J.P.Morgan

Australia and New Zealand - Weekly Prospects

Summary

- The week ahead in **Australia** includes some important economic data releases and a speech by the RBA Governor. The two confidence measures scheduled for release—business and consumer—probably will dip, even though the RBA left the cash rate steady last week. The past month has featured not only sustained weakness in the local equity market, but the sometimes unsettling debate about the merits of the government's proposed 40% tax on the profits of mining companies. Consumer confidence likely slipped another 2% (following the 7% dive in May after the most recent rate hike); business confidence likely slid 2 points. In a sign that private demand in the economy has slowed in the wake of the RBA's six rate hikes since October, the May employment report should reveal a small fall in employment and a rise in the jobless rate to 5.5%. On Wednesday, Governor Stevens will speak to the Western Sydney Business Connection. It is very unlikely that his message will deviate from the balanced tone delivered in the RBA's policy announcement last week.

- The **RBNZ's** official cash rate (OCR) announcement Thursday is the clear highlight across the Tasman. The decision to hike, the consensus view, is by no means a done deal. Market pricing suggests an 84% chance of a 25bp hike, but we maintain there are clear reasons for the RBNZ to stand pat. Not only is there ample uncertainty offshore, stemming mainly from heightened sovereign concerns in the Euro area, but the domestic recovery remains patchy. We acknowledge the relevance of the Bank of Canada's decision to tighten last week, but the Canadian economy is in much better shape than New Zealand's. The Canadian economy surged 6.1% annualized in 1Q and the key policy rate, prior to last week's rate hike, was at a highly stimulative 0.25%. Our economists offshore described the BoC's move as a "rare exception" among central banks; indeed, we have delayed previously forecast rate hikes in a number of jurisdictions.

- The overall thrust of **global activity** indicators remained upbeat through May, and the current quarter appears on track to produce the strongest global GDP gain thus far in the expansion. More important than the strength of the expansion is its broadening base as business behaviour shifts from retrenchment to expansion. We look at this shift as increasing the resiliency of the expansion and lies at the heart of our forecast of sustained above-trend global growth in the coming quarters.

- However, this upbeat news is being accompanied by signs that **Emerging Asia** is downshifting in response to a policy-induced cooling in China. Although a slowing is incorporated in our forecasts—and is starting from a much stronger 1Q10 outcome than had been anticipated—it is too early to gauge how far the downshift will run. At the same time, an encouraging lift in Euro area activity indicators is being threatened by a sovereign crisis in which Euro area banks' access to market financing has been severely curtailed. The sharp fall in investor risk appetite over the past month not only reflects concerns on these fronts but also raises the risk that the feedback loop between the real economy and financial markets shifts into reverse.

This week's highlight

A tie—the Aussie employment report and the RBNZ decision, both Thursday. We forecast that employment in Australia fell in May, after months of solid gains, and that the RBNZ will remain on the policy sidelines.

June 7, 2010

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JPMorgan Australia Ltd., Sydney
www.morganmarkets.com

Stephen Walters
(61-2) 9220-1599
stephen.b.walters@jpmorgan.com

Helen Kevans
(61-2) 9220-3250
helen.e.kevans@jpmorgan.com

Ben Jarman
(61-2) 9220-1669
ben.k.jarman@jpmorgan.com

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com
Ben Jarman (61-2) 9220-1669
ben.k.jarman@jpmorgan.com

Data and event previews - Australia and New Zealand

Date	Time [(a)]	Data/event	Forecast JPMorgan	Forecast Consensus [(b)]	*Previous*
Monday, June 7	11.30am	ANZ job advertisements (%m/m, May)	**na**	na	*-1.2*
Tuesday, June 8	8.45am	NZ manufacturing activity (%q/q, 1Q)	**na**	na	*0.7*
Wednesday, June 9	10.30am	Westpac-MI consumer confidence (%m/m, Jun.)	**-2.0**	na	*-7.0*
Wednesday, June 9	11.30am	Aust. housing finance (%m/m, Apr.)	**-2.0**	-2.0	*-3.4*
Wednesday, June 9	11.30am	NAB business confidence (Index, May)	**11.0**	na	*13*
Wednesday, June 9	1.00pm	RBA Governor Stevens' speech	**na**	na	*na*
Thursday, June 10	7.00am	RBNZ official cash rate announcement (%, Jun.)	**2.50**	2.75	*2.50*
Thursday, June 10	8.30am	NZ business PMI (Index, May)	**na**	na	*58.9*
Thursday, June 10	8.45am	NZ terms of trade (%q/q, 1Q)	**-2.3**	5.6	*5.7*
Thursday, June 10	8.45am	NZ card spending (%m/m, May)	**na**	na	*-1.7*
Thursday, June 10	11.00am	Aust. consumer inflation expectation (%, Jun.)	**na**	na	*3.6*
Thursday, June 10	11.30am	Aust. employment (ch. 000s, May.)	**-5.0**	20.0	*33.7*
Thursday, June 10	11.30am	Aust. participation rate (%, May.)	**65.2**	65.2	*65.2*
Thursday, June 10	11.30am	Aust. unemployment rate (%, May.)	**5.5**	5.4	*5.4*
Friday, June 11	8.45am	NZ food prices (%m/m, May)	**na**	na	*-0.50*

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

Australia

ANZ job advertisements (%m/m, May) - Job ads declined in every month from May 2008 to July 2009, and are still 40% below the peak. It remains a puzzle, therefore, that the Australian jobs market has posted such remarkable gains over the last nine months. But, the longevity of this phenomenon makes it difficult to deny, so we now must take those job gains as

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com
Ben Jarman (61-2) 9220-1669
ben.k.jarman@jpmorgan.com

Data previews - Cont'd.

something resembling a "free lunch." Job ads should continue to rise gradually, although, as in the last nine months, job growth could still surprise on the upside over the year, relative to that metric.

Westpac-MI consumer confidence (%m/m, Jun.) - Consumer confidence probably deteriorated further in June. The RBA held fire, but this will provide little relief given expectations of further rate hikes on the horizon, sovereign concerns still lingering in Europe, weaker AUD, and lower equity prices. The unsettling debate over the proposed 40% tax on mining profits also will have helped to depress sentiment.

Housing finance (%m/m, Apr.) - We expect the marked cooling of the housing market data that has transpired in the first few months of the year to have continued in April. The housing finance numbers should show a 2%m/m decline in loan volumes, with rising interest rates and the withdrawal of the FHBs' boost proving a toxic mix for loan demand.

NAB business confidence (Index, May) - Business confidence likely fell further in May, amid elevated sovereign concerns, higher interest rates, debate over the new mining tax, and weaker AUD. At a level of +11, though, it will remain well above the long run average (+7). In recent NAB surveys, price pressures have remained subdued, but we suspect that the May survey will reflect recent price rises, including higher labour costs.

RBA Governor Stevens' speech - The Governor delivers a speech to the Western Sydney Business Connection Wednesday. The speech title has yet to be assigned (officially), although the conference program notes the Governor will focus on the challenges the Australian economy faces in a post crisis world. There is a Q&A session scheduled following the speech.

Employment (ch. 000s, Apr.) - After adding a whopping 110,000 jobs in the first four months of the year, we expect that employment fell in May. Our forecast calls for 5,000 jobs to have been shed, marking only the second monthly fall since mid-2009. The unemployment rate probably edged up to 5.5%, with the participation rate holding steady at 65.2%. The recent shift from part- to full-time work will likely have continued.

New Zealand

RBNZ official cash rate (%, Jun.) - In an out of consensus view, we expect the RBNZ to remain on hold at this week's Board meeting, owing to the less than compelling transition to recovery thus far. We acknowledge, though, that the decision is a close call. The 1Q employment data showed a labour market that is in much better shape than previously thought, although given the magnitude of seasonal distortions, the data was not indicative of a clear positive shift in momentum. Other domestic data has disappointed, with credit, in particular, falling. The RBNZ, therefore, has scope to sit on the policy sidelines, especially given the heightened uncertainty offshore.

Terms of trade (%q/q, 1Q) - We expect the terms of trade will have fallen 2.3% in 1Q; this would make the seventh fall in the last eight quarters. Both export and import prices should have risen, by 2.6%q/q and 5%, respectively. Exports prices will be driven higher by a solid rise in the price of dairy exports, while weaker NZD (down 2.7% over the quarter) will largely explain the rise in import prices.

JPMorgan Australia Ltd., Sydney
Ben Jarman (61-2) 9220-1669
ben.k.jarman@jpmorgan.com

Research note

Housing complex: Structural issues in Aussie housing

- **Our analysis suggests a current shortfall of over 180,000 homes**
- **Model points to a 12% rise in house prices in 2010**
- **Interplay of low unemployment, tight credit, and policy distortion to yield patchy regional performance**

The Australian housing market often is described as one of the most expensive in the world. Conventional metrics like rental yields indicate that Australian housing is substantially overvalued. Yet such observations are not new. Rental yields have been low since the late 1980s, while the house price to income ratio has far exceeded that in comparable economies for many years. These dynamics describe either a market that is perversely slow to correct, or one with greater structural distortions and more subtle measurement issues than are commonly noted. Here, we attempt to separate the structural characteristics of the housing market from the cyclical forces, to assess the outlook for construction and mortgage activity, and for prices.

Structural factor I: supply shortage

There is almost universal agreement that Australia has not built sufficient new dwelling stock in recent years. Estimates of the extent of this problem vary since there are inherent difficulties in estimating long-run dwelling demand. Most analyses, ours included, therefore concentrate on the deficiency in the flow of new housing, rather than in the stock. On our estimates, production of housing stock between 4Q06 and 4Q09 has undershot demand by around 180,000 dwellings (box).

The demand side of this calculation indeed has moved in an unfavourable direction, with population growth far exceeding historical norms. Annual population growth averaged 1.3% between 1982 and 2006, but has been above 1.7% since 1Q07, and above 2% since 2Q08. In particular, elevated immigration levels, which, given skill shortages, will surely be a feature of the landscape in the future, have intensified the squeeze on the housing stock. Experience suggests that when population growth is achieved through increased immigration, rather than increased births, housing supply tends to fall relative to the population size (chart next page). This is because immigrants either fundamentally desire larger household sizes, or, since their residence may not be permanent, feel less compelled to build new housing than existing households do when their family size increases. The fact that prices have not adjusted

The shortage: widely acknowledged, never observed

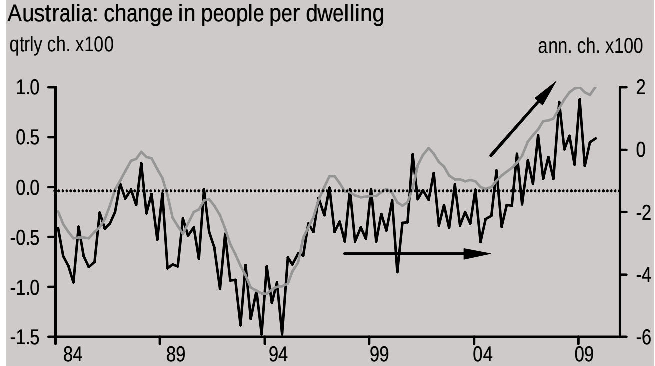
The supply of dwelling stock can be estimated using regular census figures and dwelling completion data. Demand, on the other hand, is unobservable: population figures are readily available, but the desired number of people per dwelling is not.

Shortfall = Population / desired people per dwelling
(Desired housing stock)
- Population / actual people per dwelling
(Actual housing stock)

A natural starting point in deriving the desired ratio might be to look at past levels of actual people per dwelling. However, there is an inherent problem with this method. Using an actual level of people per dwelling as a proxy for the desired ratio is equivalent to arbitrarily setting supply equal to demand at some time in the past.

Alternatively, using a moving average of the actual ratio as a proxy will avoid this problem, but the choice of the term is arbitrary. Shorter-term averages will lead the analysis to converge to the automatic equilibrium conclusion above. Longer-term averages do capture changes in the ratio that reflect true demographic changes in desired people per dwelling, but also the purely mechanical movements in the measured number of people per dwelling that are the consequence, rather than the cause, of the shortfall.

Australia: change in people per dwelling



Our conviction that a shortage indeed exists stems from the fact that the observed number of people per dwelling over recent years appears to have exhibited a prolonged, steep rise (chart). To be confident that we are capturing mostly the shortage of supply, rather than a change in demand *parameters*, we use a short period of three years, starting at the point where the annual change in people per dwelling turned positive, breaking with the long-run secular trend of diminishing household size (which occurred in 3Q06, by our downward, however, suggests that at least some of this tightening is undesirable, which raises the more pressing question: given that there are positive potential returns to investment in the housing stock, why has the supply response been so sluggish?

This is inherently a micro problem, and there are obvious policy constraints that are limiting the production of new housing. At the state level, land release programs have generally been limited in scope, leading industry groups to claim that the lag in supply is forcing up land prices and rents. Also, the recently released Henry Tax Review argued that transaction-based taxes like stamp duty limit flexibility in moving to more appropriate housing as families' circumstances change. This incentivizes renovation, and drags resources away from the production of new housing stock. Finally, local council approval processes remain needlessly time consuming, resulting in significant lags and risks in the development process. The 2010-11 Federal Budget missed an opportunity to address these impediments, meaning structural rigidities will remain.

Structural factor II: negative gearing

A fall in rental yields could, in the absence of structural factors, indicate a temporary misalignment of dwelling prices relative to fundamental value. However, a prolonged, secular decline in yields such as that witnessed in Australia likely indicates a distortion of another nature. The ability for Australian investors to offset a loss on rental property against other assessable income for tax purposes, known as negative gearing, is an influential factor. Under such a strategy, the investor is willing to accept lower immediate nominal returns on property investment, provided there is compensation in the form of capital appreciation.

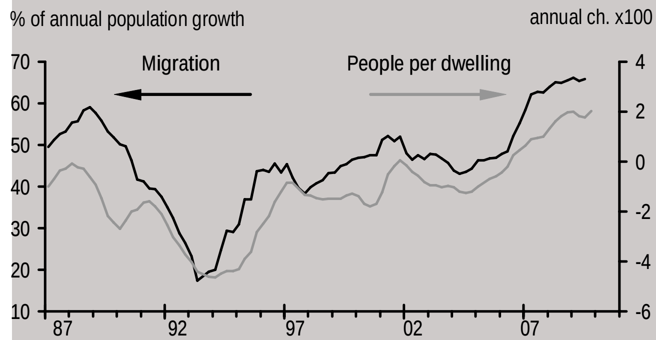
Given the experience under the temporary removal of negative gearing (1985 to 1987), when rents soared, it is argued that the policy was vital to preserving rental affordability. But, this version of events is not necessarily correct (rents rose sharply in some cities late in the 1985-87 window, but so did inflation more generally), and there are welfare issues around incentivizing price rises over rental returns. Australia historically has had an intense cultural desire for home ownership, so a policy that narrowly promotes returns through capital appreciation adds speculative investor demand to an already tight owners' market.

Structural factor III: foreign investment

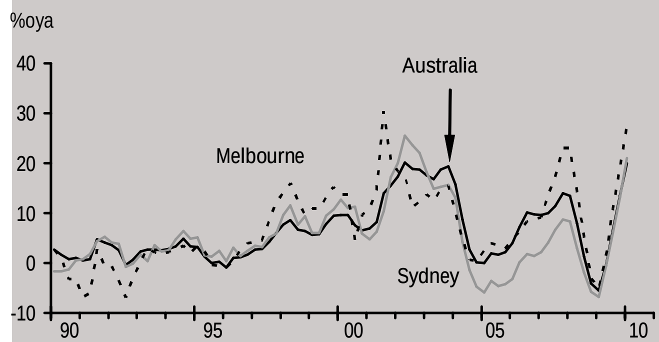
The regulation of foreign investment in residential property

estimates). We calculate the shortfall over this period by comparing the difference in stock implied by the current level of people per dwelling, and that prevailing when this ratio appeared to dramatically shift (3Q06). This results in a shortfall of 180,000 dwellings over this three-year period.

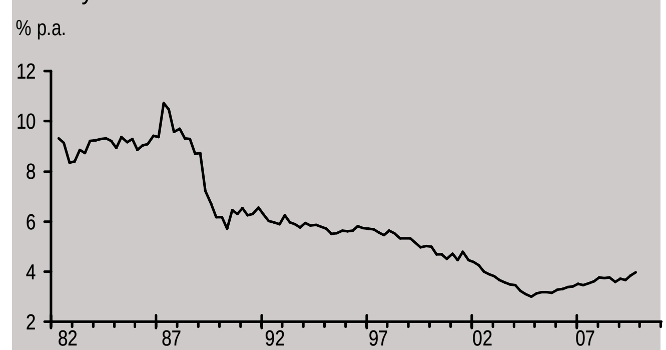
Migration and people per dwelling



House prices



Rental yields on three-bedroom houses



Source: Real Estate Institute of Australia (REIA). We have constructed the underlying measures of rents and prices for Australian 3 bedroom houses using weighted averages of those produced by REIA for Australia's five largest cities: Sydney, Melbourne, Brisbane, Adelaide, and Perth. There are more comprehensive data available on yields (for example, covering regional areas and a broader set of dwelling types), but these series are not as long. Note also that the argument that lower demand for detached housing over time could be depressing rents is insufficient, since it still leaves unexplained why lower prospective rents are not reflected in lower prices.

represents yet another moving part in the housing complex. In December 2008, the Australian government announced relaxed screening arrangements for foreign purchasers, with the intention of promoting transactional efficiency. Under the weaker rules, temporary residents purchasing property were exempted from having to notify the Foreign Investment Review Board (FIRB), provided the dwelling was new, or, in the case of an existing dwelling, was purchased for residence. Existing caps—one which restricted to 50% the proportion of dwellings in a new development project that could be sold to foreigners and another that prohibited purchases over A$300,000 by foreign students—also were abandoned.

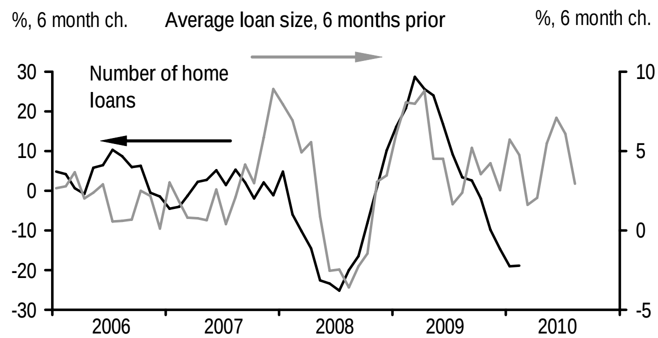
The rule changes had two significant effects. First, anecdotal evidence suggests a strong pickup in purchase activity by foreign buyers. Second, and more worrisome, is that, by definition, data on such purchases became far scarcer. This creates an informational black hole for central bank officials, who can no longer isolate the impact of foreign, high-turnover investment funds in gauging the performance of the housing market, as is necessary to calibrate policy.

The government was resigned to a partial reversal of this policy in April 2010, reinstating the approval process for the purchase of existing housing. The combination of a smaller influx of foreign funds, and increased sell-side activity (following from the requirement that temporary residents sell upon departure), should put downward pressure on prices in 2010. Again, however, it is difficult to quantify these effects, due to the period of lost data in 2009. This is most evident in the FIRB's recently released report for 2008-09, which reports a decrease of 34% in real estate approvals to foreigners, capturing six months in which foreign buyers bypassed the approvals process. We have no clue as to the base from which foreign purchases will fall, nor the volume of dwellings that will come onto the market as these temporary residents leave the country.

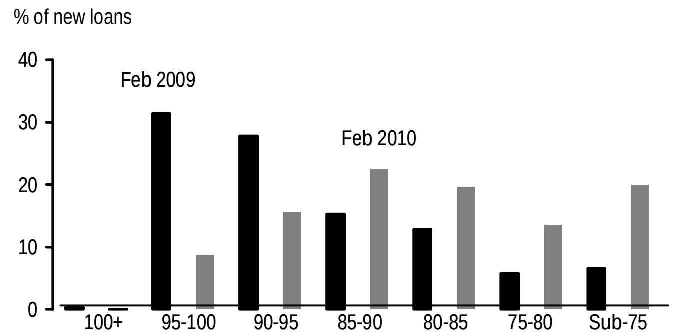
Cyclical factor I: a vacuum of FHBs

The remaining factors are medium-term trends that are uniquely relevant to the current cycle. These forces will either exacerbate or counterbalance the phenomena discussed already. This emphasizes the importance of pinning down the initial position: a market with significant supply rigidities, and therefore, price support. As such, we see the confluence of cyclical forces discussed below buffeting the housing market between outcomes that are higher up in the price space than would occur in many other markets internationally.[1] In October 2008, the vanilla First Home Buyers' (FHBs') grant was expanded from its original level of A$7,000 to A$14,000 for purchase of existing dwellings

Home loans and average loan size



First home buyer loan to value ratio (% terms)



and A$21,000 for new dwellings. From January this year, this additional support has been eliminated, with the grant returning to pre-crisis levels. Simultaneously, price caps were introduced on the vanilla grant.

The effect of the federal government's expanded FHBs' grant was to reduce effective prices for buyers and bolster demand at a point in the cycle at which confidence was particularly fragile. Now, those tailwinds have become headwinds just as interest rate hikes are beginning to bite. The recent plummet in housing finance approvals, given that it has coincided with still-elevated average loan sizes (chart), fits well with the picture of an intertemporal substitution of demand, rather than an outright contraction in demand (and perhaps, some constraints on the loan supply side, which we discuss later). Put differently, buyers are still willing to transact, but most already have bought in.

Cyclical factor II: credit conditions

The RBA's six official rate hikes between October 2009 and May 2010 have pushed borrowing rates back up to "average" levels. We forecast the cash rate to rise again

1. The IMF, for example, has repeatedly argued that the Australian housing market is overvalued and is due for a large correction, apparently ignoring the structural issues. Another problem is the imperfect data upon which such claims usually rest. House price to income ratios typically employ data that are too narrow in both dimensions: the official (ABS) data captures only capital city house prices, ignoring other generally less expensive dwelling types and those in regional areas, while income is usually measured at the individual, rather than household level.

from the current level of 4.50% to 6% by the end of 2011. Still further tightening of credit is likely from the Aussie banks. The "Big Four" facilitated the jump in loan growth that accompanied the expanded FHB grant, but will not be as accommodating in the aftermath. Funding costs continue to rise as more pre-crisis funding rolls out of the weighted cost calculation, to be replaced by more expensive post-crisis rates. Moreover, the banks will likely begin preparations for proposed changes to liquidity management regulation, which, although some years away, will substantially alter the cost of liquidity. These costs probably will be passed on to borrowers as the RBA adjusts policy.

The RBA, of course, will dynamically adjust their cash rate objectives, taking into account the bank funding premium. But loan supply could be restricted, with less credit available at the prevailing rate. Expensive funding forces the banks to reevaluate the most productive allocation of each marginal dollar. Pursuing greater growth in the mortgage space would result in yet further repricing of risk in wholesale funding markets, which the banks will seek to avoid.

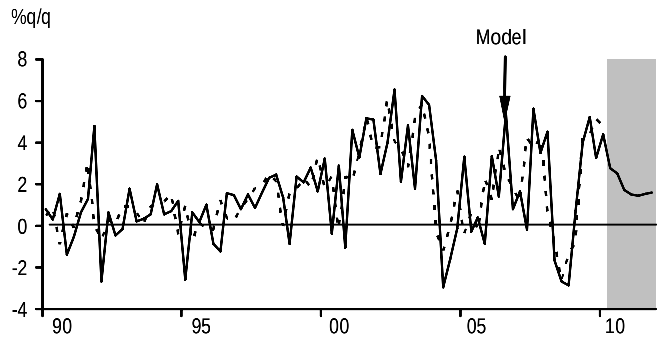
The consequences of these pressures are more moderate growth in housing credit and greater debt burdens for existing variable mortgage holders. The former effect has been taken into account in our house price model. The latter effect matters to the extent that it makes mortgages unserviceable. Anecdotal evidence suggests that most borrowers kept their repayments constant as mortgage rates were falling, so have not felt stress from the increase in rates thus far. Our analysis (see "First home buyers to suffer most as RBA tightens policy," *GDW*, May 28) suggests borrowers will soon begin to feel the pinch. Provided the economic feedback is not too intense, however, the healthy labour market should prevent significant mortgage stress.

Cyclical factor III: low unemployment

Our modeling has always placed unemployment as the most important macroeconomic determinant of house prices. During the financial crisis, our expectation of significantly higher unemployment (which was shared by the majority of economists, the RBA, and the government) was key to our expectation of a moderate house price correction. However, we underestimated the flexibility of the labour market, and the propensity for firms to use the release valve of cutting hours worked, rather than jobs. The distinction between these outcomes is small in terms of national income, but very significant from the perspective of debt serviceability.

Mortgage default is a relatively low probability outcome, but one with devastating consequences. So, too, with joblessness. The more uniform contraction in national income across households that arises from underemployment, provided it is not too great, can substantially reduce the system-wide probability of default. While sound lending practices have been widely noted as a key reason for Australia's low proportion of problem loans, the broad but shallow decrease in income attributed to trimmed worker hours surely has been influential as well. We have written repeatedly in recent months on Australia's bullish investment and employment outlook. Provided global growth remains sufficient to support these projects, a near-term substantial correction in house prices stemming from macroeconomic weakness therefore is difficult to envisage.

Australia: house prices and J.P. Morgan model



Housing market outlook 2010

The undersupply of housing is not an issue that can be resolved quickly, especially given the apparent lack of political will demonstrated thus far. Therefore, given the underlying price support such a situation provides, the interplay of the cyclical factors listed above will occur across a narrower spectrum of possible price outcomes than would otherwise be the case. Our forecast of an essentially stable unemployment rate, combined with solid immigration flows and price momentum, should outweigh the drags of higher interest rates and lower loan volumes, to produce capital city house price growth of around 12% in 2010.

There will, however, be a mix of outcomes by region and price group. Already there are reports of mortgage stress in regions where utilization of the expanded FHB grant was particularly intense; we expect this to result in some patches of weakness. Average/median prices, however, will be well supported, with a gradual slowing in momentum occurring over this year (prices rose 20% in the year to March). Home loan demand will continue to be sluggish, with FHB representation continuing to fall, but this likely overstates the moderation in house price growth to come.

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com
Ben Jarman (61-2) 9220-1669
ben.k.jarman@jpmorgan.com

Australia

- **RBA paused as expected, but job not finished**
- **Public spending underpinned Aussie growth in 1Q**
- **Labour market to have stepped backwards in May**

The commentary accompanying the RBA's no change decision last week was balanced, as we had anticipated. The policy pause was no surprise; heightened sovereign concerns in Europe and mounting evidence that previous tightening here had started to bite made last week's decision fairly straightforward. The highlight in a full week of Australian data was the 1Q GDP outcome, although the mix of growth was uninspiring. Indeed, but for the biggest annualized rise in public investment since 1960, the economy would have contracted.

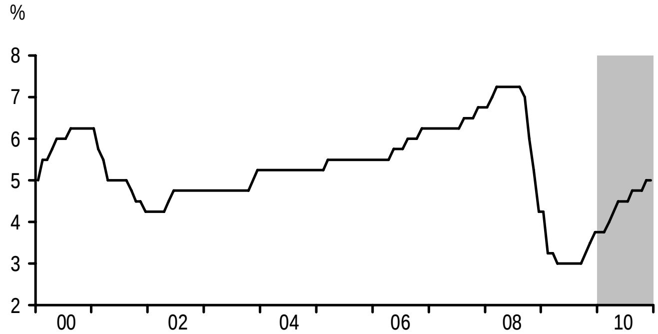
RBA stops to survey global outlook

The RBA last week left the cash rate steady at 4.5%, as we and the consensus had expected. This follows the 150bp of official rate hikes since October. The RBA's commentary announcing the decision was balanced and indicated that the setting of monetary policy is "appropriate for the near term." This simply is another way of saying that policy is "well placed for the present," the phrase officials used in the minutes from the May Board meeting.

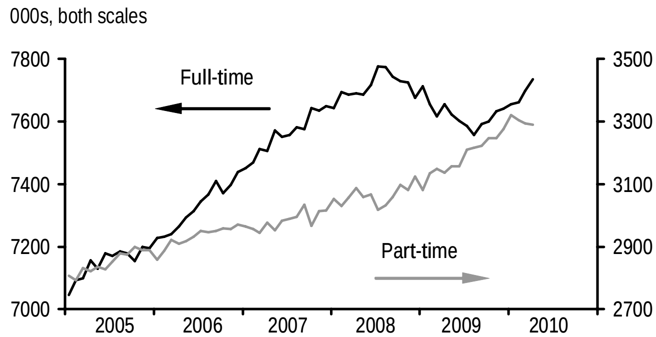
There were two main reasons the RBA paused last week. First, the commentary made explicit reference to the evolving sovereign events in Europe and the relevant actions of the authorities. While Board members appear sanguine about the extent of a likely spillover from financial market troubles to the real economy, recent events in Europe nevertheless pose a risk to the global growth outlook; developments globally will remain "under review." Second, even though the statement made no explicit mention of the consumer (or, for that matter, the labour market or house prices) there is mounting evidence that households now have crossed the interest rate pain threshold.

The commentary on Australia spanned just three lines. It again referred to the stimulatory impact on national income of the high-flying terms of trade, high commodity prices being a key driver of the filling investment pipeline. On the global outlook, officials still believe economic conditions in Asia, where 60% of Australia's exports are headed, remain "quite strong." In fact, the statement hints that the authorities to Australia's north probably should be taking action to slow growth in the region. The statement also indicates that growth in the US is becoming "more established", offsetting weakness elsewhere.

Australia: RBA cash target rate



Australia: employment



The RBA's tightening cycle has paused, not ended. Indeed, our forecast calls for another 25bp rate hike in August, and for a further hike before year-end, owing to looming inflation concerns. The dominant risk is that the RBA stays on hold for longer, but this would only occur if there is clear evidence that the events in Europe had led to a material spillover from financial markets to the real economy.

Aussie employment to have fallen in April

After adding a whopping 110,000 jobs in the first four months of the year, we expect that employment fell in May. Our forecast calls for 5,000 jobs to have been shed, marking only the second monthly fall since mid-2009. The unemployment rate probably edged up to 5.5%, with the participation rate holding steady at 65.2%. The recent shift from part- to full-time work will likely have continued.

Even though we expect stronger employment numbers going forward, the unemployment rate will likely maintain a 5%-handle this year. This owes to an elevated level of labour force participation. The participation rate will likely meander higher owing to a number of factors, including the fact that older workers are staying in the workplace longer, and some members of households that are struggling in the face of rising interest rates are reentering the workforce.

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com
Ben Jarman (61-2) 9220-1669
ben.k.jarman@jpmorgan.com

Employment and participation usually are positively correlated. Tightening labour market conditions later this year will be a growing concern for the RBA, particularly given signs already have emerged of building wage pressure.

Consumer confidence to decline further

Consumer confidence in Australia probably deteriorated further in June. We expect that confidence, as measured by the Westpac-Melbourne Institute (WMI), slipped 2%m/m, after slumping 7% in May. Consumers got a reprieve from the RBA's decision to leave the cash rate unchanged last week, but expectations of further rate hikes, still-elevated sovereign concerns in Europe, further AUD weakness, and lower equity prices will be weighing on sentiment. Indeed, AUD/USD is down nearly 10% since the start of May, and the All Ordinaries share price index has shed 8%. Higher interest rates are largely to blame for the fall in confidence in recent months. In the last consumer confidence survey in May, the WMI highlighted that the most recent rate hike pushed the variable mortgage rate from 7.15% to 7.4%, prompting an 8.1%m/m drop in confidence among those with a mortgage; this compared to average falls of only 2.3% following the five previous rate hikes in this cycle.

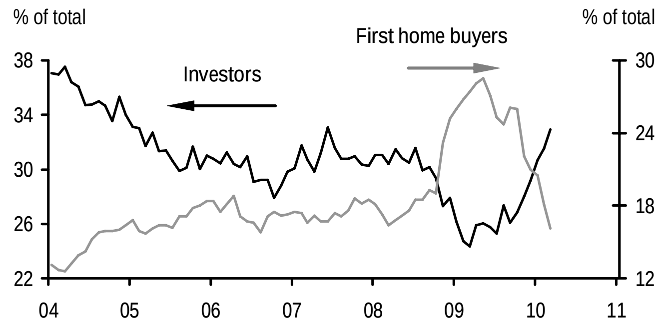
Housing finance still in freefall

The first few months of 2010 have shown a marked cooling in the Australian housing market; we expect that theme to have been continued in the April housing finance numbers, which should show a 2%m/m decline in loan volumes. Loans in March were 26% below the peak of June 2009. Growth in building approvals, being inherently more volatile, is following a less direct route down, but is definitely normalizing after the spike in 4Q09 that accompanied the end of the expanded First Home Buyer's grant. Rising interest rates and the withdrawal of the FHBs' boost are casting a long shadow on the housing market data, and the exodus of FHBs will have been noteworthy again in April.

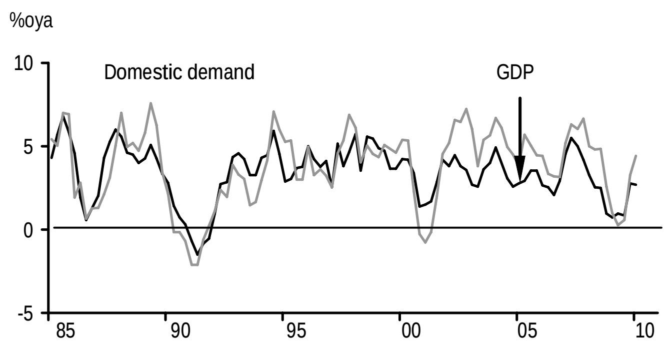
Public spending propped up 1Q GDP

The Australian economy expanded at a 0.5%q/q pace in the March quarter (J.P. Morgan: 0.4%; consensus: 0.5%), less than half the upwardly revised 1.1% rate of advance in 4Q (previously 0.9%). With net exports puncturing GDP growth again, albeit more mildly, all of the growth in the economy came from domestic sources, namely government expenditure; private sector spending weakened. Without the significant positive contribution from public spending, real GDP would have contracted in 1Q. Indeed, the largest positive contributor to GDP in 1Q was public investment,

Australia: housing finance



Australia: growth in GDP and domestic demand



which underpinned economic activity, surging 11.6%q/q and adding 0.7%-pts to GDP growth. This owed largely to the extension of the government's fiscal stimulus package, with solid public expenditure on infrastructure, public sector housing, and the schools building program. The impact of these programs should soon start to fade, meaning that the contribution to economic growth from public spending will dwindle.

In contrast, the main laggard in the growth numbers was private investment, which subtracted 0.6%-pts from GDP growth, and fell 2.4%q/q. This was no surprise. Government stimulus dragged forward private spending into 2009, leaving something of a vacuum early this year. Net exports subtracted 0.5%-pts from GDP growth in 1Q, marking the third straight quarterly decline. The drag from net exports was to a small extent offset by a 0.2%-pt contribution from inventories. Household consumption remained firm, but grew at a slower 0.6%q/q rate in 1Q, down from 0.9% in 4Q, and will remain subdued in the period ahead, particularly given the recent tumble in consumer confidence.

Retail sales held up despite rate hike

We expected that higher interest rates would have led consumers to tighten their purse strings in April. Retail sales values increased 0.6%m/m, however, after rising 0.8% in

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com
Ben Jarman (61-2) 9220-1669
ben.k.jarman@jpmorgan.com

March. We maintain, though, that the cumulative impact of the RBA's 150bp of tightening since October last year, including the latest 25bp rate hike in May, which would not have been captured in last week's retail data, will dampen retail spending in coming months. Consumers will soon take on a more conservative approach to spending as rate hikes eat further into households' disposable incomes. As such, retailers will be forced to discount goods further, which will weigh on retail sales values.

Recovery in credit growth stalled in April

Growth in the RBA's credit aggregates eased in April, although by slightly more than we had expected. After growing 0.5%m/m in March, the RBA's credit aggregates grew just 0.2% last month (J.P. Morgan: 0.4%; consensus: 0.5%), the slowest rate of growth since November last year. The drop in business credit in April was the biggest surprise. The pool of outstanding credit to businesses contracted 0.4%m/m last month, after rising in March for the first time since early 2009. Housing credit again was the fastest growing pool, although it grew at its slowest rate since August 2008. Higher interest rates and the absence of the expanded first home buyers' grant dampened demand for housing credit, which grew just 0.5%m/m. Personal credit growth also slowed, rising just 0.2%m/m.

Data releases and forecasts

Week of June 7 - 11

Mon Jun 7 11:30am — **ANZ job advertisements**
Seasonally adjusted

	Feb	Mar	Apr	May
(%m/m)	19.1	1.8	-1.2	__

Wed Jun 9 10:30am — **WMI consumer confidence survey**
100=neutral, seasonally adjusted

	Mar	Apr	May	Jun
(%m/m)	0.3	-1.0	-7.0	-2.0

Wed Jun 9 11:30am — **NAB monthly business survey**
% balance, seasonally adjusted

	Feb	Mar	Apr	May
Business confidence	19	16	13	11

Confidence likely fell further in May, amid sovereign concerns, higher interest rates, and weaker AUD, although should remain above the long run average (+7).

Wed Jun 9 11:30am — **Housing finance approvals: owner occupiers**
Number of loans, seasonally adjusted

	Jan	Feb	Mar	Apr
(%m/m)	-7.4	-2.0	-3.4	-2.0
(%oya)	-11.9	-16.4	-23.3	-25.7

Thu Jun 10 11:30am — **Labour force**
Seasonally adjusted

	Feb	Mar	Apr	May
Unemployment rate (%)	5.3	5.4	5.4	5.5
Employed (000 m/m)	-11	28	34	-5
Participation rate (%)	65.2	65.2	65.2	65.2

Review of past week's data

Inventories

	3Q09		4Q09		1Q10	
%q/q,sa	~~0.1~~	*0.0*	~~0.2~~	*0.4*	~~-0.1~~	*0.5*
%oya,sa	~~-3.7~~	*-3.9*	~~-2.6~~	*-2.7*	~~-1.7~~	*-1.2*

Company operating profits
Nominal, gross operating, sa

	3Q09		4Q09		1Q10	
%q/q	~~-1.4~~	*-1.5*	~~2.2~~	*3.2*	~~4.5~~	*3.9*
%oya	-19.7		~~-11.2~~	*-10.7*	~~-2.0~~	*-1.3*

Current account balance
A$ bn, sa

	3Q09		4Q09		1Q10	
Current account (A$ bn)	~~-14.7~~	*-13.8*	~~-17.5~~	*-18.5*	~~-16.3~~	*-16.6*
% of GDP	~~-4.7~~	*-4.4*	~~-5.4~~	*-5.8*	~~-5.0~~	*-5.1*

Private sector credit

	Feb		Mar		Apr	
%m/m,sa	0.4		0.5		~~0.4~~	*0.2*
%oya,sa	1.7		2.1		~~2.4~~	*2.1*

Building approvals

	Feb		Mar		Apr	
%m/m,sa	~~-2.7~~	*-1.9*	~~15.3~~	*16.8*	~~-6.0~~	*-14.8*
%oya,sa	~~36.3~~	*37.4*	~~51.6~~	*54.4*	~~32.3~~	*21.3*

Approvals delivered the payback we had anticipated. Permits tanked, though the composition was puzzling: private sector houses (-13.5%m/m), were responsible for the shortfall, rather than the volatile higher density dwellings category.

Retail trade

	Feb		Mar		Apr	
%m/m,sa	-1.2		~~0.3~~	*0.8*	~~-0.2~~	*0.6*
%oya,sa	~~3.4~~	*3.5*	~~1.2~~	*1.6*	~~0.5~~	*1.8*

RBA cash rate announcement

No change delivered. See main text.

Real GDP
Chain volume, sa

	3Q09		4Q09		1Q10	
%q/q	0.3		~~0.9~~	*1.1*	~~0.4~~	*0.5*
%oya	0.9		~~2.7~~	*2.8*	~~2.3~~	*2.7*

Trade balance

	Feb		Mar		Apr	
Trade balance (A$ mn,sa)	~~-1701~~	*-1641*	~~-2082~~	*-2040*	~~-1800~~	*134*

The trade balance screamed back into surplus in April for the first time since March 2009, with coal and ore exports surging 40%m/m and 25% respectively.

New Zealand

- **RBNZ OCR announcement this week a close call**
- **Relevance of BoC rate hike as a trigger is overstated**
- **Kiwi business confidence hanging tough**

The RBNZ's decision this week will not be as clear cut as was the RBA's last week. Although the RBNZ has expressed its willingness to remove policy stimulus "in coming months," events offshore, combined with lingering signs of weakness in the domestic economy, suggest that interest rates in New Zealand should stay put.

RBNZ officials to hold their nerve

We maintain our call for the RBNZ to leave policy unchanged this week, although acknowledge that it's a close call. Market pricing suggests an 84% chance of a 25bp rate hike on June 10, although there are clear reasons, in our view, for the RBNZ to stand pat. The next tightening cycle will kick off this year, however, with our forecast calling for the first hike to be delivered in July, providing that sovereign concerns in the Euro area do not escalate.

With the domestic recovery patchy, and considerable uncertainty surrounding current financial stresses in the Euro area, the RBNZ has scope to sit on the policy sidelines. This view was supported by an NZIER report last week that said the New Zealand economy is recovering, but "global financial, political, and social turmoil" are key risks, meaning there is "no urgency" for the RBNZ to hike interest rates. We agree. Indeed, the Kiwi recovery will be severely affected if problems in the Euro area spillover into the real economy at a time when the Kiwi economy already is fragile. Real retail spending, for example, currently is stagnant, credit growth is negative, and exports are recovering slowly, so the recovery is far from entrenched.

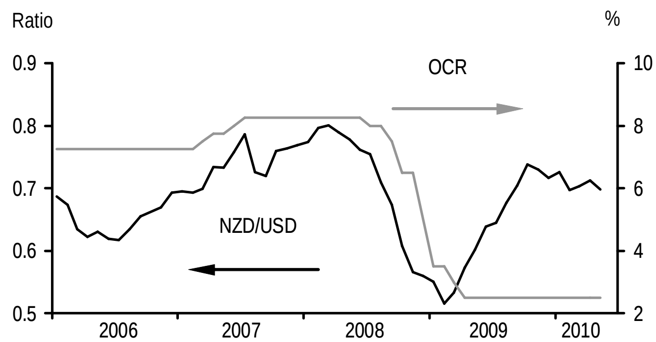
We acknowledge the Bank of Canada's decision to tighten policy last week in this current, uncertain environment. RBNZ Governor Bollard will take this into account. The Canadian economy, though, is in much better shape than New Zealand's, growing 6.1% annualized in 1Q. Further, the key policy rate, prior to last week's rate hike, was at a highly stimulative 0.25%. In contrast, the OCR in New Zealand is at 2.5% and, on our preliminary forecasts, the economy will expand just 3.0% annualized in 1Q.

NZ firms not capitulating as yet

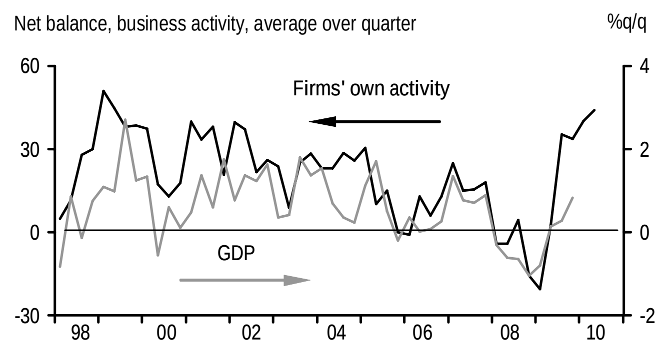
The headline reading on the NBNZ business confidence index headed lower in May, but by less than expected. A net 48% of respondents (J.P. Morgan: 45%) to the survey expect that business conditions in New Zealand will improve over the next 12 months, down from 50% in April. Furthermore, the all-important firms' own activity outlook index rose, increasing from a reading of 43.0 to hit an eleven-year high of 43.5 in May. This supports our call for the economy to expand at a healthy clip in coming quarters. Our forecast is for GDP growth of 0.5%q/q in 1Q, but a stronger 0.9% rate in the following two quarters thereafter.

We had anticipated a larger fall in the headline reading, owing mainly to heightened sovereign concerns in the Euro area, but also to mixed economic messages and the recent sell-off in global equity markets. The NBNZ said, though, that these developments were too late in the month to be captured by the survey, which had a close off date of May 14. Next month's survey will, therefore, probably show a significant drop in business confidence.

New Zealand: RBNZ official cash rate and NZD/USD



New Zealand: NBNZ business outlook survey and GDP growth



Data releases and forecasts

Week of June 7 - 11

Mon Jun 7 — QVNZ house prices
%, median

	Feb	Mar	Apr	may
(%oya)	5.5	6.1	6.1	__

Thu Jun 10 9.00am

RBNZ cash rate announcement

No change expected. See main text.

Thu Jun 10 10:30am

Business PMI

Seasonally adjusted

	Feb	Mar	Apr	May
Index	53.7	56.7	58.9	__
(%oya)	35.3	34.2	34.2	__

Thu Jun 10 10:45am

Terms of trade

Seasonally adjusted

	2Q09	3Q09	4Q09	1Q10
(%q/q)	-9.4	-1.6	5.7	-2.3

The fall in the terms of trade we anticipate would mark the seventh quarterly fall in the last eight quarters. Both export and import prices should have risen, by 2.6%q/q and 5%, respectively. Export prices will be driven higher by a solid rise in the price of dairy exports, while weaker NZD (down 2.7% over the quarter) will largely explain the rise in import prices.

Review of past week's data

NBNZ business confidence

	Mar	Apr	May	
% balance of respondents	42.5	49.5	~~45~~	*48.2*

ANZ commodity price series

Not seasonally adjusted

	Mar	Apr		May	
Index - world prices (%m/m)	1.8	~~4.9~~	*5.4*	__	*2.5*
Index - NZD (%m/m)	0.4	~~3.8~~	*4.2*	__	*2.9*

JPMorgan Chase Bank, New York
Bruce Kasman (1-212) 834-5515
bruce.c.kasman@jpmorgan.com
David Hensley (1-212) 834-5516
david.hensley@jpmorgan.com

Global Essay

- **May activity data point to strong global growth this quarter**
- **Emerging Asia's downshift has begun as regional exports to China stagnate**
- **Despite private payroll disappointment, US labour income gains accelerate**
- **Expecting COPOM tightening (75bp) and little action from the ECB this week**

It's complicated

For more than a year, forecasting global growth has been relatively easy. The upward trajectory of activity indicators has been consistent in the US and Emerging Asia. Any synchronized turn in these regional economies reliably signals where global growth is heading. Except for brief interludes, the improvement has been accompanied by rising equity values and narrowing credit spreads—forces that reinforce positive growth momentum.

That was then. Now, powerful crosscurrents have entered the scene and are complicating the forecasting process. The overall thrust of global activity indicators remained upbeat through May, and the current quarter appears on track to produce the strongest global GDP gain thus far in the expansion. More important than the strength of the expansion is its broadening base as business behaviour shifts from retrenchment to expansion. We look at this shift as increasing the resiliency of the expansion and lies at the heart of our forecast of sustained above-trend global growth in the coming quarters.

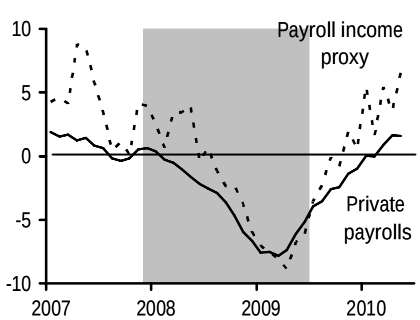
However, this upbeat news is being accompanied by signs that Emerging Asia is downshifting in response to a policy-induced cooling in China. Although a slowing is incorporated in our forecasts—and is starting from a much stronger 1Q10 outcome than had been anticipated—it is too early to gauge how far the downshift will run. At the same time, an encouraging lift in Euro area activity indicators is being threatened by a sovereign crisis in which Euro area banks' access to market financing has been severely curtailed. The sharp fall in investor risk appetite over the past month not only reflects concerns on these fronts but also raises the risk that the feedback loop between the real economy and financial markets shifts into reverse.

Against this backdrop, the US economy's performance during the coming months will likely tell the tale for the global economy during the second half of the year. Resilient US demand will increase the likelihood that Asia's downshift proves modest. Signs that the behavioural shift away from retrenchment remains intact in the US will also likely serve as a bellwether for the progress of adjustments elsewhere. Against this backdrop, the slower May private sector job growth is a disappointment. However, there was no slowdown in labour income growth—which is the key force by which a shift in business behaviour supports household purchasing power. Firms are using their existing workers more intensively as they lengthen the work week. As a result, the payroll proxy of labour income growth rose at a 6.6% annualized pace over the past three months, its fastest pace in three years.

US consumers appear to be facing a rapidly changing set of fundamentals as they move into midyear—including rising labour income, falling equity values, and lower petrol prices. If we are right, this week's May retail sales report should continue to soften on the heels of very strong gains through the end of last quarter. Overall, our projected outcome is consis-

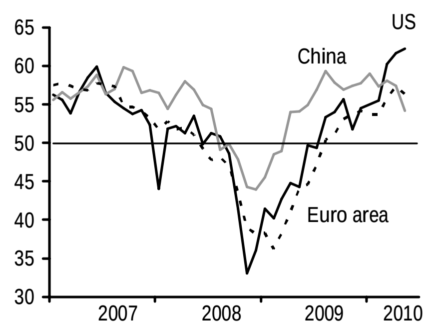
US: private sector payrolls and labor income

%ch saar, over 3 months



All-industry PMI output index

DI, sa



EM Asia exports to China

US$ bn samr; Taiwan, Korea, Thailand, Singapore

tent with a still solid 3% consumption gain this quarter.

Little room for policy action to offset risk

We believe that downside risks currently weighing on financial markets will not be realized, and the global recovery will continue unabated. However, risks are skewed to the downside, and it is unfortunate that developed market policymakers are not positioned to take out insurance to offset these risks. In most countries, fiscal supports have already been stretched to the limits, with the policy debate shifting towards the timing of consolidation. On the monetary front, rates are close to zero in most of the developed world. The expansion of quantitative easing is a step central bankers look likely to consider only under duress.

It could be argued that the ECB should be feeling duress as it meets this week. However, it is unlikely to exhaust its existing conventional tool—lowering its refi rate from 1%. Instead all it is likely to deliver is an announcement of further unlimited three- and six-month tenders, and possibly an extension of the commitment to offer unlimited weekly and monthly tenders beyond the autumn. A further deterioration in financial markets could prod the ECB to increase its covered bond purchase program and refocus it to provide more support to the southern rim.

Central banks wait and watch

A policy response to growing risk is coming from the general move to refrain from action by those central banks on a normalization path. Last week the Bank of Canada delivered an expected 25bp tightening, taking a small step away from an emergency rate setting of 0.25%. Canada's tightening move is the rare exception, however. In this vein, the RBA paused last week to allow time to see how the European situation and 150bp of past tightening play out. Central banks in Thailand, the Philippines, and Hungary also held their fire, while Russia's eased 25bp. We scaled back tightening calls in Turkey, Thailand, the Philippines, and Israel, continuing the trend of recent weeks.

This week's policy calendar is equally busy. Of the six meetings scheduled, the only rate action is expected in Brazil, where we look for the COPOM to hike an additional 75bp. A move to 100bp, while possibly warranted on domestic grounds alone, has been ruled out by global developments. Elsewhere, rates are forecast to be left unchanged in the UK, Korea, and Peru. In an out of consensus view, we also expect the RBNZ to remain on hold at this week's Board meeting, reflecting the sluggish pace of the recovery so far.

EM Asia comes off the boil

China's economy expanded about 12% over the year ended 1Q10. This rapid growth brought signs of overheating that officials sought to contain with an array of tightening measures targeting the property market and public sector investment. The signs are that these measures are having their intended effect. The most convincing evidence is the recent slide in the all-industry PMI to 54.2 in May, which was 4pts below the 1Q average. This week's May activity data should reinforce this message, confirming slower momentum in bank lending, fixed investment, and industrial production. However, it may take a few more months before we can gauge whether growth will settle at a 9%-10% annual rate for remainder of this year, as we forecast. This week's reports also are expected to show that inflation moved up to 3%oya last month; however, with the economy slowing and officials worrying about export prospects, policy is likely to remain on hold.

A moderation in China's growth will reverberate elsewhere in Asia, where growth proved surprisingly strong last quarter. Regional data already are registering the impact as exports from the rest of EM Asia to China have stagnated in the year to date. The pattern of IP growth has also turned more mixed across the region, while manufacturing PMIs have retreated in Taiwan and Korea (although not in Singapore). In addition to China, the inventory cycle likely is damping growth in regional IP and trade flows. Inventory data are limited, but with regional IP having surged by one-third over the past year (ex. China), producers probably have aligned the growth of inventories with sales, leaving final goods demand as the principal driver of IP growth.

Outside Greece, Euro area growth is up

As we have sought to gauge the macroeconomic conse-

Euro area composite PMIs

DI, sa, manufacturing PMI for Greece

quences of the sovereign stress in the Euro area, we have highlighted three reasons to maintain a relatively upbeat growth forecast. First, that the region has a significant cyclical tailwind as it recovers from a very deep recession. Second, that in aggregate, fiscal policy is broadly neutral, as easing in Germany, the Netherlands, Austria, and Finland offsets tightening in Greece, Spain, Portugal, and Ireland. And third, that the weaker euro will steer more demand to Euro area producers.

Available data, including last week's PMIs, suggest that the growth forecast is tracking for now. Perhaps most surprising are recent readings for the vulnerable periphery. In Greece, the monthly data are tracking our forecast, which calls for a significant contraction in GDP this quarter. However, in Spain, Portugal, and Ireland, survey data are tracking growth of 2%-3% annualized in the current quarter, significantly better than expected. It is too early to judge whether growth in the year as a whole will turn out better than expected in the southern periphery; the increased financial stress and the fiscal tightening measures have yet to fully impact economic activity. But, at least outside Greece, it is certainly possible that growth performs better than is currently anticipated. With the monthly budget data tracking well through April, a firmer than currently expected growth trajectory in the rest of the year would certainly help these governments achieve their fiscal objectives.

A change at the top in Japan

In Japan, the former Finance Minister Naoto Kan was appointed Prime Minister following the resignation of Yukio Hatoyama, who lasted just eight months in the office. Although Kan named both growth and fiscal consolidation as objectives in his inaugural press conference, we expect the new government to place a higher priority on growth. This course would reflect a belief that moving too early on fiscal consolidation, including an increase in the consumption tax, could jeopardize the recovery, and that higher JGB issuance will have a limited impact on government borrowing rates. Kan supports the idea of inflation targeting, which he thinks should be above the current 1% de facto inflation target. This could raise tensions between the government and the BoJ. This week's May Economy Watchers and consumer sentiment surveys, as well as April machinery orders, should be watched to gauge the economy's momentum this quarter.

An interesting weekend in Budapest

The new Hungarian government's announcement that its fiscal position is worse than previously reported has opened a new front to the European sovereign debt crisis. The government was expected to announce a two-year crisis plan over the weekend that would include the use of unorthodox measures, in order to avoid aggressive fiscal consolidation, but this has been postponed. There remains conjecture however that a flat income tax rate will be introduced, and promised tax cuts will be repealed. The government will be meeting with the EU and IMF this week, the key issue being the move toward another program being secured this fall.

Turkey: a better growth/inflation mix

In Turkey, incoming data point to a better mix of growth and inflation. Although Euro area developments are a concern, we are raising our 2010 GDP growth forecast from 5.1% to 5.9% as Turkey has limited trade and banking exposure to the more troubled southern periphery. Even as growth is surprising on the upside, inflation is turning out to be less of a threat than anticipated. The over-year-ago rate fell to 9.2% in May and remains on a downward trajectory, reflecting lower food and core inflation. In response, we trimmed our year-end inflation forecast to 7.2%. The improved inflation outlook, combined with global uncertainty, points to a more patient central bank. We now expect the CBRT to hike rates by 75bp in the last quarter of the year versus 150bp previously.

JPMorgan Securities Ltd., London
Jan Loeys (44-20) 7325-5473
jan.loeys@jpmorgan.com
John Normand (44-20) 7325-5222
john.normand@jpmorgan.com

JPMorgan View - Global Markets

The risk trade and the spread trade

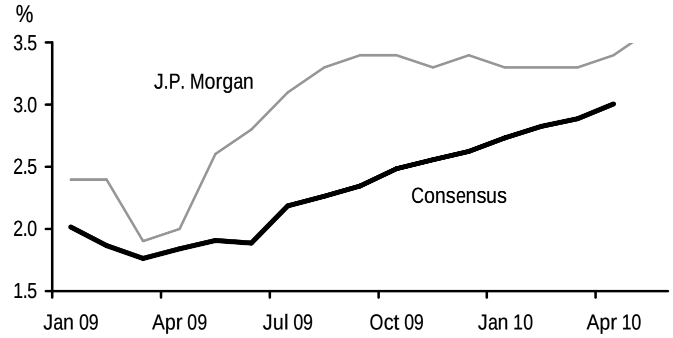
- **Asset allocation:** Overall low tactical risk, but most focused on underweighting the world's hot spots, Europe and banks. China and EM are starting to perform better. We retain a token overweight of risky assets.
- **Economics:** Global activity data remain fine, with unchanged forecasts, but the market correction creates a downside risk bias.
- **Fixed income:** Sell the front end in the US and Australia, where the payoffs to short positions are asymmetric.
- **Equities:** Underweight small caps versus large caps, especially in Europe.
- **Credit:** Remain underweight European banks.
- **FX:** Stay short EUR versus CHF, MXN, and EM Asia (ADXY).
- **Commodities:** Stay long crude oil.

Again a very volatile week last week, not just in price terms, but also in daily sentiment swings. Friday morning, we saw hints that a noisy bottom was starting to form in risky asset classes, but markets then lurched down again after bad headline news from Hungary and US payrolls. Our best guess—rather than strong conviction—is that June will remain volatile with a new year low quite possible if not likely, but that into the summer, **a relatively resilient world economy will pull risky asset prices up again**.

US job creation in May disappointed, but the details—longer hours and higher incomes—were better than the headline. This report is not enough to lower growth forecasts, but, together with the market fall, creates a downside risk bias. The **Hungarian** news that its public finances are worse than previously thought will likely force its government to announce strong remedial action in coming weeks. Headline news this week is set to be negative, even as these actions should eventually secure IMF and EU support for Hungary.

There are two major asset allocation trades out there—**the risk trade and the spread trade**. The risk trade entails being overall long or short risky assets. The spread trade entails positions involving the world's hot spots—Europe, China, and the banks. Our advice is to have a **small long on the risk trade, and to have much larger, but short, exposure in the world's hot spots through the spread trade**.

2010 global GDP growth forecasts: J.P. Morgan versus consensus



Source: J.P. Morgan, Bloomberg. J.P. Morgan forecast is current; last observation for consensus is early May. Bloomberg forecasts are for regions and countries that we averaged using the same 5-year rolling USD GDP weights that we use for our own global growth forecast. Previous charts used *Consensus Economics*, which used very different weights than J.P. Morgan global forecasts.

The spread trade is the more obvious position to have, but one needs to take heed of value. We stay underweight Europe through credit, banks, and the euro. We are not underweight in equities as the falling euro is greatly benefiting European exporters. Be short EUR against the Swiss franc, and in EM, MXN, and the Asia EM ADXY dollar index. Underweight banks globally in equities and credit. We have had an underweight of Chinese equities, but the time is coming close to buy them again, with MSCI China outperforming over the past month on signs its economy is approaching a soft landing.

On the risk trade, price momentum is now clearly negative. This is not because last month was bad, but because risk assets are down over the past six months, and 200 days, which have been the relevant look-back periods for asset allocation signals. One must respect this bearish signal, but cannot invest by price momentum alone. We have focused in recent years on the momentum in the underlying views that drive markets—forecasts of **economic growth and corporate earnings**. The chart shows how through early last month, the consensus was still steadily raising global growth forecasts. Over the past month, our own 2010 forecast was raised from 3.5% to 3.6%, all due to Asia, while Euro area growth was trimmed back. The main issue is whether the market correction will now feed back into a weaker economy into 2H.

Contagion from the European crisis could come via falls in private or public spending plans, due to increased uncertainty or reduced credit flows from banks or capital markets. We know that these pressures have induced fiscal tightening across a greater number of European countries, but by our measures the aggregate impact only brings fiscal thrust in the Euro area to neutral for this year and -1% of GDP for next year.

The impact on private spending cannot show up yet in actual spending data as these are all for March and April, preceding most of the sell-off. We do have confidence and purchasing manager surveys. Confidence is clearly falling off badly in periphery Europe, but in the rest of the world, confidence and PMIs remain strong, even as they have slipped slightly from the record highs reached in recent months.

It is possible that funding pressures among banks will force them toward a 2008 type of delevering, but over the past month at least, their clients do not seem to have noticed much of this. In our weekly *Flows & Liquidity*, we report that **European bank funding conditions continue to worsen** at a slow pace. Their US CP outstandings fell again, and they have now issued nearly nothing in the bond market for six weeks running. Another month of this illiquidity will become damaging.

Fixed income

Bond markets rallied strongly last week, on a weaker headline payrolls print and comments on Hungarian solvency by a government spokesman. Concerns over Euro area sovereigns broadened across EMU, pushing spreads to German Bunds to their widest level of the year for all countries except those targeted by the ECB's purchases—Greece, Ireland, and Portugal. Intra-EMU spreads are likely to widen further over coming weeks, as investors increasingly differentiate between core countries previously regarded as near substitutes.

We do not expect the ECB to stem the tide by increasing bond purchases at this week's policy meeting, but a modest extension of its liquidity facilities is likely. **This should keep overnight rates low for longer, and prompts us to shift our long Euro area money market position further out the curve** (see *GFIMS Euro Derivatives*).

The outlook for bond markets ultimately depends on whether market turmoil stalls the momentum of the global recovery. Indeed, the Bank of Canada encapsulated this dilemma last week in hiking rates, but with a cautious statement stressing the risks emanating from Europe. **Our strategy is to hold shorts in markets where strong economies make it hard for yields to fall much further, making the payoffs to short positions asymmetric.** Thus, we sell two-year US Treasuries, which are now only a few basis points off their all-time low. And we are short the front end in Australia, where only around one more rate increase is priced in over the next year.

Equities

Equities were down in a volatile week. Economic data were rather mixed last week while funding markets in Europe remain under pressure. Equity indices are below their 200-day moving averages, pointing to negative technicals.

What do we need to see to become positive on equity markets? First, a reopening of debt capital markets in Europe is an important marker to watch. Second is a confirmation that the financial stress of the past months has done little damage to the real economy through confidence or the credit channel. Unfortunately, it will take time, perhaps several months, for markets to make that assessment, and we thus see elevated uncertainty and a volatile range in equities for most of this summer.

How should we position at the moment? Our strategy focuses on overweighting countries that are more remote from Europe, the epicenter of the crisis, such as the US, especially industry groups with little euro exposure, and India and Mexico in EM. We are not yet recommending an overall overweight in EM versus DM equities, given still high uncertainty regarding China and growing downside risks to commodity producers.

Small caps peaked in mid-May versus large caps globally and have been underperforming since then. **We see more downside for small caps** in the near term. Investors have so far refrained from selling their more illiquid small cap holdings, meaning that they are overweight small caps. If the equity sell-off continues, a flight to liquidity will likely force equity investors to start selling their more illiquid small cap holdings. If, on the other hand, equity markets go up, investors are more likely to buy large caps that were hit the worst over the past months. The downside for small caps is admittedly greater in Europe as small caps are more exposed to the domestic economy compared to large caps.

Credit

Credit markets sold off for another week due to a disappointing US labour report and increasing sovereign risk in Hungary. With spreads widening substantially since the trough in April, we see good valuations and buying opportunities across credit markets, especially those in the US and EM. However, we keep directional risk exposure minimal for now as the market is likely to remain volatile.

The fundamentals and long-term demand drivers for credit remain in place. One of the sources of uncertainty, in our

JPMorgan Securities Ltd., London
Jan Loeys (44-20) 7325-5473
jan.loeys@jpmorgan.com
John Normand (44-20) 7325-5222
john.normand@jpmorgan.com

opinion, is beginning to recede. Although the bank regulations for Europe have yet to be agreed upon, the US Financial Reform Bill is much nearer completion. The rating agencies also signaled a delay in their reactions to the proposed financial reform bill until later this year and maybe next. The reduction of these risks is removing an immediate overhang on US financials, which in turn improves the outlook for US HG as well. Moreover, for creditors, higher capital requirements are likely to offset the lower future profitability implied by the proposed US bank reform bill.

These improvements will continue to be challenged by the risks from Europe, though. There are real structural issues that need to be resolved before the outlook for the Euro area improves. Hence, we **keep underweights in European HG and European banks**.

Foreign exchange

Investing in the current volatile environment seems to require more luck than skill. Many cyclical currencies (yen crosses, commodity currencies) are cheap on valuation grounds, but they will fall further if the ECB fails to address funding pressures on Thursday. Yet selling those pairs at current levels ignores the significant deleveraging that has occurred already, and the speed with which policymakers could address funding issues. Pre-positioning only makes sense if one could forecast the ECB, but since the bank has managed multiple *volte faces* over the past two months, its actions look close to random.

The most compelling trade is the one that has the least to do with sovereign risk—**selling EUR/CHF**. We have been short for six months through various structures. If the ECB delivers on substantive liquidity measures on Thursday, we will reenter longs in the commodity currencies and yen crosses, and sell the euro on the crosses. Selling the euro on the G-10 crosses now (except for EUR/CHF) looks premature given the systemic risks from a rapid deteriorating European funding conditions.

Commodities

Commodities were down about 2% last week, as US payrolls disappointed. While all risky markets reacted significantly to the number, there is a positive side for commodities as, by industry, the best performer continues to be manufacturing with both employment and hours increasing markedly. While manufacturing activity has been the main driver for commodity prices over the past year, the overall growth picture remains the main concern. **We keep a positive view in the medium term**, even though there is a risk that the market correction and associated volatility may last longer. In our view, economic fundamentals should not be significantly affected, but the upside for many commodities is now more limited.

On Thursday, prices reacted positively to lower crude and oil stocks due to lower crude production and higher demand for oil. The impact of the drilling ban in the Gulf of Mexico also took center stage with a report that all drilling in the Gulf of Mexico had been halted. Oil prices should recover in the coming weeks as the influence of a slew of bearish factors that pressured prices recently starts to wane. Stay long.

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	2.58	2.75	3.05	3.15	3.25
United Kingdom	3.51	3.70	3.85	4.00	4.30
Japan	1.29	1.40	1.50	1.55	1.55
GBI-EM	6.91			7.90	

Credit markets

	Current	YTD Return
US high grade (bp over UST)	178	3.6%
Euro high grade (bp over Euro gov)	202	2.7%
USD high yield (bp vs. UST)	707	3.5%
Euro high yield (bp over Euro gov)	750	4.1%
EMBIG (bp vs. UST)	352	3.8%
EM Corporates (bp vs. UST)	366	3.5%

Foreign exchange

	Current	Jun 10	Sep 10	Dec 10	Mar 11
EUR/USD	1.20	1.25	1.25	1.20	1.18
USD/JPY	91.9	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 ($/bbl)	71	86	94	93	90
Gold ($/oz)	1220	1150	1250	1200	1175
Copper($/m ton)	6495	8000	7150	6750	6500
Corn ($/Bu)	3.40	3.75	3.90	3.80	4.00

Source: J.P. Morgan, Bloomberg, Datastream

JPMorgan Chase Bank, New York
David Hensley (1-212) 834-5516
david.hensley@jpmorgan.com
Carlton Strong (1-212) 834-5612
carlton.m.strong@jpmorgan.com

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	3.0	4.0	4.0	3.5	2.5	2.5	2.4	1.8	0.9	1.1
Canada	-2.5 ↑	3.6	2.9	4.9 ↓	6.1 ↑	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	3.0	4.5	2.7	4.1	4.3	5.3	6.0	6.5	7.3	7.1
Argentina	-2.0	6.0	4.0	7.9	10.0	8.0	3.0	4.0	3.0	4.0	9.0	9.0	10.0	11.0
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	5.0	6.0	6.2	-5.9	10.0	20.0	10.0	2.0	0.0	-0.3	3.3	4.0	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	-4.0	1.0	-5.3	-5.6	-5.0	5.0	1.0	1.0	1.0	27.4	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	2.9 ↓	3.5 ↓	4.5 ↑	2.0 ↓	2.7 ↓	4.1 ↑	4.2 ↑	3.1	3.2 ↓	2.9 ↑	3.6 ↑	3.8 ↑	3.6 ↑
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	8.9	7.2	8.6 ↑	11.6 ↓	6.7 ↓	6.3 ↓	6.8	7.1	7.4	4.3	5.1	5.0	4.1
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	6.9 ↑	9.1 ↓	7.8	7.4	8.7	8.0	8.3	15.3 ↓	16.3	14.5	11.4
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	5.9 ↑	4.0 ↓	0.7	8.8 ↑	4.0	3.8 ↓	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	1.1	6.8	4.3	7.6	12.9	3.6 ↓	4.9 ↑	4.0	4.5	4.5	4.3	5.0	5.2	4.9
Singapore	-1.3	10.5	4.3	-1.0	38.6	5.7	-11.5	4.9	7.4	7.4	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	-2.2	8.5	4.0	17.0	16.0	-2.0	2.8	2.8	6.0	5.5	3.7	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	4.6	4.0	3.5	3.7	3.6	2.8	5.7	4.9	5.8	5.7
Europe														
Euro area	-4.1 ↓	1.4 ↑	1.9	0.5 ↑	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	3.6	3.0	1.7	5.9	4.5	3.5	3.0	2.8	2.8	1.0	0.8	1.8	2.8
Switzerland	-1.5	2.4 ↓	2.8	3.5 ↑	1.6 ↓	2.8	3.0	3.0	2.8	2.8	1.1	1.0	0.9	0.8
United Kingdom	-4.9	1.5	3.0	1.8	1.2	3.0	3.0	3.5	2.5	3.0	3.3	3.5	2.6	1.7
Emerging Europe	-5.0	4.2 ↑	4.7 ↓	2.3 ↓	2.0 ↓	8.1	3.3	3.3	4.0	4.4	6.1	5.3 ↓	5.5 ↓	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	4.5 ↓	2.0 ↓	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	13.5	4.0	4.0	5.0	5.0	7.2	5.8	6.7	7.0
Turkey	-4.7	5.9 ↑	5.0 ↓	...	...	...	...	...	...	...	9.3	9.3 ↓	7.5 ↓	6.7 ↑
Global	-2.5	3.6	3.3	4.2 ↑	3.7 ↓	4.0	3.5	3.4	3.0	3.1	2.2	2.2	2.0	1.9 ↑
Developed markets	-3.5 ↓	2.7	2.6	3.5 ↑	2.6	3.3	3.1	2.9	2.3	2.3	1.5	1.4 ↑	1.0	1.0
Emerging markets	1.0	6.9	5.8	7.0 ↑	7.7 ↓	6.3	4.8 ↓	5.4	5.8	6.2	5.1	5.4	5.6	5.0
Memo:														
Global — PPP weighted	-0.8	4.8	4.3	5.3	5.2	5.0	4.3	4.3	4.1	4.1	3.3	3.5	3.3	3.0

J.P. Morgan Chase Bank, New York
David Hensley (1-212) 834-5516
david.hensley@jpmorgan.com
Sam Conway (1-212) 834-9123
samuel.e.conway@jpmorgan.com

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				1.34	1.41	1.49	1.57	1.77
excluding US	GDP-weighted average	1.89	-247				1.91	2.02	2.13	2.25	2.36
Developed	GDP-weighted average	0.52	-359				0.52	0.55	0.58	0.63	0.83
Emerging	GDP-weighted average	4.50	-236				4.58	4.85	5.09	5.30	5.51
Latin America	GDP-weighted average	5.99	-294				6.29	6.85	7.31	7.49	7.77
CEEMEA	GDP-weighted average	4.13	-272				4.11	4.08	4.23	4.29	4.59
EM Asia	GDP-weighted average	4.09	-201				4.13	4.40	4.59	4.87	5.01
The Americas	GDP-weighted average	0.79	-479				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	0.50	-375	**1 Jun 10 (+25bp)**	20 Jul 10	20 Jul 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)	25 Jun 10	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	-324				1.28	1.30	1.33	1.39	1.49
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)	1 Jul 10	1 Jul 10 (+25bp)	0.25	0.75	1.00	1.25	1.50
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)	21 Jun 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)	28 Jun 10	3Q 10 (+25bp)	1.50	1.75	2.00	2.25	2.50
Poland	7-day intervention rate	3.50	-100	24 Jun 09 (-25bp)	30 Jun 10	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	3.00	0	**31 May 10 (-25bp)**	Jun 10	2Q 11 (+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)	17 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 (+25bp)**	7.00	7.00	7.75	7.75	7.75
Asia/Pacific	GDP-weighted average	2.18	-126				2.19	2.33	2.44	2.58	2.67
Australia	Cash rate	4.50	-175	4 May 10 (+25bp)	6 Jul 10	Aug 10 (+25bp)	4.50	4.75	5.00	5.25	5.50
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	3Q 10 (+27bp)	5.31	5.58	5.85	6.12	6.12
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)	5 Jul 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)	15 Jul 10	**24 Aug 10 (+25bp)**	4.00	4.25	4.25	4.50	4.75
Thailand	1-day repo rate	1.25	-200	8 Apr 09 (-25bp)	14 Jul 10	**20 Oct 10 (+25bp)**	1.25	1.25	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. Underline denotes policy meeting during upcoming week.

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com

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	2.9	3.5	3.4	1.1	4.5	2.0	2.7	4.1	4.2	3.1	3.2	4.2	2.8
Private consumption	1.6	2.0	2.0	5.1	1.3	3.6	2.3	0.8	0.4	1.6	2.8	2.4	2.4	2.0
Construction investment	-0.5	1.5	6.0	-2.8	2.6	1.1	-3.3	4.7	6.2	6.4	5.5	5.0	7.9	7.8
Equipment investment	-3.4	8.5	10.0	0.1	-13.1	46.8	-20.9	37.6	12.9	17.5	5.1	3.4	6.4	8.6
Public investment	4.9	32.3	9.7	13.5	43.6	49.7	55.4	14.7	10.3	10.9	7.1	11.8	7.1	10.1
Government consumption	2.8	3.6	1.7	3.4	5.4	7.5	3.3	0.1	3.9	0.2	0.1	3.7	3.7	0.4
Exports of goods & services	1.4	2.5	4.2	8.4	-6.5	8.3	-2.0	4.1	6.1	4.9	4.1	2.8	4.1	4.1
Imports of goods & services	-7.8	10.9	4.1	3.5	18.0	36.6	7.3	0.0	3.2	3.2	4.1	6.1	3.2	8.2
Contributions to GDP growth:														
Inventories	-0.5	-0.9	-0.6	0.9	2.9	0.7	0.7	-8.1	0.0	-0.1	-0.2	0.1	-0.2	-0.1
Net trade	2.0	-1.7	-0.1	0.9	-4.6	-5.0	-2.0	0.8	0.5	0.2	-0.1	-0.8	0.1	-1.0
GDP deflator (%oya)	0.2	3.1	2.4	0.1	-2.1	-1.5	1.4	4.1	3.7	3.2	2.2	2.4	2.5	2.5
Consumer prices (%oya)	1.8	3.5	3.6	1.5	1.3	2.1	2.9	3.6	3.5	3.8	3.8	3.6	3.6	3.7
Producer prices (%oya)	-5.4	1.6	3.5	-6.4	-7.2	-6.8	-0.2	1.4	1.1	4.0	2.5	3.5	4.0	4.0
Trade balance (A$ bil, sa)	-6.1	-15.6	-15.2	-0.9	-4.1	-5.0	-4.0	-4.0	-3.9	-3.6	-3.6	-3.6	-3.4	-4.5
Current account (A$ bil, sa)	-67.0	-64.8	-66.5	-12.7	-13.8	-18.5	-16.6	-16.2	-16.2	-15.9	-16.1	-16.3	-16.2	-17.8
as % of GDP	-6.2	-4.9	-4.7	-4.1	-4.4	-5.8	-5.1	-4.9	-4.8	-4.7	-4.7	-4.7	-4.5	-4.9
3m eurodeposit rate (%)*	6.0	4.9	5.7	3.5	3.4	4.1	4.2	4.8	5.3	5.5	5.7	5.7	5.8	5.8
10-year bond yield (%)*	5.6	5.8	6.0	5.5	5.1	5.8	5.5	5.9	5.9	6.1	6.0	6.0	6.0	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	5.8	5.6	5.3	5.4	5.5	5.5	5.4	5.3	5.2	5.0
Industrial production	-7.9	3.3	1.5	4.8	-4.2	22.1	0.2	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 down slightly in the year to June, but investment spending 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.
- **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	4.9	4.9	2.3	5.3	-0.7	1.5	2.8	3.3	12.1	3.3	2.9	3.9	3.8
%oya	2.1	2.7	4.9	1.9	1.7	2.0	2.0	2.2	1.7	4.8	5.3	5.3	5.5	3.5
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	6.1	5.4	5.9	6.5	7.1	6.0	6.3	6.3	5.9	5.7	5.4	5.3	5.2

*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.

JPMorgan Australia Ltd., Sydney
Stephen Walters (61-2) 9220-1599
stephen.b.walters@jpmorgan.com
Helen Kevans (61-2) 9220-3250
helen.e.kevans@jpmorgan.com

Australia and New Zealand economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
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 -2.0%m/m, sa NAB bus. Confidence (11: 30 am) May 11%bal, sa Housing finance approvals (11:30 am) Apr -2.0%m/m, sa	10 Jun Australia: Unemployment rate (11: 30 am) May 5.5%, sa New Zealand: RBNZ official cash rate (9:00 am) Jun Business NZ PMI (10:30 pm) May Terms of trade (10:45 am) 1Q -2.3% q/q, sa	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
21 Jun Australia: New motor vehicle sales (11:30 am) May New Zealand: Visitor arrivals (10:45 am) May	22 Jun New Zealand: Credit card spending (3:00 pm) May	23 Jun New Zealand: Current account balance (10:45 am) 1Q	24 Jun New Zealand: GDP (10:45 am) 1Q	25 Jun New Zealand: Trade balance (10:45 am) May
28 Jun	29 Jun New Zealand: Building permits (10:45 am) May	30 Jun Australia: Pvt. Sector credit (11:30 am) May	1 Jul Australia: Retail sales (11: 30 am) May Building approvals (11:30 am) May New Zealand: ANZ commodity prices Jun	2 Jul

Highlighted data are scheduled for release on or after the date shown. Times shown are local.

JPMorgan Chase Bank, New York
Sam Conway (1-212) 834-9123
samuel.e.conway@jpmorgan.com

Global Data Diary

Week / Weekend	Monday	Tuesday	Wednesday	Thursday	Friday
7 - 11 June	7 June	8 June	9 June	10 June	11 June
Japan • Cabinet office consumption index (Apr)	Brazil • Auto report (May) Germany • Mfg orders (Apr) Taiwan • Trade balance (May) United States • Consumer credit (Apr) • Bernanke interview	Brazil • GDP (1Q) Germany • Foreign trade (Apr) • IP (Apr) Japan • Economy Watcher survey (May) Turkey • IP (Apr) United States • JOLTS (Apr)	Brazil • COPOM mtg: +75bp Euro area • Trichet speech Japan • Prv mach orders (Apr) United Kingdom • Cons conf (May) United States • Beige book • Bernanke testifies to House Budget Cmte	China • Trade balance (May) Euro area • ECB mtg: no chg • Trichet press conf Korea • BoK mtg: no chg New Zealand • RBNZ mtg: no chg Peru • BCRP mtg: no chg United Kingdom • MPC mtg: no chg United States • Flow of funds (1Q) • International trade (Apr)	China • CPI, FAI, retail sales, IP (May) India • IP (Apr) United Kingdom • IP (Apr) United States • Retail sales (May) • Cons sent (Jun)
14 - 18 June	14 June	15 June	16 June	17 June	18 June
	Euro area • IP (Apr) India • WPI (May) Japan • IP final (Apr)	Chile • BCCh mtg: +25bp Euro area • Foreign trade (Apr) • Employment (1Q) Germany • ZEW bus surv (Jun) Japan • BoJ MPM mtg: no chg • Shirakawa press conf United Kingdom • CPI (May) United States • Empire State surv (Jun) • NAHB surv (Jun)	Brazil • Retail sales (Apr) Euro area • Labor costs (1Q) • HICP final (May) Israel • GDP (1Q) Russia • IP (May) United Kingdom • Labor mkt report (May) United States • Housing starts (May) • IP (May) • Bernanke speech	Japan • Reuters Tankan (Jun) Switzerland • SNB mtg: no chg Turkey • CBRT mtg: no chg United Kingdom • Retail sales (May) United States • CPI (May) • Philly Fed surv (Jun) • Leading indicators (May)	Argentina • IP (May) • GDP (1Q) Japan • MPM mtg minutes (May) Mexico • Banxico mtg: no chg Poland • IP (May)

Economic Research, Emerging Markets Research and Global FX Strategy at JPMorgan

Global Economics

Chief Economist
Bruce Kasman, New York (1-212) 834-5515

Economics: Global

David Hensley (1-212) 834-5516
Joseph Lupton (1-212) 834-5735
Sam Conway (1-212) 834-9123

Data and Forecast Systems

Carlton Strong (1-212) 834-5612
Donald Martis (1-212) 834-5667
Silvana Dimino (1-212) 834-5684

Economics: United States and Canada

United States

Robert Mellman, New York (1-212) 834-5517
Michael Feroli (1-212) 834-5523
Abiel Reinhart (1-212) 834-5614

Canada

Sandy Batten, New York (1-212) 834-9645

Economics: Latin America

Brazil

Fabio Hashizume, São Paulo
(55-11) 3048-3634
Julio Callegari, São Paulo (55-11) 3048-3369

Colombia, Ecuador, Venezuela, Peru

Luis Oganes, New York (1-212) 834-4326
Benjamin Ramsey, New York
(1-212) 834-4308
Julio Callegari, São Paulo (55-11) 3048-3369

Argentina, Chile
Vladimir Werning, New York
(1-212) 834-8144
Mexico
Alfredo Thorne, Mexico City (525) 540-9558

Economics: Asia/Pacific

Head of Japan
Masaaki Kanno, Tokyo (81-3) 6736-1166
Japan

Masamichi Adachi, Tokyo (81-3) 6736-1172
Miwako Nakamura, Tokyo (81-3) 6736-1167

Australia, New Zealand

Stephen Walters, Sydney (61-2) 9220-1599
Helen Kevans, Sydney (61-2) 9220-3250
Ben Jarman, Sydney (61-2) 9220-1669

Emerging Markets Research

Head of Emerging Markets Research
Joyce Chang (1-212) 834-4203
Head of Emerging Asia Economic Research
David G. Fernandez, Singapore,
(65) 6882-2461

Greater China

Qian Wang, Hong Kong (852) 2800-7009
Grace Ng, Hong Kong (852) 2800-7002

Korea
Jiwon Lim, Seoul (822) 758-5509
James Lee, Seoul (822) 758-5512

India
Jahangir Aziz, Mumbai (91-22) 6639-8033
Gunjan Gulati, Mumbai (91-22) 6639-3125

Indonesia, Malaysia, Philippines, Singapore, Thailand

Matt Hildebrandt (65) 6882-2253 Sin
Beng Ong (65) 6882-1623

Emerging Markets FX Strategy
Claudio Piron (65) 6882-2218
Yen Ping Ho (65) 6882-2216

Economics: Europe/Africa

Head of Western Europe
David Mackie, London (44-20) 7325-5040

United Kingdom, Switzerland

Malcolm Barr, London (44-20) 7777-1080
Allan Monks, London (44-20) 7777-1188

Euro area

Marta Bastoni, London (44-20) 7325-9114
Greg Fuzesi London (44-20) 7777-4792

Scandinavia

Nicola Mai, London (44-20) 7777-3467

Czech Republic, Hungary, Poland, Slovakia

Nora Szentivanyi, London (44-20) 7777-3981
Miroslav Plohjar, London
(44-20) 7325-0745

CEEMEA

Michael Marrese, New York
(1-212) 834-4876
Eva Sanchez, New York (1-212) 834-8217

Turkey, Bulgaria, the Baltics

Yarkin Cebeci, Istanbul (90-212) 326-8590

Russia, Ukraine, Bulgaria, Kazakhstan

Nina Chebotareva, Moscow
(7-095) 937-7321
Anatoliy Shal (7-495) 937-7321

Africa
Graham Stock (44-20) 7777-3430
Sonja Keller (27-11) 507-0376

Global FX Strategy

Global Head
John Normand (44-20) 7325-5222

Global FX Strategy, New York

Gabriel De Kock (1-212) 834-4254
Kenneth Landon (1-212) 834-2391
Arindam Sandilya (1-212) 834-2304

FX & Commodity Technical Strategy
Niall O'Connor (1-212) 834-5108

Global FX Strategy, London

Paul Meggyesi (44-20) 7859-6714
Kamal Sharma (44-20) 7777-1729
Talis Bauer (44-20) 7777-5276

Emerging Markets FX Strategy
Robert Beange (44-20) 7777-3246

Global FX Strategy: Asia

Tohru Sasaki (81-3) 5570-7717
Junya Tanase (81-3) 5570-7718

Commodity Strategy

Head of Commodites Research
Lawrence Eagles (1-212) 834-8107
Global Energy Strategy
Scott Speaker (1-212) 834-3878
Shikha Chaturvedi (1-212) 834-3245
Mark Gravener (1-212) 834-3089
Sung Yoo (1-212) 834-7045
Kristi Jones (1-212) 834-2835

Global Metals Strategy
Michael Jansen (44-20) 7325-5882

Agricultural Commodity Strategy
Lewis Hagedorn (1-312) 325-6409

Commodity Index Research
Jennie Byun (44-20) 7777-0070