

Watching Supras & Semis as fiscal issues bite in Europe & Australia

- Soft data point to a sharp 1.5% fall in Australia's Q1 GDP and has taken any heat out of the June RBA meeting.
- Peripheral EU sovereign problems are yet to impact the Australian market, but we think it's time to short KFW.
- A GST revenue hole is adding to pressure on Australian State credit ratings.

Australian bonds rallied and the curve flattened this week. The 3Y yield is 8bp lower and the 10Y is down 6bp since last Monday. In the US, the 2Y yield is 1bp lower and the 10Y yield is 1bp lower since last Monday, continuing the gradual grind lower of recent months to new lows for the year.

The Australian market has slightly outperformed the US because the Australian data was softer. Capex was largely as expected in Q1, but the estimate of planned expenditure for 2011-12 didn't quite match its earlier stellar pace. Business indicators (including profits) released on Monday were disappointing, while today's (Tuesday) figures were poor. Private Sector credit was flat in April, building Approvals fell 1.3% and the Q1 current account deficit was wider than expected at \$10.4bn.

The consensus for Wednesday's Q1 GDP release has dropped from -0.3% to -1.1% following news that net Exports will subtract a much larger than expected 2.4%points in Q1. CBA is forecasting an every weaker -1.5% result. The market hasn't reacted strongly following suggestions from Treasurer Wayne Swan on the weekend that the floods would wipe at least 1% point from GDP in the quarter. But the soft data has helped narrow the AUS-US spread back to 213bp and dented views the RBA will soon hike. The market is now pricing only a 5% chance of a move when the RBA meets next Tuesday, June 7.

We will be paying close attention to the consumption data within the national accounts to gauge whether the composition of spending is changing. There has been remarkable weakness in those categories which are subject to GST of late, which is adding to pressure on State Budgets. Adam Donaldson takes a closer look at this issue from page 6. April retail sales will make for an interesting follow-up on Thursday. We forecast an above market 0.6% bounce-back from -0.5% in March.

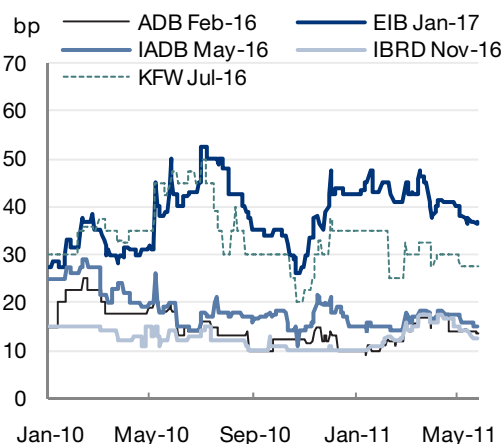
The world has been anxiously watching events in Europe, particularly Greece, but there have been no real announcements despite on-going 'suggestions' that policy-makers should examine a 're-profiling' of Greek debt. This has created a strange tone in markets. There has been a small flight-to-quality rally and a state of general nervousness, but no real focus just yet. Philip Brown discusses the impact of the European situation on basis swaps and the SSA market in his article beginning on page 3. We look to sell KFW against IBRD 2019s.

There has been a slow start in the US this week due to the holiday on Monday. But volatility should heat up, with the Chicago PMI on Tuesday night, the ISM Manufacturing on Wednesday night and the Non-Farm Payrolls release on Friday night. Current expectations are for a comparatively weak 185K print on the latter, but for the unemployment rate to ease from 9.0% to 8.9%.

Contents:

Peripheral EU sovereign problems yet to impact Australian market	3
GST revenue hole threatening State AAAs.....	6
Key Views.....	9
CBA Forecasts:.....	11
Calendar – June 2011.....	12

Australian Dollar Supras holding ground despite European concerns



Source: CBA Spectrum



Key Positions

Our trades haven't been performing too well in the rally. We continue to look for a recovery and a sell-off, but the European concerns and the rally they have caused are hurting most of our other trades.

We added an RV butterfly trade (10/20/30) last week and today we add a trade that would perform well if the European crisis does have a much larger impact than we expect. We sell the KfW Dec-19 against the IBRD Oct-19.

We have reached the target on two trades. The IBRD to QTC spread and the EIB to ACGB spread. We have been stopped out of two trades too. We have been stopped out of the AUD to NZD 3Y spread trade and the long-end butterfly. We choose to exit the IBRD slope trade, which is not going anywhere.

Key Trades

Trade	Entry	Current	Profit	Target	Stop	Comment
Buy the NSWTC Jun-20 (Govt G'teed) as an ASW	-12bp (3-Feb-10)	-25bp	+13bp	-35bp	0bp	Hold: A long-term buy-and-hold trade.
Buy the Feb-15 IBRD vs the Oct-14 IBRD	9bp (15-Feb-11)	9bp	0bp	2bp	12bp	Exit Trade: Doesn't seem to be going anywhere.
Pay the AUD 3Y rate vs the NZD 3Y rate (carry 5bp per month)	132bp (21-Feb-11)	140bp (30 May)	+17bp (including +9bp carry)	210bp	140bp	Stopped Out: Surprising strength in the NZ inflation outlook took us to our upwardly revised stop position on 30 May.
Buy the QTC 2020 against the IBRD 2020	20.5bp (28-Feb-11)	28bp	+7.5bp	28bp	15bp	Target Reached: APRA liquidity announcement helped semi-s out-perform but Budget pressures now coming to fore.
Buy an NSWTC Nov-20 Linker vs UST 1.25% Jul-20 linker	213bp (14-Mar-11)	204bp	+9bp	150bp	235bp	Hold: The real yield pickup is large. The US linkers are likely to underperform once QE ends. Rally in US is hurting though.
Buy the Renten Jul-14s against the Jan-15s	20bp (5-Apr-11)	17bp	-2bp	25bp	17bp	Hold: The Rentenbank curve flattened faster than the ACGB.
Buy a 6M*1Y receiver 20bp below spot yields (4.85%)	7.5bp premium (11-Apr-11)	Current fwd is 5.05%		n/a	n/a	Hold: A deliberate insurance trade if our general optimism proves unfounded.
Receive the 10Y Bills/Libor basis against the 3Y	15bp (11-Apr-11)	12bp	+3bp	7bp	19bp	Hold: We think the recent flow has steepened the curve too far.
Buy the ACGB Jun-14 vs EIB May-14 (trial only)	47bp	58bp	+11bp	54bp	44bp	Target Reached: A profitable trade – but the movement in swap means that our test doesn't really prove the effectiveness of the PCA technique for RV either way.
Buy the Jan-18 vs the Jun-16	11.5bp (18-May-11)	11bp	+0.5bp	4bp	15bp	Hold Not much movement. An RV contraction was offset by a general steepening .
Receive 1Y ZCS	3.00% (20-May-11)	2.91%	+9bp	2.50%	3.20%	Hold: We believe there is scope for headline CPI to snap back, which is not captured in the ZCS
Pay AUD 2Y*1Y	5.45% (23-May-11)	5.37%	-8bp	5.80%	5.30%	Hold: The market is stripping out medium-term RBA rate hikes. We think the RBA will continue to raise rates.
Receive 20Y in 10Y/20Y/30Y butterfly	28bp (25-May-11)	31bp	-3bp	22bp	31bp	Stopped Out: The 20Y swap continues to sell-off.
Sell the KfW Dec-19 against the IBRD Oct-19	22bp (30-May-11)			40bp	15bp	New Trade: Despite the growing concern in Europe, there has not been much movement in the basis or in the credit spread.



Peripheral EU sovereign problems yet to impact Australian market

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- The current flare-up in Greek sovereign risk has not, yet, impacted on the EUR to AUD basis or credit spreads.
- We think the current issue may prove more of a slow-burn, with the June 29 IMF payment far in the future.
- We recommend selling the KfW Dec-19 bond against the IBRD Oct-19 at a spread of 22bp.

Aussie Supranational bonds have been performing quite well to swap recently, including European names we might expect to suffer amid on-going EU sovereign tensions. Supras performance to bond has been slightly poorer, because swaps spreads have been widening in a trend that does appear tied to the EU back-drop. We think the direct impact on European SSAs could become a little more obvious going forward. We recommend the reverse of a trade we had established in January. We suggest selling the KfW Dec-19 against the IBRD Dec-19 at a spread of 22bp.

Greece tensions rising

Tension over the outlook for Peripheral Europe has risen further in the past week. Greek CDS and spreads and those of other troubled sovereigns have widened further. But some of the characteristic patterns that have normally coincided with these episodes have not occurred this time around. Most notably, the EUR to USD basis remains near recent highs, indicating solid demand for Euros (or at least, not particularly strong demand for US Dollars).

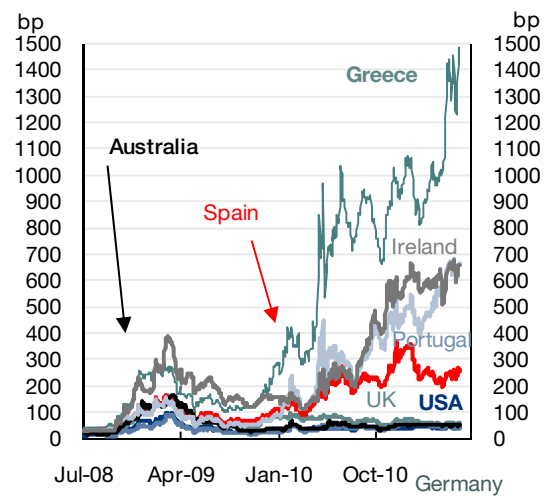
A number of recent news articles have pointed out that Greek banks use Greek bonds as repo collateral at the ECB. It is possible that the biggest impact of a Greek default on Greek banks will be via the lack of repo-able collateral, rather than the direct loss from default. Fitch made similar comments last week.

Luxembourg’s Finance Minister Jean-Claude Juncker observed on Thursday that the IMF may not pay the next €12b instalment of aid to Greece on June 29. The sticking point appears to be that the IMF can only make a payment when there is a credible plan for repayment in the next twelve months. Greece’s repayment plans are not particularly credible, it seems.

While another chapter in the Greek saga is not surprising, we are struck by how far away June 29 is. The market already feels skittish and prone to moves – in short it already feels like an “end-game” scenario. However, if the payment isn’t due until June 29, then there may be a large amount of European policy-makers argy-bargy to go before the next major announcement on Greece is made.

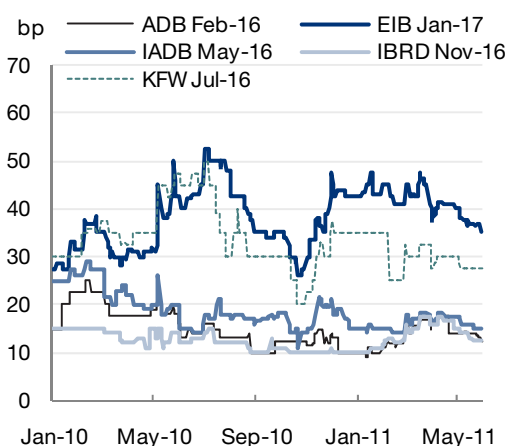
The IMF has suggested they may not make the bailout payment on 29 June

Figure 1: CDS on peripheral sovereigns rising



Source: Bloomberg, CBA

Figure 2: 5Y AUD SSAs spread to swap



Source: CBA Spectrum



Aust. SSA bonds doing well, though

Despite the tension, the SSA bonds in AUD are still performing strongly compared to swap

Despite the tension, Australian SSA bonds have generally been performing well. In fact, most Supranational bonds have been tightening in Australia over the past few weeks, whether they are “European” or “Washington” names (See Figure 2).

This performance in Australian SSA bonds is despite the growing concern about where a Greek default (or restructure) might leave losses. The strong Supra performance is not solely an Australian phenomenon, though. The major Supranational issuers have been performing fairly well in Euros too. KFW and EIB 5Y Euro-denominated bonds are still trading below swap. Despite widening slightly in the last few days, EIB USD bonds have generally been tightening to very tight swap spreads recently (Figure 3).

Basis swaps behaving strangely

Unlike previous episodes, the basis has not yet reacted

The AUD to EUR basis swap is not, however, responding to the latest leg of the crisis. The basis swap is showing a low demand for US dollars (a less negative number) compared to a massive downward spike in the EUR to USD basis during earlier phases of the European crisis. However, this time around, Figure 4 shows that there has been a small drift lower (note the inverted axis) over the past week. However, like the swap spreads of the EIB bond in USD, the move in the basis leaves it only marginally back from the recent highs.

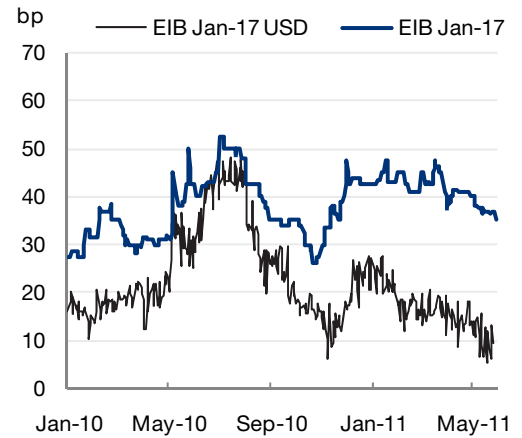
This level of the basis indicates little desire to turn Euros in to USD. The spread is negative, so we can’t say there is a demand for Euros, but there’s noticeably less demand for USD than in previous episodes. The Euro has recently weakened on the spot FX market, but the cross-currency basis has held up.

The EUR to USD basis shows demand for USD is relatively low

The performance of the EUR to USD cross-currency basis matters a lot for Australian markets. Sovereign-linked borrowers in Europe normally receive a price advantage from borrowing money in AUD. Figure 5 shows the pricing differential of the KFW Jul-16 AUD bond over the KFW Jul-16 EUR bond, once all the swaps are taken into account. As usual, the SSA issuer would find it cheaper to issuer in AUD than in its “home” currency.

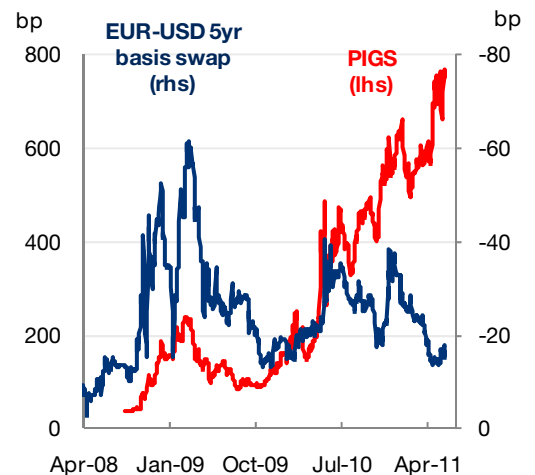
Figure 6 shows the different elements which impact the price of an EUR bond – once it is swapped into AUD. The EUR-denominated bond has a lower headline spread to swap in EUR than it does in AUD. However, the AUD bond is actually cheaper for the issuer, once all the swaps are taken into account.

Figure 3: EIB in AUD and USD ASW



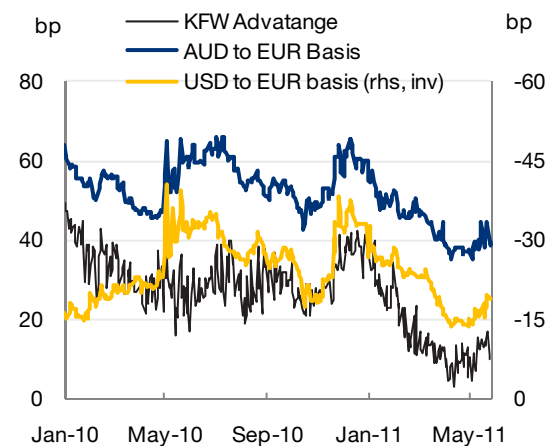
Source: Bloomberg, CBA

Figure 4: Eur to USD cross-currency basis



Source: Bloomberg, CBA

Figure 5: Eur to USD cross-currency basis



Source: Bloomberg, CBA



Basis swaps are the main driver of the attractiveness of Australia to issuers of SSA bonds

Figures 5 and 6 show that the cross-currency basis swap is the main driver of the pricing advantage that the SSAs enjoy. Within that basis, the EUR to USD basis is actually far more variable than the USD to AUD basis. From a daily, practical perspective the pricing of the EUR to USD basis swap has the most impact on the relative prices of an EUR bond and an AUD bond for an SSA issuer.

(We should point out, at this point, that the main long-term driver of the advantage SSAs experience when issuing in Australia is the large Current Account Deficit. Australian corporates and banks need to borrow offshore creates an imbalance in fund flows that generally means the basis is positive. Foreign borrowers are enticed to take advantage of this imbalance in flows via the basis swap and issue in AUD. While the CAD is the underlying driver, short term movements in attractiveness are driven by movements in the EUR to USD spread.)

Basis swaps drive SSA issuance

There was a spike in SSA issuance in January, though it has since fallen

The pricing advantage SSAs receive for AUD issuance over EUR is strongly linked to how and when SSAs choose to issue in AUD. The increase in the USD to EUR basis in January 2011 coincided with a strong increase the volume of SSA issuance in Australia. However, issuance has lessened as the basis swap has becomes less favourable (and following APRA's liquidity decision). Figure 8 shows that there is a link between the attractiveness of the swaps and the issuance of SSAs.

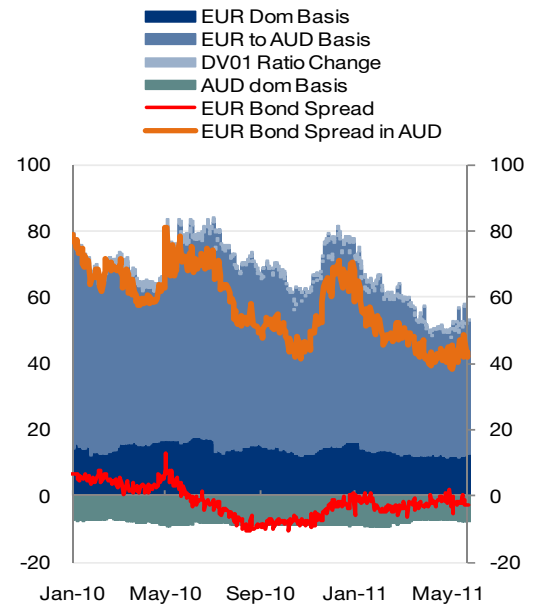
Recently, the AUD to EUR basis has been rising, which should, all else equal, tempt some more issuers back into the AUD market. However, the levels remain below what was available earlier in the year. We tend to think that if the current flare up in Greece continues, the EUR to USD basis will eventually move back towards the USD. That movement would, all else equal, make the Australian supra bonds look even dearer than they normally do.

The European supras remain fairly dear

Dearer Supra bonds in Australia (against the backdrop of European concerns) would likely lead to either significant underperformance by European issuers or a lot of Supra issuance.

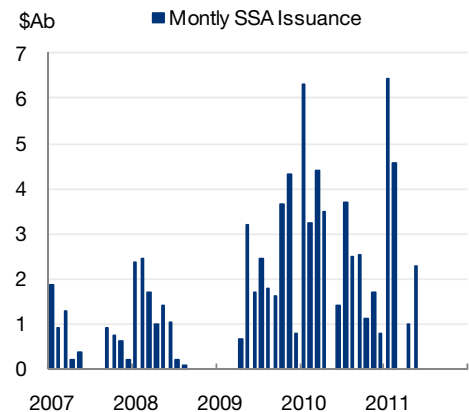
We suggested buying KfW Dec-19 bonds vs IBRD Oct-19 bonds in January at a spread of 33.5bp. We took profit just short of our target at 21bp on May 9. We now suggest reversing the trade at the current level of 22bp. We sell the KfW Dec-19 against IBRD Oct-19 to capture the risk that Greek sovereign concerns continue to play out very slowly. The impact should eventually be seen in basis swaps and credit spreads and some underperformance by the European SSAs.

Figure 6: FFW EUR bonds conversion to AUD



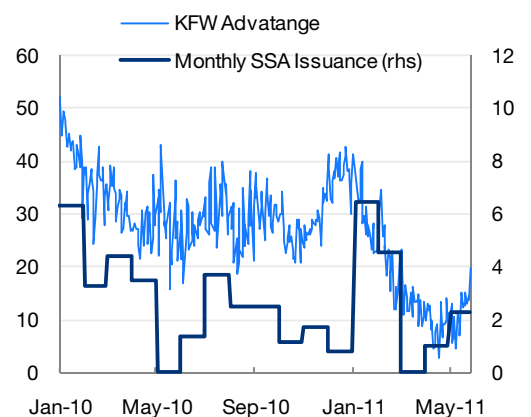
Source: Bloomberg, CBA

Figure 7: AUD SSA issuance



Source: CBA

Figure 8: AUD SSA issuance follows spreads



Source: CBA, Bloomberg



GST revenue hole threatening State AAAs

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- Weak GST receipts are adding to revenue pressure and appear to have caught States out after a strong 2009-10.
- GST revenue is difficult to forecast, but incoming data suggests growth in taxable consumption is weak.
- A further hit to revenues seems likely for States already facing pressure on their AAA ratings.

State Governments are highlighting ratings pressures

State credit ratings were in the news again last week. New NSW Treasurer Mike Baird warned that the state potentially faced two downgrades unless action is taken in the September Budget to get finances on a sustainable footing. Queensland Premier Anna Bligh was reported to have decided that the State’s reconstruction effort needed to be put ahead of ambitions to return to AAA.

Soft GST revenue is adding to pressure from floods and rising capex costs

Neither statement is a surprise given the States’ respective fiscal challenges. We have highlighted the pressure on ratings over recent months and warned that other States could not afford to see the fiscal deterioration evident in Victoria’s 2011-12 Budget. That partly reflected floods and capex cost blowouts, which are highly relevant for Queensland. But Budgets have also come under pressure due to weaker than expected GST receipts, which account for around 25% of revenue.

Western Australia enjoys a secure AAA rating thanks to its limited debt and strong revenue base. Yet it chose to offset some of the fiscal pressure it faces by ramping-up mining royalties. The subsequent stoush with the Commonwealth is yet to be resolved – diversion of GST receipts from WA to others could help alleviate pressure elsewhere, but seems unlikely. That means the question of the GST shapes as crucial for the remainder of the States.

Slippage

GST estimates have varied widely in recent years

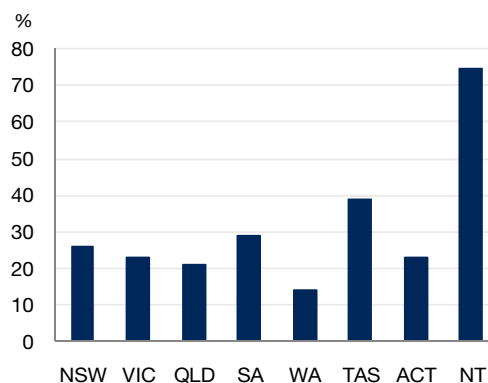
Figure 3 shows how Commonwealth estimates for GST revenue have waxed and waned over recent years. Forecasts were cut dramatically in 2008 as the global financial crisis unfolded. Figures were subsequently revised higher as Australia emerged from the crisis relatively unscathed. That helped the states post better than expected fiscal results in 2008-09. This dramatic reversal may have curtailed the States’ enthusiasm for fiscal tightening. Figure 4 shows how the 2010-11 Budgets didn’t take advantage of the much better than expected 2009-10 outcome and in fact forecast a slower return to surplus (for the broader state sector fiscal position due to higher capital spending).

Figure 1: S&P financial liability trigger level

S&P Financial Liability Trigger		2011-12 est.
NSW	120-130%	108%
Queensland	100-110%	118%
Victoria	130%	106%
Western Australia	90%	67%
South Australia	80-90%	94%
Tasmania	60%	98%
ACT	100-120%	74%
NT	n.a.	n.a.

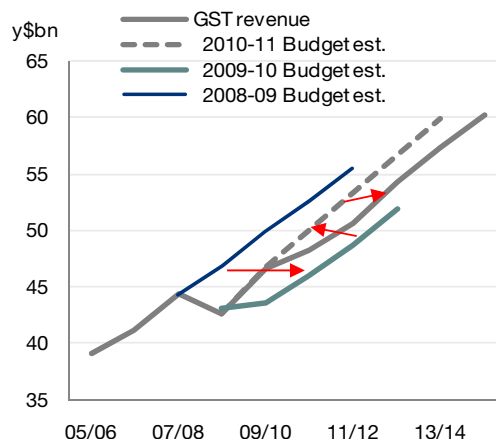
Source: State Budget Papers, S&P, CBA

Figure 2: GST revenue as a share of total general government revenue



Source: State Budget Papers, CBA

Figure 3: GST revenue forecasts



Source: Commonwealth Budget Papers, CBA



The States didn't take advantage of a strong 2009-10

Figure 4 also shows how positions have slipped further over the past year, as the States have gradually begun to account for the various pressures cited above. But only WA and Victoria have thus far released 2011-12 Budgets that fully account for the slippage in GST revenue that the Commonwealth forecast in its May budget (Figure 3). This may be a particular problem for SA and Tasmania. Figure 5 shows that, along with Victoria, these two states bear the brunt of Commonwealth changes to the distribution of the GST pie announced in February.

GST revenue distribution

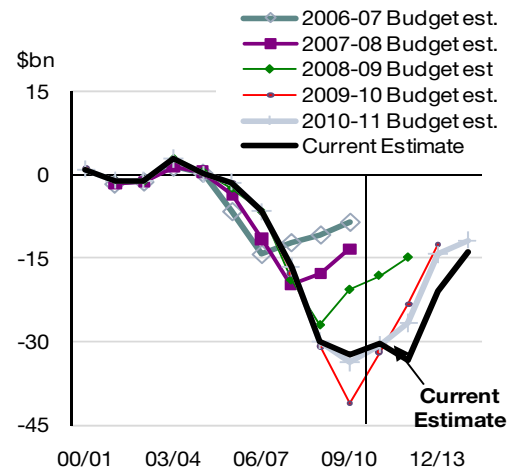
GST revenue cuts are generally manageable

The magnitude of the GST revisions in the Commonwealth's May Budget were not that large. The 2011-12 estimate was cut from \$53.4bn to \$50.6bn. \$48.4bn of that is forecast to be distributed to the states, compared to \$45.0bn in 2010-11. Once we take account of the changes in GST distribution, the end impact on each State's revenue isn't particularly large. But it could make life very difficult for NSW.

But NSW is already pushing S&P's AAA threshold

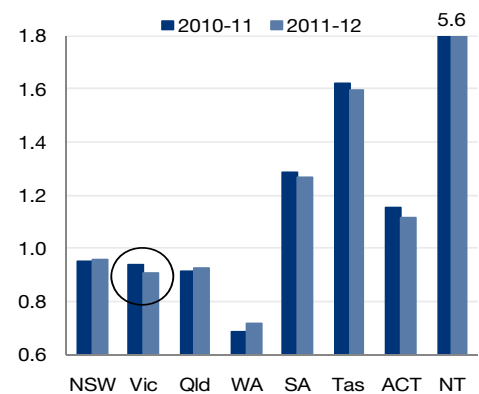
NSW shows the largest negative impact of around \$945m over 2010-11 and 2011-12 (Figure 6). But the cumulative figure for 2010-11 to 2013-14 of \$1.2bn is only a little higher than the \$863m figure quoted in the new Government's *Report on Variance* published in April. It would perhaps lift the key ratio of *net financial liabilities/operating revenue* by a further 1%pt in the years ahead. However, the numbers in the *Report on Variance* already take NSW ratio up to 117% by 2013-14. This is higher than when the forecast prevailing when S&P last placed the State's AAA rating on negative outlook in 2008, and perilously close to the 120-130% 'trigger' band previously published by S&P.

Figure 4: Total six states fiscal balance



Source: Bloomberg, CBA

Figure 5: Allocation of GST receipts



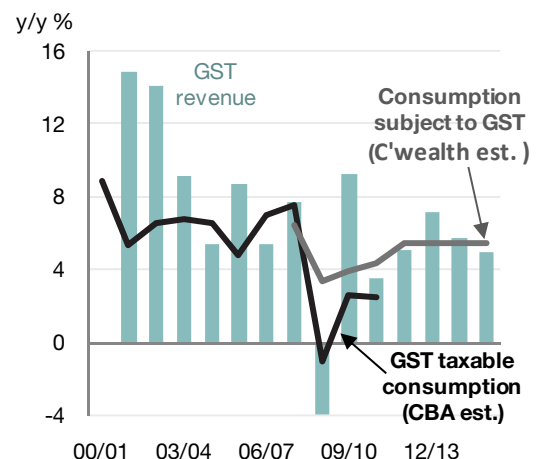
Source: Commonwealth Grants Commission, CBA

Figure 6: Payment of GST revenue to States

	Current State forecasts			Current Commonwealth forecasts			
	2010-11	2011-12	change	2010-11	diff.	2011-12	diff.
NSW	14,355	15,600	1,245	14,042	-313	14,988	-612
Vic	10,654	10,945	291	10,639	-15	10,908	-37
Qld	8,906	n.a.	..	8,414	-492	9,139	n.a.
WA	3,165	3,617	452	3,263	98	3,677	60
SA	4,427	4,546	119	4,296	-131	4,493	-53
Tas	1,704	1,821	116	1,672	-33	1,743	-78
ACT	881	916	35	877	-4	903	-13
NT	2,545	2,799	254	2,372	-173	2,672	-127

Source: State & Commonwealth Budget Papers, CBA
 * Queensland 2011-12 grants break-up not published. Our estimate for 2011-12 is close to the \$9.1bn figure for general revenue assistance published in the Commonwealth May Budget, but existing 2010-11 estimate of \$8.9bn looks too high relative to Commonwealth's revised \$8.4bn for 2010-11.

Figure 7: Growth in GST revenue versus consumption subject to GST



Source: Bloomberg, CBA



GST revenue risks

The \$45.0bn of GST to be distributed in 2010-11 is only 1.0% higher than the 2009-10 result. For a variety of reasons (including a previous over-payment), this is weaker than the 3.5% growth in GST revenue that the Commonwealth is forecasting. But the latter number is more relevant for assessing cyclical volatility, and is much weaker than the 9.2% growth rate posted in 2009-10 (Figure 7).

GST revenue is very difficult to forecast

GST revenue is very difficult to predict. Figure 7 shows how in stable years we can perhaps rely on growth to be around 5-8% per annum. But in more volatile years, GST revenue changes bear little relationship to the Commonwealth's estimate of consumption that is subject to GST.

The Commonwealth's consumption estimate is only available back to 2007-08. So we don't have a firm handle on normal history. To help overcome that problem, we have constructed our own break-down of the national accounts consumption data into GST or non-GST applicable categories (where the broad food, rent, health and education categories are non-GST). This will be at a broader level than the Commonwealth's analysis and is clearly a simplification. But there is little alternative. As the Queensland Government noted in its 2010-11 Budget:

Due to the complexities associated with the GST base, the information provided in the Australian Government Budget Papers is not sufficient to prepare indicative forecasts of the sensitivity of GST estimates to key variables.

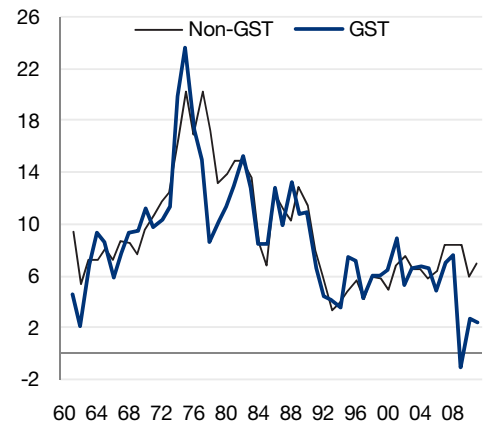
But consumption subject to GST is looking very weak

With that caveat noted, it is worth highlighting just how weak our GST consumption measure is relative to both non-GST consumption and the Commonwealth's forecast for GST consumption. The discrepancy is larger than at any time the data has been available (Figure 8). It is clear that the soft retail environment, which many attribute to the rising price of necessities is biting (figure 9). Most of these are GST-free with the exception of utilities.

A further hit to revenues seems likely

Ultimately, the gap in consumption should start to close. We will be scanning tomorrow's Q1 national accounts data to assess whether this has started to come through. But at this stage, the risks to the Commonwealth's estimate that consumption subject to GST will grow by 5.4% in 2011-12 on top of 4.4% growth in 2010-11 is looking decidedly ambitious. State Governments may yet have to take another hit on their revenue estimates in an environment where we are already pushing some AAA ratings boundaries.

Figure 8: Consumption subject to GST weaker than other components



Source: CBA, ABS

Figure 9: Consumption Price Index

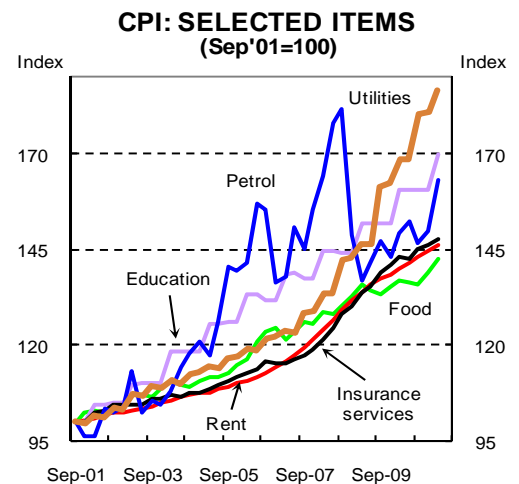
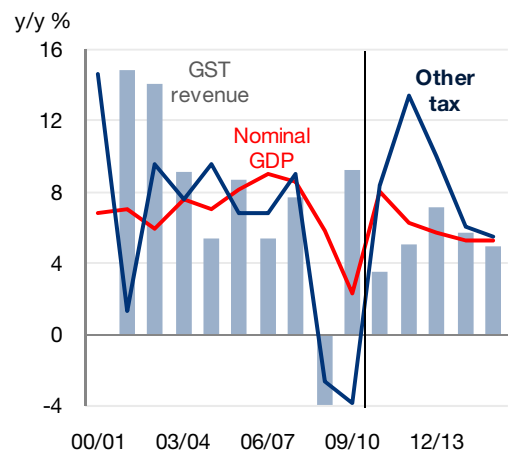


Figure 10: Profile for GST weaker than for other tax or nominal GDP



Source: Bloomberg, CBA

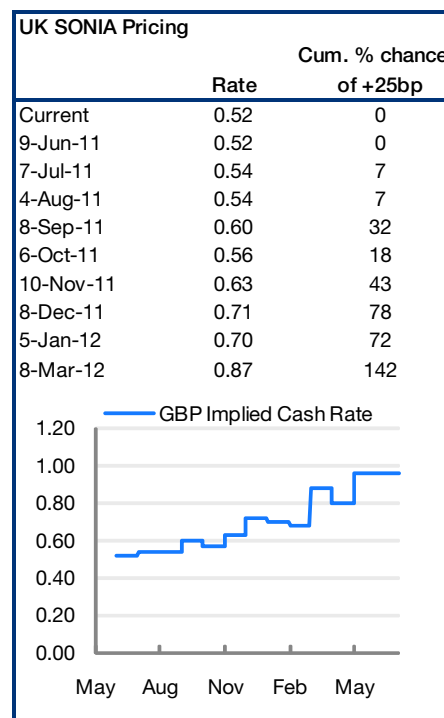
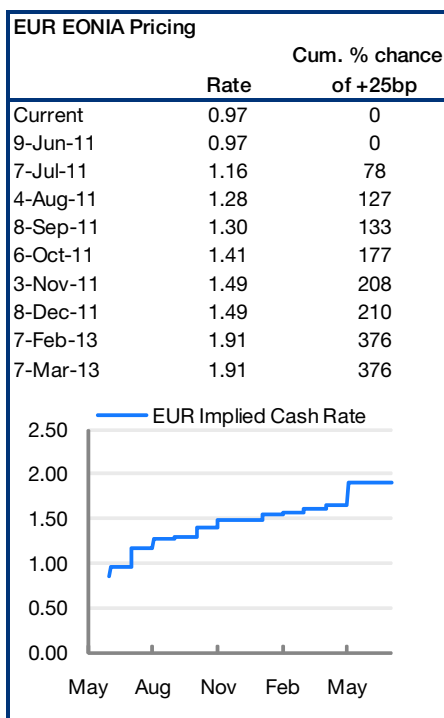
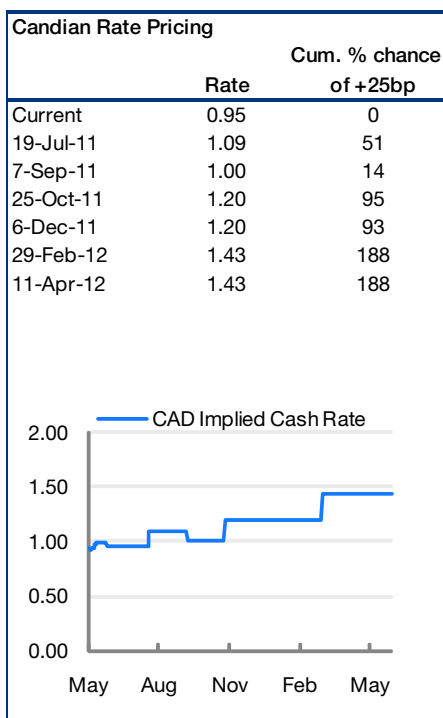
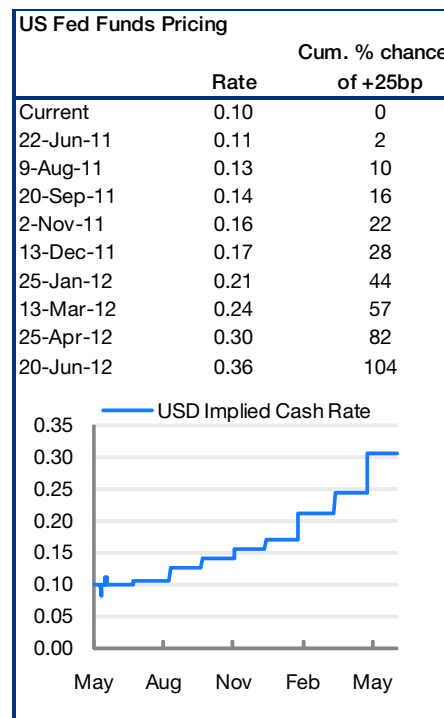
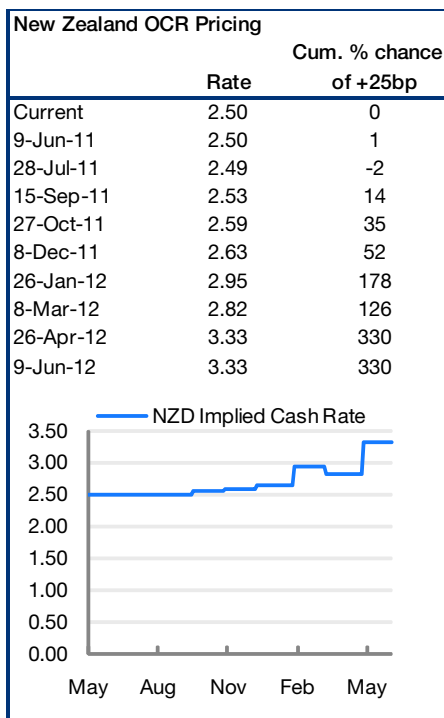
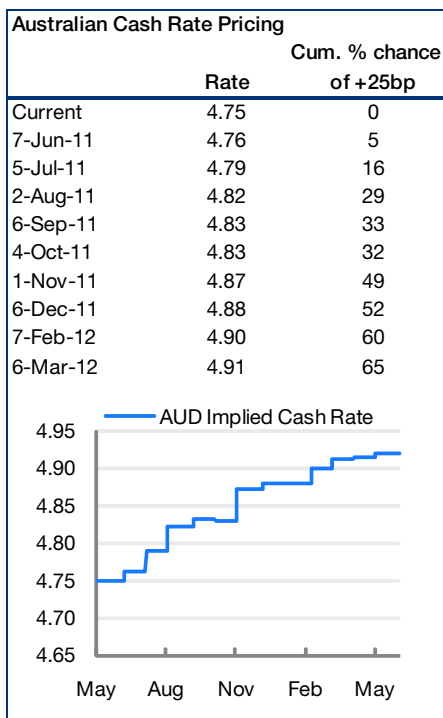


Key Views

United States		Tactical (<1 mth)	Strategic (>3 mths)
<p>Recent US economic data has shown some improvement, but there's a long slow road ahead until growth can be considered robust. Uncertainty over the stability of the Middle East, oil prices, European sovereigns and Japan's earthquake are buffeting data, confidence and markets, but aren't a recovery deal-breaker. US policy makers are still discussing plans to increase the debt ceiling, with pressure for a longer-term fiscal deal intensifying following an S&P revision to the AAA rating outlook. We think a deal will come to pass and do not expect the US to be downgraded in the next 1-2 years, reinforcing our view that the US bond sell-off will be moderate.</p> <p>We expect a stronger economic recovery to take hold in mid or late 2011 and for bond yields to head higher as the situation becomes clearer. The Fed remains concerned about the slow recovery in the labour market and the low level of (underlying) inflation. PCE data will be released this week which should confirm that underlying inflation remains low, but well above zero. Bernanke confirmed that the Fed would cease buying new bonds at the end of June, but would continue to reinvest coupons. Later, once the Fed starts raising the Fed Funds rate, we see room for the curve to flatten markedly.</p> <p>The concerns about public debt in Greece, Ireland and Portugal are likely to represent downside risks to EUR/USD in the near term. The safe haven currencies of JPY and CHF are likely to keep strengthening. Once Europe puts Greece's debt on a sustainable path, which may include a 'soft restructuring' (though that is not our base case), currency markets are likely to re-focus on the outlook for central bank interest rates. The USD is set for more downside because the US economy's Q1 soft patch appears to have carried into Q2. The Fed has indicated it is in no hurry to tighten and is likely to maintain the size of the Fed's balance sheet at record levels by re-investing coupons and maturities. The ECB is likely to keep tightening later this year. In addition, US residents are continuing to invest offshore, encouraged by firm global growth. These outflows of capital are likely to weaken the USD over the medium term.</p>	Policy rate	0.1%	0.1%
	10yr bond	3.40%	3.80%
	2/10 curve	280bp	270bp
	USD/JPY	82.00	83.00
	EUR/USD	1.45	1.47
Australia		Tactical (<1 mth)	Strategic (>3 mths)
<p>Australia's economic health and lack of spare capacity continues to stand in stark contrast to the rest of the advanced world. The recent consumer caution is unlikely to persist if wages growth picks up and unemployment continues to fall. RBA tightening in 2010 put substantial flattening pressure on the domestic curve and saw spreads to the US widen noticeably.</p> <p>An important dynamic in the domestic markets is tension between a comparatively weak current picture of the economy and a very strong medium term outlook. The RBA has been highlighting the medium-term outlook repeatedly in recent communications. We see the fundamental strength exerted by high commodity prices and booming investment as dominating over the year and pushing the RBA to continue to tighten rates over the course of 2011-12. The RBA has noted that the recent spike in CPI should be temporary, but appears to be ready to raise rates on any indication the spike is becoming a trend. Australian spreads to US should tighten quickly when the Fed starts to raise rates.</p> <p>European debt concerns are a distracting side-show for the AUD so long as Europe's debt problems are worked out without damaging the global growth outlook. The likelihood of further downside in the USD should generate a lift in the AUD back to 1.10.</p>	Policy rate	4.75%	5.00%
	10yr bond	5.50%	5.80%
	3/10 curve	40bp	30bp
	10yr EFP	52bp	55bp
	10yr v US	210	200
	AUD/USD	1.08000	1.1000
New Zealand		Tactical (<1 mth)	Strategic (>3 mths)
<p>The Christchurch earthquake has completely changed the direction of the NZ economy. The RBNZ cut rates by 50bp at the meeting on March 10. We do not expect the RBNZ to raise rates until March 2012. The destruction in Christchurch is considerable and the recovery will be a very long, slow one. The recent employment data looked strong, but excluded the Canterbury region. The New Zealand economy was already weakening before the quake and the rest of the year is likely to be a slow grind. Data continues to suggest that inflation (though high) is not a concern. This bodes well for NZ bond and swap rates to outperform as the US and AUD markets come under pressure.</p> <p>The NZD touched a record post-float high vis-à-vis the USD early Monday morning (27th May) of 0.8219. As so long as Europe's debt problems are worked out without damaging the global growth outlook, the NZD will hit 0.85 in coming months. Confidence amongst New Zealand consumers and businesses is now recovering in response to the RBNZ's March 'insurance' rate cuts. Outside of Canterbury, the RBNZ notes the economy is doing relatively well. Insurance inflows and firm export growth is helping to lift the NZD. The AUD/NZD should consolidate after recent downside pressure; our year-end targets are being achieved early.</p>	Policy rate	2.50%	2.50%
	10yr bond	5.50%	5.80%
	2/10 swap curve	210bp	200bp
	10yr v US	210	200
	10yr v AUS	-10bp	0bp
	NZD/USD	0.8200	0.8300
	AUD/NZD	1.3100	1.3100



Cash Rate Pricing



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	31-May	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
US	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.50
Australia	4.75	4.75	5.00	5.25	5.50	5.75	5.75	5.75
New Zealand	2.50	2.50	2.50	2.50	2.75	3.25	3.75	4.25
United Kingdom	0.50	0.75	1.00	1.25	1.50	1.75	2.00	2.25
Eurozone	1.25	1.25	1.25	1.50	1.75	2.00	2.25	2.50
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10

2-yr bond yield	31-May	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
US	0.48	1.10	1.40	1.70	2.00	2.30	2.60	2.80
Australia	4.81	5.20	5.40	5.70	5.90	5.90	5.80	5.70
New Zealand	3.80	3.50	3.80	4.00	4.20	4.40	4.50	4.60
United Kingdom	0.96	1.70	2.00	2.20	2.40	2.50	2.60	2.60
Eurozone	1.59	2.00	2.20	2.40	2.60	2.80	3.00	3.00
Japan	0.17	0.20	0.25	0.25	0.30	0.35	0.40	0.40

10-yr bond yield	31-May	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
US	3.08	3.70	3.90	4.00	4.10	4.20	4.30	4.30
Australia	5.22	5.70	5.80	5.90	6.00	6.00	5.90	5.90
New Zealand	5.12	5.80	5.90	5.90	6.00	6.00	5.90	5.80
United Kingdom	3.27	4.00	4.20	4.30	4.30	4.40	4.40	4.40
Eurozone	2.98	3.60	3.70	3.80	3.90	4.00	4.00	4.00
Japan	1.16	1.30	1.30	1.40	1.40	1.40	1.50	1.50

Currencies	31-May	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
AUD/USD	1.07	1.08	1.12	1.04	0.98	0.95	0.95	0.98
AUD/JPY	86.87	89.64	91.84	88.40	86.24	85.50	86.45	86.24
AUD/EUR	0.75	0.73	0.75	0.73	0.70	0.69	0.69	0.70
AUD/GBP	0.65	0.65	0.66	0.63	0.61	0.60	0.60	0.60
AUD/CAD	1.05	1.02	1.01	1.02	0.98	1.00	1.00	0.98
AUD/NZD	1.30	1.32	1.32	1.32	1.29	1.27	1.27	1.26
USD/JPY	80.92	83.00	82.00	85.00	88.00	90.00	91.00	88.00
EUR/USD	1.44	1.47	1.50	1.43	1.40	1.38	1.38	1.40
GBP/USD	1.65	1.65	1.70	1.65	1.60	1.58	1.58	1.62
USD/CAD	0.97	0.94	0.90	0.98	1.00	1.05	1.05	1.00
NZD/USD	0.83	0.82	0.85	0.79	0.76	0.75	0.75	0.78



Calendar – June 2011

Monday	Tuesday	Wednesday	Thursday	Friday
Central Bank Meetings AU RBA (7 June) EZ ECB (9 June) UK BOE (9 June) NZ RBNZ (9 June) JP BoJ (13/14 June) US FOMC (21/22 June) CA Bank of Canada (19 July)	Budget dates AU SA Budget (9 June) AU QLD Budget (14 June) AU Tas Budget (16 June) AU NSW Budget (6 September)	1 AU AI-Group PMI, May, Index, (48.4) AU HIA new home sales Apr, m%ch, (4.3) AU GDP, Ql, q/y%ch, -0.1/2.0 (0.7/2.7) NZ Terms of Trade Index, Ql, q%ch, (0.6) CH PMI Manufacturing, May, Index, (52.9) JP Vehicle sales, May, y%ch, (-51.0) EU PMI manufacturing, May, Index, (54.8/58.2/54.6) US ISM manufacturing, May, Index, (60.4) US Total vehicle sales, May, mn, (13.14)	2 AU Trade balance Apr, \$bn, 2.5, (1.74) AU Retail trade, Apr, m%ch, 0.6, (-0.5) UK PMI construction, May, Index, (53.3) US Factory orders, Apr, m%ch, (3.0)	3 AU CBA/AI-Group PSI, May, (51.5) NZ Building permits, Apr, m%ch, (2.2) CH Non-Manuf PMI May, Index, (62.5) EU PMI services/composite, May, Index, (55.4/55.4) GE/UK PMI services, May, Index, (54.9/54.3) US Avg hrly earnings, May, m/y%ch, (0.1/1.9) US Non-farm payrolls, May, '000, (244) US Unemployment rate, May, %, (9.0) US ISM non-manufacturing, May, Index, (52.8)
6 AU AI-Group PCI, May, Index, (37.9) AU TD inflat gauge May, m/y%ch, (0.3/3.6) AU ANZ Job ads, May, m%ch, (1.0) EU PPI, Apr, m/y%ch, (0.7/6.7) UK New car registrations, May, y%ch, (-7.4) CA Building permits, Apr, m%ch, (17.2) CA Ivey purchasing manager index, May, (57.7)	7 AU NAB Bus conf/cond, May, Index, (7/5) AU RBA cash rate, %, 4.75, (4.75) AU AOFM CEO Rob Nicholl speaks in Sydney JP Leading / Coincident index Cl, Apr, (100.1/103.5) EU Retail sales, Apr, m/y%ch, (-1.0/-1.7) GE Factory orders, Apr, m/y%ch, (-4.0/9.7) US Consumer credit, Apr, \$bn, (6.0)	8 AU MI/WBC Consumer Sent, Jun, Index, (103.9) AU Housing finance, Apr No. of own-occupiers, %, 4.0, (-1.5) Value of all loans, %, 7.0, (-1.1) JP Curr a/c total/adjusted, Apr, ¥bn, (1679.1/752.7) JP Trade balance - BOP basis, Apr, ¥bn, (240.3) EU GDP, Ql, q/y%ch, (0.8/2.5) GE Trade bal, Apr, €bn, (18.9) GE Industrial production, Apr, y/y%ch, (0.112) GE Industrial production, Apr, m/y%ch, (0.7/11.2) US Federal Reserve Beige Book CA Housing starts, May, '000, (179.0)	9 AU Labour Force, May employment, '000, 25, (-22.1) participation rate, %, 65.6, (65.6) unemployment rate, %, 4.8, (4.9) NZ RBNZ official cash rate, %, 2.50, (2.50) JP GDP, Ql, q%ch, (-0.9) EU ECB Monthly report EU ECB announces int. rate, %, 1.25, (1.25) UK BoE announces rates, %, 0.50, (0.50) US Trade balance, Apr, \$bn, (-48.2) US Wholesale inventories, Apr, m%ch, (1.1) CA Trade balance Apr, C\$b, (0.6)	10 NZ Credit card spending, May, m%ch, (1.7) CH Trade balance May, US\$b, (11.4) JP Domestic CGPI, May, m/y%ch, (0.9/2.5) GE CPI, May, m/y%ch UK Industrial production, Apr, m/y%ch, (0.3/0.7) UK PPI Input/Output/core, May, y%ch, (17.6/5.3/3.4) UK NIESR GDP estimate, May, m%ch, (0.3) US Import price index, May, m/y%ch, (2.2/1.1.1) CA Net change in employment, May, '000, (58.3) CA Unemployment rate, May, %, (7.6)
13 AU Queens Birthday Public Holiday JP Machine orders, Apr, m/y%ch, (2.9/6.8)	14 NZ Food prices, May, m%ch, (0.1) CH PPI/CPI, May, y%ch, (6.8/5.3) CH Industrial production, May, y%ch, (13.4) CH Retail sales, May, y%ch, (17.1) JP Capacity utilisation, Apr, m%ch, (-21.5) JP Industrial production, Apr, JP BoJ target rate, %, 0-0.10, (0-0.10) UK RICS house price balance, May, %, (-21) UK CPI, May, m/y%ch, (1.0/4.5); core, y%ch, (3.7) US Producer price index May, m/y%ch, (0.8/6.8) US Retail sales, May, m%ch, (0.5) US Business inventories, Apr, m%ch, (1.0)	15 AU Dwelling commence, Ql, q%ch, 6.0, (-5.3) AU RBA Gov Glenn Stevens speaks in Brisbane NZ Retail sales ex inflation, Ql, q%ch, (-0.4) JP Machine tool orders, May, EU Industrial production Apr, m/y%ch, (-0.2/5.3) UK ILO unemployment rate (3mths), Apr, %, (7.7) US CPI, May, m/y%ch, (0.4/3.2); core, (0.2/1.3) US Empire manufacturing, Jun, Index, (11.88) US Capacity utilisation, May, %, (76.9) US Industrial production, May, m%ch, (0.0) US NAHB housing market index, Jun, (16)	16 AU MI Consumer Inflation Expectat, Jun, %, (3.3) AU MI Unemp. Expt., June, Index, (106.0) AU New motor veh. sales, May, m/y%ch, (-3.5/-8.4) AU RBA Bulletin - June quarter 2011 NZ Business PMI, May, Index, (51.5) NZ Manufacturing activity Ql, q%ch, (3.1) EU CPI, May, m/y%ch, (0.6/2.8); core, y%ch, (1.6) UK Retail sales, May, m/y%ch, (1.1/2.8) US Building permits, May, '000, (551) US Housing starts, May, '000, (523) US Current account balance, Ql, US\$b, (-113.3) US Philadelphia Fed, Jun, Index, (3.9)	17 EU New car registrations May, y%ch, (-4.1) EU Construction output, Apr, m/y%ch, (-0.3/-4.9) EU Trade balance Apr, €bn, (-0.9) EU ECB Monthly report US Uni. Of Michigan confidence, Jun, Index NZ Leading indicators, May, m%ch, (-0.3) CA Wholesale sales, Apr, m%ch, (0.1)
20 NZ PSI, Jun, Index, (52.6) NZ Credit card spending, May, m/y%ch, (1.6/6.0) JP Trade bal total/adj, May, JP Leading / Coincident index Cl, Apr, EU Current account, Apr, €bn, (-4.7) GE Producer prices, May, m/y%ch, (1.0/6.4)	21 AU RBA Board Minutes, June EU/GE ZEW survey (econ. sentiment), Jun, (13.6/3.1) US Existing home sales, May, mn/m%ch, (5.05/-0.8) CA Leading indicators, May, m%ch, (0.8) CA Retail sales, Apr, m%ch, (0.0)	22 NZ Current account, Ql, % of GDP, (-2.3) EU Industrial new orders, Apr, UK Bank of England minutes US FOMC rate decision, %, 0-¼, (0-¼)	23 AU Population growth, QIV, q/y%ch, (0.3/1.7) AU Financial Accounts, Ql EU/GE PMI manufacturing, Jun, Index EU PMI services/composite, Jun, Index GE PMI services, Jun, Index US New home sales, May,	24 AU RBA Ass Gov Lowe speaks in Adelaide GE IFO - Business climate, Jun, Index GE Retail sales, May, US Durable goods orders, May, US GDP, Ql,
27 US Personal income/spending, May, m%ch US PCE deflator/core, May, y%ch US Dallas Fed, Jun, Index	28 RBA Ass Gov Debelle speaks in Sydney JP Retail sales, May, GE CPI, Jun, UK Total bus investment, Ql, UK Current account balance Ql, (-10.5) UK GDP, Ql, US S&P/Case-Shiller home price ind., Apr, US Richmond Fed, Jun, Index	29 AU DEWR skilled vacancies, Jun, m%ch, (-0.4) AU HIA new home sales May, JP Industrial production, May, UK Net consumer credit, May, US Pending home sales, May, CA CPI, May, m/y%ch, (0.3/3.3) CA Teranet House Prices, Apr,	30 Early July AU Job vacancies, May (1 July) AU Retail trade, May (1 July) AU Building approvals, May (1 July) AU Engineering Construction Activity, Ql (1 July) AU Trade in Goods & Services, May (6 July) AU Labour Force, June, (8 July) AU Housing Finance, May (12 July)	

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



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Japan Desk	+612 9117 0025	NY	+1212 336 7749
Melb	+613 9675 6815		
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HK	+852 2844 7538	NZ	+64 9375 5738
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