out through the economy, dragging on growth in 2009 and 2010. Hence, while the depth of the impending recession may be less than in the early 1990s, the duration may well be longer.

New Zealand Outlook

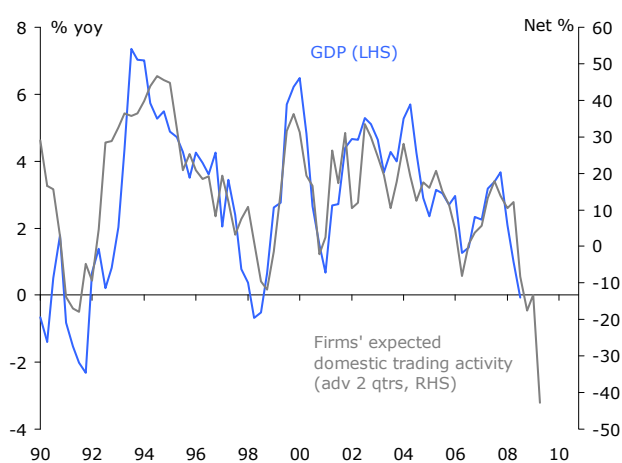
Philip Borkin

The NZ economy is yet to find a base

The economic picture is deteriorating. Business confidence surveys are either at, or near, historical lows. Consumer sentiment is also very subdued despite falling mortgage rates, tax cuts and lower petrol prices. It is now likely that the recession, which began in the March 2008 quarter, will extend for five, possibly six, quarters as the full impact of recent financial market turbulence is felt. The last time NZ experienced such a string of negative quarters was during the oil shock of the 1970s.

What started in sectors aligned to the housing market has now broadened to encompass most pockets of the economy. The initial impact of the global credit crisis was through the cost and availability of credit. While this dynamic is still having a significant influence, it is now the impact on export demand and commodity prices, as NZ's trading partners slow considerably, that is becoming increasingly apparent. The NZ economy appears to be headed for the weakest period of economic growth for over thirty years.

The economy is yet to find a trough



Sources: NZ Institute of Economic Research, Statistics NZ, ANZ

We need to appreciate this is a cyclical downturn in combination with a structural adjustment

NZ's external position is poor. The current account deficit sits at 8.6% of GDP, and we see a real risk that it breaches 9% this year. This is one of the highest deficits in the developed world. Years of running these deficits have left NZ with a large stock of net foreign liabilities, which is currently just below 90% of GDP. Even prior to current global malaise, the unbalanced nature of growth always meant that the NZ economy was set for an "adjustment" at some stage. These adjustments typically result in a fall in the currency to stimulate the export sector (and discourage imports) and a substantial contraction in the domestic economy. Both legs of this adjustment have begun.

We tend to think about the magnitude of any required current account adjustment as being sufficient to stabilise the ratio of net foreign liabilities to GDP (requiring a current account deficit around 4-5% of GDP). However, given the current global environment, which is essentially a process of de-leveraging and a return to more traditional fundamentals, we wonder if merely stabilising the external position will be sufficient. The threat of a credit rating downgrade, with Standard & Poor's revising NZ's foreign currency rating outlook to negative, and the fact that international investors are literally spoilt for choice at present, may mean that the external deficit (both the flow and the stock) not only has to stabilise, but has to improve. This will require an even larger current account deficit correction and ultimately a bigger domestic economic "adjustment".

On top of this is the fact that the global backdrop, (which involves weak export demand and falling commodity prices) will only delay the rebalancing from the spending to the earning sectors the economy requires. It is unlikely that a de-leveraging domestic economy (which continues to centre on households as they face falling house prices, high debt levels and rising unemployment) will be able to fill the tradable sector void, leaving the economy lacking any "growth engines" over 2009.

The labour market represents the next leg of vulnerability

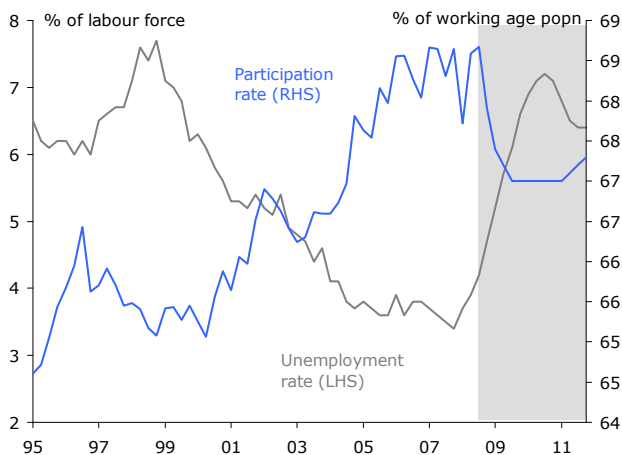
The current economic slowdown is unusual in the sense it was driven by the household sector (along with the impact of drought conditions, high petrol and food prices, and the lagged effects of previous monetary policy tightening). While the economy retreated over the first nine months of 2008, employment growth was flat, with firms continuing to hoard labour in the hope that economic conditions improved. This strategy is now not tenable given cost and demand pressures on businesses and it is becoming increasingly clear that the labour market is turning rapidly.

There has been significant concentration risk within employment over the past five years, with two thirds of all new jobs accounted for by construction, retailing and business services. These are now the sectors at the forefront of the economic slowdown as households de-leverage and housing market activity remains very weak. Recent business intention surveys have shown one third of businesses intend to reduce staff over the next three months.

This suggests the unemployment rate is set to rise rapidly over coming months and we expect it to head over 7 percent. This represents the next leg of vulnerability for the domestic economy. It must be remembered that the housing market and retail sectors were weak before the labour market turned. The risk is now that a rapid deterioration in the job

market and much smaller wage increases over the coming year, along with potentially tighter credit conditions and falling house prices, set off some non-linear type dynamics and second-round effects for the domestic economy. This will compound the period of consolidation households have already embarked on and likely result in another leg of weakness for the housing market.

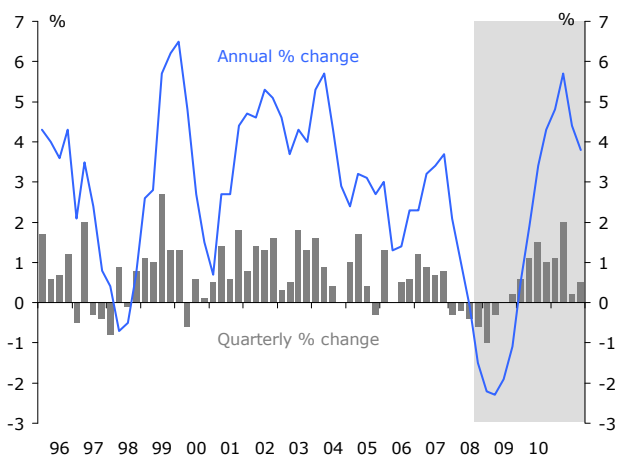
The labour market is turning rapidly



Sources: Statistics New Zealand, ANZ

Taking these factors together, we expect the NZ economy to contract by close to 2 percent over 2009. This magnitude of weakness surpasses the 1990/91 recession. Sectors linked to the housing market will remain weak, with residential investment falling 23.1% and private consumption falling 0.6%. However, rural regions are also expected to weaken on the back of lower commodity prices and an expected correction in land prices. The export sector will eventually lead the economic recovery. However, this is likely to be a 2010 story given the dampening influence weak trading partner growth will have over 2009.

New Zealand economic growth forecasts (GDP)



Sources: ANZ National, Statistics NZ

A sharp recovery is likely from mid-2010

History typically tells us that the deeper the cycle, the sharper the subsequent bounce. In terms of the alphabet of recoveries, we'd class this economic cycle as a "big U". In other words, a deep and

prolonged slowdown as imbalances are purged and structural issues are corrected, followed by a sharp recovery. Not only will a natural base effect take hold, with population growth of 1% per year, but financial conditions have loosened markedly. We are also noticing some areas where pent-up demand could develop, such as in residential construction where current building consent issuance is running below natural population growth and the depreciation on the existing stock – an indication of a potential future housing shortage. In addition, with the Rugby World Cup being held in NZ in 2011, preparations in the lead-up for the event will further add to activity. For sure, we are still eyeing pent-up demand dynamics within the scheme of the current account rebalancing process. But we cannot ignore the former completely.

Key financial market views

Despite the aggressive policy response from RBNZ already to date, with cumulative interest rate cuts of 475bps, monetary policy still has more work to do. The very nature of this global credit event has diluted the monetary policy transmission mechanism, meaning the onus has fallen on central banks to do more. There is also the fact that while fiscal policy does, and will continue to have, a role to play, it is being somewhat constrained by the desire to avoid a credit rating downgrade. Following the 150bp cut from the RBNZ this week, we see the Official Cash Rate (OCR) being lowered by 75bps in March and a further 25bp cut in April to a terminal rate of 2.50%.

Given the deteriorating economic picture, a move in the OCR to 2 percent cannot be ruled out, though this will be dependent on how the global environment evolves and whether the NZ economy is adequately responding to the stimulus imparted to date. Certainly, the historical experience has been that NZ rates end up 1% above the average across our trading partners during downturns. Looking across Europe, Australia, the UK, Japan and the US, 1% seems the prime number, which gives an endpoint of 2% in NZ. While the RBNZ will want to reserve some monetary policy "ammunition" for the "what if" scenario, we would not underestimate the capacity or necessity of looking at non-OCR measures to support the economy.

The dynamics of a current account deficit adjustment weigh heavily on our medium-term view for the NZ\$. Like a significant slowdown in domestic demand, a lower currency is an inevitable part of the rebalancing process for the NZ economy. We see the NZ\$ heading towards 40 cents against the US\$ and for the NZ\$/JPY to head into the 40s. Given the starting position for the external balance, we expect the NZ\$ to remain at a low level for an extended period. Our anchor to our currency forecasts centres on macro or external balance notions of currency equilibrium. This is flagging fair value for the NZ\$ against the US\$ around 52 cents.

Emerging Asia Outlook

Paul Gruenwald, Tamara Henderson, Chang Wei Liang and Ivy Tan

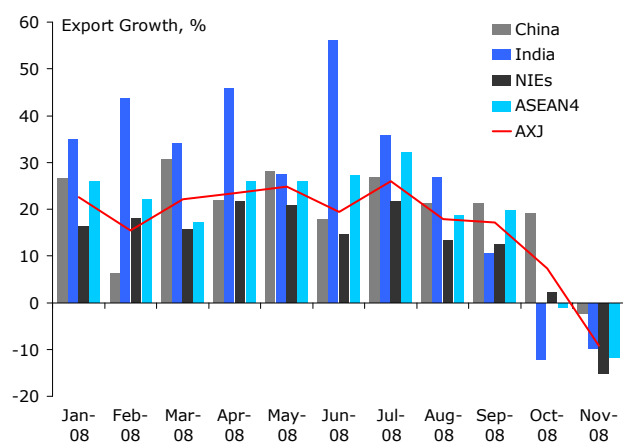
- Exports have collapsed, and GDP growth in Q4 appears to have fallen sharply as the global slowdown hit the region with full force.
- Asia is “flying solo” in 2009 as foreign demand has evaporated – it will not be a good year for the region; China looks unable to save the day.
- Rates markets will remain supported by expectations of further rate cuts, while risk aversion will keep AXJ currencies (AXJ - Asia ex-Japan exchange rate index) under pressure in the first half of 2009.

Developed economy recession hits Asia

Export growth has plummeted across emerging Asia as the recession in the advanced economies hit the region with full force. As late as September 2008, shipments from Asia were running at 17% YoY on average, with healthy growth across most economies. The subsequent collapse of exports was steep and sudden, and current data show that export growth has turned negative in each of the eleven economies we follow.

The damage has been particularly bad in the NIEs (Newly Industrialised Economies - Hong Kong, Korea, Singapore, and Taiwan) with Taiwan's exports down by a staggering 42% in December. Importantly, import growth has also collapsed across the region (trade balances in a number of economies have actually improved) owing to declining commodity prices and a slowdown in domestic demand. As of this writing, the evolution of real net exports - a key component of GDP - remains unclear.

Asian exports begin to contract



Sources: CEIC, Bloomberg

Preliminary evidence shows that GDP growth took a big hit in Q4 as well. Activity in Korea and Singapore fell at double-digit annualized rates as consumption and investment in both economies collapsed. China's growth slowed markedly to 6.8% YoY in Q4

from 9.0% in Q3, implying that growth in Q4 was close to zero. Our empirical work shows that the net export contribution to growth was a key variable in explaining the slowdown between Q1 and Q3 of last year, and we expect this to have continued into Q4. Given that net exports were a larger contributor to growth in the NIEs than the ASEAN countries and India, we expect our “Asian split” story to remain intact (China is an intermediate case).

Is the worst over for the NIEs?

What does this mean for the region in 2009? We can safely assume that foreign demand will be absent for most if not all of the year, implying that any growth for emerging Asia will have to come from within. As we have seen so far, those countries with little or no domestic demand momentum going into the slowdown, the NIEs, have seen their GDP growth go flat or negative. But will this pattern continue? Actually, we think not since a number of factors favouring the NIEs will serve to narrow the growth gaps we have seen open up over the past few quarters.

Commodity prices. Northeast Asia is resource poor, so lower prices (which tend to get passed through to end-users quicker in this part of Asia since there are fewer subsidies) will help boost firm and household balance sheets. In contrast, Southeast Asia is “long” on commodities so, on balance, incomes and spending power will be negatively affected.

Fiscal space. Public sector balance sheets are stronger in the NIEs (and China) meaning that governments have more capacity to stimulate demand to help manage, though not reverse, the slowdown. To date, these have been appropriately focused on infrastructure spending and targeted tax cuts - measures to help “force feed” the economy.

Political risk. ASEAN countries and India face more political risk this year than the NIEs. Uncertainties still haunt Thailand; Malaysia has a Prime Ministerial succession in March; Indonesia has elections in June; and the Philippines' political season is likely to get going with elections next year. While political risk levels are lower for this part of the region than in the recent past, they are still likely to weigh somewhat on activity.

China is unlikely to rescue the region in 2009. First, growth is clearly slowing and while the headline year-on-year measure remains close to 7%, we suspect that growth momentum is currently close to zero. Second, assuming that China's planned fiscal stimulus is at least partially successful in restoring growth, the physical demand for much of the infrastructure and construction projects is likely to be sourced domestically. Third, and perhaps most importantly, China is not a large end-user of Asian exports. Once we take into account that many exports to China from elsewhere in Asia are part of

the processing trade, China's "pure" demand for exports from the rest of the region looks modest.

Asian banks will also face a tougher year in 2009 than 2008. While banks in the region were able for the most part to avoid toxic assets, a decline in credit quality this year owing to sharply lower GDP growth will not be as escapable. We see the possibility of a significant drop in earnings in banks exposed to the weakest performing economies or sectors (e.g. property). That being said, low loan-to-deposit ratios across Asia suggest that when the upturn does arrive, banks will be in a position to supply credit. Corporate balance sheets are in reasonably in good shape and should not be an impediment to growth once the cycle turns.

2009: Not a year to remember

The crisis started elsewhere and the region will have to wait for the advanced economies and their banking systems to heal before the recovery begins. In the interim, the best response of the region is to loosen macroeconomic policy settings as aggressively as possible, consistent with credibility and sustainability. Of note, there has been little or no discussion of protectionist measures to "combat" the sharp trade slowdown.

In terms of forecasts, for the year as a whole, GDP growth looks set to drop to 6½ to 7% in China, 5½ to 6% in India, -2 to -3% in the NIEs and 2 to 4% in the ASEAN. While the worst of the financial crisis has passed, we still see the risks as being on the downside since the only demand component holding up growth in the region is consumption. Therefore, should the Asian consumer "roll" (particularly outside of the NIEs and especially in China) we could see significantly lower growth rates.

The good news for emerging Asia is that the region will be one of the first to exit the global recession. This is particularly true for Northeast Asia given the production there of discretionary, "income-elastic" goods such as high-end electronics. We would look for the first signs of life in the export and production orders data of Taiwan, Korea and China. However, this development depends on the recovery of consumer demand in the U.S. and Europe. There are no guarantees this will take place in 2009.

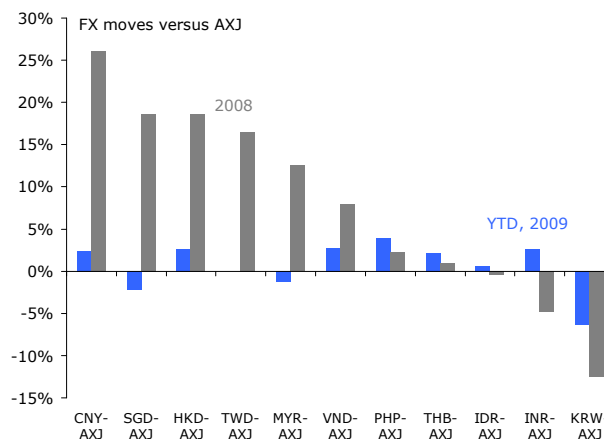
Asian Markets

As long as the trough in the global downturn remains elusive and market volatility remains elevated, AXJ currencies will remain under pressure and rates markets will remain supported. Although the uptrends in US\$-AXJ and rates markets should remain intact in the first part of the year, the pace of gains will likely slow as monetary and fiscal support measures put in place at the end of last year start to feed through to the domestic economy.

In 2008, the currencies of countries with current account deficits or small surpluses — Korea, India, Indonesia, the Philippines and Thailand — led

emerging Asia lower versus the US dollar. In 2009, we expect the currencies of countries with massive export exposure – Malaysia, Singapore and Taiwan – to play "catch-up" and under-perform within AXJ.

AXJ Performance: What CNY Manipulation?



Sources: Bloomberg, ANZ

Meanwhile, the weak outturn for Chinese GDP growth in Q4 is sure to reinvigorate market speculation that the authorities there will allow the renminbi to weaken against the US dollar in support of exports. However, we continue to believe that the Chinese authorities prefer to reap the long-term political gains from currency stability, especially since economic gains from a devaluation would be short-lived at best.

Unlike the US Federal Reserve, many central banks in emerging Asia still have plenty of scope to cut official interest rates in support of domestic demand. The prospect of further easing, along with continued risk aversion, should keep rates markets supported in emerging Asia in the first part of 2009. The countries with the most monetary policy "space" are China, India, Indonesia, the Philippines and Vietnam - all with over 500 basis points of potential ammunition. Of these, Indonesian rates would seem to offer the greatest potential for out-performance in the region this year. Bank Indonesia has only just started to ease monetary policy, and the government has surplus funding from 2008 covering most of the 2009 budget, which caps concerns about supply.

International & FX Outlook

Amy Auster

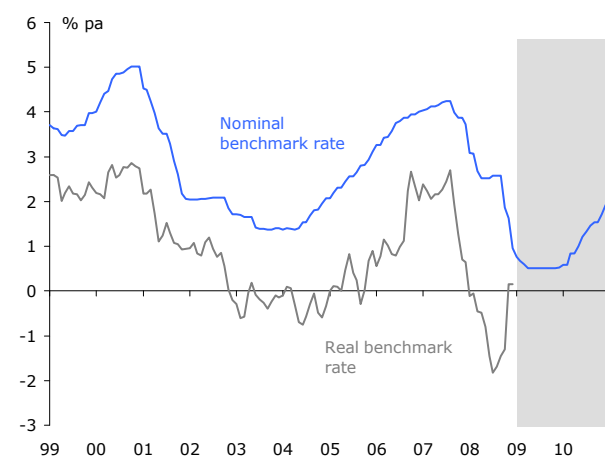
Short term interest rates fall to near zero...

The global financial crisis has turned the world on its head in more ways than one. Rules of thumb are gone, and the old formulas no longer apply. For currency markets, 2009 is a different game indeed. The dominating force in foreign exchange markets is the theory of interest rate parity, or the idea that the value of a domestic currency depends upon the interest rate advantage (disadvantage) that it holds over another, foreign currency.

The attraction of higher interest rates – a yield advantage – is particularly important for the Australian and New Zealand dollars, both of which tend to offer some of the highest interest rates in the developed world.

So what happens in this new world, when a yield advantage fails to exist? The interest rates attached to the major global currencies are approaching or have already reached zero as central banks respond to the rapid global downturn. As of December, the US Federal Reserve has switched its previous Fed funds rate to a *target range* of 0.0-0.25%. The Bank of Japan has cut its discount rate to 0.10%. The Bank of England has cut its repo rate to 1.5%, with expectations of cuts to 0.75% down the track; similarly, the European Central Bank is expected to cut its refi rate from 2% to present to 1.25%.

Index of G7 interest benchmark rate



Sources: Source: Datastream, Bloomberg, ANZ

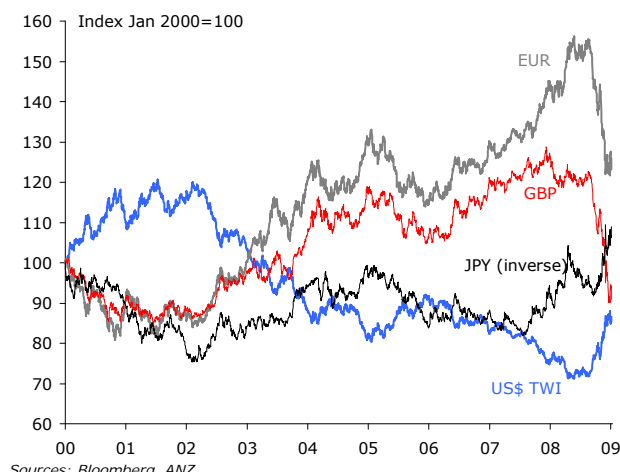
These aggressive cuts to interest rates have taken our index for the combined interest rate of the G7 from a recent peak of 4.24% in mid-2007 to just 0.95% as of December. Our forecast is for the combined rate to fall further due to European rate cuts, to a low of just 0.51% for the second half of 2009. Interestingly, despite the sharp fall in nominal rates, real (inflation-adjusted) interest rates became positive in November due to the very sharp decline in headline inflation caused by falling oil prices – an indicator of how quickly global demand is declining.

Casting currency markets adrift

For much of 2008, the currency markets responded to falling interest rate expectations in the United States by selling US dollars. This makes intuitive and theoretical sense, as the yield advantage of the US dollar was falling quickly. The US dollar trade-weighted index reached an historic low of 71.3 in April 2008, a fall of 41% from its mid-2005 high. In the second half of the year, this trend reversed as central banks outside the US started to cut interest rates. The US dollar recovered some ground and has been trading between 80-85 since the start of 2009 – above its recent lows, but still well below its 2005 as well as its long-term average of 100.

Now that it is clear that there will be little practical yield differential amongst the G7 economies this year, however, currency markets have lost their old sense of order. The UK pound has fallen well out of favour, plunging in January to its 2001 low of below GBP/USD1.40, for a decline of 32% since its March 2008 peak. The euro has held relatively firm, falling only 17% against the US dollar since its April 2008 peak and bringing about the previously unthinkable thought that the euro may reach parity with the pound. Stranger still are the fortunes of the yen, which has strengthened by 20% against the US dollar since its August 2008 low. Looking across all three major currencies against the US dollar, currency performance has shown an inverse relationship to yield – eg, the yen, which offers the worst yield relative to the US, has fared the best.

Evolution of major exchange rates



Sources: Bloomberg, ANZ

Data on positioning in the FX markets confirm that traders still hold a big net long position in the yen, and a big net short position in the pound. The positions in both the euro and the US TWI are flat. The data also confirm that the market has not much interest in the little additional yield still on offer for the AUD and NZD; the net position for the Antipodean currency pairs is a small short³

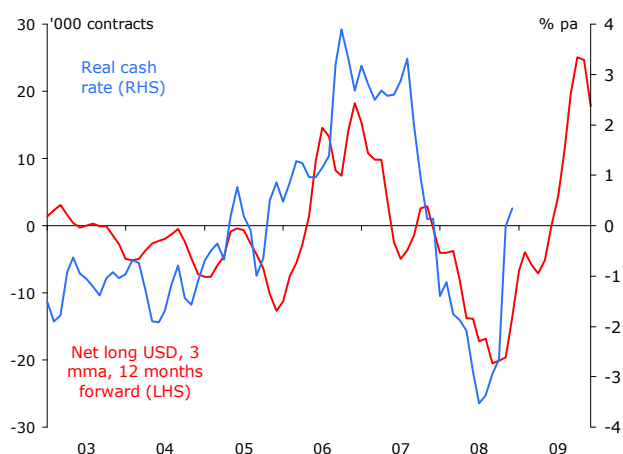
³ "International Money Market" data series shows the net long position in the futures contracts of currency pairs, as published by the Commodity Futures Trading Commission in the US.

Direction coming from real cash rates

So what is driving the market to favour the low-yielding yen over the US dollar, and euro over the pound? The answer seems to lie in real interest rates, or the return offered by interest rates less inflation. Although the nominal yield offered by the Bank of Japan at 0.10% is slightly lower than that of the Federal Reserve, the negative inflation rate in Japan and positive inflation rate in the US means there is less real yield on offer in the US.

The chart below plots the real overnight cash rate in the US and Japan against the IMM net long positions held in the US dollar and yen since 2003. The IMM data is plotted 12 months forward, and highlights how the currency markets provide an excellent clue as to the direction of real yields in both of these economies. Though the charts make it look as though the net long position in the US dollar is much greater than that of the yen, note the difference in scale. The number of net long contracts in JPY outweighs those in the USD by a factor of 4.

Currency moves anticipate real interest rates



Under normal circumstances in which inflation is stable, the shift in real interest rates in the G7 economies comes via a rise/fall in nominal interest rates. A near-zero rate environment is completely different, however. These days, the outlook for real interest rates is driven by expectations for inflation. The higher the expected rate of inflation, the more negative the real cash rate is estimated to be, removing support for the domestic currency relative to other currencies.

Herein lies the secret as to why the market may prefer Japanese yen to US dollars, and euros to pounds. Using headline CPI, we can see that the economy with the highest real cash rate on offer in the G7 is Germany at 1.36%, with France close behind at 1.2%. The real overnight cash rate in the UK has fallen sharply from +0.03% in October to -1.7% in December, corresponding with the collapse of the pound. In the US, a massive fall in headline inflation brought real yields into slightly positive territory in December for the first time in 12 months, while the negative real yield in Japan remained around -0.7%.

For cues, look to yield curves

In light of the relationship between currencies and real cash rates, currency forecasts rely on a view of the nominal cash rate and inflation. Rate forecasts for the next 6-9 months is easy: zero for the Fed and the BOJ, and another 75-100 bps or so of further cuts for the BOE and ECB. With markets already anticipating these moves, the impact on the euro and the pound is likely to be muted.

Inflation is far more difficult to forecast at this point, given the uncertainty over the growth outlook. Consensus forecasts have been revised down, such that the G7 economies are now expected to contract by 1.5% in 2009, or the worst single-year outcome since World War II. Global growth is expected to reach only 1.3% this year, a severe fall from the 5% growth recorded in 2007. However, there is growing divergence in views among forecasters, with some anticipating a recovery by end-2009 in light of very low global interest rates and fiscal stimulus packages that now amount to 4.5% of global GDP.⁴

With such a severe downturn in growth, a period of *disinflation* (or a falling rate of positive inflation) is certain. The annual headline inflation for the G7 has fallen from a peak of 4.4% in August to 1.5% in November, while core inflation has declined from 1.9% to 1.7% over the period. The debate now is whether we will enter a period of *deflation* - or a sustained period of negative annual price changes that lead to a spiral of falling wages and economic stagnation - a la Japan over the past 15 years.

The uncertain outlook for inflation is highlighted by recent fluctuations in yield curves, where long-term yields express inflation expectations. Focusing on the US, the yield curve flattened in mid-2008. More recently, however, the yield curve has been caught in a battle between concerns about increased Treasury issuance to support a rising fiscal deficit (causing yields to rise) as against concerns about deflation and/or the possibility that the US Federal Reserve will buy US Treasuries to reduce long-term interest rates (causing yields to fall). With such an uncertain short-term outlook, these longer-term cues are becoming more important for the market. Should yields fall on Fed purchases, the USD should rally against the yen as the implication is for lower inflation; a rise in yields would most likely have the opposite effect.

Recent shifts in US yield curve

Date	2yr yield	10y yield	Difference
13 Nov 08	1.23	3.85	261 bps
26 Dec 08	0.88	2.13	124 bps
22 Jan 08	0.72	2.59	187 bps

Source: Bloomberg, ANZ

⁴ Calculated on a purchasing power parity basis, and including a forecast US\$800bn fiscal stimulus plan from the new Obama administration.

Global Capital Markets

Warren Hogan, Tony Morriss, Alex Joiner and David Croy

Financial Markets Remain Fragile

Despite some tentative signs of improvement in recent months, global capital markets remain heavily strained by the presence of weakened financial institutions, elevated levels of risk aversion and the global economic downturn. Unfortunately, progress on returning financial markets to a more normal operational state is very slow. In the meantime, the provision of credit within the world's largest economies is almost solely the domain of the banks. Markets for asset-backed securities continue to experience very low levels of turnover and new issuance.

The IMF summarises this central issue in the latest World Economic Outlook, released 29 January 2009:

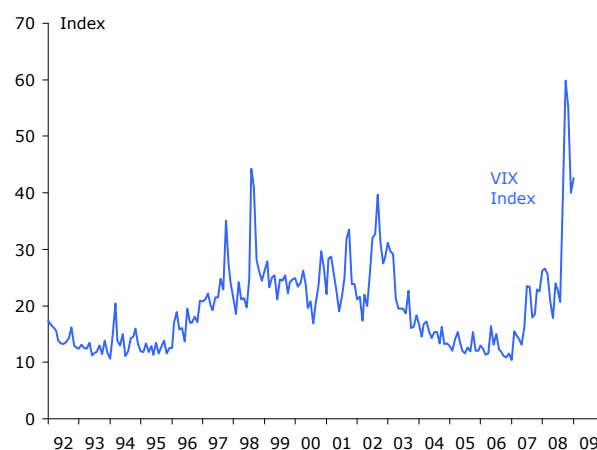
"A sustained economic recovery will not be possible until the financial sector's functionality is restored and credit markets are unclogged. For this purpose, new policy initiatives are needed to produce credible loan loss recognition; sort financial companies according to their medium-run viability; and provide public support to viable institutions by injecting capital and carving out bad assets."

The process of repairing the balance sheets of financial institutions is well advanced across the United States and Europe. Total write-downs are now US\$1.1trn. In the banking sector, new capital injections accelerated over the final months of 2008 as government support for banks in the form of new capital and liability guarantees allowed for more aggressive adjustments. Total new capital into the global banking system (including public money) stands at US\$838bn, above announced write-downs of US\$800bn. Since the end of September 2008 write-downs across global banks have increased by US\$138bn, yet new capital injections have been US\$436bn. The risk of systemic failure across the banking sector is receding as more rapid re-capitalisation allows for more realistic valuations of bank assets.

Financial market volatility remains high by historical standards but has eased from the super high levels seen in October and November last year (see chart below). But the reduction in volatility in recent months should not be mistaken for a normalisation of markets. The VIX index at current levels is high by historical standards, running at around the levels seen during the equity market crash in the US earlier this decade and the Asian crisis in the late 1990s. This suggests to us that risk appetite will remain depressed for some time. In this environment, lower risk asset markets such as government bonds and high grade credit should continue to perform better than equities or property. Given that the underlying world economy will remain soft for much of the year and that

aggressive policy stimulus will only work with a lag, we would not expect a sustained further improvement in risk appetite until late 2009 or even 2010. We doubt risky assets can perform well until the economy bottoms out, thus reducing the risk of business failure and default.

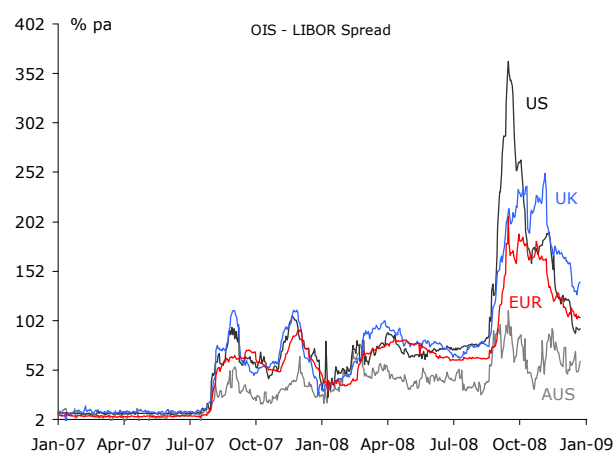
Market volatility has eased but remains high by historical standards



Sources: Bloomberg

On a brighter note there has been a genuine improvement in money market conditions. The OIS-LIBOR spread for the major markets continues to contract, reflecting a greater willingness of banks to lend to one another and a reduced tendency on the part of these institutions to hoard cash. This suggests that the efforts of policymakers to stabilise the banking sector are working. While it does not assure a rapid recovery in lending, the improvement in these markets reduces the probability of even tighter credit conditions.

Money market pressures have eased



Sources: Bloomberg

Global interest rates expected to reach low point over the first half of 2009

Global central banks have acted decisively to meet the challenge of the intense downturn in activity around the world by easing monetary policy significantly. Official policy rates are at zero in the US and Japan and look set to get close in Europe and the UK. In fact, the focus for central bank policy appears to have moved to a range of

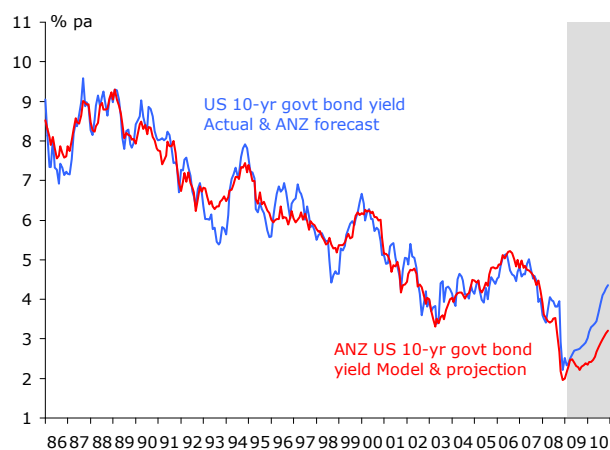
extraordinary measures to support the financial system well beyond the scope of traditional monetary policy such as liquidity injections and the purchase of financial assets to support the banking system and credit creation process.

As policy rates have declined and term yields have fallen yield curves around the world have steepened sharply. Shorter-dated yields have been anchored while long-term rates have not fallen so quickly as the market digests the implications of a sharp rise in bond issuance required to finance increased deficit spending by Governments and the funding of these extraordinary policy measures to support the financial system. The US Government is now expected to borrow up to US\$2.5 trillion this fiscal year to October, up from US\$892bn last fiscal year.

Our model tells us to expect a low point for 10-year US bond yields over the first half of 2009. The model, which successfully models the “conundrum” period of lower than expected US bond yields by taking into account the significant increase in holding of US bonds by foreign entities, suggests the ‘fair value’ for yields will begin to slowly rise throughout 2009 but will not reach 3% until 2010.

The model’s projection for 10-year bond yields remains lower than the ANZ forecast (see chart below). This is because the model makes no assumption regarding changes in the future foreign demand for US treasuries. With fiscal stimulus packages and an ever growing budget deficit in the US the supply of treasuries required for financing is expected to continue to accelerate. However it is unclear if this increase in demand will be met by the traditional large holders of treasuries, China, Japan, UK and OPEC. Potentially soft demand may result in yields climbing faster than economic fundamentals would suggest, which is reflected in the yield forecast.

Bond model suggests a low point for yields in 2009



Sources: Bloomberg, DataStream, ANZ

Government debt guarantees have also become a feature of G10 markets, including Australia’s. Issuance by local banks using the Guarantee is now around \$A40bn and the yield on this debt over

existing Government debt has come down in secondary trading to reflect continued investor demand for yield in current conditions.

Australian interest rate outlook

The RBA has undertaken aggressive rate cuts in recent months as part of the global response to the financial crisis and ensuing economic downturn. Markets expect this process to be extended even further in coming months with official cash rates now expected to head towards 2.0% by mid 2009 compared to a peak of 7.25% last August. The unprecedented easing of policy stands alongside a sharply weaker currency and fiscal stimulus as part of the local policy response to help insulate the local economy from the worst of the global downturn.

It would be premature to expect local cash rates to head towards zero as in the US and Japan. Monetary policy should be more effective here due to the greater proportion of housing loans priced off the cash rate. US mortgage rates have not fallen by nearly as much as local rates despite the severity of the collapse in US housing activity. The RBA can also take some comfort from the speed and extent of the easing in general financial conditions and the fact that the government’s fiscal position starts from a far healthier position compared to the US and other major countries.

It looks increasingly likely that rates will however be kept lower for longer to respond to the scale of current economic challenges, and with Government term-debt issuance set to increase to finance more expansive fiscal policy, yield curves look set to steepen further.

New Zealand interest rate outlook

The two major issues for New Zealand interest rates in 2009 are the speed and extent of monetary policy easing that lies ahead, and the impact of fiscal policy on risk premiums. While the RBNZ has cut rates aggressively and continues to hint at further easing, it has also signalled that it intends to keep some “ammunition in reserve”. It has held this stance for some time now, and as a result, the market has tended to underestimate the size of rate cuts. Indeed, both the December and January cuts were larger than market expectations.

We doubt the RBNZ will disappoint in 2009, and given the abrupt slowing in market expectations for rate cuts beyond the March Monetary Policy Statement, there is scope for more easing to be priced in for April, and possibly June. The other main issue – risk premiums – is likely to come to a head after the Budget in May following S&P’s decision to place NZ on negative outlook, pending a “credible medium-term fiscal plan combined with an easing of New Zealand’s external imbalances”. The Government’s weekly bond tenders have been well received since being implemented earlier this month, but it remains to be seen what appetite investors will have if a credit rating downgrade becomes inevitable.

Commodities Outlook

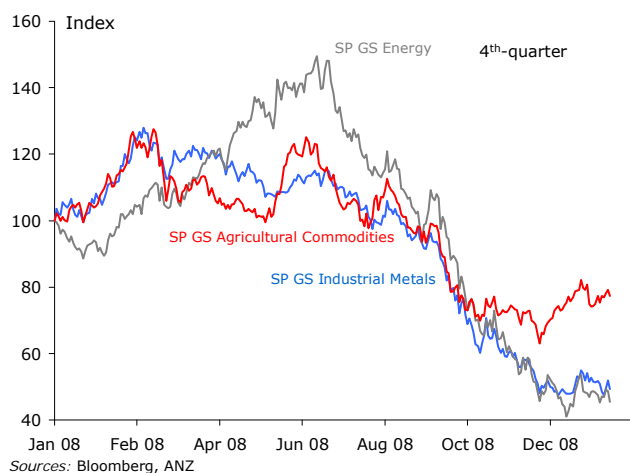
Mark Pervan and Doug Whitehead

It's a soft story

Commodity markets slumped in the fourth quarter of 2008 as the rising global economic crisis and a recovering USD weighed heavily on the growth-orientated asset class. The absence of a demand rebound in China post the Beijing Olympics was a major warning signal as was a series of output cuts by major commodity producers caught out by the sharp drop in end-user demand. Not even an unprecedented synchronised global stimulus program by the world's leading central banks could curb the negative sentiment tide, with many convinced the "Super-Commodity-Cycle" rally of the past six years had passed.

The benchmark S&P GSCI index fell 44% over the period – easily the largest quarterly decline on record. Performances were not even, with the bulk of the selling occurring in the energy and industrial metals sectors. In contrast, fortunes in the agricultural sector (softs and ags) were considerably better, down 12% for the period, with cocoa registering a 5% rise. Yet performances since have been more encouraging, with some commodities staging mild-rebound rallies and others showing signs of bottoming.

Major S&P GSCI Indices



In fact, increased volatility in prices recently highlights a strong appetite to re-enter commodity markets from perceived oversold positions. However, in the absence of positive economic news, we think most of the gains have been bear-rallies or dead-cat-bounces. What we do concede is that price declines in the past quarter were faster and deeper than expected, and that most of the downside risk going forward has now been factored in.

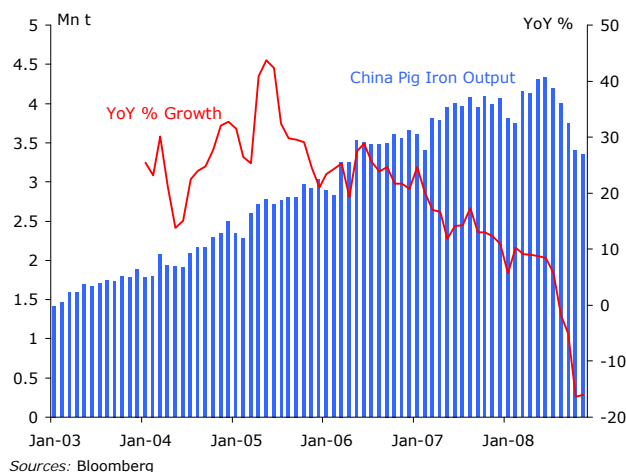
Masking what we think are still poor fundamentals has been start-of-the-year commodity index re-weighting programs, with the indices buying back commodities hardest hit in 2008. The 50% or 351 point recovery in the closely watched Baltic freight index may be contradicting our cautious view – but the gains need to be put in context with the 95% or

11,100 point index drop in the second half of 2008 and the mild easing in credit markets which has restored some liquidity to the previously cash-strapped shipping market, rather than an improvement in fundamentals.

The coming quarter could throw up both positive and negative surprises, but we think on balance commodity markets will move sideways in a choppy fashion. False recovery rallies will create a fair bit of volatility triggered in most cases by the market believing it's finding early signs of stimulus package demand. However, China economic data will remain the key bellwether – and on current trends, is more likely to disappoint rather than please. China's actions post the lunar New Year (through February) will be closely watched – traditionally a strong restocking period could be absent if the run of recent poor growth numbers are any guide.

Performances within commodities will likely remain mixed, with softs and ags continuing to perform better than energy and metals. The less cyclical nature (demand wise) of the agricultural market lends itself to greater influences from supply-side issues – which in the current environment remain tight on most fronts. Oil and metals will continue to be weighed down by poor demand fundamentals, while precious metals should continue to stand-out positively, increasingly being sought for safe-haven purposes and hedging against universally poor looking currency markets.

Chinese Steel output growth has collapsed



Base metals oversold?

Base metals were heavily sold in the past six months and the rapid response by producers to cut production suggests the declines were too sharp too soon. While we agree, we think it's a timing rather than a pricing issue. That is, current price levels are three months ahead of our forecasts, but any recovery is unlikely while fundamentals remain weak. A feature to watch (on the downside) is the increasing level of consumer defaults – particularly by Chinese downstream metal fabricators who sourced input materials (base metals) 12 months prior at much higher prices.

Oil too leveraged to the US

Oil has shown signs of bottoming around the low \$30/bbl mark – and mini-rallies off this level highlight the strong interest to re-enter a fundamentally very positive longer-term market. However, oil's high leverage to US growth (or lack of it) will remain its Achilles heel near term – and prices are likely to test fresh lows in the coming months. OPEC's compliance performance to recent cutbacks will be closely watched and may create some upside appeal if they toe the line - in our view unlikely.

Gold the premium currency play

Gold has been the positive hard metal stand-out of the past six months and will likely continue to be in the next six months. Encouragingly, it's becoming less of a safe-haven play and more of a premium currency play, which lends even more upside appeal. Investors appear to be becoming increasingly weary of backing a sick looking USD at the expense of a deteriorating Euro and Yen. Gold makes for a palatable alternative – and until US economic conditions improve gold could well be the positive surprise story of the next six months.

Bulks set for tough talks

Firming spot iron and coal prices and a recovering Baltic freight market may finally be signalling some positive news for the bulk market. However, we caution against getting too optimistic. Coal markets seasonally pick up at this time of year as cooler weather spurs heating/energy demand - and spot iron demand has probably picked up to the detriment of a much weaker higher-priced contract market. Rio Tinto's 50% decline in Pilbara/Dampier shipments in November highlights the contract market weakness. Steel production cutbacks are also being extended, which should not be ignored. Regardless, it's going to be a tough negotiating season, with consumers looking to claw back some of the massive price hikes over the past 3-4 years.

Agricultural Commodities

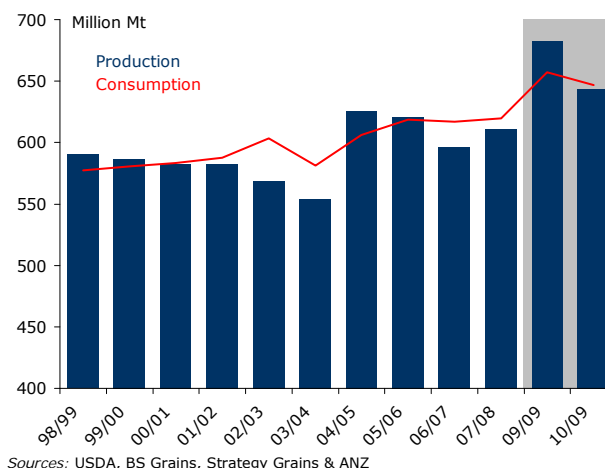
Traditionally, demand for agricultural commodities has been less susceptible to periods of economic downturn than other commodity sectors. While the dynamics of demand have changed, especially for those commodities with a link to energy markets (as biofuel feedstock), food and animal feed consumption remains a relatively inelastic occurrence. However, in the current economic environment, a stable demand outlook will not be sufficient to generate a strong positive price response from the market.

A number of commodities, particularly in softs markets, such as coffee, cocoa and sugar are facing supply/demand deficits in 2009, which in some cases will see a second or even third consecutive year of stock draw-downs. In the grains markets, the situation remains evenly poised, with South American production concerns and Northern

Hemisphere winter crop growing conditions a key determinant as to whether supply will be sufficient to meet current demand needs.

While it is unlikely that prices will reach the unsustainable heights achieved in the first half of 2008, the fund community has returned and while risk aversion and caution remains a prominent feature in financial markets, it appears constructive fundamentals in a number of agricultural commodities has drawn their attention, adding to a more positive scenario.

Global Wheat Supply & Demand



Wheat prices to lead grains in 2009

While the more immediate view for wheat is for range-bound trade. We believe that the wheat market is developing a more bullish longer-term outlook. Black Sea offers are now equal to or even above US, EU, Australian and Canadian offers for like quality, which is likely to place a floor under US futures prices. Attention is also now shifting to the supply outlook for the 2009-10 marketing year, with plantings on a global scale forecast to decline by 5%, while yields are not expected to reach last years bumper levels. With 2009-10 wheat supply potentially falling by 40-45 Mn t, we believe that there is a probable chance that wheat consumption will exceed supply in 2009 and are therefore maintaining a more bullish view on wheat than either corn or new crop soybeans.

Coffee looks the cream of the crop

The global coffee market is expected to experience a significant supply/demand deficit as the world's largest coffee producer, Brazil, enters into the lower production year of a two year production cycle. The Brazilian situation is also likely to be amplified, due to a reduction in farm input applications. Brazilian production could potentially fall by 20%. Coffee consumption as a whole does not deteriorate in a weak economic environment; instead consumers tend to alter consumption habits, which could see the global production shortfall reach 5 Mn t. We see coffee being the strongest performer out of the softs. However, the likes of sugar and cocoa will not be too far behind.

International Economic Growth Forecasts

GDP	2007	2008(f)	2009(f)	2010(f)	2011(f)
US	2.0	1.4	-1.6	1.2	3.2
Japan	2.4	0.1	-1.5	1.0	1.6
Germany	2.6	1.3	-1.6	0.8	1.2
France	2.1	0.8	-1.1	0.8	2.8
Italy	1.4	-0.5	-1.5	0.6	0.6
UK	3.0	0.7	-1.9	0.6	1.9
Canada	2.7	0.6	-0.7	2.0	3.8
G7	2.2	0.9	-1.5	1.4	2.5
Spain	3.7	1.2	-1.5	0.3	2.6
Euro zone	2.6	0.9	-1.2	0.7	1.9
Australia	4.0	2.3	0.1	2.0	3.2
New Zealand	3.2	0.4	-1.9	2.5	4.7
Developed countries	2.4	1.0	-1.4	1.4	2.5
China	11.8	9.1	6.9	8.5	10.0
Korea	5.0	2.7	-2.9	4.0	5.0
Taiwan	5.7	1.3	-1.8	3.9	4.6
Indonesia	6.3	6.0	4.5	5.1	6.4
Thailand	5.0	3.1	1.9	3.9	5.6
Hong Kong	6.4	2.0	-1.8	4.2	4.7
Malaysia	6.3	5.2	2.1	4.2	6.0
Singapore	7.8	1.2	-3.0	3.4	5.6
Philippines	7.1	4.6	1.4	3.9	5.1
Vietnam	8.5	6.4	6.6	7.5	7.0
East Asia excl. Japan & China	6.0	3.5	0.4	4.4	5.6
East Asia excl. Japan	9.5	7.0	4.5	7.0	8.4
India	9.3	7.2	5.3	6.9	8.0
South Asia	8.7	6.7	5.1	6.4	7.6
Eastern Europe	7.2	6.3	3.3	4.3	5.5
Latin America	5.6	4.1	2.4	2.8	4.2
Emerging countries	8.0	6.1	3.9	5.5	7.0
World (PPP)	4.8	3.2	1.0	3.3	4.6

Australian and New Zealand Economic Forecasts

	Annual % change (period average)				Quarterly % change			
	2007	2008(f)	2009(f)	2010(f)	Dec-08(f)	Mar-09(f)	June-09(f)	Sep-09(f)
Australia								
GDP	4.0	2.3	0.1	2.0	0.2	-0.2	-0.1	0.1
Household consumption	4.3	2.2	0.6	1.4	0.7	0.2	-0.2	0.1
Dwelling investment	2.7	0.9	-4.2	17.8	-4.0	-3.3	0.1	2.3
Business investment	13.9	12.4	-3.2	-4.5	-1.0	-0.9	-2.1	-2.7
Public demand	2.7	5.7	3.7	2.4	1.3	0.7	0.6	0.6
<i>Domestic final demand</i>	5.4	4.1	0.2	1.6	0.2	-0.1	-0.3	-0.1
Net Exports (cont. to growth)	-1.7	-1.7	-0.1	0.3	-0.2	0.2	0.1	0.0
Inflation: Headline CPI	2.3	4.4	2.9	3.1	-0.3	1.0	0.6	1.1
Core	3.1	4.5	3.3	2.8	0.8	0.8	0.8	0.7
Wages (Wage Price Index)	4.1	4.2	3.6	3.5	1.0	0.9	0.8	0.8
Employment	2.8	2.3	-0.1	-0.2	0.2	-0.2	-0.2	-0.2
Unemployment rate (%)	4.4	4.2	5.4	6.8	4.4	4.7	5.2	5.6
Current account balance (A\$ bn)	-68.2	-53.7	-72.6	-88.9	-10.2	-12.0	-17.3	-20.8
(% of GDP)	-6.3	-4.5	-6.0	-7.1	-3.3	-3.9	-5.7	-6.9
New Zealand								
GDP	3.1	0.4	-1.8	2.6	-0.6	-1.0	-0.3	0.0
Inflation: Headline CPI	3.2	3.4	2.1	2.3	-0.5	0.0	0.8	0.6
Wages	4.3	5.0	3.8	2.9	0.9	0.9	0.8	0.8
Employment	1.8	0.0	-2.5	-0.3	-1.5	-1.0	-0.6	-0.5
Unemployment rate (%)	3.4	4.7	6.6	7.1	4.7	5.2	5.7	6.1
Current account balance (NZ\$ bn)	-14.3	-16.0	-11.2	-12.1	-3.7	-3.0	-2.7	-2.6
(% of GDP)	-8.2	-9.0	-6.4	-6.7	-9.0	-8.9	-7.8	-7.0

Financial Market Forecasts

	Annual (period end)				Quarter (period end)			
	2008	2009(f)	2010(f)	2011(f)	Dec-08	Mar-09(f)	Jun-09(f)	Sep-09(f)
Interest rates (% p.a.)								
<i>Australia</i>								
90 day bank bills	4.15	2.80	4.70	5.65	4.15	3.45	2.80	2.80
10 year bond rate	3.99	4.25	5.55	6.35	3.99	3.90	4.15	4.15
<i>United States</i>								
3 month LIBOR	1.43	0.50	2.25	4.50	1.43	1.20	0.90	0.70
10 year bond rate	2.21	2.90	4.35	5.15	2.21	2.40	2.70	2.75
<i>Euro area</i>								
3 month LIBOR	2.89	2.00	2.90	3.40	2.89	3.25	2.50	2.25
<i>New Zealand</i>								
90 day bank bills	5.12	2.76	5.58	6.00	5.12	3.17	2.94	2.84
Exchange rates								
A\$/US\$	0.70	0.54	0.60	0.70	0.70	0.63	0.58	0.56
NZ\$/US\$	0.58	0.41	0.46	0.55	0.58	0.50	0.45	0.43
A\$/¥	63.68	55.08	67.20	80.50	63.68	61.74	58.00	56.56
A\$/€	0.50	0.49	0.53	0.58	0.50	0.50	0.48	0.50
A\$/£	0.48	0.36	0.35	0.35	0.48	0.44	0.40	0.38
A\$/NZ\$	1.21	1.32	1.30	1.27	1.21	1.26	1.29	1.30
US\$/¥	90.6	102.0	112.0	115.0	90.6	98.0	100.0	101.0
€/US\$	1.40	1.10	1.14	1.20	1.40	1.25	1.20	1.12
A\$/TWI	55.60	47.94	52.30	59.19	55.60	53.62	50.30	49.40

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