

## Australia and New Zealand - Weekly Prospects

### Summary

- Sentiment indicators dominated the **Aussie** data flow last week, and told seemingly conflicting stories—consumers became less upbeat, firms considerably more so. The two measures converged at an elevated position, which probably is the core message. Dwelling starts stalled, which supports our view that housing activity will be subdued from here. This week, the highlights will be a speech today by the RBA Governor (the focus will be on regional Australia—watch the Q&A), and the release of Board minutes tomorrow. Last week’s RBA action—a speech by the Assistant Governor (Economic)—should not go unnoticed. Phil Lowe highlighted that our economy already is operating at close to full capacity, and that our fortunes increasingly are tied to Asia, not the “old world.” Neither snippet is new, but Lowe’s speech was a timely reminder of where the inflation risks lie.
- The **New Zealand** economy continues to shed momentum, with the weakness in activity to be compounded near-term by the impact of the earthquake in Canterbury. The RBNZ last week suggested the devastating tremor will knock 0.3%-points off 3Q GDP growth; our estimate is 0.2%. The tone of the RBNZ’s policy assessment last week was more downbeat than we (and the market) had anticipated. RBNZ officials downgraded their growth forecasts, owing mainly to the weakness onshore. Indeed, the soft retail sales numbers last week provided more evidence that the recovery has all but stalled. Further removal of “emergency” policy support is inevitable, but the new official forecast imply several “on-hold” decisions. Our forecast is for the next OCR hike to be delivered in December, but the risks are skewed toward a later move if the domestic data continues to disappoint.
- Our forecast looks for a return to above-trend growth in the **US and China** next year, but it is the current soft patch that is guiding policy choices. With US core inflation already below 1% and the jobless rate still close to 10%, the Fed is increasingly concerned about delivering on each leg of its dual mandate. It has already signaled that it will keep policy rates near zero for an extended period, and is now considering a further round of asset purchases. It will most likely express a bias in this direction at this week’s FOMC meeting and follow through with further quantitative easing before year-end.
- In order for **US monetary policy** to be effective, the Fed must convince households and businesses that the economy is on a path toward meeting its goals. The slide in market-based measures of inflation expectations in recent months was thus a concern as it suggested faith in the Fed’s ultimate success was waning. Indeed, medium-term inflation expectations fell more than 50bp in the three months through August, touching the low end of its band over the past decade. Market sentiment appears to have shifted in the past two weeks, however, as expectations have moved back into the middle of this band. The data flow allaying growth concerns have contributed to this outcome. However, real yields have remained close to their lows—a development suggesting that much of this shift reflects rising expectations of quantitative easing.

### This week’s highlight

The release Tuesday of the minutes of the RBA’s last Board meeting. Of particular interest will be the discussion of global conditions—lingering offshore risks seem the only things keeping the RBA on the policy sidelines.

September 20, 2010

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### Forecast changes:

We have pushed out some of the **RBNZ** rate hikes we forecast for 2011. We now forecast an OCR of 4.25% by end-2011, compared to 4.5% previously.

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## Data and event previews - Australia and New Zealand

Date	Time <sup>(a)</sup>	Data/event	Forecast		Previous
			JPMorgan	Consensus <sup>(b)</sup>	
Monday, September 20	1.00pm	NZ ANZ consumer confidence (Index, Sep.)	na	na	116.3
Monday, September 20	1.30pm	RBA Governor Stevens' speech	na	na	na
Tuesday, September 21	8.45am	NZ net migration (ppl., Aug.)	na	na	970
Tuesday, September 21	1.00pm	NZ credit card spending (%m/m, Aug.)	na	na	-1.2
Tuesday, September 21	11.30am	RBA Board minutes (Sep.)	na	na	na
Wednesday, September 22	8.45am	NZ current account (NZ\$ bn., 2Q)	-0.6	-0.5	0.176
Wednesday, September 22	10.30am	Westpac Leading Index (%m/m, Jul.)	na	na	0.0
Thursday, September 23	8.45am	NZ GDP (%q/q, 2Q)	1.0	0.8	0.6

(a) Australian Eastern Standard Time.

(b) Consensus based on Bloomberg survey.

### Australia

**RBA Governor Stevens' speech** - The Governor will deliver a speech on "Monetary Policy and the Regions" in rural Victoria. Presumably, the speech will address the difficulties in having to implement a one-size-fits-all monetary policy, which inevitably will pinch the slower-growing of the regional areas. The Q&A scheduled after the speech likely will garner the most attention.

**RBA Board minutes (Sep.)** - We expect the minutes to follow familiar themes in terms of the domestic indicators: credit growth is picking up gradually, business credit has stabilized, the housing market has cooled after previous rate rises, and commodity prices have come off their peaks, but remain high by historical standards. The most notable new theme of recent weeks has been the RBA's notion that we may be living in a new era of consumer austerity, reducing the inflationary consequences of the coming income surge. Extensive elaboration on this point would lend a dovish note to the minutes. RBA commentary has always been conservative on the possibility of a US double-dip recession, so there seems little reason for the RBA to fine-tune its language. But a surprise shift toward a more upbeat description of the US would be very significant given that we see management of external risks as the decisive factor in keeping the RBA on hold.

### New Zealand

**Current account (NZ\$bn, 2Q)** - Having improved significantly to a surplus in 1Q, the current account balance probably returned to deficit in the June quarter. The annual CAD should print at NZ\$5.45 billion, or 2.9% of GDP, compared to 2.4% in 1Q. If in the March quarter, though, we had excluded the large one-off tax transactions recorded during the March 2010 year, the CAD would have been much worse, at 3.3% of GDP. It should return to these levels in the very near term.

## Data previews - Cont'd.

**GDP (%q/q, 2Q)** - The economy probably expanded at a healthy clip in the most recent completed quarter. Our forecast is for GDP growth of 1.0%q/q, or 2.8%oya, marking the fastest quarterly rate of expansion since 1Q07. The main driver of growth will be household consumption, with retail sales volumes having surged 1.3%q/q. Indeed, consumers spent heavily in 2Q following confirmation in May that the government will hike the GST on October 1. The significant amount of discounting among the nation's retailers also bolstered spending. Government spending should have risen, investment should be up, and inventories relatively steady. Net exports probably were a drag on growth for the fifth straight quarter.

## Research note

# Escalating inflation in Australia: the long and the short of it

- Recent benign inflation is cold comfort for the RBA, after a series of higher troughs
- Phillips curve estimations highlight importance of expectations and central bank credibility
- Monetary tightening can only partially solve what is also a supply-side inflation problem

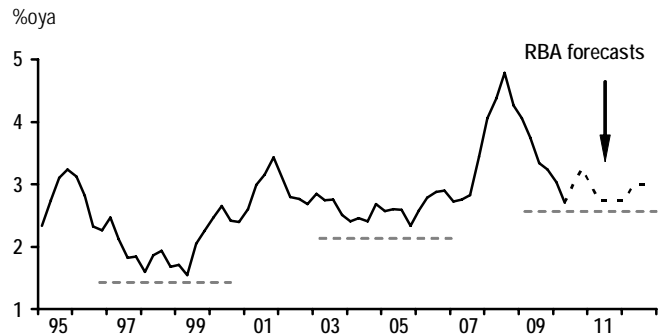
Inflation in Australia has traced a steady path downward over the past two years. The disinflation, triggered by the onset of the financial crisis, mercifully interrupted a price dynamic that was getting out of hand for the RBA (first chart). Given that the economy barely flirted with recession during the crisis, it is natural to review how macro variables drive inflation in Australia. Our previous work has discussed the factors we see forcing down labor productivity and potential growth, pushing inflation higher than would otherwise be the case (see “Aussie inflation on the back burner...for now,” *GDW*, April 23, 2010). Here, we look at a traditional framework—the Phillips curve—which tracks how the inflation/resource utilization trade-off historically has played out in the data.

## More growth, inflation, and rate hikes

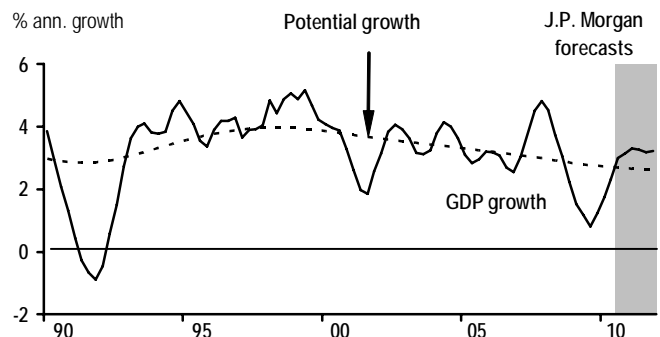
Our analysis formalizes the idea that the economy, before the crisis, had embarked on a prolonged period in which capacity utilization was high and rising, and prices were accelerating. We present statistical evidence that, at face value, would support a persistent positive relationship between output and inflation (for example, during the rapid rise in inflation under the growth surge of 2005 to mid-2008, see chart top right), but also note that consideration of the policy framework tempers this result substantially. The conclusion is that the data support an ever-greater need for credible inflation-fighting, in the face of an illusory growth benefit from looser policy.

Given our view that potential growth is falling—due to a combination of slower productivity, as usually occurs in mining booms, regional growth imbalances, and an absence of major structural reforms—inflation will rise more quickly for a given level of growth. Policymakers need to be attentive to this fact and look beyond actual growth in gauging price pressures. They need also to be wary of the temptation to allow higher inflation—viewing it as the “price” of faster growth in the long run—since history suggests that such a situation quickly can spiral out of control.<sup>1</sup>

Core inflation: higher troughs over time



Actual and potential GDP growth



Following the bumper 2Q GDP print of 1.2%q/q, the output gap now is exiting negative territory, and we forecast inflation to rise in turn. The absence of structural reforms, and the difficulty of addressing the imbalances generated by a “two-speed economy,” mean that the heavy lifting in capping inflation ultimately will fall to the RBA. This will force more rate hikes, though monetary tightening can only partially address what also is a supply-side problem. We therefore expect inflation to track above the target band of 2%-3% over the forecast horizon, averaging 3.1% in 2010, and 3.8% in 2011.

## That’s not PC: toying with Phillips curves

The Phillips curve describes the theoretical idea that the level of output (proxied by capacity utilization, for example) should move positively with wage and price inflation. There is a wide range of specifications for this relationship, varying in structural assumptions and econometric techniques. Consequently, there is a rich history to this work that we cannot cover here, but the basic issue all such models address is what the inflation/output trade-off looks like in the short and long run. In the conventional, “accelerationist” framework, short-run surges in output ulti-

1. A recent RBA paper by Norman and Richards (2010), which has a similar flavor to our analysis, shows policymakers are well aware of this issue. We expand on this paper briefly later.

mately are fruitless, eventually turning up in higher inflation as the economy returns to the natural rate of output or unemployment through adjustments to expectations and wages.

One of the consolations of the traditional Phillips curve view is that because short-term inflation pressures cannot boost growth in the long run, policymakers will not be too ambitious. A drawback however is that the framework usually imposes this condition, which effectively assumes away the possible longer-run implications of short-run fluctuations in inflation. While there are valid theoretical reasons to enforce such a restriction, doing so throws out some econometrically useful information, and misses some of the subtleties in these relationships that are important for policy and the economic outlook.

We therefore estimate accelerationist style models with and without that assumption, and find that the unrestricted model, which allows long-run effects, does a better job of explaining the data for Australia.<sup>2</sup> Specifically, the parameter estimates, taken at face value, would imply that there is a long-run positive relationship between output and inflation. Such a conclusion is mildly heretical in macro theory and, having been derived from manipulation of regression parameters (box), is subject to careful interpretation. The estimates appear to be capturing the fact that continued strong growth is feeding into escalating inflation pressure in Australia (again, first chart, previous page). As we shall see though, somewhat counterintuitively, that fact says as much about central bank credibility as it does about the fundamental properties of inflation and output, and supports our view that the RBA's hiking cycle has a considerable way to run.

### The short run: inflation and growth

The parameter estimates (approximately +0.1 in both models, see table, right) suggest a positive short-run relationship between core inflation and our measure of capacity utilization, the "demand gap." This is the conventional relationship, where in the short run, increases in output (or decreases in unemployment) are associated with temporary inflation. In the accelerationist model, participation in the labour market is driven by real wages. A surprise jump in inflation decreases the ex post real wage, meaning employment and output are higher during that period than they would have been, had workers been fully informed.

Workers then refine their expectations to incorporate the

2. An obvious alternative to the accelerationist approach would be one from the suite of New Keynesian models. These specifications replace backward-looking expectations with forward-looking ones, which are a function of future marginal costs. There is a significant number of researchers who support this method, though the micro foundations are not so robust, and the empirical success of this approach has been contested, see for example, Rudd and Whelan (2005) for a critique.

### Phillips curves: specifications and results

The two models regress core inflation (% oya) on: the lagged change in oil and commodity prices (both in AUD terms, % oya) to capture external supply-side effects; core inflation (% oya) lagged by two and four quarters, to capture inflation expectations; and the demand gap, a weighted average of the output gap and the deviation of unemployment from its long-run average.

The models differ in the following sense. In the restricted version, the coefficients on lagged inflation are constrained to sum to one, which is the standard means of achieving the vertical long-run Phillips curve, where output and inflation are independent. To explain, if past inflation eventually passes through completely into future inflation, in the long run there is no "room" for the demand gap to play a role—past inflation is the whole story—so the demand gap is fixed at a "natural rate," independent of inflation.

The unrestricted model, however, seems to explain the data better, and involves lagged inflation/expectation terms that sum to less than one. This means that as inflation passes through time into expectations—into the (-2) lag, then to the (-4) lag—it transmits less than completely into future inflation. In the estimated equation, the demand gap is left to explain the rest (along with oil and commodity prices), moving up with inflation in the long run.

Phillips curve models

Variable	Restricted		Unrestricted	
	Coefficient	P value	Coefficient	P value
Intercept	-0.090	0.187	0.754	0.000
Oil, %oya (-1)	0.005	0.007	0.003	0.057
Core, %oya (-2)	1.213	0.000	0.872	0.000
Core, %oya (-4)	-0.213	n/a	-0.179	0.061
Demand gap	0.105	0.245	0.127	0.060
Commodities (-1)	0.004	0.351	0.007	0.047
Adj. R-squared	0.64		0.76	
F-statistic	34.03		48.04	

inflation shock, and respond to the "true," lower real wage, which pulls employment and output back down again in the long run. We end up with an unchanged level of output and employment, with inflation determined separately by its own history of positive and negative shocks. In this case, output and inflation are independent, meaning the long-run Phillips curve is vertical, and there is no long-run relationship between the two variables.

The analogue of this framework in our setup is the restricted model, and our estimation results do not support the conclusion that output and inflation have moved inde-

pendently. Importantly, though, we cannot alternatively say our results endorse any (exploitable) long-run positive relationship between inflation and output. The reason is that the results are inherently wound up with the historical actions of the central bank. A change in central bank behaviour would mean we are in a world where the previous relationships our equations capture are no longer valid. In other words, we can expect higher growth alongside higher inflation only in a future where the central bank maintains the fight against inflation. In the following two sections, we discuss our empirical results for the long-run relationships in further detail, and more importantly, what conclusions we can reasonably draw from them.

## The long run: expectations vs. gaps

Inflation data tend to exhibit inertia through time. In a standard Phillips curve setup like ours, expectations are the workhorse in formalizing this dynamic. We have, therefore, modeled inflation as a function of past inflation (and other variables, see box previous page), with the latter being individuals' best guess in forming expectations for the purpose of wage negotiations. Our model estimates tell us how past inflation, through expectations, feeds into future inflation. The better-performing of our two specifications—the unrestricted model—suggests that prior inflation passes through less than completely into future inflation over time (see box, previous page for more detail). This has two immediate implications.

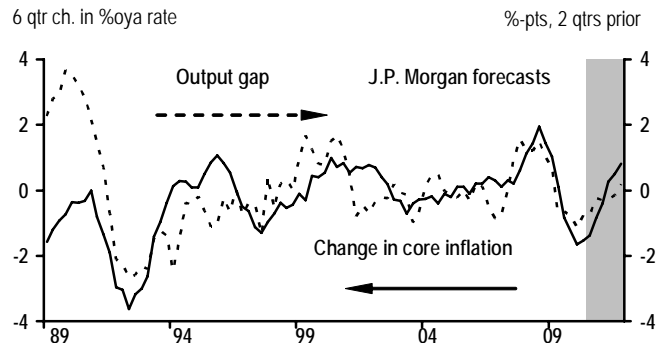
**1. Inertia becomes less important.** The less-than-complete passthrough of prior inflation that is implied by the data is a double-edged sword. In terms of the current cycle, it means that the recent fall in core inflation loses significance, i.e., is less influential in trimming future inflation.

**2. Output takes up the slack.** The reduced importance of inertia means there is a compensating mechanism that takes up the slack in pushing inflation higher over the long run: the demand gap. This embodies a dangerous situation whereby growth and inflation appear to have moved together over the long run (in our sample, since 1998) in Australia. Policymakers in such an environment must be vigilant to the temptation of allowing higher inflation to accompany outsized growth gains, particularly since there is no guarantee that such a relationship will remain stable if inflation gets off the RBA's chain altogether. This point brings us to a very important concept in interpreting our results: the Lucas Critique.

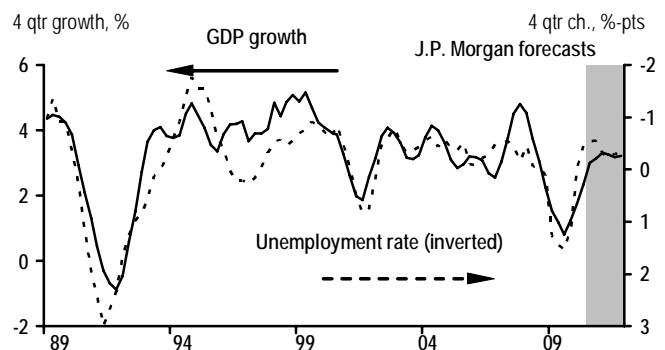
## Everything changes in time

The Lucas critique asserts that changes to the political, le-

Core inflation and the output gap



Unemployment and GDP growth



gal, regulatory, and policy frameworks not only influence the macroeconomic variables, but can change the interactions between these variables. That is, the parameters themselves are a function of their environment. Robert Lucas spelled out the broad argument over a series of publications in the 1970s (e.g., see Lucas (1976)), but his original example related to econometric tests of the long-run Phillips curve just as we have undertaken here.

Our model parameters suggest inflation and output have not moved independently over recent years. But, in consideration of the Lucas Critique, we would stop short of concluding that inflation and output categorically move together in the long run in Australia, i.e., that we can throw out the vertical long-run Phillips curve altogether. What is historically true under a period of low and fairly stable inflation need not hold over a broader range of outcomes. And the Lucas Critique warns that any attempt to exploit a perceived correlation to achieve policy ends would almost certainly disrupt that very relationship.

## The role of policymakers

The most obvious element of the economic environment that could influence our results is the central bank, which influences inflation and output through monetary policy.

Given that the RBA operates under an explicit inflation target, it is natural that its performance would play a role in how expectations are formed. The fact that past inflation does not pass through completely into future inflation—i.e., that it does not persist—suggests that it is mean-reverting in character.<sup>3</sup> This appears to have been true in the data, and is consistent with the idea that the inflation target is credible: prior deviations of inflation from the target can and should be partially ignored in forming expectations.

In this sense, the implied long-run correlation between output and employment, rather than being a trade-off the central bank is working under, could actually be the by-product of credible central bank operations. Credibility means a smaller role for prior experience (inertia) in forming expectations, which means that, in the models, the output gap will be left to explain the remaining variation in inflation.

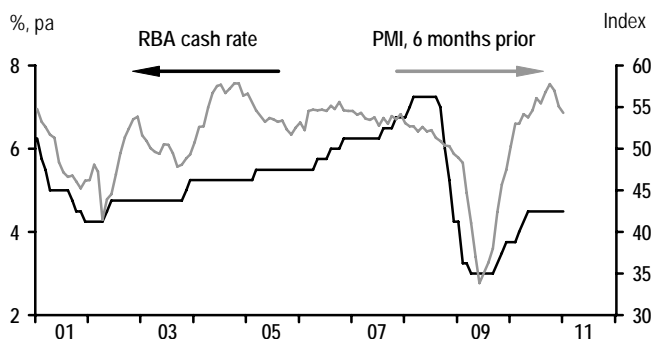
## RBA will need to swing for the fences

The conventional accelerationist model remains the dominant framework in thinking about inflation, particularly, it seems, for central banks. It is therefore unlikely that Australia's recent growth performance will lead the RBA to become soft on inflation. Officials also are aware of the more subtle conclusion we have drawn here: that the statistics do not support output and inflation being independent, but that the Lucas Critique can likely explain that. Indeed, Norman and Richards note that "imposing a restriction to ensure that the long-run Phillips curve is vertical results in a significant deterioration of fit," but "it may be 'near rational' for agents to devote limited attention to inflation when it is at low levels," meaning the former result may purely be a consequence of credible inflation-fighting.

We should therefore expect the RBA to remain vigilant to mounting inflation pressures, over and above their mandate. Credibility has been a crucial ingredient in achieving sustained strong growth, with inflation only modestly above target. That is a delicate situation, though, and expectations can turn quickly. The RBA was fortunate that the crisis interrupted the 2005–2008 spike in inflation. The subsequent disinflation occurred while the RBA was aggressively easing, so at least part of the mean-reverting characteristic of inflation captured in our modeling is an artifact of the crisis.

3. Indeed, a key blow struck by Lucas' work was his demonstration that it was possible to construct examples where output and inflation truly were independent in the long run, but inflation was mean-reverting, i.e., where inflation had a less than complete passthrough, as in our data.

RBA cash rate and J.P. Morgan global manufacturing PMI



For this reason, we expect the RBA to be particularly attuned to the recent persistence of inflation, and so believe that the RBA's tightening cycle is far from over. A cursory glance at the recent domestic data shows that the current policy pause owes solely to external growth concerns (first chart). Provided these risks do not escalate over coming months, we expect a further 100bp of monetary tightening starting in February 2011. If the overseas data surprise on the upside, the cycle could in fact resume at the November meeting, following the late-October delivery of 3Q CPI.

## Structural reform is the silver bullet

Australia's growth prospects are bright over the long run, owing to the economy's strong ties to Asia, which our analysis suggests will generate long-run inflation pressures. We have discussed the factors that the RBA will consider, and how they will set policy, but ultimately the demand gap reflects both aggregate demand and supply, and monetary policy is far better suited to impacting the former. Measures that increase potential growth, and/or decrease NAIRU, will reduce the "demand gap" over time, even if growth remains strong, and therefore trim inflation. Following a lack of major reform initiatives by a series of governments, it is difficult to see inflation remaining in check, however, even with the central bank remaining vigilant.

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Norman, David and Richards, Anthony (2010). "Modelling Inflation in Australia," *Research Discussion Paper 2010-3*, RBA.

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## Australia

- Aussie consumers' optimism faded in September
- Dwelling starts indicative of midyear slowdown
- RBA's Lowe highlights importance of EM Asia

The Australian data flow last week was dominated by the sentiment indicators, which told seemingly conflicting stories. Consumer confidence unexpectedly fell 5% m/m, while business confidence pushed up from a net balance of 2% to 11%. Dwelling starts, however, were consistent with our view that housing market activity began downshifting in 2Q and will remain subdued for the remainder of the year. This week, the few events of note surround the RBA: the Governor delivers a speech in rural Victoria on Monday and the September Board minutes are released on Tuesday.

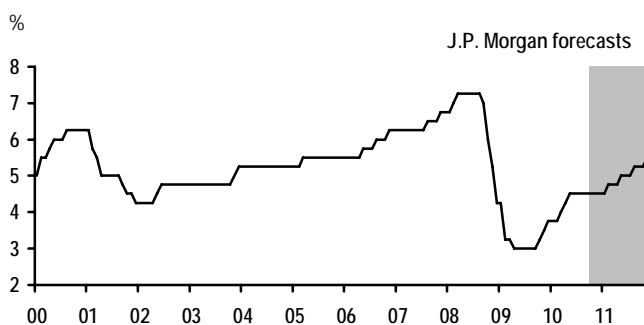
### Minutes to flesh out previous commentary

The RBA now has been on hold for four consecutive months. It is not surprising, therefore, that the recent commentary has framed building inflation pressure as a longer-term problem that is slightly too distant to force immediate policy actions. For example, multiple official speeches of late have addressed the challenges associated with managing resources-driven expansions, while cash rate announcements continue to forecast inflation "close to target", with headline overshooting only because of tax distortions.

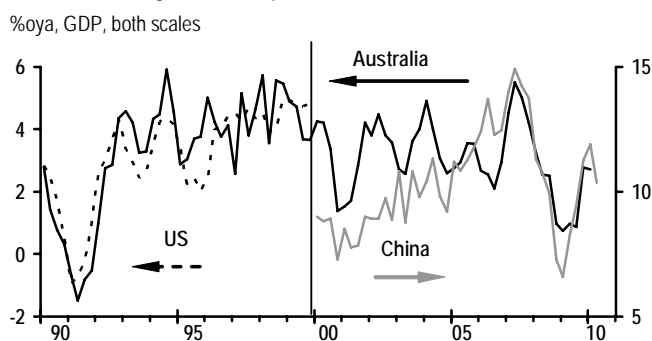
As has been reflected by the upturn in AUD, it now is becoming increasingly difficult to talk down the domestic growth story, especially given the data over the past few weeks. In the minutes this week, however, there will be no imperative to acknowledge the acceleration in output that occurred in 2Q—where growth surged to 1.2% q/q—given that officials did not have this information in hand at the September meeting. As such, we expect the minutes to expand on the fact that growth and labour demand are firming, while remaining constructively ambiguous as to whether this is posing upside risks to the inflation view.

For the other domestic indicators, the news should be pretty much unchanged: credit growth is picking up gradually, business credit has stabilized, the housing market has cooled after previous rate rises, and commodity prices have come off their peaks, but remain high by historical standards. The most notable new theme of recent weeks has been the RBA's notion that we may be living in a new era of consumer austerity, reducing the inflationary consequences of the coming income surge. Extensive elaboration

Australia: RBA cash target rate



Australia: GDP growth, compared with the US and China



on this point would lend a dovish note to the minutes.

On the global front, the data seem to have confirmed that China has negotiated the growth downshift without the much-feared hard landing. This lends weight to RBA officials' confidence in the Asian outlook, so the minutes likely will again describe this moderation as a discretionary move toward "sustainability" by Chinese policymakers.

Of greater interest, though, will be the discussion of the North Atlantic economies. In our view, the policy pause of recent months has owed much to risk management around market fears of a deterioration in US growth. The leveling off in the US data over the past few weeks seemingly gives the RBA license to talk up prospects, but the official commentary on global growth usually evolves more gradually, and it never seriously acknowledged the "double-dip" scenario that was weighing on markets. For this reason, while the minutes will no doubt be more expansive on the US situation than the policy announcements, there seems little reason for the RBA to fine-tune its language on this front, at least not yet. So, the commentary should follow the familiar theme that growth was strong in 1H, but will be softer in 2H. A marked shift toward a more upbeat descrip-



tion of the US is unlikely, but would be very significant given that we see management of external risks as the decisive factor in keeping the RBA on hold.

### RBA's Lowe: prospects best in 10 years

On the theme of overseas linkages, the timing and content of RBA Assistant Governor (Economic) Lowe's speech last week piqued our interest. Lowe spoke Thursday to a statistics conference on the risk and returns for Australia as Asia continues to develop. It is well established that Australia's fortunes increasingly are attached to Asia. Lowe, though, chose to reiterate the point, and emphasized that this transition has come at the expense of the linkage with the US, in a forceful manner, noting that while "financial news from the US and Europe dominates our newspapers... it is sometimes easy to forget just how profound—and important to Australia—are the structural changes taking place in Asia."

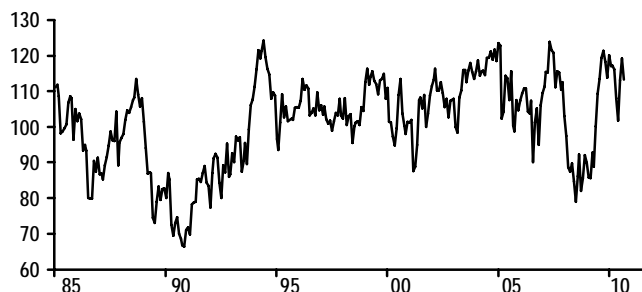
We appreciate that the US now takes less than 5% of Aussie exports, and so has become far less important in terms of its influence on domestic growth. Indeed, our forecast for the RBA to remain on hold until February was not pinned to the expectation of subtrend US growth, but on the risks to that outcome, i.e., a double-dip recession that would have broader implications for financial markets, commodity prices, and growth in EM Asia. Moreover, we saw near-term tightening as difficult to undertake with the specter of more QE from other central banks still lingering.

However, Lowe's speech raises the interesting possibility that RBA officials no longer see these risks as sufficient to delay tightening for too much longer. The significance of other central banks embarking on further QE in an environment where there was not a significant slowing in GDP growth, for example, would lower the hurdle for RBA hikes. We maintain our call for a February hike, but continue to emphasize the rising risk of a November move, following the delivery of 3Q CPI in late October.

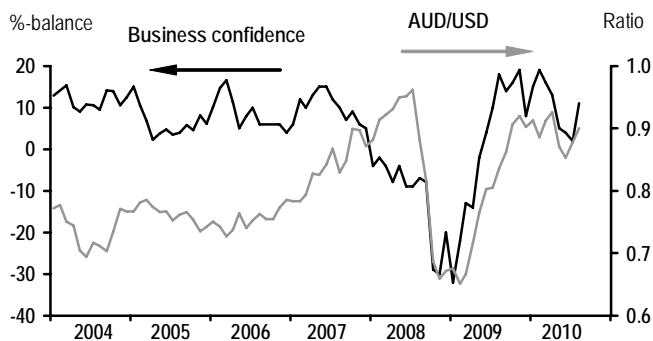
### Confidence data not a game-changer

The Westpac-MI consumer confidence index took a surprise hit of 5% m/m in September, despite higher equity prices, AUD appreciation, solid labour market gains, a rate hike reprieve from the RBA, and the final resolution of the election outcome. The WMI framed this result as an inevitable pullback following the "relief rally" of +5.4% m/m in August. Back then, the RBA's pause would have been particularly significant given intense media speculation of a looming rate hike. As such, confidence now has come down from an artificially high base, but remains at elevated

Australia: Westpac-Melbourne Institute consumer confidence index



Australia: NAB business confidence and AUD



levels (chart). The NAB business confidence numbers were a mirror image: confidence surged from a net 2% to 11%, but having tracked consistently below the improvement in consumer confidence, the convergence in the two measures consolidates the message that both sides of the economy are upbeat on the outlook.

### Industry data show divergent prospects

Of course, the economywide story masks a significant divergence across industry sectors. Confidence in the mining sector now is testing pre-crisis levels, with the index tracking 25%-pts above manufacturing and construction on a 3mma basis. Disaggregated wage data tell a similar story: mining wages are up 7% oya. The consequent upward march in AUD, however, is strangling the export-reliant sectors of the economy that have not benefited from higher commodity prices. The manufacturing sector, in particular, is feeling the pinch, as was evidenced in the 3Q Westpac-ACCI survey of industrial trends. The composite measure of actual manufacturing activity fell sharply, to 49.5 from 56.6, indicating that the sector is now moving sideways after a substantially above-trend first half. The moderation in manufacturing is particularly notable given that the private demand indicators appear to be accelerating. This outcome is not surprising, given that growth prospects have

been stacked toward the resources sector since commodity prices began to recover in 2009. However, the rebalancing implications are significant—as the familiar “two-speed” economy tag suggests.

### Data releases and forecasts

Week of September 20 - 24

Wed Sep 22 10:30am	WMI leading index Sa	Apr	May	Jun	Jul
	%m/m	0.1	0.3	0.0	—

### Review of past week's data

#### NAB monthly business survey

% balance, seasonally adjusted

	Jun	Jul	Aug	
Business confidence	4	2	<u>3</u>	11

#### WMI consumer confidence survey

100=neutral, seasonally adjusted

	Jul	Aug	Sep	
(%m/m)	11.1	5.4	<u>4.0</u>	-5.0

All components of the index fell this month. In particular, sentiment was down toward family finances a year ahead (-6.1%), family finances a year ago (-1.1%), and buying major household items (-3.8%). This arguably was payback after the bounce in August; see main text.

#### Dwelling starts

	4Q09	1Q10	2Q10	
(%q/q, sa)	<u>16.8</u>	16.7	4.3	9.1 <u>-2.0</u> 0.8

Dwelling commencements were soft in 2Q, coming back to earth after a very robust nine months to March 2010. The earlier spike in housing starts witnessed between 3Q09 and 1Q10 reflected a catch-up period, when residential activity benefited from the government's fading presence in the infrastructure space. Now, that effect is waning as an impetus to growth, and broader housing market activity has cooled moving into the second half of the year.

## New Zealand

- **RBNZ on hold last week, and issued dovish statement**
- **Slew of Kiwi data this week—GDP the highlight**
- **Growth will be bolstered by earthquake rebuild**

Across the Tasman in New Zealand, the RBNZ held the cash rate steady last week, as was unanimously forecast, but offered a more dovish commentary than many expected. This week, the market awaits the belated (as always) GDP report for the second quarter. We expect growth to have strengthened to 1.0%q/q, thanks to a surge in retail volumes.

### RBNZ left rates on hold, as expected

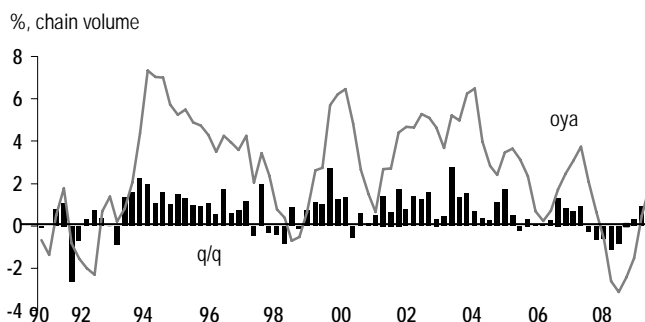
RBNZ Governor Alan Bollard last week left the official cash rate (OCR) at 3% (J.P. Morgan and consensus: no change) as unanimously forecast by all economists surveyed by Bloomberg. But the accompanying statement was more downbeat than expected. The Governor did maintain, though, that further removal of monetary policy support would be required and reiterated the statement made six weeks ago, suggesting that “the pace and extent of further OCR increases is likely to be more moderate than was projected in the June statement.”

A number of factors steadied the Governor’s hand, including heightened uncertainty surrounding the global outlook, the sluggish nature of the recovery under way in the domestic economy, and the recent devastating earthquake in Christchurch, New Zealand’s second-largest city. Perhaps the most fundamental reason, though, was the Governor’s acknowledgment that the recovery had shed momentum. Consumer confidence had deteriorated, households have become more cautious, and consumer spending had softened. With current policy settings still accommodative, we expect that a series of OCR hikes will be delivered over the forecast horizon. Our base case is for the next rate hike to be delivered in December, although we acknowledge that the risks are skewed to a later move if current accommodative policy settings are still required to prop up growth in the New Zealand economy.

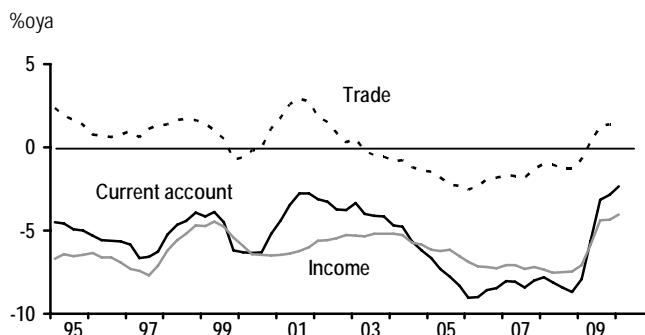
### NZ GDP robust in 2Q, but fading thereafter

The monthly indicators for New Zealand signal that the economy has shed momentum in 3Q, but the 2Q GDP result this week should show the economy expanded at a healthy clip in the most recent completed quarter. Our forecast is for GDP growth of 1.0%q/q, or 2.8%oya, marking the fastest quarterly rate of expansion since 1Q07.

New Zealand: GDP



New Zealand: current account balance



The main driver of growth will be household consumption, with retail sales volumes having surged 1.3%q/q. Indeed, consumers spent heavily in 2Q following confirmation in May that the government will hike the GST on October 1. The significant amount of discounting among the nation’s retailers also bolstered spending. Sales should continue to be strong leading into October, after which volumes likely will suffer a significant hangover, given a vacuum of demand and as households consolidate spending. We expect the savings rate likely will rise as a result.

Of the other expenditure components, government spending should have continued to rise at a healthy pace, inventories probably were little changed, and net exports should subtract from growth, yet again. Earlier this month, Statistics New Zealand reported that export volumes, which account for 30% of the economy, grew a mere 0.3% over the quarter, whereas import volumes surged 1.0%, meaning that net exports will be a drag on economic growth for the fifth straight quarter. With the RBNZ banking on an export-led recovery to offset the weakness in domestic demand, this is not the outcome officials are hoping for. Governor Bollard did, though, highlight last week that growth in Australia and China, New Zealand’s top two export destinations, remained strong.

Third-quarter GDP growth also should be relatively firm, with GDP growth printing at around 0.7%q/q; this, though, is 0.2%-pt weaker than we previously had forecast, owing to the impact of the recent earthquake in the Canterbury region. The earthquake will have a negative, near-term impact on activity: the RBNZ estimates it will knock 0.3%-pt off of 3Q GDP growth. With consumer and business sentiment set to take a hit, employees unable to work, and consumer spending to be firm, but not quite as firm as we had expected, economic growth will moderate from the previous quarter. In the medium term, though, in the later stages of 2011, the disaster will boost GDP growth via higher construction, greater government spending, and increased employment, which will have a positive impact on sentiment, household incomes, and spending.

## Data releases and forecasts

Week of September 20 - 24

Wed Sep 22 10:45am	Visitor arrivals nsa	May	Jun	Jul	Aug
	Total (%m/m)	1.2	0.7	1.4	—
Wed Sep 22 10:45am	Net permanent immigration Nsa	May	Jun	Jul	Aug
	Monthly (000s)	0.3	-0.7	1.4	—
	12-month sum (000s)	18.0	16.5	15.2	—
Wed Sep 22 3:00pm	Credit card spending % change	May	Jun	Jul	Aug
	%oya	3.4	4.4	2.7	—

Wed Sep 22 10:45am	Balance of payments NZ\$ mn, nsa	3Q09	4Q09	1Q10	2Q10
	Current account	-1586	-3414	176	<u>-600</u>

Having improved significantly to a surplus in 1Q, the current account balance probably returned to deficit in the June quarter. The annual CAD should print at NZ\$5.45 billion, or 2.9% of GDP, compared to 2.4% in the previous quarter. If in the March quarter, though, we had excluded the large one-off tax transactions recorded during the March 2010 year, the CAD would have been much worse, at 3.3% of GDP. It should return to these levels in the very near term.

Thu Sep 23 10:45am	Real GDP Sa, production-based	3Q09	4Q09	1Q10	2Q10
	%oya	-1.5	0.5	1.9	<u>1.0</u>
	%q/q	0.3	0.9	0.6	<u>2.8</u>

## Review of past week's data

Retail trade	May	Jun	Jul	
(%m/m, sa)	0.4	<del>0.9</del>	1.0	<del>-0.5</del> -0.4
(%oya, sa)	2.3	3.2	<u>3.7</u>	

Retail sales values took a step back in July, falling 0.4% m/m (J.P. Morgan: -0.5%; consensus: 0%), following the solid 0.4% and 1.0% monthly gains recorded in the previous two months. The significant discounting still occurring among the nation's retailers continues to weigh on sales in value terms, but the retail numbers also suggest, to some extent, that the drag-forward of spending ahead of the GST hike in October already may have run its course.

## RBNZ cash rate announcement

No change delivered. See main text.

## Global Essay

- **Slower growth in US and China producing easier global monetary stance**
- **Fed to signal leaning toward additional QE in meeting statement**
- **Euro area core inflation still trending downward excluding tax hikes**
- **Turkish vote raises odds of political stability and fiscal prudence**

### US and China export monetary easing

Although the US and China are always important drivers of the global economy, their leadership role is enhanced at the current juncture as near-term growth and monetary policy dynamics are aligned. The data flow is signaling that the midyear downshift in these economies is close to over, calming fears that the global soft patch will intensify. Policy linkages are also delivering additional monetary accommodation in these two economies, a development which is reverberating elsewhere. EM policy makers are now pausing on the path of rate normalization as they try to shield their traded-goods sectors from slower global growth and a falling dollar and yuan. The resultant easier global policy stance may provide a helpful offset to the lower bound constraints faced by developed economy central banks.

To be sure, the cyclical positions of the US and Chinese economies stand worlds apart. The US is recovering from a deep recession and faces persistently high unemployment and a daunting fiscal adjustment. China, in contrast, is in a mature expansion phase that has pushed its utilization rates high. However, each economy downshifted into the middle of this year, and this deceleration is reverberating elsewhere this quarter. In China, August reports show that the drag

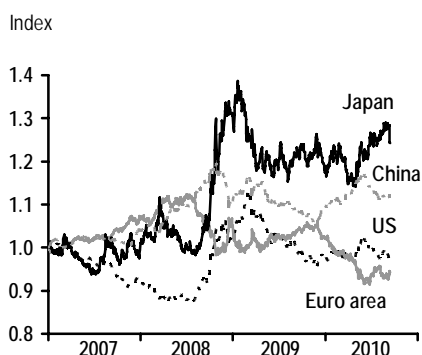
from policy actions to slow lending and public sector investment is fading. With production releases suggesting that an inventory correction has ended and retail sales growth remains firm, GDP growth looks likely to stabilize at close to 8% in the coming quarters—even as a midyear surge in export growth unwinds.

The case for stabilization in the US economy is more tentative. The message from September surveys is that the downshift in manufacturing has further to run. In addition, the fading of a midyear round of fiscal tightening will be followed by another wave in early 2011. Nonetheless, retail sales are lifting through the summer, and labour income continues to rise. A key issue now is whether softer growth and heightened uncertainty will derail the move by firms away from a defensive posture which is expected to remain the central fuel for growth. In this regard, the decline in September jobless claims is encouraging. We expect this week's August durable goods report to post a rebound in core capital goods orders following last month's sharp fall.

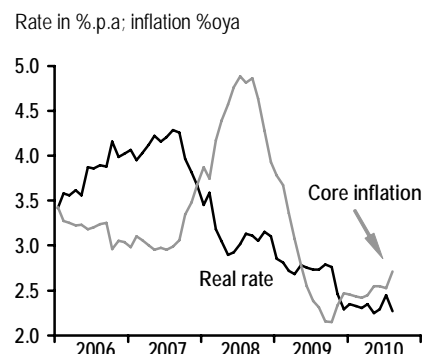
Our forecast looks for a return to above-trend growth in the US and China next year, but it is the current soft patch that is guiding policy choices. With US core inflation already below 1% and the unemployment rate still close to 10%, the Federal Reserve is increasingly concerned about delivering on each leg of its dual mandate. It has already signaled that it will keep policy rates near zero for an extended period, and is now considering a further round of asset purchases. It will most likely express a bias in this direction at this week's FOMC meeting and follow through with further quantitative easing before year-end.

A dollar decline is part of the monetary policy transmission mechanism, and its recent slide should be linked to the shift in rhetoric by the Fed. However, China continues to tie its

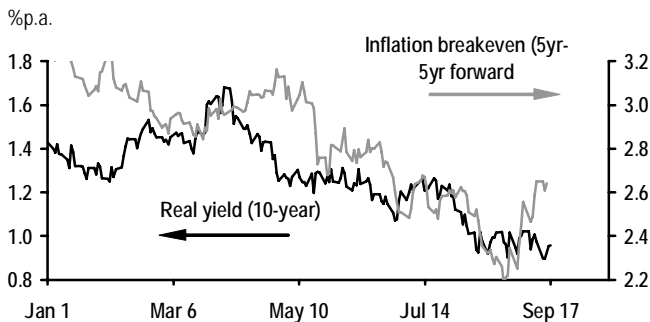
Real broad effective exchange rates



EM real policy rate and core CPI



### US TIPS yields



currency to the dollar. Thus, Chinese real policy rates remain in negative territory, and the trade-weighted yuan has drifted lower. The domestic pressures created by this easy money stance have been managed through sector-specific actions to curb property price appreciation.

### MoF prods reluctant BoJ

A main counterparty to the falling dollar and yuan has been a sharp rise in the yen. Over a third of Japan's exports go to the US and China. Consequently, the recent weakening in the US dollar, which has also weighed on the pegged yuan, has hit Japan's currency hard. The 10% move up in the trade-weighted yen since April is now threatening an economy where GDP remains over 4% below its previous cyclical peak and is now mired in deflation.

It is thus not surprising to see the MoF return to FX intervention for the first time since 2004. Although monetary and fiscal policies are already overextended, the government was increasingly feeling pressured to act on the currency. With the first half of the current fiscal year soon coming to a close, the impact of the stronger yen on corporate profits will be visible, especially for exporters. Moreover, the recently reelected PM Kan likely wanted to assure markets of his commitment to growth.

The BoJ appears to have reluctantly embraced the MoF intervention by coupling it with an longer-term expansion of its balance sheet. In practice, the MoF's intervention is by definition sterilized as the temporary rise in central bank reserves would quickly be unwound without BoJ action. However, the BoJ has made clear that bank reserves will remain higher by JPY2 trillion, almost equivalent to the estimated amount of the intervention. In response to the government's actions, the yen has fallen over 3% against the USD. However, it will be hard for the MoF to deliver a

sustained yen decline in a world in which Japanese interest rates are no longer relatively depressed. The key issue now is whether yen appreciation and slower growth will prompt the BoJ to become more aggressive. With a bill now in the Diet threatening central bank independence, a greater coordinated effort to ease monetary conditions broadly may soon be in the offing.

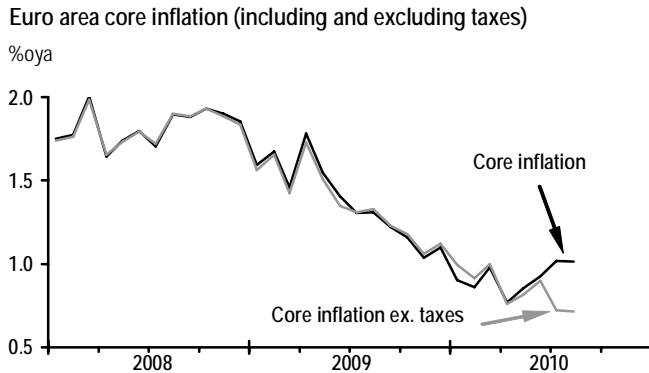
### Fed shift produces some traction

In order for US monetary policy to be effective, the Federal Reserve must convince households and businesses that the economy is on a path toward meeting its goals. The slide in market-based measures of inflation expectations in recent months was thus a concern as it suggested faith in the Fed's ultimate success was waning. Indeed, medium-term inflation expectations (as measured by five-year, five-year forward breakevens) fell more than 50bp in the three months through August, touching the low end of its band over the past decade. Market sentiment appears to have shifted in the past two weeks, however, as expectations have moved back into the middle of this band. The data flow allaying growth concerns have contributed to this outcome. However, real yields have remained close to their lows—a development suggesting that much of this shift reflects rising expectations of quantitative easing. Although the beneficial effects of low interest rates on credit sensitive spending and growth remain uncertain, it should be encouraging to the Fed that markets have responded in a positive way to its shift towards unconventional action.

### EM policy normalization slows to a crawl

Price pressures are building in key parts of the emerging world, reflecting the fact the excess slack promoting disinflation in the DM is largely absent in EM Asia and Latin America, where the output gap has turned positive once again. Core inflation has followed the output gap higher, in line with the standard Phillips curve relationship. Moreover, EM food prices, which account for over 1/4 of the EM consumer price basket, are rising at a faster pace on the back of the recent surge in agricultural commodity prices.

Although these developments argue for a swift normalization in EM monetary policy, the process has moved forward at a snail's pace thus far. Even with interest rate hikes in India and Chile last week, real policy rates remain over 150bp below their pre-recession levels. With EM growth not expected to fall materially below trend, underlying inflation pressures will likely continue to build.



Against this backdrop, the latest signals pointing to a pause in the adjustment process are troubling. Although interest rate normalization and the associated rise in currency values will not likely slow capital inflows or depress domestic demand growth, it would help contain inflation pressures by rebalancing production to developed economies where utilization rates are low. To be sure, EM trade-weighted exchange rates have increased this year, but domestic monetary authorities have increasingly leaned against the trend via slow rate adjustment and widespread intervention in FX markets. This activity is becoming more intense now that policymakers respond to a falling dollar and yuan.

In EM Asia, virtually every central bank except India's has intervened in the FX market. Likewise, many central banks in Latin America have bought dollars this year, notably in Brazil, Mexico, and Peru. Last week the continued appreciation of the Colombian peso prompted the central bank to resume intervention in the spot market, and even more restrictive measures may follow (e.g., non-remunerated reserve requirements on short-term portfolio inflows). Brazil's finance minister highlighted the possibility of Treasury intervention through the Sovereign Wealth Fund and the resumption of central bank intervention through swaps on top of regular USD purchases by the central bank. The door also is open to a higher IOF tax rate (on capital inflows).

## Underlying inflation slide in W. Europe

The August CPI reports last week point to less disinflation than anticipated in Western Europe. In the Euro area, core inflation rates receded substantially last year but have stabilized just below 1% since last spring. However, the disinflation process has been masked by indirect tax increases across the periphery, where core inflation has risen by a full percentage point this year. Excluding the impact of these one-off factors suggests core inflation has continued to trend down in recent months.

There has been no disinflation in the UK, where the August CPI report brought yet another upside surprise. Still, these moves have been largely driven by a sequence of temporary idiosyncratic factors while underlying inflation appears to be turning down. Core goods inflation is slowing significantly, reflecting the recent stabilization in the currency and a sizable output gap. Services price inflation is sticky, but once the impact of the recent VAT hike is excluded, the recent trend is also down. A key issue is whether ongoing elevated inflation readings delay the implementation of further BoE asset purchases. We are looking for UK inflation to fall faster than is expected by consensus, an outcome that would reinforce our call for more QE come November.

## Turkish vote signals stability

The AKP-sponsored constitutional amendment package was approved by a larger-than-expected margin in the September 12 referendum. The amendment package aims to streamline Turkey's social, political, and especially legal framework with EU practices. For financial markets, the most important takeaway from the vote is the strong support for the ruling AKP. The result suggests that the chances that the AKP maintains its majority in parliament after next year's general elections are higher than previously estimated, which would point to a more extended period of political stability. Equally important, the persuasive victory reduces the risk that the government will increase spending sharply in the runup to the election in an attempt to remain in power.

## JPMorgan View - Global Markets

### Relief rally continues but fundamental support needed

- **Economics:** The downshift in growth has happened, but there is little sign of an imminent upmove: sub-3% global growth through 1Q.
- **Asset allocation:** Short covering is leading the equity rally and does not seem over. Equities to lead other risky assets in the next few weeks.
- **Fixed income:** Treasuries will outperform on any further JPY intervention.
- **Equities:** Bearish equity positions are supportive of further short covering near term.
- **Credit:** Stay long higher-yielding credits.
- **FX:** Any QE is bad for the dollar, but QE II should be much less damaging than last year's QE I. We again go short USD vs. JPY.
- **Commodities:** With increasing supply concerns in corn and sugar markets, we move our overweight to an outright long in agriculture.

**Equities rallied strongly** again last week, pulling commodities and credit with them, but without added damage to bond markets. Economic activity data were supportive, but so far are only telling us that the downshift in growth is behind us, without providing much indication that growth is about to reaccelerate.

This is not the first time that **equities are running ahead of reality**. But you could say that that is their job. Equities will fall on the first sign of danger, and similarly jump on any chance that things are picking up. The rally of the past three weeks seems to be largely short-covering by active investors, such as hedge funds. **Short covering is not a dirty word, though. All longer-lasting rallies start this way.** Our impression is that investors are far from having moved back to normal levels of equity exposures, even by the standards of the low-growth world we are in. This suggests that **without accidents, or disappointing economic news, equities and other risky asset classes are headed higher in coming weeks.**

**But what happens afterwards?** For the rally in risk to last, we need to go beyond reduced downside risk, to better upside potential. We need to start thinking about better global growth than the barely-at-potential 2% handle we have

in our forecasts for the next few quarters. Here, our economists tracking the data report that the downside has been controlled, but there is no convincing sign of reacceleration. The two economies at the forefront of the global cycle—the US and China—are clearly stabilizing at lower growth paces, while Europe is now weakening.

We have expressed here a preference for credit over equity risk, given credit's better flow support, better carry, and lower vulnerability to weak economic growth. This trade did not work last week as short-covering implied buying of equities, where investors were short, rather than of credit, where positions were long. With the short-covering rally likely not over, equities are set to do better again in coming weeks. However, considering three months out, to year-end, long positions in high-yield and debt-like equities—preferreds and high-dividend stocks—are probably a safer long-risk position. Within the broad credit class, we strongly prefer corporate and EM exposures over sovereign, such as periphery EMU. The EMU periphery, both sovereign and banks, remain an orphan asset class, where credit fundamentals are not really improving, even as they have stopped worsening.

### Fixed income

A mixed week for bonds saw Japan and especially the US rally, with core European markets little changed. **Treasuries were bolstered by Wednesday's Japanese currency intervention**, reported to be the largest in a single day at around JPY1.8 trillion (\$21 billion). The experience of Japan's past interventions suggests that these dollars will quickly find their way into the Treasury market. Thus, any further intervention should see Treasuries continuing to outperform.

The stabilization of activity data in recent weeks has dampened the impetus to lower yields. **We remain on the bullish side, and stay in flatteners**, as we think elevated slack and muted growth will likely push both the Fed and the Bank of England to expand QE over the coming months. But we recognize that bonds are priced for very easy monetary policy, and that yields will correct higher if central banks dash these expectations.

European peripherals underperformed a little, led once again by Ireland, on upcoming issuance and more speculation over its troubled banks. We stay neutral overall, pending a sustained revival of private sector demand for non-core bonds. Within the periphery, **we expect heavy supply to push Spanish yields higher**, while short-dated Greek spreads should continue to narrow from what remain very wide levels.



**EM local bonds have gone sideways this month, even as DM bonds have sold off, extending EM's YTD outperformance to over 2%.** We stay long, as inflows remain solid, and we expect EM central banks to look through the coming food-driven spikes in headline inflation, meaning any tightening should remain gradual. Favour Poland, the focus of flows into Eastern Europe, and Korea, where too much tightening is priced in. (See J. Chang, *Emerging Markets Outlook and Strategy*, 13 Sep).

## Equities

Equities rose for a third straight week on slightly better US economic data. Last week's rebound pushed **equity prices to the top of their four-month range and above the important technical level of 200-day moving averages.** Equity flows have also improved with large inflows into equity ETFs. Over the past two weeks, equity ETFs saw large inflows of \$18 billion, more than reversing the \$11 billion of outflows over the previous four weeks. This suggests that the rebound in equities may have been driven by more than just short covering by short-term investors.

**Hedge fund short covering was probably a big driver of the rally in equities this month.** In August, both Macro and Equity long-short hedge funds had cut their exposures to equities sharply, to the low levels of March of last year and May of this year. This is evidenced by the 21-day rolling beta of daily HF returns to global equities shown in the chart at the bottom. This month, both anecdotal evidence and the strong buying flows in ETFs, which are heavily used by hedge funds, suggest they have bought significantly. In contrast, flows continue out of non-exchange traded mutual funds, indicating that retail investors are not yet part of this buying. The still low level of their 21-day rolling equity beta suggests that hedge funds are still far from getting back to normal/average exposures to equities. See also today's *Flows & Liquidity* for more details.

All this evidence signals that **short covering has likely further to go.** This makes us more positive for equities over the next few weeks. Beyond that, we need to get fundamental support. This could come from the 3Q US earnings season which starts mid-October. The economic backdrop for 3Q is not great, with economic data for the quarter still tracking our 1.5% growth rate. But there is reason to believe this is already in earnings expectations, if not in the price. Bottom-up projections for **3Q S&P500 EPS** now show a drop of 3.8% from 2Q. It is not unprecedented to

see sequential 3Q/2Q EPS declines of this magnitude, but in the past, they took place during financial crises or recessions, e.g., during Sep 2007, Sep 2000, and Sep 1998. **The current bottom up estimate of \$20.67 should be easily surpassed.**

Japanese equities rallied strongly on the news of heavy intervention by the Ministry of Finance—through the BoJ—to prevent a damaging rise in the yen versus the dollar. **We do not think this positive impact on relative performance will last.** For one, we believe that the MoF FX intervention won't be sustained. And even if it were sustained, the lesson from the 2003-2004 intervention was indeed that this relative boost does not last.

## Credit

Credit markets rallied last week, especially in HY corporate bonds. We maintain the view that the current environment is supportive of credit and stay **overweight, focused on higher-yielding assets.**

One of our key overweights is on US high yield corporates. The current spread of 658bp continues to be attractive given declining default rates and improving credit fundamentals. At the current pace, the default rate will be 0.2% by year-end, **the lowest on record** since data became available in 1982. In addition, the August 12-month rolling upgrade-to-downgrade ratio is at a record high, matching the peak seen in mid 1997. We stay overweight.

EM bonds are also likely to benefit from a search for yield. EM dollar corporate bonds (CEMBI) are expected to rally from a spread of 330bp to 300bp by year-end. Although we consider the return potential of CEMBI equal to that of EM external debt, EM dollar corporates are expected to outperform US HG bonds. The default rate of EM corporates has fallen to 0.9% YTD and is expected to remain low for the rest of the year. **Within EM corporates, we favour high grade issues, especially those in Asia and Latin America.**

The announcement by the Basel Committee suggests that step Tier 1 bonds—Tier 1 bonds that have increasing coupons over their lives—would likely no longer qualify as regulatory capital after the first call date of the bond. As a result, we believe issuers will find it unattractive to extend the bonds beyond their first call date. The reduction of extension risk is good for valuation and we turn **Overweight**

**Tier 1 bonds** from Neutral as we expect further compression in the bank capital structure (for details see *What's In The Price? Tier I Relative Value*, R. Henriques).

## Foreign Exchange

**The dollar is selling off** as if QE II is guaranteed. It is not. Or at least it is not guaranteed to look like QE I. The Fed asset purchase announcement in March 2009 was so fatal for the dollar and FX volatility because (1) it was unexpected and massive (\$1.5 trillion); (2) it occurred when investors were long dollars and short-to-underweight stocks; and (3) it coincided with a turnaround in economic growth expectations. Given the lack of Fed consensus on the merits of further asset purchases, the FOMC may announce an upper limit on asset purchases depending on the economy's health rather than a commitment to purchase a notional value irrespective of the economy's performance. The worst outcome for the dollar would be a commitment to sizable asset purchases (at least \$500 billion). The moderately bearish outcome would be authorization to purchase assets, but dependent on growth momentum.

**Both QE outcomes are dollar-bearish**, though they differ in magnitude and pace. And they ignore key constraints on an unfettered dollar decline: (1) possible but fleeting intervention in USD/JPY; (2) recurring intervention by emerging market central banks; (3) a weak US economy until 2011; and (4) the revival of sovereign stress in Europe. The first and second issues make positioning for modest dollar declines more sensible than positioning for a dollar collapse. The third and fourth issues argue for narrowing the components of a short USD basket to avoid EUR/USD (due to sovereign stress) and USD/CAD (due to the US link). Thus we recommend **re-selling USD/JPY** through an 85/82 put spread, and selling USD/NOK in cash. **We also stay short USD/INR and short EUR/SEK, EUR/AUD, GBP/SEK and GBP/AUD.**

## Commodities

Last week, all commodity sectors rallied with the exception of crude oil which fell 2%. **Over the past week, the two main oil benchmarks have diverged considerably**, with WTI falling nearly 2.5% while Brent rallied around 1%. This is largely the result of a build-up in WTI inventories while Brent prices are supported by increased regional demand and

### Ten-year Government bond yields

	Current	Dec 10	Mar 11	Jun 11	Sep 11
United States	2.74	2.50	2.50	2.50	2.50
Euro area	2.42	2.15	2.20	2.30	2.30
United Kingdom	3.12	3.00	3.00	3.10	3.25
Japan	1.07	0.80	0.80	0.90	0.95
GBI-EM	6.36	7.90			

### Credit markets

	Current	YTD Return
US high grade (bp over UST)	162	9.3%
Euro high grade (bp over Euro gov)	166	4.5%
USD high yield (bp vs. UST)	658	10.4%
Euro high yield (bp over Euro gov)	621	11.2%
EMBIG (bp vs. UST)	302	12.4%
EM Corporates (bp vs. UST)	338	12.0%

### Foreign exchange

	Current	Dec 10	Mar 11	Jun 11	Sep 11
EUR/USD	1.30	1.25	1.25	1.25	1.20
USD/JPY	85.8	79	81	83	85
GBP/USD	1.56	1.44	1.42	1.42	1.38

### Commodities - quarterly average

	Current	10Q4	11Q1	11Q2	11Q3
WTI (\$/bbl)	73	75	75	77	80
Gold (\$/oz)	1277	1275	1250	1250	1250
Copper(\$/m ton)	7689	6750	6750	7000	6800
Corn (\$/Bu)	5.06	3.80	4.00	4.20	4.10

Source: J.P. Morgan, Bloomberg, Datastream

seasonal maintenance in the North Sea. Last week, we moved to neutral crude oil from underweight and with volatility rising due to the issue above, **we remain neutral** and await more clarity as to the overall direction of crude.

**Agriculture** continued to gain with a further 3% rise last week. Wheat stocks appear to be at healthy levels and we see downside risks to prices into year-end. Corn and softs, however, are likely to more than compensate. Last week, farmers in the US reported a disappointing start to the corn harvest, raising further risks to already tight supplies. In addition, sugar prices rallied another 8% last week as low stocks combined with significant supply problems to push prices to new highs. We do not currently see an end to the supply problems in these markets and we believe there is strong support for even higher levels. As such, **we move our overweight to an outright long in agriculture.**

## 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	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	2Q10	4Q10	2Q11	4Q11
<b>The Americas</b>														
United States	-2.6	2.6	2.4	3.7	1.6	<u>1.5</u>	2.0	2.5	2.5	3.0	1.8	0.9	1.2	1.1
Canada	-2.5	3.1 ↓	2.2 ↓	5.8	2.0	<u>2.2</u> ↓	2.0 ↓	2.3 ↓	2.0	2.4	1.4	2.0 ↑	2.1 ↑	2.1
Latin America	-2.4	5.6	4.0 ↑	5.0	<u>9.0</u>	1.8 ↓	3.0 ↓	4.0 ↑	5.5 ↑	3.5 ↑	6.5	7.1 ↓	7.3 ↓	7.3
Argentina	-2.0	8.5	4.5	12.5	<u>13.0</u>	4.0	4.0	2.0	4.0	8.0	9.0	10.0	11.0	12.0
Brazil	-0.2	7.5	4.5 ↑	11.3	5.1	<u>2.3</u> ↓	3.2 ↓	5.7 ↑	4.7 ↑	5.0 ↑	5.1	5.0 ↓	5.1 ↓	5.1 ↑
Chile	-1.5	5.0	6.0	-6.0	18.4	<u>20.0</u>	10.0	2.0	0.0	4.0	1.2	3.8	3.8	3.5
Colombia	0.8	4.5	4.1	5.3	<u>4.8</u>	3.7	4.0	4.0	4.1	5.0	2.1	2.8	3.3	4.0
Ecuador	0.4	2.0	3.0	1.3	<u>3.5</u>	4.0	4.5	3.0	2.5	2.5	3.3	3.9	4.1	3.9
Mexico	-6.5	4.5	3.5	-2.5	13.5	<u>-3.6</u>	3.1	2.9	9.2	-0.1	4.0	5.1	4.5	4.0
Peru	0.9	8.2	6.0	8.0	12.7	<u>4.8</u>	3.5	5.8	6.7	7.2	1.2	2.6	2.2	2.7
Venezuela	-3.3	-2.2	1.0	-2.0	5.2	<u>3.0</u>	-5.0	2.0	1.0	1.5	31.9	31.6	34.7	35.1
<b>Asia/Pacific</b>														
Japan	-5.2	3.0	1.1	5.0	1.5	<u>2.5</u>	-0.5	0.5	1.5	1.8	-0.9	-0.7	0.1	-0.1
Australia	1.2	3.1	3.2 ↑	2.7	4.9	<u>2.4</u>	2.8 ↑	3.1 ↑	4.0 ↑	3.0	3.1	3.3	3.8	3.4
New Zealand	-1.7	2.7 ↓	3.1 ↑	2.3	<u>3.2</u> ↓	3.5 ↓	3.1 ↑	2.8	3.3	3.5 ↑	1.8	4.9	5.6	3.2
Asia ex Japan	5.6	8.7	7.0	10.5	7.4	<u>5.5</u>	6.4	7.4	7.3	7.5	4.5	4.2 ↓	4.0	3.9
China	9.1	9.8	8.6	10.8	7.2	<u>7.5</u>	8.1	9.1	8.9	9.1	2.9	2.8	2.7	2.6
Hong Kong	-2.8	6.6	4.1	8.7	5.7	<u>3.0</u>	3.5	4.2	4.3	4.7	2.6	2.5	2.2	2.4
India	7.4	8.3	8.5	9.2	8.5	<u>8.0</u>	8.9	8.0	8.5	8.6	13.7	11.0 ↓	10.1	10.2
Indonesia	4.5	6.0	5.4	3.0	7.5	<u>4.5</u>	5.0	5.3	5.2	5.0	4.4	6.8	6.6	4.8
Korea	0.2	6.1	4.0	8.8	5.8	<u>2.5</u>	3.8	4.0	4.0	4.5	2.6	3.2	3.5	3.3
Malaysia	-1.2	7.2	4.6	4.8	7.2	<u>3.0</u>	3.5	4.9	4.9	4.5	1.6	1.1	1.3	2.4
Philippines	1.1	7.0	3.9	11.9	7.7	<u>0.8</u>	1.6	4.9	4.9	4.9	4.2	1.8	1.5	3.5
Singapore	-1.3	14.8	4.2	45.7	24.0	<u>-11.5</u>	-2.0	8.7	6.6	7.4	3.1	3.0	1.4	1.6
Taiwan	-1.9	9.9	4.1	10.9	7.2	<u>1.5</u>	2.3	4.2	4.6	5.5	1.1	2.0	1.8	1.7
Thailand	-2.2	8.5	5.0	13.9	0.6	<u>2.8</u>	2.8	6.0	5.5	4.0	3.2	1.1	1.5	1.8
<b>Africa/Middle East</b>														
Israel	0.8	3.5	4.5	3.8 ↑	4.6 ↓	<u>3.0</u>	3.0	4.0	5.0	5.5	2.8	2.6	3.0	2.8
South Africa	-1.8	2.9	3.1	4.6	3.2	<u>3.1</u>	3.2	3.1	3.1	3.4	4.5	4.5	4.7	5.9
<b>Europe</b>														
Euro area	-4.0	1.7	1.5	1.3	3.9	<u>2.0</u>	1.0	1.0	1.0	1.8	1.5	1.7 ↑	1.1 ↑	1.0
Germany	-4.7	3.3	2.4	1.9	9.0	<u>3.0</u>	2.0	2.0	1.5	2.0	1.0	1.2	0.6 ↓	0.7 ↓
France	-2.5	1.6	1.4	0.7	2.5	<u>2.0</u>	1.5	1.0	1.0	1.5	1.8	1.3	0.7 ↑	1.1 ↑
Italy	-5.1	1.1	1.3	1.6	1.5	<u>2.0</u>	1.0	1.0	1.0	1.5	1.6	1.7 ↑	1.4 ↑	1.5 ↑
Norway	-1.2	1.5	2.3	0.7	1.9	<u>3.0</u>	2.5 ↓	2.0	2.0	2.5	2.6	2.1 ↑	1.3 ↑	1.3
Sweden	-5.1	4.5	3.1	6.0	8.0	<u>4.5</u>	3.0	2.3	2.3	2.8	1.0	1.5 ↓	1.6 ↓	1.8 ↓
Switzerland	-1.9	2.9	2.0 ↓	4.2	3.5	<u>2.5</u>	2.0 ↓	1.5 ↓	1.5 ↓	2.3 ↓	1.0	0.4 ↓	0.1 ↓	0.7 ↓
United Kingdom	-4.9	1.7	2.2	1.3	4.9	<u>2.5</u>	1.5	1.0	2.5	3.0	3.5	2.6	1.9	2.1
Emerging Europe	-5.3	3.9 ↑	4.2 ↓	2.7	3.8	<u>2.4</u>	3.8	3.9	4.2	4.6	5.7	6.4	6.5	5.6 ↓
Bulgaria	-5.0	-0.5	4.0	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	-4.1	2.0	3.2	1.5	3.8	<u>2.5</u>	2.3	2.5	3.0	5.0	1.2	2.8	2.7	2.6
Hungary	-6.3	1.0	2.8 ↓	2.4	0.0	<u>2.0</u>	2.0	2.0	3.0	3.5	5.4	4.4 ↓	3.4 ↓	3.6 ↓
Poland	1.8	3.5	3.8	2.8	4.5	<u>3.5</u>	3.5	3.0	3.5	4.0	2.3	2.6	2.7 ↑	2.9 ↓
Romania	-7.1	-2.0	1.5	...	...	...	...	...	...	...	4.4	8.0	7.2	4.0
Russia	-7.9	4.3	4.7	3.3	4.3	<u>2.5</u>	5.0	5.0	5.0	5.0	5.9	7.6	8.4	7.1
Turkey	-4.7	6.4 ↑	4.7 ↓	...	...	...	...	...	...	...	9.2 ↓	7.5	7.0 ↑	6.2 ↓
<b>Global</b>	-2.2	3.6	2.9	4.2	<u>3.9</u>	2.5 ↓	2.3 ↓	2.8 ↑	3.0	3.3	2.5	2.3	2.3	2.2
Developed markets	-3.5	2.3	1.9	3.0	<u>2.8</u>	2.0	1.4	1.6	1.9	2.4	1.5	1.2	1.2	1.1
Emerging markets	1.3	6.9 ↑	5.7 ↑	7.7	<u>7.1</u>	4.0 ↓	5.1 ↓	5.9 ↑	6.3 ↑	5.9 ↑	5.2	5.3 ↓	5.3	5.1
<b>Memo:</b>														
Global — PPP weighted	-0.8	4.5	3.8	5.2	4.7	3.1 ↓	3.2 ↓	3.7	4.0	4.2	3.2	3.0 ↓	3.0	2.9

## Global Central Bank Watch

	Official interest rate	Change from			Forecast		Sep 10	Dec 10	Mar 11	Jun 11	Sep 11
		Current	Aug '07 (bp)	Last change	Next meeting	next change					
Global	GDP-weighted average	1.76	-320				1.77	1.81	1.87	1.94	1.98
excluding US	GDP-weighted average	2.39	-242				2.40	2.47	2.54	2.64	2.70
Developed	GDP-weighted average	0.60	-359				0.61	0.63	0.64	0.66	0.69
Emerging	GDP-weighted average	4.99	-211				5.00	5.14	5.29	5.52	5.61
Latin America	GDP-weighted average	7.22	-218				7.22	7.31	7.80	8.39	8.47
CEEMEA	GDP-weighted average	4.07	-295				4.08	4.10	4.11	4.17	4.36
EM Asia	GDP-weighted average	4.54	-171				4.55	4.76	4.84	5.00	5.05
The Americas	GDP-weighted average	1.26	-455				1.28	1.31	1.40	1.51	1.55
United States	Federal funds rate	0.125	-512.5	16 Dec 08 (-87.5bp)	<u>21 Sep 10</u>	On hold	0.125	0.125	0.125	0.125	0.125
Canada	Overnight funding rate	1.00	-350	8 Sep 10 (+25bp)	19 Oct 10	19 Oct 10 (+25bp)	1.00	<b>1.25</b>	<b>1.50</b>	<b>1.75</b>	<b>2.00</b>
Brazil	SELIC overnight rate	10.75	-125	21 Jul 10 (+50bp)	20 Oct 10	Jan 11 (+25bp)	10.75	10.75	11.50	12.50	12.50
Mexico	Repo rate	4.50	-270	17 Jul 09 (-25bp)	<u>24 Sep 10</u>	On hold	4.50	4.50	4.50	4.50	4.50
Chile	Discount rate	2.50	-250	<b>16 Sep 10 (+50bp)</b>	14 Oct 10	16 Sep 10 (+50bp)	2.50	3.25	4.00	4.75	5.50
Colombia	Repo rate	3.00	-600	30 Apr 10 (-50bp)	<u>24 Sep 10</u>	1Q 11 (+50bp)	3.00	3.00	4.00	5.00	5.50
Peru	Reference rate	3.00	-150	9 Sep 10 (+50bp)	7 Oct 10	4Q 10 (+50bp)	3.00	4.00	4.50	4.50	4.50
Europe/Africa	GDP-weighted average	1.44	-322				1.44	1.45	1.46	1.47	1.52
Euro area	Refi rate	1.00	-300	7 May 09 (-25bp)	7 Oct 10	On hold	1.00	1.00	1.00	1.00	1.00
United Kingdom	Repo rate	0.50	-500	5 Mar 09 (-50bp)	7 Oct 10	On hold	0.50	0.50	0.50	0.50	0.50
Sweden	Repo rate	0.75	-275	2 Sep 10 (+25bp)	26 Oct 10	26 Oct 10 (+25bp)	0.75	1.25	1.25	1.25	1.50
Norway	Deposit rate	2.00	-250	5 May 10 (+25bp)	<u>22 Sep 10</u>	<b>3Q 11 (+25bp)</b>	2.00	2.00	2.00	<b>2.00</b>	<b>2.25</b>
Czech Republic	2-week repo rate	0.75	-200	6 May 10 (-25bp)	<u>23 Sep 10</u>	2Q 11 (+25bp)	0.75	0.75	0.75	1.00	1.25
Hungary	2-week deposit rate	5.25	-250	26 Apr 10 (-25bp)	27 Sep 10	3Q 11 (+25bp)	5.25	5.25	5.25	5.25	5.50
Israel	Base rate	1.75	-225	26 Jul 10 (+25bp)	27 Sep 10	27 Sep 10 (+25bp)	2.00	2.25	2.50	2.75	3.25
Poland	7-day intervention rate	3.50	-100	24 Jun 09 (-25bp)	29 Sep 10	2Q 11 (+25bp)	3.50	3.50	3.50	3.75	4.00
Romania	Base rate	6.25	-75	4 May 10 (-25bp)	29 Sep 10	3Q 11 (+25bp)	6.25	6.25	6.25	6.25	6.50
Russia	1-week deposit rate	2.75	-25	31 May 10 (-50bp)	Sep 10	3Q 11 (+25bp)	2.75	2.75	2.75	2.75	3.00
South Africa	Repo rate	6.00	-350	9 Sep 10 (-50bp)	18 Nov 10	On hold	6.00	6.00	6.00	6.00	6.00
Switzerland	3-month Swiss Libor	0.25	-225	12 Mar 09 (-25bp)	4Q 10	Jun 11 (+25bp)	0.25	0.25	0.25	0.50	0.75
Turkey	1-week repo rate	7.00	-1050	-	14 Oct 10	4Q 11 (+50bp)	7.00	7.00	7.00	7.00	7.00
Asia/Pacific	GDP-weighted average	2.92	-128				2.92	3.04	3.10	3.21	3.26
Australia	Cash rate	4.50	-175	4 May 10 (+25bp)	4 Oct 10	Feb 11 (+25bp)	4.50	4.50	4.75	5.00	5.25
New Zealand	Cash rate	3.00	-500	29 Jul 10 (+25bp)	27 Oct 10	Dec 10 (+25bp)	3.00	3.25	<b>3.50</b>	<b>3.75</b>	4.25
Japan	Overnight call rate	0.10	-43	19 Dec 08 (-20bp)	5 Oct 10	On hold	0.10	0.10	0.10	0.10	0.10
Hong Kong	Discount window base	0.50	-625	17 Dec 08 (-100bp)	<u>22 Sep 10</u>	On hold	0.50	0.50	0.50	0.50	0.50
China	1-year working capital	5.31	-126	22 Dec 08 (-27bp)	3Q 10	4Q 10 (+27bp)	5.31	5.58	5.58	5.85	5.85
Korea	Base rate	2.25	-225	9 Jul 10 (+25bp)	7 Oct 10	4Q 10 (+25bp)	2.25	2.50	2.75	2.75	2.75
Indonesia	BI rate	6.50	-200	5 Aug 09 (-25bp)	5 Oct 10	2Q 11 (+25bp)	6.50	6.50	6.50	6.75	6.75
India	Repo rate	<b>6.00</b>	-175	<b>16 Sep 10 (+25bp)</b>	2 Nov 10	4Q 10 (+25bp)	<b>6.00</b>	6.25	6.50	6.50	6.75
Malaysia	Overnight policy rate	2.75	-75	8 Jul 10 (+25bp)	12 Nov 10	On hold	2.75	2.75	2.75	2.75	2.75
Philippines	Reverse repo rate	4.00	-350	9 Jul 09 (-25bp)	7 Oct 10	1Q 11 (+25bp)	4.00	4.00	4.25	4.75	5.00
Thailand	1-day repo rate	1.75	-150	26 Aug 10 (+25bp)	20 Oct 10	20 Oct 10 (+25bp)	1.75	2.00	2.00	2.00	2.00
Taiwan	Official discount rate	1.375	-175	24 Jun 10 (+12.5bp)	30 Sep 10	30 Sep 10 (+12.5bp)	1.50	1.50	1.50	1.50	1.625

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			2009			2010				2011			
	2009	2010	2011	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Chain volume GDP	1.2	3.1	3.2	2.2	1.3	4.2	2.7	4.9	2.4	2.8	3.1	4.0	3.0	3.4
Private consumption	1.7	3.2	2.4	5.2	1.3	3.3	1.9	6.5	2.4	1.6	2.0	1.6	2.8	3.2
Construction investment	-0.5	2.3	4.7	-3.7	2.4	2.6	-3.1	9.9	3.6	5.3	5.1	2.1	5.2	5.5
Equipment investment	-6.6	-0.9	7.9	-18.0	-5.9	60.3	-26.0	-12.0	13.0	13.0	8.7	6.4	6.4	8.6
Public investment	4.4	32.5	8.9	13.3	43.9	40.6	81.2	0.1	10.2	10.9	7.0	12.4	7.1	10.1
Government consumption	2.8	5.2	4.3	3.2	5.4	7.7	4.8	7.2	2.0	2.0	4.5	8.0	4.3	0.8
Exports of goods & services	0.9	4.6	4.4	4.5	-9.2	9.7	-2.8	24.2	1.6	2.0	4.1	4.1	3.6	3.2
Imports of goods & services	-8.3	13.1	6.2	0.3	18.8	32.7	6.6	12.8	6.1	5.7	6.1	4.1	7.4	5.7
Contributions to GDP growth:														
Inventories	-0.5	-0.5	-1.0	0.7	2.8	0.8	1.4	-2.9	-5.9	-0.1	-0.2	0.1	-0.2	-0.1
Net trade	2.0	-1.8	-0.5	0.8	-5.2	-4.1	-1.9	1.7	-1.0	-0.9	-0.6	-0.1	-0.9	-0.6
GDP deflator (%oya)	0.3	5.0	2.9	0.1	-1.9	-1.3	2.0	6.6	6.0	5.5	4.2	2.4	2.5	2.5
Consumer prices (%oya)	1.8	3.1	3.6	1.5	1.3	2.1	2.9	3.1	3.0	3.3	3.5	3.8	3.6	3.4
Producer prices (%oya)	-5.4	2.5	3.8	-6.4	-7.2	-6.8	-0.2	2.5	2.3	5.2	3.7	3.5	4.0	4.0
Trade balance (A\$ bil, sa)	-6.8	20.2	16.7	-0.9	-4.1	-4.9	-2.7	7.4	8.7	6.8	4.5	3.6	4.2	4.5
Current account (A\$ bil, sa)	-51.4	-24.3	-40.8	-13.8	-14.6	-19.3	-16.5	-5.6	4.7	-7.0	-9.5	-10.6	-10.4	-10.3
as % of GDP	-4.1	-1.8	-2.8	-4.4	-4.7	-6.0	-5.0	-1.7	1.4	-2.0	-2.7	-3.0	-2.8	-2.8
3m eurodeposit rate (%)*	6.0	4.7	5.4	3.5	3.4	4.1	4.3	4.8	4.8	5.0	5.3	5.3	5.4	5.5
10-year bond yield (%)*	5.6	5.3	5.3	5.5	5.1	5.8	5.6	5.5	5.0	5.0	5.2	5.3	5.3	5.4
US\$/A\$*	0.75	0.88	0.90	0.82	0.88	0.91	0.94	0.84	0.88	0.86	0.88	0.92	0.90	0.89
Commonwealth budget (FY, A\$ bil)	-27.0	-51.0	-32.0											
as % of GDP	-2.1	-3.7	-2.2											
Unemployment rate	5.6	5.3	5.0	5.7	5.8	5.6	5.3	5.2	5.2	5.1	5.0	5.0	4.9	4.8
Industrial production	-7.9	4.8	1.5	5.3	-3.8	21.3	4.6	2.0	-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** emerged from the global downturn largely unscathed. GDP expanded at a rapid clip in 2Q, with households leading the way. The savings rate dropped.
- **Business investment** probably will rise strongly in 2010-11, with mining leading the way, particularly with the mining tax roadblock being “dismantled”. There will be a bigger rise in 2011-12.
- 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** deteriorated sharply earlier this year as mortgage rates rose. The index rebounded in July and August, but fell in September. Optimists, though, easily outnumber pessimists.
- **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.
- The **RBA** hiked the cash rate six times between October and May, but then paused. The Bank will likely remain on the sidelines for the remainder of the year. We expect four rate hikes throughout 2011.
- The **Labor government** has been “reelected,” even though it secured a smaller share of the popular vote than the Coalition and won fewer seats in the Lower House.

## Economic forecasts - New Zealand

New Zealand: economic projections <i>percentage change over previous period, seas. adjusted annual rates, unless stated</i>														
				2009			2010				2011			
	2009	2010	2011	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (1995-96 prices)	-1.7	2.7	3.1	0.3	1.2	3.7	2.3	3.2	3.5	3.1	2.8	3.3	3.5	2.6
Private consumption	-0.6	2.7	1.9	1.2	3.8	3.2	0.9	5.1	2.7	1.0	1.1	1.2	2.5	3.3
Fixed Investment	-12.5	0.1	5.3	7.1	-10.4	-7.2	3.3	4.5	3.5	5.6	5.1	5.6	6.4	6.3
Residential construction	-18.5	2.7	5.0	-8.4	-14.7	20.3	2.2	2.8	2.8	5.6	4.8	5.6	6.4	5.6
Other fixed investment	-11.3	-0.4	5.4	10.2	-10	-11.6	3.5	4.8	3.6	5.6	5.2	5.6	6.4	6.4
Inventory change (NZ\$ bil, saar)	-1.8	0.6	0.7	-1.1	-0.7	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.1
Government spending	1.7	3.5	2.4	-3.9	2.6	4.5	6.7	2.4	1.8	3.2	2.0	2.8	2.4	0.8
Exports of goods & services	0.0	3.8	6.8	19.2	0.6	-2.7	5.5	1.3	8.0	8.0	7.0	7.0	6.0	6.0
Imports of goods & services	-15.2	8.4	5.3	-11.2	6.3	25.5	7.4	4.2	7.0	6.0	4.0	5.0	6.0	6.0
Contributions to GDP growth:														
Domestic final sales	-5.0	2.4	2.8	1.4	-1.9	1.1	4.0	4.5	2.8	2.5	2.2	2.5	3.4	3.6
Inventories	-2.6	1.8	0.0	-10.2	5.0	11.6	-0.9	-0.3	0.6	0.1	-0.2	0.2	0.2	-0.9
Net trade	5.9	-1.6	0.3	9.9	-1.8	-8.3	-0.8	-1.0	0.1	0.5	0.8	0.5	-0.1	-0.1
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	5.0	3.2	2.3	5.3	-0.7	1.5	1.1	5.5	12.1	3.3	1.8	3.9	3.8
%oya	2.1	2.6	4.9	1.9	1.7	2.0	2.0	1.8	1.8	4.9	5.4	5.6	5.2	3.2
Trade balance (NZ\$ bil, sa)	2.5	5.6	5.1	0.8	0.7	0.3	0.9	1.6	1.5	1.6	1.4	1.3	1.2	1.2
Current account (NZ\$ bil, sa)	-5.5	-5.1	-12.0	-0.4	0.1	-2.9	-1.2	-1.3	-1.0	-0.6	-2.1	-5.2	-3.6	-3.5
as % of GDP	-3.0	-2.7	-6.0	-0.9	0.1	-6.5	-2.8	-2.2	-1.3	-4.4	-7.3	-7.1	-5.5	-4.3
Yield on 90-day bank bill (%)*	3.0	3.1	4.1	2.8	2.8	2.8	2.7	2.9	3.3	3.5	3.8	4.0	4.3	4.3
10-year bond yield (%)*	5.5	5.5	4.9	5.7	5.7	5.9	5.9	5.7	5.3	5.1	5.1	4.9	4.8	4.8
US\$/NZ\$*	0.64	0.70	0.70	0.60	0.68	0.73	0.71	0.70	0.70	0.67	0.68	0.72	0.71	0.70
Commonwealth budget (NZ\$ bil)	-4.0	-7.2	-7.1											
as % of GDP	-2.2	-3.8	-3.6											
Unemployment rate	6.1	6.5	5.8	5.9	6.5	7.1	6.0	6.8	6.7	6.4	6.0	5.9	5.7	5.7

\* 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.
- Thereafter, households are set to undergo a period of **consolidation**. As a result, private consumption will be sub-trend post GST hike, particularly given higher interest rates and softer house price growth.
- The **unemployment** rate shot up to 6.8% in 2Q from 6.0% in 1Q, and probably will maintain a 6%-handle in the foreseeable future. Actual hiring remains well-below long run averages and, with corporate profitability down, new hiring will likely be postponed.
- The **RBNZ** left the OCR unchanged in September and delivered a more downbeat assessment of the economy, owing mainly to the weakness on the domestic front. We expect the next rate hike to be delivered in December, although the risks are skewed toward a later move.
- Headline **inflation** continued to hover around the middle of the RBNZ's 1%-3% target range in the June quarter, although this precedes what we expect will be a series of elevated inflation prints over the coming year.
- 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
20 Sep	21 Sep	22 Sep <b>Australia:</b> Westpac leading index (10:30 am) Jul  <b>New Zealand:</b> Credit card spending (10:45 am) Aug	23 Sep <b>New Zealand:</b> GDP (10:45 am) 2Q <u>1.0%oya</u>	24 Sep
27 Sep	28 Sep	29 Sep <b>New Zealand:</b> Trade balance (9:45 am) Aug	30 Sep <b>Australia:</b> Private sector credit(11:30am) Aug Building approvals (11:30 am) Aug  <b>New Zealand:</b> Building permits(11:30 am) Aug	1 Oct
4 Oct <b>New Zealand:</b> ANZ commodity prices Sep NZIER business opinion survey 3Q  <i>Holiday Australia</i>	5 Oct <b>Australia:</b> ANZ job ads. (10:30 am) Sep NAB business confidence (10:30 am) Sep Retail sales (10:30 am) Aug RBA cash target Oct	6 Oct	7 Oct <b>Australia:</b> Unemployment rate (10:30 am) Sep	8 Oct
11 Oct <b>Australia:</b> Housing finance (11:30 am) Aug  <b>New Zealand:</b> QV house prices Sep	12 Oct	13 Oct <b>Australia:</b> Westpac consumer confidence (10:30 am) Oct	14 Oct <b>New Zealand:</b> Retail sales (9:45 am) Aug Business NZ PMI Sep	15 Oct

## Global Data Diary

Week / Weekend	Monday	Tuesday	Wednesday	Thursday	Friday
20 - 24 September	20 September	21 September	22 September	23 September	24 September
	Euro area • Trichet speech  Taiwan • Export orders (Aug)  United States • NAHB surv (Sep)	Canada • CPI (Aug)  United States • FOMC mtg: no chg • Housing starts (Aug)	Euro area • Industrial new orders (Jul) • EC cons conf prelim (Sep)  Norway • Norges bank mtg: no chg  United Kingdom • MPC minutes (Sep)	Brazil • Unemployment rate (Aug)  Czech Republic • CNB mtg: no chg  Euro area • PMI flash (Sep)  France • INSEE bus conf (Sep)  Taiwan • IP (Aug)  United States • Existing home sales (Aug)	Colombia • BanRep mtg: no chg  France • GDP final (2Q)  Germany • IFO bus surv (Sep)  Mexico • Banxico mtg: no chg  Poland • Retail sales (Aug)  Singapore • IP (Aug)  United States • Durable goods (Aug) • New home sales (Aug) • Bernanke speech
27 Sep - 1 Oct	27 September	28 September	29 September	30 September	1 October
Russia • CBR mtg: no chg • CPI (Sep)	Hungary • HNB mtg: no chg  Israel • Bol mtg: +25bps  Japan • Trade bal (Aug)  United States • Dallas Fed surv (Sep)	Germany • CPI prelim (Sep) • GfK cons conf (Oct)  Italy • ISAE cons conf (Sep)  Japan • Shoko-Chukin surv (Sep)  United Kingdom • GDP final (2Q)  United States • C-S HPI (Jul) • CB cons conf (Sep) • Richmond Fed surv (Sep)	Euro area • EC bus conf (Sep) • EC cons conf final (Sep)  France • INSEE cons conf (Sep)  Italy • ISAE bus conf (Sep)  Japan • BoJ Tankan (3Q)  Poland • NBP mtg: no chg  Romania • BNR mtg: no chg	Euro area • HICP flash (Sep)  Germany • Labor mkt rept (Aug/Sep)  Japan • PMI mfg (Sep) • Retail sales (Aug) • IP prelim (Aug)  Korea: IP (Aug)  Taiwan • CBC mtg: +12.5bps  United Kingdom • GfK cons conf (Sep)  United States • GDP 3rd print (2Q) • KC Fed surv (Sep)	Brazil • IP (Aug)  Euro area • Unemployment rate (Aug)  India • Trade balance (Aug)  Japan • Unemployment rate (Aug) • Core CPI (Aug) • Auto regs (Sep)  United States • Personal income (Aug) • UMich cons conf fin (Sep) • Auto sales (Sep)  Global • Mfg PMIs (Sep)

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