

Australia and New Zealand - Weekly Prospects

Summary

- **Australian** politics took centre stage last week, with the appointment of a new Prime Minister. Kevin Rudd stepped down, with his Deputy, Julia Gillard, taking over at the helm. Attention is now firmly centred on the new PM's treatment of the resources "super profits" tax. Her appointment already has fuelled hopes of a faster resolution to the dispute over the controversial mining tax that has weighed down business, consumer, and investor sentiment. The economic data this week—on retail sales, credit aggregates, and building approvals for May—should provide further evidence that the RBA's assertive policy tightening is weighing on the interest rate-sensitive sectors of the economy. The RBA's tightening cycle has paused, not ended, however. The length of the pause will depend on inflation. We expect the next RBA rate hike to be delivered in August, shortly after the late-July release of the 2Q CPI numbers.
- The **New Zealand** economy expanded 0.6%q/q in 1Q, marking the fourth straight quarter of expansion, following one of the nation's worst recessions in decades. The nation's economic recovery should continue, underpinned in the very near term by higher private consumption. We expect that Kiwi consumers will bring a significant amount of spending forward ahead of the October 1 GST hike. Thereafter, however, private consumption likely will be subtrend, as households embark on a period of consolidation. This will occur as the RBNZ continues to tighten monetary policy. Our forecast is for another 100bp of tightening before year end, taking the OCR to 3.75%. RBNZ Governor Alan Bollard signalled this month that the central bank's policy outlook will be determined by three key factors: inflation expectations; household consolidation; and, global growth.
- The European debt crisis has put the brakes on what already was a very slow process of **monetary policy** normalization. The G-3 central banks are expected to remain on hold indefinitely, and we took additional steps in this direction last week, pushing back expected rate hikes in the UK and Norway. Indeed, the only European central bank that is expected to hike rates in the near term is Sweden's Riksbank. Although about half of the central banks in our coverage universe are on hold this year, most of EM Asia and many commodity-exporting countries are still projected to hike. Indeed, the biggest news on policy last week was made by China, which announced that it was relaxing its currency peg to the US dollar. Over the past week, CNY/USD spot rate resumed its gradual appreciation trend, with higher daily trading volatility than before. We expect CNY/USD to reach 6.6 by year-end, and look for Chinese officials to complement FX appreciation with a rate hike in the coming quarter.
- Economic activity looks to have accelerated this quarter despite a marked deterioration in risk appetite. **Global GDP** growth is tracking at a 4% pace as a sharp acceleration in the developed markets is more than offsetting a slowing in EM growth. This projected rotation is confirmed by the monthly indicators. Industrial production in the US and Western Europe ramped up to a near double-digit pace in recent months while appearing to have come off the boil in EM Asia. The regional manufacturing PMIs—which are less impacted by the seasonality in the official production data in EM Asia—underscore this rotation.

This week's highlight

The Aussie retail sales data on Thursday. We expect a fall in retail sales in May, with a marked decline in spending on discretionary items.

June 28, 2010

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Data and event previews - Australia and New Zealand

Date	Time ^(a)	Data/event	Forecast		
			JPMorgan	Consensus ^(b)	Previous
Monday, June 28	1.00pm	NBNZ business confidence (%m/m, Jun.)	42.0	na	48.2
Tuesday, June 29	8.45am	NZ building permits (%m/m, May)	2.0	na	8.5
Wednesday, June 30	11.00am	Aust. DEWR skilled vacancies (%m/m, Jun.)	na	na	1.0
Wednesday, June 30	11.00am	HIA new home sales (%m/m, May)	na	na	6.2
Wednesday, June 30	11.30am	Aust. private sector credit (%m/m, May)	0.2	0.4	0.2
Thursday, April 1	9.30am	AiG performance of manufacturing (Index, Jun.)	na	na	56.3
Thursday, April 1	11.30am	Aust. retail sales (%m/m, May)	-0.3	0.3	0.6
Thursday, April 1	11.30am	Aust. building approvals (%m/m, May)	0.0	0.0	21.3

(a) Australian Eastern Standard Time.

(b) Consensus based on Bloomberg survey.

Australia

DEWR skilled vacancies (%m/m, Jun.) - Job opportunities at the professional and associate professional level were scarce again May, with vacancies in the trades picking up the slack. While we expect the divergence between categories to gradually correct over time, this dynamic is instructive of growth dynamics across sectors and should remain in place for the foreseeable future.

HIA new home sales (%m/m, May) - Home sales probably were soft in May, after jumping 6% m/m in April. The RBA's delivered a further 25bp rate hike early in the month, marking the sixth rate hike in just eight months, and first home buyers (FHBs) continued to withdraw from the market. Indeed, FHBs accounted for just 16% of new home loans in May.

Private sector credit (%m/m, May) - We expect credit growth to have remained unchanged at a subdued 0.2% m/m in May, as the RBA's brisk monetary tightening continues to trim loan demand. Higher interest rates and the absence of the expanded FHBs' grant are expected to have weighed on demand for housing credit, though this will remain be the fastest growing component, increasing again by 0.5% m/m. Personal credit growth also likely remained steady at 0.2% m/m, and business credit likely contracted by a further 0.2%.

Retail sales (%m/m, May) - Retail sales likely fell 0.3% m/m in May, marking the first fall since February, with a significant decline likely to be reported in sales of discretionary items. The RBA's decision to hike the cash rate a further 25bp depressed consumer confidence, which fell 7% over the month, and likely dampened consumer spending. The drop in AUD and the sizeable fall in the local equity market would have further depressed spending.

Data previews - Cont'd.

Building approvals (%m/m, May) - Building approvals were likely flat in May, but given the cross-currents shown in this series in the last two months, it is difficult to get a sense of the underlying momentum. A near 60% m/m spike in approvals for higher density dwellings delivered a surge in total approvals in March, which was almost perfectly unwound in April, but through an entirely different channel: a 14% m/m fall within the detached houses category. Perhaps the best way to describe the data flow is to focus on the headline, which showed that total approvals were essentially flat over the past two months. With rising interest rates continuing to squeeze the flow of finance, we have every reason to believe activity will remain soft for some time yet.

New Zealand

NBNZ business confidence (%m/m, Jun.) - The headline reading on the NBNZ business confidence index probably headed lower in June, owing mainly to heightened sovereign concerns in the Euro area. We suspect that a net 42% of respondents to the survey, compared to 48% previously, will expect that business conditions in New Zealand will improve over the next 12 months. We will be watching responses in the retail sector particularly closely, given the surprise jump in confidence within this category in May.

Building permits (%m/m, May) - Building approvals in New Zealand likely grew 2.0% m/m in May, marking a sharp slowdown from the 8.5% spike in April, but the fourth straight monthly rise. The result, though, will confirm our expectation that residential construction give a healthy boost to economic growth in 2Q. We suspect that building approvals will hold up throughout the year, particularly now that the uncertainty surrounding property taxation has been cleared following the government Budget in May.

Australia

- **Surprise leadership change gives Australia a new PM**
- **Retail and credit numbers likely soft in May**
- **Building approvals data sending mixed signals**

Last week was an unexpectedly busy one for Australian politics. Early on Thursday, Kevin Rudd stepped down as Australia's Prime Minister, with his Deputy, Julia Gillard, taking over at the helm. In a press conference shortly after the announcement, Gillard announced three key areas of policy that would now come under review: industrial relations, climate change, and the resources "super profits" tax. The new Prime Minister also reaffirmed the government's intention to return the Budget to surplus by 2013, and hinted at an election "in coming months."

There was no top-tier economic data in Australia released last week. That said, we expect that retail sales, credit, and building approvals data this week will provide further evidence that the RBA's assertive policy tightening is weighing on the interest rate-sensitive sectors of the economy.

New PM Gillard takes the reigns

Kevin Rudd stepped down last week as Australia's Prime Minister, making him the first Labor PM to leave office before completing a first term. Rudd relinquished his leadership, handing power to his Deputy. He had called for a leadership ballot to be held, but subsequently decided not to contest after it became clear that Gillard would overwhelmingly claim victory. Treasurer Wayne Swan has stepped in as Deputy Prime Minister.

In a press conference following the announcement, the new Prime Minister spoke on three key policy issues that will now be under review ahead of the forthcoming election, and also pledged to restore the Federal Budget to surplus by 2013, as had her predecessor. The three policy areas identified by the new PM were the following:

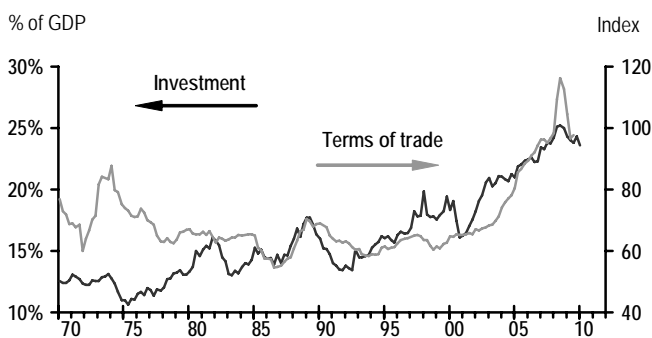
Industrial relations. Centralization of workplace relations was probably the most obvious policy angle one could have expected Gillard to have emphasized, given her well-renowned trade union ties and her role in recent efforts to wind back the Howard government's Work Choices legislation. Protecting worker rights will be at the forefront of Gillard's election campaign. The new PM will have her work cut out for her, however. The new modern award system, introduced under her Fair Work industrial relations regime and effective July 1, has caused mass confusion

Commonwealth Budget position and economic forecasts

	10-11(f)	11-12(p)	12-13(p)	13-14(p)
Budget balance				
A\$ bn	-40.8	-13.0	1.0	5.4
% of GDP	-2.9	-0.9	0.1	0.4
GDP (%oya)				
Budget forecasts	3.3	4.0	3.0	3.0
J.P. Morgan forecasts	3.5	4.25	3.8	3.25

Source: Budget Papers

Terms of trade and investment as a share of GDP



among employers. The change from the Howard government's Work Choices regime to the Fair Work regime has been complex, and will need to be clarified as quickly as possible.

Climate change. The delay of the Emissions Trading Scheme (ETS) was one of the key issues that led to Rudd's downfall. Voter support for Rudd slumped following his decision in April to delay the ETS, a key platform for his election victory three years ago, which he had previously described as the "greatest moral and economic challenge of our time." Gillard believes firmly in the need for such climate change legislation, and will "re-prosecute" the case for a carbon price. First, though, she aims to build a "community consensus" on the need for climate change, which presumably will take considerable time.

Resource Super Profits Tax (RSPT). The government's proposed "super profits" tax on mining companies has generated harsh opposition from resources giants, who have announced that they would shelve billions of dollars worth of investment projects in Australia, putting at risk tens of thousands of jobs. Given how poorly negotiations with industry bodies appear to have been going, Gillard will likely dilute the RSPT in some shape or form. To reach a consensus between the government and the mining industry, the new PM intends to consult and negotiate with the mining

sector in order to end the uncertainty surrounding the RSPT that has been hindering the Australian economy.

Before last week's announcement, we were expecting the Federal election to be held in October 2010. With the new PM hinting this week that an election would be called "in coming months," October is indeed still "live." The timing of the election will, however, ultimately depend on how successful the new Prime Minister is in selling her policy agenda to the public.

Retail sales soft on discretionary items

Retail sales likely fell 0.3% m/m in May, marking the first fall since February, with a significant decline likely to be reported in sales of discretionary items. The RBA's decision to hike the cash rate a further 25bp in May (marking the sixth rate move in just eight months) depressed consumer confidence, which fell 7% over the month, and likely dampened consumer spending. Sentiment toward buying major household items, in particular, was down 3.4% m/m. Adding to the rise in market interest rates, consumers probably reined in spending given the 6% drop in AUD over the month and the fall in the local equity market (down 8%). Retail sales values also will have been dragged lower by the continued, and significant, discounting of goods among retailers.

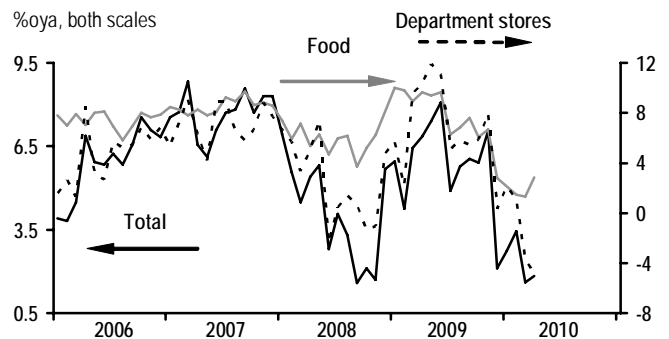
Smaller retailers, in particular, likely found the retail environment difficult in May, given the government's decision to increase the tobacco excise tax 25% from April 30. The move added A\$2.20 to the average price of a pack of cigarettes. We expect that the price hike forced many smokers to cut back on other items to buy cigarettes, meaning businesses like news agents, petrol stations, and convenience stores are taking a smaller piece of the consumer's discretionary spending. This will not immediately affect the retail sales numbers per se, but the drop in sales volumes may force firms to discount other items to compensate.

Credit growth hamstrung by rate hikes

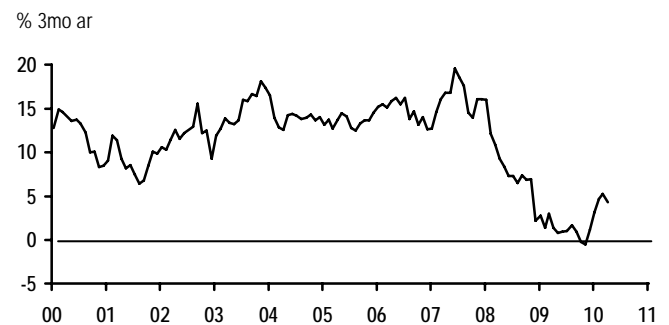
The RBA's credit aggregates for May should show that credit growth remained unchanged at a subdued 0.2% m/m. The credit aggregates will provide further evidence that the RBA's six rate hikes since October are hurting demand.

Higher interest rates and the absence of the expanded first home buyers' grant are expected to have weighed on demand for housing credit. We expect that housing credit will be the fastest growing component, increasing again by 0.5%

Australia: retail sales values



Australia: private sector credit aggregates



in May; this will, however, mark the slowest rate of expansion within that category since August 2008. Personal credit growth also likely remained steady at 0.2% m/m. On the business front, the pool of outstanding credit to businesses likely contracted further. After falling 0.4% m/m in April, our forecast is for business lending to have dropped 0.2% in May. This weakness is expected owing to a drop in demand from firms amid troubles in Europe, and despite some signs of an easing in credit conditions for small- to medium-sized businesses.

Building approvals facing cross currents

We expect building approvals to have been flat in May, after tanking 14.8% m/m in April. The movements in this series recently have been puzzling, over and above the usual volatility. A near 60% m/m spike in approvals for higher density dwellings delivered a surge in total approvals in March. That bounce was almost completely unwound in April, but through an entirely different channel: a 14% m/m fall within the detached houses category, the biggest decline since the introduction of the GST in 2000.

The Australian Bureau of Statistics did not identify any extraordinary factors to explain these movements, so, volatility notwithstanding, we have to take the past two readings

at face value. Perhaps the best way to describe the data flow is to focus on the headline, which showed that total approvals were essentially flat over the past two months. With rising interest rates continuing to squeeze the flow of finance, we have every reason to believe activity will remain soft for some time yet.

Data releases and forecasts

Week of June 28 - July 2

Wed Jun 30 11:30am	Private-sector credit Sa	Feb	Mar	Apr	May
%m/m		0.4	0.5	0.2	<u>0.2</u>
%oya		1.7	2.1	2.1	<u>2.3</u>

Thu Jul 1 11:30am	Building approvals Sa	Feb	Mar	Apr	May
%m/m		-1.9	16.8	-14.8	<u>0.0</u>
%oya		37.4	54.4	21.3	<u>32.5</u>

Thu Jul 1 11:30am	Retail trade Sa	Feb	Mar	Apr	May
%m/m		-1.2	0.8	0.6	<u>-0.3</u>
%oya		3.5	1.6	1.8	<u>0.7</u>

Review of past week's data

Sales of new motor vehicles

Units, sa	Mar	Apr	May
%m/m	-2.8	9.0	— -3.2
%oya	19.5	29.1	— 16.4

New Zealand

- NZ expanded at a healthy clip of 0.6%q/q in 1Q
- Current account surprisingly surged into surplus
- NBNZ business confidence will have fallen in June

In New Zealand, the 1Q GDP data last week showed the economy expanded at its fastest pace in two years. The belated nature of the GDP data means, though, that it has few implications for monetary policy decisions near term. What was more surprising last week, however, was that the current account moved into surplus for the first time since early 2003. This week's economic calendar, however, is absent of top-tier economic data.

Kiwi GDP growth hit a two-year high

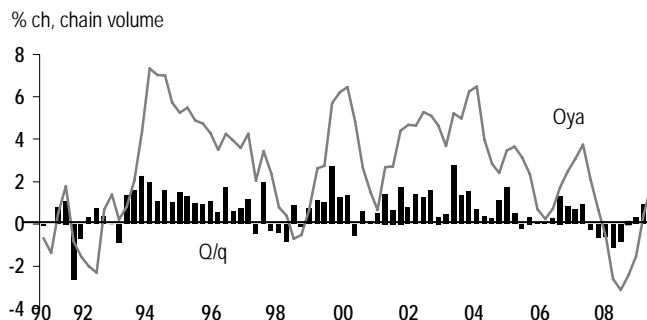
The New Zealand economy maintained a healthy rate of expansion in 1Q. GDP growth printed at a healthy clip of 0.6%q/q (J.P. Morgan: 0.7%; consensus: 0.6%), marking the fourth straight quarter of expansion, although this slowed from 0.9% in 4Q. Annual economic growth printed at 1.9%oya, as expected, the fastest rate of growth in two years.

While government spending shot up 1.7%q/q, marking the largest rise since 1Q08, private consumption slowed significantly. Private consumption, which accounts for two-thirds of the economy, grew a mere 0.2%q/q, although this should pick up considerably in coming quarters. Consumers will likely "bring forward" spending ahead of the forthcoming GST hike on October 1, as was the case when the GST was introduced in 1986 and in 1989 when it was lifted by 2.5%-pts. Post the GST hike, the vacuum left by the "bring forward" of spending, coupled with rising interest rates and more moderate house price growth, should mean household spending weakens considerably.

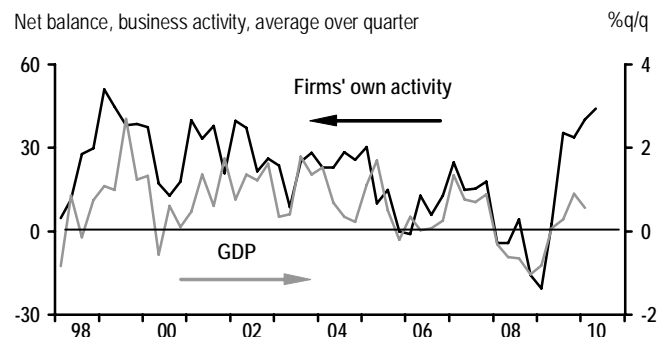
Investment also added to growth in 1Q, rising 0.8%q/q. This increase owed to a rise in investment in intangibles, driven by an increase in exploration activity, which was reflected on the production side—mining rose 4.5% over the quarter. The persistent weakness in nonresidential investment (-3.5%q/q) was offset by a rise in residential investment (+0.5%), but also a rise in investment in other fixed assets (+0.9%) after two straight quarters of decline.

Net exports, however, again dragged on growth, subtracting 0.1%-pt from GDP growth. Export volumes, which account for 30% of the economy, were up 1.4%q/q, buoyed by strong growth in the nation's major trading partners in Asia. Import volumes, however, moved up by a greater

New Zealand: GDP



New Zealand: NBNZ business outlook survey and GDP



1.9%q/q, driven by an increase in consumption goods and the acquisition of a NZ\$93 million offshore patrol vessel; the latter was recorded under central government consumption expenditure.

Our forecast is for the New Zealand economy to continue expanding into midyear, before slowing in late-2010. We expect that net exports will (finally) add to economic growth in coming quarters, provided that the troubles in Europe do not spill over into the real economy, and that household consumption will pick up significantly in the very near term.

Business confidence lower in NZ

The headline reading on the NBNZ business confidence index probably headed lower in June, owing mainly to heightened sovereign concerns in the Euro area. We suspect that a net 42% of respondents to the survey, compared to 48% previously, will expect that business conditions in New Zealand will improve over the next 12 months.

It will be interesting to see the responses of those in the retail sector. Surprisingly, the retail sector posted the biggest rise in sentiment in May, with a 10pt jump. Indeed,

consumer confidence has remained upbeat, although this optimism has yet to translate to stronger spending. Retailers may, however, be more optimistic, owing to the significant improvement in the labour market in 1Q, and expectations that consumers will bring forward spending ahead of the forthcoming GST hike.

NZ current account burst back into black

New Zealand's current account balance improved significantly in 1Q, with the quarterly deficit transforming into surplus, thanks to a better trade balance. The current account balance rose to a surplus of NZ\$176 million from a massive deficit of NZ\$3.4 billion in 4Q. The last surplus on the current account was recorded in 2Q09, although that was due to a large tax transaction. Apart from 2Q09, the last surplus was recorded in 1Q03. The annual CAD printed at NZ\$4.5 billion in 1Q, or 2.4% of GDP, down from 2.9% previously. This improvement will likely be short-lived. Excluding the large one-off tax transactions recorded during the March 2010 year, the CAD would have been much worse at NZ\$6.1 billion, or 3.3% of GDP.

Investment income posted its usual deficit, though it improved to NZ\$2.27 billion in 1Q from NZ\$3.25 billion, owing to lower profits earned by foreign direct investors from their subsidiaries in New Zealand. The fall in profits was overstated, however, by the NZ\$379 million tax transaction in 4Q, which temporarily increased profits of the banking sector. Excluding this tax transaction, banks' profits would have remained flat this quarter.

Other details showed that New Zealand's net international debt position was NZ\$167 billion in 1Q, or nearly 89% of GDP. New Zealand still relies heavily on foreign borrowing to fund its government deficit because of perennially low levels of household saving. Short-term overseas debt was 40% of the total foreign liabilities. This was the lowest on record and is largely the result of the RBNZ's new liquidity policy, which requires banks to hold longer-term foreign funding.

Data releases and forecasts

Week of June 28 - July 2

Tue Jun 29 10:45am	Building consents Sa	Feb	Mar	Apr	May
	%m/m	6.1	0.1	8.5	<u>2.0</u>
	%oya	29.8	33.3	32.1	<u>27.2</u>
Thu Jul 1 3:00pm	ANZ commodity price series Nsa	Mar	Apr	May	Jun
	Index - world prices (%m/m)	1.8	5.4	2.5	—
	Index - NZD (%m/m)	0.4	4.2	2.9	—

Review of past week's data

Visitor arrivals	Mar	Apr	May
Total (%m/m,nsa)	0.8	-1.8	— 1.0
Net permanent immigration	Mar	Apr	May
Monthly (000s,nsa)	-0.3	-0.6	— 0.3
12-month sum (000s,nsa)	21.0	20.0	— 18.0
Credit card spending	Mar	Apr	May
%oya	6.2	1.9	— 0.7
Balance of payments	3Q09	4Q09	1Q10
NZ\$ mn, nsa			
Current account	-1586	-3574	-2237 176
Real GDP	3Q09	4Q09	1Q10
Sa, production-based			
(%oya)	-1.4	0.4	<u>1.9</u>
(%q/q)	0.3	0.8	<u>0.7</u> 0.6
Trade balance	Mar	Apr	May
Trade balance (NZ\$ mn,nsa)	590	656	<u>1000</u> 814

The trade balance remained in surplus in May for the fourth straight month, but was slightly narrower than expected, thanks to a larger than forecast rise in imports.

Global Essay

- **As DM fiscal policy turns tight, monetary stances to stay “low for longer”**
- **EM Asia industry boom is fading and June global PMIs should follow**
- **One small step from China may open a large door for regional policy flexibility**
- **Expecting a rebound in US private payrolls this week (170,000)**

Previewing the 2011 X games

While the uncertainties surrounding where private sector behaviour is heading have increased, the path of developed market (DM) policy has become clearer. Fiscal tightening is taking hold broadly in the aftermath of the European financial crisis. On the heels of recent announcements across the Euro area, the new UK government presented an emergency budget last week that adds to a substantial tightening already in place. The US Congress also failed to extend Emergency Unemployment Compensation (EUC), signaling shifting sentiment on this side of the Atlantic. Although the EUC extender is likely to be passed soon, other initiatives anticipated to dampen next year’s fiscal drag now look less likely to materialize. We also are learning that the new Japanese government under Prime Minister Kan intends to be more aggressive on fiscal consolidation with new JGB issuance in FY2011 not to exceed the FY2010 amount and spending capped for the next three years. Accordingly, we have raised estimates of the aggregate fiscal tightening in recent months by 0.4%-pt to about 1% of DM GDP next year. This adjustment would be the most aggressive DM tightening in more than four decades.

As fiscal policy consolidates, monetary policy is shifting toward a “low for longer” stance. Our long-held view that

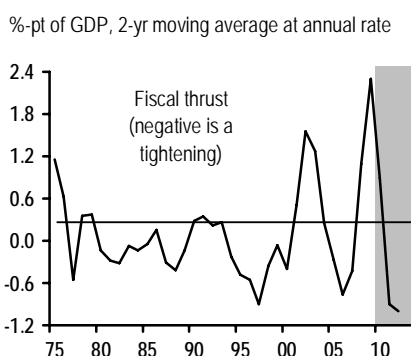
the developed world policy normalization would not start this year has been extended until late 2011. As a result, our expectation of mid-2011 DM policy rates now stands 45bp lower than three months ago. With central bank balance sheets expected to remain bloated and real rates set to stay in negative territory for at least two full years, monetary policy stances will remain far more accommodative than at any point since the mid-1970s.

Standard macroeconomic models mark these moves as having offsetting effects on growth, a point that reflects the policy objective of achieving early progress on fiscal consolidation while using monetary policy to sustain above-trend growth. Low inflation will allow central banks to hold up their part of the agreement. But it also underscores the significant risk of fiscal tightening in the current environment. A significant shortfall in growth or a slide in inflationary expectations would require a quick and decisive monetary policy response. But policy rates are at the zero bound—and already anticipated to remain there. To be sure, asset purchases and other unconventional measures are available tools. But evidence that these tools can lift activity or anchor inflation expectations is sorely lacking.

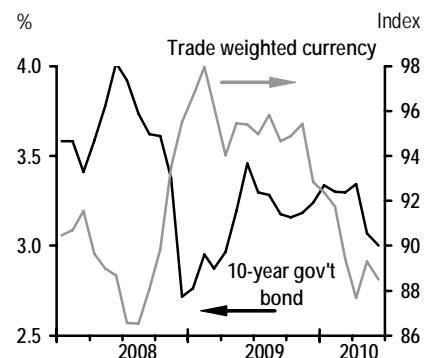
A precondition for this extreme policy mix to achieve its aim is the transmission of it to lower DM borrowing rates and currency values. It is thus encouraging that DM 10-year government bond yields have moved lower, alongside stable medium-term inflation expectations. The real effective DM exchange rate is also sliding and stands 7% below its level a year ago.

The private sector response to these financial incentives and improving economic conditions holds the key to the outlook. As the table above shows, a significant improvement in underlying private demand—both directly and in

Developed markets fiscal impulse



Developed world financial conditions



Fiscal thrust and private final sales

%oya	DM	US	Euro area	Japan	UK
GDP					
2009	-3.5	-2.4	-4.1	-5.3	-4.9
2010	2.7	3.5	1.3	3.6	1.4
2011	2.4	3.1	1.4	2.2	2.5
Fiscal thrust (+ is stimulative)					
2009	2.3	2.8	1.9	2.2	2.1
2010	0.1	0.1	0.5	0.3	-2.0
2011	-0.9	-1.3	-0.7	0.2	-2.4
Inventory contribution					
2009	-0.6	-0.6	-0.8	0.2	-1.2
2010	0.8	1.2	1.0	-0.2	0.8
2011	-0.1	0.0	-0.4	-0.1	0.4
Underlying private final sales					
2009	-5.2	-4.6	-5.2	-7.7	-5.8
2010	1.8	2.2	-0.2	3.5	2.7
2011	3.4	4.4	2.5	2.1	4.5

response to easier money—will be needed to offset fiscal tightening and a fading of the inventory cycle. In this regard, the establishment of a hiring and capital spending upturn across the globe sends a positive signal that a shift in business behaviour away is under way. However, the damage to consumer confidence from developments in Europe and the recent decline in equity prices remains to be assessed, even as June readings are proving to be resilient.

Industry momentum to taper into 3Q

Economic activity looks to have accelerated this quarter despite a marked deterioration in risk appetite. Global GDP growth is tracking at a 4% pace as a sharp acceleration in the developed markets is more than offsetting a slowing in EM growth. This projected rotation is confirmed by the monthly indicators. Industrial production in the US and Western Europe ramped up to a near double-digit pace in recent months while appearing to have come off the boil in EM Asia. The regional manufacturing PMIs—which are less impacted by the seasonality in the official production data in EM Asia—underscore this rotation.

The latest business surveys also suggest momentum is cresting at midyear. Last week delivered the June business surveys for the Euro area. Although the 2Q10 average is consistent with our GDP forecast of 3%q/q saar, national surveys all peaked in April or May. To be sure, it is encouraging that no indicators in the region have broken to the downside in the face of significant financial market turmoil. Indeed, consumer sentiment actually edged up this

month, albeit to a still-low level.

This week's manufacturing PMIs for the rest of the world should show a similar pattern. We are looking for a 1-pt decline in our global manufacturing PMI for June—with the US ISM and Japan PMI both moving down—that would leave the 2Q average about a point above the 1Q level but infer a softening trajectory into next quarter. With production gains moderating, continued improvement in private sector spending growth even as fiscal support wanes will be crucial for preventing a more material downshift. This week's US payroll report (170,000 private) and motor vehicle sales (11.4 million) will be important markers for tracking this dynamic.

China currency shift will reverberate

The European debt crisis has put the brakes on what already was a very slow process of monetary policy normalization. The G-3 central banks are expected to remain on hold indefinitely, and we took additional steps in this direction last week, pushing back expected rate hikes in the UK and Norway. Indeed, the only European central bank that is expected to hike rates in the near term is Sweden's Riksbank. Sweden's economy has rebounded strong recently, and the central bank has yet to lift rates from the 0.25% emergency setting. We look for the Riksbank to begin a gradual tightening cycle with a 25bp move at Thursday's policy meeting.

Although about half of the central banks in our coverage universe are on hold this year, most of EM Asia and many commodity-exporting countries are still projected to hike. Indeed, the biggest news on policy last week was made by China, which announced that it was relaxing its currency peg to the US dollar. Over the past week, CNY/USD spot rate resumed its gradual appreciation trend, with higher daily trading volatility than before. We expect CNY/USD to reach 6.6 by year-end. In addition, we look for Chinese officials to complement FX appreciation with a rate hike in the coming quarter.

While last week's decision was fraught with politics, it also represents a vote of confidence by Chinese officials in the resilience of the economic recovery. This suggests that policy action in China may serve as a catalyst elsewhere in Asia, where officials have been slow to respond to a robust recovery that already has produced a firming in core inflation. A few days after China made its announcement, Taiwan's central bank kicked off its tightening cycle with an unexpected rate hike. We expect further rate increases in

Manufacturing indicators

Underlined values based on fcast

	Factory output		Mfg PMI, composite		
	Jan-Mar	Apr-May	Jan-Mar	Apr-May	June
Global	1.0	<u>0.8</u>	56.1	57.5	<u>56.3</u>
Developed	1.0	<u>0.7</u>	55.6	57.6	<u>56.7</u>
US	0.6	1.0	58.2	60.1	<u>58.5</u>
EMU	1.2	<u>0.4</u>	54.4	56.7	<u>55.6</u>
Japan	1.6	<u>0.9</u>	52.6	54.3	<u>54.0</u>
EM Asia-3	1.4	<u>0.8</u>	57.3	55.0	<u>53.4</u>
China	1.3	0.7	56.6	54.0	<u>52.4</u>
Korea	1.8	<u>0.8</u>	56.5	55.8	<u>54.3</u>
Taiwan	1.2	0.8	62.3	59.1	<u>57.1</u>

the coming quarter. Elsewhere in Asia, we also look for hikes in India, Korea, Malaysia, the Philippines, and Thailand in coming months. These rate increases are likely to be accompanied by faster FX appreciation, which has been held back up until now by China's reticence on the yuan.

China's FX policy shift will have more lasting repercussions. The mushrooming of global trade imbalances was a hallmark of the 2000s expansion. The developments of the past few years produced a sharp reduction in these imbalances, bringing them back to near the position of a decade ago. Although some of this progress appears to be transitory in nature, a set of policies that promotes domestic demand growth in the EM (FX appreciation, stronger social safety nets, reduced import barriers) can be helpful in supporting growth and containing the rise in global imbalances.

Japan slowing to a still-solid pace

Following back-to-back quarters of near 5% growth, Japan's economy is downshifting along with the rest of Asia. That said, it appears that there is upside risk to our forecast for 2.5% growth in the current quarter. The monthly business surveys advanced significantly through May compared to their 1Q averages. And last week's reports showed that export growth has exceeded expectations. On the other hand, IP growth has slowed significantly, and the pace of consumption growth appears subdued. This week's updates on these indicators will help

frame expectations for near-term GDP growth.

Downgrading near-term outlook for UK

Last week's emergency budget in the UK largely met expectations. With a hike in VAT the main additional tightening measure over the next 18 months, the structural primary deficit is forecast to decline by 2% of GDP this year and an additional 2.4% of GDP in 2011. Further out, the government is targeting a falling debt to GDP ratio in 2014. As fiscal tightening proceeds, officials have pointed to the ability of monetary policy to provide an offset should growth falter. This is questionable. With policy rates already near zero, there are doubts about both the effectiveness of further extensions of QE and whether markets would tolerate such action with inflation having run above target for most of the last three years. Though the budget did not surprise us, recent stress in European credit markets and downward revision to the Euro area forecast have led us to mark down views for the UK. Following a 3% gain this quarter, we look for growth to moderate to an average 2.4% through 2Q11. We have pushed the forecast for the first hike in rates from the MPC to May of next year.

Latin growth fueled by domestic demand

Latin America's growth continues to surprise on the upside, maintaining the momentum seen in 1Q10. The expansion is rooted in an impressive recovery in domestic demand, both consumption and investment. The strength of domestic demand is fueling a surge in imports. Thus, even though exports are expanding on the back of the global recovery, net trade is forecast to be a drag on GDP expansion this year in all the countries we cover in the region, including Mexico, subtracting about 1.8%-pts from full-year 2010 GDP. A key factor behind the resilience of domestic demand in Latin America has been policy stimulus amid a healthy financial system, along with a bounceback in the terms of trade. Notably, this pattern of growth is the opposite of what has been seen in Asia, where the recovery in net exports has made an important contribution to growth.

JPMorgan View - Global Markets

A summer range beckons

- **Economics:** Growth momentum should soften as support from fiscal policy and inventories wanes. DM growth to fall from 3.3% in 2Q to 2% in 1H11.
- **Asset allocation:** Falling growth momentum and unresolved EU long-term funding to keep risky markets in a range during the summer.
- **Fixed income:** Stay positioned for higher yields, but only in the front end of the US and Australia, where the risk of further declines appears limited.
- **Equities:** Reverse underweight on global banks. Global regulators likely to soften or postpone onerous liquidity requirements under Basel III.
- **Credit:** US HG spread year-end forecast revised up to 150bp from 125bp.
- **FX:** JPY and EUR in longer-term range vs. USD. Be long CAD and INR vs. USD, and CHF vs. EUR
- **Commodities:** Oil forecast lowered to \$85 for year-end but fundamentals remain positive. Stay long.

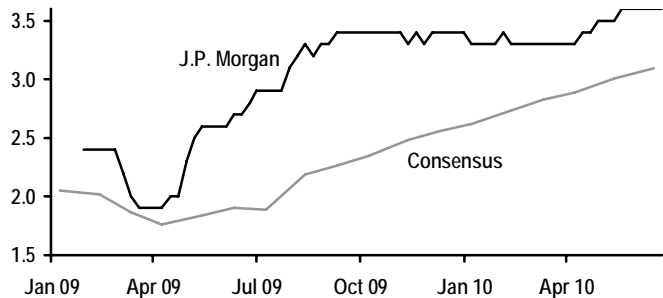
A messy week, with equities and EM FX down, while commodities and credit were flat, and bonds are up. Japanese data were strong, tracking stronger than our 2Q forecast, while European data confirmed our view that growth is accelerating into 2Q. US housing data were poor, though, creating growth risks.

Markets are approaching the **halfway mark for the calendar year**, and have not performed as many of us expected at the start of the year. Fixed income is up, while equities are down, with commodities posting both the top price (for gold) and the bottom (other commodities).

At the start of the year, we forecast that risky markets would strongly outperform defensive assets (govies and cash) on rising growth and earnings expectations and the attractiveness of high risk premia relative to falling uncertainty. Return forecasts were smack on target through April, but the correction of the past two months has pushed YTD returns on equities and commodities (gold excepted) to the negative side, and fixed income to the positive. Within fixed income, credit still outperformed government debt and cash on the strength of its higher yield.

What went wrong? We can't blame economic or company forecasts, as activity data and company earnings have sur-

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



prised on the upside during 1H, pushing up consensus views for 2010 and 2011 earnings and 2010 growth to our own bullish anticipations. But markets price in both expected prices and the risks around them. If the means of our probability distributions for future growth and cash flows have improved, **then higher risk premia must be the result of increased risk perceptions, or uncertainty** around these projections.

We have argued frequently that **uncertainty about the economy and earnings over the next year is steadily falling**. We stay with that view. However, many investors are countering that while the near-term outlook has become clearer, **the longer term has become much less transparent**. At the core is the **endgame question**: How can policy-makers unwind the massive liquidity and public debt incurred during the crisis, without creating inflation, debt repudiation, growth-destroying taxation, or Japanese-style deflation?

Without real time, non-price measures of investor worries about the longer-term outlook, we need to try to project **whether events over the next few months will worsen or soften these concerns**. Growth is the obvious cure for most debt problems and would reduce concerns about debt sustainability. Our economists are highlighting that beyond the current quarter, **growth momentum will be coming down** as the impetus of the inventory cycle loses steam and fiscal policy moves from net stimulus to drag. By our measure and expectations, fiscal stimulus in developed markets should move from +4.4% of GDP last year, to -0.9% this year and -1.6% next year. **DM growth should peak this quarter (2Q) at 3.3% and slow to 2% during the first half of next year.**

The Euro sovereign debt crisis is the second area where news flow will influence perceptions of the fiscal endgame, as it is a laboratory of how other countries can, and will have to, address debt sustainability. Here we find that periphery Euro area governments and banks have been able to

fund themselves this month, but are increasingly depending on the ECB for that (see our weekly *Flows & Liquidity*), thus not improving confidence.

Mixed signals on growth and European funding and the lack of price momentum make it increasingly likely that risk markets will trade in a volatile range this summer.

This is tough on investors as most positions contain some risk directionality. In this week's *Global Markets Outlook and Strategy*, we will present a portfolio of recommendations that will try to exploit relative value and momentum opportunities to still eke out a decent return in markets.

Fixed income

T-bonds continue to gain, fueled by a dovish Fed and falling risky assets. Gilts outperformed, on dramatic spending cuts in the emergency budget. US and UK yields fell to their lowest yield levels in a year. What can sustain yields at these very low levels? Either continued deterioration in risky assets, or a marked turn down in the economy. Though downside risks have increased and we expect global growth to soften, it should remain above trend. It will take several months to establish the impact of market turbulence and the European crisis on the economy, with risk markets likely remaining volatile in the meantime. Thus, **we remain only modestly positioned for higher yields, and only in the front end of the US and Australia**, where the risk of further declines appears limited.

Intra-EMU spreads widened last week, led by Greece, where yields rose over 1% across the curve. Greek bonds have faced a steady stream of selling from indexed investors, with more to come this week as the bonds drop out of investment-grade indices at month-end. Meanwhile, the ECB has become less active in supporting the market, as evidenced by a steady decline in its weekly purchases. **Euro peripheral spreads are likely to narrow afterwards, once selling pressure on Greek bonds has abated.** This should also contribute to narrower euro swap spreads (see *GFIMS*). Further ahead, the question of who can absorb heavy non-core issuance remains. In this respect, the increased dependence of non-core banks—notably Portugal's—on ECB funding is troubling, as it suggests they may only be able fund further government bond purchases through further recourse to the central bank.

Equities

Equities reversed some of their recent gains and **moved again below the technically important 200-day moving average level.** Equity markets remain hostage to continued high uncertainty about the impact of the Euro debt crisis on the real economy and to continued pressures in European

funding markets. None of these issues is likely to be resolved soon.

The **2Q reporting season** that kicks off in two weeks in the US **should provide some relief.** Strong above-trend global GDP growth in 2Q, and a level of positive/negative earnings pre-announcements consistent with prior quarters, point toward a positive outcome.

Our economists are warning us that the global manufacturing cycle has likely peaked and that it will lose some of its strength in coming months as final demand moderates and the inventory cycle matures. This **downshifting in the global manufacturing sector raises downside risks** for industrial and commodity sectors and **cyclical sectors** more generally.

Across regions, we **remain overweight countries that are remote from Europe.** We like US equities, especially industry groups with little euro exposure, and India and Mexico within EM. We do not yet recommend an EM overweight, given downside risks to commodity producers. Within Europe, we stay the core vs. the periphery by overweighting the Dax vs EuroStoxx50.

House and Senate negotiators agreed last week on a softened version of the financial reform bill. Coupled with reports that global regulators are likely to propose to **soften or postpone onerous liquidity requirements under Basel III** in the G-20 summit, this is inducing us to **reverse our underweight on global banks.** Our preference is for US banks given the rather favourable final version of the financial reform bill.

Credit

Credit sold off last week, partially reversing the prior week's rally, as mixed data keep uncertainty elevated. However, there are some signs that **investors' appetite for credit is recovering slightly**, especially for the high yield market.

Investors bought a large \$1.4 billion of US high yield bond funds last week, the strongest pace since August 2003. The inflows over the past two weeks reverse about one-third of the previous outflows since the beginning of May. Moreover, the European HY bond market readily absorbed a large \$4.4 billion of new issuance with little change in Euro HY bond spreads, after essentially no issuance over previous weeks. These signal that investors remain supportive of high yield bonds, which are expected to have few defaults this year.

The case for **value in credit** is getting stronger, especially

for high-yield corporate bonds and super senior CMBS, which continue to see improvements in fundamentals and good expected returns in both spread and yield terms. However, **the momentum of spreads over the past weeks remains negative**, and we only keep a small overweight.

The value of high grade is less compelling as all-in yields are low and spreads are vulnerable to movements in the Treasury market. **We raised our year-end forecast of US HG spreads to 150bp** from 125bp over UST. The European sovereign debt crisis has ignited strong demand for US Treasury bonds and UST yields are significantly lower than we originally expected, and we now anticipate lower UST yields by year-end compared to the start of the year. **Although weaker, the drivers for tighter credit spreads**, namely a recovering economy, rising UST yields, strengthening fundamentals, and strong demand with weak supply, **remain in place**. Thus we maintain the view that US HG spreads will tighten from the current level of 182bp.

Foreign exchange

Throughout June, we have argued that the macro environment was too fluid to justify aggressive trades or forecasts. Since the key issues—European refunding in July and the global growth deceleration this summer—have not been resolved, the strategy is unchanged. Hold below-average risk: **stay short EUR/CHF in cash and options, short USD/CAD in options, and short USD/INR in cash**.

We have extended forecasts to end-2011 with the publication of *World Financial Markets* this week. The key revision is in the dollar's inflection point in 2011. Previously, we expected **EUR/USD** stability around 1.25 in 4Q10 followed by a decline to 1.18 by mid-2010 on the presumption that the Fed would tighten by early summer 2010. Having pushed back the first Fed hike to late 2011, we expect **EUR/USD to range trade for longer around a midpoint of 1.25**, so flatline the forecast at that level until 2Q11. From 3Q11 forward, the dollar should strengthen as US rate expectations trend higher.

Similarly for **USD/JPY**, we set the inflection point at June 2011 and expect the currency to range around 93 from 4Q10 until mid-2011. We continue to think that the consensus bearish view on the yen based on Japan's fiscal position is too extreme given the offsetting bid the yen receives in a very low yield environment.

Ten-year Government bond yields

	Current	Sep 10	Dec 10	Mar 11	Jun 11
United States	3.11	3.45	3.85	4.15	4.50
Euro area	2.61	2.90	3.15	3.25	3.35
United Kingdom	3.38	3.55	3.90	4.10	4.25
Japan	1.15	1.30	1.40	1.50	1.55
GBI-EM	6.83			7.90	

Credit markets

	Current	YTD Return
US high grade (bp over UST)	182	5.0%
Euro high grade (bp over Euro gov)	202	2.8%
USD high yield (bp vs. UST)	711	5.0%
Euro high yield (bp over Euro gov)	756	4.3%
EMBIG (bp vs. UST)	338	5.2%
EM Corporates (bp vs. UST)	364	5.6%

Foreign exchange

	Current	Sep 10	Dec 10	Mar 11	Jun 11
EUR/USD	1.24	1.25	1.25	1.25	1.25
USD/JPY	89.4	90	93	93	93
GBP/USD	1.50	1.47	1.44	1.42	1.42

Commodities - quarterly average

	Current	10Q3	10Q4	11Q1	11Q2
WTI (\$/bbl)	79	85	85	90	85
Gold (\$/oz)	1255	1250	1200	1175	1175
Copper(\$/m ton)	6667	7150	6750	6500	6500
Corn (\$/Bu)	3.60	3.90	3.80	4.00	4.20

Source: J.P. Morgan, Bloomberg, Datastream

Commodities

Crude oil rose over 3% Friday, erasing all of the losses experienced earlier in the week as the US National Hurricane Center raised the probability of a tropical cyclone in the Gulf of Mexico to 70%. A serious storm would threaten oil production in the Gulf and could interrupt BP's clean-up efforts. **We remain positive on oil, but lower our crude oil price forecast**. WTI should average \$85 in 4Q, an \$8 decrease relative to our previous forecast. This is largely due to a stronger USD/EUR and higher inventories year-to-date than we had expected.

Industrial metals gained over 4% last week. China allowed the renminbi to appreciate slightly against the dollar early last week and traders anticipated that a stronger currency would result in increased Chinese buying power for commodities. Furthermore, LME data suggest that inventories have fallen to their lowest level since December 2009. **Stay long industrial metals**.

Global Economic Outlook Summary

	Real GDP			Real GDP							Consumer prices			
	% over a year ago			% over previous period, saar							% over a year ago			
	2009	2010	2011	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	1Q10	2Q10	4Q10	2Q11
The Americas														
United States	-2.4	3.4 ↓	3.1	5.6	2.7 ↓	4.0	4.0	3.5	2.5	2.5	2.4	1.8	0.9	1.1
Canada	-2.5	3.6	2.7 ↓	4.9	6.1	3.5 ↑	3.4 ↑	3.2 ↓	2.7 ↓	2.0	1.6	1.5 ↑	1.8	1.9 ↓
Latin America	-2.9	5.2 ↑	3.8	7.4 ↑	4.3 ↑	4.7	2.5	4.0 ↑	4.3	5.2	6.0	6.5	7.2	6.6
Argentina	-2.0	6.0	4.0	9.6 ↑	12.5 ↑	8.0	3.0	4.0	3.0	4.0	9.0	9.0	10.0	11.0
Brazil	-0.2	7.5	4.0	9.3	11.4	6.0	4.0	3.3	3.8	4.2	4.9	5.3	5.8	4.5
Colombia	0.8 ↑	4.5 ↑	4.1	4.5 ↓	5.3 ↑	4.8	3.7 ↑	4.0 ↑	4.0	4.1	2.0	2.1	3.3	3.6
Ecuador	0.4	2.0	3.0	1.3	2.0	3.5	4.0	4.5	3.0	2.5	4.0	3.3	3.9	4.1
Mexico	-6.5	4.5	3.5	7.9	-1.4	3.2	-1.8	4.2	5.7	7.9	4.8	4.4	5.1	4.5
Peru	0.9	7.3	6.0	10.2	7.3	9.5	4.0	4.5	6.0	6.7	0.7	1.0	2.1	2.2
Venezuela	-3.3	-4.0	1.0	-5.3	-5.6	-5.0	5.0	1.0	1.0	1.0	27.4	32.1	32.1	32.1
Asia/Pacific														
Japan	-5.3	3.6	2.2	4.6	5.0	2.5	2.7	2.7	2.2	2.0	-1.2	-1.4	-0.7	0.1
Australia	1.3	2.9	3.5	4.5	2.0	2.7	4.1	4.2	3.1	3.2	2.9	3.6	3.8	3.6
New Zealand	-1.7 ↓	2.6 ↓	2.9 ↓	3.7 ↑	2.3 ↓	3.8 ↑	2.9 ↓	1.9 ↓	3.0 ↑	3.4 ↑	2.0	2.2	4.8	5.3
Asia ex Japan	4.7	8.9	7.2	8.7 ↑	11.6	6.8	6.5	6.9	7.1	7.4	4.3	4.6 ↓	4.4 ↓	3.8 ↓
China	8.7	10.8	9.4	10.8	13.1	9.4	9.3	9.0	9.1	9.5	2.2	3.2	3.1	2.4
Hong Kong	-2.8	6.8	4.2	10.8 ↑	8.7 ↓	4.3	4.0	3.8	4.2	4.3	1.9	2.6 ↑	2.5 ↑	2.2 ↑
India	7.4	8.3	8.5	6.9	9.2	8.1	8.0	8.9	8.0	8.5	15.3	12.8 ↓	10.3 ↓	9.4 ↓
Indonesia	4.5	6.2	5.7	6.2	5.4	7.0	6.0	6.0	5.5	5.8	3.7	5.3	6.3	4.9
Korea	0.2	5.9	4.0	0.7	8.8	4.0	3.8	3.8	4.0	4.0	2.7	2.8	3.4	3.6
Malaysia	-1.7	7.7	4.8	8.2	5.0	4.0	5.0	5.0	4.9	4.9	1.3	1.7	2.4	2.4
Philippines	1.1	6.8	4.3	7.6	12.9	3.6	4.9	4.0	4.5	4.5	4.3	5.0	5.2	4.9
Singapore	-1.3	10.5	4.3	-1.0	38.6	5.7	-11.5	4.9	7.4	7.4	0.9	3.4	4.7	3.7
Taiwan	-1.9	9.2	4.8	16.7	11.3	3.3	3.5	3.5	5.0	5.3	1.3	0.9	2.0	1.8
Thailand	-2.2	8.5	5.0	17.0	16.0	-2.0	2.8	2.8	6.0	5.5	3.7	5.5	4.4	3.0
Africa/Middle East														
Israel	0.7	3.0	4.5	4.8	3.3	3.5	3.0	3.0	4.0	5.0	3.5	3.0	3.0	3.2
South Africa	-1.8	3.0	3.5	3.2	4.6	3.9 ↓	3.5	3.7	3.7 ↑	3.1 ↑	5.7	4.6 ↓	5.4 ↓	5.6 ↓
Europe														
Euro area	-4.1	1.3	1.4	0.5	0.8	3.0	2.0	1.0	1.0	1.0	1.1	1.5	1.5	0.9
Germany	-4.9	2.2	2.2	0.7	0.6	5.0	3.0	2.0	2.0	1.5	0.8	1.0	1.2	0.9
France	-2.5	1.5	1.4	2.2	0.5	2.5	2.0	1.5	1.0	1.0	1.5	1.8	1.3	0.6
Italy	-5.1	1.2	1.3	-0.3	1.7	2.0	2.0	1.0	1.0	1.0	1.3	1.5	1.5	1.1
Norway	-1.5	1.6	2.4	1.6	0.6	2.0	3.0	2.8	2.0	2.0	2.9	2.5	1.3	1.0
Sweden	-5.1	3.7	2.8	1.7	5.9	5.0	3.5	2.8	2.3	2.3	1.0	1.0	2.3	2.4
Switzerland	-1.5	2.3	2.5	3.5	1.6	2.8	2.5	2.3	2.3	2.5	1.1	1.1	0.9	0.6
United Kingdom	-4.9	1.4 ↓	2.5 ↓	1.8	1.2	3.0	2.5 ↓	2.5 ↓	2.0 ↓	2.5 ↓	3.3	3.5	2.6	1.7
Emerging Europe	-4.9	4.2	4.4	2.3	2.1	7.9	3.1	3.2	4.0	4.2	6.1	5.4	5.5	5.4
Bulgaria	-5.0	-0.5	4.0	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	-4.1	2.0	3.2	2.2	2.0	2.5	2.5	2.3	2.5	3.0	0.7	1.3	2.8	2.7
Hungary	-6.3	0.8	3.0	0.8	3.6	2.0	2.0	1.0	3.5	2.5	6.0	5.3	4.1	3.3
Poland	1.8	3.2	3.7	4.5	2.0	3.0	2.5	2.5	3.0	4.0	3.0	2.3	2.6	2.6
Romania	-7.1	1.0	2.8	...	...	...	...	...	...	...	4.6	4.4	4.7	4.5
Russia	-7.9	5.5	5.0	2.7	2.2	13.5	4.0	4.0	5.0	5.0	7.2	5.8	6.7	7.0
Turkey	-4.7	5.9	5.0	...	...	...	...	...	...	...	9.3	9.3	7.5	6.7
Global	-2.5	3.6	3.1	4.3	3.6 ↓	4.0	3.4 ↓	3.1 ↓	2.8	2.8 ↓	2.2	2.1 ↓	1.9 ↓	1.8
Developed markets	-3.5	2.7	2.4 ↓	3.5	2.5 ↓	3.3	3.1	2.5 ↓	2.0	2.0	1.5	1.4	1.0	1.0
Emerging markets	1.0	7.0	5.8	7.1	8.0 ↑	6.4	4.8	5.4	5.8	6.2	5.1	5.1 ↓	5.2 ↓	4.7 ↓
Memo:														
Global — PPP weighted	-0.8	4.8	4.2	5.3	5.3	5.0	4.3	4.1	3.9	3.9	3.3	3.3	3.0	2.8

Global Central Bank Watch

	Official interest rate	Change from			Forecast		Jun 10	Sep 10	Dec 10	Mar 11	Jun 11
		Current	Aug '07 (bp)	Last change	Next meeting	next change					
Global	GDP-weighted average	1.33	-333				1.34	1.42	1.48	1.54	1.61
excluding US	GDP-weighted average	1.90	-245				1.91	2.03	2.12	2.21	2.31
Developed	GDP-weighted average	0.53	-359				0.53	0.55	0.58	0.60	0.65
Emerging	GDP-weighted average	4.56	-230				4.58	4.87	5.10	5.29	5.45
Latin America	GDP-weighted average	6.32	-261				6.32	6.90	7.37	7.50	7.64
CEEMEA	GDP-weighted average	4.05	-281				4.05	4.07	4.22	4.24	4.53
EM Asia	GDP-weighted average	4.10	-200				4.14	4.41	4.59	4.86	4.97
The Americas	GDP-weighted average	0.83	-476				0.83	0.93	1.01	1.06	1.11
United States	Federal funds rate	0.125	-512.5	16 Dec 08 (-87.5bp)	10 Aug 10	4Q 11 (+37.5bp)	0.125	0.125	0.125	0.125	0.125
Canada	Overnight funding rate	0.50	-375	1 Jun 10 (+25bp)	20 Jul 10	20 Jul 10 (+25bp)	0.50	1.00	1.50	2.00	2.50
Brazil	SELIC overnight rate	10.25	-175	9 Jun 10 (+75bp)	21 Jul 10	21 Jul 10 (+75bp)	10.25	11.50	12.50	12.50	12.50
Mexico	Repo rate	4.50	-270	17 Jul 09 (-25bp)	16 Jul 10	4Q 11 (+25bp)	4.50	4.50	4.50	4.50	4.50
Colombia	Repo rate	3.00	-600	30 Apr 10 (-50bp)	23 Jul 10	1Q 11 (+50bp)	3.00	3.00	3.00	4.00	5.00
Peru	Reference rate	1.75	-275	10 Jun 10 (+25bp)	8 Jul 10	8 Jul 10 (+25bp)	1.75	2.25	3.00	3.75	4.50
Europe/Africa	GDP-weighted average	1.28	-325				1.28	1.29	1.31	1.32	1.41
Euro area	Refi rate	1.00	-300	7 May 09 (-25bp)	8 Jul 10	On hold	1.00	1.00	1.00	1.00	1.00
United Kingdom	Repo rate	0.50	-500	5 Mar 09 (-50bp)	8 Jul 10	May 11 (+25bp)	0.50	0.50	0.50	0.50	0.75
Sweden	Repo rate	0.25	-325	2 Jul 09 (-25bp)	<u>1 Jul 10</u>	1 Jul 10 (+25bp)	0.25	0.75	0.75	0.75	1.00
Norway	Deposit rate	2.00	-250	5 May 10 (+25bp)	11 Aug 10	2Q 11 (+25bp)	2.00	2.00	2.00	2.00	2.25
Czech Republic	2-week repo rate	0.75	-200	6 May 10 (-25bp)	5 Aug 10	2Q 11 (+25bp)	0.75	0.75	0.75	0.75	1.00
Hungary	2-week deposit rate	5.25	-250	26 Apr 10 (-25bp)	19 Jul 10	3Q 11 (+25bp)	5.25	5.25	5.25	5.25	5.25
Israel	Base rate	1.50	-250	28 Mar 10 (+25bp)	<u>28 Jun 10</u>	3Q 10 (+25bp)	1.50	1.75	2.00	2.25	2.50
Poland	7-day intervention rate	3.50	-100	24 Jun 09 (-25bp)	<u>30 Jun 10</u>	2Q 11 (+25bp)	3.50	3.50	3.50	3.50	3.75
Romania	Base rate	6.25	-75	4 May 10 (-25bp)	<u>30 Jun 10</u>	3Q 11 (+25bp)	6.25	6.25	6.25	6.25	6.25
Russia	1-week deposit rate	2.75	-25	31 May 10 (-50bp)	<u>Jun 10</u>	2Q 11 (+25bp)	2.75	2.75	2.75	2.75	3.25
South Africa	Repo rate	6.50	-300	25 Mar 10 (-50bp)	22 Jul 10	2Q 11 (+50bp)	6.50	6.50	6.50	6.50	7.00
Switzerland	3-month Swiss Libor	0.25	-225	12 Mar 09 (-25bp)	16 Sep 10	16 Dec 10 (+25bp)	0.25	0.25	0.50	0.75	1.00
Turkey	1-week repo rate	7.00	-1050	-	15 Jul 10	14 Oct 10 (+25bp)	7.00	7.00	7.75	7.75	7.75
Asia/Pacific	GDP-weighted average	2.18	-126				2.20	2.34	2.44	2.58	2.65
Australia	Cash rate	4.50	-175	4 May 10 (+25bp)	6 Jul 10	Aug 10 (+25bp)	4.50	4.75	5.00	5.25	5.50
New Zealand	Cash rate	2.75	-525	10 Jun 10 (+25bp)	28 Jul 10	29 Jul 10 (+25bp)	2.75	3.25	3.75	4.25	4.50
Japan	Overnight call rate	0.10	-43	19 Dec 08 (-20bp)	15 Jul 10	2Q 12 (+15bp)	0.10	0.10	0.10	0.10	0.10
Hong Kong	Discount window base	0.50	-625	17 Dec 08 (-100bp)	11 Aug 10	4Q 11 (+37.5bp)	0.50	0.50	0.50	0.50	0.50
China	1-year working capital	5.31	-126	22 Dec 08 (-27bp)	3Q 10	3Q 10 (+27bp)	5.31	5.58	5.85	6.12	6.12
Korea	Base rate	2.00	-250	12 Feb 09 (-50bp)	8 Jul 10	3Q 10 (+25bp)	2.00	2.25	2.50	2.75	3.00
Indonesia	BI rate	6.50	-200	5 Aug 09 (-25bp)	5 Jul 10	1Q 11 (+25bp)	6.50	6.50	6.50	6.75	7.00
India	Repo rate	5.25	-250	20 Apr 10 (+25bp)	27 Jul 10	2Q 10 (+25bp)	5.50	6.00	6.00	6.50	6.75
Malaysia	Overnight policy rate	2.50	-100	13 May 10 (+25bp)	8 Jul 10	8 Jul 10 (+25bp)	2.50	3.00	3.00	3.00	3.00
Philippines	Reverse repo rate	4.00	-350	9 Jul 09 (-25bp)	15 Jul 10	24 Aug 10 (+25bp)	4.00	4.25	4.25	4.50	4.75
Thailand	1-day repo rate	1.25	-200	8 Apr 09 (-25bp)	14 Jul 10	20 Oct 10 (+25bp)	1.25	1.25	1.75	2.00	2.25
Taiwan	Official discount rate	1.38	-175	24 Jun 10 (+12.5bp)	3Q 10	3Q 10 (+25bp)	1.375	1.625	1.750	1.875	2.000

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

Economic forecasts - Australia

Australia: economic projections <i>percentage change over previous period, seasonally adjusted annual rates, un</i>														
	2009			2010			2011							
	2009	2010	2011	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Chain volume GDP	1.3	2.9	3.5	3.4	1.1	4.5	2.0	2.7	4.1	4.2	3.1	3.2	4.2	2.8
Private consumption	1.6	2.0	2.0	5.1	1.3	3.6	2.3	0.8	0.4	1.6	2.8	2.4	2.4	2.0
Construction investment	-0.5	1.5	6.0	-2.8	2.6	1.1	-3.3	4.7	6.2	6.4	5.5	5.0	7.9	7.8
Equipment investment	-3.4	8.5	10.0	0.1	-13.1	46.8	-20.9	37.6	12.9	17.5	5.1	3.4	6.4	8.6
Public investment	4.9	32.3	9.7	13.5	43.6	49.7	55.4	14.7	10.3	10.9	7.1	11.8	7.1	10.1
Government consumption	2.8	3.6	1.7	3.4	5.4	7.5	3.3	0.1	3.9	0.2	0.1	3.7	3.7	0.4
Exports of goods & services	1.4	2.5	4.2	8.4	-6.5	8.3	-2.0	4.1	6.1	4.9	4.1	2.8	4.1	4.1
Imports of goods & services	-7.8	10.9	4.1	3.5	18.0	36.6	7.3	0.0	3.2	3.2	4.1	6.1	3.2	8.2
Contributions to GDP growth:														
Inventories	-0.5	-0.9	-0.6	0.9	2.9	0.7	0.7	-8.1	0.0	-0.1	-0.2	0.1	-0.2	-0.1
Net trade	2.0	-1.7	-0.1	0.9	-4.6	-5.0	-2.0	0.8	0.5	0.2	-0.1	-0.8	0.1	-1.0
GDP deflator (%oya)	0.2	3.1	2.4	0.1	-2.1	-1.5	1.4	4.1	3.7	3.2	2.2	2.4	2.5	2.5
Consumer prices (%oya)	1.8	3.5	3.6	1.5	1.3	2.1	2.9	3.6	3.5	3.8	3.8	3.6	3.6	3.7
Producer prices (%oya)	-5.4	1.6	3.5	-6.4	-7.2	-6.8	-0.2	1.4	1.1	4.0	2.5	3.5	4.0	4.0
Trade balance (A\$ bil, sa)	-6.8	-18.7	-21.4	-0.9	-4.1	-5.0	-4.0	-4.7	-5.0	-5.0	-5.1	-5.2	-5.1	-6.0
Current account (A\$ bil, sa)	-51.4	-35.7	-28.8	-12.7	-13.8	-18.5	-16.6	-7.6	-4.9	-6.7	-7.1	-7.0	-7.0	-7.7
as % of GDP	-4.1	-2.7	-2.0	-4.1	-4.4	-5.8	-5.1	-2.3	-1.5	-2.0	-2.0	-2.0	-2.0	-2.1
3m eurodeposit rate (%)*	6.0	5.0	5.9	3.5	3.4	4.1	4.2	5.1	5.3	5.5	5.8	5.8	5.9	6.0
10-year bond yield (%)*	5.6	5.6	6.0	5.5	5.1	5.8	5.6	5.5	5.7	5.8	5.9	6.0	6.0	6.0
US\$/A\$*	0.75	0.89	0.87	0.82	0.88	0.91	0.94	0.82	0.87	0.92	0.90	0.88	0.86	0.84
Commonwealth budget (FY, A\$ bil)	-27.0	-57.1	-27.0											
as % of GDP	-2.1	-4.3	-1.9											
Unemployment rate	5.6	5.4	5.3	5.7	5.8	5.6	5.3	5.4	5.5	5.5	5.4	5.3	5.2	5.0
Industrial production	-7.9	3.3	1.5	4.8	-4.2	22.1	0.2	0.0	-1.0	-2.0	0.0	1.0	2.0	3.0

*All financial variables are period averages

Australia - summary of main macro views

- The Australian **economy** powered out of the global downturn largely unscathed. Growth probably will be close to trend in 2010, but above trend in 2011, despite the further withdrawal of policy support.
- **Business investment** will be down slightly in the year to June, but investment spending probably will rise close to 20% in 2010-11, with mining leading the way.
- On **housing**, with the expanded first home owners' grant now having expired and price caps on the basic grant in place, house price growth should cool, particularly at the low- and middle-end of the price spectrum.
- **Consumer confidence** has deteriorated sharply owing mainly to rising mortgage rates. The consumer confidence index has shed 16% since October 2009, when the RBA starting tightening policy.
- **Export volumes** have held up owing mainly to firm demand from China, but the terms of trade tumbled. This decline is reversing, thanks mainly to higher bulk commodity prices; we forecast a 25% rise.
- The **RBA** was the first central bank in the G20 to tighten policy and has hiked six times since last October. We now expect a pause, which will be extended if recent financial troubles spill over to real economies.
- The recent **Commonwealth budget** was "beige", with bolder policy announcements probably delayed until closer to this year's Federal election.

Economic forecasts - New Zealand

				2009			2010				2011			
	2009	2010	2011	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (1995-96 prices)	-1.7	2.6	2.9	0.3	1.2	3.7	2.3	3.8	2.9	1.9	3.0	3.4	3.5	2.5
Private consumption	-0.6	2.0	1.4	1.2	3.8	3.2	0.9	1.8	1.9	0.4	1.0	1.0	2.2	3.5
Fixed Investment	-12.5	0.5	4.6	7.1	-10.4	-7.2	3.3	5.3	5.5	5.7	2.2	4.1	6.0	7.3
Residential construction	-18.5	3.2	4.7	-8.4	-14.7	20.3	2.2	4.0	4.8	6.0	3.2	4.8	6.0	4.0
Other fixed investment	-11.3	-0.1	4.6	10.2	-10	-11.6	3.5	5.6	5.6	5.6	2.0	4.0	6.0	8.0
Inventory change (NZ\$ bil, saar)	-1.8	0.7	0.4	-1.1	-0.7	0.2	0.1	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Government spending	1.7	3.4	1.9	-3.9	2.6	4.5	6.7	2.4	1.6	2.4	1.6	2.4	2.0	0.4
Exports of goods & services	0.0	5.2	8.6	19.2	0.6	-2.7	5.5	8.0	9.0	8.0	9.0	9.0	8.0	8.0
Imports of goods & services	-15.2	8.9	5.8	-11.2	6.3	25.5	7.4	7.0	7.0	6.0	4.0	5.0	7.0	9.0
Contributions to GDP growth:														
Domestic final sales	-5.0	2.0	2.4	1.4	-1.9	1.1	4.0	2.7	2.7	2.0	2.1	2.1	3.5	2.5
Inventories	-2.6	1.9	-0.2	-10.2	5.0	11.6	-0.9	0.9	-0.2	-0.6	-0.6	0.1	-0.2	0.5
Net trade	5.9	-1.3	0.8	9.9	-1.8	-8.3	-0.8	0.1	0.4	0.5	1.5	1.2	0.2	-0.5
GDP deflator (%oya)	2.0	2.4	2.2	3.3	2.5	-0.1	1.0	1.9	2.8	3.9	2.8	2.4	1.9	1.6
Consumer prices	2.1	4.9	3.5	2.3	5.3	-0.7	1.5	2.8	3.3	12.1	3.3	2.9	3.9	3.8
%oya	2.1	2.7	4.9	1.9	1.7	2.0	2.0	2.2	1.7	4.8	5.3	5.3	5.5	3.5
Trade balance (NZ\$ bil, sa)	2.5	3.4	3.0	0.8	0.7	0.3	0.9	0.8	0.8	0.9	0.9	0.8	0.8	0.6
Current account (NZ\$ bil, sa)	-5.5	-5.7	-7.1	-0.4	0.1	-2.9	-1.2	-1.3	-1.0	-0.9	-2.5	-5.2	-4.3	-1.9
as % of GDP	-3.0	-3.0	-3.6	-0.9	0.1	-6.5	-2.8	-2.1	-1.9	-5.2	-8.9	-3.8	-1.9	0.0
Yield on 90-day bank bill (%)*	3.0	3.1	4.4	2.8	2.8	2.8	2.7	2.8	3.3	3.8	4.3	4.4	4.5	4.5
10-year bond yield (%)*	5.5	5.9	6.1	5.7	5.7	5.9	5.7	6.0	6.0	6.1	6.1	6.1	6.0	6.0
US\$/NZ\$*	0.64	0.72	0.72	0.60	0.68	0.73	0.73	0.67	0.71	0.75	0.73	0.71	0.71	0.71
Commonwealth budget (NZ\$ bil)	-4.0	-7.2	-7.1											
as % of GDP	-2.2	-3.8	-3.6											
Unemployment rate	6.1	6.1	5.4	5.9	6.5	7.1	6.0	6.3	6.3	5.9	5.7	5.4	5.3	5.2

*All financial variables are period averages

New Zealand - summary of main macro views

- The **New Zealand economy** expanded at a healthy clip of 0.6%q/q in 1Q. Economic growth should remain strong in 2Q and 3Q, underpinned by consumer spending, with consumers likely to bring forward spending ahead of the October 1 GST hike.
- Households are set to undergo a period of **consolidation**. As a result, private consumption will be sub-trend post GST hike. Furthermore, rising interest rates and more moderate house price growth, should mean household spending weakens considerably.
- The **unemployment** rate tumbled to 6% in 1Q (from 7.1%), although is unlikely to fall far below this level in the near-term. Actual hiring remains well-below long run averages, and with corporate profitability fall in 1Q, new hiring will likely be postponed.
- **The RBNZ hiked the OCR 25bp in June**. The accompanying commentary was upbeat and we expect a 25bp rate hike at each of the remaining four announcements this year, taking the OCR to 3.75% by year end.
- **Inflation** returned to positive territory in 1Q, after falling in the final three months of 2009. Medium term inflation pressures are a concern, given diminishing excess capacity and firms' intentions to raise domestic prices.
- Managing **inflation expectations** will be a growing challenge for the RBNZ, given the July 1 introduction of the amended ETS and the GST hike on October 1.

Australia and New Zealand economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
28 Jun	29 Jun New Zealand: Building permits (10:45 am) May <u>2.0%/m,sa</u>	30 Jun Australia: Pvt. sector credit (11:30 am) May <u>0.2%/m,sa</u>	1 Jul Australia: Retail sales (11:30 am) May <u>-0.3%/m,sa</u> Building approvals (11:30 am) May <u>0.0%/m,sa</u> New Zealand: ANZ comm prices (3:00 pm) Jun	2 Jul
5 Jul Australia: ANZ job ads (11:30 am) Jun	6 Jul Australia: Trade balance (11:30 am) May RBA cash target (2:30 pm) Jul	7 Jul	8 Jul Australia: Unemployment rate (11:30 am) Jun	9 Jul
12 Jul Australia: Housing finance approvals (11:30 am) May	13 Jul Australia: NAB business confidence (11:30 am) Jun	14 Jul Australia: Westpac consumer confidence (10:30 am) Jul New Zealand: Retail sales (10:45 am) May	15 Jul Australia: New motor vehicle sales (11:30 am) Jun New Zealand: Business NZ PMI (10:30 am) Jun	16 Jul New Zealand: CPI (10:45 am) 2Q
19 Jul	20 Jul	21 Jul Australia: Westpac leading index (11:30 am) May New Zealand: Visitor arrivals (10:45 am) Jun Credit card spending (3:00 pm) Jun	22 Jul	23 Jul Australia: Export price index (11:30 am) 2Q Import price index (11:30 am) 2Q

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

Global Data Diary

Week / Weekend	Monday	Tuesday	Wednesday	Thursday	Friday
28 June - 2 July	28 June	29 June	30 June	1 July	2 July
Germany • Retail sales (May) Russia • CBR mtg: no chg	Germany • CPI prelim (Jun) Israel • Bol mtg: no chg Japan • Retail sales (May) United States • Dallas Fed surv (Jun) • Personal income (May)	Euro area • EC business conf (Jun) • EC cons conf final (Jun) France • INSEE cons conf (Jun) Japan • Unemployment rate (May) • IP prelim (May) • Shko Chkn sm bus (Jun) • Hhold spending (May) Spain • HICP flash (Jun) United States • Consumer conf (Jun) • Case-Shiller HPI (Apr)	Euro area • HICP flash (Jun) Germany • Labor mkt rpt (May/Jun) Japan • Mfg PMI (Jun) Korea • IP (May) Poland • NBP mtg: no chg Romania • BNR mtg: no chg United Kingdom • GfK cons conf (Jun) United States • Chicago PMI (Jun) • ADP employment (Jun)	Australia • Retail sales (May) Brazil • IP (May) Germany • Retail sales (May) Japan • BoJ Tankan (2Q) Korea • Trade balance (Jun) Sweden • Riksbank mtg: +25bp United States • Pending home sales (May) • Auto sales (Jun) Global Mfg PMI	Euro area • Unemp rate (May) United States • Employment (Jun) • Factory orders (May)
5 - 9 July	5 July	6 July	7 July	8 July	9 July
China • Trade balance (Jun) Japan • Cabinet Office private consumption index (May)	Euro area • Services PMI (Jun) • Retail sales (May) Indonesia • BI mtg: no chg Japan • Services PMI (Jun) United Kingdom • Services PMI (Jun) United States • Independence Day (observed) • Markets closed	Australia • RBA mtg: no chg Brazil • Auto report (Jun) United Kingdom • New car regs (Jun) United States • Nonmfg ISM (Jun)	Euro area • GDP final (1Q) Germany • Mfg orders (May) Taiwan • Trade balance (Jun)	Australia • Unemp rate (Jun) Euro area • ECB mtg: no chg Germany • Trade balance (May) • IP (May) Japan • Prv mach orders (May) • Econ Watcher surv (Jun) Malaysia : BNM mtg: +25bp Peru : BCRP mtg: +25bp United Kingdom • IP (May) • MPC mtg: no chg	Canada • Employment (Jun) Korea • BoK mtg: no chg United Kingdom • Trade balance (May)

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