

Winners and losers as fiscal largesse makes way for austerity.

- The market has rallied strongly after S&P lowered the US outlook to negative and a Greek restructure looked likely.
- Slower growth, the high AUD and the floods are impacting Government finances, but consolidation still on track.
- Public sector borrowing is set to fall sharply, opening the way for SSA, bank and particularly corporate issuance.

All the recent CPI releases have printed, more-or-less, at expectations which left the way clear for S&P's decision to revise the US credit rating to take the spotlight.

Bonds markets had been drifting lower in yield over last week, but the S&P announcement triggered (eventually) another rally of about 10bp across the curve. The growing chance of a restructure of Greek debt added to the rally, too. Since last Monday, the US 2Y has rallied 19bp overall and the 10Y 24bp. Australia followed the same pattern, with Australian 3Y yields down 12bp and the 10Y 15.5bp since last Monday.

Our core view of rates has been to look for a sell-off, so the rally has affected many of our outright positions, including the paid 6m/1yr trade. The relative value and spread trades have done well though. For full trade details see page 2.

The S&P report revising the US outlook to negative was, in a measured way, critical of US policy-makers' response to the crisis. The extended S&P document notes that the recession in the US was no worse than in Germany and not as severe as the recession in the UK. However, those countries have already enacted budget responses to correct the deficits while the US has not. The problem is the estimated US deficit of 6% of GDP in 2013. While most other countries are expected to have their budgets under control by then, the US will still be running a significant deficit and increasing their debt/GDP ratio.

The S&P change in outlook doesn't fundamentally change the future of the US bond market. We have been expecting a muted sell-off over 2011-12 as US fiscal tightening counteracts a recovering economy. The S&P action suggests the likely austerity measures will be slightly tougher (and the politics even more complicated) but the direction is little changed. The research team's combined thoughts on the implications for the US economy, currency and credit markets are on page 10.

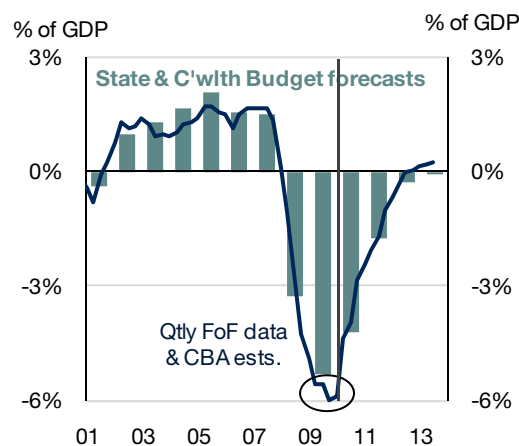
Government austerity is not solely the province of the US - or even the "North Atlantic" - it appears to be the flavour of the month in Canberra too. Alex Stanley examines the upcoming Australian Federal budget in his article on page 3. Adam Donaldson extends the analysis to consider the "crowding out" (or otherwise) of public sector borrowing on the Australian corporate debt market in an article on page 6.

Not much data is scheduled over the next week due to 3 Australian public holidays in the next 7 days. Some precursors to CPI will be released this week (import/export prices, PPI) but the main game will be the Australian CPI data on 27 April. Our economists expect a relatively high headline CPI print of 1.3%. We will provide a more comprehensive view on what this means for the market in our first linker monthly to be published tomorrow. Our next weekly will be on May 2.

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State and Federal Governments will need to borrow less in coming years



Source: ABS, CBA



Key Positions

The rally after S&P revised their outlook for the US has damaged many of our positions, which were generally biased towards expectations of higher yields. Many of the spread trades and relative value trades have done well and this lessens the blow a little.

We have been stopped out at the revised stop for our paid 6M*1Y trade. Our butterfly trade was stopped out last week.

We also choose to take profit on the swap spread widening trade (the ASW on Oct-14). The trade hadn't quite reached our target, but was close.

Key Trades

Trade	Entry	Curent	Profit	Target	Stop	Comment
Buy the NSWTC Jun-20 (Govt G'teed) as an ASW	-12bp (3-Feb-10)	-22.5bp	+10.5bp	-35bp	0bp	Hold: A long-term buy-and-hold trade.
Buy the ACGB Jan-18 vs the ACGB Nov-12	54bp (8-Dec-10)	50bp	+4bp	10bp	85bp	Hold. We apologise, this trade was recommended a while ago, but was accidentally excluded from the trade table.
Buy the KfW Dec-19 vs the IBRD Oct-19	33.5bp (31-Jan-11)	25bp	+8.5bp	20bp	40bp	Hold: The Portuguese issues are not affecting KfW.
Pay the ASW of the ACGB Oct-14	31bp (14-Feb-11)	38.5bp	+7.5bp			Take Profit: Near our target and quite wide.
Buy the Feb-15 IBRD vs the Oct-14 IBRD	9bp (15-Feb-11)	10bp	-1bp	2bp	12bp	Hold: The IBRD curve is too steep compared to the ACGB curve
Pay the AUD 3Y rate vs the NZD 3Y rate (carry 2.9bp per month)	132bp (21-Feb-11)	148bp	+22bp (including +6bp carry)	210bp	140bp	Hold: The spread is relatively stable but should trend wider. There is strong positive carry so we can hold the trade for the medium term.
Buy the QTC 2020 against the IBRD 2020	20.5bp (28-Feb-11)	24.5bp	+4bp	28bp	15bp	Hold: We expect the APRA liquidity announcement will see the spread widen more.
Receive the 5Y vs paying the 2Y and 10Y in an AUD swap butterfly	14bp (14-Mar-11)	26bp	-12bp	0bp	26bp	Stopped Out: The 2Y/5Y curve steepened to new highs and the market didn't price any RBA action.
Receive fixed in 1Y ZCS vs paying 5Y ZCS	-38bp (14-Mar-11)	-35bp	+3bp	-15bp	-50bp	Hold: The ZCS curve is overestimating the impact of the floods
Buy an NSWTC Nov-20 Linker vs UST 1.25% Jul-20 linker	213bp (14-Mar-11)	230bp	-17bp	150bp	235bp	Hold: The real yield pickup is large. The US linkers are likely to underperform once QE ends.
Pay 6M*1Y AUD swap	5.07% (18-Mar-11)	5.20%	+13bp			Stopped out at revised stop: The rally after S&P revised the US outlook took rates lower.
Buy the ACGB Feb-17 against the Apr-15 (double exposure)	20.5bp (30-Mar-11)	16.75bp	+7.5bp	15bp	25bp	Hold: An RV trade which also benefits from a flattening curve
Buy the TCV Oct-14 against the ACGB Oct-14	25bp (31-Mar-11)	25bp	0bp	20bp	28bp	Hold: An RV trade to take advantage of the wideness of the TCV
Receive the ASW on the NZGB Dec-17 against pay the Apr-15	15bp (4-Apr-11)	8bp	+7bp	5bp	20bp	Hold: The NZGB ASW curve is out of alignment.
Buy the Renten Jul-14s against the Jan-15s	20bp (5-Apr-11)	21bp	+1bp	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)			n/a	n/a	Hold: A deliberate insurance trade if our general optimism proves unfounded. (Given rally, trade would be profitable)
Receive the 10Y Bills/Libor basis against the 3Y	15bp (11-Apr-11)	13bp	+2bp	7bp	19bp	Hold: We the recent flow has steepened the curve too far.



The Federal Budget is facing short term headwinds

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- Government revenue is being adversely impacted by natural disasters and a higher Aussie dollar.
- Despite short term challenges to the budget, debt levels probably won't increase significantly.
- CGS supply still looks set to fall substantially over the next few years.

The 2011/12 Federal Budget is released on May 10.

The Federal Government passes the 2011/12 Budget on May 10. The usual pre-budget political posturing is underway and speculation is building over deficit targets and spending decisions. Federal Treasurer Wayne Swan is already making noise about being fiscally “tough”. And there are good reasons to be tough. As the recovery in the Australian economy gains momentum and inflationary pressures build, the macro cycle is demanding tighter fiscal policy.

Compared with recent years, the Government budget position continues to improve. However, changing economic and financial market conditions, along with a spate of natural disasters, are making the pace of fiscal recovery more challenging than initially expected.

Budget facing short term headwinds

In the Mid Year Economic and Fiscal Outlook (MYEFO), the Government noted revenue challenges, mostly from lower corporate tax receipts, reflecting a high Aussie dollar. At the time, the 2010/11 deficit was revised up by \$800m to \$41.5bn, or 3.0% of GDP. The longer term goal of a cash surplus by 2012/13 looked to be on track. The Aussie dollar has appreciated since November, suggesting a further adverse revenue shock.

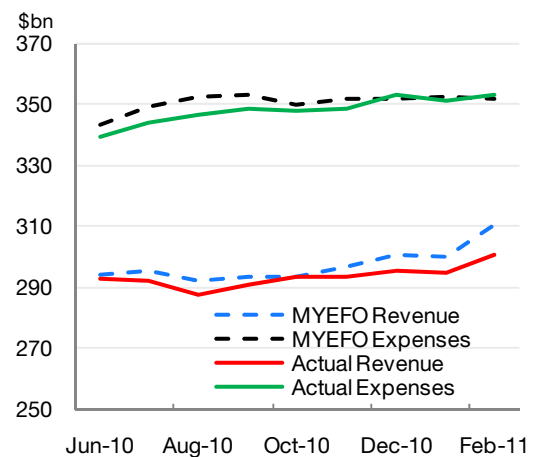
There are also large new costs from recent severe weather events, which are placing additional pressure on the budget. The Government's initial estimate puts the total budget damage from the Queensland floods alone at \$5.6bn. The flood levy is expected to recoup just \$1.8bn, but the Government won't see that revenue until next financial year. Ongoing budget provisions for natural disasters provide some offset, as do previously flagged cuts to green programs (such as the \$0.4bn “cash for clunkers” program).

The economic consequences of the Japan disaster and slower consumer spending will probably add further setbacks to revenue. Press reports on the weekend suggest the Government's 2010/11 GDP growth forecast has been lowered further to 2 ¼%, following a cut in February to 2 ½% from 3 ¼%.

Higher AUD and floods present downside risks to Government revenue.

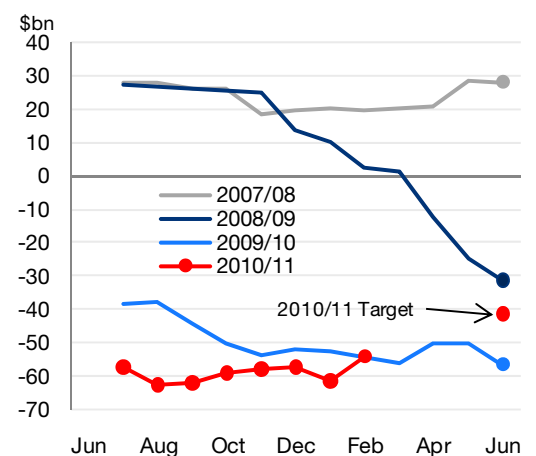
There are short term economic risks from the Japan crisis and slower consumer spending.

Figure 1 – Government Monthly revenue and expenses (rolling annual balance)



Source: Department of Finance, CBA

Figure 2 – Monthly Government budget balance (rolling annual headline cash balance)



Source: Department of Finance, CBA



The 2010/11 deficit target looks challenging, based on current trajectory.

The Government announced that Commonwealth tax revenue is down by around \$4.5bn, mostly because of lower tax receipts from businesses. On the expenditure side, we're yet to see the full impact of the flood reconstruction costs. The Treasury only just released the February numbers last Friday. It's likely that the full extent of the reconstruction costs won't be known until many months later. Still, the figures at hand show that the deficit is looking slightly worse than expected this year. As of February, the underlying cash balance was behind budget by around \$2.4bn. General Government sector total revenue and expenditure is in the order of \$350bn annually. In this context, \$2.4bn is not a particularly alarming variance.

Figure 1 illustrates that, relative to the MYEFO projections, actual revenue is slightly behind budget and expenses are broadly in line. In Figure 2 we compare the headline balances over a number of financial years. The recovery in monthly finances required to meet the 2010/11 target looks challenging, even relative to the performance of the boom year in 2007/08.

Implications for bonds

While the deficit might look worse this year, we expect the recent shocks to revenue and expenditure to be mostly temporary. Moreover, on budget night, markets will be less concerned with the current year's balance. Instead, focus shifts towards the forward operating balance projections, policy changes and macroeconomic assumptions.

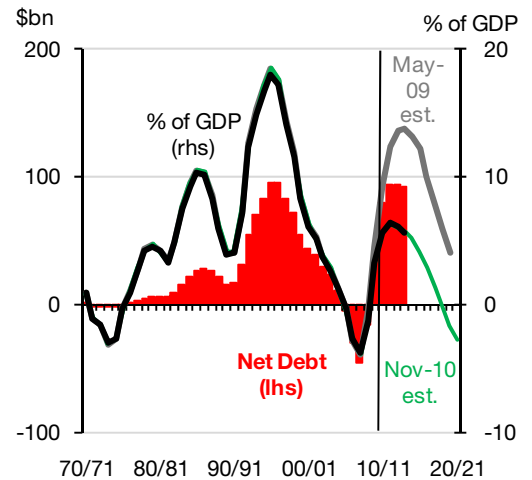
The longer term fiscal path still looks broadly on track. Certainly the Government has been firm on their commitment to deliver a surplus by 2012/13 (although it's not clear if that surplus will be less than the 0.2% of GDP forecasted at the MYEFO). The political risk from missing this target is high. In an economy of increasingly tighter capacity and with high household debt levels, excessive Government spending could be viewed as adding extra fuel to RBA rate hikes. It's likely that the aforementioned short term revenue pressure will be met with a sufficient reduction in future expenditure. As always, delivering on that commitment will be no easy task.

Political pressure is likely to re-enforce 2012/13 surplus target.

Net debt levels and CGS issuance aren't likely to be substantially higher.

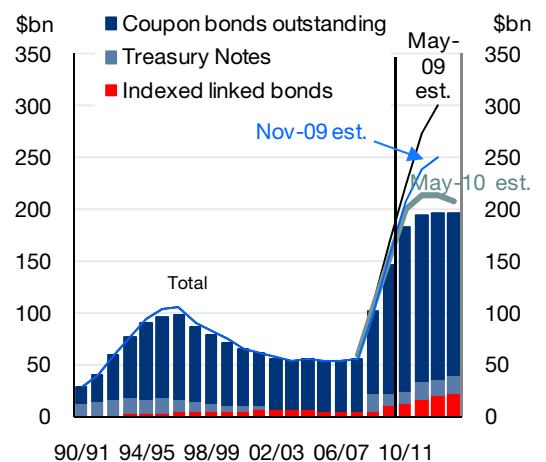
If there is a temporary increase in the deficit before 2012/13, it's unlikely to significantly alter the outlook for net debt. Figure 3 illustrates the progressive decline in Government net debt projections in recent years, which remain low by global standards. The expected peak in Australian Government debt of 6.4% of GDP is significantly lower than G7 debt levels in the order of 90% of GDP.

Figure 3 – Commonwealth General Government net debt



Source: Department of Treasury, CBA

Figure 4 – Commonwealth Securities outstanding



Source: AOFM, CBA



Figure 4 illustrates the fall in CGS issuance forecasts in recent years. Following the MYEFO in November, the AOFM made small downward revisions to CGS issuance forecasts. We don't think the current adverse fiscal shocks will lead to large revisions to CGS issuance volumes compared with the MYEFO. Total Government bond outstandings are still likely to reach approximately \$180bn in 2011/12, before declining over the following years.

Lower CGS supply and rate hikes are likely to add flattening pressure to the curve over time.

In our view, falling CGS supply from lower Government debt, combined with strong offshore demand are likely to remain key themes for the Australian market in the coming years. However, if the budget reveals an excessive reduction in government expenditure, the RBA will have less work to do on the rate hike front. The full ramifications won't be known until May 10. However, on balance, we favour a higher cash rate and flattening of the Aussie curve over time.



Crowds coming back for the new (corporate) game in town

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- The deterioration in Government fiscal positions is only small in the scheme of things.
- The sharp increase in Government borrowing seen in 2009 and 2010 is starting to slow.
- This opens the way for an increase in the borrowing of SSAs and banks, but particularly true corporate issuers.

We are approaching Budget season in Australia. As highlighted in the accompanying article (p3), the Federal Government is indicating that Commonwealth finances are under pressure. The newly-elected Governments in Victoria and New South Wales are also flagging fiscal pressures in those States. However, unlike the situation in the United States, we don't perceive that the AAA rating of any of these governments is under pressure (see p10 for our take on S&P's move to place the long-term US rating on negative outlook). Nor do we expect anything other than a marginal impact on funding requirements.

Government budgets have been slightly weakened by the soft spot in the economic expansion

It is clear that government revenue has been weaker than expected. The soft-patch in the economy has lowered company profits, housing stamp duties and GST receipts (with Victoria also suffering from an additional change to the distribution of federal grants). Expenses are also under pressure due to rising capex costs and the spate of natural disasters. But none of this is terribly important in the broader scheme of things, with the on-going economic expansion and strength in national income growth ensuring that fiscal strategies remain broadly on track. We see much of the 'guidance' as reflecting the usual softening up that new governments undertake ahead of their first Budgets.

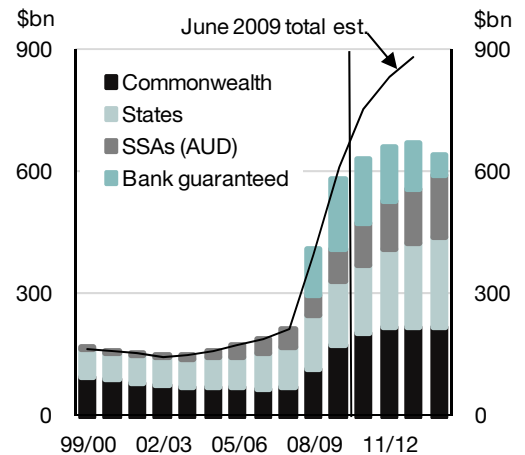
But there will be limited growth in high-grade bond outstandings

The broad story remains one of limited growth in high-grade AUD bond outstandings (see Figure 1). By contrast, demand for these securities is very strong due to the AUD's growing status as a reserve currency and bank liquidity requirements. That underpins our call for AUS-US spreads to narrow over time and for the domestic yield curve to flatten.

SSAs and high grade issuers will likely issue more – but so will corporates

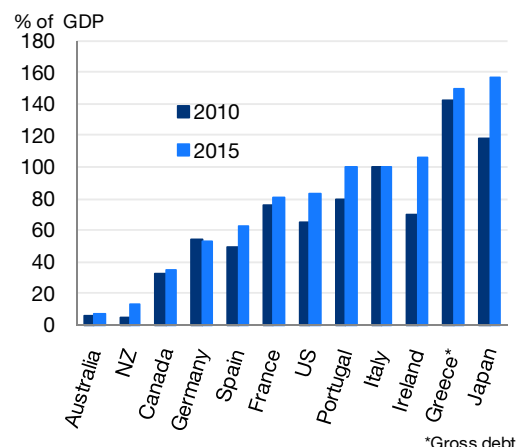
We have also anticipated that the public sector's reduced call on national savings will open the door for alternative issuers to step in. SSAs are a logical replacement given the wide cross-currency basis swap. They were issuing record volumes ahead of the APRA liquidity ruling and we expect the market to pick up again before long. AAA covered bonds issued by domestic and foreign banks will be another significant growth market once legislation is passed (hopefully later this year). But we also see the door opening for greater corporate and bank issuance in the years ahead.

Figure 1 – High-grade AUD bond outstandings



Source: Budget Reports, KangaNews, CBA

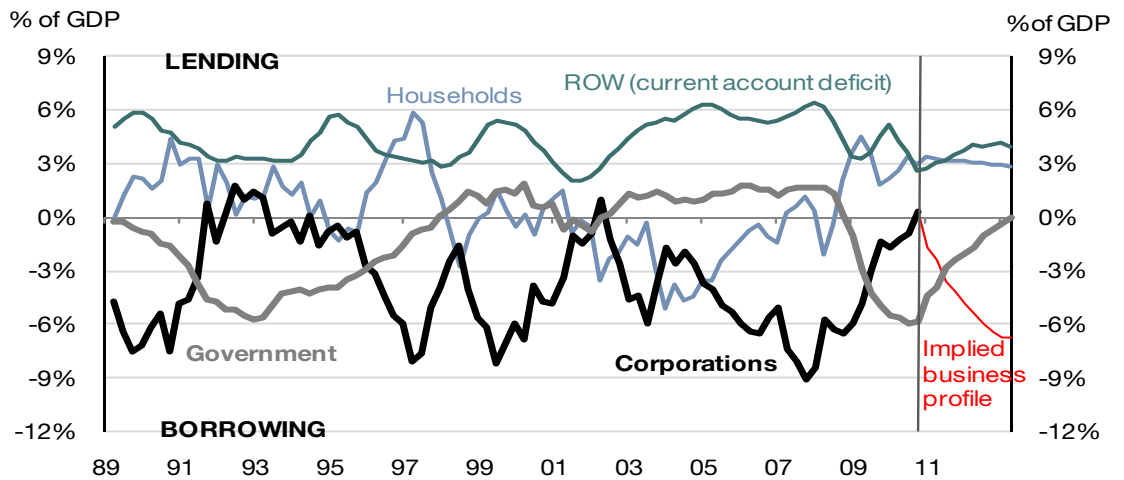
Figure 2 – General government net debt



Source: IMF, CBA



Figure 3 – National Financial Accounts Flow of Funds Matrix

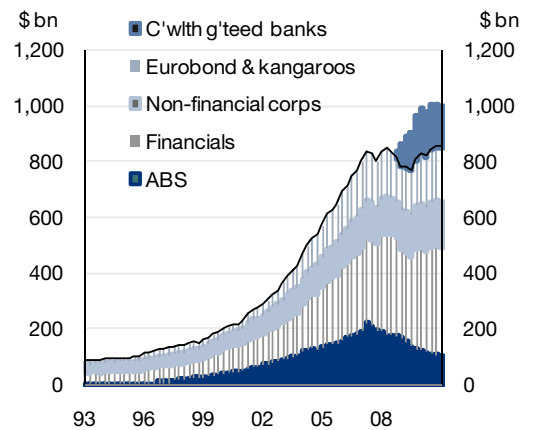


Source: ABS, Budget Reports, CBA

Crowds return for the new game

Back in February 2009 (much to the chagrin of our DCM colleagues), we suggested that the Australian debt market was about to experience a classic case of ‘crowding out’. It was clear that public sector finances were deteriorating rapidly. Without much scope for household savings to lift substantially, or tolerance for the current account deficit to widen sharply amid the GFC, we perceived this would crimp the room of the corporate sector to issue much paper. Figure 4 shows that if we exclude the new Government supported bank GG bonds, overall Australian non-government issuance has been broadly flat since that time.

Figure 4 – Non-government bond outstandings



Source: State Budget Reports, KangaNews, CBA

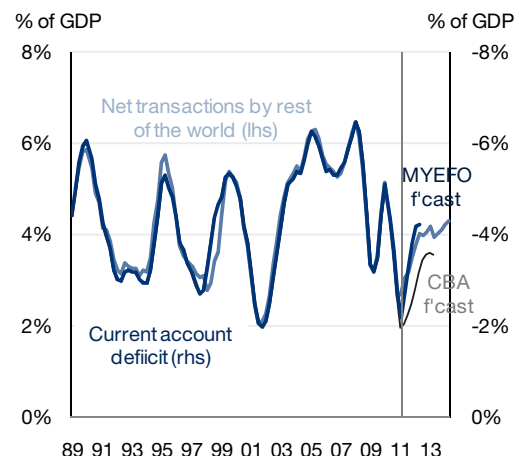
In 2009 Government borrowing increased while businesses borrowed less

Picking issuance trends from the bottom-up is difficult. Our analysis instead reflected top-down usage of the flow of funds data published within the national financial accounts each quarter. The flow of funds matrix is constructed using the principle that one sector’s borrowing must equate to the lending of the other sectors within the economy. The data is volatile and can be subject to significant revisions, but it does allow one to estimate business credit usage as a residual of other sector’s lending.

The reduction in Government borrowing allows businesses back in

Figure 3 shows how the pull-back in business borrowing coincided with the public sector’s shift into deficit. It also shows that we now envisage this cycle is about to turn – the unfolding improvement in government finances, together with a relatively steady current account deficit and household saving rate, means the door is wide open for borrowing to pick-up.

Figure 5 – Lending by the rest of the world



Source: MYEFO, ABS, CBA

Calculations

Figures 5,6 and 7 show the assumptions (forecasts) resting behind this analysis:



Assumptions for calculations

- the profile for the current account deficit rests between that of our economists and the Commonwealth Government estimate in the latest MYEFO;
- household net lending is assumed to recede slightly in line with our economists profile for the savings rate to gradually ease from current levels, though on-going 'consumer caution' clearly presents some near-term risk to that profile;
- government borrowing is forecast to diminish as combined State and Commonwealth Budget positions gradually return to surplus.

Governments were borrowing less, but that was before the floods and softer data

Governments kindly forecast their borrowing requirements 3-4 years forward, so this should be the easiest component of the accounts to forecast (relative to fickle consumers and global capital flows). However, Figure 7 shows that the latest readings from the national accounts are somewhat inconsistent with the various mid-year reviews published in late 2010. The quarterly data shows that the combined deficit actually peaked at 6% of GDP in Q3 and improved only slightly to 5.9% in Q4 (on a 12-month rolling sum basis).

There was a significant fall in government borrowing in dollar terms in Q4 (to \$16.4bn from \$22.7bn), suggesting the forecasts for a much lower deficit in 2010-11 could be achieved. But that was before the floods hit Queensland and Victoria and the January-February patch of softer activity data. The risk of slippage in fiscal positions that governments have been alluding to does therefore look quite real. That indicates there could be a delay to the pick-up in corporate borrowing that Figure 3 points to.

Side note – implications for the curve

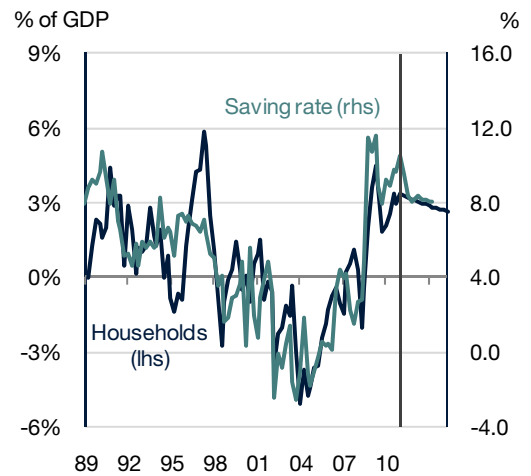
Austerity might slow the flattening of the curve

Any revenue measures or cuts to spending to address this slippage will impact on growth forecasts. The signal and reality of fiscal rectitude (as already demonstrated by the Commonwealth through the introduction of the 'flood levy') should provide underlying support to Aussie bonds. That would support our forecast for AUS-US bond spreads to narrow (but needs to be gauged against the possibility of more extensive near-term fiscal action in the United States). However, fiscal action could see the market further push out the timing or extent of expected RBA tightening, which would challenge our core curve flattening view.

Who will borrow?

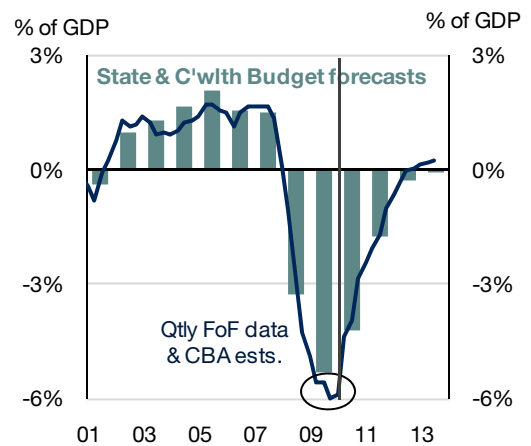
While there is risk that the lift in borrowing is more modest than implied by the flow of funds analysis, the broad picture is clearly pointing to a turn in the cycle. Quarterly trends can be

Figure 6 – Lending by the rest of the world



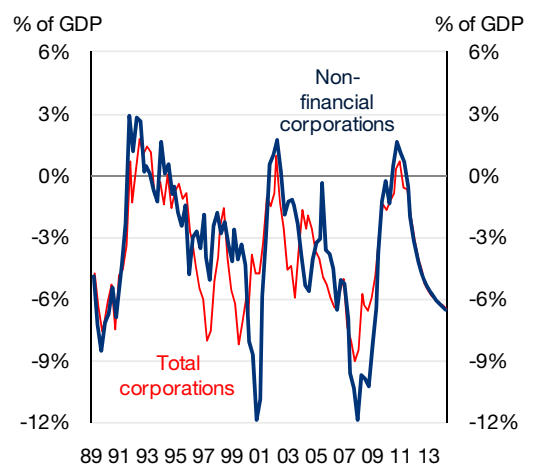
Source: ABS, CBA

Figure 7 – General government fiscal balance



Source: ABS, CBA

Figure 8 – Change in financial position



Source: Department of Treasury, CBA



Flow of funds data mimics business credit

knocked around by financing decisions within the financial sector. But Figure 8 highlights that the non-financial corporate sector is the key driver of borrowing trends (as should be expected given the data is net).

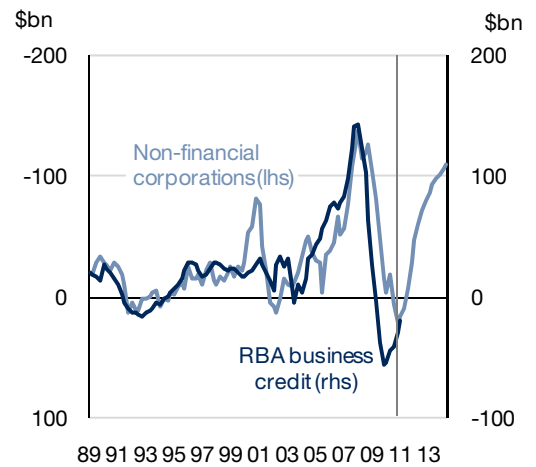
Figure 9 shows that the flow of funds data correlates with the RBA business credit aggregates published each month. Normally we would expect a significant upswing in business credit to unfold from here – to perhaps \$100bn a year by 2013. The usual intermediation process would point to a sharp lift in financials bond issuance, as we saw before the GFC (Figure 10). It seems likely the hiatus in bank debt issuance should soon ease.

It is also true, however, that there has been a degree of disintermediation taking place. Figure 11 highlights how corporate bond outstandings have grown even as business credit has shrunk. The corporate sector is clearly diversifying its funding sources in the wake of the GFC. The intensity of that trend may weaken as banks compete for growth in the quarters ahead. However, the rise in bank funding costs experienced during 2H-09 (when housing credit was strong) suggests there will be limits on how much of the pick-up in credit is funded through the banking sector.

We expect a sustained pickup in true corporate issuance

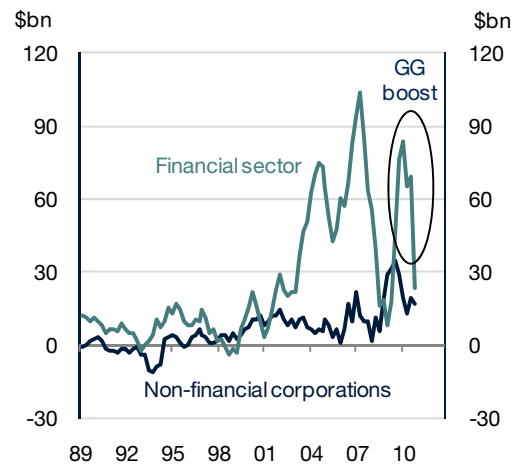
Financial credit spreads have generally underperformed true corporates over the past year, suggesting the latter will continue to find capital markets an attractive option for financing. We think this environment bodes well for a sustained pick-up in corporate bond issuance. The only real question seems to be whether any of this will be captured domestically. Figure 12 shows how all of the growth of recent times has been accounted for by issuance into offshore markets.

Figure 9 – Change in corporates financial position v RBA business credit



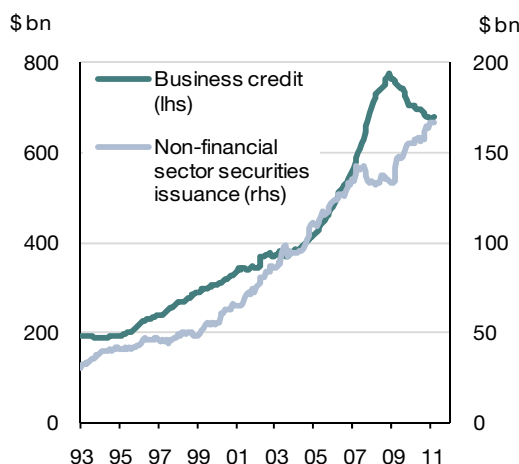
Source: RBA, ABS, CBA

Figure 10 – Long-term debt issuance (net)



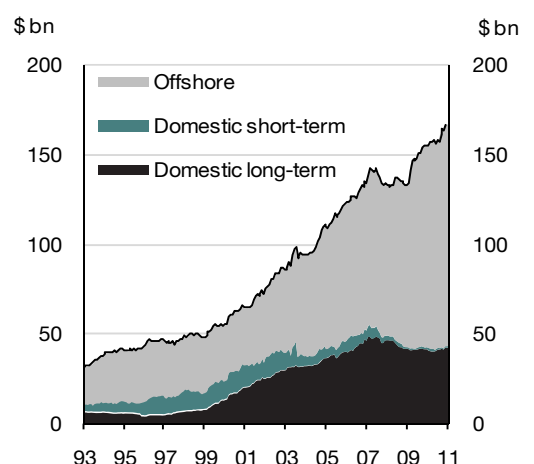
Source: Department of Treasury, CBA

Figure 11 – Corporate bonds on issue v credit



Source: ABS, RBA, CBA

Figure 12 – Corporate bonds on issue



Source: RBA, CBA



S&P revises US AAA long-term sovereign outlook – Market implications

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Also contributing: Richard Grace, Joseph Capurso, Philip Brown, Steve Shoobert, Michael Bors and James McIntyre

- S&P have affirmed the US's AAA long-term ratings, but revised the long-term outlook from stable to negative.
- We see limited implications for US GDP growth, global GDP growth, US treasuries or investment grade yields.
- The USD is likely to feel some mild downward pressure. But the implications for the USD are not large.

Standard & Poor's decision

S&P affirmed its 'AAA' long-term and 'A-1+' short-term sovereign credit ratings on the United States of America. *The AAA rating reflects "its high income, highly diversified and flexible economy, backed by a strong record of prudent and credible monetary policy".* However, S&P also revised its outlook on the long-term rating to negative from stable.

S&P states that there is at least a one-in-three likelihood that it could lower its long-term rating on the U.S. within two years. *"The outlook reflects our view of the increased risk that the political negotiations over when and how to address both the medium- and long-term fiscal challenges will persist until at least after national elections in 2012".*

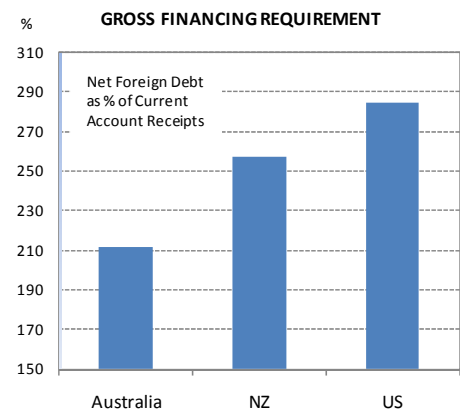
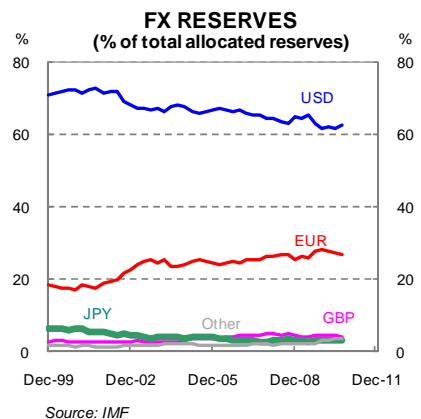
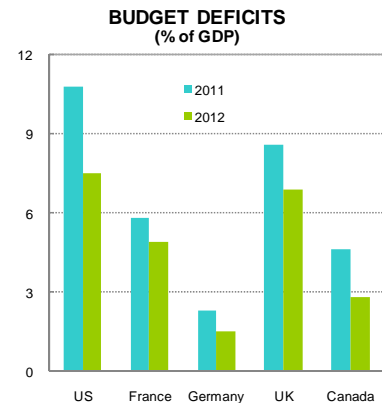
Our central view is there is no imminent downgrade of the US sovereign rating, but we note the real risk of a downgrade in coming years if the US fiscal deficit reduction strategy is not credibly implemented.

S&P forecasts 3% annual real growth for the US economy, with net general government debt to reach 84% of GDP by 2013. As way of comparison, S&P placed the UK on negative outlook in May 2009 because of perceived challenges to strengthen the tax base and contain public spending. At the time, S&P forecast the UK government debt burden could approach 100% of GDP by 2013 and remain near that level thereafter. However, the rating was revised to stable when S&P believed that the UK government would implement most of its spending-led fiscal consolidation program, and that debt would instead peak at approximately 80% of GDP in 2013 and decline thereafter. If the US can successfully implement a deficit reduction strategy, then S&P is likely to change the outlook back to stable, as they did for the UK.

Implications for the USD

The implications for the USD are modestly negative. The main effect is an erosion of the perceived role of the USD as a store of value. But any erosion takes a long time to work its way through the currency market. The downward pressure on US sovereign ratings only supports our view that the USD is in a long-run structural decline. Please see *FX Strategy – The long-run structural decline in the USD*, published 23 March 2011.

In the short and medium-term, we expect the USD to remain the world's largest reserve currency. Currently, the USD accounts for 61.4% of total central bank foreign exchange reserves. But it is very clear that major fund managers are diversifying their reserves out of USDs. In 2001, USD reserves accounted for almost 73% of total central bank FX reserves.





The implications on the exchange rate of a change to the *outlook* on the US AAA sovereign rating are very different to a downgrade of the AAA sovereign rating. By way of illustration, when S&P revised the UK ratings outlook from stable to negative in May 2009, the GBP initially fell. But the impact was short-lived. The GBP gained ground over subsequent months, rising more than 7.5% on a trade-weighted basis. The UK government began to implement a credible fiscal-deficit reduction strategy, which eventually resulted in S&P revising the ratings outlook back to stable in October 2010.

If the US's actual AAA sovereign rating were to be downgraded at some point in the future, the short-term implications for the USD would be much more negative. In the long-term, there is a real possibility that the US will experience such a downgrade.

The S&P press release makes it clear that the rating agency is getting less-tolerant of the US's AAA rating when they compare the US to other AAA-rated peers. The inability of the US government to agree upon and implement a credible fiscal-deficit reduction strategy is damaging US ratings metrics. The stock of US government debt is now approaching 84% of GDP. US net foreign debt is not particularly high at 42% of GDP, but it is now approaching 300% of current account receipts. This "gross financing requirement" measure is "one of the highest of all the sovereigns" S&P rate. The same "gross financing requirement" measure in Australia and New Zealand is 212% and 257% respectively.

We remain fundamentally bearish on the USD. But continue to have a short-term cyclical strengthening of the USD in our forecasts, which we anticipate will occur over the second half of 2011, following the conclusion of the US's quantitative easing policy at the end of June 2011. The eventual lift in US two-year bond yields relative to the bond yields of the US major trading partners' is expected to guide the USD temporarily higher.

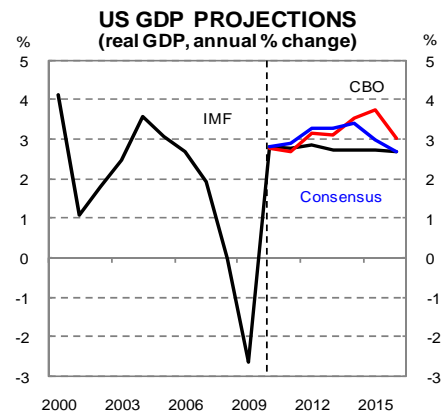
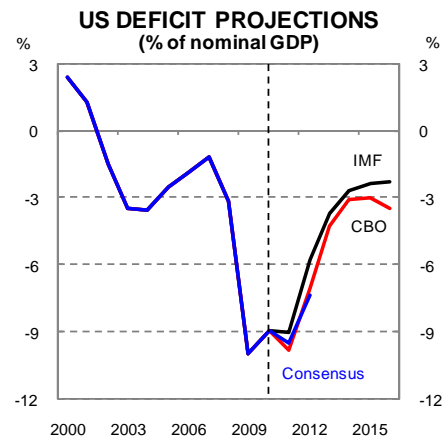
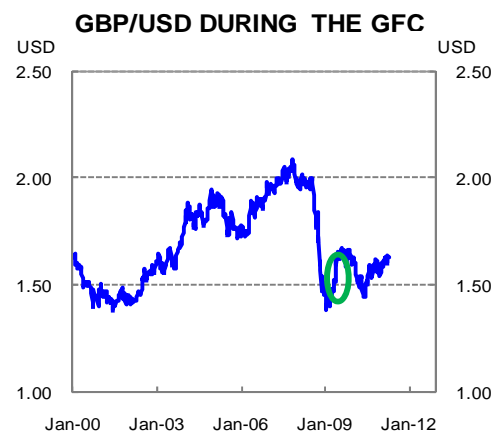
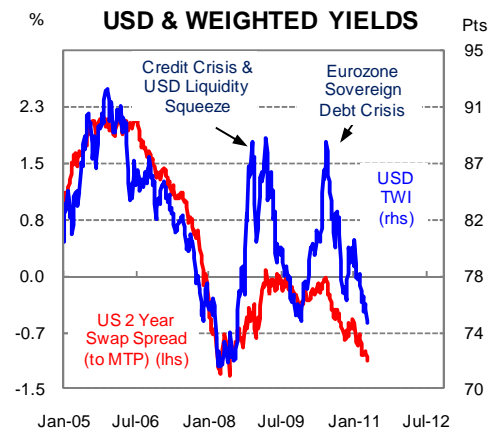
US and global economic growth implications

In our view, there are few implications for US or global economic growth. The downward revision to the US sovereign outlook by S&P reflects the political difficulty in agreeing on the type of fiscal consolidation. The proposals for a significant shift are there. The Obama Administration's Budget proposal is to reduce the cumulative budget deficit by US\$4.0 trillion in twelve years or less, and some fiscal consolidation has already been factored into expectations for the US and global economic outlook. The opposition Republican proposals centre on cutting both taxes and spending. The opposition Republican party is aiming to reduce the cumulative budget deficit by US\$4.4 trillion in ten years.

There are differences of view as to the pace at which fiscal consolidation occurs. For example, the IMF is forecasting a more significant fiscal consolidation than the CBO and Consensus. Consequently the IMF are forecasting a slightly slower rate of GDP growth for the US economy. However, most GDP growth forecasts centre around a 3.0%pa average or just below, until 2016.

A path of swifter fiscal consolidation would require larger cuts to spending, and/or tax increases. Larger spending cuts would impact public sector demand for labour, but private sector jobs growth is more than offsetting the cuts to public sector employment currently underway.

Revenue saving measures are targeted towards the upper end of the economic spectrum, with the expiry of income tax cuts for high-income earners at the end of 2012. This impacts a very small proportion of taxpayers. The overall economic impact is relatively small because the lost consumption from increases in tax paid by a small proportion of households is likely to be swamped by a normalisation of US consumer





spending patterns by the other 98% of consumers.

Implications for bond markets

The US rating outlook change is the story of the day. But the change is unlikely to have much direct impact on US yields. US Treasuries initially sold off on the news overnight, but subsequently rallied amid a flight to quality on the back of further European sovereign concerns and the sharp drop in risk appetite. The short-term price reaction highlights how broader economic and market tensions are likely to dominate the impact of US concerns. Even in the event of a downgrade, the impact is not necessarily a negative. For example, while there are clear differences between the two economies (particularly foreign ownership of government bonds), Japan’s experience over recent years also highlights how broader economic factors can be a more important driver of bond yields than bond supply or credit rating.

We do not expect S&P will downgrade the US in the next 1-2 years. The S&P change in outlook partly reflects the poor outlook for the US fiscal position over the long term and a perceived lack of political will to fix it. This is not new. It does highlight the long-term challenges confronting US policy-makers. These challenges do mean there is a reasonable chance of a downgrade sometime over the next decade (as there is for many AAA economies). But US policy makers were already discussing a range of (quite different) deficit reduction plans before the S&P announcement. S&P’s warning shot (along with the approaching debt ceiling) should help act as a catalyst for achieving agreement that will preserve the AAA rating for the time being. Fiscal tightening normally tends to lower bond yields due to the impact on the economy and potentially monetary policy.

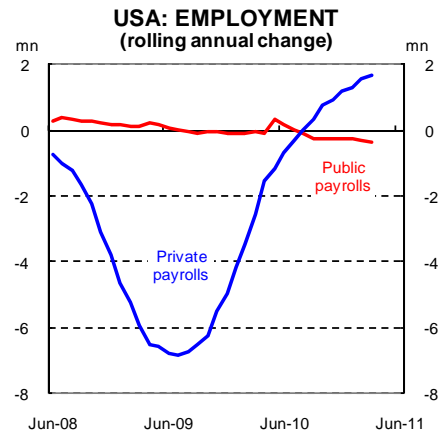
We recently updated our forecasts for US bonds. We see no reason to change them again now. We continue to forecast a slow rise in US yields, driven by the unfolding US recovery, an end to QE2 and an eventual modest rise in the federal funds rate. We forecast only a slow rise because some government action to alter the fiscal trajectory has been anticipated. The S&P action has, at the margin, increased the chance of a more severe austerity package, but not enough to change our underlying view on yields. The end of QE should contribute to a rise in real bond yields, as the Fed ends its purchase program. But some tightening of fiscal policy and the end of QE should also moderate inflation expectations, which have been the major driver of the sell-off since October.

Implications for investment grade credit markets

At this stage, we see little reason why the outlook change should prompt a material repricing of high-grade private sector credit spreads. This view is predicated on the assumption that outright interest rates do not rise materially. Corporate bonds valuations should therefore continue look attractive on the basis that credit spreads represent a high (40%-50%) component of overall yields.

Valuation considerations aside there are also some fundamental reasons to think that investment grade credit can have some immunity from sovereign considerations:

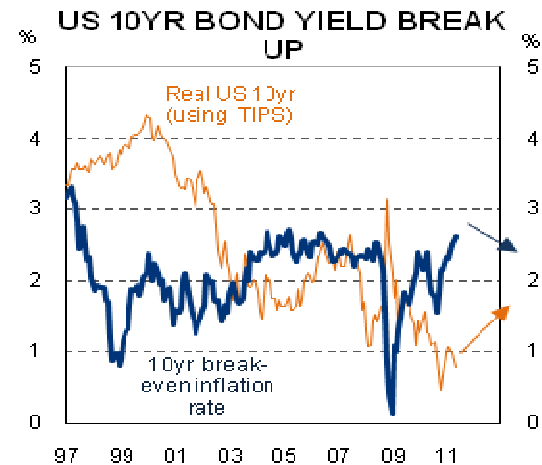
- The huge deleveraging of the private sector since the GFC has increased the capacity to withstand exogenous shocks or changed market conditions;
- The capacity to raise yet more equity from shareholders (a lever unavailable to a sovereign) remains in place; and
- Sovereign issues should keep corporate memory of the GFC stronger for longer and therefore contain the otherwise growing



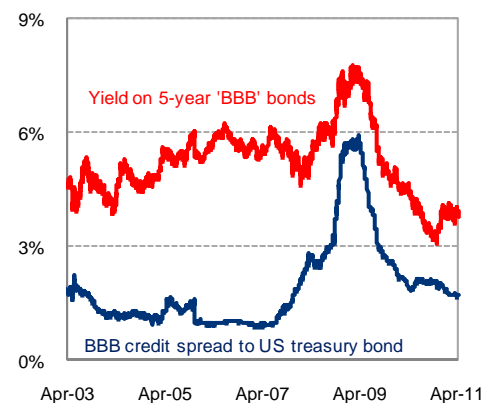
SUMMARY OF CBA BOND FORECASTS

(%)	Now	Jun-11	Dec-11	Jun-12
Official Cash	4.75	4.75	5.25	5.75
90-day BBSW	4.86	5.00	5.60	6.00
Aus 3yr bond	5.05	5.30	5.75	5.90
Aus 10yr bond	5.49	5.70	5.90	6.00
Aus 3-10yr (bp)	45	40	15	10
US 2yr bond	0.64	1.10	1.70	2.30
US 10yr bond	3.37	3.70	4.00	4.20
AUS-US 10yr spread (bp)	212	200	190	180

Source: CBA, Bloomberg



BBB 5-YEAR BONDS



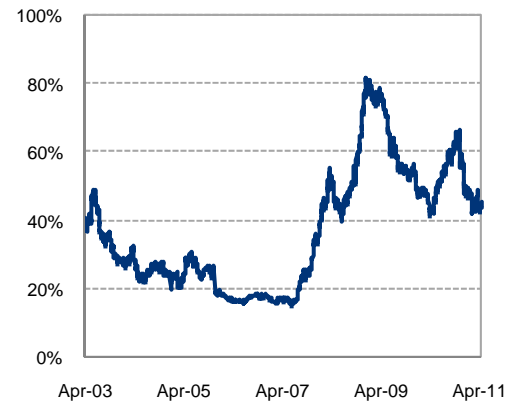


threat from event risk (share buy-backs, M&A, etc).

With regards to financials specifically, we highlight that Moody's was already in the process of revising the systemic support assumptions in bank ratings, while S&P is reviewing its entire bank rating methodology.

These reviews may now involve greater consideration of the capacity and willingness of the US government to support certain bank creditors. But we do not envisage further material methodology changes beyond those already underway.

BBB CREDIT SPREAD/BBB YIELDS





Key Views

United States		Tactical (<1 mth)	Strategic (>3 mths)
<p>The underlying data in the US continues to improve, though global events are clouding the picture. Uncertainty about the stability of the Middle East & high oil prices are buffeting data, confidence and markets, but aren't a recovery deal-breaker. US politicians have agreed a budget deal to avoid shutdown. The next step will be to pass an increase in 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 (though even this is now starting to show signs of life) and the very low level of (underlying) inflation, though Bernanke has been softening his tone on this a little in the face of high commodity prices. Various Fed officials are starting to publically debate when and how to remove QE, though no action is likely until expiry on June 30. Later, once the Fed starts raising the Fed Funds rate, we see room for the curve to flatten markedly.</p> <p>The USD is likely to stay heavy while the Fed maintains QE until the end of June. Low volatility, the US company profit reporting and US debt issues are likely to keep the USD soft in the near term. The ECB is significantly more hawkish than the Fed so we expect EUR to keep tracking higher as Eurozone-US 2yr bond spread push out to fresh cyclical highs.</p>	Policy rate	0.1%	0.1%
	10yr bond	3.60%	3.80%
	2/10 curve	280bp	270bp
	USD/JPY	83.00	84.00
	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. RBA tightening in 2010 put substantial flattening pressure on the domestic curve and saw spreads to the US widen noticeably. But the impact of that tightening on both the retail sector and the AUD has curbed inflation pressure and contributed to a change in market trend in late 2010 (together with the US bond sell-off).</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. However, with no "smoking gun" likely in the near term, a new flood levy on the way and some further fiscal tightening in prospect, timing on rate rises is harder to predict. Australian spreads to US should tighten quickly when the Fed starts to raise rates.</p> <p>The AUD has met our intermediate target of 1.05. Now 1.08 is in play as the USD remains weak and market under-pricing for RBA rate hikes is likely to be supportive. In a low volatility environment, the recent good US economic data raises the risk of a further lift in equities that would support a higher AUD.</p>	Policy rate	4.75%	5.00%
	10yr bond	5.70%	5.80%
	3/10 curve	40bp	30bp
	10yr EFP	52bp	55bp
	10yr v US	210	200
	AUD/USD	1.0500	1.0800
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.</p> <p>The New Zealand economy was already weakening before the quake and the rest of the year is likely to be a slow grind. Economic activity appears to have stalled over the second half of 2010. Data continues to suggest that inflation 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>Even though New Zealand is close to recession, the weak USD and firm global agricultural prices and low vol environment are very supportive for the NZD. We expect the USD to remain weak in the near term and keep NZD comfortably in a mid-to-high 70s range. Now that the Reserve Bank of New Zealand has delivered its rate cut and signalled no more cuts are likely, NZD is likely to benefit more than AUD from firm global growth, as well as an eventual re-pricing of RBNZ rate hikes.</p>	Policy rate	2.50%	2.50%
	10yr bond	5.60%	5.80%
	2/10 swap curve	210bp	200bp
	10yr v US	200	200
	10yr v AUS	-10bp	0bp
	NZD/USD	0.79	0.75
	AUD/NZD	1.35	1.32



CBA Forecasts:

Cash rate	20-Apr	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	20-Apr	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
US	0.65	1.10	1.40	1.70	2.00	2.30	2.60	2.80
Australia	4.94	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	1.15	1.70	2.00	2.20	2.40	2.50	2.60	2.60
Eurozone	1.80	2.00	2.20	2.40	2.60	2.80	3.00	3.00
Japan	0.21	0.20	0.25	0.25	0.30	0.35	0.40	0.40
10-yr bond yield	20-Apr	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
US	3.37	3.70	3.90	4.00	4.10	4.20	4.30	4.30
Australia	5.51	5.70	5.80	5.90	6.00	6.00	5.90	5.90
New Zealand	5.74	5.80	5.90	5.90	6.00	6.00	5.90	5.80
United Kingdom	3.55	4.00	4.20	4.30	4.30	4.40	4.40	4.40
Eurozone	3.28	3.60	3.70	3.80	3.90	4.00	4.00	4.00
Japan	1.26	1.30	1.30	1.40	1.40	1.40	1.50	1.50
Currencies	20-Apr	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
AUD/USD	1.06	0.99	0.94	0.92	0.90	0.88	0.85	0.85
AUD/JPY	87.48	85.14	81.78	80.96	79.20	77.44	74.80	74.80
AUD/EUR	0.74	0.68	0.66	0.66	0.66	0.65	0.64	0.65
AUD/GBP	0.65	0.58	0.56	0.56	0.56	0.55	0.54	0.54
AUD/CAD	1.01	1.01	0.97	0.96	0.95	0.92	0.92	0.92
AUD/NZD	1.33	1.32	1.31	1.30	1.29	1.28	1.25	1.25
USD/JPY	82.81	86.00	87.00	88.00	88.00	88.00	88.00	88.00
EUR/USD	1.44	1.45	1.42	1.40	1.36	1.35	1.32	1.30
GBP/USD	1.63	1.70	1.68	1.65	1.60	1.59	1.58	1.58
USD/CAD	0.95	1.02	1.03	1.04	1.05	1.05	1.08	1.08
NZD/USD	0.79	0.75	0.72	0.71	0.70	0.69	0.68	0.68



Calendar – April 2011

Monday	Tuesday	Wednesday	Thursday	Friday
Early May AU House Prices, Q1 (2 May) AU Building approvals, Mar (5 May) AU Retail trade, Mar (5 May) AU Trade in Goods & Services, Mar (10 May) AU Federal Budget (10 May) AU Labour force, Apr (12 May) AU Housing finance, Mar (16 May)	Central Bank Meetings AU RBA (5 April) JP BoJ (7, 28 April) UK BoE (7 April) EU ECB (7 April) CA BoC (12 April) US FOMC (27 April) NZ RBNZ (28 April)			AU AI-Group PMI, Mar, Index, (51.1) NZ Manufacturing activity QIV, q%ch, (1.3) CH PMI Manufacturing, Mar, Index, (52.2) EU/GE/UK PMI manufacturing, Mar, Index, (57.7/60.9/61.5) US Non-farm payrolls, Mar, '000, (192K) US Unemployment rate, Mar, %, (8.9) US Avg hrlly earnings, Mar, m/y%ch, (0.0/1.7) US Construction spending, Feb, m%ch, (-0.7) US ISM manufacturing, Mar, Index, (61.4) US Total vehicle sales, Mar, mn, (13.38)
4 AU CBA/AI-Group PSI, Mar, (48.7) AU TD inflat gauge Mar, m/y%ch, (0.2/3.6) AU ANZ Job ads, Mar, m%ch, (1.2) EU PPI, Feb, m/y%ch, (1.5/6.1) UK PMI construction, Mar, Index, (56.5) UK BoE Housing equity withdrawal, QIV, £bn, (-6.1) IMF World Economic Outlook Chapters	5 AU Trade balance Feb, \$bn, 1.2, (1.875) AU RBA cash rate, %, 4.75, (4.75) NZ NZIER Business opinion survey Q1, (8) EU PMI services/composite, Mar, Index, (56.9/57.5) EU Retail sales, Feb, m/y%ch, (0.4/0.7) GE/UK PMI services, Mar, Index, (60.1/52.6) US ISM non-manufacturing, Mar, Index, (59.7) US FOMC Minutes	6 AU AI-Group PCI, Mar, Index, (44.6) AU Housing finance, Feb, m%ch No. of own-occupiers, %, -5.0, (-4.5) Value of all loans, %, -5.0, (-4.6) JP Leading / Coincident index CI, Feb, , (101.5/105.9) EU GDP, QIV, q/y%ch, (0.3/2.0) GE Factory orders, Feb, m/y%ch, (2.9/16.0) UK Industrial production, Feb, m/y%ch, (0.5/4.4) UK NIESR GDP estimate, Mar, m%ch, (0.2) CA Ivey purchasing manager index, Mar, (69.3)	7 AU Labour force, Mar employment, '000, 25, (-10.1) participation rate, %, 65.7, (65.7) unemployment rate, %, 4.9, (5.0) JP BoJ target rate, %, 0-0.10 (0-0.10) EU ECB announces int. rate, %, 1.00, (1.00) GE Industrial production, Feb, m/y%ch, (1.8/12.5) UK BoE announces rates, %, 0.50, (0.50) US Consumer credit, Feb, \$bn, (5.0) CA Building permits, Feb, m%ch, (-5.1)	8 JP Curr a/c total/adjusted, Feb, ¥bn, (461.9/1089.2) JP Trade balance - BOP basis, Feb, ¥bn, (-394.5) GE Trade bal, Feb, €bn, (10.1) UK PPI Input/Output/core, Mar, y%ch, (14.6/5.3/3.1) US Wholesale inventories, Feb, m%ch, (1.1) CA Net change in employment, Mar, '000, (15.1) CA Unemployment rate, Mar, %, (7.8) CA Housing starts, Mar, '000, (181.9)
11 NZ Business PMI, Feb, Index, (53.7) CH Trade balance Mar, US\$bn, (-7.3) NZ Card spending, Mar, m%ch, (-0.2) JP Machine orders, Feb, m/y%ch, (4.2/5.9) IMF World Economic Outlook Forecasts	12 AU NAB Bus conf/cond, Mar, Index, (14/-2) EU/GE ZEW survey (econ. sentiment), Apr, (31/14.1) GE CPI, Mar, m/y%ch, (0.5/2.0) UK RICS house price balance, Mar, %, (-26) UK Total trade balance, Feb, £bn, (-2.95) UK CPI, Mar, m/y%ch, (0.7/4.4); core, y%ch, (3.4) US Import price index, Mar, m/y%ch, (1.4/6.9) US Trade balance, Feb, \$bn, (-46.3) CA Housing price index, Feb, m%ch, (0.2/1.9) CA Trade balance Feb, C\$, (0.1) CA Bank of Canada, %, 1.00, (1.00)	13 AU RBA Gov Glenn Stevens speaks in New York AU MI/WBC Consumer Sent, Apr, Index, (104.1) AU DEWR skilled vacancies, Apr NZ Food prices, Mar, m%ch, (0.1) JP Domestic CGPI, Mar, m/y%ch, (0.2/1.7) EU Industrial production Feb, m/y%ch, (0.3/6.6) UK ILO unemployment rate (3mths), Feb, %, (8.0) US Federal Reserve Beige Book US Retail sales, Mar, m%ch, (1.0) US Business inventories, Feb, m%ch, (0.9) CA Bank of Canada Monetary Policy Report	14 AU MI Consumer Inflation Expectat, Apr, %, (3.6) AU MI Unemp. Exp., Apr, Index (105.9) AU New motor veh. sales, Mar, m/y%ch, (0.2/-1.5) NZ Business PMI, Mar, Index NZ PSI, Feb, Index, (50.8) NZ Retail sales, Feb EU ECB Monthly report US Producer price index Mar, m/y%ch, (1.6/5.6)	15 CH PPI/CPI, Mar, y%ch, (7.2/4.9) CH Industrial production, Mar, y%ch, (14.9) CH GDP, Q1, y%ch, (9.8) CH Retail sales, Mar, y%ch, (11.6) JP Industrial production/Capacity utilisation, Feb EU CPI, Mar, m/y%ch, (0.4/2.4); core, y%ch, (1.0) EU Trade balance Feb, €bn, (-3.3) EU ECB Monthly report US CPI, Mar, m/y%ch, (0.5/2.1); core, m/y%ch, (0.2/1.1) US Capacity utilisation, Mar, %, (76.3) US Industrial production, Mar, m%ch, (-0.1) US Uni. Of Michigan confidence, Apr, Index, (67.5)
18 NZ PSI, Apr, Index NZ CPI, Q1, q/y%ch, (2.3/4.0) US NAHB housing market index, Apr, (17)	19 AU RBA Board Minutes JP Consumer confidence, Mar, Index, (40.7) EU Current account, Feb, €bn, (-0.7) EU Construction output, Feb, m/y%ch, (1.8/-4.5) US Housing starts/permits, Mar, '000, (479/517) CA CPI, Mar, m/y%ch, (0.3/2.2) CA Leading indicators, Mar, m%ch, (0.8) CA Wholesale sales, Feb, m%ch, (1.5)	20 AU MI Consumer Inflation Expectat, Apr, % AU Trade Price Indices, Q1, q%ch import prices, 3.5, (-3.8) export prices, -0.6, (-8.1) GE Producer prices, Mar, m/y%ch, (0.7/6.4) UK Bank of England minutes US Existing home sales, Mar, mn/m%ch, (4.88/-9.6)	21 AU PPI Q1, q/y%ch, 1.0, (0.1) NZ Credit card spending, Mar, m/y%ch, (-0.3/5.3) GE IFO - Business climate, Apr, Index, (111.1) UK Retail sales, Mar, m/y%ch, (-0.8/1.3) US Leading indicators, Mar, m%ch, (0.8) US Philadelphia Fed, Apr, Index, (43.4) CA Retail sales, Feb, m%ch, (-0.3)	22
25 JP Trade bal total/adj, Mar, ¥bn, (654.1/556.0) US New home sales, Mar, m%ch, (-16.9) US Dallas Fed, Apr, Index	26 GE Retail sales, Mar, US S&P/Case-Shiller home price ind., Feb, US Richmond Fed, Apr, Index, (20)	27 AU Consumer Price Index, Q1, q/y%ch Headline, 1.3/3.1, (0.4/2.7) RBA Underlying, 0.6/2.1 (0.4/2.3) NZ NBNZ Business confidence, Apr, Index EU Industrial new orders, Feb, m/y%ch, (0.1/20.9) UK GDP, Q1, US Durable goods orders, Mar, m%ch, (-0.9) US FOMC rate decision, %, 0-¼, (0-¼) CA Teranet House Prices, Feb,	28 NZ RBNZ official cash rate, %, 2.50, (2.50) JP CPI, Mar, JP Industrial production, Mar, JP Housing starts/construction orders, Mar, JP BoJ target rate, %, 0-0.10 (0-0.10) UK GfK consumer confidence survey, Apr, Index US GDP, Q1, q%ch/saar, (3.1) US Pending home sales, Mar,	29 AU Private sector credit, Mar, AU RP Data house prices, Mar, NZ Building permits, Mar, NZ Trade balance, Mar, US Employment cost index, Q1, q%ch, (0.4) US Personal income/spending, Mar, m%ch US PCE deflator/core, Mar, y%ch US Uni. Of Michigan confidence, Apr, Index

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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