J.P.Morgan

Australia and New Zealand - Weekly Prospects

Summary

- Last week, the **RBA** overlooked deteriorating sentiment over Europe and hiked for the sixth time since October. Market interest rates now are back in a normal range, so the pace of tightening can slow. In fact, we expect a pause in June, but a resumption of the tightening cycle in July. The pause will, however, be extended if there is evidence of significant contagion beyond Europe. Either way, stage two of the hiking cycle, which probably will see the RBA push the stance of policy into restrictive territory, is yet to start. Last Friday, the RBA raised the growth and inflation forecasts, indicating that further hikes are inevitable; the main debate remains over the timing, which now is more problematic than before. Tomorrow night, the government will release what it describes as a "no frills" Budget. With an election up for grabs, though, it will include some sweeteners, including previously announced personal tax cuts and extra health funding. The jobs report Thursday should show only a modest gain in employment, and a rise in the jobless rate.

- A sharp drop in the unemployment rate in **New Zealand,** and more hawkish comments from RBNZ Governor Alan Bollard, prompted financial markets to price in with certainty a 25bp hike to the official cash rate (OCR) in June. Although those odds since have been trimmed, we maintain our call for the first rate hike to be delivered in July. The timing and pace of returning the OCR to more normal levels ultimately will depend on how the economic data evolves, however. Providing the data prints in line with our forecasts, we anticipate a steady string of 25bp hikes throughout the latter six months of the year, moves that will take the key rate to 3.5% by year end.

- At the source of the **Euro area's** problem is the excessive deficit and debt buildup on the periphery. The fiscal challenge for the area as a whole is not larger than the one facing the US, UK, or Japan. However, given this concentrated buildup, the Euro area system—which combines a shared currency and integrated financial markets with individual responsibility for fiscal consolidation—is poorly designed to deal with the adjustment at hand. Although the bailout package effectively removes Greece from funding markets for three years, it also requires Greece to shoulder an even greater fiscal burden—a more than 10% of GDP fiscal adjustment over four years. Absent a flexible currency, such an adjustment is a herculean task and leaves Euro area holders of Greek debt vulnerable.

- At this juncture, it is difficult to judge how much **macroeconomic damage** will come from this fiscal crisis. The immediate threat is focused in Europe, reflecting the extensive banking and trade relationships inside the Euro area and with the UK. However, the spillover is radiating more broadly as generalized uncertainty about sovereign risk and contagion produces a pullback from risk assets.

- It is important to recognize that the crisis is occurring against a backdrop of increasingly strong **global growth**. Our upbeat global forecast is premised on the formation of a positive feedback loop between financial markets, confidence, and shifts in private sector behaviour that promote self-sustaining growth. The key link in this chain—a recovery in global labour markets—has now arrived. Job growth has resumed across much of the globe and last week's US employment report was especially encouraging.

This week's highlight

The Aussie Budget Tuesday night. The goverment has to walk a fine line; it has to appear to be fiscally responsible, while simultaneosuly providing sweeteners ahead of the election, which probably will be held in October.

May 10, 2010

Contents

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Data and event previews - Australia and New Zealand

			Forecast		
Date	**Time [a]**	**Data/event**	**JPMorgan**	Consensus [b]	***Previous***
Monday, May 10	11.30am	Aust. NAB business confidence (%m/m, Apr.)	**13.0**	na	*16.0*
Monday, May 10	11.30am	ANZ job advertisements (%m/m, Apr.)	**na**	na	*1.8*
Tuesday, May 11	8.45am	NZ card spending (%m/m, Apr.)	**na**	na	*2.1*
Tuesday, May 11	7.30pm	Aust. 2010/11 Federal Budget delivered	**na**	na	*na*
Wednesday, May 12	11.30am	Aust. housing finance (%m/m, Mar.)	**-3.5**	-3.0	*-1.8*
Thursday, May 13	8.30am	NZ business PMI (Index, Apr.)	**na**	na	*56.3*
Thursday, May 13	8.45am	NZ food prices (%m/m, Apr.)	**na**	na	*0.2*
Thursday, May 13	11.00am	RBA Assistant Governor Lowe's speech	**na**	na	*na*
Thursday, May 13	11.30am	Aust. employment (ch. 000s, Apr.)	**7.5**	22.5	*19.6*
Thursday, May 13	11.30am	Aust. unemployment rate (%, Apr.)	**5.4**	5.3	*5.3*
Thursday, May 13	11.30am	Aust. participation rate (%, Apr.)	**65.1**	65.1	*65.1*
Friday, May 14	8.00am	NZ REINZ house price index (%m/m, Apr.)	**na**	na	*1.7*
Friday, May 14	8.00am	NZ REINZ house sales (%oya, Apr.)	**na**	na	*-8.0*
Friday, May 14	8.45am	NZ retail sales (%m/m, Mar.)	**0.9**	1.1	*-0.6*
Friday, May 14	8.45am	NZ retail sales ex auto (%m/m, Mar.)	**0.4**	1.5	*-0.9*
Friday, May 14	8.45am	NZ retail sales ex inflation (%q/q, 1Q)	**0.2**	0.3	*1.0*

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

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Data previews - Cont'd.

Australia

NAB business confidence (%m/m, Apr.) - The 3-point drop in headline confidence that we anticipate will owe much to the RBA's decision to hike the cash rate a further 50bp in the first four months of the year (the RBA hiked again in May), and also a deterioration in sentiment among AUD-sensitive firms.

Federal Budget - We expect the 2010/11 Budget will come in at A$27 billion. The government, however, will forecast a somewhat slower improvement in the deficit position. See research note in these pages for our Budget preview.

Housing finance (%m/m, Mar.) - Monthly home loans currently are 20% below the levels of June 2009, which marked the planned expiry of the expanded First Home Buyers' (FHBs') grant - the expanded grant subsequently was extended to the end of last year. We expect a further decline of 3.5%m/m in March. Notably, though, housing credit growth is still tracking at a healthy clip. The RBA's Statement on Monetary Policy last week attributed this discrepancy to "households making smaller excess principal repayments than was the case last year."

RBA Assistance Governor Lowe's speech - The Assistant Governor (Economic) is speaking at an investment forum in Sydney Thursday morning. A Q&A session is scheduled following the speech.

Employment (ch. 000s, Apr.) - On our forecasts, an additional 7,500 jobs were created in April, with the majority of gains occurring in full time employment. This will be a more modest pace of job growth than that recorded in previous months. The unemployment rate should have ticked up slightly to 5.4%, owing to the elevated participation rate, which continues to linger at 65.1%. The hours worked series will be of particular interest—the rate at which hours are being rebuilt will have an important bearing on where the unemployment rate heads from here.

New Zealand

REINZ house price index (%m/m, Apr.) - Our forecast calls for a 2.0%m/m decline in house prices in April. The main reason will owe to a pull-back in demand ahead of the government's Budget in May, which probably will include changes to the way property is taxed. More property listings since the start of the year also will assist in easing supply-side pressures.

Retail sales (%m/m, Mar.) - Credit card data showed that total billings on New Zealand credit cards surged 1.2%m/m in March, pointing to a surge in retail sales during that month. Headline retail sales values should have grown 0.9%m/m, although the rise in core sales will be more modest, owing in part to only a small rise in food prices. The recent rise in petrol prices will eat into households' disposable incomes, which will keep a lid on spending near term, as will rising expectations of a near-term OCR hike.

Research note

Australia's Budget to set scene for election battle

- **Treasurer Wayne Swan delivers Australia's annual Budget Tuesday**
- **Looming election means the "no frills" Budget will include some sweeteners to entice voters**
- **Election could be held as early as August; Government now trailing in opinion polls**

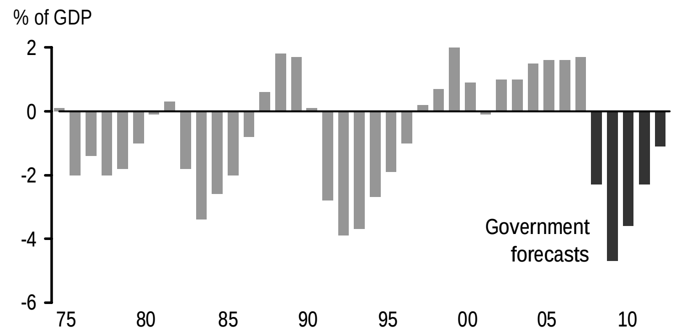
Even after recent frenetic activity, Australia's policymakers face an unusually busy period. The federal government revealed on Sunday the outcome of a "root and branch" review of the tax system, and Tuesday night will deliver the Budget for the year ahead. Then, the government faces an election, possibly as early as August; unofficial campaigning by the major parties kicked off some time ago and no doubt will escalate in coming weeks. Meanwhile, the Reserve Bank continues to raise official interest rates; the Bank last week hiked rates for the sixth time in seven Board meetings, partly owing to the hugely stimulative effect of the booming terms of trade.

With the election looming and opinion polls tightening in favour of the Opposition, the Budget will include sweeteners that government officials hope will boost their chances of reelection. There already is another round of (modest) personal income tax cuts on the way from July 1, and there will be measures such as quarantining interest earned on bank deposits from taxation. There probably will be changes to healthcare arrangements, but also broad expenditure savings across many portfolios. The imminent election means the government, whose officials say the Budget will have "no frills", will steer clear of politically sensitive measures like a rise in "vice" taxes on gambling and alcohol, and higher taxes on petrol. History shows that few treasurers are courageous enough to utter the words "tax" and "election" in the same sentence.

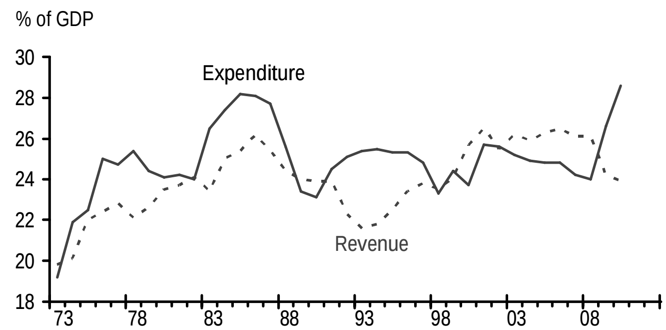
Lower headline Budget deficit and debt

The good news for the government is that the unexpectedly robust economy means the Treasurer will announce a significantly improved fiscal position, relative to the last forecasts published in November. We forecast a headline Budget deficit of A$27 billion for 2010-11, significantly below the government's previously published estimate of A$46.6 billion, which likely will remain elevated this week. The Treasurer probably will announce smaller Budget imbalances over the forecast horizon, including a small surplus in 2012-13, three years earlier than first projected. The lower peak in

Commonwealth budget balance



Commonwealth Government revenue and expenditure



government debt means there will be a substantial reduction in projected CGS bond issuance. We estimate peak bonds on issue of A$215 billion in mid-2014.

The government has refused to speculate publicly about whether the Budget will be back in surplus earlier than under the existing projections. The Treasurer has indicated that accumulated corporate losses during the financial crisis, partly via asset write-downs, will be a drag on tax collection for some time. The unexpectedly rapid bounce in the economy, though, inevitably will be reflected in higher revenue. It also will have capped growth in non-discretionary spending. Predictably, however, the government's discretionary spending has ballooned as the election approaches.

Government shows mining no ReSPecT

The release last Sunday of the long-awaited Henry Tax Review (kept on ice since late 2009) revealed that the government plans to adopt a mere handful of the 138 recommendations of the review panel headed by Treasury Secretary Dr. Ken Henry. Among the more contentious measures the government adopted is a Resources Super Profits Tax (RSPT); if approved, this 40% tax will be levied from July 2012 on the "super profits" of mining companies, which stand to make excess returns amid booming commodity prices and strong demand from China. The proceeds of the mining tax will be used to fund tax relief for small businesses, a staged decline in the company tax rate from 30% to 28% by 2014, and public spending on mining-related infrastructure. The government announced a rise in employer-funded retirement payments from 9% of income to 12% by 2020, but did not abolish a single tax, even the inefficient state levies like the payroll tax, a disincentive to job creation. Australia, therefore, will likely have more taxes in 2012 than it does now.

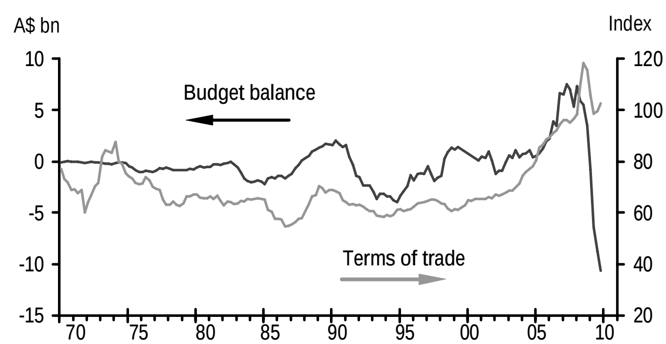
The contentious mining tax probably will face stiff opposition in Parliament—the main opposition party last week committed to opposing it. The government, therefore, could delay the relevant legislation's introduction until after the next election, when government officials hope the mix of the Senate will change in their favour; Green senators, for example, seem inclined to pass the legislation. The government claims the new regime, which offsets the cost of existing royalty payments, will boost GDP growth, partly by making marginal mines more economical, thus boosting early stage investment. There is evidence, however, that investors in large projects already are having second thoughts. Global resources giant Rio Tinto has all mining investment in Australia "under review"; a number of smaller operators have put investment on hold.

Many of the reforms recommended by the Henry Review panel have significant merit on efficiency grounds, but will not be adopted in the near term. The Treasurer declined to change, for example, the tax treatment of housing, which distorts investment decision-making, or to reinstate indexation of the excise tax on petrol; indexation was suspended by the former coalition government ahead of the 2001 election. These measures simply are too politically toxic for the government to adopt in an election year. While deferring difficult decisions is understandable in this politically charged environment, it means the Review falls short of delivering fundamental reform. We view this experience, therefore, as a golden opportunity missed.

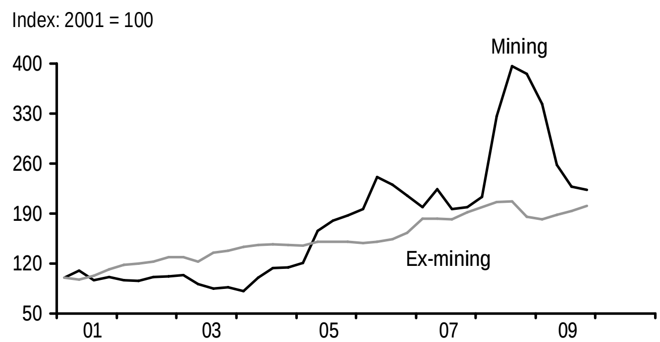
Some sweeteners in a "beige" Budget

Adoption of some of the review panel's less objectionable recommendations probably have been held over to the Budget (or even to the election campaign to follow). With many policy "cats" already out of the bag, however, this Budget could be one of the blandest for some time. The government hopes to use Tuesday's Budget to endorse its public perception as a competent manager of the economy. Opinion polling consistently indicates that respondents give the government credit for steering Australia's economy through the global crisis with minimal damage. The government acted quickly in late 2008 via fiscal policy to stimulate growth, although evidence has emerged recently that some

Terms of trade and budget balance



Company profits



of the discretionary spending was misdirected into less productive parts of the economy, and even wasted. Maintaining a perception of economic competence means the government has to resist delivering a free-spending Budget, even though it precedes an election that looks increasingly like being a tight contest.

Tax cuts, child care, health, and housing

However, with the election still up for grabs, and the latest published opinion polls showing the main opposition party leading the Labor government for the first time since 2006, the Budget almost certainly will include a few sweeteners for voters, including:

- Confirmation of the *personal tax breaks* announced in last year's Budget. The 38% tax rate for those earning above A$80,000 is being trimmed to 37%, and the A$35,000 threshold raised to A$37,000;
- The provision of *tax breaks for interest* earned on saving deposits, as recommended by the review panel. This could boost deposits with banks, lowering the banks' reliance on offshore wholesale funding;
- Addressing the *punitive tax rates* that apply to some low income earners when they move from welfare to work;

- More funding for public *child care places*. The government recently controversially shelved promised plans to build new child care facilities;
- Relief for *unincorporated small businesses*, which will not benefit from the planned cut to the corporate tax rate;
- Easing the *taxation compliance burden* on lower income earners by, for example, making personal income tax returns optional (currently, filing a return is compulsory for all taxpayers earning more than the tax-free threshold);
- A rise in funding for *health and hospitals*, in line with the recent agreement with seven of the eight state and territory governments. There may be changes to private health rebates for higher income earners;
- More public funding of *pharmaceuticals*, with relief aimed at lower income earners;
- A boost to the *old-age pension* and possibly changes to eligibility criteria for other benefits;
- Changes to the *tax treatment of superannuation*, including a possible rise in the 15% concessional tax rate for high income earners, and the contribution limits; and
- Steps to improve *housing affordability* for first-home buyers (FHBs). Possible measures include a boost to publicly funded construction to help alleviate shortages. The FHBs' grant and the existing tax break on investment in housing (negative gearing) will not be touched.

With many fiscal measures already in the public domain, the fluffiest "rabbit" the Treasurer will pull out of his hat will be the earlier return to surplus. The transition "back to black" will be helped by the first year of revenue from the new mining tax and the recent rise in the tobacco tax. The government announced the regressive rise in the tobacco tax two weeks ago, just days before releasing the tax review. Cynical commentators suggested this was to divert attention from the government's backflip on its commitment to address global warming; it shelved plans for an emissions trading scheme (ETS) until at least 2013.

Election 2010: opinion polls tightening

The Labor government led by Prime Minister Kevin Rudd has suffered an abrupt slide in opinion polls, following a series of policy reversals in recent weeks. In addition to the reversal on emissions trading, the government canceled the controversial roof insulation scheme, following the deaths of four installers and dozens of associated house fires;

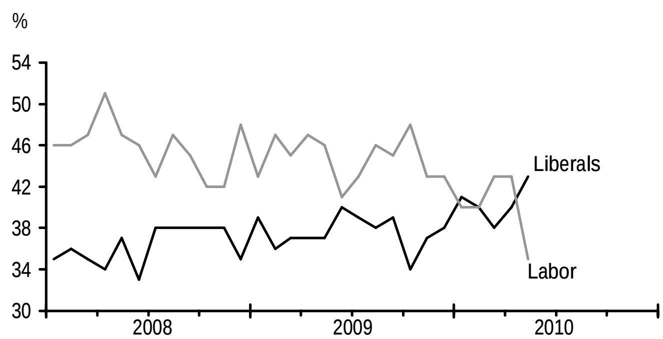
Australia's Parliament : state of the houses

Number of seats

	Lower house	Upper house
Liberal (Coalition)	55	32
Country Liberal (Coalition)	-	1
National (Coalition)	9	4
Labor	83	32
Green	-	5
Family First	-	1
Independent	3	1
Total seats	150	76

Source: Australian Electoral Commission

Voting intentions: major parties



scaled back promised construction of child care centers; and announced a review of the multi-billion-dollar school construction program. Earlier, the government abandoned its programs to massage energy and grocery prices. The latest shift in polling reflects a growing concern among some voters that the government has failed to deliver on key election promises, and that ministers lack the courage to make tough political decisions. The government, for example, also recently backflipped on the established policy for asylum seekers arriving by boat from Sri Lanka and Afghanistan, to appease popular opinion.

That said, the government delivered on its promise to repeal the former Howard government's industrial relations laws, which proved unpopular with many voters, and gets significant credit for managing Australia's economy through the global recession—even though booming demand for bulk commodities in China and soaring commodity prices arguably played more significant roles in Australia's outperformance than the government's pump-priming. The RBA's aggressive interest rate cuts in late 2008 also were crucial in supporting domestic demand.

The government's alarming slide in the opinion polls was so sharp that the Liberals now lead the government for the first time in more than four years, even though most of the "vote" that deserted the government headed for the minor parties, not the Coalition. This implies voters are not convinced opposition leader Tony Abbott would be a better prime minister than Rudd.

Election held no earlier than August 2010

Australians generally go to the polls in federal elections every three years. Voting is compulsory. There is, however, no fixed term; prevailing governments can choose the timing of elections. There have, for example, been elections in consecutive years, like 1983-84. All 150 seats in the lower house of Parliament are up for grabs at each election, with elected members supposed to serve at least a three-year term. Only half of the 76 seats in the upper house Senate, however, are contested each time. The 12 senators from each of the six states are supposed to serve six-year terms, but the two senators each from the two territories are supposed to serve only for three years. Only under a double dissolution election, which are few and far between, are all seats in both houses of Parliament contested at the same federal election.

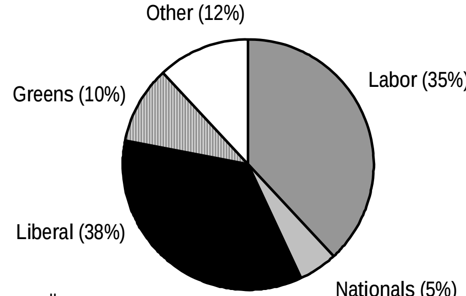
Labor topped the 2007 poll by winning 52.7% of the two-part preferred vote (after distribution of preferences of minor parties). Labor, with 83 seats, has a 16-seat majority in the lower house. The Coalition has five more seats than Labor in the Senate, but no majority; the balance of power is held by minor parties. From July 1, the outcome of the 2004 election will be reflected in a change in the composition of the Senate. Labor's poor election outcome back then will "rotate" out of the new senate; Labor and the Greens should gain seats.

The earliest the coming election can be held is Saturday, August 7, 2010; latest it can be held is Saturday, April 16, 2011. The most likely timing is October, after the football finals in September; politicians of all persuasions know not to distract Australians from their sport. The government can have the election earlier than in August only by calling for the dissolution of both houses of Parliament. The government already has the right to call a double dissolution election owing to key pieces of legislation twice being rejected by the Senate. The government has, however, declined to take this option, at least so far.

Election issues: health, rates, economy

The government has history on its side: only once since Federation in 1901 has a first-term government *not* been re-

Voting intentions - all parties
Percent



Source: Newspoll

elected. The government has been clearing the decks of contentious issues; its aim is to have the electorate focus on the two areas where polling indicates the government has an advantage: health and hospitals and management of the economy. The opposition, meanwhile, hopes the election will be fought over the government's recent policy reversals and rising interest rates. The latter always are politically sensitive, but particularly so ahead of an election. It can be argued that the RBA's interest rate hike two weeks ahead of the 2007 poll was the final nail in the coffin of the long-serving Howard government; Prime Minister John Howard had promised to keep interest rates low.

The 2010 election probably will be fought on the following primary issues:

- *management of the economy*, including the impact of rising interest rates and the cost of living—the latter was a big issue in the 2007 election;
- the opposition will be pushing the idea that the government has *failed to deliver on promises;*
- *industrial relations* —trade unions claim the Liberals would, if elected, bring back their notorious industrial laws;
- *health and hospital reform*— the government recently announced new funding arrangements in conjunction with state and territory governments;
- *parental leave and child care*—the government and the Coalition are competing to be more generous to families;
- the *environment*, particularly given that the government recently withdrew support for an ETS. The opposition opposes introduction of an ETS; and
- the controversial *mining tax* and other "reforms" announced following the Henry Tax Review.

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Australia

- **First phase of RBA's tightening cycle now complete**
- **Consumers restraining spending**
- **Unemployment rate will tick up slightly to 5.4%**

The RBA completed phase one of its tightening cycle last week, returning market rates to "normal" levels. Officials probably will sit on the policy sidelines next month to assess the impact of the 150bp of tightening delivered since October. The RBA last week also upgraded its inflation forecasts, reinforcing the decision to hike. The week ahead in Australia sees the release of the Budget, an important policy event ahead of the upcoming federal election (see the research note, "Australia's Budget to set the scene for looming election battle," in these pages).

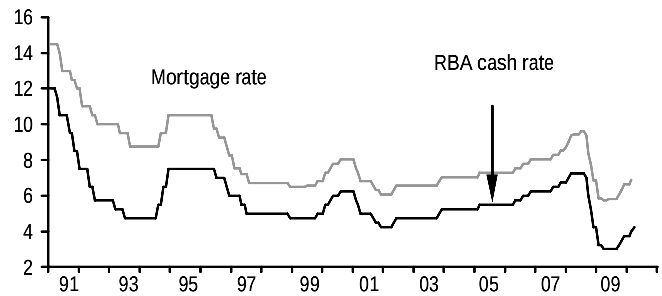
Hawkish RBA lifted cash rate again

The RBA Board last week lifted the cash rate another 25bp to 4.5%, as we and the consensus had expected. The surprise was that the RBA delivered unexpectedly hawkish commentary. Indeed, the statement made important adjustments in three key areas. First, global growth now may be "a little above trend," rather than just "at trend." Second, the RBA now expects the rise in the terms of trade to be larger than previously expected. Third, the official assessment now is that inflation will be higher than previously expected: in the upper half of the RBA's 2%-3% target range over the coming year.

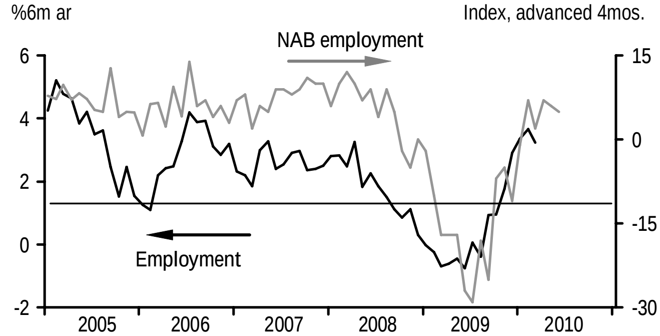
The flipside of this, though, is that the statement also indicated that market interest rates now are back to "average" levels. The reference to "average," a key phrase mentioned by RBA officials in speeches in recent weeks, means the RBA probably has scope to pause next month. That said, if key domestic data print on the firm side of expectations, a fourth straight hike in June is possible. With the policy stance now closer to a normal setting, though, we lean toward the RBA delaying the next hike until July.

The main arguments for last week's hike were the same as those used to explain the hike in early April: the booming terms of trade, which are about to trigger a huge wave of national income, and soaring house prices. Interestingly, the RBA's reference to the terms of trade again led the discussion on Australia's economy; there is a clear message in that. It seems the recent bounce in bulk commodity prices has fed through to the official commentary. On inflation, the statement now indicates that inflation will be in the upper half of the target range in the year ahead. Before, the commentary said inflation will be "consistent with target."

Australia: RBA cash rate and standard variable mortgage rate



Australia: NAB survey and employment growth



There may, therefore, be further upgrades in the pipeline. Indeed, it now is crystal clear that the economy has entered a new, more rapid pace of expansion, with very little spare capacity. Rates of capacity utilization are rising and the jobless rate has been falling. Inflation pressures, therefore, are building. Already, there is evidence of substantial wage gains in the hot mining regions. The riches on offer in mining towns to the west and north have triggered skill shortages even in non-mining sectors of the economy, as the mining industry drains the pool of workers elsewhere.

The RBA on Friday released its quarterly Statement on Monetary Policy (SoMP), which included upgraded growth and inflation forecasts. The tone of the statement again was upbeat—clearly, it was written well before the escalation of European woes late in the week. The RBA upgraded the GDP growth and core inflation forecasts by 25bp across most of the forecast horizon (out to end-2012). The nudge higher for the official GDP growth forecast means officials now expect the economy to expand at a well-above-trend pace in the next two years or so. Clearly, this will put even more strain on already stretched resources.

On inflation, the RBA now forecasts headline inflation as high as 3.25% this year. On core inflation, the RBA raised

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by 25bp the published forecasts for the year ended June and December 2010, and June 2011, respectively. The other forecasts are unchanged, including the prediction that core inflation will be at the top of the target range in 2012.

Aussie job gains should slow in April

Australia likely added 7,500 jobs in April after adding 75,000 jobs in the first three months of the year. We suspect that the gain in employment, albeit more modest than that recorded in previous months, will owe mainly to an increase in full-time employment. The recent shift from part- to full-time work will continue as workers' hours, which were cut significantly in 2009, are reinstated. Workers' hours should, therefore, have risen again in April, after rising 1.9%oya in February and 1.5% in March.

The jobless rate probably edged up to 5.4%; the rate will creep higher in the near term, owing to a rise in workforce participation. The anticipated rise in the unemployment rate will occur even though solid gains in employment are likely in 2H, owing to the swelling investment pipeline, which has positive implications for the labour market.

Housing finance likely to fall modestly

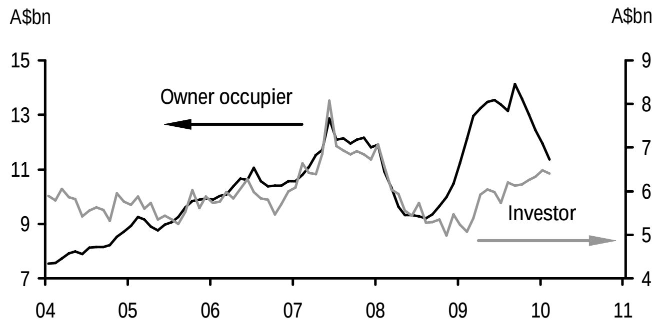
We expect a further decline in housing finance in March, with commitments likely to fall 3.5%m/m. The impact of rising interest rates is beginning to bite, and the stimulus tailwinds that pushed the surge in demand over the life of the subsidy now are buffeting loan volumes from the opposite direction. On the supply side, lenders are keen to rebalance their loan books after the mortgage binge under the expanded grant, which will lead to increasingly tighter mortgage lending conditions this year.

The RBA's sanguine observation in last week's statement that "new loan approvals have moderated" underplays the persistent decline in home loan demand observed in recent months. Monthly home loan demand is currently 20% below the levels of June 2009, which marked the planned expiry of the expanded First Home Buyers' (FHBs') grant.

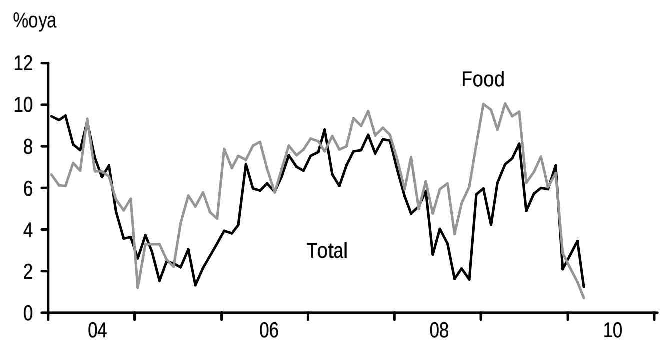
Aussie consumers still cautious

Consumer spending remained sluggish in March, which was not entirely surprising given the RBA's recent policy tightening and expectations of further hikes to come. Retail sales values grew just 0.3%m/m (J.P. Morgan: 0.2%; consensus: 0.7%), in line with anecdotes from retailers suggesting that sales were soft during the month. The result was, though, a

Australia: housing finance



Australia: retail sales



marked improvement on the revised 1.2%m/m slump recorded in February.

Consumers appear to be taking a conservative approach to spending even though consumer confidence remains elevated. Such restraint by households, combined with continued discounting of goods among the nation's retailers, has weighed down retail sales values. Several major retailers have highlighted that the absence of the government's A$900 fiscal stimulus payments, which were delivered in late 2008 and early last year, are making comparative growth this year harder to achieve. Indeed, with no added fiscal handouts likely to be delivered, interest rates rising, and growing uncertainty about global financial markets, further spending restraint is likely.

House prices kept climbing into 2010

Australian house prices increased 4.8%q/q in 1Q (J.P. Morgan: 3.5%, consensus: 3.0%), decelerating only very modestly from the 5.1% gain in 4Q. The gain took over-year-ago growth in house prices to a breakneck 20%.

With the expanded FHBs' grant phased down over 4Q then eliminated at year-end, we had expected a more marked moderation in price growth in 1Q. It is important to note that the

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ABS house price index, which reflects sales for detached houses in capital cities only, probably overstates true economywide dwelling prices. Also, the housing market indicators of late have painted a more mixed picture than is implied by last week's report, with prices and general market sentiment buoyant but loan demand sagging.

We still expect house price growth to ease over 2010 as the significant policy tailwinds pushing the sector fade away. The FHBs' grant is now back to its original level and price caps were introduced on the grant as of January 1. The risk, though, is that the supply constraints that have lingered, unresolved, for so long, combined with the momentum garnered in the last year, cause the market to overheat.

Data releases and forecasts

Week of May 10 - 14

Mon May 10 11:30am

ANZ job advertisements
Seasonally adjusted

	Jan	Feb	Mar	Apr
%m/m	-8.1	19.1	1.8	

Tue May 11 11:30am

NAB monthly business survey
% balance, seasonally adjusted

	Jan	Feb	Mar	Apr
Business confidence	15	19	16	13

Weaker confidence will owe to a further rate hike and a drop in sentiment among currency-sensitive firms.

Wed May 12 11:30am

Housing finance approvals: owner occupiers
Number of loans, seasonally adjusted

	Dec	Jan	Feb	Mar
%m/m	-5.2	-7.3	-1.8	-3.5
%oya	-0.1	-11.6	-16.1	-22.6

Thu May 13 11:30am

Labour force
Seasonally adjusted

	Jan	Feb	Mar	Apr
Unemployment rate (%)	5.2	5.3	5.3	5.4
Employed (000 m/m)	59.4	-4.7	19.6	7.5
Participation rate (%)	65.3	65.2	65.1	65.1

Review of past week's data

House price index: eight capital cities
Weighted average

	3Q09	4Q09		1Q10	
%q/q	4.4	~~5.2~~	*5.1*	~~3.5~~	*4.8*
%oya	6.6	~~13.6~~	*13.5*	~~18.5~~	*20.0*

RBA cash rate announcement

25bp hike delivered. See main text.

Building approvals

	Jan		Feb		Mar	
%m/m sa	~~-5.5~~	*-5.0*	~~-3.3~~	*-2.7*	~~-1.0~~	*15.3*
%oya sa	~~52.7~~	*53.5*	~~34.2~~	*36.3*	~~23.1~~	*51.6*

The spike owed to a huge 60% jump in approvals for higher-density dwellings. Approvals for houses rose just 0.5%.

Retail trade

	Jan		Feb		Mar	
%m/m	~~1.1~~	*0.9*	~~-1.4~~	*-1.2*	~~0.2~~	*0.3*
%oya	~~3.0~~	*2.7*	3.4		~~1.1~~	*1.2*

Retail trade ex inflation

	3Q09		4Q09		1Q10	
%q/q, sa	-0.7		~~1.1~~	*1.0*	*0.1*	
%oya, sa	~~3.2~~	*3.1*	3.4		~~2.2~~	*2.0*

Trade balance

	Jan		Feb		Mar	
Trade balance (A$ mn,sa)	~~-1120~~	*-951*	~~-1924~~	*-1701*	~~-1500~~	*-2082*

New Zealand

- **Employment grows for first time in five quarters**
- **RBNZ commentary somewhat hawkish**
- **Retail sales to have shifted up a gear in March**

The RBNZ last week reiterated that it would commence the tightening cycle “in coming months.” Fresh comments from RBNZ Governor Bollard and an unexpectedly upbeat jobs report increased the risk of an OCR hike in June, a month earlier than in the J.P. Morgan forecast.

RBNZ Governor talks up the recovery

RBNZ Governor Bollard spoke on the outlook for the New Zealand economy last week. The speech was an expansion of the bank’s statement on April 29, when the RBNZ left the OCR at a record-low 2.5% and signaled that the policy stimulus may be removed “in coming months,” rather than “around the middle of 2010.” We interpreted the new guidance as hinting at a June or July move, possibly even later. The new language can be rolled over from month to month should economic conditions deteriorate. As such, Bollard last week maintained the flexibility acquired in the official statement two weeks ago, which will allows the policy stimulus to be removed when economic conditions are appropriate.

Key to the Governor’s speech was his “truck driver” analogy: “...our foot is strongly on the accelerator. Over coming months we expect to reduce the pressure on this pedal, but in effect to keep some throttle going. Truck drivers know they must reduce acceleration long before the corner.” This implies that the RBNZ is readying to begin to remove the policy stimulus, but exactly when the truck driver will decide to “reduce acceleration” will depend on how the economic data evolve. If the data evolves in a positive fashion, a June rate hike will be delivered. The Governor last week reiterated, however, that conditions on the domestic front remain fragile.

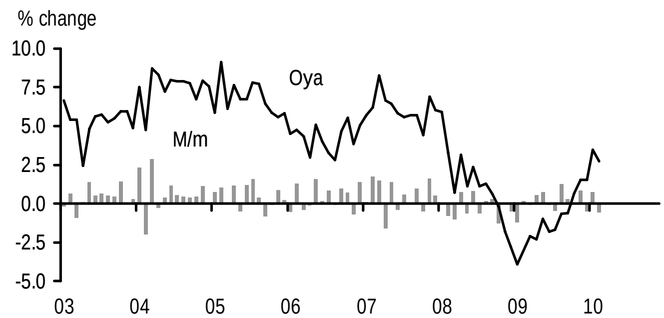
We still think that a July move is more likely. By then, the RBNZ should have another healthy GDP print in hand (we are forecasting 1Q GDP growth of 0.8%q/q), and the case for keeping the cash rate at historic lows should have weakened substantially. Also by then, the troubling events in Europe, hopefully, will have cooled.

Kiwi unemployment dropped sharply

New Zealand’s unemployment rate posted a remarkable fall

New Zealand: labor market

New Zealand: retail trade



in 1Q, dropping from a revised 7.1% in 4Q to just 6.0%, marking the largest drop since 1986 and the first fall in more than two years. We believe that the unemployment rate is unlikely to head below 6.0% in the near term, however. The NZIER quarterly surveys have showed that hiring intentions have turned marginally positive, but actual hiring is still below long-run averages. With corporate profitability having fallen in 1Q, any significant pickup in new hiring will be delayed.

There were significant seasonal factors at play, however. In 1Q, unadjusted employment tends to fall, but the decline this year was not as large as usual. While seasonally adjusted employment was up 1.0%q/q, unadjusted employment was down 0.2%. The discrepancy between the two measures was largely a reversal of the previous quarter. In 4Q, seasonally adjusted employment was flat, while the unadjusted data showed a 1.5% spike. Given that seasonal factors were a major factor pushing employment down in 4Q and up in 1Q, one may suggest that unemployment in original terms was fairly stable at some intermediate point (say 6.5%) over the last six months, rather than fluctuating sharply between 6.0% and 7.1% as the data suggests.

NZ retail due for a jump higher

After two months of decline, retail sales should have spiked 0.9%m/m in March, or 3.7%oya. Credit card data showed that total billings on New Zealand credit cards surged 1.2%m/m in March, suggesting strong growth in retail sales during that month. Core sales probably rose only modestly, however, increasing 0.4%m/m. Part of this will be linked to the small rise in food prices in March (+0.2%m/m), given around 45% of the value of core retail sales comes from the five food-related industries.

Despite the anticipated rebound in retail sales, any recovery in consumer spending this year, in our view, will be only modest. With petrol prices having risen considerably since the start of the year, housing market activity having moderated owing to uncertainty surrounding prospective changes to the taxation of property, and wage growth still subdued, households will remain cautious.

Data releases and forecasts

Week of May 10 - 14

Mon
May 10

QVNZ house prices
%, median

	Jan	Feb	Mar	Apr
%oya	4.4	5.5	6.1	__.

Thu
May 13
10:30am

Business PMI
Seasonally adjusted

	Jan	Feb	Mar	Apr
Index	52.2	53.6	56.3	__
%oya	23.0	35.3	34.4	__

Fri
May 14
10:45am

Retail trade
Seasonally adjusted

	Dec	Jan	Feb	Mar
%m/m	-0.5	0.7	-0.6	0.9
%oya	1.8	3.6	2.3	3.7

Review of past week's data

ANZ commodity price series
Not seasonally adjusted

	Feb		Mar		Apr	
Index—world prices (%m/m)	3.8		1.8		__	*4.9*
Index—NZD (%m/m)	7.9		0.4		__	*3.8*

Labour cost index and average hourly earnings
Private sector, ordinary time, sa

	3Q09	4Q09	1Q10
%q/q	0.4	0.3	*0.3*

Labour force survey

	3Q09		4Q09		1Q10	
Unemployment rate (%,sa)	6.5		~~7.3~~	*7.1*	~~7.3~~	*6.0*
Employment (000, q/q,sa)	-~~17~~	*-15.0*	-~~2~~	*1.0*	~~4.9~~	*22.0*
Participation rate (%,sa)	68.0		68.1		*68.1*	

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Global Essay

- **The Euro area sovereign crisis leaves the ECB with difficult choices**
- **Although global growth is accelerating and resilient, an effective policy response is needed to limit macroeconomic damage from the crisis**
- **Global labour markets turn led by a resurgence in US private payrolls**

Frankfurt, we have a problem

The market response to Euro area policy action last week was not exactly what authorities had hoped for. The EMU/IMF €110 billion bailout package for Greece was followed by a sharp rise in interest rates across the fiscally challenged countries on the periphery. For its part, the ECB relaxed its collateral requirements on Greek debt. But its failure to respond to building stress in bank funding markets at its policy meeting accelerated the decline in the euro and the fall in risk appetite across the globe.

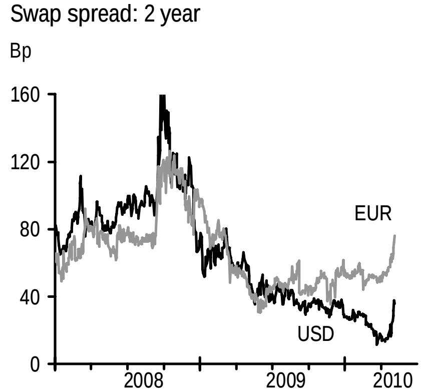
At the source of the Euro area's problem is the excessive deficit and debt buildup on the periphery. The fiscal challenge for the area as a whole is not larger than the one facing the US, UK, or Japan. However, given this concentrated buildup, the Euro area system—which combines a shared currency and integrated financial markets with individual responsibility for fiscal consolidation—is poorly designed to deal with the adjustment at hand. Although last week's bailout package effectively removes Greece from funding markets for three years, it also requires Greece to shoulder an even greater fiscal burden—a more than 10% of GDP fiscal adjustment over four years. Absent a flexible currency, such an adjustment is a herculean task and leaves Euro area holders of Greek debt vulnerable.

Authorities made no mention of possible funding arrangements for the other periphery nations last week. As such, their borrowing rates moved higher, and short-term funding markets across both sides of the Atlantic felt a chill. This should be no surprise given the elevated level of European bank exposure to sovereign debt and the large role European banks play in short-term dollar funding markets. Indeed, over 30% of US outstanding CP/ABCP is issued by European banks.

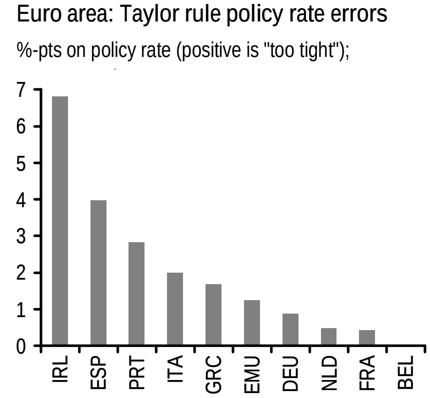
A reasonable first step would be to reopen the generous liquidity facilities available during the financial crisis—notably the Fed's USD FX swap lines and the ECB's longer-term repo funding. While this action looks likely, the complications regarding the Fed swap lines should be recognized. Opening swap lines requires the Fed to expand its bloated balance sheet further. And with the US Congress considering regulatory reform that limits Fed power—partly because of anger over perceptions that the Fed was too quick to support troubled banks—it is hard for the Fed to engage in something perceived to be "bailout" of foreign banks. The Fed would want to get the Treasury and some key lawmakers to sign off on this action. While the Fed led the last time in opening up swap lines, this time there would need to be a sense that the ECB is taking the lead and the Fed is playing a collegial, but supporting, role.

If concerns about fiscal positions intensify, these steps may not prove sufficient in the face of pressures on sovereign debt funding and rising fear that the quality of assets held by some European banks is impaired. As such, it may prove necessary to create a backstop facility for government debt on the periphery. It appears unlikely that the ECB will provide this backstop by direct purchases of government debt any time soon, given the resistance of central bankers to step directly into the space of funding sovereign borrowing needs. The preferred outcome would be a solution involving EU governments. However, as

Swap spread: 2 year



Euro area: Taylor rule policy rate errors



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Global employment

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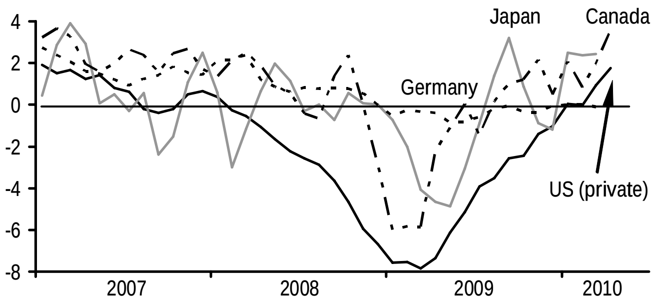

we have seen in the case of Greece, agreements among heads of states are difficult to forge.

Thus, the ECB may find itself in a similar position to the Fed which searched for new tools in the midst of the 2007-8 financial crisis. There is a possibility that the ECB could try to follow the Bank of England, in setting up an off-balance sheet vehicle to purchase debt (the Asset Purchase Facility), which was indemnified by the fiscal authorities. It may also follow the Fed and create a TALF-type facility in which it provides nonrecourse lending for private sector purchases of debt.

Meanwhile, global growth is accelerating

At this juncture, it is difficult to judge how much macroeconomic damage will come from this fiscal crisis. The immediate threat is focused in Europe, reflecting the extensive banking and trade relationships inside the Euro area and with the UK. However, the spillover is radiating more broadly as generalized uncertainty about sovereign risk and contagion produces a pullback from risk assets.

The economic consequences for the most fiscally challenged countries are clearly negative, in that these countries are facing some combination of higher funding costs, banking system stress, and increased fiscal tightening. However, the most affected nations—Spain, Portugal, Italy, Ireland, and Greece—account for less than 20% of Euro area output. For the healthier Euro area economies conditions are mixed. Negative spillover to the banking system are being partly offset by the shift by investors in their direction. This is evident in the differentiation in government borrowing rates, which have fallen sharply in the stronger core countries inside Europe.

It is important to recognize that the crisis is occurring against a backdrop of increasingly strong global growth. Our upbeat global forecast is premised on the formation of a positive feedback loop between financial markets, confidence, and shifts in private sector behaviour that promote self-sustaining growth. The key link in this chain—a recovery in global labour markets—has now arrived. Job growth has resumed across much of the globe and last week's US employment report was especially encouraging. US private payrolls have now increased in five of the past six months, with gains averaging 156,000 since February. Job gains in the household survey have been even more powerful. Combined with the recovery in other telltale indicators including the workweek, the labour force participation rate, and the ISM employment indexes, there is a convincing case that the US is in the midst of a solid labour market recovery. Notably, the booming pace of G-3 capital goods orders and shipments also indicates that an impressive recovery in business capital expenditures is in train.

This positive message about the momentum of both the economy and business spending is reinforced by the impressive round of April global business surveys. Our global all-industry PMI output index rose another point to 57.7 in April. This is the highest level since May 2006, when the economy was growing near 4% annualized. The global manufacturing PMI now rivals the series high dating back to 1998, as the global factory sector continues to boom on the back of strong final demand and a turn toward inventory restocking. Even more encouraging was the continued advance in the services index—signaling that the base of growth is broadening.

BoJ mandate change may be coming

Under pressure from the government to lift Japan out of deflation, the BoJ recently returned to unconventional easing. This resulted in an announcement two weeks agothat the central bank is preparing a new lending facility to promote growth in targeted industries including the environmental and energy industries. More radical changes may be coming. Just ahead of the summer Upper House election, the DPJ is reported to be considering new ways of achieving its inflation objective. Although the details are not yet decided, there is a possibility that the government will set a higher inflation target or even alter the Bank's mandate to include "maximizing employment" in addition to price stability, similar to the Fed.

Central Europe hit by contagion fears

The escalating fiscal crisis in peripheral Europe hit emerging markets last week, as the global flight to quality prompted

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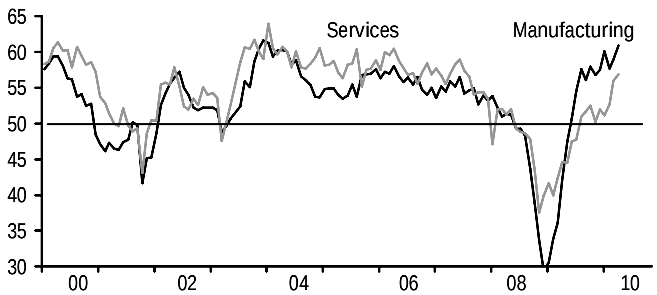
J.P. Morgan global PMI output indexes

DI, sa



risk reduction across the board. While market jitters reached the shores of Emerging Asia and Latin America, pressures were particularly acute in Central Europe given its geographical proximity, with PLN, HUF, and RON being the worst performing currencies. However, direct trade, investment, and banking sector links between Central Europe and EMU periphery countries are actually small. Exports to Greece, Spain, Portugal, and Italy together account for less than 5% of CE-4 GDP on average, with Italy accounting for about two-thirds of that. That said, second-round contagion channels can have a marked impact if stress intensifies because core Euro area countries, such as Germany and France, are the key trading partners of Central European countries. Moreover, with the exception of Romania, CE banks are predominantly owned by non-periphery Western European parents. In Romania, Greek banks hold about 18% of banking sector assets.

For now, the cyclical growth dynamic in the Euro area is expected to dominate sovereign stress. Yet, risks for slower growth or even a double-dip recession have risen. If not for these risks, we would probably be inclined to slightly upgrade some of our growth forecasts for Central Europe in light of the strong incoming high-frequency data.

The risk of contagion has a nonlinear impact on CE central bank reaction functions, in our view. A slower Euro area recovery would prompt us to push back rate hikes in the Czech Republic and Poland, and might even imply additional rate cuts. However, a double-dip recession in the Euro area, together with heightened financial market stress, might call for higher interest rates to stem the likely downward pressure on CE currencies. The sensitivity of CE central banks to FX moves differs, depending mainly on their external imbalances and the share of FX loans. Indeed, while the Romanian central bank decided to ease less than expected last week due to currency weakness, the Czech central bank cut rates unexpectedly owing to fears of a weaker recovery.

Australasia extends normalization lead

The scattered drive toward policy normalization in the Asia-Pacific region continued last week. The RBA remained at the vanguard, raising rates for a sixth time to 4.50%, by far the highest level in the developed world. The RBA appears set to take a breather in June, particularly if the stress in global financial markets continues. However, with little spare capacity and inflation already running near the top of the RBA’s band, further rate hikes are likely. For its part, the RBNZ signaled last week that it may start to remove the policy stimulus “in coming months.” Our call is that the first OCR hike will be in July, providing the economic data in New Zealand evolve in a positive fashion.

While financial markets are still waiting for China to begin its rate hiking cycle and to allow its currency to appreciate, the central bank turned to a different policy lever last week, raising the RRR by 50bp for the third time in 2010. In addition, the central and local governments have implemented a series of tightening measures directed at the housing sector. These moves are consistent with our forecast for moderating growth in fixed-asset investment and overall GDP growth. China will release most of its April data this week. One focus will be inflation, which is expected to move up in April, though it may not breach the 3%oya hurdle that is thought to be needed to trigger an interest rate hike. With global financial market stress building, action on rates and the currency—which we had thought would come in the April/May period— may be delayed to June. This week’s foreign trade report also bears close watching to see whether the trade balance returns to surplus after a rare fall into deficit in March, in line with our forecast.

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JPMorgan View - Global Markets

Everyone is cutting risk

- **Asset allocation:** The sell-off remains to us a correction in a medium-term bull market, although it is probably not over yet. We hold a reduced overweight of risky assets.
- **Economics:** Great activity data with strong US payrolls, and Global PMI back to May 2006 high. Some policy initiative is likely, but unlikely to be a fix-all.
- **Fixed income:** The Euro debt crisis is set to worsen without further official action.
- **Equities:** Keep directional risk to a minimum. Stay short Euro area equities and banks.
- **Credit:** Stay tactically short US HG and underweight European versus US corporates
- **FX:** Short sterling versus the dollar.
- **Commodities:** Be long commodities on improving fundamentals, but downside risks remain near term.

Markets went into semi-panic last week on the escalating sovereign credit crisis in Europe and the unexpected lack of action by the ECB. Hopes are high that global policymakers will take dramatic action soon, but the limited impact they have had so far is reducing their enthusiasm for new, groundbreaking initiatives. Policymakers do not appear to consider liquidity conditions and systemic risk bad enough yet to throw away the rule book. **Any policy actions next week will likely focus on bank funding, rather than the more fundamental problem of Euro government debt funding.** Markets, from their side, seem bent on making conditions bad enough to induce such needed policy action.

Given the uncertainty about policy support and the speed of the market fall, few market participants are ready to catch this falling knife. We ourselves retain a positive medium-term view on economic growth and risky markets, but recognize the negative market dynamic and the damaging impact it can have on economic fundamentals. Our monthly *Global Markets Outlook and Strategy*, released on May 5, reduced its long in risky assets to a token level, focusing risk instead on **underweighting the hot spots in the world—Europe, China, and banks**.

How bad are conditions in the Euro area? Objective conditions on the ground are not as bad as reflected in the collapse in bond and equity prices. Economic activity data for March and April are showing that the recovery is taking hold. Investment losses on higher-yielding Euro government bonds are approaching €100 billion YTD, but the gains on the lower-yielding ones remain of the same magnitude. This is not like subprime, when there was huge uncertainty about what their market value was and where losses were located, and leverage was much higher than today. Euro money markets have tightened further, but from conditions that were not great to start with, and the ECB is still the dominant money market lender. European banks, including the large Spanish banks, retain access to US CP and USD liquidity in Europe but at a significantly higher price and at shorter terms.

The main problems in Europe are the **"sell first and then ask questions"** attitude of market participants, **the lack of political and policy leadership, and the uncertainty of where to find a new home for the bonds of what we like to call "higher-yielding Euro sovereigns."** Sentiment will not stay in panic mode for long. But the lack of leadership in the Euro area is institutional and will remain. In addition, the long-held assumptions are that all European government bonds are safe and liquidity is damaged. This risks turning some of them into an orphan asset class, in search of a new home. If higher-yielding Euro sovereigns are not safe in govies, credit, or EM, then what are they and who will be their natural holder? In due time, this asset class, with higher risk and return than other, safer govies, will find a home, but the transition will take time, challenging the funding of a number of Euro governments.

The **correction** in global equities is so far very similar to the June and January ones (chart, next page). Both started from technically overbought levels, took three weeks, and cost 8% in price terms—similar to the last three weeks. But the current correction has not bottomed yet. The June correction ended with stronger economic data, while the January correction bottomed in early February with the EU Summit promising financial support to Greece. We are similarly getting stronger economic data, including a great US payrolls report, and there is a decent chance of new policy measures this week. But risk cutting does not seem over, and the cavalry may not be at full strength. We are cautious.

Fixed income

The Euro area crisis widened and worsened, after last week's announcement of a €110 billion liquidity package for Greece failed to calm a market now squarely focused on sovereign solvency risks. The widening of Greek, Portuguese, and Irish spreads accelerated, and hitherto less-affected countries like Belgium also saw spreads widen. Bank funding conditions deteriorated further, with interbank borrowing rates rising relative to expected policy rates, and the basis swap market indicating a shortage of dollars among European banks. All this, together with falling equities and credit, drove a sharp rally in core bond markets despite

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strong activity data. **German 10-year yields fell more than 20bp to an all-time low**, and that decline in yields was matched by Treasuries.

The debt crisis is self-reinforcing, in that higher government yields raise debt servicing costs, and thus spur concerns about solvency as well as liquidity. In addition, heightened volatility pushes conservative government bond investors to reduce their exposure to high-deficit Euro area countries. This means that significantly stronger official support will likely be needed to restore confidence in high-deficit Euro area countries, and risky assets more generally.

Contagion from the Euro area pushed EM bonds sharply lower last week, reversing most of this year's out-performance versus DM. Inflows to EM bond funds have remained strong so far, but are likely to be dampened by the rise in bond market volatility. We stay cautiously long in South Africa, where the central bank is on hold and government debt is relatively low, but recognize that further underperformance is possible near term.

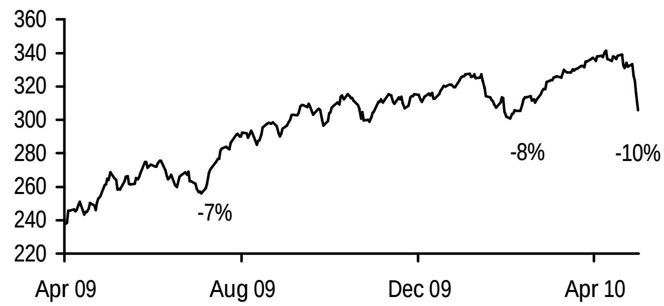
Equities

Global equities suffered a heavy loss last week as the absence of policy support led to intensification of sovereign fears. The MSCI All Country World Index fell over 7% and now stands 3% below its level at the start of the year. **Uncertainty and volatility rose sharply** with the VIX seeing its steepest rise since Lehman, to 35%. The rise in the VSTOXX (the Euro counterpart of the VIX index) was even more pronounced to 50%.

We **advise a cautious stance near term** keeping directionality to a minimum given heightened uncertainty and contagion risks. With no signs that the debt crisis that engulfed the region is about to subside, we retain our underweight on Euro area equities, which is at the epicenter of the crisis. Similarly, we underweight banks, the sector more susceptible to sovereign stress.

Overweighting **small caps and cyclical sectors** has been at the cornerstone of our strategy this year. Both lost money last week but are well in the black year-to-date. Although we continue to like these trades medium term, we prefer to **take profits now given negative momentum**. Both trades are crowded and the potential for further risk reduction by investors represents a serious headwind. It is true that small caps have shown resiliency to modest 5%-10% market corrections in the past, managing to outperform large caps.

MSCI AC World Local
Price index



This is because investors tend to reduce risk by selling the more liquid large caps. History shows, though, this is less likely to happen in more pronounced corrections.

Credit

Credit markets sold off last week as the Euro area debt crisis escalated. HG bond spreads widened 15bp while HY spreads widened 61bp. CDS underperformed significantly as US CDS indices widened twice as much as cash bonds, a large 36bp and 136bp for US HG and HY, respectively.

We stay **tactically short US HG** as the risk factors that led us to underweight the market became stronger over the past week. The lack of action by the ECB suggests further deterioration in markets, while uncertainty on the US financial reform bill persists. Valuation of HG bonds in yield terms has yet to improve as the rally in US Treasuries offset the widening of HG bond spreads. Our US HG client survey is showing a **sharp deterioration in investor sentiment**. Investors are now net bearish credit spreads with a net 7% of investors expecting wider spreads over the next month versus a net 27% of investors expecting tighter spreads last month.

We stay **neutral credits that are vulnerable** due to heavy positioning and high valuations, such as EM corporates, EMBIG, and benchmark ABS. For US high yield, off-the-run/subordinated ABS and super senior CMBS, we stay overweight as positive fundamentals and strong demand outweigh near-term headwinds. The spread tightening trend will take a pause during the market correction, but given the liquidity of these instruments and our bullish medium-term view, we see sell-offs as buying opportunities.

As European sovereign risks take center stage, we favour sectors with little European exposure such as US REITS. REITS are one of the best performing sectors within US HG, with US REIT spreads at 192bp, the sector continues to be cheap relative to HG spreads of 143bp, which historically trade at similar levels. Moreover, our strategists believe property values have bottomed and expect cash dividends to return. **Overweight US REITS** versus HG given strong momentum and good value.

Foreign exchange

The ECB's refusal last week to extend liquidity has put markets in endgame mode, where policy inertia will inspire **further deleveraging**. In currencies, this process always involves an unwind of the carry trade, so reasonable targets should be based on the assumption that investor positions in high-yield currencies would be fully liquidated. Longs in high-yield and commodity currencies were liquidated quickly during the credit crisis but did not turn meaningfully short. If we assume a repeat of this pattern, the betas between commodity currencies and IMM positions imply that AUD/USD and NZD/USD could fall to 0.84 and 0.67, respectively, and USD/CAD rise to 1.06. If yen IMM shorts were fully unwound, USD/JPY would reach 90, but given the tendency of yen positions to move from short to long during a crisis, USD/JPY could reach 87 or below.

EUR/USD's path if the crisis intensifies is much less clear, since the unwind of longs in commodity currencies and emerging markets imply euro buying as investors delever. This flow would partially offset euro selling from capital flight, but we suspect the latter would dominate, thus **pushing EUR/USD to 1.20**. Cable would fall by more since a hung parliament leaves the UK institutionally unable to tighten fiscal policy at a time when European deficits are under the microscope. GBP/USD could thus fall to 1.35.

We thus take profits on euro shorts versus Asia (IDR, INR) and commodity FX (CAD), and roll them into **short Europe versus the dollar**. Sell GBP/USD rather than EUR/USD as the sovereign funding focus shifts to the UK following confirmation of the hung parliament. As outlined last month, sterling's cheapness does not insulate it against a further decline in coming months. Whatever government emerges risks mediocre growth as fiscal policy is tightened, or a rating downgrade and funding crisis if it delays tightening. Sell GBP versus USD and add a cash short versus CHF to the existing options position. Also take losses on short USD/CAD and JPY/KRW. Stay short EUR/CHF in view of the SNB's waning tolerance for unprecedented intervention.

Commodities

Commodities were massively down last week, as markets are now more concerned about the likely spillover effects of the sovereign debt crisis. All major sectors are down with the exception of precious metals. The rally in precious metals was, however, only due to an increase in gold prices (despite USD strength), as silver, platinum, and palladium also posted losses. Energy saw double-digit percentage losses with crude oil down to below $75 at a certain point, while base metals were not too far behind.

We remain **positive on improving fundamentals, but prices are likely to remain under pressure near term**. Our modal view is that conditions for future commodity demand growth are more supportive now than a few months ago and will continue to improve. Even though our modal view is for improving fundamentals, downside risks to prices are increasing and will continue to do so if the sovereign crisis lasts a lot longer and starts hurting growth prospects. For now, we maintain our medium-term view that stronger global growth will benefit base metals and crude oil, but also keep long positions in precious metals as uncertainty should remain high.

Ten-year Government bond yields

	Current	Jun 10	Sep 10	Dec 10	Mar 11
United States	3.43	4.10	4.25	4.50	4.70
Euro area	2.80	2.80	3.00	3.35	3.75
United Kingdom	3.83	4.05	4.20	4.30	4.55
Japan	1.28	1.40	1.50	1.55	1.55
GBI-EM	7.09			7.70	

Credit markets

	Current	YTD Return
US high grade (bp over UST)	158	4.6%
Euro high grade (bp over Euro gov)	173	2.0%
USD high yield (bp vs. UST)	649	5.6%
Euro high yield (bp over Euro gov)	657	7.5%
EMBIG (bp vs. UST)	338	2.7%
EM Corporates (bp vs. UST)	339	4.3%

Foreign exchange

	Current	Jun 10	Sep 10	Dec 10	Mar 11
EUR/USD	1.27	1.30	1.35	1.35	1.30
USD/JPY	91.4	87	90	93	96
GBP/USD	1.48	1.43	1.50	1.52	1.48

Commodities - quarterly average

	Current	10Q2	10Q3	10Q4	11Q4
WTI ($/bbl)	75	86	94	93	90
Gold ($/oz)	1209	1400	1300	1200	1225
Copper($/m ton)	6912	8000	6800	6250	6500
Corn ($/Bu)	3.72	4.05	3.95	3.90	4.00

Source: J.P. Morgan, Bloomberg, Datastream

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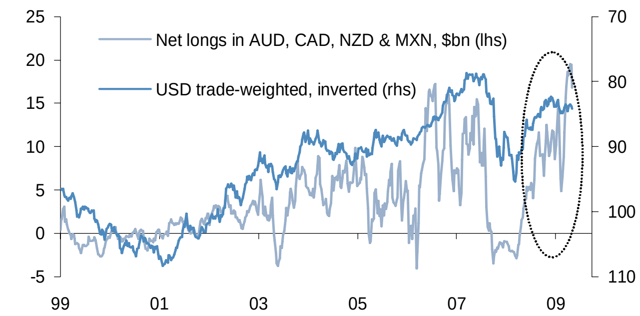
AUD and NZD Commentary

- **The ECB's refusal last week to extend liquidity has put markets in endgame mode, where a local funding issue morphs into a global leverage crisis due to a succession of policy missteps**
- **Weak tone against the USD raises the risk of an extension of the recent corrective phase for both AUD and NZD.**
- **AUD/USD extends into the medium term range highs as the medium term backdrop supports higher prices; NZD/USD confirms a short term low above the .7200 area.**

Chart 1: IMM net longs in commodity currencies vs trade-weighted USD



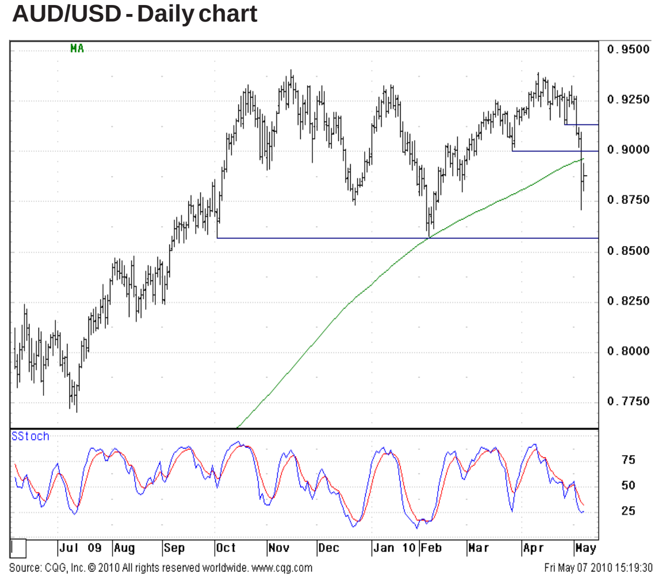
Source: J.P. Morgan

- We believe that near term action is likely from the ECB, but in the absence of policy actions, conditions will likely worsen, resulting in a liquidity crisis and further deleveraging across markets. In currencies this process always involves an unwind of the carry trade, so reasonable targets should be based on the assumption that investor positions in high-yield currencies would be fully liquidated. As highlighted in chart 1, longs in high-yield and commodity currencies were liquidated quickly during the credit crisis but did not turn meaningfully short. If we assume a repeat of this pattern, the historical betas between commodity currencies and IMM positions imply that AUD/USD and NZD/USD could fall to 0.84 and 0.67, respectively. Again, we believe that policy action is likely in the near term, and that these types of moves can be avoided, but we are also cognizant that deleveraging likely has further to run.
- This week is very heavy on data (Euro GDP, US retail sales, China IP and house prices), but policy events will still dominate. In this environment, weekend announcements of any of the above liquidity measures are possible.

Technical analysis

- AUD and NZD finally see some cracks in the bullish foundation following the past week's sharp declines. For AUD/USD, the reversal from the important medium term range highs near .9390/.9407 has reasserted the broad consolidation phase while raising the risk of additional weakness. Key support rests at this week's .8712 low as well as the critical .8578 February low. Violations here would confirm a deeper corrective phase. Alternately, strength back above the .9000/.9135 resistance levels would confirm a short term low suggesting another run at the medium term range highs. Note that the short term setup will remain bearish against these levels.
- For NZD/USD the past week's failure to sustain the breakout through the key .7200 resistance zone has reasserted the short term bearish setup, as well as the broader consolidation phase. The key test enters at the .6955 support area which includes the April low and the uptrendline from the February low. Breaks would confirm a deeper retracement into the .6850/.6807 lows. Note that the .7330 area will act as key resistance now defining a return to the short term rally phase. Also, as NZD has outperformned over the past several weeks, note that AUD/NZD is quickly approaching important support in the 1.24/1.23 area which can allow for some pause and retracement to the recent decline.

AUD/USD - Daily chart



Source: CQG, Inc. © 2010 All rights reserved worldwide. www.cqg.com Fri May 07 2010 15:19:30

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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	3.5	3.1	5.6	3.2	4.0	4.0	3.5	2.5	2.5	2.4	2.2	1.2	1.1
Canada	-2.6	3.5 ↑	2.9 ↓	5.0	5.8	3.3 ↑	3.2 ↓	3.5 ↓	3.0 ↓	2.0 ↓	1.6	1.3	1.8	2.1
Latin America	-2.9	4.9	3.8	7.2	4.8 ↓	4.6	3.3 ↑	4.5	4.0	4.9	5.9 ↑	6.4 ↑	7.3 ↑	7.0 ↑
Argentina	-2.0	4.5	3.0	7.9	8.0	8.0	3.0	3.0	2.0	3.0	7.5	8.0	10.0	10.0
Brazil	-0.2	7.0	4.0	8.4	8.7	6.3	4.8	4.0	3.8	4.2	4.9 ↑	5.3 ↑	5.8 ↑	4.5
Chile	-1.5	5.5	5.5	5.9	-6.0	8.0	22.0	18.0	-2.0	-6.0	0.2	3.3	4.1	3.8
Colombia	0.4	3.0	4.1	4.7	2.7	2.8	2.9	3.1	4.5	4.8	2.0	2.1	3.3 ↓	3.6 ↑
Ecuador	0.4	2.0	3.0	1.3	2.0	3.5	4.0	4.5	3.0	2.5	4.1	3.9	4.7	4.4
Mexico	-6.5	4.5	3.5	8.4	4.0 ↓	3.2	-1.8 ↑	4.2	5.7	7.9	4.6	4.4	5.1	4.5
Peru	0.9	6.0	6.0	11.5	4.1	4.3	4.6	5.0	6.3	7.2	0.6	1.0	2.0	2.2
Venezuela	-3.3	-1.5	2.5	-4.6	-4.0	-2.0	12.5	1.5	1.5	1.5	27.6	31.8	33.7	39.3
Asia/Pacific														
Japan	-5.2	3.2	2.2	3.8	5.0	2.5	2.7	2.7	2.2	2.0	-1.2	-1.4	-0.7	0.1
Australia	1.3	3.1	3.6	3.7	3.0	3.3	3.8	3.9	3.1	4.2	2.5	2.5	2.6	3.0
New Zealand	-1.6	2.8	2.5	3.3	3.2	3.2	3.7	2.9	1.3	2.3	2.2	2.3	2.5	2.8
Asia ex Japan	4.6	8.6	7.2	7.6	10.4	7.1	6.4	6.8	7.2	7.4	3.8	4.4	3.8	3.2
China	8.7	10.8	9.4	10.8	13.1	9.4	9.3	9.0	9.1	9.5	2.2	3.2	3.1	2.4
Hong Kong	-2.7	5.3	4.2	9.5	4.5	4.3	4.0	3.8	4.2	4.3	1.1	2.4	2.3	1.9
India	7.2	8.0	8.3	-2.0	10.4	8.1	7.0	8.7	7.9	7.8	12.7	11.9	6.2	5.5
Indonesia	4.5	6.2	5.8	9.6	6.0	6.0	4.0	5.0	6.5	6.5	4.4	5.3	6.3	4.9
Korea	0.2	5.8	4.1	0.7	7.5	4.0	4.5	3.8	4.0	4.0	2.7	2.8	3.4	3.6
Malaysia	-1.7	7.7	4.8	15.4	5.0	4.0	5.0	5.0	4.9	4.9	0.8	1.7	2.4	2.4
Philippines	0.9	4.5	4.3	3.5	6.0	5.0	3.5	4.0	4.5	4.5	4.3	5.0	5.2	4.9
Singapore	-2.0	9.0	4.0	-2.8	32.1	5.3	-9.6	4.9	6.6	6.6	0.9	3.4	4.7	3.7
Taiwan	-1.9	8.2	4.8	18.0	5.7	3.6	3.8	4.0	5.0	5.3	-0.3	0.9	2.0	1.8
Thailand	-2.3	7.3	6.6	15.3	5.7	5.3	3.6	3.6	8.0	8.0	4.0	5.5	4.4	3.0
Africa/Middle East														
Israel	0.7	3.0	4.5	4.8	3.5	3.5	3.0	3.0	4.0	5.0	3.5	2.7	2.7	3.1
South Africa	-1.8	3.0	3.5	3.2	3.9	4.2	4.0	4.0	3.6	2.8	5.6	4.6	5.4	5.7
Europe														
Euro area	-4.0	1.4 ↓	2.1	0.2	1.0 ↓	3.0	2.3	2.0	2.0	2.0	1.1	1.5 ↑	1.5 ↑	0.9 ↑
Germany	-4.9	1.5 ↓	2.1	0.0	0.5 ↓	3.0	2.0	2.0	2.0	2.0	0.8 ↓	1.0 ↑	1.2 ↓	0.9 ↓
France	-2.2	1.9 ↓	2.2	2.4	1.2 ↓	3.0	2.0	2.5	2.0	2.0	1.5 ↑	1.8 ↑	1.3 ↑	0.6 ↓
Italy	-5.1	1.2 ↑	1.7	-1.3	2.0 ↑	2.5	1.5	2.0	1.5	1.5	1.3	1.5 ↑	1.5 ↑	1.1
Norway	-1.4	2.0 ↓	2.8	1.3	1.6 ↓	3.0	3.0	3.0	2.8	2.8	2.9 ↓	3.0 ↓	1.6 ↓	0.7
Sweden	-5.1 ↓	1.9 ↑	3.1	-1.6 ↑	3.8 ↑	4.0 ↑	3.5	3.0	3.0	3.0	1.0 ↓	1.4 ↓	1.0 ↓	1.9
Switzerland	-1.5	2.5	2.8	3.0	2.5	2.8	3.0	3.0	2.8	2.8	1.1	1.0	0.9	0.8
United Kingdom	-4.9	1.4	3.2	1.8	0.8	3.0	3.0	3.5	3.0	3.0	3.3	2.9	1.9	1.5
Emerging Europe	-5.0	4.1	4.7	5.0	1.8	4.5	3.9	3.8	4.1	4.4	6.2	5.8	5.9	5.4
Bulgaria	-5.0	-1.5	4.5	...	...	...	...	...	...	...	...	...	...	...
Czech Republic	-4.2	2.0	4.0	3.0	2.5	2.5	2.0	2.0	3.5	4.5	0.6	1.2	2.8	2.8
Hungary	-6.3	0.5	4.0	-1.7	1.5	2.5	2.0	2.0	4.0	4.0	6.1	4.8	3.7	2.8
Poland	1.8	3.2	4.2	5.3	3.0	4.0	2.7	3.0	3.0	4.0	3.0	2.0	2.6	2.8
Romania	-7.1	1.5	4.0	...	...	...	...	...	...	...	4.9	4.5	4.5	4.5
Russia	-7.9	5.5	5.0	8.1	1.0	6.0	5.5	5.0	5.0	5.0	7.3	6.5	7.2	7.0
Turkey	-4.7	5.1	5.5	...	...	...	...	...	...	...	9.3	10.3	8.5	6.6
Global	-2.5	3.5	3.3 ↓	4.0	3.7 ↓	3.9	3.6 ↑	3.5	3.1	3.1	2.2	2.2 ↑	1.9 ↑	1.7
Developed markets	-3.4	2.7	2.7	3.2	2.7 ↓	3.3	3.2	2.9	2.4	2.3	1.5	1.4	1.1 ↑	1.0
Emerging markets	1.0	6.7	5.8	6.9	7.4	5.9	5.1 ↑	5.6	5.8	6.2	4.8	5.1 ↑	5.0 ↑	4.4
Memo:														
Global — PPP weighted	-0.8 ↓	4.7 ↑	4.4 ↑	4.9 ↑	5.2 ↑	4.8 ↑	4.4 ↑	4.4 ↑	4.2 ↑	4.2 ↑	3.1 ↑	3.3 ↑	2.9 ↑	2.6 ↑

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Global Central Bank Watch

	Official interest rate	Current	Change from Aug '07 (bp)	Last change	Next meeting	Forecast next change	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11
Global	GDP-weighted average	1.31	-335				1.35	1.45	1.53	1.67	1.99
excluding US	GDP-weighted average	1.87	-248				1.93	2.07	2.19	2.39	2.69
Developed	GDP-weighted average	0.52	-359				0.52	0.56	0.60	0.72	1.07
Emerging	GDP-weighted average	4.50	-237				4.67	5.00	5.22	5.44	5.67
Latin America	GDP-weighted average	5.99	-294				6.29	6.85	7.31	7.49	7.77
CEEMEA	GDP-weighted average	4.13	-273				4.16	4.40	4.48	4.67	5.11
EM Asia	GDP-weighted average	4.08	-202				4.26	4.54	4.72	4.97	5.09
The Americas	GDP-weighted average	0.78	-481				0.83	0.92	1.00	1.06	1.43
United States	Federal funds rate	0.125	-512.5	16 Dec 08 (-87.5bp)	23 Jun 10	2Q 11 (+25bp)	0.125	0.125	0.125	0.125	0.50
Canada	Overnight funding rate	0.25	-400	21 Apr 09 (-25bp)	2 Jun 10	2 Jun 10 (+25bp)	0.50	1.00	1.50	2.00	2.50
Brazil	SELIC overnight rate	9.50	-250	28 Apr 10 (+75bp)	9 Jun 10	**9 Jun 10 (+75bp)**	**10.25**	**11.50**	**12.50**	**12.50**	**12.50**
Mexico	Repo rate	4.50	-270	17 Jul 09 (-25bp)	21 May 10	Oct 10 (+25bp)	4.50	4.50	4.50	4.50	4.75
Chile	Discount rate	0.50	-450	9 Jul 09 (-25bp)	13 May 10	Jun 10 (+25bp)	0.75	1.50	2.25	3.75	5.00
Colombia	Repo rate	3.00	-600	**30 Apr 10 (-50bp)**	27 May 10	1Q 11 (+50bp)	3.00	3.00	3.00	4.00	5.00
Peru	Reference rate	1.50	-300	**6 May 10 (+25bp)**	10 Jun 10	**July 10 (+25bp)**	1.50	2.25	3.00	3.75	4.50
Europe/Africa	GDP-weighted average	1.28	-324				1.29	1.33	1.39	1.63	2.07
Euro area	Refi rate	1.00	-300	7 May 09 (-25bp)	10 Jun 10	1Q 11 (+25bp)	1.00	1.00	1.00	1.25	1.75
United Kingdom	Repo rate	0.50	-500	5 Mar 09 (-50bp)	10 May 10	Nov 10 (+25bp)	0.50	0.50	0.75	1.00	1.25
Sweden	Repo rate	0.25	-325	2 Jul 09 (-25bp)	Jul 10	1Q 11 (+25bp)	0.25	0.25	0.25	0.50	0.75
Norway	Deposit rate	2.00	-250	**5 May 10 (+25bp)**	23 Jun 10	**22 Sep 10 (+25bp)**	2.00	2.25	2.50	2.75	3.25
Czech Republic	2-week repo rate	0.75	-200	**6 May 10 (-25bp)**	23 Jun 10	**1Q 11 (+25bp)**	0.75	0.75	0.75	1.25	1.75
Hungary	2-week deposit rate	5.25	-250	26 Apr 10 (-25bp)	31 May 10	**23 Aug 10 (-25bp)**	5.25	5.00	5.00	5.00	5.00
Israel	Base rate	1.50	-250	28 Mar 10 (+25bp)	24 May 10	24 May 10 (+25bp)	2.00	2.25	2.75	3.25	3.75
Poland	7-day intervention rate	3.50	-100	24 Jun 09 (-25bp)	25 May 10	4Q 10 (+25bp)	3.50	3.50	3.75	4.00	4.50
Romania	Base rate	6.25	-75	**4 May 10 (-25bp)**	30 Jun 10	**30 Jun 10 (-25bp)**	6.00	5.50	5.50	6.00	6.50
Russia	1-week deposit rate	3.25	25	29 Apr 10 (-25bp)	May 10	May 10 (-25bp)	3.00	3.00	3.00	3.00	3.50
South Africa	Repo rate	6.50	-300	25 Mar 10 (-50bp)	13 May 10	1Q 11 (+50bp)	6.50	6.50	6.50	7.00	8.00
Switzerland	3-month Swiss Libor	0.25	-225	12 Mar 09 (-25bp)	Jun 10	Sep 10 (+25bp)	0.25	0.50	0.75	1.00	1.25
Turkey	Overnight borrowing rate	6.50	-1100	19 Nov 09 (-25bp)	17 Jun 10	17 Jun 10 (+50bp)	7.00	8.50	8.50	8.50	8.50
Asia/Pacific	GDP-weighted average	2.17	-127				2.25	2.41	2.51	2.65	2.72
Australia	Cash rate	4.50	-175	**4 May 10 (+25bp)**	1 Jun 10	**Jul 10 (+25bp)**	4.50	5.00	5.25	5.50	5.75
New Zealand	Cash rate	2.50	-550	30 Apr 09 (-50bp)	10 Jun 10	29 Jul 10 (+25bp)	2.50	3.00	3.50	4.00	4.25
Japan	Overnight call rate	0.10	-43	19 Dec 08 (-20bp)	21 May 10	4Q 11 (+15bp)	0.10	0.10	0.10	0.10	0.10
Hong Kong	Discount window base	0.50	-625	17 Dec 08 (-100bp)	24 Jun 10	2Q 11 (+25bp)	0.50	0.50	0.50	0.50	1.00
China	1-year working capital	5.31	-126	22 Dec 08 (-27bp)	2Q 10	2Q 10 (+27bp)	5.58	5.85	6.12	6.39	6.39
Korea	Base rate	2.00	-250	12 Feb 09 (-50bp)	12 May 10	3Q 10 (+25bp)	2.00	2.25	2.50	2.75	3.00
Indonesia	BI rate	6.50	-200	5 Aug 09 (-25bp)	4 Jun 10	4Q 11 (-25bp)	6.50	6.50	6.50	6.50	6.50
India	Repo rate	5.25	-250	20 Apr 10 (+25bp)	27 Jul 10	2Q 10 (+25)	5.50	6.00	6.00	6.50	6.75
Malaysia	Overnight policy rate	2.25	-125	4 Mar 10 (+25bp)	13 May 10	13 May 10 (+25bp)	2.50	3.00	3.00	3.00	3.00
Philippines	Reverse repo rate	4.00	-350	9 Jul 09 (-25bp)	3 Jun 10	3 Jun 10 (+25bp)	4.25	4.75	5.00	5.00	5.00
Thailand	1-day repo rate	1.25	-200	8 Apr 09 (-25bp)	2 Jun 10	2 Jun 10 (+25bp)	1.50	1.75	1.75	1.75	1.75
Taiwan	Official discount rate	1.25	-188	18 Feb 09 (-25bp)	2Q 10	3Q 10 (+25bp)	1.25	1.50	1.75	2.00	2.25

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

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Economic forecasts - Australia

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

				2009			2010				2011			
	2009	2010	2011	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Chain volume GDP	1.3	3.1	3.6	2.9	1.1	3.7	3.0	3.3	3.8	3.9	3.1	4.2	4.2	1.8
Private consumption	2.2	1.7	2.1	3.5	3.0	2.6	1.2	0.8	0.4	1.2	3.2	2.8	2.4	2.0
Construction investment	-0.3	2.9	4.6	-2.8	3.4	1.7	3.6	3.4	4.5	3.5	4.3	5.1	6.0	6.2
Equipment investment	-3.4	22.1	9.3	4.3	-11.0	51.2	32.6	22.5	13.0	17.6	5.1	3.4	6.4	8.6
Public investment	3.8	21.3	10.7	18.3	28.3	47.7	17.0	9.5	15.1	11.2	7.4	14.0	7.4	11.8
Government consumption	2.9	3.7	1.7	3.6	5.7	7.2	3.9	0.1	3.9	0.1	0.1	3.8	3.8	0.4
Exports of goods & services	0.5	3.7	4.6	3.3	-9.1	7.0	6.6	4.9	3.2	7.4	4.1	4.1	4.1	4.1
Imports of goods & services	-7.7	11.6	4.1	3.0	18.5	34.6	8.2	4.1	2.0	4.1	4.1	4.1	2.0	12.6
Contributions to GDP growth:														
Inventories	-0.5	-1.9	-0.1	1.1	2.6	0.4	-8.9	-0.2	-0.1	-0.1	-0.2	0.0	-0.3	-0.1
Net trade	1.8	-1.7	0.0	0.1	-5.2	-4.9	-0.5	0.1	0.2	0.5	-0.1	-0.1	0.3	-1.8
GDP deflator (%oya)	0.4	1.8	2.4	0.3	-2.0	-1.4	0.1	2.9	2.4	2.0	2.2	2.4	2.5	2.5
Consumer prices (%oya)	1.8	2.5	2.8	1.5	1.3	2.1	2.5	2.5	2.4	2.6	2.7	3.0	2.8	2.6
Producer prices (%oya)	-5.4	-1.4	3.5	-6.4	-7.2	-6.8	-3.1	-1.6	-1.9	1.0	2.5	3.5	4.0	4.0
Trade balance (A$ bil, sa)	-6.7	-23.4	-23.3	-0.9	-4.3	-5.7	-6.0	-6.0	-5.9	-5.6	-5.6	-5.7	-5.5	-6.6
Current account (A$ bil, sa)	-67.0	-72.1	-74.6	-13.1	-14.7	-17.5	-18.0	-18.1	-18.1	-17.9	-18.1	-18.4	-18.3	-19.9
as % of GDP	-6.2	-5.4	-5.3	-4.2	-4.7	-5.4	-5.5	-5.5	-5.4	-5.3	-5.3	-5.3	-5.2	-5.6
3m eurodeposit rate (%)*	6.0	4.8	5.5	3.5	3.4	4.1	4.3	4.8	5.0	5.3	5.5	5.5	5.5	5.5
10-year bond yield (%)*	5.6	5.8	5.9	5.5	5.1	5.8	5.7	5.8	5.8	5.9	5.9	5.9	5.9	6.0
US$/A$*	0.75	0.96	0.92	0.82	0.88	0.91	0.94	0.95	0.99	0.97	0.95	0.92	0.91	0.90
Commonwealth budget (FY, A$ bil)	-27.0	-42.0	-27.0											
as % of GDP	-2.1	-3.2	-1.9											
Unemployment rate	5.6	5.4	5.3	5.7	5.7	5.6	5.3	5.4	5.5	5.5	5.4	5.3	5.2	5.0
Industrial production	-7.8	3.3	1.5	5.2	-5.5	21.8	1.0	0.0	-1.0	-2.0	0.0	1.0	2.0	3.0

*All financial variables are period averages

Australia - summary of main macro views

- The Australian **economy** powered out of the global downturn largely unscathed. Growth probably will be close to trend in 2010, but above trend in 2011, despite the further withdrawal of policy support.
- **Business investment** will be broadly unchanged at high levels in the year to June now that firms have upgraded spending plans. Investment probably will rise close to 20% in 2010-11, with mining leading the way.
- On **housing**, with the expanded first home owners' grant now having expired and price caps on the basic grant in place, house price growth should cool, particularly at the low and middle-end of the price spectrum.
- The plucky **consumer** has been resilient in the absence of further fiscal support from the government. Consumer confidence quickly returned to pre-crisis highs, but has eased in recent months in the wake of the RBA's rate hikes. Retail sales plunged in February and were soft in March too.
- **Export volumes** have held up owing mainly to firm demand from China, but the terms of trade tumbled.This decline is reversing, though, 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. The hikes have been driven partly by recent developments in the terms of trade and house prices.
- Having front-loaded the **policy support**, the government is winding back the fiscal stimulus, albeit slowly. Government officials say they will not use the Budget to buy votes; we shall see.

Economic forecasts - New Zealand

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

				2009			2010				2011			
	2009	2010	2011	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (1995-96 prices)	-1.6	2.8	2.5	0.6	1.1	3.3	3.2	3.2	3.7	2.9	1.3	2.3	2.7	3.8
Private consumption	-0.6	2.4	1.6	1.6	3.5	3.4	2.5	1.5	1.1	2.0	1.0	1.5	2.0	3.5
Fixed Investment	-13.5	-1.0	4.6	-1.6	-6.2	-3.5	-5.4	5.3	5.5	5.7	2.2	4.1	6.0	7.3
Residential construction	-18.7	4.6	4.7	-9.3	-15.3	21.1	8.0	4.0	4.8	6.0	3.2	4.8	6.0	4.0
Other fixed investment	-12.4	-2.1	4.6	0.0	-4	-7.6	-8.0	5.6	5.6	5.6	2.0	4.0	6.0	8.0
Inventory change (NZ$ bil, saar)	-1.7	0.8	0.4	-1.0	-0.7	0.2	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Government spending	1.5	2.2	1.7	-5.0	2.4	3.6	3.2	2.4	1.6	2.4	0.9	3.2	0.8	0.2
Exports of goods & services	0.0	7.2	9.0	19.8	0.7	-3.4	10.0	12.0	11.0	10.0	8.0	7.0	10.0	8.0
Imports of goods & services	-15.2	8.5	7.1	-10.3	6.2	26.4	5.0	8.0	5.0	8.0	5.0	8.0	9.0	9.0
Contributions to GDP growth:														
Domestic final sales	-5.0	1.4	2.3	0.6	-0.4	1.7	0.8	2.5	2.1	3.0	1.2	2.5	2.7	3.8
Inventories	-2.5	1.9	-0.3	-9.0	3.3	11.1	0.9	-0.4	-0.2	-0.6	-0.8	0.2	-0.2	0.5
Net trade	5.9	-0.5	0.5	9.7	-1.7	-8.8	1.4	1.0	1.8	0.5	0.9	-0.4	0.2	-0.4
GDP deflator (%oya)	1.9	1.3	2.2	2.0	2.7	0.1	-0.2	1.0	1.8	2.8	2.8	2.4	1.9	1.6
Consumer prices	2.1	2.5	3.0	2.3	5.3	-0.7	2.2	2.7	2.1	2.9	3.3	2.9	3.2	3.6
%oya	2.1	2.2	3.0	1.9	1.7	2.0	2.2	2.3	1.6	2.5	2.7	2.8	3.1	3.2
Trade balance (NZ$ bil, sa)	2.5	-2.2	-4.2	0.8	0.6	0.2	-0.5	-0.5	-0.6	-0.7	-0.8	-1.0	-1.1	-1.3
Current account (NZ$ bil, sa)	-5.6	-12.1	-14.2	-0.4	0.0	-3.1	-1.2	-2.8	-4.1	-3.0	-2.2	-5.2	-3.0	-2.9
as % of GDP	-3.1	-6.5	-7.2	-0.9	0.1	-6.9	-6.2	-8.9	-6.3	-4.6	-6.1	-5.9	-8.1	-8.8
Yield on 90-day bank bill (%)*	3.0	3.1	4.4	2.8	2.8	2.8	2.7	2.8	3.3	3.8	4.3	4.4	4.5	4.5
10-year bond yield (%)*	5.5	5.9	6.1	5.7	5.7	5.9	5.7	6.0	6.0	6.1	6.1	6.1	6.0	6.0
US$/NZ$*	0.64	0.75	0.70	0.60	0.68	0.73	0.73	0.76	0.75	0.74	0.72	0.70	0.70	0.68
Commonwealth budget (NZ$ bil)	-4.0	-7.2	-7.1											
as % of GDP	-2.2	-3.8	-3.6											
Unemployment rate	6.2	7.0	6.0	6.0	6.5	7.3	7.3	7.1	6.9	6.6	6.4	6.2	6.0	5.5

*All financial variables are period averages

New Zealand - summary of main macro views

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

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Australia and New Zealand economic calendar

Monday	Tuesday	Wednesday	Thursday	Friday
10 May Australia: ANZ job ads (11:30 am) Apr New Zealand: QVNZ house prices Apr	11 May Australia: NAB bus. Confidence (11: 30 am) Apr 13 % bal, sa	12 May Australia: Housing finance approvals (11:30 am) Mar	13 May Australia: Unemployment rate (11: 30 am) Apr New Zealand: Business NZ PMI (10:30 pm) Apr	14 May New Zealand: Retail sales (10:45 am) Mar
17 May	18 May New Zealand: PPI (10:45 am) 1Q	19 May Australia: Westpac consumer confidence (10: 30 am) May	20 May	21 May New Zealand: Visitor arrivals (10:45 am) Apr Credit card spending (2:00 pm) Apr
24 May Australia: New motor vehicle sales (11: 30 am) Apr	25 May	26 May Australia: Westpac leading index (10: 30 am) Mar Construction work done (11:30 am) 1Q	27 May Australia: Private capital expenditure (11:30 am) 1Q New Zealand: Trade balance (10:45 am) Apr	28 May New Zealand: Building permits (10:45 am) Apr
31 May Australia: Pvt. Sector credit (11:30 am) Apr Current account balance (11:30 am) 1Q Company operating profits (1:30am) 1Q	1 Jun Australia: Building approvals (11:30 am) Apr Retail sales (11:30am) Apr RBA cash target (2:30 pm) Jun	2 Jun Australia: GDP (11:30 am) 1Q New Zealand: ANZ commodity price (2:00 pm) May	3 Jun Australia: Trade balance (11:30 am) Apr	4 Jun

Global Data Diary

Week / Weekend	Monday	Tuesday	Wednesday	Thursday	Friday
10 - 14 May	10 May	11 May	12 May	13 May	14 May
China • Money supply (Apr) Japan • Cabinet Office private consumption index (Mar) Russia • GDP (1Q)	France • IP (Mar) Germany • Foreign trade (Mar) Indonesia • GDP (1Q) Italy • IP (Mar) Japan • BoJ MPM minutes (Apr) Turkey • IP (Mar) United Kingdom • MPC mtg: No chg	China • CPI, FAI, retail sales, IP (Apr) Germany • CPI final (Apr) United Kingdom • Retail sales (Apr) • IP (Mar) United States • JOLTS (Mar)	Brazil: Retail sales (Mar) Euro area • IP (Mar)) India: IP (Mar) Korea: BoK mtg: No Chg Mexico: IP (Mar) United Kingdom • Labor mkt rpt (Mar) • BoE qtrly inflation rpt United States • International trade (Mar) • Federal budget (Apr) GDP: • Euro area, France, Germany, Italy, Spain (1Q)	Chile • BCCh mtg: No chg Japan • Econ Watcher surv (Apr) Malaysia • BNM mtg: +25bp South Africa • MPC mtg: No chg United Kingdom • Trade balance (Mar) United States • Bernanke speech	Hong Kong • GDP (1Q) United States • Retail sales (Apr) • IP (Apr) • Consumer sent (May) • Bus inventories (Mar)
17 - 21 May	17 May	18 May	19 May	20 May	21 May
Venezuela • GDP (1Q)	United States • Empire State surv (May) • NAHB surv (May)	Euro area • HICP final (Apr) • Foreign trade (Mar) Germany • ZEW bus surv (May) Japan • Reuters Tankan (May) Turkey • CBRT mtg: No chg United Kindgom • CPI (Apr) United States • Housing starts (Apr)	Spain • GDP final (1Q) United States • CPI (Apr)	Japan • GDP 1st est (1Q) • BoJ MPM mtg Mexico • Real GDP (1Q) Norway • GDP (1Q) Poland • IP (Apr) United Kingdom • Retail sales (Apr) United States • Philly Fed surv (May)	Argentina: IP (Apr) Canada • Retail sales (Mar) Euro area • PMI flash (May) Germany • GDP final (1Q) • PMI flash (May) • IFO bus surv (Mar) Japan • BoJ MPM mtg: No chg • Shirakawa prss conf Mexico • Banxico mtg: No chg

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