J.P.Morgan

Australia and New Zealand - Weekly Prospects

Summary

- Last week's plunge in the **Aussie** consumer confidence reading all but confirms that the pain threshold for many households has been crossed. It always was challenging to identify the precise timing of said crossing before the event, but we recognize it now that it's happened. Indeed, the dive in confidence compliments cautious anecdotes from retailers signaling that consumers have pulled in their horns in the wake of the RBA's assertive rate hikes since October. The good news is that the weakness in household spending and the troubling events in Europe mean the Reserve Bank probably is on hold for a while, despite the deteriorating inflation outlook. Indeed, it now looks as though the pause we anticipated in June will extend until at least the August Board meeting. The highlight in the week ahead will be the 1Q business investment survey; 99% of the survey results pre-date the "shock" announcement of the new tax on mining company profits.

- The **New Zealand** Budget this week delivered few surprises. Personal income tax cuts, a hike to the goods and services tax (GST), and changes to the way property is taxed were consistent with our expectations. The Budget is slightly stimulatory near term, with the income tax cuts to more than offset the GST hike (both effective October 1). With contractionary measures coming into effect April 1 next year, however, it will be relatively neutral thereafter. We suspect that the Budget will be viewed by the RBNZ in the same light. Market pricing now suggests a 50:50 chance of a June move, but we maintain that the first rate hike will be delivered in July. Growing uncertainties in the Euro area and weakness in some of the domestic indicators suggest the RBNZ has scope to sit on the sidelines for a little bit longer.

- Our outlook for the **developed economies** incorporates a fundamental tension. On one side are forces lifting activity from depressed levels, which we judge as powerful and synchronized. Perhaps most important, there appears to be enough fuel to sustain above-trend growth for at least another year as the private sector's shift away from its defensive stance is still at an early stage. On the other side, this cyclical lift is not likely to generate sufficient growth to heal developed-world labour markets and public finances, which have been severely damaged by the recession. What's more, worrisome social pressures are building due to the slow and uneven nature of the healing process. In recognizing these tensions, we have coined the phrase "bouncing towards malaise" to characterize a forecast that is both optimistic about cyclical lift and sober about the medium-term consequences of the policy choices taken in this environment.

- **Core inflation** in the G-3 economies tumbled to 0.4%oya in April, based on last week's reports for the US and Euro area and our forecast for Japan (-1.9%oya ex food and energy, due this week). The continued slide has confirmed our belief that the record high amount of resource slack would create a highly disinflationary backdrop in the world's largest economies. Our long-standing call has been that G-3 core inflation will decline to near zero by late this year, with historic lows of 0.3%oya in the US and 0.6%oya in the Euro area (4Q/4Q).

This week's highlight

The Aussie capex numbers on Thursday. We suspect that firms will have upgraded their spending plans, albeit marginally. The survey results were collected before the announcement of the new tax on mining "super" profits.

May 24, 2010

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Data and event previews - Australia and New Zealand

Date	Time [a]	Data/event	Forecast		
			JPMorgan	Consensus [b]	***Previous***
Monday, May 24	11.30am	Aust. new motor vehicle sales (%m/m, Apr.)	**-3.5**	na	*-2.7*
Tuesday, May 25	1.00pm	RBNZ 2yr inflation expectation (%, 2Q)	**na**	na	*2.7*
Wednesday, May 26	10.30am	Westpac Leading Index (%m/m, Mar.)	**na**	na	*0.5*
Wednesday, May 26	11.30am	Aust. construction work done (%q/q, 1Q)	**-1.0**	4.0	*2.6*
Thursday, May 27	8.45am	NZ trade balance (NZ$ mn., Apr.)	**500**	455	*567*
Thursday, May 27	10.00am	Conference Board Leading Index (%m/m, Mar.)	**na**	na	*-0.3*
Thursday, May 27	11.30am	Aust. private capital expenditure (%q/q, 1Q)	**5.0**	2.5	*5.5*
Friday, May 28	8.45am	NZ building permits (%m/m, Apr.)	**-2.0**	na	*-0.4*

(a) Australian Eastern Standard Time.
(b) Consensus based on Bloomberg survey.

Australia

New motor vehicle sales (%m/m, Apr.) - New motor vehicle sales have fallen for the last three months, and will likely have slipped again in April. The RBA's assertive policy tightening, the resulting drop in confidence, and the end to the expanded investment allowance will have reduced demand for vehicles last month.

Construction work done (%q/q, 1Q) - Total construction work done should have been down 1%q/q in 1Q. In the latter half of 2009, the construction numbers were inflated by the government's intervention in the education infrastructure space—public sector building work completed was up 53.5% in the final quarter. We expect a further, though much more moderate contribution from public sector construction in 1Q. Private sector activity, however, has been struggling, in particular due to the lag between building approvals and housing starts.

Private capital expenditure (%m/m, Mar.) - The 1Q capex survey should paint a positive picture of the investment outlook; firms will likely have upgraded their future spending plans, albeit marginally. For 2009-10, the sixth estimate of firms' spending plans should print at A$116 billion, compared to A$110.6 billion in the previous survey. After allowance for firms' usual estimation errors, this will imply that spending essentially is unchanged from the record high levels reported for 2008-09. New spending in mining should lead the way, thanks to soaring demand for bulk commodities in Asia. It remains to be seen whether the spectre of the new Resources Super Profit Tax (RSPT) will affect investment in such projects in the future. With respect to the outlook, firms' spending plans for the year ended June 2011, by our estimates, will imply a rise of 18% on current el-

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Data previews - Cont'd.

evated levels, unchanged from the previous survey. New spending in mining should lead the way, thanks to soaring demand for bulk commodities in Asia.

New Zealand

Trade balance (NZ$ mn., Apr.) - We expect another healthy surplus in April, with exports underpinned by strong demand from Australia and Asia. Both export and imports will be slightly lower over the month, however, with the sharper fall in exports leading to a narrowing of the surplus to NZ$500 million.

Building permits (%m/m, Apr.) - Permits likely fell further in April, with the 2% m/m drop we forecast to mark the fourth fall in five months. The decline will provide further evidence that the property market is slowing, and reaffirm our view that residential investment will be flat over the first six months of the year.

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Australia

- **RBA policy "well placed", indicating near-term pause**
- **Aussie firms' capex plans to remain impressive**
- **Consumer confidence plummets after sixth rate hike**

The data flow in Australia last week showed that monetary policy has reached a key touchstone for both RBA officials and consumers. The minutes from the May Board meeting describe policy as "well placed", while plummeting consumer confidence showed that higher market interest rates are beginning to hit home. The highlight in the week ahead is the 1Q capex survey, which should show a substantial increase in spending plans, although there is little else on the economic agenda.

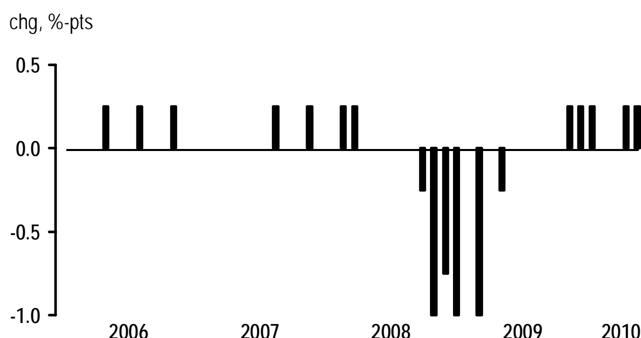
RBA officials believe policy "well placed"

Last week's minutes from the RBA's Board meeting three weeks ago confirmed that the main reason the RBA hiked the cash rate a further 25bp was the soaring terms of trade, owing to the forthcoming, stimulatory (and inflationary) effects of the resources boom. That said, Board members were wary of the uncertainty in the Euro-area, which added to the case for a pause. Officials concluded at the May Board meeting, however, that another rise in the cash rate would leave monetary policy "well placed." Indeed, with the policy stance now closer to a "normal" setting, the first phase of the tightening cycle appears to be over.

The minutes again referred to market interest rates being back to "average" levels for most borrowers. Following six rate hikes in seven meetings, however, the RBA acknowledged that the policy tightening may have started to affect behaviour. Recent economic data had shown subdued retail sales and a sharp drop in home loan approvals, for example. On the other hand, credit conditions for parts of the business sector had started to improve, and forward-looking indicators suggested solid growth in the labour market in the period ahead.

As flagged in the minutes, the "major news of the domestic economy has been the further strengthening in commodity markets." Contract prices for iron ore were estimated by the RBA to have risen and were up close to 100% in the June quarter, and coking coal prices had risen significantly, meaning the terms of trade would likely recover to the highs seen in 2008. The RBA believes that the huge wave of national income set to be triggered by the rising terms of trade, which officials forecast will grow by around 20% this year, will more than offset the scaling back of fiscal and monetary stimulus. The net effect suggests that domestic output will

Australia: RBA policy moves



Australia: real mining investment

continue to strengthen.

That said, the surging terms of trade have given rise to further concerns about the inflation outlook, particularly given that many sectors of the economy appear to be operating with little spare capacity. The recent upward revision to the RBA's inflation forecasts mean that inflation would "not be much below the top of the target range." We believe inflation will track above the RBA's 2%-3% comfort zone in the period ahead. There already is evidence, for example, of substantial wage gains in the hot mining regions. The riches on offer in mining towns to the west and north have triggered skill shortages even in non-mining sectors of the economy, as the mining industry drains the pool of workers elsewhere.

On global conditions, the RBA's commentary mentioned that global growth would be a little above trend. There remained significant divergence across regions, however. Growth in Asia remains robust, with the Chinese economy continuing to expand strongly, though in Europe it remained weak, with activity appearing relatively flat in the March quarter. On the latter, the RBA Board discussed in detail increasing sovereign debt concerns in the Euro area, and acknowledged that the situation could worsen further. Indeed, conditions have since deteriorated, meaning that the

fiscal consolidation likely to occur in the Euro area will likely lead to a deeper economic contraction than RBA members foresaw two weeks ago.

Global factors likely will dominate the RBA's near-term decision making; as a result, we anticipate a policy pause at the next Board meeting in early June. The pause will be extended for longer if global conditions remain troubling. The tightening cycle is not over, however. With Australia's economy already growing at trend, with little spare capacity, policy eventually will head into restrictive territory, especially given growing official concerns surrounding the medium-term inflation outlook.

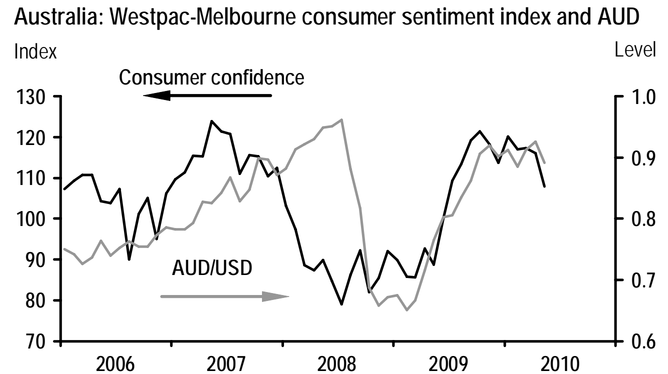
1Q capex survey this week's highlight

The 1Q investment survey this week likely will deliver on expectations for the further swelling of Australia's already bulging investment pipeline. It is important to note, though, that this survey preceded the announcement of the government's response to investment-sensitive portions of the Henry Review. The government earlier this month, for example, announced its intention to introduce a tax on "excess" mining company profits. The proposed 40% Resource Super Profits Tax (RSPT) kicks in after capital allowances, and an allowance for the risk-free rate. Australian mining companies since have announced that a host of investment projects may not go ahead if the RSPT is introduced.

The 1Q capex survey, though, should paint a positive picture of the investment outlook; firms will likely have upgraded their future spending plans. For 2009-10, the sixth estimate of firms' spending plans should print at A$116 billion, compared to A$110.6 billion in the previous survey. After allowance for firms' usual estimation errors, this will imply that spending essentially is unchanged from the record high levels reported for 2008-09. With respect to the outlook, firms' spending plans for the year ended June 2011, by our estimates, will imply a rise of 18% on current elevated levels, unchanged from the previous survey. New spending in mining should lead the way, thanks to soaring demand for bulk commodities in Asia.

Private investment as a share of Australia's GDP already is running at 24% of GDP, close to the record high reached toward the end of 2008. If the plans of managers in the 1Q survey are realized, this ratio will rise to new highs in the next fiscal year. On the RSPT, Dr. Ken Henry, Secretary to the Treasurer, focused much of his annual post-Budget speech last week on justifying the new resources tax. Henry argued that the proposal would reduce the tax burden on

Australia: Westpac-Melbourne consumer sentiment index and AUD



Australia: labor price index and unemployment

companies, thereby encouraging additional investment. He said that given that the RSPT is similar to an allowance for corporate capital, in that it taxes only economic rent compared to royalties, which tax receipts, it does not distort production or investment. Further, because it taxes rent, it should have no impact on prices.

Rate hikes stinging the consumer

Consumer confidence, as measured by the Westpac-Melbourne Institute (WMI), slumped 7% m/m in May, marking the largest fall since October 2008. We anticipated a smaller drop in confidence, although we suspected it would be driven mainly by a fall in sentiment toward family finances, owing to the RBA's policy tightening and the fact that the government delivered a "no frills" Budget that did little to woo voters in this election year. But, a large decline was recorded in sentiment toward the economic outlook, possibly owing to the mounting risks to global growth resulting from heightened sovereign concerns in Europe.

The WMI reiterated, though, that the deterioration in confidence owed mainly to higher mortgage rates. In the last rate hike cycle, after average mortgage rates rose to 7.3% in March 2005 from 7.05%, the WMI index dropped by 15.5%, then fell 8.5% on average following each of the next seven

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rate hikes. The most recent rate hike in the current tightening cycle, delivered in early May, pushed the variable mortgage rate up to 7.4% from 7.15%; this prompted an 8.1%m/m drop in confidence among those respondents with a mortgage, compared to average falls of 2.3% following the five previous rate hikes in this cycle.

Aussie wage growth rose sharply in 1Q

Australia's labour price index (LPI) grew more than expected in 1Q, rising 0.9%q/q (J.P. Morgan and consensus: 0.8%), marking the fastest quarterly growth rate since the end of 2008. Both public and private wages accelerated, rising 1.2% and 0.8%, respectively.

Given solid employment gains (the economy has added 110,000 jobs, mostly full time, this year) and signs of emerging skills shortages, pressure on wages will continue to build. Indeed, tightening labour market conditions will be a growing concern for RBA officials, particularly after the government announced tow weeks ago that it expects the economy to approach full employment by mid-2012. With leading indicators of employment recently creeping higher, it appears that solid job gains will continue, meaning wages should rise further. This will be particularly obvious in sectors such as mining, where wage growth already has picked up sharply, rising to 1.9%q/q in 1Q from 1.1% in 4Q. The threat of steeply rising wages and broader inflation pressures reinforces our view that the RBA will tighten policy further this year, after a near-term pause.

Data releases and forecasts

Week of May 24 - 28

Mon
May 24
11:30am

Sales of new motor vehicles
Units, sa

	Jan	Feb	Mar	Apr
%m/m	-3.2	-1.9	-2.7	-3.5
%oya	15.5	17.3	19.2	11.8

Wed
May 26
10:30am

WMI leading index
Sa

	Dec	Jan	Feb	Mar
%m/m	0.7	0.4	0.5	__

Wed
May 26
11:30am

Construction work done
Sa

	2Q09	3Q09	4Q09	1Q10
%q/q	3.6	1.6	2.6	-1.0
%oya	10.1	5.4	3.9	6.9

A very high base from last quarter's spike in public building works (in particular in the education sector) will have depress growth in construction work completed in 1Q.

Thu
May 27
11:30am

Private new capital expenditure
Sa

	2Q09	3Q09	4Q09	1Q10
%q/q	2.3	-5.2	5.5	5.0
%oya	8.2	-2.7	-2.3	7.4

Investment spending probably rose 5%q/q in real terms in the March quarter, reflecting improved conditions for mining, in particular.

Review of past week's data

WMI consumer confidence survey
100=neutral, seasonally adjusted

	Mar	Apr	May	
%m/m	0.3	-1.0	~~-3.0~~	*-7.0*

Labour price index
Seasonally adjusted

	3Q09	4Q09	1Q10	
(%q/q)	0.7	0.6	__	*0.9*
(%oya)	3.6	2.9	__	*3.0*

New Zealand

- **Kiwi Budget incentivizes saving over consumption**
- **Fiscal position will worsen, but economic outllook better**
- **Price pressures building at the producer level**

In New Zealand, the 2010 Budget was released last week. The budget aimed to promote savings over consumption and property speculation; we had anticipated the impact of less advantageous taxing of housing for some time, as had households, which explains the softening in the housing market over recent months. The government's forecasts were a mixed bag, with a better economic outlook contrasting against a near-term worsening of the fiscal position.

NZ Budget to deteriorate further near term

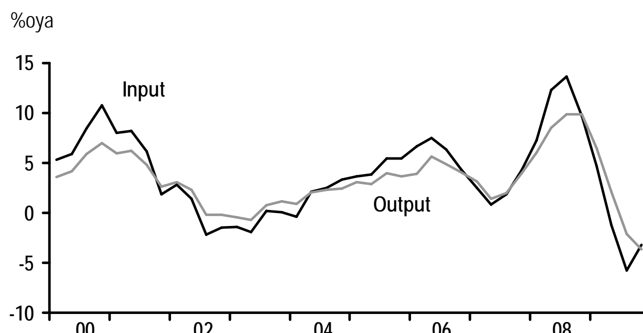
"Save and invest" was the key theme of the New Zealand Budget released last week. The Budget focused on rebalancing the tax system toward savings and investment, and away from the borrowing and consumption that have historically dominated as the main drivers of economic growth. Finance Minister Bill English described Budget 2010 as "broadly fiscally neutral," but the jump in the projected operating deficit in the March 2011 year suggests otherwise, at least in the near term. The highlights were a reduction in personal income taxes, the confirmed hike in the goods and services tax (GST), and the changes to the way property is taxed. Of the (few) surprises, the tax package undoubtedly was the most impressive, particularly the personal tax cuts worth NZ$14.3 billion over four years.

The Budget included updated Treasury forecasts, which showed that the government believes New Zealand's economic growth outlook is better than that expected six months ago. Treasury now forecasts that the economy will expand 3.2% in the March 2011 year, compared to 2.4% previously. We had expected a better fiscal position in the year ahead given the improved economic outlook, but this was not the case. Beyond the next year, however, Treasury forecasts the fiscal position to improve significantly, with the operating balance returning to surplus in 2015/16.

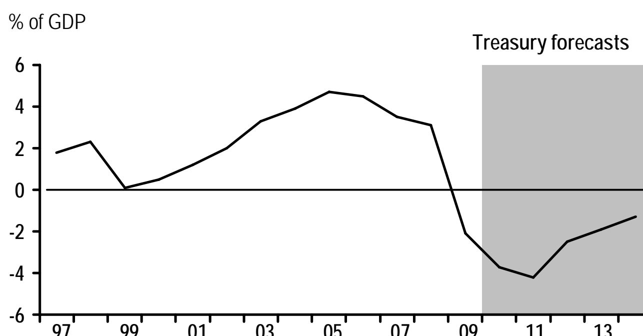
NZ PPI spiked, but will not influence RBNZ

The PPI numbers released in New Zealand last week showed that producer prices picked up in the March quarter. The numbers, though, will have few implications for the RBNZ; the consumer price data were released weeks ago,

New Zealand: producer prices



New Zealand: operating balance excluding gains and losses (OBEGAL)



and showed that headline inflation remained at the very midpoint of the RBNZ's 1%-3% target range for the second straight quarter.

Input prices, or changes in the costs involved in production, were up 1.3%q/q (J.P. Morgan: 0.8%; consensus: 0.5%), rising for the second straight quarter. The main driver of the rise in input prices was electricity generation and supply, up 16.2%q/q. Prices received by producers spiked 1.8%q/q in 1Q (J.P. Morgan: 0%; consensus: 0.5%) following four straight quarters of decline. The increase owed mainly to the dairy product manufacturing index, which surged 29.6%q/q, marking the largest increase on record. With respect to monetary policy, although we believe the PPI numbers will have few implications for near-term policy decisions, we maintain our call for the first rate hike to be delivered in July. While we acknowledge the risk of a June move, growing uncertainties in the Euro area and weakness in some of the domestic indicators suggest that the RBNZ has scope to sit on the sidelines for a little while longer.

Data releases and forecasts

Week of May 24 - 28

Thu
May 27
10:45am

Trade balance
nsa

	Jan	Feb	Mar	Apr
Trade balance (NZ$ mn)	271	335	567	500

We expect another healthy surplus in April, with exports underpinned by strong demand from Australia and Asia. Both export and imports will be slightly lower over the month, but with exports to fall more sharply, the surplus will narrow.

Fri
May 28
10:45am

Building consents
Sa

	Jan	Feb	Mar	Apr
%m/m	-2.9	5.8	-0.4	-2.0
%oya	35.0	29.8	32.9	15.8

Permits likely fell further in April, marking the fourth fall in five months. The decline will provide further evidence that the property market is slowing, and reaffirm our view that residential investment will be flat over the first six months of the year.

Review of past week's data

Producer price index

	3Q09		4Q09		1Q10	
Inputs (%q/q,nsa)	~~-1.1~~	*-1.4*	~~0.3~~	*-0.1*	~~0.8~~	*1.8*
Outputs (%q/q,nsa)	~~-1.4~~	*-1.1*	~~-0.4~~	*0.4*	~~0.0~~	*1.3*

Visitor arrivals

	Feb		Mar		Apr	
Total (%m/m,nsa)	~~-1.9~~	*-2.1*	~~1.1~~	*0.8*	__	*-1.8*

Net permanent immigration

	Feb		Mar		Apr	
Monthly (000s,nsa)	2.6		-0.3		__	*-0.6*
12 month sum (000s,nsa)	21.6		21.0		__	*20.0*

Credit card spending

	Feb		Mar		Apr	
%oya	~~1.2~~	*1.1*	~~6.3~~	*6.2*	~~1.5~~	*1.9*

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Global Essay

- **Our outlook for a strong and resilient expansion is being challenged**
- **Heightened uncertainty about Euro area fiscal and monetary regimes**
- **DM core inflation hits record low in April; further declines lie ahead**

The bounce meets malaise

Our outlook for the developed economies incorporates a fundamental tension. On one side are the forces lifting activity from depressed levels, which we judge as powerful and synchronized. Perhaps most important, there appears to be enough fuel to sustain above-trend growth for at least another year as the private sector's shift away from its defensive stance is still at an early stage.

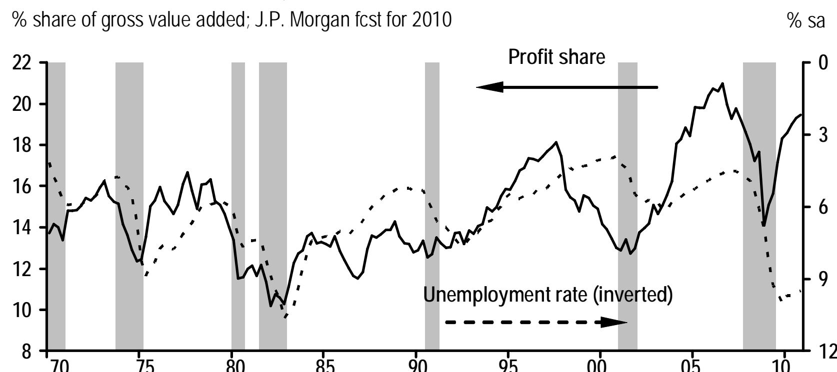
However, on the other side, this cyclical lift is not likely to generate sufficient growth to heal developed-world labour markets and public finances, which have been severely damaged by the recession. What's more, worrisome social pressures are building due to the slow and uneven nature of the healing process. In recognizing these tensions, we have coined the phrase "bouncing towards malaise" to characterize a forecast that is both optimistic about cyclical lift and sober about the medium-term consequences of the policy choices taken in this environment. In the US, the juxtaposition of high and rising corporate profit margins alongside sustained high unemployment increases pressure to steer regulatory and tax policy actions in a direction that could buy stability at the expense of harming incentives for growth. In the Euro area, the sharp divergence in the prospective paths of the core countries and the periphery creates risks for a monetary union that has limited tools and appetite to deal with intra-regional imbalances.

Against this backdrop, the financial market turmoil of recent weeks can be seen as representing a shift in market focus from the forces driving the economic bounce to those likely to generate malaise. Although the catalyst for this shift was narrow—concerns about funding pressures related to financing European sovereign debt—risk aversion has broadened even as Euro area authorities have taken aggressive action to contain these pressures. The European crisis has raised more basic questions about the effectiveness of Euro area policymaking and the sustainability of the euro currency. At the same time, uncertainties about the impact of regulatory legislation in the US have raised questions about growth and where the thrust of policy actions is headed. Taken together with a softer tone to early readings on US economic activity in May, these concerns have fed a fire that challenges our view that the cyclical upturn will prove resilient and long lasting.

Although our global forecast is little changed, we take this challenge seriously. There are three issues that need to be tracked closely in coming weeks to gauge whether the contours of the cyclical upturn we project remain in place:

• **Confirming private sector lift.** Our view is that private sector demand was accelerating coming into the recent turmoil, led by an expansionary turn in the business sector. This needs to be verified in upcoming activity reports, which are unlikely to have been affected by the recent turmoil, at least outside of Europe. First and foremost will be readings on our global PMI and US payrolls.

• **Assessing collateral damage to credit availability.** A key channel though which risk aversion is transmitted to the economy is through the banking system. It seems highly



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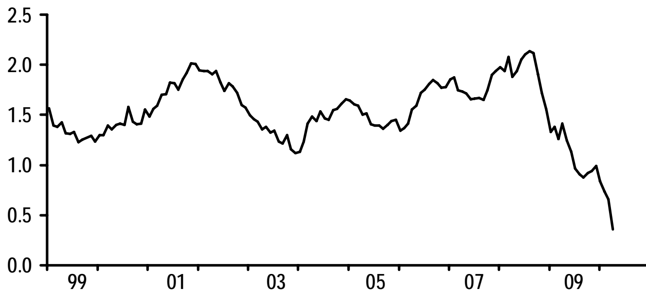
G-3 core inflation
% ch over 12 months; w/ Apr est for Japan



likely that banks will turn more cautious in Europe in light of recent events. The question is to what degree and whether this will become a more global phenomenon.

• **Risk aversion on Main Street.** It remains to be seen whether financial market fears will be mirrored in a similar shift in household and business behaviour. Europe is the most vulnerable, and both Euro area consumer confidence and the business PMI took a step down in May, although the moves were not dramatic. The effect that changes in financial market conditions have on activity also matters. Conditions probably have turned more restrictive on balance, but it is important to note that the plunge in equity prices is somewhat mitigated by the sharp drop in oil prices, lower high-grade corporate borrowing rates, and lower US mortgage rates.

Core inflation is plummeting in the G-3

Core inflation in the G-3 economies tumbled to 0.4%oya in April, based on last week's reports for the US and Euro area and our forecast for Japan (-1.9%oya ex food and energy, due this week). The continued slide has confirmed our belief that the record high amount of resource slack would create a highly disinflationary backdrop in the world's largest economies. Our long-standing call has been that G-3 core inflation will decline to near zero by late this year, with historic lows of 0.3%oya in the US and 0.6%oya in the Euro area (4Q/4Q).

A move into core deflation could happen if inflation expectations start to move down, reinforcing the disinflationary impulse from slack. A more adverse growth outcome, in which spillover from the European debt crisis delivers a major blow to global growth, would have the same effect. G-3 central banks are likely to guard against this development by maintaining record support to the economy, including leaving policy rates at their current level of near zero well into 2011 in the US, and until 2012 in the Euro area and Japan.

Euro area institutional uncertainty

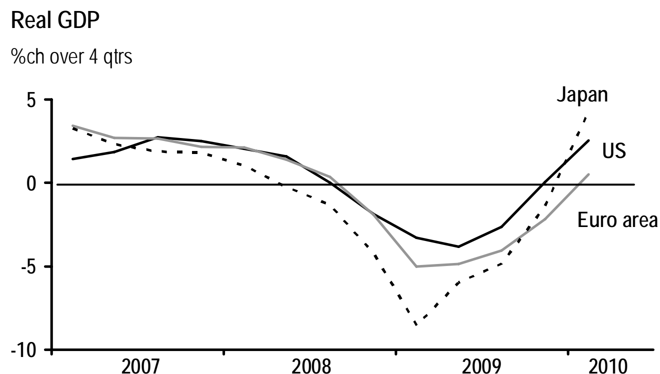
The solvency questions being raised about some Euro area sovereigns have not only created weakness and volatility in asset markets and parts of the banking system; they also have put the institutional structure of the Euro area in flux. The greatest overhaul will undoubtedly come on the fiscal side. Up until now, the Euro area's fiscal structure has involved a small, balanced EU budget and significant autonomy of budgets at the national level. The Stability and Growth Pact was supposed to provide the incentives and sanctions to ensure that national fiscal policy did not destabilize the monetary union.

Where the fiscal structure goes next is unclear. The support package for Greece and the European Stabilization Mechanism represent a significant step toward mutual fiscal support. However, many believe that the region's survival depends on a far greater degree of fiscal integration, which means greater supranational authority over national budget decisions and more cyclical and structural transfers. For now, Euro area policymakers are trying to strengthen the existing fiscal architecture: budget policy still set at the national level, but with more peer review and sanctions for excessive deficits. The European Commission set the ball rolling with some proposals for reforming the Stability and Growth Pact. Last week Germany put forward its own views on what should happen, calling for balanced budget mandates across the region and an orderly default mechanism as the ultimate sanction for a lack of fiscal discipline.

There is also institutional uncertainty about the monetary regime. The ECB's decision to start purchasing the debt of sovereigns whose solvency is in question has not only been controversial within the central bank, but has also raised questions outside about its independence. The ECB has tried to create the impression these purchases are "ring fenced" by highlighting their temporary nature and stressing that they will be sterilized. But, in the event, the auction of one-week term deposits, which can be used as collateral in the ECB's normal tender operations, is not sterilization as we understand it.

UK MPC dogged by high inflation

From the standpoint of inflation, the UK ought to be in the same boat as the G-3, following a severe recession and lackluster recovery. Yet inflation is running far above target,



largely reflecting temporary factors the MPC has chosen to look through. Although recent activity data are encouraging, the risks arising from the crisis in the Euro area and the UK's own need to tighten fiscal policy are likely to keep the MPC on hold for now. The persistence of high CPI inflation runs the risk of destabilizing inflation expectations. The good news is that gauges of inflation expectations remain anchored. But the forecast continues to anticipate that the recent history of inflation performance will turn the MPC's mind toward tightening relatively quickly as risks to the growth outlook fade, putting the UK ahead of the US and Euro area in raising policy rates in early 2011.

Japan is the fastest-growing DM economy

Japanese GDP surged 4.9% annualized in 1Q, marking a fourth straight quarter of growth. Taking on board positive revisions to past quarters, Japan's economy expanded at a 4.2% pace over the four quarters ended 1Q10, the fastest in the developed world. That said, the report was a slight disappointment, in that there was less growth in domestic demand than anticipated, and more reliance on net exports. This week's reports will show how the economy performed in April, while the May Shoko Chukin survey will provide the first clear look at how businesses are responding to heightened uncertainty in the global economy and markets. The BoJ upgraded its economic assessment again last week, while providing an outline of its new lending scheme. Financial institutions will be offered one-year funds at a 0.1% rate if they willing to make loans or otherwise invest in companies operating in targeted industries. The effectiveness of this program may depend on whether the government provides tax advantages or other incentives to spur activity in these sectors when it unveils its new growth strategy next month.

EM policymakers eyeing global turmoil

In the summer of 2008, the EM economies appeared insulated from the economic and financial troubles in the major economies. Most EM central banks were tightening policy to combat an incipient wage/price spiral, only to have to reverse course after the failure of Lehman. Almost two years later, EM policymakers once again are watching a blowup take place in the developed world and wondering what the fallout will be for their economies. As before, the drift of EM policy is toward raising interest rates, which remain at emergency lows despite an impressive pickup in growth and signs that core inflation has bottomed.

Against this backdrop, it seems likely that EM central banks, which have already been reluctant to tighten with G-3 rates on hold, will move even more slowly to normalize than we had anticipated. Last week we scaled back our policy calls in Central Europe, which is most directly affected by developments in the Euro area. Rate hikes are now expected to begin later (in all cases in 2011), with end-2011 rates 50bp to 100bp lower than before. We also pushed back initial rate hikes in Turkey and South Africa.

In booming EM Asia, the most important decisions will be taken by China. Amid signs the economy is overheating, Chinese authorities have become increasingly concerned about a potential slowdown in Europe and the US. With more targeted tools at their disposal, officials are likely to hike rates by less this year than currently forecast. For CNY, we changed the year-end target to 6.6 from 6.5, noting the appreciation of the currency this year in REER terms. China's emphasis is on increasing the flexibility of the currency regime, and we look for officials to widen the daily trading band and introduce more two-way volatility going forward. From a political standpoint, the optimal timing for a shift in FX policy is to move by midyear.

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JPMorgan View - Global Markets

Q&A on market sell-off

- **Asset allocation:** Keeping risk tight, we're avoiding consensus trades where feasible, but not giving up on medium-term bullish view on risky assets.
- **Economics:** Slightly softer data may unnerve markets but are not enough to change our growth forecasts.
- **Fixed income:** Bond yields to move higher medium term, but remain hostage to market volatility near term.
- **Equities:** Position squaring favours Europe, large versus small caps, and defensive versus cyclical sectors in the near term.
- **Credit:** Flows out of high yield mutual funds have been occurring for three consecutive weeks, pointing to further spread widening near term.
- **FX:** The recovery in commodity currencies looks to be on hold until after G-20.
- **Commodities:** The medium-term direction is still positive.

After another awful week for markets, we would like to present our thoughts around a set of basic questions, acknowledging there is a lot we do not know. What happened? Is it real or just fear? Can the sell-off become self-fulfilling? How bad can it get? What is most at risk? What will stop it? And what can we do in the meanwhile?

1. What happened? A beaten up and jittery market saw economic data that were not as good as hoped and policy actions that were less than helpful. Market participants and makers thus went into full-fledged position squaring, reducing tactical risk, adding cash, and cross-hedging illiquid positions with markets where there was still liquidity. Markets have learned from the 2008 crisis to sell/hedge first and ask questions later. Market turnover fell and bid-ask spreads rose. The weaker economic data—claims, NY Fed, Taiwan exports—are not bad enough to elicit changes to our growth forecasts, but hit those investors, like us, who had held on, on a conviction that fundamentals trumped the market technicals. Policy actions—such as the US Senate bank overhaul bill and German restrictions on shorting its debt—may just reflect widespread frustration with the financial industry, but are not coming at a good time. Draconian fiscal measures in Greece and Spain are being ignored.

2. Is it real or just fear? Price action two weeks ago seemed driven more by uncertainty and fear, but last week the sell-off was more "real," with weaker data and less-than-helpful policy actions.

3. Can the sell-off become self-fulfilling? The 2008 crisis reminded us of the negative feedback from markets to economies, through capital destruction and a seizing up of lending flows. The fresh memory of that crisis is leading market participants to the same, self-destructive defensive positioning as two years ago, but is also inducing central banks to flood markets with liquidity, to prevent a repeat of 2008. We observe that wealth losses this time around are mostly in equities and very little in fixed income. As a result, bank capital remains intact. With bank capital intact, bank funding largely unmolested, and bank balance sheets much less leveraged, there seems little risk that banks will transmit the market turmoil into a funding crisis for the real economy.

4. How bad can it get? If we are right that the underlying cyclical rebound remains in place, that banks will not be a source of contagion, and that policymakers will be generally supportive, then risky markets should bottom over the next month or so. But this argument does not tell us how far the knife can fall.

5. What assets are most vulnerable in this sell-off? With our view that investors are largely position-squaring in response to uncertainty, rather than being convinced a double-dip recession is coming, the vulnerable positions are the consensus trades. This is part of why both gold and the dollar suddenly fell last week. Consensus positions (many in our own model portfolio) are still vulnerable, including: cyclicals, small caps, carry-oriented curve steepeners, EM bond longs, HY credit overweights, European bank underweights.

6. What will stop the sell-off? Three signals are most important: (1) confirmation that the nonfinancial sector—companies and households—are not panicking and remain in expansion mode; (2) coordination among policymakers to support markets rather than punish them; and (3) markets cease reacting to bad news and start reacting to good news, something that was clearly not present last week. One can understand the frustration of policymakers in the midst of renewed market panic, but the only solution for overstretched public balance sheets is growth, and that requires coordinated support to markets.

7. What to do in the meanwhile? Keeping tactical risk low is obvious. Investors with staying power should start buying oversold assets, though, without being in a hurry. Remaining positions should be focused on non-consensus exposures.

Fixed income

Bond markets rallied strongly once more, and continued to move in lockstep with equities, sparked by the German ban on short sales and slightly weaker economic data. Euro area

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high-yielders, heretofore at the epicenter of the crisis, saw spreads widen only slightly, as the ECB kept buying. Private sector buyers remain largely absent, however, and the rising dispersion of bids in Euro area government bond auctions testifies to increased funding stresses (see G. Salford, *GFIMS Euro Cash*). Short-maturity Euro area peripherals are strongly supported in the medium term by the European Stabilization Mechanism, approved today by Germany, while the ECB's backstop bid should limit any near-term spread widening.

The ECB's reintroduction of unlimited term lending has contributed to a further increase in excess liquidity in the Euro area money market. This should keep overnight rates low, meaning that the **very short end of the money market curve should decline further**.

We maintain our bearish medium-term view on duration. The strong bond rally over the past month leaves yields consistent with a significant spillover from falling risky assets to economic weakness; although possible, this is not our central case. We recognize however, that **demand for the safety of government bonds will stay strong until uncertainty diminishes**, not least about Euro area sovereigns.

Any economic spillover would weigh most heavily on the Euro area. The brighter economic prospects in the US underpin our continuing **short position in US Treasuries versus German Bunds**. We are mindful however of the risk of capital flight from Europe to Treasuries; the March TIC data released last week showed near-record foreign buying of Treasuries even at that early stage of the crisis.

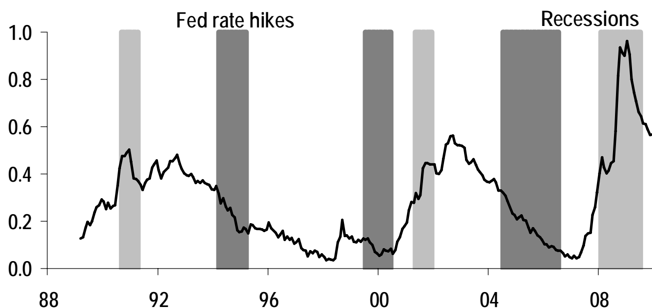
Equities

Global equities declined further last week driven by broad-based risk reduction and position squaring. **Uncertainty and volatility rose** sharply with the VIX and VSTOXX (the Euro counterpart of the VIX index) moving to 46% and 52%, respectively, later in the week, above the levels seen on Friday, May 5, the day before the European Stabilization Mechanism was announced.

Equity markets broke important technical levels with the S&P 500 index falling below its 200-day moving average and testing intraday the 1,066 May 6 spike low. Our **technical** strategist looks for a volatile range in the near term and sees a support above 950-1,000 for the S&P 500 index.

Position-squaring is the dominant market theme for the near term. Position-squaring favours Europe across regions. In the

Slope of the US market risk-return tradeoff line
Required return per unit of risk



Merrill Lynch fund manager survey for May, 34% of respondents said that they were underweight Europe, almost double the previous month's level and the highest since early 2009. Keep a long in MSCI EMU versus MSCI World.

Similarly, we see more near-term upside on **defensive versus cyclical sectors** and on **large versus small caps.** Overweighting cyclical sectors and small caps were consensus trades that have so far retraced only a small portion of their year-to-date outperformance (see charts). The early indications from US and Eurozone business surveys and the decline in Taiwanese export orders for a second straight month suggest a loss of momentum for global manufacturing, which is negative for cyclical stocks. In terms of small caps, their illiquidity cushions them during modest market sell-offs as investors tend to sell their more liquid holdings, but acts a drag during more significant market sell-offs due to flight to liquidity.

Credit

Credit markets sold off last week as investors trimmed positions and as market makers reduced their inventory. US HG spreads widened 6bp while US HY spreads widened by a large 52bp resulting in **credit spreads reaching a new high for the year**.

We believe many real money investors are simply sidelined and see any further sell-off as a buying opportunity. This has the potential to push spreads tighter in the medium term.

Near term, however, the balance of risks is skewed to the downside as uncertainty and volatility remain high. Funds have flowed out of high yield mutual funds for three consecutive weeks. Our trading model based on mutual fund flow momentum suggests that spreads for corporates will continue to widen in the near term. Investors wanting to hedge this near-term risk are likely to use CDS indices rather

than selling the cash bonds, keeping demand for protection strong.

Foreign exchange

As the predominant funding currency for longs in commodity FX and emerging markets, **the euro rallied last week with the risk unwind**. Its movements will remain highly erratic. Friday's German approval of the European Stabilization Mechanism is positive, but given the risk of additional regulatory policy moves around the G-20 summit in late June, a further risk unwind could prompt additional short covering in the euro. We have been stopped out of short euro trades versus USD, CHF, and Asia, and we recommend staying flat. Assuming risky markets stabilize, we continue to expect the euro to underperform high-yielders and EM due to loose ECB policy, and to range-trade versus USD until US rates start to drift higher.

The past week's deleveraging has slashed **commodity FX** valuations to levels that suggest that short-term positioning is probably flat. And, in view of acute near-term policy risks, a recovery in these currencies looks to be on hold until after G-20. Consistent with this assessment, we have pulled the end-June forecasts for AUD, CAD, and NZD to their current spot levels. Uncertainty about the policy direction in Europe should recede over the summer as already-agreed policy measures are implemented, allowing the global growth backdrop to return to being a boost to the dollar bloc currencies. With the BoC still likely to hike faster than markets anticipate, we forecast USD/CAD at 0.95 by year-end before signals of a shift in Fed policy direction pull the cross back toward parity in the first half of 2011. For AUD/USD and NZD/USD our end-2010 targets are 0.92 and 0.75, respectively, and new targets for June 2011 are 0.88 and 0.71.

Commodities

Commodities were down about 5% last week. Oil is now around $71, one dollar lower than the previous week's close. Volatility was very high yesterday as June WTI futures saw prices trade in a breathtaking $7/bbl range over the course of the day. Our year-end bullish forecasts now seem hard to reach, but we still believe the medium-term direction is positive. Fundamentals are still positive for prices, even though revisions to supply estimates indicate that production is higher than previously believed. OPEC will however act if prices continue to slide from the current levels. Earlier this year, we were expecting the oil curve to become backwardated in early 2H. While this is still the medium-term trend, it is unlikely to happen until late in the year.

Base metals were higher Friday, and losses last week were modest compared to energy and precious metals. Signs of a modest improvement in underlying consumption is helping to support base metals. Copper is $100 higher today and it seems that copper has found good buying support around the $6,500 area. Aluminum, zinc, and lead have been at the forefront of the price decline. Aluminum has retreated to a level where analysts and traders are starting to worry about price-driven production cuts.

Ten-year Government bond yields

	Current	Jun 10	Sep 10	Dec 10	Mar 11
United States	3.20	3.30	3.60	4.00	4.25
Euro area	2.67	2.75	3.05	3.15	3.25
United Kingdom	3.55	3.70	3.85	4.00	4.30
Japan	1.24	1.40	1.50	1.55	1.55
GBI-EM	7.00			7.90	

Credit markets

	Current	YTD Return
US high grade (bp over UST)	164	5.1%
Euro high grade (bp over Euro gov)	198	3.4%
USD high yield (bp vs. UST)	711	3.6%
Euro high yield (bp over Euro gov)	746	4.4%
EMBIG (bp vs. UST)	356	2.6%
EM Corporates (bp vs. UST)	369	3.3%

Foreign exchange

	Current	Jun 10	Sep 10	Dec 10	Mar 11
EUR/USD	1.26	1.25	1.25	1.20	1.18
USD/JPY	89.8	87	90	93	96
GBP/USD	1.45	1.44	1.39	1.35	1.34

Commodities - quarterly average

	Current	10Q2	10Q3	10Q4	11Q1
WTI ($/bbl)	70	86	94	93	90
Gold ($/oz)	1177	1150	1250	1200	1175
Copper($/m ton)	6583	8000	7150	6750	6500
Corn ($/Bu)	3.69	3.75	3.90	3.80	4.00

Source: J.P. Morgan, Bloomberg, Datastream

AUD and NZD Commentary

- **Despite collapses in EUR/USD, commodity currencies and the yen crosses, few currencies have undershot short-term value as dramatically as they did post-Lehman.**
- **AUD, NZD and CAD targets revised in view of deleveraging.**
- **Bearish break of key support and February lows suggests a higher risk for a broader corrective phase for both AUD/USD and NZD/USD.**

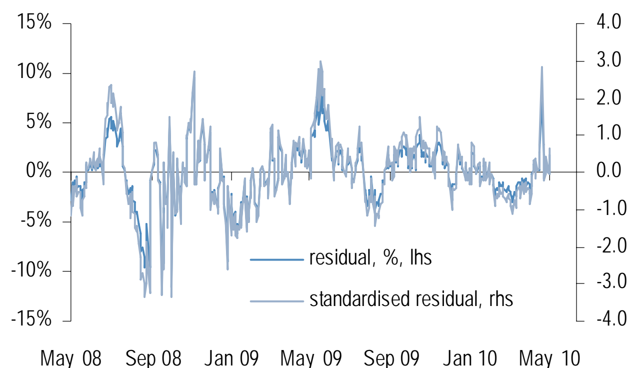
- The past week's deleveraging has pushed commodity FX valuations to levels which suggest that short-term positioning is probably flat. And, in view of acute near-term policy risks, a recovery in these currencies looks on hold until after G-20. Consistent with this assessment, we have pulled the end-June forecasts for AUD, and NZD to their current spot levels. Uncertainty about the policy direction in Europe should recede over the summer as already-agreed policy measures are implemented, allowing the global growth backdrop to return as a boost to the dollar bloc currencies. **We have changed AUD/USD and NZD/USD end-2010 targets to 0.92 and 0.75, respectively, and new targets for June 2011 to 0.88 and 0.71.**
- It is tempting to think that the collapse in EUR/USD, commodity currencies and the yen crosses must have rendered these pairs so cheap that they will soon stabilise, either because cheapness signals extreme short positions, or because longer-term investors seek to earn excessive risk premia. Fair value models based on rate spreads, commodity prices and equity volatility provide some basis to assess the extreme moves witnessed in commodity FX over the past week. Surprisingly, commodity currencies do not look cheap. AUD/USD and NZD/USD trade only 3% below predicted. These currencies have fallen in line with fundamentals rather than overshot, so there is no argument for buying based on an excessive risk premium; the cyclical outlook will need to change first.

Technical analysis

- The bearish shift over the past week amid the broad risk unwind has confirmed the onset of a protracted consolidation phase for both AUD and NZD. With regards to AUD/USD, the impulsive violation of the key 0.8600/0.8575 support zone which included the February low confirmed an important double top and extension into the next zone of key support near 0.8000. While some pause can develop against this key support area, the intermediate term risks will remain bearish against the critical 0.8600/0.8710 breakdown levels. Deeper targets rest in the 0.7830/0.7700 area, which includes the 50% retracement from the 2009 low and double top target.
- The violation of the important 0.6807 February low confirmed a deeper corrective phase for NZD/USD as well. While the decline is holding the next zone of key support near 0.6640/0.6595 (October channel and 38.2% retracement from the 2009 low), the risks should continue to point lower particularly as the decline from the late-April high appears incomplete. Importantly, last week's breakdown area and now key resistance at 0.7000 will maintain the short term downside bias for new lows with deeper targets near 0.6500 and then 0.6300. The ability to rally back above the 0.7000 area would confirm an improved setup for additional upside and a recovery in risk sentiment.

AUD/USD's undershoot of fair value this month has been half that of the Lehman default

AUD/USD deviation from fair value as percentage of spot (left axis) and as a standardised residual (right axis). Regression based on rate spreads, commodity prices and equity volatility, daily data over the past two years.



NZD/USD - Daily chart

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Global Economic Outlook Summary

	Real GDP % over a year ago			Real GDP % over previous period, saar							Consumer prices % over a year ago			
	2009	2010	2011	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	1Q10	2Q10	4Q10	2Q11
The Americas														
United States	-2.4	3.5	3.1	5.6	3.2	4.0	4.0	3.5	2.5	2.5	2.4	**1.8** ↓	**0.9** ↓	1.1
Canada	-2.6	**3.6** ↑	2.9	5.0	**6.0** ↑	3.3	3.2	3.5	3.0	2.0	1.6	1.3	1.8	2.1
Latin America	-2.9	4.9	3.8	**7.1** ↓	**2.9** ↓	4.6	3.3	**4.4** ↓	**4.1** ↑	4.9	5.9	6.4	7.3	7.0
Argentina	-2.0	4.5	3.0	7.9	8.0	8.0	3.0	3.0	2.0	3.0	7.5	8.0	10.0	10.0
Brazil	-0.2	7.0	4.0	8.4	8.7	6.3	4.8	4.0	3.8	4.2	4.9	5.3	5.8	4.5
Chile	-1.5	5.5	5.5	**6.2** ↑	**-5.9** ↑	8.0	22.0	18.0	-2.0	-6.0	**-0.3** ↓	3.3	4.1	3.8
Colombia	0.4	3.0	4.1	4.7	2.7	2.8	2.9	3.1	4.5	4.8	2.0	2.1	3.3	3.6
Ecuador	0.4	2.0	3.0	1.3	2.0	3.5	4.0	4.5	3.0	2.5	4.1	3.9	4.7	4.4
Mexico	-6.5	4.5	3.5	**7.9** ↓	**-1.4** ↓	3.2	-1.8	4.2	5.7	7.9	**4.8** ↑	4.4	5.1	4.5
Peru	0.9	**6.5** ↑	6.0	11.5	**7.3** ↑	**4.5** ↑	**4.1** ↓	**4.0** ↓	**7.0** ↑	**6.9** ↓	**0.7** ↑	1.0	**2.1** ↑	2.2
Venezuela	-3.3	-1.5	2.5	-4.6	-4.0	-2.0	12.5	1.5	1.5	1.5	27.6	31.8	33.7	39.3
Asia/Pacific														
Japan	-5.2	**3.5** ↑	2.2	**4.2** ↑	**4.9** ↓	2.5	2.7	2.7	2.2	2.0	-1.2	-1.4	-0.7	0.1
Australia	1.3	3.1	3.6	3.7	3.0	3.3	3.8	3.9	3.1	4.2	2.5	2.5	2.6	3.0
New Zealand	-1.6	**2.6** ↓	**2.6** ↑	3.3	**1.9** ↓	**3.7** ↑	3.7	2.9	**1.4** ↑	2.3	**2.0** ↓	**2.2** ↓	**2.3** ↓	2.8
Asia ex Japan	4.6	**8.8** ↑	7.3	**7.1** ↓	**11.1** ↑	**6.8** ↓	**6.7** ↑	6.8	7.2	7.4	**3.9** ↑	4.4	3.8	3.2
China	8.7	10.8	9.4	10.8	13.1	9.4	9.3	9.0	9.1	9.5	2.2	3.2	3.1	2.4
Hong Kong	-2.8	**6.8** ↓	4.2	10.0	10.0	4.3	4.0	3.8	4.2	4.3	1.9	2.4	2.3	1.9
India	7.2	8.3	8.5	-2.0	10.4	8.1	7.0	8.7	7.9	7.8	12.7	11.9	6.2	5.5
Indonesia	4.5	6.2	5.8	6.2	5.4	6.0	4.0	5.0	6.5	6.5	3.7	5.3	6.3	4.9
Korea	0.2	5.8	4.1	0.7	7.5	4.0	4.5	3.8	4.0	4.0	2.7	2.8	3.4	3.6
Malaysia	-1.7	7.7	4.8	8.2	5.0	4.0	5.0	5.0	4.9	4.9	1.3	1.7	2.4	2.4
Philippines	0.9	4.5	4.3	3.5	6.0	5.0	3.5	4.0	4.5	4.5	4.3	5.0	5.2	4.9
Singapore	**-1.3** ↑	**9.6** ↑	**4.8** ↑	**-1.0** ↑	**38.6** ↑	**-7.8** ↓	**2.0** ↑	4.9	6.6	6.6	0.9	3.4	4.7	3.7
Taiwan	-1.9	**9.2** ↑	4.8	**16.7** ↓	**11.3** ↑	**3.3** ↓	**3.5** ↓	**3.5** ↓	5.0	5.3	**1.3** ↑	0.9	2.0	1.8
Thailand	-2.3	7.3	6.6	15.3	5.7	5.3	3.6	3.6	8.0	8.0	4.0	5.5	4.4	3.0
Africa/Middle East														
Israel	0.7	3.0	4.5	4.8	**3.3** ↓	3.5	3.0	3.0	4.0	5.0	3.5	3.0	3.0	3.2
South Africa	-1.8	3.0	3.5	3.2	**4.5** ↑	4.0	3.5	3.7	3.6	2.8	**5.7** ↑	**4.9** ↑	**5.8** ↑	5.7
Europe														
Euro area	-4.0	1.3	1.9	0.2	0.8	3.0	2.0	1.8	1.8	1.8	1.1	1.5	1.5	0.9
Germany	-4.9	1.9	2.6	0.7	0.6	3.0	3.0	3.0	2.5	2.5	0.8	1.0	1.2	0.9
France	-2.5	1.7	2.1	2.2	0.5	3.0	2.0	2.0	2.0	2.0	1.5	1.8	1.3	0.6
Italy	-5.1	1.4	2.0	-0.2	2.1	2.5	1.5	2.0	2.0	2.0	1.3	1.5	1.5	1.1
Norway	**-1.5** ↓	**1.7** ↓	**2.7** ↓	**1.6** ↑	**0.6** ↓	**2.5** ↓	3.0	3.0	**2.5** ↓	**2.5** ↓	2.9	3.0	1.6	0.7
Sweden	-5.1	1.9	**3.0** ↓	-1.6	**4.0** ↑	4.0	3.5	3.0	**2.8** ↓	**2.8** ↓	1.0	1.4	1.0	1.9
Switzerland	-1.5	2.5	2.8	3.0	2.5	2.8	3.0	3.0	2.8	2.8	1.1	1.0	0.9	0.8
United Kingdom	-4.9	1.4	3.0	1.8	0.8	3.0	3.0	3.5	2.5	3.0	3.3	**3.5** ↑	**2.6** ↑	**1.7**
Emerging Europe	-5.0	4.1	4.7	2.5	2.2	4.5	4.1	3.8	4.0	4.4	6.1	5.8	5.9	5.4
Bulgaria	-5.0	**-0.5** ↑	4.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	-4.2	2.0	4.0	3.0	0.7	3.0	2.5	2.0	3.0	4.0	0.7	1.3	2.8	2.8
Hungary	-6.3	0.8	4.0	0.8	3.6	2.0	2.0	1.5	3.5	4.0	6.0	4.8	3.7	2.8
Poland	1.8	3.2	4.2	5.3	3.0	4.0	2.7	3.0	3.0	4.0	3.0	2.0	2.6	2.8
Romania	-7.1	1.0	4.0	...	...	...	...	...	...	...	4.6	4.4	4.7	4.5
Russia	-7.9	5.5	5.0	2.7	2.2	6.0	5.5	5.0	5.0	5.0	7.2	6.5	7.2	7.0
Turkey	-4.7	5.1	5.5	...	...	...	...	...	...	...	9.3	10.3	8.5	6.6
Global	-2.5	**3.6** ↑	3.3	3.9	**3.6** ↓	**3.8** ↓	3.5	3.4	3.0	3.1	2.2	2.1	1.8	1.7
Developed markets	-3.4	**2.7** ↑	2.6	**3.3** ↑	2.7	3.3	3.1	2.9	2.3	2.3	1.5	**1.3** ↓	**1.0** ↓	1.0
Emerging markets	1.0	6.8	5.9	**6.2** ↓	**7.4** ↓	**5.7** ↓	**5.3** ↑	5.6	5.8	6.1	**4.9** ↑	5.1	5.0	4.4
Memo:														
Global — PPP weighted	-0.8	4.8	4.4	4.6	5.1	4.8	4.4	4.4	4.1	4.1	3.2	3.2	2.8	2.6

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Global Central Bank Watch

	Official interest rate	Current	Change from Aug '07 (bp)	Last change	Next meeting	Forecast next change	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11
Global	GDP-weighted average	1.32	-334				1.35	1.43	1.51	1.59	1.79
excluding US	GDP-weighted average	1.88	-247				1.93	2.05	2.16	2.28	2.39
Developed	GDP-weighted average	0.52	-359				0.52	0.55	0.58	0.63	0.82
Emerging	GDP-weighted average	4.52	-234				4.66	4.94	5.21	5.42	5.63
Latin America	GDP-weighted average	5.99	-294				6.29	6.85	7.31	7.49	7.77
CEEMEA	GDP-weighted average	4.22	-264				4.13	4.12	4.41	4.49	4.82
EM Asia	GDP-weighted average	4.09	-201				4.25	4.53	4.72	4.99	5.14
The Americas	GDP-weighted average	0.78	-481				0.83	0.92	1.00	1.06	1.43
United States	Federal funds rate	0.125	-512.5	16 Dec 08 (-87.5bp)	23 Jun 10	2Q 11 (+25bp)	0.125	0.125	0.125	0.125	0.50
Canada	Overnight funding rate	0.25	-400	21 Apr 09 (-25bp)	2 Jun 10	2 Jun 10 (+25bp)	0.50	1.00	1.50	2.00	2.50
Brazil	SELIC overnight rate	9.50	-250	28 Apr 10 (+75bp)	9 Jun 10	9 Jun 10 (+75bp)	10.25	11.50	12.50	12.50	12.50
Mexico	Repo rate	4.50	-270	17 Jul 09 (-25bp)	18 Jun 10	2Q 11 (+25bp)	4.50	4.50	4.50	4.50	4.75
Chile	Discount rate	0.50	-450	9 Jul 09 (-25bp)	15 Jun 10	15 Jun 10 (+25bp)	0.75	1.50	2.25	3.75	5.00
Colombia	Repo rate	3.00	-600	30 Apr 10 (-50bp)	<u>27 May 10</u>	1Q 11 (+50bp)	3.00	3.00	3.00	4.00	5.00
Peru	Reference rate	1.50	-300	6 May 10 (+25bp)	10 Jun 10	July 10 (+25bp)	1.50	2.25	3.00	3.75	4.50
Europe/Africa	GDP-weighted average	1.29	-323				1.28	1.29	1.33	1.40	1.50
Euro area	Refi rate	1.00	-300	7 May 09 (-25bp)	10 Jun 10	On hold	1.00	1.00	1.00	1.00	1.00
United Kingdom	Repo rate	0.50	-500	5 Mar 09 (-50bp)	10 Jun 10	10 Feb 11 (+25bp)	0.50	0.50	0.50	0.75	1.00
Sweden	Repo rate	0.25	-325	2 Jul 09 (-25bp)	Jul 10	1Q 11 (+25bp)	0.25	0.25	0.25	0.50	0.75
Norway	Deposit rate	2.00	-250	5 May 10 (+25bp)	23 Jun 10	22 Sep 10 (+25bp)	2.00	2.25	2.50	2.75	3.25
Czech Republic	2-week repo rate	0.75	-200	6 May 10 (-25bp)	23 Jun 10	**2Q 11 (+25bp)**	0.75	0.75	0.75	**0.75**	**1.00**
Hungary	2-week deposit rate	5.25	-250	26 Apr 10 (-25bp)	31 May 10	**21 Jun 10 (-25bp)**	**5.00**	**4.50**	**4.50**	**4.50**	**4.50**
Israel	Base rate	1.50	-250	28 Mar 10 (+25bp)	<u>24 May 10</u>	24 May 10 (+25bp)	**1.75**	2.25	2.75	3.25	3.75
Poland	7-day intervention rate	3.50	-100	24 Jun 09 (-25bp)	<u>25 May 10</u>	**1Q 11 (+25bp)**	3.50	3.50	**3.50**	**3.75**	**4.00**
Romania	Base rate	6.25	-75	4 May 10 (-25bp)	30 Jun 10	30 Jun 10 (-25bp)	6.00	5.50	5.50	**5.50**	**5.75**
Russia	1-week deposit rate	3.25	25	29 Apr 10 (-25bp)	May 10	May 10 (-25bp)	3.00	3.00	3.00	3.00	3.50
South Africa	Repo rate	6.50	-300	25 Mar 10 (-50bp)	22 Jul 10	**2Q 11 (+50bp)**	6.50	6.50	6.50	**6.50**	**7.00**
Switzerland	3-month Swiss Libor	0.25	-225	12 Mar 09 (-25bp)	Jun 10	16 Dec 10 (+25bp)	0.25	0.25	0.50	0.75	1.00
Turkey	**1-week repo rate**	**7.00**	-1050		17 Jun 10	**14 Oct 10 (+50bp)**	7.00	**7.00**	8.50	8.50	8.50
Asia/Pacific	GDP-weighted average	2.18	-126				2.25	2.41	2.51	2.66	2.74
Australia	Cash rate	4.50	-175	4 May 10 (+25bp)	1 Jun 10	Jul 10 (+25bp)	4.50	5.00	5.25	5.50	5.75
New Zealand	Cash rate	2.50	-550	30 Apr 09 (-50bp)	10 Jun 10	29 Jul 10 (+25bp)	2.50	3.00	3.50	4.00	4.25
Japan	Overnight call rate	0.10	-43	19 Dec 08 (-20bp)	14 Jun 10	4Q 11 (+15bp)	0.10	0.10	0.10	0.10	0.10
Hong Kong	Discount window base	0.50	-625	17 Dec 08 (-100bp)	24 Jun 10	2Q 11 (+25bp)	0.50	0.50	0.50	0.50	1.00
China	1-year working capital	5.31	-126	22 Dec 08 (-27bp)	2Q 10	2Q 10 (+27bp)	5.58	5.85	6.12	6.39	6.39
Korea	Base rate	2.00	-250	12 Feb 09 (-50bp)	10 Jun 10	3Q 10 (+25bp)	2.00	2.25	2.50	2.75	3.00
Indonesia	BI rate	6.50	-200	5 Aug 09 (-25bp)	4 Jun 10	1Q 11 (+25bp)	6.50	6.50	6.50	6.75	7.00
India	Repo rate	5.25	-250	20 Apr 10 (+25bp)	27 Jul 10	2Q 10 (+25bp)	5.50	6.00	6.00	6.50	6.75
Malaysia	Overnight policy rate	2.50	-100	13 May 10 (+25bp)	8 Jul 10	3Q 10 (+25bp)	2.50	3.00	3.00	3.00	3.00
Philippines	Reverse repo rate	4.00	-350	9 Jul 09 (-25bp)	3 Jun 10	3 Jun 10 (+25bp)	4.25	4.75	5.00	5.00	5.00
Thailand	1-day repo rate	1.25	-200	8 Apr 09 (-25bp)	2 Jun 10	14 July 10 (+25bp)	1.25	1.50	1.75	2.00	2.25
Taiwan	Official discount rate	1.25	-188	18 Feb 09 (-25bp)	2Q 10	3Q 10 (+25bp)	1.25	1.50	1.75	2.00	2.25

Bold denotes move since last GDW and forecast changes. <u>Underline</u> denotes policy meeting during upcoming week.

Economic forecasts - Australia

Australia: economic projections *percentage change over previous period, seasonally adjusted annual rates, un*

				2009			2010				2011			
	2009	2010	2011	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Chain volume GDP	1.3	3.1	3.6	2.9	1.1	3.7	3.0	3.3	3.8	3.9	3.1	4.2	4.2	1.8
Private consumption	2.2	1.7	2.1	3.5	3.0	2.6	1.2	0.8	0.4	1.2	3.2	2.8	2.4	2.0
Construction investment	-0.3	2.9	4.6	-2.8	3.4	1.7	3.6	3.4	4.5	3.5	4.3	5.1	6.0	6.2
Equipment investment	-3.4	22.1	9.3	4.3	-11.0	51.2	32.6	22.5	13.0	17.6	5.1	3.4	6.4	8.6
Public investment	3.8	21.3	10.7	18.3	28.3	47.7	17.0	9.5	15.1	11.2	7.4	14.0	7.4	11.8
Government consumption	2.9	3.7	1.7	3.6	5.7	7.2	3.9	0.1	3.9	0.1	0.1	3.8	3.8	0.4
Exports of goods & services	0.5	3.7	4.6	3.3	-9.1	7.0	6.6	4.9	3.2	7.4	4.1	4.1	4.1	4.1
Imports of goods & services	-7.7	11.6	4.1	3.0	18.5	34.6	8.2	4.1	2.0	4.1	4.1	4.1	2.0	12.6
Contributions to GDP growth:														
Inventories	-0.5	-1.9	-0.1	1.1	2.6	0.4	-8.9	-0.2	-0.1	-0.1	-0.2	0.0	-0.3	-0.1
Net trade	1.8	-1.7	0.0	0.1	-5.2	-4.9	-0.5	0.1	0.2	0.5	-0.1	-0.1	0.3	-1.8
GDP deflator (%oya)	0.4	1.8	2.4	0.3	-2.0	-1.4	0.1	2.9	2.4	2.0	2.2	2.4	2.5	2.5
Consumer prices (%oya)	1.8	3.4	3.8	1.5	1.3	2.1	2.9	3.5	3.5	3.8	3.8	3.7	3.7	3.8
Producer prices (%oya)	-5.4	-1.4	3.5	-6.4	-7.2	-6.8	-3.1	-1.6	-1.9	1.0	2.5	3.5	4.0	4.0
Trade balance (A$ bil, sa)	-6.7	-23.4	-23.3	-0.9	-4.3	-5.7	-6.0	-6.0	-5.9	-5.6	-5.6	-5.7	-5.5	-6.6
Current account (A$ bil, sa)	-67.0	-72.1	-74.6	-13.1	-14.7	-17.5	-18.0	-18.1	-18.1	-17.9	-18.1	-18.4	-18.3	-19.9
as % of GDP	-6.2	-5.4	-5.3	-4.2	-4.7	-5.4	-5.5	-5.5	-5.4	-5.3	-5.3	-5.3	-5.2	-5.6
3m eurodeposit rate (%)*	6.0	4.9	5.6	3.5	3.4	4.1	4.3	4.8	5.0	5.5	5.7	5.7	5.6	5.6
10-year bond yield (%)*	5.6	5.9	6.0	5.5	5.1	5.8	5.7	5.9	5.9	6.1	6.0	6.0	5.9	6.0
US$/A$*	0.75	0.89	0.87	0.82	0.88	0.91	0.94	0.82	0.87	0.92	0.90	0.88	0.86	0.84
Commonwealth budget (FY, A$ bil)	-27.0	-57.1	-27.0											
as % of GDP	-2.1	-4.3	-1.9											
Unemployment rate	5.6	5.4	5.3	5.7	5.7	5.6	5.3	5.4	5.5	5.5	5.4	5.3	5.2	5.0
Industrial production	-7.8	3.3	1.5	5.2	-5.5	21.8	1.0	0.0	-1.0	-2.0	0.0	1.0	2.0	3.0

*All financial variables are period averages

Australia - summary of main macro views

- The Australian **economy** powered out of the global downturn largely unscathed. Growth probably will be close to trend in 2010, but above trend in 2011, despite the further withdrawal of policy support.
- **Business investment** will be broadly unchanged at high levels in the year to June now that firms have upgraded spending plans. Investment probably will rise close to 20% in 2010-11, with mining leading the way.
- On **housing**, with the expanded first home owners' grant now having expired and price caps on the basic grant in place, house price growth should cool, particularly at the low and middle-end of the price spectrum.
- **Consumer confidence** has deteriorated sharply owing mainly to rising mortgage rates. Rate hikes are starting to bite, with confidence among respondents with a mortgage tumbling 8% in May. This is nearly four times the fall following the five previous rate hikes.
- **Export volumes** have held up owing mainly to firm demand from China, but the terms of trade tumbled.This decline is reversing, thanks mainly to higher bulk commodity prices; we forecast a 25% rise.
- The **RBA** was the first central bank in the G20 to tighten policy and has hiked six times since last October. We now expect a pause, which will be extended if recent financial troubles spill over to real economies.
- The recent **Commonwealth budget** was "beige", with bolder policy announcements probably delayed until closer to this year's federal election.

Economic forecasts - New Zealand

New Zealand: economic projections *percentage change over previous period, seas. adjusted annual rates, unless stated*

				2009			2010				2011			
	2009	2010	2011	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (1995-96 prices)	-1.6	2.6	2.6	0.6	1.1	3.3	1.9	3.7	3.7	2.9	1.4	2.3	2.7	3.9
Private consumption	-0.6	2.4	1.6	1.6	3.5	3.4	2.5	1.5	1.1	2.0	1.0	1.5	2.0	3.5
Fixed Investment	-13.5	-1.0	4.6	-1.6	-6.2	-3.5	-5.4	5.3	5.5	5.7	2.2	4.1	6.0	7.3
Residential construction	-18.7	4.6	4.7	-9.3	-15.3	21.1	8.0	4.0	4.8	6.0	3.2	4.8	6.0	4.0
Other fixed investment	-12.4	-2.1	4.6	0.0	-4	-7.6	-8.0	5.6	5.6	5.6	2.0	4.0	6.0	8.0
Inventory change (NZ$ bil, saar)	-1.7	0.8	0.4	-1.0	-0.7	0.2	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Government spending	1.5	2.2	1.7	-5.0	2.4	3.6	3.2	2.4	1.6	2.4	0.9	3.2	0.8	0.2
Exports of goods & services	0.0	7.2	9.0	19.8	0.7	-3.4	10.0	12.0	11.0	10.0	8.0	7.0	10.0	8.0
Imports of goods & services	-15.2	8.5	7.1	-10.3	6.2	26.4	5.0	8.0	5.0	8.0	5.0	8.0	9.0	9.0
Contributions to GDP growth:														
Domestic final sales	-5.0	1.2	2.4	0.6	-0.4	1.7	-0.4	3.0	2.1	3.0	1.2	2.4	2.7	3.8
Inventories	-2.5	1.9	-0.3	-9.0	3.3	11.1	0.9	-0.4	-0.2	-0.6	-0.8	0.2	-0.2	0.5
Net trade	5.9	-0.5	0.5	9.7	-1.7	-8.8	1.4	1.1	1.8	0.5	0.9	-0.4	0.2	-0.4
GDP deflator (%oya)	1.9	1.3	2.2	2.0	2.7	0.1	-0.2	1.0	1.8	2.8	2.8	2.4	1.9	1.6
Consumer prices	2.1	2.3	3.0	2.3	5.3	-0.7	1.5	2.7	2.1	2.9	3.3	2.9	3.2	3.6
%oya	2.1	2.0	3.0	1.9	1.7	2.0	2.0	2.2	1.4	2.3	2.7	2.8	3.1	3.2
Trade balance (NZ$ bil, sa)	2.5	2.5	-0.1	0.8	0.6	0.2	1.2	0.6	0.5	0.3	0.2	0.0	-0.1	-0.3
Current account (NZ$ bil, sa)	-5.6	-12.1	-14.2	-0.4	0.0	-3.1	-1.2	-2.8	-4.1	-3.0	-2.2	-5.2	-3.0	-2.9
as % of GDP	-3.1	-6.5	-7.2	-0.9	0.1	-6.9	-6.2	-8.9	-6.3	-4.6	-6.1	-5.9	-8.1	-8.8
Yield on 90-day bank bill (%)*	3.0	3.1	4.4	2.8	2.8	2.8	2.7	2.8	3.3	3.8	4.3	4.4	4.5	4.5
10-year bond yield (%)*	5.5	5.9	6.1	5.7	5.7	5.9	5.7	6.0	6.0	6.1	6.1	6.1	6.0	6.0
US$/NZ$*	0.64	0.72	0.72	0.60	0.68	0.73	0.73	0.67	0.71	0.75	0.73	0.71	0.71	0.71
Commonwealth budget (NZ$ bil)	-4.0	-7.2	-7.1											
as % of GDP	-2.2	-3.8	-3.6											
Unemployment rate	6.1	6.7	6.0	5.9	6.5	7.1	6.0	7.1	6.9	6.6	6.4	6.2	6.0	5.5

*All financial variables are period averages

New Zealand - summary of main macro views

- The **New Zealand economy** expanded at a healthy clip of 0.8%q/q in 4Q, driven again by firm private consumption. Inventories, though, were not the drag on growth we expected. In fact, inventories were built up by NZ$172 million, after three quarters of run downs.
- **Business confidence** is elevated and investment plans firm. Investment will, though, remain a drag on GDP growth this year.
- The **unemployment** rate tumbled to 6% in 1Q (from 7.1%), although is unlikely to fall far below this level in the near-term. Actual hiring remains well-below long run averages, and with corporate profitability fall in 1Q, new hiring will likely be postponed.
- **The RBNZ will begin tightening policy in July.** The RBNZ has said that the policy stimulus may start to be removed "in coming months." Our forecast for a July move is highly data dependent.
- **Inflation** returned to positive territory in 1Q, after falling in the final three months of 2009. Medium term inflation pressures are a concern, given diminishing excess capacity and firms' intentions to raise domestic prices.
- Managing **inflation expectations** will be a growing challenge for the RBNZ, given the July 1 introduction of the amended ETS and the GST hike on October 1.

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Australia and New Zealand economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
24 May Australia: New motor vehicle sales (11: 30 am) Apr -3.5%m/m, sa	25 May	26 May Australia: Westpac leading index (10: 30 am) Mar Construction work done (11:30 am) 1Q -1.0% q/q, sa	27 May Australia: Private capital expenditure (11:30 am) 1Q 5.0% q/q, sa New Zealand: Trade balance (10:45 am) Apr 500NZ$ mn	28 May New Zealand: Building permits (10:45 am) Apr -2.0%m/m, sa
31 May Australia: Pvt. Sector credit (11:30 am) Apr Current account balance (11:30 am) 1Q Company operating profits (11:30am) 1Q	1 Jun Australia: Building approvals (11:30 am) Apr Retail sales (11:30am) Apr RBA cash target (3:30 pm) Jun	2 Jun Australia: GDP (11:30 am) 1Q New Zealand: ANZ commodity price (3:00 pm) May	3 Jun Australia: Trade balance (11:30 am) Apr	4 Jun
7 Jun Australia: ANZ job ads (11:30 am) May New Zealand: QVNZ house prices May *Holiday New Zealand*	8 Jun New Zealand: Manufacturing activity (10: 30 am) 1Q	9 Jun Australia: Westpac consumer confidence (10: 30 am) Jun NAB bus. Confidence (11: 30 am) May Housing finance approvals (11:30 am) Apr	10 Jun Australia: Unemployment rate (11: 30 am) May New Zealand: RBNZ official cash rate (9:00 am) Jun Business NZ PMI (10:30 pm) May Terms of trade (10:45 am) 1Q	11 Jun
14 Jun New Zealand: Retail sales (10:45 am) Apr *Holiday Australia*	15 Jun	16 Jun Australia: Westpac leading index (10: 30 am) Apr Dwelling starts (11:30 am) 1Q	17 Jun	18 Jun

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Global Data Diary

Week / Weekend	Monday	Tuesday	Wednesday	Thursday	Friday
24 - 28 May	24 May	25 May	26 May	27 May	28 May
	Israel • BoI mtg: +25bp Japan • All sector act index (Mar) Russia • Retail sales (Apr) Thailand • GDP (1Q) United States • Existing home sales (Apr)	Euro area • Ind new orders (Mar) Italy • ISAE cons confl (May) Poland • NBP mtg: no change South Africa • GDP (1Q) United Kingdom • GDP prelim (1Q) United States • Case-Shiller HPI (Mar) • Consumer conf (May) • FHFA HPI (Mar) • Bernanke speech	France • INSEE bus conf (May) • Consumption of mfg goods (Apr) Japan • Shoko Chukin (May) • BoJ MPM minutes (Apr) • Shirakawa speech United States • Durable goods (Apr) • New home sales (Apr)	Colombia • BanRep mtg: no change France • INSEE cons conf (May) Italy • ISAE business conf (May) Japan • Trade balance (Apr) Philippines • GDP (1Q) United States • Real GDP 2nd rel (1Q)	Japan • Core CPI (Apr) • Household spending (Apr) • Retail sales (Apr) • Unemployment (Apr) Sweden • GDP (1Q) United States • Chicago PMI (May) • Consumer sentiment final (May) • Personal income (Apr)
31 May - 4 June	31 May	1 June	2 June	4 June	3 June
Germany • Retail sales (Apr)	Canada • GDP (1Q) Euro area • EC business conf (May) • HICP flash (May) Hungary • NBH mtg: no change India • GDP (1Q) Japan • IP prelim (Apr) • PMI mfg final (May) • Shirakawa speech Korea • IP (Apr) United States • Memorial Day: markets closed	Canada • BoC meeting: no change Euro area • PMI mfg final (May) United States • ISM mfg (May) PMI • Czech Republic, Hungary, Poland, Sweden, Switzerland, Turkey (May) PMI manufacturing • China, Norway, Russia, South Africa, UK (May)	Australia • GDP (1Q) Euro area • PPI (Apr) United States • Light vehicle sales (May) • Pending home sales (Apr) Thailand • BoT meeting: no change	Euro area • GDP prelim (1Q) Indonesia • BI meeting: no change Switzerland • Hildebrand speech United States • Employment (May)	Euro area • PMI services/comp (May) • Retail sales (Apr) Japan • PMI services/comp (May) • MoF corporate survey (May) Philippines • BSP meeting: +25bp United Kingdom • PMI services (May) United States • Factory orders (Apr) • ISM nonmfg (May) • Productivity and costs (1Q)

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