Fixed Income: Weekly Strategy

5 December 2011

Collecting on our insurance as European sentiment improves

- Sentiment in Europe has been improving and peripheral bond yields are falling.
- Australian bond yields remain low. We take profit on our risk reversal options trade.
- Because of new ACGB issuance and RBA easing, the Australian ultra-long end is quite steep.

Australian Bond markets have been selling-off over the last week as the sentiment about Europe has improved. Australian 3Y bonds have sold off 20bp in the week and the 10Y bond yields are up 10bp. This has flattened the curve to 74.5bp.

US markets were mixed. 10Y bonds sold-off by 7bp, but the 2Y rate rallied by 2bp. In Europe, sentiment towards sovereign bonds improved. Peripheral yields are falling (though still elevated) and the Bunds have been rallying.

The main driver of international markets continues to be the European political gyrations. There is an important leaders meeting scheduled for Friday and many more smaller meetings in the lead-up. Angela Merkel and Nicholas Sarkozy have been speaking publically about the need for greater fiscal unity. This is generally being interpreted as some form of oversight of European Sovereign Governments' fiscal plans. The line of reasoning suggests that once fiscal discipline is locked in it becomes easier to convince potential "saviours" to invest money in bonds.

The improving sentiment has convinced us to take profit on our 3Y risk reversal trade. Now that bond yields are lower but sentiment is improving the risk reversal trade is less attractive. Philip Brown explains in full on page 3.

Alex Stanley examines the recent behaviour of the Australian ultra-long end in his article on page 5.

Locally, the RBA meeting tomorrow (Tuesday) and the GDP data on Wednesday are both potentially market moving. The broader market expects the RBA to cut rates, but economists are less convinced with many (including CBA's) suggesting the RBA will leave rates unchanged. Quarterly GDP is expected to put in another strong performance as the coal production comes back online and the capex boom continues. Both the market consensus and CBA are looking for 1.2% Q/Q at the moment, though our economists note that today's reduction in inventories adds some downside risk to the GDP number.

The US data flow is light this week. The highlights are early Saturday morning (Sydney time), when the trade balance and University of Michigan confidence data will both be released.

The European political meetings are likely to be the most important events of the week. Sarkozy and Merkel meet tonight ahead of the ECB on Thursday and a larger EU meeting of Friday night. The timing of political announcements is less predictable than economic data releases, though. The tone of the lead-up statements might be just as important as the final communiqués.

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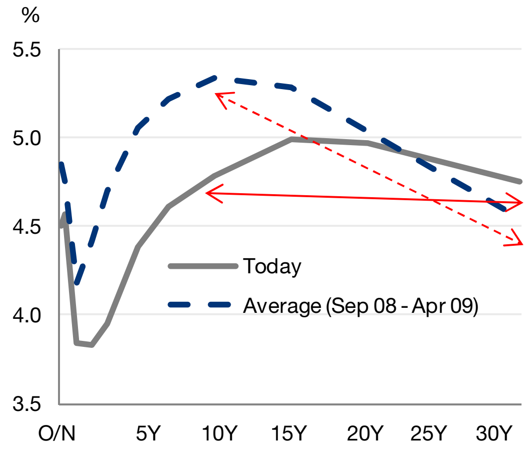
Current Swap curve versus average curve through the last easing cycle



Source: CBA, Bloomberg

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Key Positions

This week has been fairly good for our recommended trades. The improvement in the KFW credit spread has moved our KFW vs QTC trade from loss-making to profit-making,

We take profit on the risk reversal options trade because sentiment is improving and the trade now has significant negative carry.

Key Trades

Trade	Entry	Curent	Profit	Target	Stop	Comment
Buy the NAB Apr-13 as an ASW against selling the NAB Apr-13 FRN	+11bp (3-Aug-11)	+16	-5bp	0bp	17bp	**Hold:** There is little reason for the ASW fixed rate to be different to the FRN price.
Pay 5Y ZCS against receiving BEI on the Aug-15 bond	+14bp (22-Aug-11)	+36bp	+22bp	+70bp	-5bp	**Hold:** An insurance trade, if the market keeps rallying, the spread should widen. It is currently mid-range
Implement a 1Y forward 2Y/10Y AUD swap steepener	85bp (5-Oct-11)	96bp	+11bp	120bp	70bp	**Hold:** The RBA's easing bias should keep steepening the curve.
Buy the Westpac May-16 against the Nov-16 at a spread of 6bp (May-16 lower in yield)	6bp (17-Oct-11)	12bp	+6bp	20bp	-2bp	**Hold:** On an RV basis the Westpac May-16 looks far too cheap.
Buy a 6M*3Y a risk reversal on the Oct-14, profiting from a rally. (Buy 6M*3Y call at 3.41, sell put at 3.81)	0bp premium (7-Nov-11)	Yield = 3.27	34bp			**Take Profit:** Any shift in sentiment is likely to flatten this curve again.
Receive 1Y ZCS	2.84% (10-Nov-11)	2.70%	+14bp	2.40	3.00	**Hold:** The combination of substitution bias and the falls in fruit prices should see ZCS fall (We apologise, this trade was recommended in the Inflation Monthly of 11 Nov, but overlooked in this summary) .
Sell the SAFA May-21 Versus the QTC Jun-21	11bp (16-Nov-11)	11bp	0bp	0bp	22bp	**Hold:** We expect spreads to equalise given SA seems likely to lose its AAA rating. Wider stop implemented due to illiquidity in market.
Buy the IBRD Oct-20 against NSWTC May-20	28bp (16-Nov-11)	30bp	-2bp	18bp	34bp	**Hold:** The IBRD has room to tighten against NSWTC.
Buy the TCV Jun-20 NSWTC May-20	0.5bp (16-Nov-11)	0bp	-0.5bp	10bp	-5bp	**Hold:** TCV's AAA is safe and the funding task is modest. NSW is subject to some rating risk.
Pay the AUD versus NZD 2/10Y swap box (AUD 2/10Y steepener versus NZD 2/10Y flattener, quoted as AUD slope less NZD slope)	-56bp (23-Nov-11)	-56bp	0bp	-20bp	-70bp	**Hold:** The Aussie curve should remain steep, while the NZ curve should flatten.
Buy the QTC GG Oct-15 against ACGB Oct-15	76bp (23-Nov-11)	+76bp	0bp	30bp	100bp	**Hold:** The QTC GG spread has reached an attractive level for the underlying credit risk
Buy KFW Aug-20 against QTC Feb-20	+57bp (23-Nov-11)	+51bp	+6bp	25bp	75bp	**Hold:** KFW's AUD pricing is out of alignment with EUR pricing.

Collecting on our insurance as European sentiment improves

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- We are taking 34bp profit on the risk reversal we established on November 7.
- The balance of risks no longer looks as biased towards a rally. Sentiment in Europe is improving.
- The trade now has negative carry because the option is in the money.

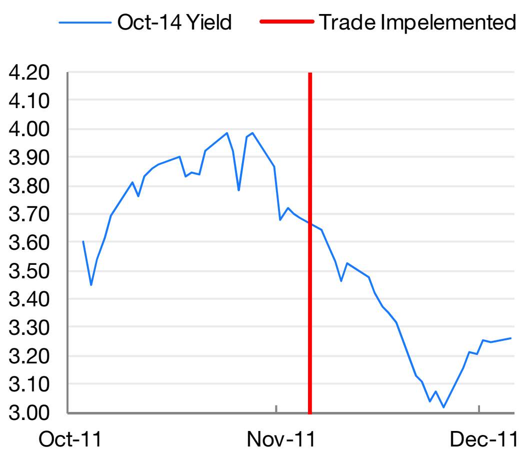
On November 7 we recommended buying a "risk reversal" on AUD rates via the Oct-14 bond. This trade was designed as insurance to protect us against the possibility of a major rally. (See *Weekly Strategy* of November 7 2011.) Our risk reversal bought a bond call option and balanced the exposure with a bond put. We would now exit that position for a profit of 34bp.

We exit our risk reversal on the Oct-14

We noted in November that the possibility for a major calamity in Europe remained and that the risks were tilted in favour of a rally. There has been a sizeable rally since November 7, though this has reversed slightly in recent days. (See Figure 1.) Our risk reversal was designed to capture the rally with an out-of-the-money call on the Oct-14 bond.

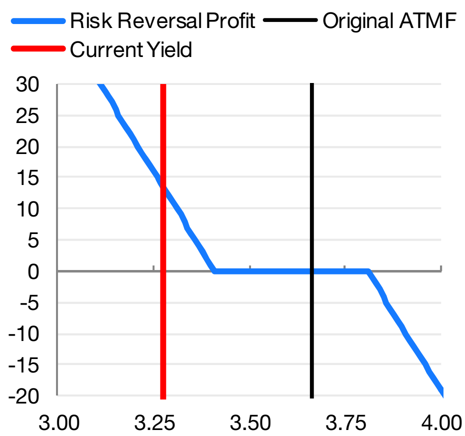
The balance of risks has now changed. The situation in Europe appears to be improving and Australian yields remain exceptionally low by historical standards. We no longer see the central risk in Australian rates as being heavily tilted towards a rally. Also, the change in yield has altered the character of our trade and created negative carry. As such, we take profit on the risk reversal now.

Figure 1: Oct-14 yields



Source: CBA, Bloomberg

Figure 2: Payoff Structure at expiry



Source: CBA

Rates have fallen, but may have bottomed

Rates are much lower…

Figure 1 shows how the Oct-14 bond yield has behaved over the last two months. After falling very sharply, the bond yield has crept up in recent weeks. We no longer look for a major rally from these new, lower, levels. The lowest yield on the Oct-14 bond ever recorded was 3.02% on 25 November. Since then the bond has sold-off slightly, back up to 3.26%. However, that is still well below the yield of 3.66% that prevailed when we recommended the trade.

…and may have bottomed out.

There is a reasonable chance that the Australian 3Y bond yield will have bottomed. The lowest ever closing yield on the 3Y bond futures is 2.88%, not that far below current levels.

Although the situation in Europe remains serious, the prevailing yields are so low that the bond yield could easily rise even with a fairly poor outcome in Europe, particularly if the RBA doesn't cut rates tomorrow (as our economists forecast).

The challenges are extreme, but a short-term reprieve for markets seems possible

We remain highly dubious that a lasting solution for Europe's problems is possible without further major market disruptions. However, sentiment is improving as Europe's leaders, particularly Merkel and Sarkozy, work towards a solution to be unveiled on Friday or the weekend. The market seems to feel hopeful and risk exposures have been increasing in recent days. Australian yields have risen (slightly) and the AUD is back above parity with the USD.

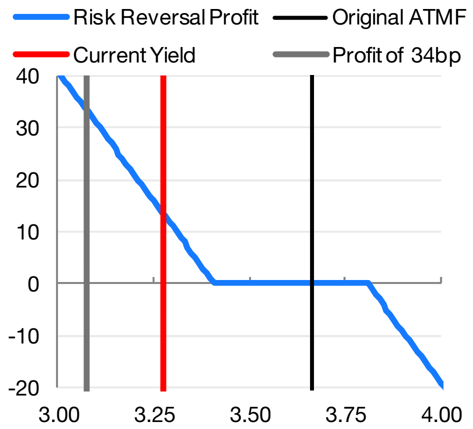
The improving sentiment means that the risk of a major rally has lessened.

A change in yields means time is now of the essence

Figure 2 shows the payoff diagram of the risk reversal we implemented. The current yield would suggest a profit of 15bp. However, because there is significant value remaining in the options the profit is 34bp. This is good, but it creates a type of negative carry.

The trade was done with bond options and, as the yield of the bond changes, the character of a bond option structure changes. We originally set a risk reversal by buying a call and selling a put that were both approximately equidistant from the prevailing yield. The prevailing yield was 3.66%, the two options were at 3.41% and 3.81%.

Figure 3: Move necessary to gain 34bp



Source: CBA

The two options were, originally, the same price and so the structure was zero cost. Originally, the structure was balanced and the passing of time neither made nor lost money for the trade (in bond terms "zero carry"; in options terms, "zero theta").

Now the bond yields have fallen substantially and the options are no longer balanced. The call is 15bp in-the-money. The put is 54bp out-of-the-money. This is unbalanced and has changed the character of the structure. As things stand, the call is much more valuable than the put. In essence, our risk reversal is now more like being long a call with no hedge.

Our trade is in the money

This has two important implications. First, it's why the price to exit the structure today is 34bp, not the 15bp that the trade is in-the-money. Our original risk reversal is now much more like a straight call and so we also have some of the time-value of the call.

Second, the unbalanced nature also means the trade now has significantly negative carry (A.K.A. negative theta). As figure 3 shows, the time value of the option is now a significant proportion of the total profit. To give a 34bp profit the bond would need to expire with a yield of 3.07%, well below the current levels.

But now has negative carry

We are exiting the risk reversal for two reasons. First, it no longer seems as likely that the balance of risks favours a rally. Second, because of its success, the trade now has negative carry. Approaching the Christmas period we like to reduce our risk exposure and this trade, with a negative carry, is not one we want to hold over Christmas.

Even if you believed that risks were tilted to a rally, there are cheaper ways to position for it now. If you believed the rally would continue, you should still exit our risk reversal – and replace it with a new risk reversal set at current levels. A new risk reversal would have similar exposure to rates, but would not have the same negative carry.

Explaining the steepness at the long end of the swap curve

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- The Aussie swap curve beyond 10Y is steep by historical standards.
- The new 15Y bond has been an important driver of that steepening, but this impact is unlikely to be sustained.
- The Aussie dollar and the US curve have had varying effects on the long end swap curve.

The very long end of the Aussie swap curve is steep

The European crisis and the RBA's shift to an easing stance on policy have driven a rally across the whole Aussie swap curve in 2011. However, as Figures 1 and 2 illustrate, the very long end of the curve has underperformed and the curve has steepened.

Curve steepening out to ten years is to be expected during a period of crisis as the market prices aggressive easing from the RBA. In this regard, the current shape of the swap curve is reasonably consistent with the late 2008 to early 2009 period.

The curve steepness stands out compared with the 2008-09 period.

However, the current shape of the curve beyond 10Y has behaved differently from the 2008-09 period. As Figures 2 and 3 illustrate, the 10-20Y and 10-30Y slopes initially inverted sharply from late 2008 to early 2009 before steepening.

Lately, we haven't observed the same sharp movements in ultra-long end slopes. Through the latest rally in Aussie rates, the curve has steepened consistently across the entire curve.

We examine why this steepening has occurred. We find that structural changes in the market have contributed to a consistently steeper swap curve at the long end than was the case during the last period of heightened market volatility and aggressive RBA easing. The main structural factors are: a lengthening of the bond curve, a shift to non-standard monetary policy by the Fed and a structural appreciation of the Aussie dollar.

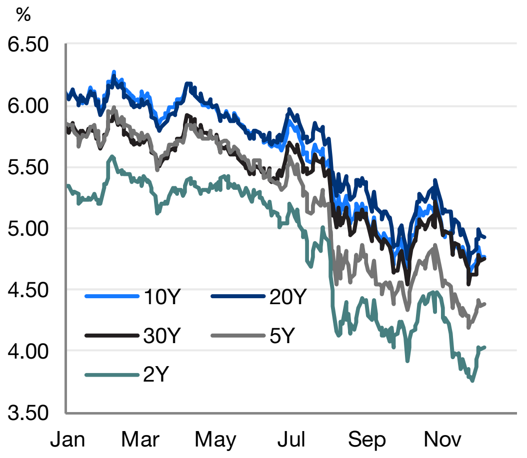
We see some scope for flattening at the long end of the curve, mostly because the steepening effect of the new long bond issue on the curve is unlikely to be sustained.

A longer bond curve makes for a steeper swap curve, but can it continue?

The ACGB curve is now longer.

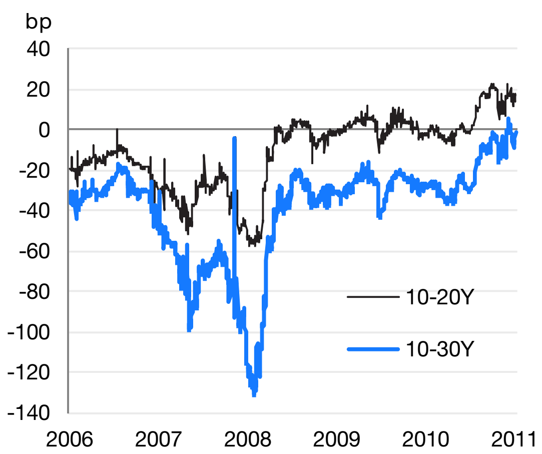
Recently, new ACGB issuance has contributed to a steeper long end of the swap curve. In late October, the AOFM issued $3.3bn of a new Apr-27 nominal bond - extending the ACGB curve from 11 to 15 years. At the time, the AOFM said that new issuance of the 15Y won't be forthcoming until early 2012, leaving just the initial tender amount in the market. Because the

Figure 1 – Aussie swap rates near 2011 lows



Source: CBA, Bloomberg

Figure 2 – The long end is steep compared with past crisis periods



Source: CBA, Bloomberg

Apr-27 is a new line and extends the bond curve, it's not clear whether the initial pay-side impact on swap is sustainable.

As we noted in the lead up to the issue of the Apr-27 (*Weekly Strategy,* Oct-11), the 15Y has tended to be the peak rate across the swap curve. Thereafter, the curve has tended to invert. An important driver of this inversion is the lack of available bonds for investors seeking very long duration in the Australian fixed income market. After all, before the Apr-27 bond hit the street, high grade nominal investment options were slim beyond the 10-12 year part of the curve. The exception was the $1.3bn of TCV Nov-26 bond.

The new bond takes some receiving pressure off long end swaps.

To an extent, long duration investors may be able to substitute between bonds and swap. Therefore, as we noted at the time of the Apr-27 issue, there is now less receiving pressure on long end swaps than would be the case if the curve was shorter. This drop-off in receive-side pressure may be a key reason why the 10-30Y part of the curve has lagged in the November rally. Indeed, much of the move came in anticipation of the new supply in October. The 10-20Y and 10-30Y curves steepened 8bp immediately following the announcement of the new bond on October 7 (Figure 4).

It is, however, worth considering the sustainability of this source of curve steepening. The AOFM announced in October that there will be no new issuance of the Apr-27 bond until February 2012. Thereafter, we don't see a clear reason for supply of the 15Y to be built-up rapidly. Semis may, at some point, be interested in lengthening the duration of their curves, now that there's a longer ACGB curve. However, spreads for semis have been volatile and liquidity has been challenging in recent weeks. It's hardly the best environment to be extending the duration of borrowing for significant volumes.

Steepening pressure from issuance is unlikely to be sustained.

On balance, we think the long end of the swap curve will struggle to steepen much more purely because of issuance, in the short term.

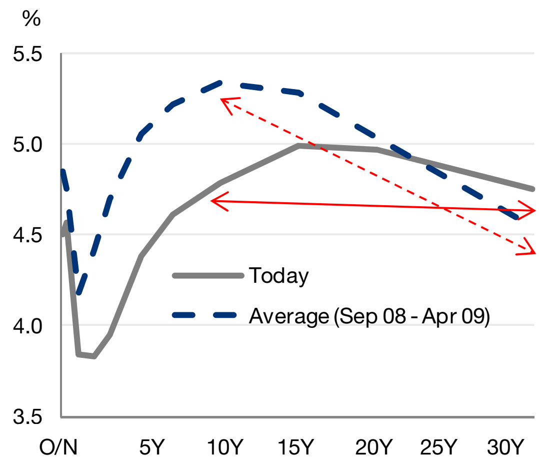
Non-standard Fed policy has distorted the relationship between the Australian and US curves even further

Figure 5 illustrates that the shape of the ultra long end of the Aussie curve hasn't been strongly correlated with the US ultra-long end over a long period of time. The divergence between the two curves' behaviours has been particularly strong in recent years.

The Aussie curve has disconnected further from the US curve at the very long end,

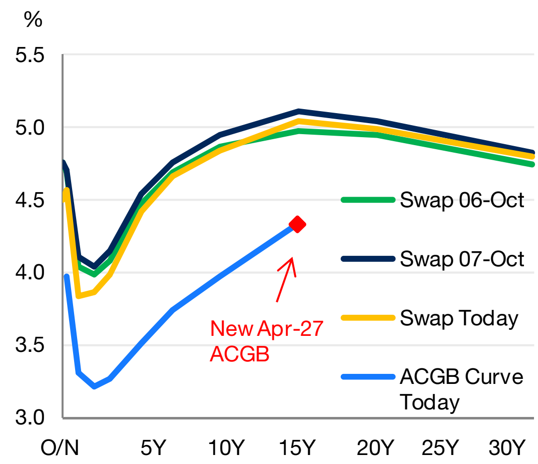
The Aussie market followed the steepening trend in the US from early 2009 until QE2 in late 2010. As Figure 5 illustrates, the relationship between the two curves became especially

Figure 3 – Current Swap curve versus average curve through the last easing cycle



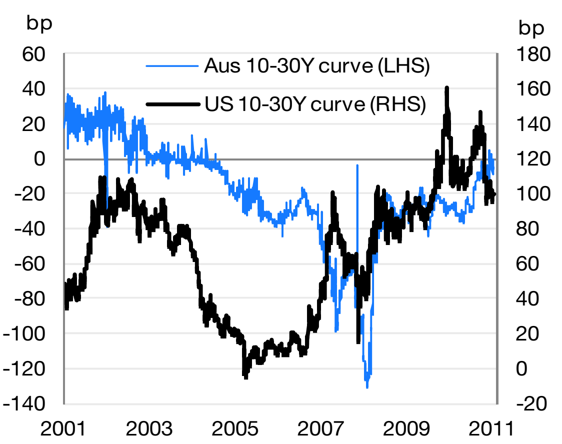
Source: CBA, Bloomberg

Figure 4 – Swap and ACGB curve



Source: CBA, Bloomberg

Figure 5 – Aussie swap versus long end US Treasury curve



Source: CBA, Bloomberg

disparate after the second round of QE. In late 2010, inflation fears steepened the US 10-30Y curve. However, as the US economic recovery faltered through 2011, these inflation fears dissipated. The Fed's decision to lengthen the duration of their portfolio has subsequently flattened the US 10/30Y curve since September.

The Aussie curve hasn't followed either of these sharp moves in the US 10-30Y curve over the last year. If the Fed eases policy further in the next year, we'd expect this disconnect at the long end of the curve to remain. But, recent economic data in the US is more encouraging, so we don't think the Fed is in a hurry to further lengthen the duration of their Treasury holdings. Therefore we see some prospect for the Aussie and US 10-30Y curves to correlate more strongly. However, we think idiosyncratic factors have a bigger role to play in the Aussie 10-30Y curve at present.

The Aussie dollar has taken a smaller escalator down recently

As we've pointed out before (for example, *Weekly Strategy* 17 October), a sharp fall in the AUD can lead to a pick-up in receiving flows at the long end of the swap curve, from structured currency-linked note hedgers.

The Aussie dollar hasn't been driven as much flattening of late.

As Figures 6 and 7 illustrate, the Aussie dollar has generally being in an upward trend since reaching a low point in the last crisis. Also, currency volatility, while elevated, is under previous peaks (Figure 9).

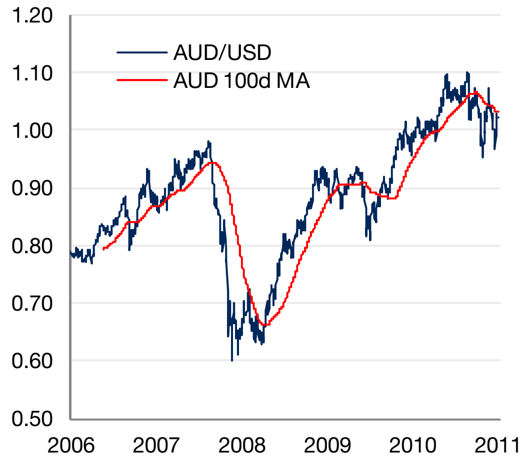
In turn, the recent receiving pressure in the swap market from structured note hedgers is less pronounced now than it was in 2008/09.

Through November, the Aussie dollar dipped below parity following the risk-off trend in markets everywhere, before rallying back above parity over the last week. This most recent dip in the AUD below parity was comparatively modest and smaller than the September fall in the AUD. Structured note hedgers probably played a part in the flattening of the 10/20Y and 10/30Y curves in September. However, the long end of the swap curve steepened through November, suggesting that structured note hedging has been less prevalent over the last month.

Looking ahead, our Currency Strategists expect the Aussie dollar to remain steady in the short term, finishing 2011 around USD 1.03. They then expect the AUD to fall towards USD 0.95 by mid 2012. They see slower global growth, further rate RBA rate cuts and a stronger USD as the main drivers of a lower AUD.

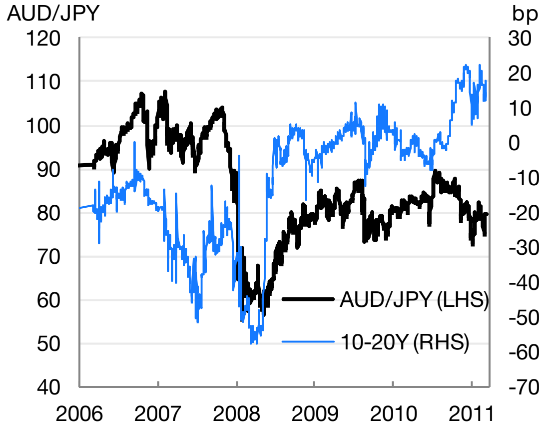
Our AUD forecast also takes into account some

Figure 6 – The Aussie dollar is much higher than in the last easing cycle



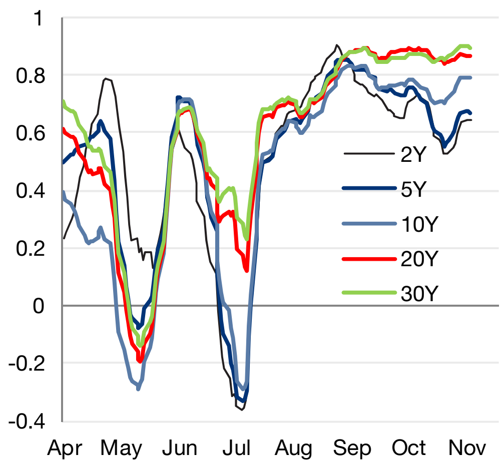
Source: CBA, Bloomberg

Figure 7 – AUD/JPY and the 10/20Y swap curve



Source: CBA, Bloomberg

Figure 8 – Swap rates and AUD/USD – rolling 100d correlation



Downside risks to the AUD could drive further flattening at the long end of the curve.

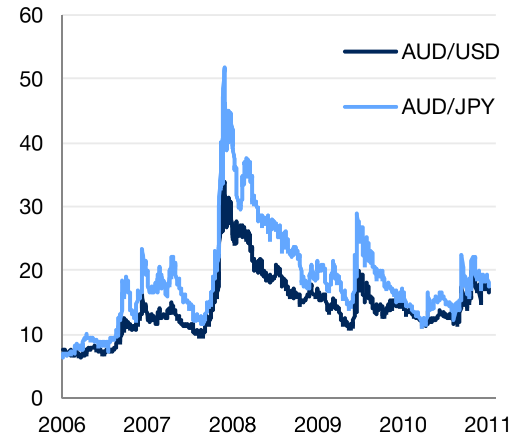
ongoing volatility from the European debt crisis. However, further downside in the AUD is possible if the situation in Europe worsens considerably. After all, the AUD has historically behaved as a barometer of global market risk appetite. Large risk-off moves in the market could see the AUD fall further than expected and this would likely benefit flattening positions at the long end of the Aussie curve.

Conclusion

Mixed pressures confronting the long-end of the swap curve

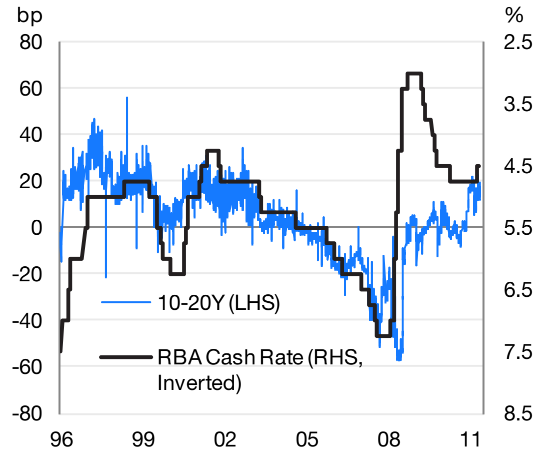
Overall, we find the failure of the long end of the swap curve to flatten (inverse) during the latest phase of the GFC as surprising and out of kilter with earlier crisis episodes. A further pick-up in volatility and renewed AUD weakness could bring such a move on quickly. However, the curve is also significantly impacted by the outlook for monetary policy, with the RBA's shift to an easing cycle imparting steepening pressure. Overall, with significant uncertainty coming from both directions, we suspect the curve will hold in its current range for the time being.

Figure 9 – AUD/USD and AUD/JPY 3 month implied currency vol



Source: CBA, Bloomberg

Figure 10 – Cash rate versus long-end swap curve



Source: CBA, Bloomberg

Key Views

United States

The US economy appears to have picked up some momentum from the very weak first half. The recovery in the labour market continues, with the unemployment rate falling again to 8.6%, in November, although falls in the participation rate have exacerbated the decline. Despite sub-par economic growth, US inflation remains stronger than Fed predictions. The core CPI results are still trending higher, making it hard for the 10yr BEI to hold much below 2%.

With 'Operation Twist' now in force and the Fed promising further action if required, we look for US 10yrs to hold around current levels for some time. Market direction should therefore continue to be dominated by the outlook for Europe, gyrating between concerns over sovereign contagion into banks and core Europe versus hopes for a 'fiscal solution' and bank recapitalisation.

Market participants seem to be anticipating positive developments from the 9 Dec. EU Leaders Summit. Despite the positive sentiment, European debt concerns are likely to continue to flare up over the months ahead. Underlying concerns about the Eurozone debt crisis suggests that demand for USD denominated assets may continue, and the USD uptrend will resume. We have recently revised up our USD forecasts. US GDP growth is improving, while Eurozone, Japanese and Canadian GDP growth is being revised down. The spread between US and G7 GDP growth has moved above the 1.0% threshold, which typically generates a lift in the USD. Mirroring these diverging growth trends, the US-G7 two-year bond spread is moving higher, providing underlying valuation support for a firmer USD.

	Tactical (<1 mth)	**Strategic** (>3 mths)
Policy rate	0.1%	0.1%
10yr bond	2.20%	2.20%
2/10 curve	200bp	190bp
USD/JPY	77.00	76.50
EUR/USD	1.3300	1.3000

Australia

The RBA changed tack and cut rates at the November meeting, citing a lower inflation outlook as providing scope to assist the weak sectors of the economy. Markets had priced in the cut and continue to look for further easing, including a 25bp cut in December (tomorrow) and an aggressive move to 3.0% by mid 2012.

CBA looks for a further cut in the cash rate, most likely in February. The negative impact of the ongoing problems in Europe on business and consumer confidence seem unlikely to recede given long-term solutions in Europe appear next to impossible. We expect continuing flare-ups in Europe will see another rate cut and bond markets well bid as a result. We expect 3yrs to be particularly well supported in this environment, outperforming both bill futures and 10yr bonds.

The AUD has lifted in early December as anxiety over European debt issues has eased. We expect AUD direction to remain heavily influenced by developments in Europe over the coming weeks. We have lowered our AUD forecasts to reflect our stronger USD outlook mentioned above, and downward revisions to the global growth outlook. It is very difficult for the AUD to appreciate in an environment where global growth estimates are being revised lower. Global GDP growth estimates for 2012 have been revised down by some 20% since or prior forecasts were made in September.

	Tactical (<1 mth)	**Strategic** (>3 mths)
Policy rate	4.50%	4.25%
10yr bond	4.40%	4.40%
3/10 curve	90bp	85bp
10yr EFP	65bp	60bp
10yr v US	200bp	220bp
AUD/USD	1.0300	0.9800

New Zealand

The NZ economy is slowly recovering, but, like Australia, is suffering from global volatility. The NZ unemployment rate ticked up in Q3. But employment growth has been surprisingly strong outside of earthquake affected Christchurch over the past 3 quarters. This suggests that the underlying economic recovery remains intact, despite some recent disappointing data. Q3 retail sales volumes were boosted by Rugby World Cup (RWC) spending, and Q4 sales should also receive a RWC boost. The RBNZ has indicated global developments remain the dominant factor for determining its interest rate outlook. We have moved our expectation for the first OCR increase out to December 2012. The first half of next year no longer looks soon enough for the RBNZ to have confidence that the risks to the global economy have been sufficiently defused, even assuming Europe contains the crisis very soon. In addition, we also expect the tightening cycle to be more gradual.

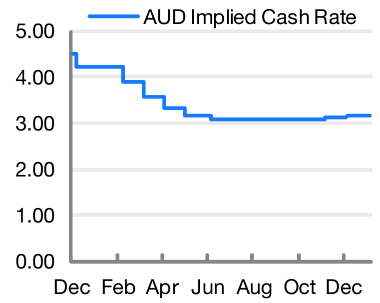
We expect NZD direction to remain heavily influenced by developments in Europe over the coming weeks. We have adjusted our NZD forecasts to reflect the lower NZ interest rate outlook, a stronger USD, and the impact of downward revisions to global growth. Downward revisions to the global growth outlook are expected to weigh on New Zealand-specific commodity prices. The NZ terms of trade, which has been an important driver of the NZD is expected to remain high, but has likely peaked.

	Tactical (<1 mth)	**Strategic** (>3 mths)
Policy rate	2.50%	2.50%
10yr bond	4.20%	4.40%
2/10 swap curve	150	140
10yr v US	210	230
10yr v AU	0bp	40bp
NZD/USD	0.7800	0.7500
AUD/NZD	1.3200	1.3000

Cash Rate Pricing

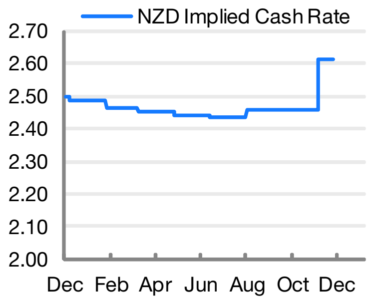
Australian Cash Rate Pricing

	Rate	Cum. % chance of +25bp
Current	4.22	0
7-Feb-12	3.91	-235
6-Mar-12	3.58	-368
3-Apr-12	3.32	-472
1-May-12	3.18	-530
5-Jun-12	3.09	-564
3-Jul-12	3.10	-562
7-Aug-12	3.09	-562
4-Sep-12	3.08	-567
2-Oct-12	3.09	-566



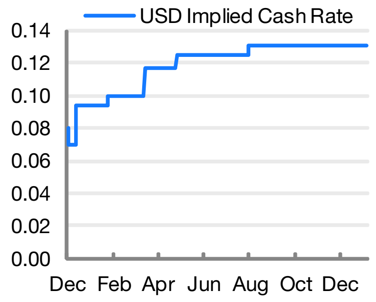
New Zealand OCR Pricing

	Rate	Cum. % chance of +25bp
Current	2.50	0
8-Dec-11	2.49	-6
26-Jan-12	2.46	-16
8-Mar-12	2.45	-19
26-Apr-12	2.44	-23
14-Jun-12	2.43	-26
1-Aug-12	2.46	-16
7-Nov-12	2.61	44



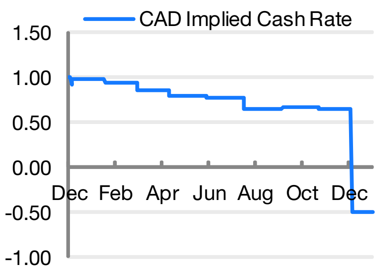
US Fed Funds Pricing

	Rate	Cum. % chance of +25bp
Current	0.07	0
13-Dec-11	0.09	10
25-Jan-12	0.10	12
13-Mar-12	0.12	19
25-Apr-12	0.13	22
20-Jun-12	0.13	22
31-Jul-12	0.13	24
12-Sep-12	0.13	24
24-Oct-12	0.13	24
11-Dec-12	0.13	24



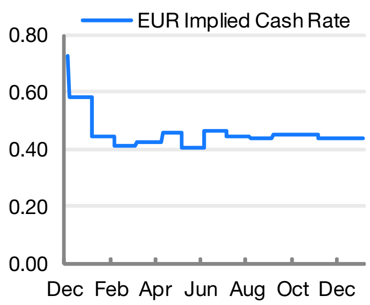
Candian Rate Pricing

	Rate	Cum. % chance of +25bp
Current	0.98	0
6-Dec-11	0.98	14
18-Jan-12	0.95	0
29-Feb-12	0.86	-32
11-Apr-12	0.79	-63
30-May-12	0.77	-70
18-Jul-12	0.65	-120



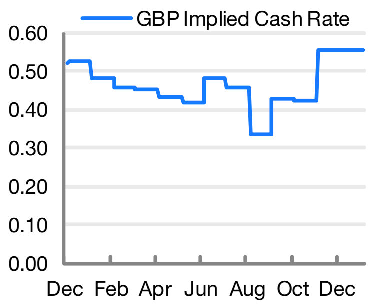
EUR EONIA Pricing

	Rate	Cum. % chance of +25bp
1W repo	0.40	
8-Dec-11	0.58	73
12-Jan-12	0.45	20
9-Feb-12	0.41	5
8-Mar-12	0.42	10
4-Apr-12	0.46	10
3-May-12	0.41	4
6-Jun-12	0.46	25
7-Feb-13	0.44	16
7-Mar-13	0.44	16



UK SONIA Pricing

	Rate	Cum. % chance of +25bp
Current	0.53	0
8-Dec-11	0.53	0
5-Jan-12	0.48	-18
8-Mar-12	0.45	-30
5-Apr-12	0.43	-37
10-May-12	0.42	-43
7-Jun-12	0.48	-19
5-Jul-12	0.46	-27
2-Aug-12	0.34	-76
6-Sep-12	0.43	-40



Source: All data sourced from Bloomberg. Rates displayed are calculated using IB Futures (Australia), FF Futures (US) and OIS in all other currencies.

CBA Forecasts:

Cash rate	5-Dec	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
US	0.25	0.25	0.25	0.25	0.25	0.25
Australia	4.50	4.50	4.25	4.25	4.25	4.25
New Zealand	2.50	2.50	2.50	2.75	3.25	3.50
United Kingdom	0.50	0.50	0.50	0.50	0.50	0.50
Eurozone	1.25	1.00	0.50	0.50	0.50	0.50
China	6.31	6.56	6.56	6.81	6.81	7.06
Japan	0.10	0.10	0.10	0.10	0.10	0.10
2-yr bond yield	**5-Dec**	**Dec-11**	**Mar-12**	**Jun-12**	**Sep-12**	**Dec-12**
US	0.25	0.30	0.30	0.30	0.30	0.30
Australia	3.31	3.80	3.80	3.90	4.10	4.30
New Zealand	2.58	3.30	3.60	3.90	4.20	4.30
United Kingdom	0.38	0.60	0.60	0.60	0.70	0.90
Eurozone	0.31	0.60	0.60	0.70	0.90	1.30
Japan	0.14	0.25	0.25	0.25	0.25	0.25
10-yr bond yield	**5-Dec**	**Dec-11**	**Mar-12**	**Jun-12**	**Sep-12**	**Dec-12**
US	2.06	2.20	2.20	2.20	2.20	2.20
Australia	3.98	4.40	4.40	4.50	4.60	4.80
New Zealand	4.06	4.80	5.00	5.10	5.20	5.25
United Kingdom	2.29	2.50	2.50	2.60	2.70	2.80
Eurozone	2.14	2.30	2.30	2.40	2.40	2.50
Japan	1.05	1.10	1.10	1.10	1.10	1.20

Currencies	5-Dec	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
AUD/USD	1.02	1.03	0.98	0.95	0.97	1.00
AUD/JPY	79.70	79.31	75.46	73.15	75.66	79.00
AUD/EUR	0.76	0.77	0.75	0.75	0.76	0.77
AUD/GBP	0.65	0.66	0.65	0.64	0.65	0.67
AUD/CAD	1.04	1.04	1.05	1.05	1.05	1.05
AUD/NZD	1.31	1.32	1.31	1.30	1.29	1.28
USD/JPY	77.97	77.00	77.00	77.00	78.00	79.00
EUR/USD	1.34	1.33	1.30	1.27	1.28	1.30
GBP/USD	1.56	1.55	1.50	1.48	1.49	1.50
USD/CAD	1.02	1.01	1.07	1.10	1.08	1.05
NZD/USD	0.78	0.78	0.75	0.73	0.75	0.78

Calendar – December 2011

Monday	Tuesday	Wednesday	Thursday	Friday
Early January AU Trade in Goods & Services, Nov (5 Jan) AU Retail trade, Nov (9 Jan) AU Building approvals, Nov (10 Jan) AU Job vacancies, Nov (11 Jan) AU Housing finance, Nov (16 Jan) AU Labour force, Dec (19 Jan)	***Central Bank Meetings*** AU RBA (6 Dec) CA Bank of Canada (7 Dec) UK BOE (8 Dec) EZ ECB (8 Dec) NZ RBNZ (8 Dec) US FOMC (14 Dec) JP BoJ (21 Dec)		1 **AU AI-Group PMI, Nov, Index, (47.4)** **AU Retail trade, Oct, m%ch, 0.5, (0.4)** **AU Build approv, Oct, m%ch, 3, (-13.6)** NZ Terms of Trade Index, QIII, q%ch, (2.3) CH PMI Manufacturing, Nov, Index, (50.4) EU/GE/UK PMI manufacturing, Nov, Index US ISM manufacturing, Nov, Index, (50.8) US Total vehicle sales, Nov, mn, (13.20)	2 EU PPI, Oct, m/y%ch, (0.3/5.8) UK PMI construction, Nov, Index, (53.9) US Non-farm payrolls, Nov, '000, (80) US Unemployment rate, Nov, %, (9.0) US Avg hrly earnings, Nov, m/y%ch, (0.2/1.8) CA Unemployment rate, Nov, % CA Net change in employment, Nov, '000, (-54.0)
5 **AU CBA/Ai-Group PSI, Nov, (48.8)** **AU Company profits, QIII, q%ch, 5.0, (6.7)** **AU Inventories, QIII, q%ch, 1.7, (2.5)** **AU ANZ Job ads, Nov, m%ch, (-0.7)** **AU TD inflat gauge Nov, m/y%ch, (0.1/2.6)** CH Non-Manuf PMI Nov, Index, (57.7) EU PMI services/composite, Nov, Index EU Retail sales, Oct, m/y%ch, (-0.7/-1.5) GE/UK PMI services, Nov, Index US ISM non-manufacturing, Nov, Index, (52.9) US Factory orders, Oct, m%ch, (0.3)	6 **AU Current acc deficit, QIII, $bn, -6.1, (-7.4)** **AU Net export contrib, QIII, ppt, -0.6, (-0.5)** **AU RBA cash rate, Dec, %, 4.50, (4.50)** EU GDP, QIII, q/y%ch, (0.2/1.4) GE Factory orders, Oct, m/y%ch, (-4.3/2.4) UK New car registrations, Nov, y%ch, (2.6) CA Building permits, Oct, m%ch, (-4.9) CA Bank of Canada, %, 1.00, (1.00)	7 **AU Ai-Group PCI, Nov, Index, (34.7)** **AU GDP, QIII, q/y%ch, 1.2/2.3 (1.2/1.4)** JP Leading / Coincident index CI, Oct GE Industrial production, Oct, m/y%ch, (-2.7/5.4 UK Industrial production, Oct, m/y%ch, (0/-0.7) UK NIESR GDP estimate, Nov, m%ch, (0.5) US Consumer credit, Oct, $bn, (7.386) CA Bank of Canada, %, 1.00, (1.00)	8 **AU Labour Force, Nov** **employment, '000, 10, (10.1)** **participation rate, %, 65.6, (65.6)** **unemployment rate, %, 5.2, (5.2)** AU RBA Gov Stevens speaks at the University of Sydney NZ Manufacturing activity QIII, q%ch, (2.1) NZ RBNZ official cash rate, %, 3.00, (2.5) JP Machine orders, Oct, m/y%ch, (-8.2/9.8) EU ECB announces int. rate, %, 1.00, (1.25) UK BoE announces rates, %, 0.50, (0.50) US Wholesale inventories, Oct, m%ch, (-0.1) CA Housing starts, Nov, '000, (207.6)	9 NZ Credit card spending, Nov, m%ch, (1.8) JP GDP, QIII, q%ch, (1.5) CH PPI/CPI, Nov, y%ch, (5.0/5.50) CH Industrial production, Nov, y%ch, (13.2) CH Retail sales, Nov, y%ch, (17.2) UK PPI Input/Output, Nov, y%ch, (14.1/5.7); core, y%ch (3.4 UK Total trade balance, Oct, £bn, (-3.940) GE CPI, Nov, m/y%ch GE Trade bal, Oct, €bn, (17.4) US Uni. Of Michigan confidence, Dec, Index US/CA Trade balance, Oct, bn/Cbn, (-43.1/1.25) CA Trade balance Oct, CA$bn, (1.25)
12 **AU Housing Finance, Oct, m%ch** **No. of own-occupiers, %, 1.0, (2.2)** **Value of all loans, %, -2.0, (0.7)** **AU Trade balance Oct, $bn, 2.0, (2.6)** CH Trade balance Nov, US$bn, (17.03) JP Domestic CGPI, Nov, m/y%ch, (-0.7/1.7) JP Consumer confidence, Nov, Index JP Machine tool orders, Nov, y%ch, (26.0)	13 **AU Dwelling commence, QIII, q%ch, -2.0, (-4.7)** **AU NAB Bus conf/cond Nov, Index, (2/-1)** **AU HIA Housing Affordability Index, QIII, (56.2)** NZ Food prices, Nov, m%ch, (-1.3) EU/GE ZEW survey (econ. sentiment), Dec, , (-59.1/-55.2) UK CPI, Nov, m/y%ch, (0.1/5.0); core y%ch, (3.4) UK RICS house price balance, Nov, %, (-24.0) US Business inventories, Oct, m%ch, (0) US Retail sales, Nov, m%ch, (0.5)	14 **AU MI/WBC Consumer Sent, Dec, Index, (103.4)** **AU DEWR skilled vacancies, Nov, m%ch, (-1.9)** AU RBA Dep. Gov Battellino speaks in Sydney JP Industrial production, Oct, m/y%ch EU CPI, Nov, m/y%ch, (0.3), core, y%ch, (1.6) EU Industrial production Oct, m/y%ch, (-2.0/2.2) UK ILO unemployment rate (3mths), Oct, %, (8.3) US Import price index, Nov, m/y%ch, (-0.6/11.0) CA Leading indicators, Nov, m%ch, (0.2) US FOMC rate decision, %, 0-¼, (0.25)	15 **AU MI Consumer Inflation Expect., Dec, %, (2.5)** **AU MI Unemp. Expt., Dec, Index, (130.2)** **AU Motor veh. sales, Nov, m/y%ch, (1.1/4.4)** **AU Financial Accounts, QIII** **AU RBA Dep Gov Battellino speaks in Sydney** NZ Business PMI, Nov, Index, (46.5) US Producer price index Nov, m/y%ch, (-0.3/5.9) US Current account balance, QIII, US$bn, (-118.0) US Industrial production, Nov, m%ch, (0.7) US Capacity utilisation, Nov, %, (77.8)	16 EU New car registrations Nov, y%ch, (-1.8) EU Trade balance Oct, €bn,1.5, (2.1) US CPI, Nov, m/y%ch, (-0.1/3.5); core, m/y%ch, (0.1/2.1)
19 **AU Population growth, QII, q/y%ch, (0.4/1.4)** NZ PSI, Nov, Index, (50.6) NZ NBNZ Business confidence, Dec, Index EU Current account, Oct, €bn EU Construction output, Oct, m/y%ch, (-1.3/0.4) US NAHB housing market index, Dec, , (20) CA Wholesale sales, Oct, m%ch, (0.2)	20 **AU RBA Board Minutes, Dec** JP Leading / Coincident index CI, Oct GE Producer prices, Nov, m/y%ch, (0.2/5.3) GE IFO - Business climate, Dec, Index US Housing starts, Nov, '000, (628) US Building permits, Nov, '000, (653) CA CPI, Nov, m/y%ch, (0.2/2.9)	21 NZ Credit card spending, Nov, NZ Current account, QIII, % of GDP, (-3.7) JP Trade bal total/adj, Nov JP BoJ target rate, %, 0-0.10, (0.10) UK Bank of England minutes US Existing home sales, Nov, CA Retail sales, Oct, m%ch	22 NZ GDP, QIII, q/y%ch, (0.1/1.5) UK GDP, QIII, UK Total bus investment, QIII, UK Current account balance QIII, £bn, (-2.0) US Uni. Of Michigan confidence, Dec, Index US Leading indicators, Nov, m%ch, (0.9) US GDP, QIII,	23 US Durable goods orders, Nov, US Personal income/spending, Nov, US PCE deflator/core, Nov, US New home sales, Nov,
26 **Christmas Day Holiday**	27 **Boxing Day Holiday** JP Housing starts / Construction orders, Nov, JP Vehicle production, Nov, US S&P/Case-Shiller home price index, Oct US Richmond Fed/Dallas Fed, Dec, Index	28 JP Retail sales, Nov, JP Industrial production, Nov, JP CPI, Nov, CA Teranet House Prices, Oct,	29 GE CPI, Dec, US Pending home sales, Nov,	*30* **AU RP Data house prices, Nov,** **AU Private sector credit, Nov,** JP Markit/JMMA PMI, Dec, Index UK BoE Housing equity withdrawal, QIII,

Note: Figures in brackets represent previous result (if available). All information is preliminary and subject to revision. Chief Economist: Michael Blythe ph: 9118-1101 Economist: James McIntyre: 9118-1100

Unless otherwise noted, all data is sourced from Australian Bureau of Statistics material (www.abs.gov.au).

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