J.P.Morgan

Australia and New Zealand - Weekly Prospects

Summary

- Events in **Australia** last week tipped the delicate policy tussle between cautious consumers and an "expansionary and inflationary" resources boom more in favour of the latter. Indeed, last week's capex survey revealed that mining companies plan to boost investment spending another 50% in the year ended June 2012 (from a record high!), as commodity prices soar. RBA Governor Glenn Stevens last week described the terms of trade bonanza as the biggest in more than a century. Yes, consumer austerity and the drag from January's floods have kept the RBA sidelined since November (and will do so again tomorrow), but the looming wall of income and investment suggests to us that consumer austerity won't last. We suspect RBA officials will want to stay in front of the boom and, therefore, will hike before midyear, most likely in May. The week ahead sees an avalanche of data, including the 4Q GDP print, which will be soft. Also, there will be a spray of monthly indicators for January, including retail sales, credit, trade and building approvals.

- It is too early to quantify the precise economic impact of the severe earthquake in **New Zealand**. What we can say, though, is that the chances of a rate hike this year have evaporated; we now see the RBNZ sidelined until 2012. In fact, there is a material risk of a rate cut as officials try to underpin confidence. At this stage, though, we believe a cut is not warranted. The policy rate already is highly-stimulative, and GDP growth will be above trend in 2H11 as the rebuilding effort kicks in. Also, additional policy stimulus will do little to boost the tourism and agricultural industries upon which Christchurch and surrounding areas rely. In fact, the announcement last week by dairy cooperative Fonterra to increase its payout forecast will add a significant NZ$780mn to national income this financial year.

- **Oil price increases** have been associated with global economic downturns in the past, but the direct income drag from higher oil prices has generally not been the prime factor promoting weakness. Indeed, our estimates suggest that a 20% rise in crude oil prices—roughly the recent move in Brent crude from its 4Q10 average—shaved only 0.25% off annualized global growth during 1H11. The damage from oil shocks have, of course, been magnified when they 1) are sudden (the price spikes more than 50% in the space of a quarter); 2) contribute to tight monetary policy and rising interest rates; and/or 3) are caused by geopolitical stress that depresses confidence and risk appetites. None of these magnifiers is present in the current environment. If anything, global business and consumer confidence have continued to rise this year along with oil prices. And developed world policy rates are unlikely to rise much this year.

- The full story of the 2011 **energy price shock** remains to be written and uncertainty remains high. Our commodity strategists highlight volatility and not further price increases in the near-term forecasts. Libyan oil production is currently near zero but the combination of Saudi spare capacity (3.5 million bbl/day) and IEA strategic reserves can cope with the reduced supply for a meaningful period of time. Yesterday, the IEA's governing board announced that it stands prepared to release reserve inventories if necessary, which helped drive the intraday price reversal. Our baseline forecast—assuming supply problems are limited to Libya—has the spot price adjust toward $95/bbl into midyear.

This week's highlight

With the RBA on hold tomorrow, the highlight will be Wednesday's GDP data. There was some idle talk of a possible negative print, but last week's data now make this unlikely. We expect a small gain, but GDP still might fall in 1Q.

February 28, 2011

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Forecast changes:

Last week's severe earthquake in NZ saw us lower our 1Q GDP growth forecast. Also, we pushed out the timing of the next RBNZ rate hike to 2012.

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

			Forecast		
Date	**Time [a]**	**Data/event**	**JPMorgan**	Consensus [b]	***Previous***
Monday, February 28	11.30am	Company profits (%qoq)	**3.0**	1.0	*-1.5*
Monday, February 28	11.30am	Inventories (%qoq)	**0.7**	-0.5	*-0.8*
Monday, February 28	1.00pm	NBNZ business confidence	**22.0**	na	*29.5*
Monday, February 28	11.30am	Private sector credit (%mom)	**0.3**	0.3	*0.2*
Tuesday, March 1	8.45am	NZ terms of trade (%qoq, 4Q)	**0.9**	na	*3.0*
Tuesday, March 1	11.30am	Current account balance (A$bn)	**-7.1**	-7.0	*-7.8*
Tuesday, March 1	11.30am	Retail sales (%mom)	**0.3**	0.3	*0.2*
Tuesday, March 1	2.30pm	RBA cash rate announcement (%)	**No change**	No change	*No change*
Wednesday, March 2	11.30am	GDP (%qoq)	**0.3**	0.6	*0.2*
Thursday, March 3	11.30am	Building approvals (%mom)	**-2.0**	-3.3	*8.7*
Thursday, March 3	11.30am	Trade balance (A$mn)	**1400**	1550	*1981*

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

Australia

Company profits and inventories (%qoq) - Each of these business indicators will fill in missing pieces of the GDP jigsaw (released Wednesday). Company profits likely rose modestly in the fourth quarter. The 3.0%q/q increase we forecast (consensus is for a 1.0% rise) will owe mainly to big gains in the mining sector, thanks to higher commodity prices. Inventories made a large negative contribution to growth in the 3Q, but likely added to GDP growth in the fourth quarter.

Private sector credit (%mom) - The picture on national credit should have improved modestly in January. We expect private sector credit growth to accelerate, mainly owing to less of a drag from business lending. The pool of credit for businesses has contracted for six straight months, but we suspect it will be flat in January. Medium- to large-sized firms, in particular, turned away from intermediated finance over the course of last year, opting instead to access capital markets for funding. Indeed, robust employment performance and a booming investment pipeline suggest constrained supply is not hampering firms' desire to expand. With personal lending also likely to be flat, the growth in credit will stem primarily from higher lending for housing. Housing credit, by far the largest pool, probably grew 0.5%m/m for the third straight month.

Current account balance (A$bn) - The current account balance probably narrowed in the December quarter from a CAD of A$7.8 billion to A$7.1 billion on our forecasts. The goods and services surplus should widen further, with exports benefitting from stronger trading partner growth and higher commodity prices. The CA data will give us key information on net exports. Our preliminary estimate is for net exports to shave 0.2%-points off 4Q GDP growth.

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.

RBA cash rate announcement (%) - The RBA decision almost certainly will be "no change", and the tone of the commentary probably won't deviate much from that delivered after the last Board meeting in February. If anything, the tone will be slightly more upbeat given the larger than expected investment pipeline, continued improvement in the global outlook, and the boom in the terms of trade. The RBA will likely acknowledge, however, the caution by consumers and the recent rise in global energy prices. We expect the consumer caution to be short-lived; households ultimately will benefit from the surge in national income. RBA officials will not necessarily wait for evidence that consumer austerity is ending. Indeed, the building wave of investment spending, the expansionary impact of the terms of trade and growing global inflation pressure should be enough to see the RBA to resume the tightening cycle in May.

Retail sales (%mom) - The January retail sales numbers should show a modest pick up in sales growth, from 0.3%m/m to 0.4%. Rising food prices will push up the food component, which accounts for 40% of retail sales, but discretionary spending likely will have been weak. Day-to-day living costs are rising sharply in the aftermath of the floods and the cyclone in northern Australia. The anticipated jump in food, fuel, and electricity prices will eat further into households' disposable incomes, which already have shrunk owing to higher mortgage repayments.

GDP (%qoq) - Our forecast is for modest GDP growth of 0.3%q/q in the December quarter, although we reserve the right to refine this estimate in the wake of this week's profits, inventories, external trade and government spending data. The material impact of the flooding in Queensland, which commenced in December, prompted us to push our GDP growth forecast lower by 0.2%-point, mainly owing to lost coal exports. The biggest headwind, though, will have been the consumer, with household spending, accounting for the lion's share of the economy, likely to have been flat over the quarter. This headwind should fade over the course of the year as wage growth accelerates in the wake of a significantly tightening in the labour market last year. Investment, government spending, and inventories probably added to growth, while net exports probably were a drag.

Building approvals (%mom) - Having spiked higher in December, we expect a payback in approvals in January, with our forecast calling for a fall of 2%m/m. The December surge of nearly 9%m/m was driven by the volatile "other dwellings" category, which likely would have turned around last month. The private sector houses category, a more stable measure of underlying fundamentals, should be flat to slightly higher. Despite the burden of higher interest rates, the building approvals data are likely to have gained significant strength by midyear, given the extent of rebuilding activity required following the Queensland floods. Also, a large portion of the bounce in approvals we forecast likely will be recognized in the non-dwellings category. In particular, we expect a large rise in non-residential public sector projects like schools and other government buildings.

Trade balance (A$mn) - Preliminary data showed that imports declined 5%m/m in January. Exports likely also will be lower owing to the disruption to coal production and port activity resulting from the flooding in Queensland. We expect a significant fall in the trade surplus from A$1.9 million to A$1.4 billion.

New Zealand

Terms of trade (%qoq) - With prices for New Zealand's key commodity exports elevated, and stronger NZD depressing import prices, we expect the terms of trade to increase further. Our forecast is for a 0.9%q/q rise, the fifth straight quarterly gain. Importantly for our GDP forecast, SNZ also will report on the performance of export and import volumes in the fourth quarter. The results should show that net exports made a small positive contribution to 4Q GDP growth. A downside surprise, though, would increase the risk of a negative GDP print.

Research note

Australia's virtuous cycle of a rising terms of trade

- **Australia's terms of trade has risen to the highest level since the wool boom of the 1950s**
- **It is triggering a virtuous cycle of high national income flowing through the economy**
- **The process also works in reverse and complicates RBA decision-making**

In a research note published last March ("Only brief reversal of rise in Australia's terms of trade," *GDW*, March 26, 2010), we predicted that the sharp fall in the terms of trade (ToT) over 1H09 (albeit from a then 60-year high) would be short-lived. We anticipated that the fall in commodity prices in the wake of weaker demand during the global financial crisis would reverse, and that the resulting rise in the ToT would be a renewed source of stimulus to Australia's economy. This scenario has played out broadly as we expected.

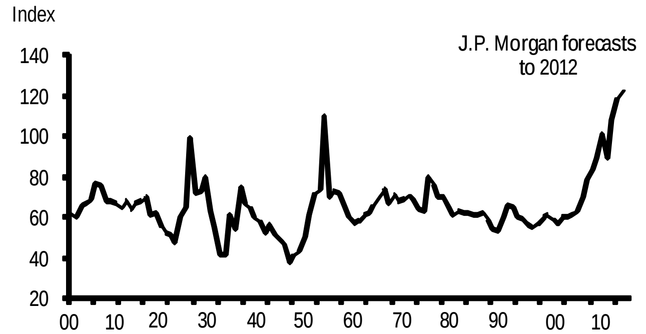
Recent evidence, however, indicates that while getting the direction correct, we underestimated the bounce in the ToT, as did RBA officials. Prices for the bulk, energy, and farm commodities most relevant to Australia have reached levels well above our forecasts, near all-time highs. At the same time, prices for many imported goods have tumbled owing to unexpectedly efficient passthrough of disinflation from high AUD. Australia's economy, therefore, enjoys the best of both worlds—soaring export prices and lower import prices. 1,000 tons of exported coal now buys 170 imported flat-screen TVs, compared to just 30 five years ago.

Boom the largest in more than a century

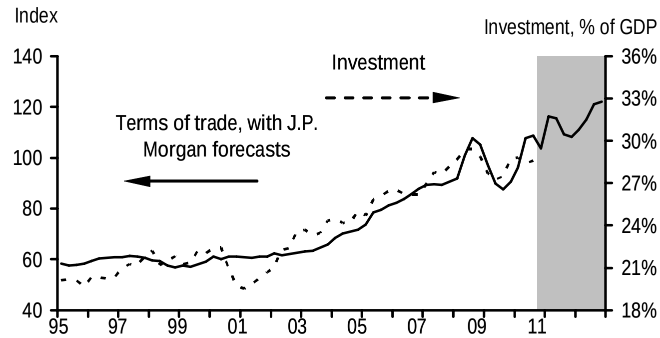
RBA Governor Glenn Stevens this week described this resources boom as the largest since Australia's federation in 1901, "at least." In fact, references to the "highly expansionary" elevated ToT have been consistent and prominent in RBA guidance for some time. The RBA's commentary after the January floods, which will likely shave 0.6%-pt off GDP growth in 1Q11, gave more prominence to the boost from higher commodity prices than the drag from the floods. Also, RBA officials now believe the investment pipeline is larger than the official forecasts had anticipated, partly owing to added incentives from higher prices.

We believe the growing stimulus from the rising ToT has been the primary reason the RBA Board has lifted the official cash rate seven times since late 2009, albeit from the "emergency" low set at the height of the global crisis. By tightening policy preemptively, RBA officials have tried to "stay in front" of the wave of national income poised to break over an economy operating at close to full capacity, in order to minimize the risks to the medium-term inflation outlook. In this context, our assessment is that only the floods (and subsequent cyclone) and consumer caution have kept the RBA sidelined since November. Unanticipated household austerity, which has seen the savings rate bounce above 10% of income, has provided an important dampening offset to the boost from the mining sector.

Terms of trade since 1900



Terms of trade and private investment



ToT to rise another 18% by end-2012

One factor key to determining the power of the stimulus to the economy from the high ToT is gauging how long the strength in commodity prices will persist. Our latest forecasts anticipate that prices for coal and iron ore, which make up half Australia's commodity exports, will dip later in 2011 as output responds, but rise in 2012 owing to new supply constraints and stronger global demand. Although import prices probably will stabilize, an even higher ToT will remain a key driver of what we anticipate will be very strong growth in national income. It likely also will be a key trigger for further monetary tightening by the RBA.

Our revised estimates of the ToT show the ToT rising another 12% in CY2011, after a likely 10% gain in CY2010. The probable persistence of higher prices for bulk and energy commodities means the ToT should rise a further 4% in

2012, assuming broadly stable import prices. If realized, these gains will leave the ToT at the end of next year a mammoth 90% above its 50-year average. Recent history suggests that a gain of this magnitude could see national income grow more than 12% in nominal terms both this year and next.

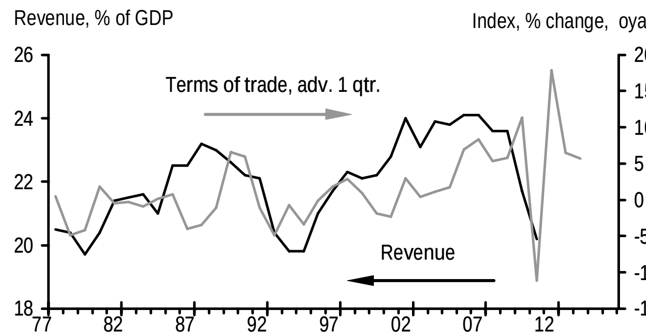
The ToT leaks, but politics supportive

A complication in determining the impact from the high ToT is estimating leakage via the external capital account. The RBA estimates that only “about half” the ToT boost stays in Australia. One mechanism by which high export prices boost the economy is via the expansion of mining company profits. This ultimately lifts share prices and, other things equal, boosts dividend payments to shareholders of the relevant mining companies. Also, it raises labour income for workers in mining and related sectors. It is a virtuous cycle (which can, of course, work in reverse), but many of the beneficiaries reside outside Australia.

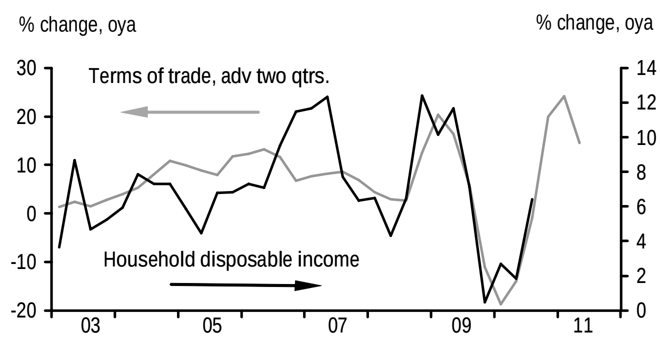
Still, higher profits also lift real activity in the economy via stimulating expansion of existing projects, spending on new ventures, and employment. A report by Access Economics shows that the investment pipeline reached a record-high A$780 billion in 4Q10 (equivalent to 60% of GDP) with, predictably, firms’ spending intentions in mining leading the way. Also, this week’s 4Q official investment survey showed that the mining boom will be even larger than it first appeared, with spending rising more than 50% in 2011-12. This unprecedented pipeline of investment was reached before the likely further gains in the ToT became clear. There may also be a boost to demand for housing and home prices as new migrants, in particular, are attracted by job opportunities and high labour income.

Another mechanism by which the ToT boosts the economy is via fiscal policy, where the leakage offshore is limited. Higher profits and labour income boost federal tax receipts, and higher commodity prices lift royalty revenue for state governments. With the minority Labor government in Canberra clinging to power only with the support of a handful of independent MPs, politicians are more likely than ever to try and keep MPs and voters onside. This means the boost to government revenue (first chart) is more likely than not to be “returned” to taxpayers via increased spending on infrastructure, higher transfer payments, and income tax breaks. Household income usually moves two quarters after changes in the ToT, reflecting lags through the transmission mechanisms (second chart).

Terms of trade and Commonwealth government tax revenue



Terms of trade and household disposable income



The downside? A multispeed economy

A downside of sustained gains in export prices, however, is that growth in the economy becomes increasingly one-dimensional. Consistent rises in export prices, fueled partly by strong demand from China (which now receives 28% of Australia’s goods exports) mean the mining sector will continue to boom. Related gains in AUD, however, add to the pain for sectors not benefiting directly from high export prices, like tourism and manufacturing. Australia is not (yet) afflicted with the famed “Dutch disease,” but the base of growth in the economy is uncomfortably narrow.

Also, the stimulative impact of the ToT creates policy dilemmas for the RBA. Officials must balance the boost from the resources boom against weakness in nontraded goods sectors and the austerity of households, which was triggered partly by the pain of rate hikes designed to quell exuberance elsewhere. Our assessment is that the RBA will be sidelined in the near term as officials assess whether the caution of households is likely to persist. We suspect not, as households usually trim their saving in anticipation of lasting boosts to income. This normally occurs ahead of a large lift in the ToT. The combination of the prospect of revived consumers and a booming mining industry should be enough to trigger a resumption of the RBA’s hiking cycle at the May 2 Board meeting.

Research note

Another earthquake in NZ puts rate hikes off agenda

- **The devastating earthquake in Christchurch makes three straight quarters of falling GDP more likely**
- **We now expect RBNZ Governor Bollard to delay the resumption of the tightening cycle until 2012**
- **Significant impulse to growth in 2H11 means, though, that "emergency" rate cuts are not warranted**

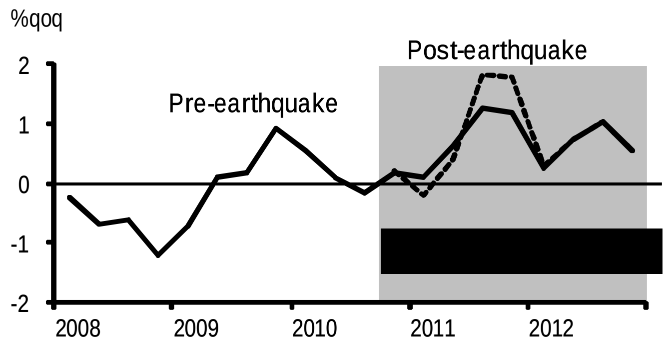
The city of Christchurch was hit by another earthquake last week, the second such natural disaster to rock the city within six months. New Zealand's second largest city, and the surrounding region of Canterbury, which accounts for 15% of national GDP, was hit by an earthquake last September that measured 7.1 on the Richter scale. The magnitude of the earthquake last week was lower at 6.3, but the epicenter was shallower and closer to the city center, so the damage was more extensive. The quake happened in the middle of the working day (unlike the September quake, which occurred in the early hours of a Saturday morning), claiming dozens of lives and injuring many more.

It will be some time before we can estimate with precision the full economic impact of the latest quake, but we can say that the likelihood of the RBNZ resuming the tightening cycle this year has diminished significantly. We expect the RBNZ will stay on the sidelines for an extended period while officials assess the impact of the earthquake and other recent information on the economy. Thus, we now forecast that the next rate hike won't be delivered until 2012. While the government has declared a state of emergency, we believe interest rate cuts, while possible, are unnecessary, partly owing to the likely steep recovery in 2H11 and because the current OCR already is highly stimulative. The RBNZ already has moved to ensure market liquidity remains plentiful.

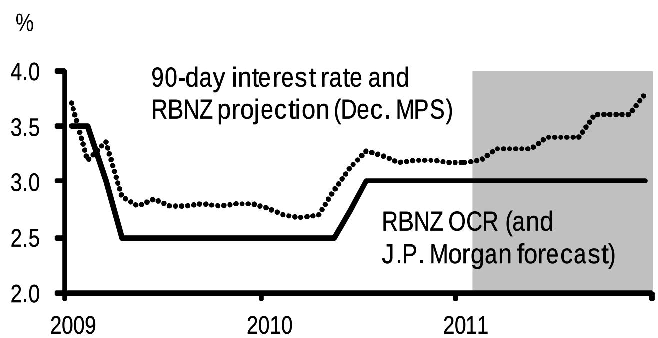
Tightening bias to be abandoned

The RBNZ will significantly change the rhetoric in the upcoming policy meeting on March 10. This probably will be accompanied by significant downward adjustments to the Bank's forecasts in the accompanying Monetary Policy Statement (MPS). The unexpected decline in GDP in the September quarter, the growing risk of a contraction in growth in 4Q10 owing to recent soft data, and the negative impact of last week's earthquake on growth in 1Q11 will see the growth profile pushed lower. These downgrades probably, in turn, will prompt a lower 90-day interest rate profile compared to that included in the December MPS. This means the RBNZ almost certainly will let go of its current implied tightening bias.

Extent of earthquake impact on GDP growth



RBNZ rate trajectory probably will be lowered



As we flagged after the September earthquake, the rebuilding effort in the aftermath of a natural disaster will be significantly "growth positive," with the construction sector, in particular, to reap the benefits in the latter half of this year. Higher "soft" commodity prices, stronger export volumes, and the tourism and sentiment boost from the Rugby World Cup also loom as supportive of growth, meaning the economy in 2H11 likely will grow well above trend.

Shallower, closer, more damage

Our estimates of the impact of the September earthquake suggested that it shaved 0.2%-pt off GDP growth in 3Q10, but the impact on the current quarter from last week's quake likely will be larger. The epicenter of the quake was shallow at less than 5 kilometres beneath the surface, and just 10 kilometers from the city centre. The September quake was 33 kilometres in depth, and the epicentre was 37 kilometers from the city centre.

Despite measuring lower on the Richter scale, the latest quake has caused greater damage to buildings and infrastructure. Buildings in the center of the city collapsed, there were power outages, and roads were awash with water.

With aftershocks continuing at a magnitude of more than 5.0, the damage bill will be huge. Already fragile consumer and corporate confidence will take another hit, businesses will be closed for an extended period, and many of the 25,000 workers in the centre of the city will be unable to work for weeks, or even months. The disruption to economic activity prompted us to lower our 1Q GDP growth forecast from 0.1%q/q to a fall of 0.2%.

There now, therefore, is a considerable risk the economy will contract for three straight quarters. GDP contracted 0.2%q/q in 3Q10, and the risk of a further contraction in 4Q10 is growing given recent disappointing data. The 4Q data released to date indicate higher unemployment, still-soft wage growth, and weaker retail spending. Our preliminary forecast for 4Q GDP growth is for a modest 0.2%q/q expansion, but a downside surprise on the trade volumes numbers due March 1 could push our forecast into the red.

Price environment not threatening

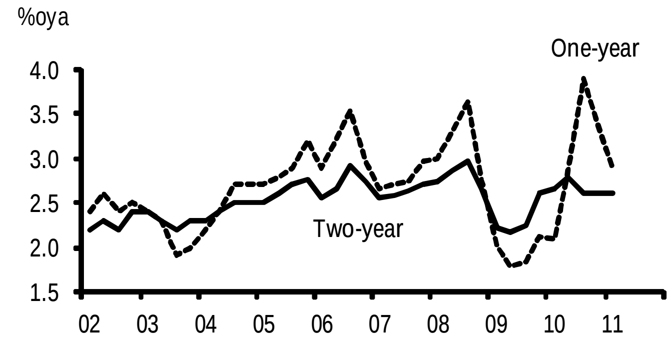
Even in the absence of the recent tremors, and the dismal near-term growth profile, the current price environment leaves little imperative for the RBNZ to lift the OCR back toward neutral. In the absence of a rise in the goods and services tax on October 1, quarterly CPI would have printed at a mere 0.3%q/q in 4Q10. Underlying inflation is weak owing mainly to continued household balance sheet repair. Weak domestic demand meant many firms were forced to wear the tax increase in their margins.

Further, inflation expectations remain anchored, as indicated by last week's RBNZ survey of business managers' inflation expectations. Expectations were steady over the two-year horizon at 2.6%oya, while those over the one-year horizon dropped considerably, falling from 3.4% to 2.9%. The drop in the one-year measure follows a 0.4%-pt fall in the last survey and puts near-term expectations back within the RBNZ's target range. With expectations anchored, pricing intentions subdued, and underlying inflation benign, there already was little incentive for Governor Bollard to remove the stimulus in place.

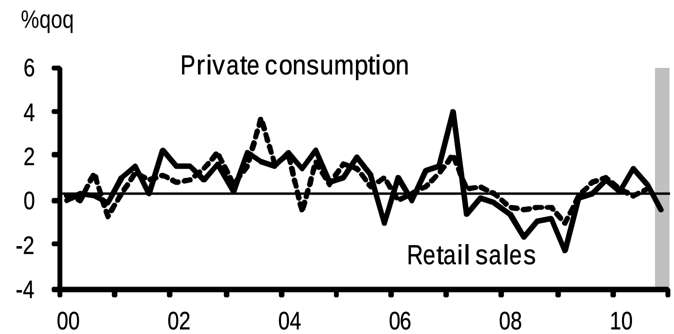
Disappointment after disappointment

Indeed, even prior to the earthquake last week, we had flagged the risk of the RBNZ delaying the next rate hike. In particular, the consumer has been weak, rather than merely subdued, owing to a backdrop of a frustratingly slow labour market recovery. Retail sales, both headline and core, fell

RBNZ inflation expectations



Households more frugal in recent quarters



more than 1%m/m in December, and volumes dropped 0.4%q/q over 4Q10.

Continued caution among households suggests that current low interest rates are having a less stimulatory impact than in the past. Indeed, this was one of a number of domestic risks flagged by Bollard in a speech delivered in Christchurch on January 28. He highlighted the risk that recent household caution could turn out to be a structural change in behaviour, rather than a cyclical response to recession. House prices likely would decline in response, which could cast "a pall of gloom over the market, with homeowners keeping houses off the market, not rebuilding, and trying to pay off mortgages faster, saving more, and spending less."

Another risk highlighted by the Governor, one that could be more positive, was the prospect of a large pickup in construction in the aftermath of the September quake. The Reserve Bank estimated the reconstruction to follow the 2010 earthquake would add NZ$5 billion to nominal GDP, and add 1%-pt to growth in each of the next two years. Damages from ongoing aftershocks, however, meant that the extent of the "ultimate rebuild could be significantly larger." Now, of course, the coming rebuilding effort is even larger than before.

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

- **Surging terms of trade and investment to trigger next RBA hike in May**
- **Firms' capital spending intentions even stronger than before**
- **RBA probably will resume tightening cycle in May**

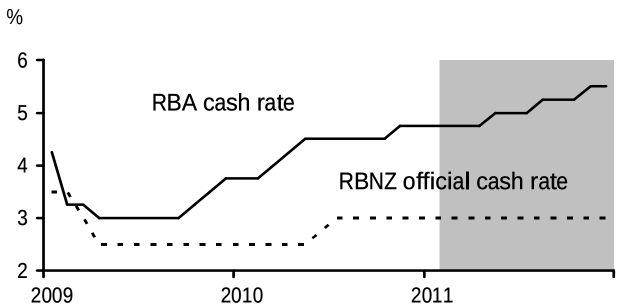
Australia and New Zealand now both have been struck by natural disasters this year, the former by the worst floods in decades last month (and then a cyclone), the latter by last week's severe earthquake. While the floods left a dent in Australia's otherwise healthy growth profile, the earthquake will do more lasting and material damage to New Zealand's outlook. Indeed, Australia is riding high on the biggest terms of trade boom in more than a century, and a huge rise in investment in mining projects, which now looks even larger than before. RBA officials, therefore, probably will resume the tightening cycle in May as they try and curb growing medium-term inflation risks.

RBA unlikely to change tune

The RBA will not deliver a material surprise in the statement announcing the cash rate decision Tuesday. The decision almost certainly will be "no change," and the commentary probably won't deviate much from that delivered after the last Board meeting in February. If anything, it would be even more upbeat than before. The dominant themes will be the elevated terms of trade (as always) and the bulging investment pipeline, which swelled even more is last week's investment survey (see below). References to the improving global outlook also will be prominent.

Indeed, soaring bulk and energy commodity prices, and a matching wave of planned investment, much of it in mining and related sectors, made it difficult for the RBA Governor to be anything but upbeat when delivering a speech on Australia's resources boom last week. The very fact that the Governor spoke on the mining boom—rather than weak consumer spending or the impact of the recent floods—signals that he remains focused on the medium-term picture for Australia's economy, which is rosy. The Governor's comments reinforced the message that, while soggy household spending and the drag from the floods in Queensland argue for caution on policy for now, the offset from cautious consumers to the massively expansionary impact of the mining boom is unlikely to last indefinitely. The Governor's assessment is that this boom is the largest since Australia's Federation in 1901—"at least"—and looks likely to be longer lasting.

Australia and New Zealand: official policy rates



Australia: terms of trade

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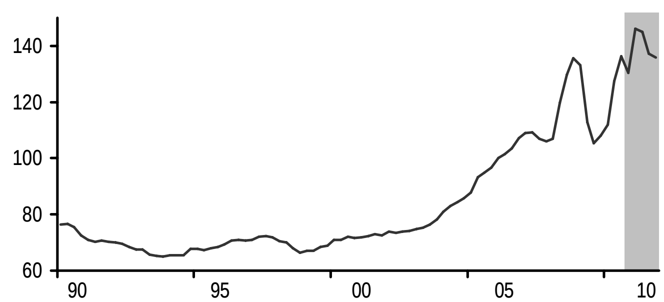


Consumer caution won't last long

Households ultimately should benefit from the soaring terms of trade via higher mining company profits (and, probably, rising share prices and dividends), more job opportunities and rising incomes, and via the fiscal policy transmission mechanism. That said, in the statement Tuesday, the RBA will likely acknowledge continued caution in consumer spending. Indeed, the best indication of increased caution among households is the recent rise in the saving rate to a two-decade high of 10%.

The RBA, in its own forecasts, has assumed a "middle path" for the saving rate, i.e., a normalization from current highs, but which still keeps the saving rate above that seen throughout the majority of the last decade. As indicated recently by Assistant Governor (Economic) Lowe, "consumption growth broadly matching income growth" implies healthier retail sales numbers than we are currently seeing. And even a historically high saving rate should be cold comfort when income is growing so quickly. The January retail sales numbers next week, though, likely will show only a modest pickup in sales growth (to 0.4%m/m), but this will owe mainly to higher food prices, with food accounting for 40% of the retail sales index. Discretionary spending likely

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

will have been weak, particularly with oil prices having risen sharply over the month.

Our assessment remains, therefore, that the RBA will resume tightening policy by midyear. Officials will not necessarily wait for evidence that the exaggerated consumer austerity is ending; the huge investment boom is evidence enough that the cash rate needs to rise. Moreover, fading uncertainty around what officials describe as a "once in a century" terms of trade event signal that the tightening cycle has much further to run, particularly given that current policy settings are only marginally restrictive. We expect the next hike in May and a further two hikes in the second half of this year as RBA officials try to stay ahead of the highly expansionary impact of the resources boom.

Capex survey highlighted the point

Australia's business investment survey for the December quarter indicated that the resources boom will be much larger, and extend for longer, than previous episodes. Firms upgraded slightly their already elevated spending plans for the year ended June 2011. More importantly, though, the first glimpse of managers' plans for the year ended June 2012 show they plan to lift spending another 32% in the next fiscal year. Firms in mining plan to lift spending 40%, and 55%, this year and next, respectively. If realized, the economy-wide gains will take the private investment share to a new high close to 30% of GDP.

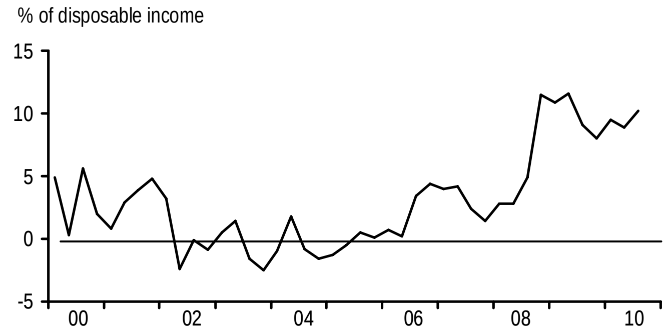
Firms lifted spending only 1.3%q/q in 4Q but, in the context of the massive wave of spending still to come, this hardly seems to matter. The rise over the year was a decent 5.6%oya (albeit down from just over 10% in 3Q) but this metric will accelerate markedly from here.

Outlook rosy, but 4Q GDP subdued

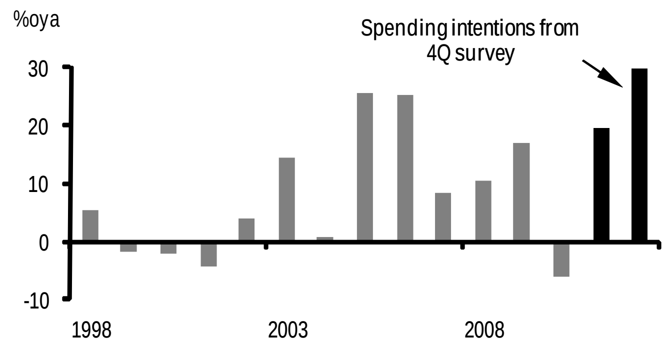
The Aussie 4Q10 GDP numbers this week, however, likely will be on the weak side. The impact of the flooding in Queensland (which commenced in December and carried into January) was material, mainly owing to lost coal exports, damaged food crops, and lost service sector activity. The flooding prompted us to trim our 4Q GDP growth forecast by 0.2%-pt, such that we now expect nationwide growth of just 0.3%q/q. Investment, government spending, and inventories probably added to growth, while net exports probably were a drag.

The biggest headwind, though, will have been the consumer, with household spending, accounting for the lion's share of the economy, likely to have been flat over the quarter. This headwind should fade over the course of the year as wage growth continues to accelerate, having picked up from 3.5%oya to 3.9% in 4Q. As labour market conditions tighten further (after the economy added record jobs in 2010), wages will become a key channel through which inflation will pop. Indeed, larger wage gains likely will be realized as higher commodity contract prices passthrough to bumper resource sector profits.

Australia: household saving rate



Australia: private capital expenditure



Data releases and forecasts

Week of February 28 - March 4

Mon
Feb 28
11:30am

Company profits
Sa

	1Q10	2Q10	3Q10	4Q10
%q/q	4.6	17.0	-1.5	3.0
%oya	-1.8	28.2	25.0	24.2

Mon
Feb 28
11:30am

Inventories
Sa

	1Q10	2Q10	3Q10	4Q10
%q/q	1.0	-0.1	-0.8	0.7
%oya	-0.8	1.0	0.4	0.8

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

Mon
Feb 28
11:30am

Private sector credit
Sa

	Oct	Nov	Dec	Jan
%m/m	0.1	0.3	0.2	0.3
%oya	3.3	3.6	3.4	3.2

Private credit probably grew 0.3%m/m in January. With personal and business lending flat in our forecasts, the growth will stem primarily from lending for housing. Housing credit, by far the largest pool, probably grew 0.5%m/m for the third straight month.

Tue
Mar 1
11:30am

Current account balance
Sa

	1Q10	2Q10	3Q10	4Q10
A$ bn	-16.2	-5.4	-7.8	-7.1
% of GDP	-4.9	-1.6	-2.3	-2.1

Tue
Mar 1
11:30am

Retail sales
Sa

	Oct	Nov	Dec	Jan
%m/m	-0.9	0.4	0.2	0.3
%oya	2.3	1.2	2.1	2.4

Tue
Mar 1
2:30pm

RBA cash rate announcement

No change forecast. See main text.

Wed
Mar 2
11:30am

GDP
Sa

	1Q10	2Q10	3Q10	4Q10
%q/q	0.7	1.1	0.2	0.3
%oya	2.3	3.1	2.7	2.3

Thu
Mar 3
11:30am

Building approvals
Sa

	Oct	Nov	Dec	Jan
%m/m	6.0	-3.9	8.7	-2.0
%oya	4.3	-9.0	-6.1	-5.7

Thu
Mar 3
11:30am

Trade balance
Sa

	Oct	Nov	Dec	Jan
A$ mn	2589	2078	1981	1400

Preliminary data showed that imports declined 5%m/m in January. Exports likely will be lower owing to the disruption to production and ports resulting from the flooding in Queensland.

Review of past week’s data

Construction work done

	2Q10	3Q10	4Q10	
%q/q	4.5	-1.5	~~2.5~~	*0.8*
%oya	10.2	7.3	~~9.9~~	*8.7*

Wage cost index

	2Q10	3Q10	4Q10	
%q/q	0.8	1.1	~~1.1~~	*1.0*
%oya	3.0	3.5	~~4.0~~	*3.9*

Wage growth in the public sector continued to outpace that on the private side. Public sector wages were up 4.0%oya for the third straight quarter, compared to the 3.8% increase in the private sector, although the gap between the two measures has narrowed significantly over the last year. The private sector is more cyclically responsive and, with the unemployment rate likely to fall from the current 5%, private sector wage growth will pick up even more quickly from here.

Private capital expenditure

	2Q10	3Q10	4Q10	
%q/q	-3.2	6.2	~~2.0~~	*1.3*
%oya	-3.2	8.6	~~4.7~~	*5.6*

New Zealand

- **NZ hit by severe earthquake; GDP downgraded**
- **RBNZ on hold for extended period**
- **OCR cut a risk next week, but is not in our forecast**

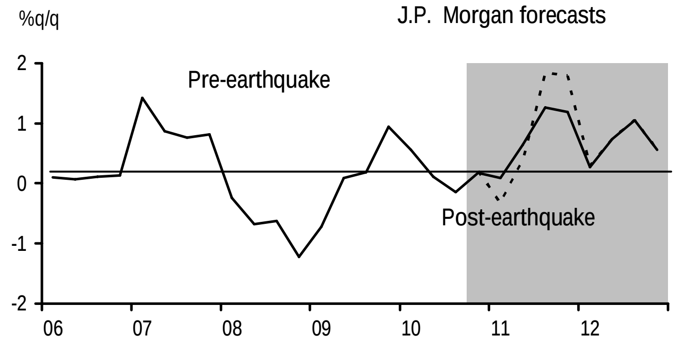
On the other side of the Tasman, New Zealand is at risk of falling into its second recession in three years. We believe this is unlikely but, at best, the economy looks likely to all but stall. RBNZ Governor Bollard, therefore, probably will be sidelined for the remainder of 2011. There is a chance of an emergency rate cut, perhaps even before the next policy announcement in March. We believe, however, that a rate cut now is unwarranted; the low policy rate already is highly stimulative, and the economy faces a massive re-building effort that will stimulate growth.

Another natural disaster, this time in NZ

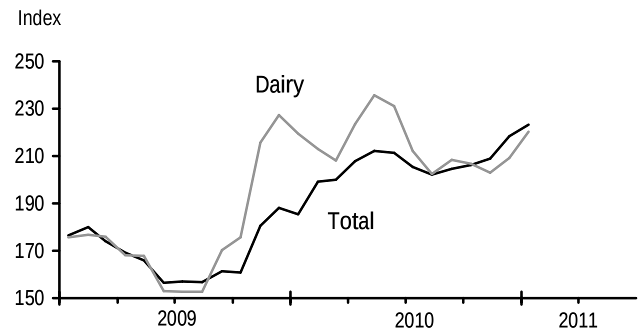
Last Tuesday, an earthquake of magnitude 6.3 on the Richter scale hit Christchurch, New Zealand's second largest city. This is the second such natural disaster to rock the city within six months. Christchurch and the surrounding region of Canterbury, which accounts for 15% of total GDP, were hit by an earthquake last September that measured 7.1. On our estimates, the September disaster shaved around 0.2%-pt off growth in 3Q10, but with the epicenter of last week's quake shallow and much closer to the city center, the impact likely will be larger. Already fragile confidence will take another hit, businesses will be closed, and many of the 25,000 workers in the centre of the city will be left unable to work for days, weeks, or even months.

The risk now is that the economy will contract again in 1Q, meaning there now is a risk the economy will contract for three straight quarters. GDP fell 0.2%q/q in 3Q10, and the risk of a further contraction in growth in 4Q10 is significant given recent soft data. Indeed, the 4Q numbers released to date indicate higher unemployment, still-soft wage growth, and weaker retail spending. Our preliminary forecast for 4Q GDP growth is for a modest 0.2%q/q rate of expansion, but a downside surprise in the trade volumes numbers due March 1 could push our forecast into the red. As we flagged after the September earthquake, the rebuilding effort will be a "growth positive," with construction to reap many of the benefits. The extent of this net additional effect will depend on the full extent of the damage, which will not be known for some time.

New Zealand: GDP



New Zealand: ANZ commodity prices



RBNZ in "wait and see" mode

The likelihood of the RBNZ resuming the tightening cycle this year has, therefore, diminished significantly. A change in the tone of the rhetoric in the upcoming policy meeting on March 10 is likely. This probably will be accompanied by significant downward adjustments to the Bank's forecasts in the Monetary Policy Statement (MPS). The unexpected negative GDP print in 3Q, the growing risk of a contraction in growth in 4Q10, and the impact of last week's earthquake on 1Q11 will see the growth profile lowered. These downgrades probably will, in turn, prompt a lower 90-day profile compared to that included in the December MPS. This means the RBNZ probably will let go of its current implied tightening bias.

The RBNZ's survey of business managers' inflation expectations last week added to the case for RBNZ officials to drop their current tightening bias. Inflation expectations remained steady over the two-year horizon at 2.6%oya, while those over the one-year horizon dropped considerably, falling from 3.4% to 2.9%. The decline in the one-year measure follows a 0.4%-pt fall in the last survey and puts near-term expectations back within the RBNZ's target range. With inflation expectations anchored, pricing intentions subdued, and underlying inflation benign, there already was little impulse for RBNZ Governor Bollard to remove the stimulus in place before last week's unfortunate events.

While we acknowledge the material risk of a rate cut as officials attempt to underpin confidence, we believe that, at this stage, a cut is unwarranted. The current policy rate is highly stimulative, and the earthquake rebuilding effort will provide a much larger boost to the economy. In addition, higher commodity prices, stronger exports, and the boost to tourism and sentiment from this year's Rugby World Cup also loom as supportive of growth. In fact, our forecast is for GDP growth well above-trend in 2H11. But, for now, the resumption of the tightening cycle looks likely to be delayed until 2012.

On a more positive note ...

The positive announcement by dairy cooperative Fonterra to increase its payout forecast was overshadowed by the earthquake. Fonterra produces 90% of New Zealand's milk and accounts for one-third of global dairy trade. Rising prices mean the cooperative can increase the payout to farmers by NZ60c per kilogram of milk solids (kgMS) for 2010/11, to NZ$7.90-NZ$8.00 kgMS. With current production around 1.3 billion kilograms, this will add NZ$780 million to national income this financial year, and a welcome boost to sentiment.

Data releases and forecasts

Week of February 28 - March 4

Tues Mar 1 8.45am	Terms of trade Sa				
		1Q10	2Q10	3Q10	4Q10
	%qoq	6.1	1.9	3.0	0.9

Review of past week's data

RBNZ 2-year inflation expectations

	3Q10	4Q10	1Q11
%oya	2.6	2.6	2.6

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

- **Oil price moves are letting some steam out of recovery but not derailing it**
- **Political risk factors on the rise in the G-3**
- **Asia sending mixed messages on global growth**
- **This week: ECB bias shifts and US payrolls bounce**

So far, a modest oil shock

Turmoil in the MENA region has pushed oil prices high enough for us to materially raise our first-half global inflation forecast. We now expect US CPI inflation to run at close to a 3% pace during 1H11 and upward revisions are being made elsewhere. However, the corresponding drag on growth is modest—we shaved our US 1H11 forecast to 3.8% this week—and the global economy remains on track to deliver strong growth in the coming quarters.

Oil price increases have been associated with economic downturns in the past, but the direct income drag from higher oil prices has generally not been the prime factor promoting weakness. Indeed, our estimates suggest that a 20% rise in crude oil prices—roughly the recent move in Brent crude from its 4Q10 average—shaved only 0.25% off annualized global growth during 1H11. The damage from oil shocks have, of course, been magnified when they 1) are sudden (the price spikes more than 50% in the space of a quarter); 2) contribute to tight monetary policy and rising interest rates; and/or 3) are caused by geopolitical stress that depresses confidence and risk appetites. None of these magnifiers is present in the current environment. If anything, global business and consumer confidence have continued to rise this year along with oil prices. And developed world policy rates are unlikely to rise much this year, even if the ECB shifts its bias of inflation risk at this week's meeting.

The full story of the 2011 energy price shock remains to be written and uncertainty remains high. Our commodity strategists highlight volatility and not further price increases in the near-term forecasts. Libyan oil production is currently near zero but the combination of Saudi spare capacity (3.5 million bbl/day) and IEA strategic reserves can cope with the reduced supply for a meaningful period of time. Yesterday the IEA's governing board announced that it stands prepared to release reserve inventories if necessary, which helped drive the intraday price reversal. Furthermore, inventories are considerably above the levels seen in 2008 when oil hit $145 per barrel, and seasonal refinery maintenance is beginning, which will reduce the immediate demand for crude over the next six weeks. Our baseline forecast—assuming supply problems are limited to Libya—has the spot price adjust toward $95/bbl into midyear.

A full plate of political chicken

Turmoil in the oil-producing nations is not going away, but we maintain our view that other major OPEC members are unlikely to see violent regime changes. Rather, protests in Algeria and Bahrain appear to be accelerating reforms. Algeria ended its emergency law while in Bahrain negotiations between the government and opposition are ongoing. Contagion risks to Saudi Arabia also appear limited; the King's initiative to raise public spending should help contain social pressures. Although there is some risk of a spillover of unrest in Bahrain, risks of a disruption to crude supply remain low.

Gamesmanship and posturing will also be on display in all corners of the developed world. In Europe, last week's Irish election is a step toward agreement regarding the EFSF and ESM expected next month. A constructive outcome that expands the regional lending capacity and lowers funding rates for Ireland and Greece is likely, but the path is likely to prove rocky. The incoming Irish government will surely feel it has a mandate to renegotiate terms with the rest of the region. The potential for restructuring of existing senior bank debt is a

Comparing oil price shocks

	Peak oil price rise (6 mth %ch)	Peak inflation rate rise (bp) 12 mth	Peak policy rate ch. (bp) 12 mth	Peak bond yield rise (bp) 12 mth	Peak US consumer expectations change 6 mth
1973-74	299	690	550	173	-47
1979-80	56	450	643	313	-28
1990	121	110	88	142	-44.2
2008	46	280	-62	-36	-35.6
2010-11 Latest	27	40	10	-13	23.1

Note: Peak changes in oil are compared to changes in other variables within a 6-month period of the month oil inflation peaked.

Recent US household polls, raising the debt ceiling
%

	Oppose	Approve	Undecided
IBD/TIPP (Jan 30-Feb 5)	70	25	5
The Hill (Feb 1)	62	27	11
Reuters/IPSOS (Jan 7-10)	71	18	11

low risk given Ireland's current reliance on EFSF credit. But the threat will no doubt be a bargaining chip.

In the US, the government faces a shutdown of federal non-essential services if Congress can't agree to extend the Continuing Resolution that expires on March 4. Although a shutdown would cover only 20% of non-interest spending, the experience during 1995-96 suggests that it could have a significant effect on GDP if it lasts for a number of weeks. However, the biggest threat to the economy and financial markets relates to the debt ceiling limit, which is likely to be reached sometime next quarter. The risks that this debate evolves into a game of chicken are high and can roil financial markets even if an agreement is reached at the last minute. Importantly, the stakes are much higher than they were 1995: with the deficit running close to 10% of GDP, a dramatic fiscal contraction would result from a failure to extend the limit. Public understanding of this issue is also very poor as polls indicate that over 60% of Americans oppose raising the debt ceiling. A similar bout of gamesmanship is playing out in Japan, as a chaotic political scene may not allow budget and related legislation to be passed before the new fiscal year starts in April. According to the Ministry of Finance, tax revenues and financial bill issuance should provide sufficient funding until June when the current Diet session is scheduled to end.

Risk rising of earlier ECB exit

This week's ECB meeting could bring an upward shift in the risk distribution for medium-term price stability. Comments last week from council member Mersch raised the odds that policy normalization would start earlier than our current forecast of December. The turmoil in the Middle East poses a clear downside risk, while fiscal tightening this year and ongoing adjustments in the banking sector will remain sizable headwinds. However, the latest data suggest that the economy has accelerated sharply in recent months, and growth is poised to run at a well-above-potential pace for a while.

The business surveys for January and February point not only to continued strength in Germany and in manufacturing—the main sources of growth thus far in the recovery—but also to a significant pickup in the rest of the region and in services. Particularly striking has been the improvement in sentiment around the periphery. A rising tide is truly lifting all of the boats in the region. At the same time, the transmission mechanism looks to be normalizing, judging by the acceleration in money and credit.

The ECB decision will be heavily influenced by the interpretation of recent inflation outturns. Core inflation has drifted up, raising questions about the level of slack in the region, but at 1.1%oya as of December remains well below the ECB's comfort level. The more pressing concern is the recent moves in commodity prices, which have pushed headline inflation up to a likely reading of 2.3%oya in January and have prompted a significant increase in the input and output pricing components of the business surveys. There is little sign yet of any second-round effects, but the ECB will want to remain alert.

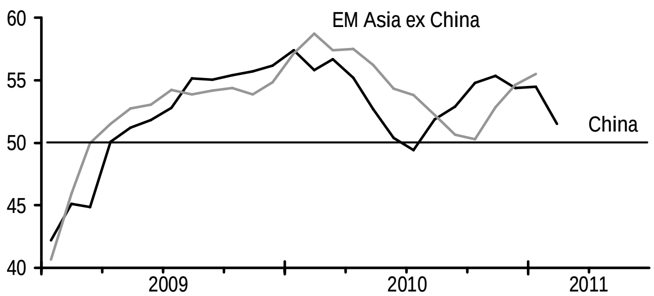
EM Asia cushions GDP from inflation rise

Gains in commodity prices continue to pressure policymakers in EM Asia. Agriculture prices have retreated some in the past week but remain up over 4% this month, while the more recent spike in oil prices is amplifying concerns that consumer inflation is set to jump throughout the region. In response, policymakers are implementing a broad array of measures to cushion the impact on household and business purchasing power despite growing concerns of overheating in parts of the region. We have revised up our consumer price forecasts throughout the region but the magnitudes vary depending on the nature of the fiscal responses. In whole, headline inflation will now peak around 5-1/2% this year—well above the region's 3% implicit inflation target.

The fiscal measures to offset the recent rise in oil prices range from direct rebates or income subsidies, such as those announced last week in Singapore and Hong Kong, to outright price controls. Elsewhere, direct and indirect subsidies—along with reduced energy taxes—are capping the rise in domestic petrol prices, which have risen notably less than in other regions around the world. Specifically, oil subsidies can operate directly—as in India, Indonesia, Malaysia, and recently Thailand. They can also operate indirectly through the reduction of import taxes/tariffs on oil

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

Purchasing Managers Index, manufacturing
DI, sa



products and through managing, usually through government-owned companies, the passthrough of energy prices to end users. In countries that have explicit subsidies, previous plans to liberalize subsidized prices are in the process of being postponed indefinitely.

Mixed global growth signals out of Asia

Recent developments in Asia have raised more questions than answers. Last week's surprising 3pt decline in the flash February PMI for China to a level consistent with more modest gains in factory output raises concerns of a broader regional, and perhaps global, deceleration in activity. After going through a sharp inventory-induced slowdown in the middle of last year, Chinese manufacturing ramped up into 4Q, with the PMI peaking at a robust level in November. Manufacturing in the rest of the region emerged from its own inventory correction a few months after China, and was still accelerating into January. Whether the rest of the region, and the world, will follow the lead of the China PMI remains to be seen. Moreover, this month's celebration of the Lunar New Year complicates data interpretation.

In Japan, real exports reportedly tumbled in January, raising some downside risk to our 1Q11 GDP forecast. However, this too contrasts sharply with the rest of the region. China, Korea, and Taiwan have all reported very strong export gains for January. The soft Japan reading is all the more surprising given the increasingly upbeat manufacturers' forecasts and reports of brisk overseas demand growth. Again, it is possible that the Lunar New Year holidays disrupted activity in different ways in different countries across Asia, underscoring the need to smooth through the monthly readings. Monday's IP report for January and February PMI reading will likely send a more positive signal.

Looking through the mixed signals, we are expecting this week's global PMI for February to be about unchanged, consistent with global GDP growth in 1Q11, above our forecast of 4% annualized. Although we marked down our US outlook somewhat last week, the business surveys out of the US, Euro area, and Japan have all generally been very upbeat, giving us confidence in the global economic outlook.

New Zealand dips into recession

The Antipodean economies have suffered a string of natural disasters this year. Australia's state of Queensland was inundated with the worst floods for generations, and then hit by a severe cyclone. Although the floods left a dent, the overall outlook remains healthy given robust terms of trade and booming investment growth in the mining industry. The Reserve Bank of Australia appears on track to hike again before midyear. Governor Stevens last week spoke of the "expansionary and inflationary" nature of previous terms of trade booms, while the 4Q investment survey showed the spending pipeline to be larger than ever. In contrast to Australia, last week's devastating earthquake in New Zealand's second largest city likely pushed the fragile economy into recession. The RBNZ will likely now be on hold for the remainder of this year. Officials may even cut interest rates to underpin confidence, although the cash rate already is highly stimulative and the massive rebuilding effort will boost GDP growth.

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

Oil to head lower into 2Q

- **Economics:** US 1Q GDP growth cut to 3.5% from 4%. A higher oil price eliminates upside risk on global growth, for the moment. Central banks are unlikely to react to higher oil inflation.
- **Asset allocation:** We stay overweight equities to bonds, despite heightened uncertainty, as equity risk premia remain wide. But we need to consider this more a 3-to-6-month position than one that will work each month.
- **Fixed income:** Risk reduction tempers our mildly bearish outlook, but only near term. Close Treasury shorts, and go tactically long UK gilts and German Bunds.
- **Equities:** We see no threat to profit margins from higher oil prices.
- **Credit:** Only limited impact of higher energy prices on US HG corporates.
- **FX:** Correlations are breaking down. The dollar is unlikely to benefit from Middle East crisis until the threat of a US government shutdown fades.
- **Commodities:** Brent is expected to stay volatile, but should head back down to $105 as Saudi Arabia makes up for the drop in Libyan supply and extreme fear of contagion fades. Close the long in Brent and open a long in gold.

The Libyan uprising pushed risk markets down mildly last week, from new cycle highs reached only last Friday. The resulting spike in oil prices **takes out upside risks on our growth forecasts, and moves markets into a more volatile phase**.

Two forces have been keeping us long risky assets—upside risks on global growth forecasts and high risk premia. The growth force has been neutralized for the moment, hopefully only temporarily. The second force—still high risk premia, mostly on equities—remains in place, but needs to reassessed relative to any rise in risk/uncertainty. It is our qualitative judgement that **uncertainty has not risen enough to offset the return pickup on riskier assets**. We thus stay long.

Oil prices are up $10 in the past two weeks, and $16ytd. Our economists estimate that, all else constant and if prices stay at these levels, this depresses current-quarter GDP by 0.5% annualized and 0.1%-0.2% for the full year. Today, we lowered our US 1Q forecasts by exactly 0.5%-pt. These are not rounding errors, but are not enough to derail the recovery Still, it appears likely that **growth upgrades are on hold**, after five months of steady hikes in our growth projections.

At least half of Libyan oil production appears to have been shut down. Libya accounts for 1.4 million bbl/day of crude supply in export markets, almost all of which is to Southern Europe. The IEA has stated it is prepared to release part of its strategic reserves, while Saudi Arabia has already started ramping up production, to make up for the Libyan shutdown. Hence, oil will stay very volatile, but Brent should touch $95 again over the next month (see *Oil Market Weekly: Time to step back from the fray*, Eagles et al, February 25).

What is the risk of **contagion in MENA**? Protests have spread to almost every country in the region, and it is likely that most will be induced to make political concessions if not wholesale reform. That is a positive for the world. The dominoes that have not fallen yet largely have leaders with stronger followings and more respect in their own countries that the three that have fallen. Libya is a special case and could see civil war raging for some time. News flow is likely to stay scary for weeks and keep markets volatile.

Equities took a dive last week on the Libyan news, and were down 3% from the cycle high reached the previous Friday. We have seen six episodes since equities bottomed in March 2009, of prices moving up in almost a straight line for 10-12 weeks, then correcting by single-digit percentages over two to four weeks. The second quarter of last year was the only correction with stocks losing over 10%. Most tactical investors are assuming that any move down will again be such a profit-taking correction. The self-fulfilling nature of this assumption implies that unless economic data surprise dramatically on the downside, investors will soon again move into stocks. **We thus see downside limited and remain overweight equities to bonds.**

Fixed income

Bonds rallied strongly and curves flattened, as the unrest in Libya escalated. Activity data have remained encouraging, and over time we expect stronger growth and inflation risks to push bond yields higher. Indeed, the ECB ratcheted up its hawkish inflation rhetoric last week. However, the heightened uncertainty in MENA is likely to keep investors cautious near term, prompting position-squaring and demand for safe assets. This leads us to close US Treasury shorts, and go tactically long UK gilts and German Bunds.

Inflation breakevens rose last week. In large part, this reflects surging oil prices. We estimate that a 10% rise in oil prices pushes up global inflation by around 0.2%-pt, with a

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

larger impact in the US. And higher oil market volatility will also tend to raise inflation risk premia. Even leaving oil aside, inflation risks seem skewed to the upside, and **we are positioned for wider breakevens in the UK and Euro area** (see J. Garayo, *GFIMS Inflation*).

Ireland went to the polls Friday, with a new centrist coalition government very likely. Over the election campaign, the opposition has rowed back from advocating unilateral haircuts on senior bondholders in Ireland's troubled banks. The EU's reluctance to countenance haircuts on senior bank bonds makes a near-term restructuring of peripheral government debt all the more unlikely. That said, **we move to a tactically underweight stance on peripherals, as they risk being buffeted by continued risk reduction flows near term**. Further out, the key question for peripherals remains the same: just how comprehensive will the March solution promised by EU leaders turn out to be?

Equities

Equities retreated from the previous week's cycle highs on rising geopolitical concerns and oil prices. Sectors where positions were more elevated—cyclicals and small caps—underperformed. We see the rise in uncertainty as short-lived and stay long equities. We also expect little impact on earnings from higher oil prices.

As discussed above, the impact on global GDP growth should be modest even if oil prices stay at current elevated levels. So top line growth should be little affected assuming no further spike in oil prices. But what about **profit margins**? Does the 30% rise in oil prices over the past three months threaten profit margins? We do not think so.

A useful comparison is to look at what happened during 1H08 when oil prices rose 70%. At the time, there was little impact on profit margins. **The ratio of EBITDA to Sales for the MSCI AC World index was little changed during the first three quarters of 2008.** It only fell sharply after the Lehman crisis as a collapse in final demand forced companies to lower output prices.

What explains the muted response of profit margins to commodity price shocks? Companies typically employ labour and capital and thus profit margins are predominantly a function of how the prices of these two inputs—labour and capital—evolve vs. output prices. The unit labour cost over GDP deflator is a proxy for the relative price of labour vs. output. The investment deflator over GDP deflator is a proxy for the relative price of capital over output. The lower these relative prices, the higher the profit margin.

The bull run in commodity prices between 2003 and 2008 was accompanied by a rise in the relative price of capital goods, but this rise was more than offset by a decline in the relative price of labour. During the oil price spike of 1H08, these relative prices posted only a modest increase. The recent spike in commodity prices, which is smaller in magnitude relative to that of 2008, should not be different. As long as final demand holds up, labour bargaining power remains suppressed, and capital good prices remain tamed as capex rebounds from a very low level, **companies should be able to protect their profit margins**.

Credit

Credit spreads widened last week as the Middle East crisis escalated. **What is the impact of higher energy prices on corporate credit?** If energy prices stay elevated for long, economic growth should be slower than we currently forecast, but not a lot, and the overall impact on US HG corporates **should be limited**. The majority of HG bonds should be unaffected as the Financials, Healthcare, and TMT (Tech, Media, and Telecom) sectors are neutral in energy costs, and are 55% of the US HG universe. The sector that would benefit the most is Energy, which represents 9% of the overall US HG index.

For the remaining sectors, strong profit margins would absorb the increase in energy costs without significantly changing credit fundamentals. The most adversely affected sectors—Airlines and Freight—are less than 2% of the HG universe and should be able to pass on higher energy costs through fuel surcharges, etc., over the medium term. With the YTD rally in US HG lagging behind that of the broader risky market, we see limited downside risk in US HG credit (see *CMOS*).

High yield bonds, in contrast, may see a larger correction if risky markets sell off. The performance of high yield bonds is typically well correlated with equities. If equities fall by say 5%, then high yield spreads should widen by 55bp based on the historical relationship. However, this does not alter our medium-term positive view on HY credit as investor flows into HY bond funds continue and the 2011 default outlook remains benign. Overall, although short-term political risks and uncertainties have risen, we see little change in our medium-term bullish view in credit.

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

Foreign exchange

The Middle East has quickly replaced sovereign risk as the world's chief systemic risk, a turnaround most apparent in EUR/USD. Dollar weakness versus the yen and Swiss franc, as well as dollar strength versus EM, are textbook deleveraging. But its collapse versus the euro and losses versus commodity currencies are highly unusual when supply disruptions in oil threaten growth and weaken equities.

Europe's readiness to lift rates as inflation climbs explains part of this pattern, but the breadth of the dollar decline against the rest of the G-10 hints at a **regime change in currency markets**. We use that term lightly, however, since neither the euro nor the commodity currencies are bulletproof in this environment. But for the next few weeks, the threat of a Washington shutdown as Congress debates raising the debt ceiling is upending traditional deleveraging patterns in FX, and cross-market correlations among stocks, bonds, and currencies. Combined with recent evidence that central banks have been reducing purchases of USD assets since QE2 was launched, the dollar will struggle to benefit from the Middle East/North Africa crisis until the threat of a US government shutdown passes.

So while we cannot handicap the odds of this event, the possibility of an oil shock during a US funding crisis seems high enough to avoid commodity currencies. Take profits on short USD/CAD, close short AUD/CAD, and roll into short USD/CHF. Also add to sterling shorts by re-entering long EUR/GBP. UK data are finally weakening, which confirms our view that a worst-case MPC hiking cycle (100bp over the next year) is priced and that the UK will remain a negative real-rate economy second only to India.

Commodities

The Libyan revolt and fears of further contagion pushed Brent to $119 intraday Friday. Our view remains that the uncertainty about contagion will result in increased volatility in the oil price, but that **Saudi spare capacity (3.5 million bbl/day) and in an emergency, IEA strategic reserves, can cope with the reduced supply for some time**. Furthermore, inventories are considerably above the levels seen in 2008 when oil hit $145, and seasonal refinery maintenance is beginning, which will reduce the immediate demand for crude over the next six weeks. As such, from here **we expect spot prices to move down toward an average of $105/bbl in 2Q11, in a very volatile fashion, touching $95 at times**. We thus **close our long in Brent**. This is a tactical decision, and we remain bullish on oil in the medium term on strong demand.

Having anticipated the spot gold price correction in mid-January, we now use the exit from our Brent trade to **reestablish a long position in gold**, where we believe the correction has ended and upward momentum has resumed.

Ten-year Government bond yields

	Current	Mar 11	Jun 11	Sep 11	Dec 11
United States	3.41	3.60	3.80	3.75	3.70
Euro area	3.15	3.15	3.25	3.40	3.50
United Kingdom	3.62	3.55	3.80	4.00	4.20
Japan	1.24	1.15	1.25	1.30	1.35
GBI-EM	7.09				7.30

Credit markets

	Current	YTD Return
US high grade (bp over UST)	133	0.5%
Euro high grade (bp over Euro gov)	168	-0.2%
USD high yield (bp vs. UST)	517	3.4%
Euro high yield (bp over Euro gov)	508	3.4%
EMBIG (bp vs. UST)	298	-0.8%
EM Corporates (bp vs. UST)	281	0.4%

Foreign exchange

	Current	Mar 11	Jun 11	Sep 11	Dec 11
EUR/USD	1.37	1.40	1.43	1.45	1.48
USD/JPY	81.7	81	80	79	78
GBP/USD	1.61	1.61	1.61	1.63	1.68

Commodities - quarterly average

	Current	11Q1	11Q2	11Q3	11Q4
Brent ($/bbl)	112	108	105	102	102
Gold ($/oz)	1409	1425	1475	1450	1500
Copper($/m ton)	9504	9650	9450	9750	10000
Corn ($/Bu)	7.22	6.60	7.00	6.75	6.10

Source: J.P. Morgan, Bloomberg, Datastream

AUD and NZD Commentary

- **Deleveraging during the Middle East/North Africa crisis is not following the usual script. The dollar is weaker versus many more currencies than is typical in a high-stress environment.**
- **We close positions in commodity FX in our portfolio.**
- **Technicals- Short term range bias continues to develop for AUD/USD and NZD/USD as key support levels hold.**

The Middle East has quickly replaced sovereign risk as the world's chief systemic risk. Since mid-February oil prices have soared 15% (basis Brent), stocks are down 3% (MSCI World), equity vol has spiked 6 points (VIX), peripheral spreads are 25bp wider and yet the dollar is down versus all major currencies, including the euro.

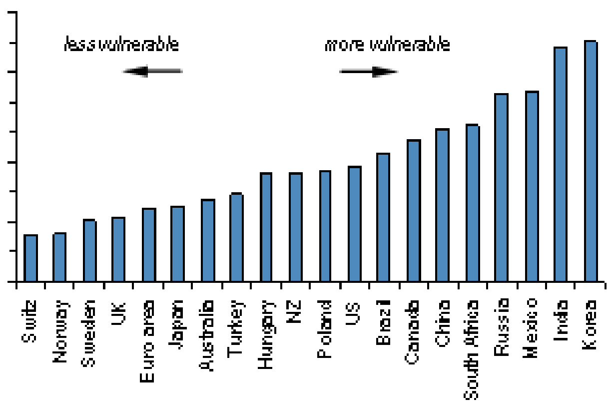
Dollar weakness versus the yen and Swiss franc, as well as dollar strength versus most emerging markets is textbook deleveraging. But its collapse versus the euro and losses versus commodity currencies is highly unusual when supply disruptions in oil threaten growth and weaken equity markets. The breadth of the dollar decline against the rest of the G-10 hints at a regime change in currency markets. We use that term lightly, however, since neither the euro nor the commodity currencies are bulletproof in this environment. But for the next few weeks, the threat of a Washington shutdown as Congress debate raising the debt ceiling is upending traditional deleveraging patterns in FX, and cross-market correlations amongst stocks, bonds and currencies.

The possibility of an oil shock during a US funding crisis seem high enough to avoid commodity currencies. Commodity currencies are no safe harbour in this environment, judging from their performance during the three major supply shocks of the past forty years - AUD and NZD rallied during only one of three episodes. The MENA crisis is ebbing into the weekend on Saudi Arabia's pledge to offset the loss in Libyan oil production, but it is too early to write off oil's influence on FX. We therefore close our commodity FX positions in our portfolio this week.

Technicals

The price action over the past few weeks has affirmed the short term range bias for both AUD/USD and NZD/USD. Following the reversals from the December highs, key support levels have held in during the recent declines. For AUD/USD, the .9955/.9800 zone will continue to act as key support and maintain the cosolidation bias as well as the potential for a quick return to the medium term underlying uptrend. The upside focus is on the 1.0165/1.0200 area which includes the triangle trendline resistance as well as the February highs and should define whether prices are staging a bullish breakout. Again, the medium term bias targets the 1.0330/1.0550 zone.

Chart: Cyclical risks from oil prices - Annual oil consumption as percentage of GDP, 2010



Source: J.P.Morgan

Similarly, NZD/USD has held above the important .7385/.7343 support zone which represents the December lows. This area should continue to hold to maintain the bias for a sideways consolidation rather than a deeper pullback into the .7270/.7200 zone. The .7655/70 area will act as key resistance with breaks shifting the focus back to the .7827 February high, if not a retest of the .7978 December peak. Still, we continue to see risk that NZD can underperform on the crosses particularly as AUD/NZD is in position to extend above the 1.3520 December high.

AUD/USD - Daily chart

Source: CQG Inc. © 2011 All rights reserved worldwide. http://www.cqg.com Fri Feb 25 2011 13:27:17

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			
	2010	2011	2012	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12	4Q10	2Q11	4Q11	2Q12
The Americas														
United States	2.8 ↓	3.2 ↓	3.0	2.6	2.8 ↓	3.5 ↓	4.0	3.5	3.0	2.0	1.2	2.5 ↑	2.1 ↑	1.4 ↑
Canada	2.9	2.0	2.7	1.0	2.0	2.0	1.9	2.2	2.8	2.8	2.2	2.3	1.9	2.0
Latin America	6.1 ↑	4.5	4.1	2.7 ↑	4.0 ↑	4.2 ↓	5.6	3.8 ↓	4.5 ↑	3.6 ↓	6.7	6.9	7.5	7.6
Argentina	8.5	5.5	5.0	1.6	2.0	6.0	8.0	8.0	6.0	3.0	10.5	11.0	12.0	12.0
Brazil	7.7	4.5	4.5	2.1	4.2	5.4	4.4	4.0	5.2	5.0	5.6	5.9	5.9	6.2
Chile	5.3	6.0	4.5	8.1	4.0	5.0	5.0	5.0	4.5	4.5	2.5	4.2	5.5	5.0
Colombia	4.0	4.5	4.0	0.9	5.0	6.0	5.0	4.5	4.7	4.0	2.7	3.1	3.6	3.5
Ecuador	3.0	3.5	3.0	6.5	3.0	3.0	2.5	2.5	2.0	3.5	3.3	3.5	3.8	3.6
Mexico	5.5 ↑	4.5	3.5	3.2 ↑	5.1 ↑	2.0 ↓	8.0	2.5 ↓	3.6 ↑	1.5 ↓	4.2	3.6	3.7	3.6
Peru	8.8	6.5	6.0	6.7	8.0	5.5	5.0	5.5	5.0	7.0	2.1	2.5	2.4	2.8
Venezuela	-1.4 ↑	1.5	3.0	0.6 ↑	-1.8 ↓	2.5 ↑	1.5	2.0 ↑	2.5 ↑	3.0	27.3	29.0	33.8	34.6
Asia/Pacific														
Japan	4.0	1.7	1.8	3.3	-1.1	2.2	2.2	2.5	2.0	1.8	0.1	0.5 ↑	0.4 ↑	0.3 ↑
Australia	2.6 ↓	2.9 ↓	4.3 ↓	0.8	1.1 ↓	1.0 ↓	5.7 ↑	5.7 ↑	4.0 ↓	4.9 ↑	2.6 ↓	3.2 ↓	3.6 ↓	3.3 ↓
New Zealand	1.4	1.6 ↓	3.9 ↑	-0.6	0.7	-0.7 ↓	1.6 ↓	7.6 ↑	7.4 ↑	1.2 ↑	4.0 ↑	4.8 ↓	3.2 ↓	2.9 ↓
Asia ex Japan	9.1	7.7	7.5	7.5	8.2 ↑	8.1	7.8	8.1	7.1	7.1	5.0	5.3 ↑	4.5 ↑	4.0 ↑
China	10.3	9.6	9.0	9.9	12.7	9.5	9.0	8.7	8.7	9.3	4.7	5.1	3.3	3.0 ↑
Hong Kong	6.8 ↑	4.8 ↑	4.7 ↓	3.6 ↑	6.1 ↑	4.2	4.3	4.7	5.0	4.8 ↓	2.8 ↑	3.9 ↑	4.2 ↑	3.7 ↑
India	8.5	8.8	8.4	14.2	2.5	8.0	10.0	14.0	6.0	5.0	9.5	8.1	8.7	8.3
Indonesia	6.1	5.4	6.7	6.7	7.5	5.3	5.2	4.5	5.0	7.0	6.3	8.4 ↑	7.5 ↓	5.5
Korea	6.1	4.2	4.5	3.0	2.2	5.5	4.0	4.5	5.5	4.0	3.6	3.8	3.4	3.1
Malaysia	7.2	5.2 ↑	4.4	-0.6	8.9	5.5	5.3	5.0	4.5	5.5	2.0	3.4 ↑	3.7 ↑	3.0
Philippines	7.3	5.3	5.0	-3.1	12.7	4.9	6.1	4.1	4.1	5.3	2.9	5.6 ↑	5.1 ↑	3.9 ↑
Singapore	14.5	5.0	5.6	-16.7	3.9	8.7	7.8	7.0	6.6	4.9	4.0	6.0 ↑	4.8 ↑	2.3 ↓
Taiwan	10.8	5.0	5.4	3.2	0.0	9.0	6.5	5.8	6.0	5.5	1.1	1.8	2.9	2.1
Thailand	7.9	5.0	4.8	-0.9	5.0	7.5	6.0	5.5	5.5	4.5	2.9	4.3 ↓	4.2 ↓	4.5
Africa/Middle East														
Israel	4.5	4.5	4.0	4.4	7.8	4.5	4.5	4.5	4.5	4.5	2.5	3.3	3.2	3.0
South Africa	2.7	3.7 ↑	3.8 ↑	2.7 ↑	4.4 ↑	3.6 ↑	3.7 ↓	4.0 ↑	4.1 ↑	3.0 ↓	3.5	4.2 ↑	5.9 ↑	5.8 ↑
Europe														
Euro area	1.7	2.3	2.3	1.4	1.5 ↑	3.0	2.5	2.0	2.5	2.3	2.0	2.2 ↑	2.1 ↑	1.6 ↑
Germany	3.5	3.5 ↑	2.2	2.8	2.0 ↑	4.5	3.0	2.5	2.5	2.0	1.6	2.1 ↑	2.0	1.6 ↑
France	1.5	2.5 ↑	2.6	1.2 ↑	2.0 ↑	3.5	2.5	2.5	3.0	2.5	1.9	2.2 ↑	2.2	1.8 ↑
Italy	1.0 ↓	1.5	2.2	1.0 ↓	0.5 ↑	1.5	2.0	2.0	2.5	2.5	2.0	1.9 ↓	1.8 ↓	1.8
Norway	2.2	3.0	3.0	4.4	1.3	3.5	3.5	3.3	3.0	3.0	2.2	2.1	1.5	0.9
Sweden	5.3	4.6	3.0	8.7	4.0	4.0	3.5	3.5	3.0	3.0	1.9	3.2	3.2	2.6
United Kingdom	1.3 ↓	1.7 ↓	2.7	2.8 ↓	-2.3 ↓	2.8	2.0	2.5	3.0	2.5	3.4	3.9	3.5	2.1
Emerging Europe	4.3	4.1	4.6	-0.9	9.4	3.2	3.2	3.7	5.0	5.2	6.6	7.7 ↑	6.9	6.0
Bulgaria	0.1	3.5	4.0	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	2.3	3.0	3.5	3.9	2.0	1.5	3.0	3.5	4.0	3.5	2.1	2.0	2.5	2.6
Hungary	1.2	2.8	3.5	2.4	0.8	2.5	3.0	3.5	3.5	3.5	4.4	4.0 ↓	4.2 ↓	3.8 ↑
Poland	3.8	4.0	4.2	5.3	3.8	3.5	4.0	4.5	4.5	4.2	2.9	4.0 ↑	2.9 ↓	2.7 ↓
Romania	-1.2	2.0	4.0	...	...	...	...	...	...	...	7.9	6.8	4.3	4.5
Russia	4.0	4.5	5.0	-3.8	14.5	3.5	3.0	3.5	5.5	6.0	8.2	10.9	9.7	7.9
Turkey	8.3	4.5	5.0	...	...	...	...	...	...	...	7.4	6.4	6.4	6.1
Global	3.8	3.6	3.5	3.0 ↑	3.0	3.9 ↓	4.0 ↑	3.7	3.6	3.2	2.7	3.3 ↑	3.0 ↑	2.5 ↑
Developed markets	2.5	2.6	2.6	2.3	1.4 ↓	3.0 ↓	3.1 ↑	2.8	2.7 ↓	2.2	1.6	2.3 ↑	2.0 ↑	1.4 ↑
Emerging markets	7.2	6.1	6.0	4.9 ↑	7.2	6.2 ↓	6.4	6.2	6.0	5.8 ↓	5.6	6.1 ↑	5.7 ↑	5.3 ↑
Memo:														
Global — PPP weighted	4.8	4.4 ↓	4.4 ↓	3.9	4.2	4.6 ↓	4.8	4.7	4.3	4.3	3.4	4.0 ↑	3.6 ↑	3.1 ↑

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	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12
Global	GDP-weighted average	1.89	-309				1.92	2.02	2.11	2.24	2.34
excluding US	GDP-weighted average	2.57	-226				2.62	2.76	2.88	3.07	3.21
Developed	GDP-weighted average	0.62	-358				0.63	0.67	0.71	0.83	0.94
Emerging	GDP-weighted average	5.38	-172				5.50	5.77	5.98	6.14	6.22
Latin America	GDP-weighted average	7.56	-185				7.84	8.33	8.46	8.49	8.49
CEEMEA	GDP-weighted average	4.08	-294				4.18	4.37	4.66	5.12	5.42
EM Asia	GDP-weighted average	5.10	-115				5.17	5.40	5.61	5.69	5.69
The Americas	GDP-weighted average	1.33	-448				1.37	1.47	1.51	1.53	1.55
United States	Federal funds rate	0.125	-512.5	16 Dec 08 (-87.5bp)	15 Mar 11	On hold	0.125	0.125	0.125	0.125	0.125
Canada	Overnight funding rate	1.00	-325	8 Sep 10 (+25bp)	1 Mar 11	12 Apr 11 (+25bp)	1.00	1.25	1.50	1.75	2.00
Brazil	SELIC overnight rate	11.25	-75	19 Jan 11 (+50bp)	2 Mar 11	2 Mar 11 (+50bp)	11.75	12.50	12.50	12.50	12.50
Mexico	Repo rate	4.50	-270	17 Jul 09 (-25bp)	4 Mar 11	2Q 12 (+25bp)	4.50	4.50	4.50	4.50	4.50
Chile	Discount rate	3.50	-150	17 Feb 11 (+25bp)	17 Mar 11	17 Mar 11 (+25bp)	3.75	4.50	6.00	6.50	6.50
Colombia	Repo rate	3.25	-575	**25 Feb 11 (+25bp)**	18 Mar 11	**18 Mar 11 (+25bp)**	3.50	4.25	5.00	5.00	5.00
Peru	Reference rate	3.50	-100	10 Feb 11 (+25bp)	10 Mar 11	10 Mar 11 (+25bp)	3.75	4.50	4.50	4.50	4.50
Europe/Africa	GDP-weighted average	1.49	-323				1.51	1.58	1.68	1.97	2.23
Euro area	Refi rate	1.00	-300	7 May 09 (-25bp)	3 Mar 11	Dec 11 (+25bp)	1.00	1.00	1.00	1.25	1.50
United Kingdom	Bank rate	0.50	-500	5 Mar 09 (-50bp)	10 Mar 11	May 11 (+25bp)	0.50	0.75	1.00	1.25	1.50
Sweden	Repo rate	1.50	-200	15 Feb 11 (+25bp)	20 Apr 11	15 Feb 11 (+25bp)	1.50	1.75	2.25	2.75	3.00
Norway	Deposit rate	2.00	-250	5 May 10 (+25bp)	16 Mar 11	16 Mar 11 (+25bp)	2.25	2.50	2.75	2.75	3.00
Czech Republic	2-week repo rate	0.75	-200	6 May 10 (-25bp)	24 Mar 11	23 Jun 11 (+25bp)	0.75	1.00	1.25	1.75	2.00
Hungary	2-week deposit rate	6.00	-175	24 Jan 11 (+25bp)	28 Mar 11	4Q 11 (+25bp)	6.00	6.00	6.00	6.25	6.50
Israel	Base rate	2.50	-150	**21 Feb 11 (+25bp)**	28 Mar 11	2Q 11 (+25bp)	2.50	2.75	3.25	4.00	4.50
Poland	7-day intervention rate	3.75	-75	19 Jan 11 (+25bp)	2 Mar 11	**5 Apr 11 (+25bp)**	3.75	4.25	4.25	4.50	4.50
Romania	Base rate	6.25	-75	4 May 10 (-25bp)	29 Mar 11	3Q 11 (+25bp)	6.25	6.25	6.50	6.75	7.00
Russia	1-week deposit rate	3.00	0	24 Dec 10 (+25bp)	Mar 11	Mar 11 (+25bp)	3.25	3.50	3.75	4.00	4.25
South Africa	Repo rate	5.50	-400	18 Nov 10 (-50bp)	24 Mar 11	Nov 11 (+50bp)	5.50	5.50	5.50	6.00	6.50
Turkey	1-week repo rate	6.25	-1125	20 Jan 11 (-25bp)	23 Mar 11	Aug 11 (+50bp)	6.25	6.25	7.00	8.00	8.50
Asia/Pacific	GDP-weighted average	3.23	-96				3.27	3.41	3.54	3.61	3.61
Australia	Cash rate	4.75	-150	2 Nov 10 (+25bp)	1 Mar 11	May 11 (+25bp)	4.75	5.00	5.25	5.50	5.50
New Zealand	Cash rate	3.00	-500	29 Jul 10 (+25bp)	10 Mar 11	**1Q 12 (+25bp)**	3.00	3.00	3.00	3.00	3.25
Japan	Overnight call rate	0.05	-45	5 Oct 10 (-5bp)	16 Mar 11	On hold	0.05	0.05	0.05	0.05	0.05
Hong Kong	Discount window base	0.50	-625	17 Dec 08 (-100bp)	16 Mar 11	On hold	0.50	0.50	0.50	0.50	0.50
China	1-year working capital	6.06	-51	9 Feb 11 (+25bp)	-	2Q 11 (+25bp)	6.06	6.31	6.56	6.56	6.56
Korea	Base rate	2.75	-175	13 Jan 11 (+25bp)	10 Mar 11	Apr 11 (+25bp)	2.75	3.00	3.25	3.50	3.50
Indonesia	BI rate	6.75	-175	4 Feb 11 (+25bp)	4 Mar 11	**12 Apr 11 (+25bp)**	7.00	7.00	7.00	7.00	7.00
India	Repo rate	6.50	-125	25 Jan 11 (+25bp)	17 Mar 11	17 Mar 11 (+25bp)	6.75	7.00	7.25	7.50	7.50
Malaysia	Overnight policy rate	2.75	-75	8 Jul 10 (+25bp)	11 Mar 11	5 May 11 (+25bp)	2.75	3.00	3.00	3.00	3.00
Philippines	Reverse repo rate	4.00	-350	9 Jul 09 (-25bp)	24 Mar 11	5 May 11 (+25bp)	4.00	4.25	4.50	4.50	4.50
Thailand	1-day repo rate	2.25	-100	12 Jan 11 (+25bp)	9 Mar 11	9 Mar 11 (+25bp)	2.50	3.00	3.00	3.00	3.00
Taiwan	Official discount rate	1.625	-150	30 Dec 10 (+12.5bp)	Mar 11	Mar 11 (+12.5bp)	1.75	1.875	2.00	2.125	2.25

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

Economic forecasts - Australia

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

				2010			2011				2012			
	2010	2011	2012	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Chain volume GDP	2.6	2.9	4.3	4.6	0.8	1.1	1.0	5.7	5.7	4.0	4.9	2.7	3.5	4.3
Private consumption	2.6	1.3	1.7	5.9	2.4	0.0	1.2	0.4	1.6	1.2	2.0	2.4	1.6	2.0
Construction investment	2.1	2.8	5.1	11.9	4.5	-3.3	0.0	2.9	12.7	1.7	6.4	3.0	3.5	7.2
Equipment investment	-3.8	11.3	12.6	-16.9	-3.6	28.3	12.8	10.5	17.5	12.8	13.2	8.7	13.2	13.2
Public investment	28.6	9.3	6.2	-15.0	7.9	10.3	12.6	13.8	8.7	10.7	3.9	-3.3	13.2	6.6
Government consumption	3.3	3.7	4.7	6.6	1.8	3.0	6.5	1.0	2.9	5.6	4.8	6.5	4.8	2.6
Exports of goods & services	4.4	2.0	6.7	25.6	-9.3	-2.0	-9.6	21.6	6.1	4.5	6.6	5.7	6.6	5.7
Imports of goods & services	12.2	1.8	4.7	16.5	-2.2	1.2	-3.9	6.1	4.1	4.1	4.1	4.1	8.2	3.2
Contributions to GDP growth:														
Inventories	0.3	-0.3	-0.1	-2.1	-0.8	0.6	-0.9	0.0	0.1	0.4	0.2	-0.9	-0.2	-0.3
Net trade	-1.6	0.1	0.5	1.8	-1.8	-0.7	-1.4	3.2	0.5	0.1	0.6	0.4	-0.3	0.6
GDP deflator (%oya)	4.8	3.3	2.7	5.4	6.8	5.9	4.8	3.1	2.7	2.7	2.7	2.7	2.8	2.7
Consumer prices (%oya)	2.8	3.3	3.3	3.1	2.8	2.6	2.9	3.2	3.3	3.6	3.3	3.4	3.3	3.3
Producer prices (%oya)	2.1	3.4	4.0	2.5	1.5	4.5	2.9	2.7	4.0	4.0	4.0	4.0	4.0	4.0
Trade balance (A$ bil, sa)	-6.8	24.0	30.4	7.0	6.5	4.8	4.9	5.5	6.4	7.2	7.7	7.2	7.4	8.1
Current account (A$ bil, sa)	-51.4	-33.5	-29.6	-5.4	-7.8	-8.9	-9.1	-8.7	-8.2	-7.6	-7.3	-7.8	-7.6	-6.9
as % of GDP	-4.1	-2.4	-1.9	-1.6	-2.3	-2.6	-2.6	-2.5	-2.3	-2.1	-2.0	-2.0	-2.0	-1.8
3m eurodeposit rate (%)*	6.0	5.4	5.9	3.5	4.3	4.9	5.0	5.3	5.5	5.8	5.9	5.9	6.0	6.0
10-year bond yield (%)*	5.6	5.7	5.5	5.5	5.1	5.5	5.8	5.8	5.8	5.6	5.6	5.6	5.5	5.5
US$/A$*	0.75	1.02	0.97	0.82	0.88	1.01	1.00	1.01	1.03	1.04	1.02	0.98	0.95	0.92
Commonwealth budget (FY, A$ bil)	-51.0	-26.0	-8.0											
as % of GDP	-3.8	-1.8	-0.5											
Unemployment rate	5.2	5.1	4.8	5.2	5.2	5.1	5.2	5.0	5.0	4.9	4.9	4.8	4.7	4.7
Industrial production	4.5	0.3	1.3	-4.1	0.6	-3.0	-2.0	5.0	4.0	3.0	0.0	-1.0	2.0	4.0

*All financial variables are period averages

Australia - summary of main macro views

- We trimmed our 2011 **GDP growth** forecast to 2.9% owing to the impact of the floods and cyclone in Queensland. We are comfortable with the investment outlook (particularly in mining), but remain cautious on consumers, who face interest rate pain. We recently lifted the 2012 forecast to 4.3%.
- **Business investment** will rise strongly in 2011 and 2012, with mining leading the way (again).
- On **housing**, with the expanded first home owners' grant now having expired and price caps on the basic grant in place, house price growth has cooled, particularly at the low end of the price spectrum.
- **Consumer confidence** deteriorated in 2010 as mortgage rates rose. The index fell 5.7%m/m in January, but rebounded in February. Optimists outnumber pessimists, but rate hikes are hurting.
- **Export volumes** have held up owing mainly to firm demand from China, and the terms of trade has bounced thanks mainly to higher bulk commodity prices.
- We expect the next **RBA** rate hike in May. Officials have been tightening ahead of the substantial boost to national income from the booming terms of trade; that particular story remains on track, even though officials likely will tread carefully in the near term owing to the impact of the recent natural disasters.
- The **Federal government** is sticking with its promise to deliver a Budget surplus next fiscal year. A proposed levy and targeted spending cuts will help plug the hole caused by the flood/cyclone rebuilding effort.

Economic forecasts - New Zealand

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

				2010			2011				2012			
	2010	2011	2012	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (1995-96 prices)	1.4	1.6	3.9	0.5	-0.6	0.7	-0.7	1.6	7.6	7.4	1.2	3.0	4.3	2.3
Private consumption	2.0	1.2	2.9	0.6	2.0	-1.6	1.0	1.5	4.0	3.2	2.6	2.8	3.0	3.0
Fixed Investment	2.2	6.2	7.5	26.8	-6.9	6.5	3.7	8.0	10.2	12.0	7.0	4.9	5.0	4.0
Residential construction	6.3	7.4	8.3	53.7	-26.4	20.0	6.0	8.0	11.2	12.0	10.0	5.2	4.0	4.0
Other fixed investment	1.4	6.0	7.3	22.0	-2	4.0	3.2	8.0	10.0	12.0	6.4	4.8	5.2	4.0
Inventory change (NZ$ bil, saar)	-0.3	0.2	0.3	-0.7	0.1	0.2	0.1	0.0	0.1	0.1	-0.1	0.0	0.2	0.2
Government spending	2.0	1.4	1.3	2.0	-2.9	1.1	2.4	2.8	2.0	1.6	1.2	0.8	0.8	0.8
Exports of goods & services	2.5	4.7	5.9	2.3	-4.5	3.0	7.0	6.0	9.0	9.0	4.0	5.0	4.0	5.0
Imports of goods & services	8.3	7.5	5.4	1.2	12.5	8.0	8.0	10.0	3.0	3.0	6.0	6.0	6.0	8.0
Contributions to GDP growth:														
Domestic final sales	2.4	2.3	3.9	8.1	-3.6	0.8	2.0	3.5	5.3	5.2	3.6	3.1	3.2	3.0
Inventories	1.0	0.4	0.0	-7.6	9.1	1.8	-2.1	-0.2	0.4	0.2	-1.6	0.5	1.9	0.6
Net trade	-2.0	-1.1	0.0	0.3	-5.6	-1.8	-0.6	-1.6	1.8	1.8	-0.8	-0.5	-0.9	-1.3
GDP deflator (%oya)	1.8	2.0	1.6	1.6	2.2	3.3	2.6	2.1	1.9	1.6	1.1	1.5	1.9	2.0
Consumer prices	2.3	3.2	2.2	0.7	4.4	9.7	3.3	1.8	3.9	3.8	2.0	1.7	2.6	2.3
%oya	2.3	4.3	2.6	1.7	1.5	4.0	4.5	4.8	4.6	3.2	2.9	2.8	2.5	2.2
Trade balance (NZ$ bil, sa)	3.1	1.8	2.1	1.2	0.8	0.1	0.2	0.5	0.6	0.5	0.6	0.4	0.4	0.7
Current account (NZ$ bil, sa)	-6.6	-5.5	-1.1	-1.9	0.0	-3.5	-1.2	-3.3	-1.3	-0.7	-0.2	-5.2	-0.2	-0.8
as % of GDP	-3.6	-2.8	-0.5	-4.1	0.1	-7.4	-6.9	-2.6	-1.5	-0.4	-0.4	-1.6	-1.0	0.9
Yield on 90-day bank bill (%)*	3.0	3.6	4.1	2.9	3.2	3.2	3.2	3.5	3.8	4.0	4.1	4.1	4.2	4.2
10-year bond yield (%)*	5.5	5.5	5.1	5.6	5.2	5.5	5.8	5.6	5.4	5.2	5.2	5.1	5.1	5.1
US$/NZ$*	0.72	0.79	0.78	0.70	0.72	0.76	0.77	0.78	0.79	0.80	0.80	0.78	0.76	0.76
Commonwealth budget (NZ$ bil)	-7.2	-9.8	-5.0											
as % of GDP	-3.9	-5.1	-2.5											
Unemployment rate	6.4	6.2	5.3	6.9	6.4	6.8	6.5	6.3	6.0	6.0	5.7	5.4	5.0	5.1

*All financial variables are period averages

New Zealand - summary of main macro views

- The **New Zealand economy** contracted 0.2%q/q in 3Q. The economy has expanded less than 2% since it exited recession more than a year ago. The devastating earthquake in Christchurch in February makes three straight quarters of falling GDP a risk. Our estimate is that it shaved 0.3%-points off 1Q GDP growth.
- Post-earthquake reconstruction work, higher export volumes and elevated commodity prices, and the positive economic effects related to the Rugby World Cup will help **GDP accelerate later in 2011.**
- The recent surge in imports of capital goods—up 30% over the last six months—suggests that **business investment** will pick up; hence, the recovery in the labour market should gain traction.
- The **unemployment** rate spiked 0.4%-points to 6.8% in 4Q. Had it not been for a sharp drop in the participation rate, the unemployment rate would have probably surpassed the post-recession peak of 7.0%.
- Headline **inflation** printed at 1.5%oya in 3Q, boosted by the October GST hike, but even that had a limited pass-through: underlying inflation was just 0.3%q/q. We expect that the RBNZ will be on hold until 2012.
- **Inflation expectations** have remained anchored despite the GST hike. Two-year inflation expectations held steady in 4Q at 2.6%oya. A further drop in inflation expectations, combined with benign inflation, will provide more scope for the RBNZ to sit on the sidelines until mid-year.

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
28 Feb Australia: Pvt. sector credit Jan <u>0.3%m/m, sa</u> Company profits 4Q <u>3.0%q/q, sa</u> Business inventories 4Q 0.7%q/q, sa	1 Mar Australia: Current account 4Q <u>A$-7.1bn</u> Retail trade Jan <u>0.3%m/m, sa</u> RBA meeting <u>no change</u> New Zealand: Terms of trade index 4Q	2 Mar Australia: GDP 4Q <u>0.3%q/q, sa</u>	3 Mar Australia: Building approvals (11:30 am) Jan <u>-2.0%m/m, sa</u> Trade balance (11:30 am) Jan <u>A$1400mn, sa</u>	4 Mar
7 Mar	8 Mar Australia: NAB business confidence Feb New Zealand: Manufactring activity 4Q	9 Mar Australia: Westpac consumer confidence Mar Housing finance Jan	10 Mar Australia: Unemployment rate Feb New Zealand: RBNZ meeting	11 Mar
14 Mar New Zealand: Retail trade Jan	15 Mar Australia: New motor vehicle sales Feb	16 Mar Australia: Westpac leading index Jan	17 Mar	18 Mar
21 Mar New Zealand: Credit card spending Feb	22 Mar	23 Mar New Zealand: Current account balance 4Q	24 Mar New Zealand: GDP 4Q	25 Mar

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Global Data Diary

Week / Weekend	Monday	Tuesday	Wednesday	Thursday	Friday
26 Feb - 4 Mar	28 February	1 March	2 March	3 March	4 March
	Canada • GDP (4Q) Chile • IP (Jan) Euro area • HICP final (Jan) Germany • Retail sales (Jan) India: GDP (4Q) Japan • PMI mfg (Feb) • IP prelim (Jan) • Retail sales (Jan) • Shoko Chukin (Feb) United States • Personal income (Jan) • Pending home sales	Australia • RBA mtg: no chg Canada • BoC mtg: no chg Euro area • HICP flash (Feb) • Unemployment (Jan) Germany • Labor mkt report (Jan/ Feb) United States • ISM mfg (Feb) • Auto sales (Feb) • Bernanke testifies before Senate Global: PMI mfg (Feb)	Australia • GDP (4Q) Brazil • IP (Jan) • COPOM mtg: +50bp Korea • CPI (Feb) Poland • GDP (4Q) • NBP mtg: no chg United States • ADP employment (Feb) • Beige book • Bernanke testifies before House • Bernanke speech	Brazil: GDP (4Q) Euro area • ECB mtg: no chg • GDP revision (4Q) • Retail sales (Jan) Japan • MoF corp survey (4Q) Korea: IP (Jan) Turkey • CPI (Feb) United States • Prodctvty & costs rev (4Q) • ISM nonmfg (Feb) Global • PMI srv & composite (Feb)	Brazil • CPI (Jan) Euro area • Trichet speech Indonesia • BI mtg: no chg Mexico • Banxico mtg: no chg Russia • CPI (Feb) United Kingdom • Auto regs (Feb) United States • Employment (Feb) • Factory orders (Jan)
5 - 11 March	7 March	8 March	9 March	10 March	11 March
Japan • Cabinet Office private consumption index (Jan)	Taiwan • Trade report (Feb) • CPI (Feb)	Germany • Industrial orders (Jan) Japan • Econ Watchers surv (Feb) Turkey • IP (Jan) United States • NFIB surv (Feb)	Germany • IP (Jan) Japan • Private mach orders (Jan) Mexico • CPI (Feb) Thailand • BoT mtg: +25bp	Brazil • COPOM minutes (Jan) China: Trade report (Feb) Germany: Trade report (Jan) Korea: BoK mtg: no chg New Zealand • RBNZ mtg: no chg Peru: BCRP mtg: +25bp United Kingdom • IP (Jan) • MPC mtg: no chg United States • Flow of Funds (4Q)	Canada • Employment (Feb) China • CPI (Feb) • FAI (Feb) • Retail sales (Feb) • IP (Feb) India • IP (Jan) Malaysia • BNM mtg: no chg United States • Retail sales (Feb) • Business invntories (Jan) • JOLTS (Jan)

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
Michael Mulhall (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
Daniel Silver (1-212) 622-6039

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

Grace Ng, Hong Kong (852) 2800-7002
Lu Jiang, Hong Kong (852) 2800-7053

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
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

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

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