Global Markets Research

Fixed Income: Weekly Strategy

21 March 2011

CommonwealthBank

Re-pricing the front-end as worst case scenarios recede

- The market briefly priced an RBA rate cut by September. The implied rate has risen, but remains below 4.75%.
- We don't believe the RBA will lower rates. We recommend paying the 6m*1Y swap
- Supranational bonds may experience selling as Japanese investors reposition after the quake.

Financial markets spent the week grappling with the Japan earthquake and nuclear crisis. In response to the disaster, risk assets sold-off and bonds rallied across the globe. In Australia, 3Y and 10Y yields have fallen 3bp and 1bp respectively. In the US, the flight to safety led to an 8bp fall in US 10Y and only a 1bp fall in 2Y yields. The outperformance of the US long end pushed the Aus-US 10y spread 9bp wider to 215bp.

In Australia, there has been a distinct shift in the market's outlook for the RBA since our last Weekly Strategy note. When news emerged of a possible nuclear contamination last Tuesday, rates at the front end of the Aussie curve fell substantially. At one point, the market was pricing a chance of an emergency rate cut from the RBA before the end of March. There's been a sell-off in the last two days, but the market is still pricing a 15% chance of a 25bp rate cut in April and a 30% chance of a rate cut by July. In an article on page 3, Philip Brown examines the transmission of risk from the Japan disaster to the Australian economy and interest rate market. He finds that an RBA rate cut is unlikely and current market pricing presents an opportunity to pay 6M*1Y swap or 6M*6M OIS.

In the midst of the news about the Japan crisis, the Aussie market received the March RBA Minutes and a speech by RBA Assistant Governor Guy Debelle. The minutes contained few surprises and attracted no interest from the market. Debelle's speech focussed on trends in the Aussie bond market, but it was his comments on the new APRA liquidity rules that were of most interest. The RBA don't think the new rules will favour any particular bonds. In an article on page 7, Adam Donaldson examines the post APRA announcement bond landscape and finds the initial effects have largely unwound.

The events in Japan (and market moves in anticipation of the repatriation of Yen) prompted the G7 to intervene to weaken the Yen. Meanwhile NATO established a no-fly zone in Libya. The Australian market focus looks set to remain on these global stories. There is no important Australian economic data scheduled for release in the next week. On Thursday, the semi-annual RBA Financial Stability Review is released and RBA Assistant Governor Malcolm Edey will speak.

In the US, the FOMC statement and CPI were the key releases last week. The Fed was more upbeat about the US outlook, but they haven't changed their position on QE2. We continue to expect the Fed to allow the program to expire in June. The headline US CPI rose 0.5% (consensus +0.4%) in February, reflecting higher food and energy costs. CPI Excluding food and energy rose 0.2% in the month, to be 1.1% higher over the year. The week ahead in the US is quieter from a data perspective. The main focus for the market will be on the February durable goods orders (consensus +1.2%) on Thursday and PCE data next Monday (consensus 0.2%).

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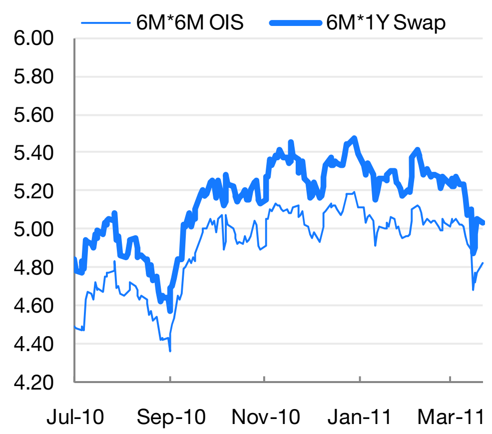
Australian front end rates reacted strongly to Japanese news – but now starting to retrace



Source: CBA, Bloomberg

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Key Positions

The Japan nuclear scare has damaged a number of our trades by a small amount, but no one trade suffered severely. We had generally positioned with an assumption of rising RBA rates so the rally in the front end was against our core view.

However, we did not have an outright short rates position, though. We have used the recently rally to position with an outright short in the 6M*1Y rate.

We hold all our other trades as they are likely to improve as the market returns to pricing RBA rate increases.

Key Trades

Trade	Entry	Curent	Profit	Target	Stop	Comment
Buy the NSWTC Jun-20 (Government Guaranteed) as an ASW	-12bp (3-Feb-10)	-12bp	0bp	-35bp	0bp	**Hold**: A long-term buy-and-hold trade.
Buy the Suncorp Metway Govt Guaranteed Apr-11 Floater.	TM of 29.5bp	13bp	+16.5bp	0bp	40bp	**Hold:** This bond is Government Guaranteed. It should be much tighter. Repurchases of GG bank bonds becoming common.
Buy the KfW Dec-19 vs the IBRD Oct-19	33.5bp (31-Jan-11)	30bp	+3.5bp	20bp	40bp	**Hold:** The EU Sovereign CDS is improving, but the spread has not yet moved in AUD.
Pay the ASW of the ACGB Oct-14	31bp (14-Feb-11)	36bp	+5bp	40bp	25bp	**Hold:** We replace our 3Y EFP with this ASW instead. The bonds have lagged swap.
Buy the Feb-15 IBRD vs the Oct-14 IBRD	9bp (15-Feb-11)	9bp	0bp	2bp	12bp	**Hold:** The IBRD curve is too steep compared to the ACGB curve
Receive the 10Y swap vs the 20Y*10Y	-175bp (17-Feb-11)	-169bp	+6bp	-145bp	-195bp	**Hold:** The 30Y is too low in yield, the 20Y*10Y has pulled away from the 10Y spot rate.
Pay the AUD 3Y rate vs the NZD 3Y rate (carry 2.9bp per month)	132bp (21-Feb-11)	151bp	+22bp (including +3bp 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)	19bp	-1.5bp	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)	17bp	-3bp	0bp	20bp	**Hold:** RBA hikes would flatten the 2Y/5Y but the US may steepen the 5Y/10Y. A butterfly captures both. Rally following Japan earthquake is likely to reverse.
Receive fixed in 1Y ZCS vs paying 5Y ZCS	-38bp (14-Mar-11)	-44bp	-6bp	-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)	217bp	-4bp	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)	5.05%	-2bp	5.25%	4.98%	**New Trade:** We don't believe the pricing of rate cuts will continue

Front end showing rate cuts is a paying opportunity

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- The rally in the front end has left a moderate chance of an RBA rate cut in the front of the curve
- We think the RBA is very unlikely to cut rates. We recommend paying 6M*1Y swap or 6M*6M OIS.
- The swap is preferable to the OIS because the bills/OIS spreads would likely widen in a catastrophe scenario.

The devastation in Japan has prompted a rally in the Australian yield curve. The market, for a very short period, was pricing an implied RBA rate of as low as 4.50% in late 2011. However, the fall in rates in the body and at the longer end of the curve has perhaps been smaller than you might expect. (See Figure 1.)

While the front end of the curve has rallied strongly, the back end has rallied a little, but since rebounded. The body of the curve generally lagged the moves. On Friday we recommended a paid 6M*1Y swap position. We continue to recommend that trade, although we also like the 6M*6M OIS.

Front end rates below cash

The 6M*6M OIS is below the current cash rate (after you remove the effect of compounding). The sub-4.75% pricing is likely to quickly reverse. We also think that, over time, the OIS pricing will return to indicating rate hikes.

Rally is strongest at the front end and back end

We identified in our analysis of Australian butterflies (see Strategy Weekly of 14 March) that there was a possibility moves in US bonds would affect the butterfly by changing the 5Y/10Y slope. We were right about the mechanism, but wrong on the direction. The combination of news from Japan and Libya has seen the 5Y/10Y part of the curve flattening and the butterfly rising.

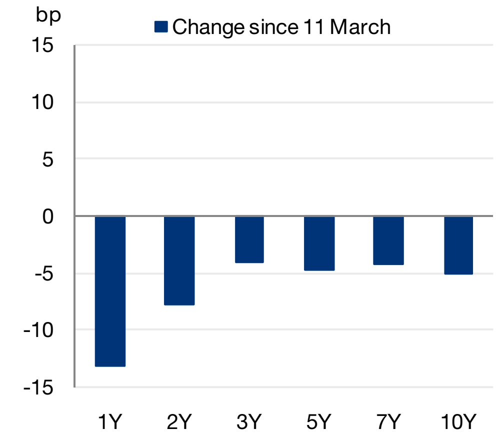
The AUD swap butterfly has moved a little wider since our suggestion to receive it last Monday. However, our PCA analysis suggests the 5Y is now far too high in yield compared to the 2Y and 10Y, so we recommend staying in the butterfly position we originally recommended.

An indication of a small chance of a large cut

The large move at the front end of the swap curve includes cash rate expectations. The implied RBA cash rate is now just under 4.75% for most of 2011. However, we interpret the this positioning as indicating the market expects a small chance of an extremely large cut rather than a moderate chance of a small cut.

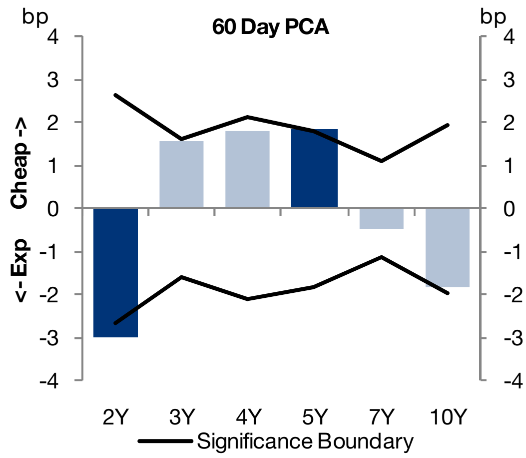
On March 11 (just before the earthquake) there

Figure 1 – Rally focused on front end and long end



Source: CBA, Bloomberg

Figure 2 – PCA cheap/dear of AUD swap curve



Source: CBA, Bloomberg

was a moderate expectation of the RBA raising rates priced into the Australian curve. (See Figure 2.) At the time we had suggested that the RBA was more likely to raise rates than the market was pricing.

Since the earthquake - with all the other crises it has caused - the market has significantly repriced RBA expectations to favour rate cuts. We don't think this is appropriate. Although there are some mechanisms by which the Japanese disaster will impact the Australian economy, they are not direct.

Mechanisms that transfer the problems from Japan to Australia

Japan could only trigger an RBA cut in the most extreme circumstances

Our economists published some thoughts on the crisis in the Economics Perspectives of 18 March. Unless the nuclear problems in Japan noticeably worsen, the impact on the Australian economy is likely to be relatively contained.

Although Australia exports significant volumes to Japan, there is very little correlation in the growth rates of the two countries. Australia's main categories of export to Japan are bulk commodities (coal and iron ore), food and tourism. These are not necessarily in industries that will be harmed by the recent events.

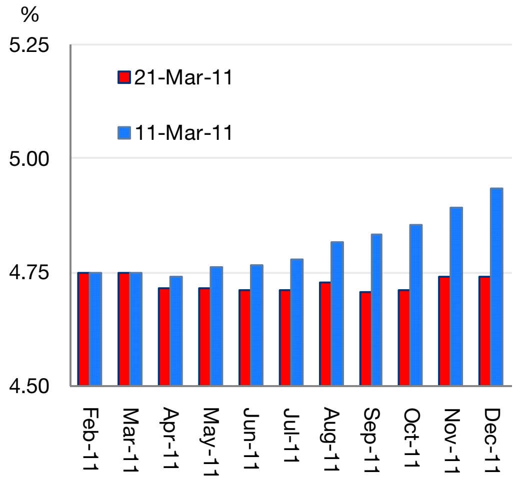
The three main exports to Japan are commodities, food and tourism

The bulk commodities Australia exports to Japan will be needed for rebuilding. Also, our economists pointed out that most of these exports are for long-run contracts which don't react quickly to unexpected events.

The food exports will be difficult to predict, but will rely on what, if any, damage is sustained in Japan's agricultural regions. Initial reports are that the tsunami affected agricultural regions. Generally speaking, Japan is so highly cultivated that almost all available space is already used. There will be no ability to rotate within the country to replace any lost production. Any damage to domestic crops from the tsunami or from nuclear contamination will increase Japan's imports of food. Australia would be a possible origination point for those imports.

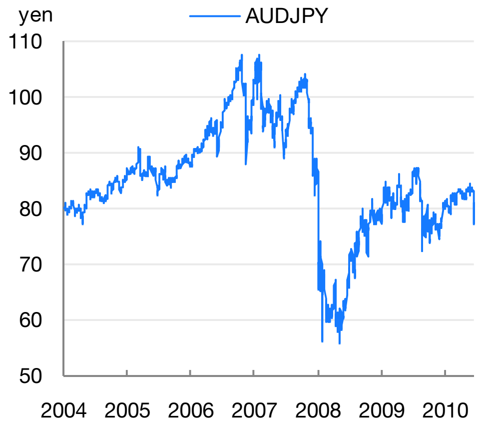
The final type of "export" to Japan is actually Japanese tourists coming to Australia. This market will be difficult to predict and has been declining in importance over the past few years. During the boom of 2005-2007 the strong AUD made Australia an expensive destination for Japanese tourists and damaged the tourist trade. Somewhat paradoxically, the Yen has been exceptionally strong since the quake and the AUDJPY is not particularly far from long-term averages. However, there will still likely be fewer overseas trips taken by the Japanese because of the earthquake.

Figure 3 – RBA pricing has borne the brunt of the move



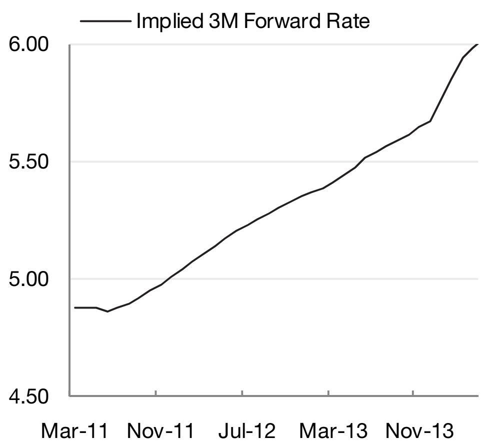
Source: CBA, Bloomberg

Figure 4 – AUDJPY isn't unfavourable for tourists



Source: CBA, Bloomberg

Figure 5 – Australian 3M rolling forward rates



Source: CBA, Bloomberg

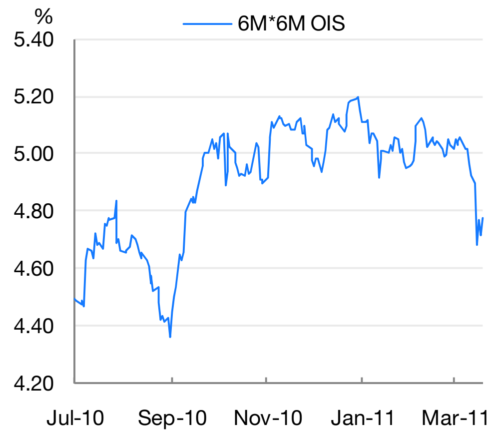
Yet, of the three, tourism is the only category that is likely to be dented and it was the least important anyway. The medium-term and longer-term impacts should be small. Globally, there are already a number of equity analysts highlighting that the combination of the Gulf oil spill and the Japanese nuclear crisis makes coal and natural gas the place to be. That suits Australia quite well in the medium term.

Japan will lose work days from voluntary shutdowns. This will affect the data in short term.

The very short term is not so positive. There is a significant prospect of short-term dislocation damaging volumes of exports. Many manufacturing plants and other business have shut down for safety reasons. The lost work days will impact on much of the Japanese data, but will only do so in the short term. A factory that has been voluntarily shut down can usually be opened again very quickly.

The other shorter-term impact is that the Australian market has been affected by the loss of confidence. Many international investors view Australia as comparatively high risk and highly leveraged to the global economy. In a risk-reduction period, like this past week, the AUD falls quickly. We think the rally in rates over the past week was more about the fear in the market than a considered reasoning about Australia's future. As the market calms down, which it appears to be doing now, the pricing should return to near the levels seen before the quake. In that vein, the G7 decision to intervene to weaken the Yen should assist the market to calm.

Figure 6 – AUD 6M*6M OIS



Source: CBA, Bloomberg

Delayed hikes are possible, but cuts only possible in the most extreme circumstances

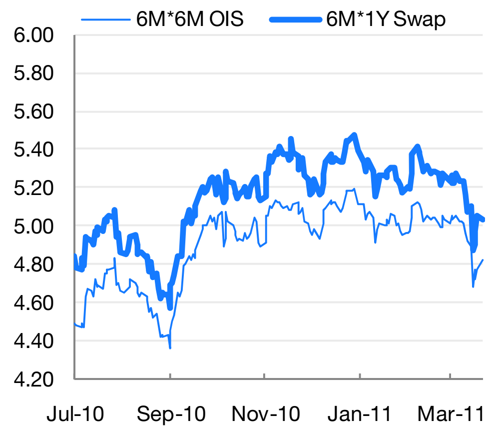
Given the overall strength in Australia's domestic economy we believe that the RBA will still be raising rates this year. The problems in Japan may delay RBA rate hikes but we don't think it is likely the RBA will be forced to cut rates.

6M*1Y swap or 6M OIS would capture rate risk

Yet, as we showed in Figure 2, the market is still pricing a chance of a rate cut. To take advantage of this we would concentrate short positions right at the front of the curve. This shape can also be seen in the rolling forward rates, which show that the front end of the curve is flat. (There has been a sell-off since we featured this in the Daily Wrap of 17 March.)

The two trades this front end inversion suggests are a 6M*6M OIS or a short-dated but forward starting swap trade. Figure 6 shows the 6M*6M OIS rallied significantly over the past week, before recovering a little. The 6M*6M is now trading at around 4.80%. OIS is quoted as a fixed rate, of course, so 4.80% for 6M is, in fact, below the current cash rate once the

Figure 7 – 6M*1Y swap



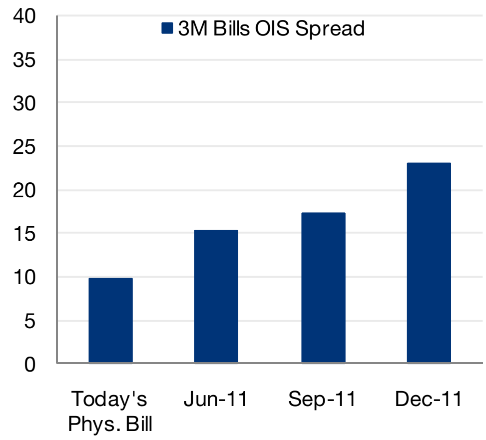
Source: CBA, Bloomberg

compounding is taken into account. Six months of compounding at 4.75% would yield an OIS quote of 4.81%.

Both the CBA economists and the general consensus of economists are looking for further rate hikes this year. The concern about Japan makes the timing harder to predict, but does not alter the fundamental direction. By positioning with a 6M*6M OIS rate that is below the current cash rate you would have a two-fold possibility for profit. We think a slight sell-off to reflect an unchanged cash rate is highly likely and should happen relatively quickly (assuming there is no further worsening of the radiation leak). There is also a strong possibility the market returns to pricing a chance of a rate hike, much like they were before the Japanese earthquake.

Over time, we expect the continuing strength of the Australian economy will draw the RBA into the fray and the possibility of a rate hike will become the actuality of one. (Or at least, the complete pricing of one in the futures market.) This will take more time - a month or two most likely - but will also profit the trade.

Figure 8 – Bills/OIS



Source: CBA, Bloomberg

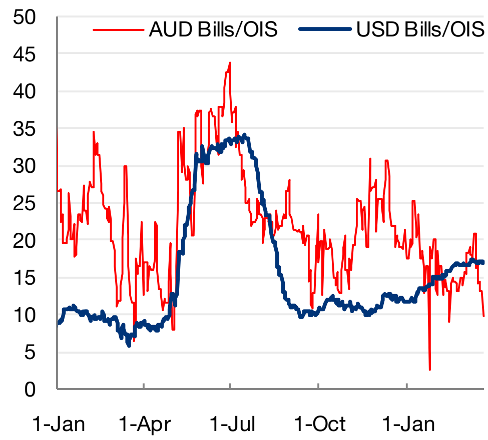
6M*1Y swap serves the same function – but overlays bank risk too

But 6M*1Y swap also captures widening in bank risk, should disaster occur

The 6M*1Y swap trade we implemented on Friday afternoon serves the same function. As we observed in Figure 4 there was an inversion of the curve at the front end, which made the front end swaps relatively cheap. 3M BBSW is currently setting around 4.84%, only 20bp below the 6M*1Y rate.

Figure 6 shows that the 6M*1Y has already rebounded further than the 6M*6M OIS, but probably has further to recover as well. The 6M*1Y swap is longer than the 6M*6M OIS, so the extra length implies a greater sell-off if the market returns to pricing a series of RBA rate moves. The 6M*1Y swap would also have an element of hedging in it if our assumption about Japan turns out to be wrong.

Figure 9 – Bills/OIS history



Source: CBA, Bloomberg

In our view, only the most horrible of the scenarios possible in Japan would influence the RBA to cut rates. There is a very small chance of a very large rate cut in response to a nuclear catastrophe. However, a scenario bad enough to hugely impact Australia economy and trigger a RBA rate cut would also involve some increase in bank risk. If the nuclear risk in Japan is damaging global growth, the damage to Japanese banks would be large. From there, the linkages between the Australian and Japanese banks would likely be strong enough to raise bank risk here. At the very least, the crisis would force the spread between bills and OIS up from its current very low levels. (These low levels have been caused, in part, by a reduction in bill issuance driving down yields.)

We doubt that the widening of bank risk would protect the trade from a loss. However, should our optimism prove misplaced and the market gap lower in yield, the bank risk implicit in the swap position should make the swap underperform the rally in the OIS. Since a catastrophe scenario implies a strong chance of a market dislocation and a big gap, that extra protection is useful.

APRA impact fades

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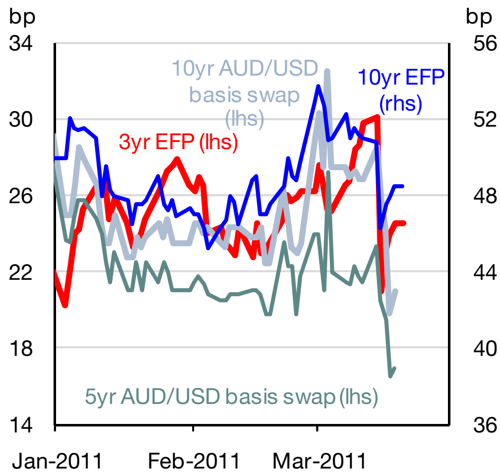
- Markets initially reacted strongly to APRA's liquidity announcement, though this has faded.
- Bank balance sheets only invested a small proportion in SSAs. This was a large proportion of the SSA market.
- Japanese investors may reduce their SSAs holdings after the quake. We hold our IBRD to QTC 10Y trade.

The immediate market impact of the 28 February APRA announcement on bank liquid assets faded quite quickly and has partially reversed.

Figure 1 shows that 10yr swap (EFP) and cross-currency basis swap spreads initially widened on the announcement, but later contracted. The 3yr EFP and 5yr AUD-USD basis swap also widened in the days immediately after the announcement. In recent days, the disaster in Japan has caused the 3y EFP to widen further and the 5y AUD-USD basis to fall. The basis is highly sensitive to large, unexpected, falls in the AUD/JPY rate because of the pressure this puts on structured carry trades.

Figure 1 – AUD basis swap and swap spreads



Source: Bloomberg, CBA

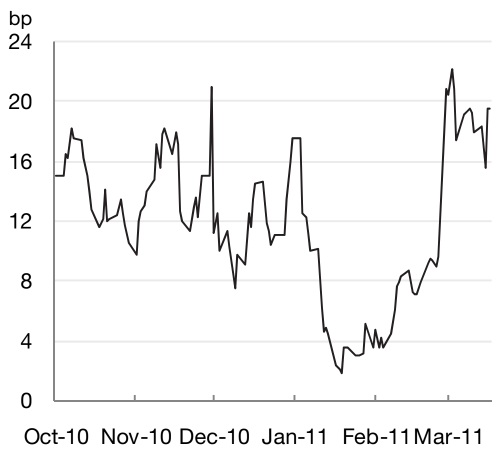
After the APRA announcement SSAs underperformed

If we look at the period between the 28th of February (APRA announcement) and the 11th of March (Japan earthquake), there was a significant reversal of the initial moves. This tightening appears to reflect greater confidence that Kangaroo issuance (and consequent hedging activities) will continue with minimal interruption – a view that was supported and no doubt reinforced by a couple of recent bank kangaroo deals. The consolidation in secondary market spreads may have brought an SSA deal to market if it hadn't been for the sudden narrowing in the basis swap (which diminishes the funding cost advantage of AUD issuance for SSAs).

But SSAs have recovered since

The widening in Supranational spreads versus swap and semi-government spreads also looks to have run its course. Figure 2 shows that the IBRD 2020 spread to QTC drifted as wide as 22bp following the APRA announcement before tightening back to 19bp at present. With our IBRD-QTC spread-widening trade now 2bp out of the money, we review the APRA developments and reconsider the relative outlook in the high-grade sector.

Figure 2 – IBRD Oct-20 spread to QTC Feb-20



Source: CBA

Revisiting the liquidity rules

APRA announced SSAs were not Level 1 assets in February

To recap, APRA announced in late February which assets will directly qualify for calculation of banks' Liquidity Coverage Ratio (Table 1). That list did not include covered bonds or any SSA securities, which we had thought would be a chance for inclusion given recent and prospective issuance into these markets and the shortage of other qualifying liquid assets in Australia. (Figure 3 shows we estimate total supply of CGS and semi-govts will rise to only about A$400bn, well below estimated bank liquidity requirements of around A$600bn.)

There has been no new information available since the APRA statement. However, it has emerged that not all investors (or issuers) were as familiar with the proposed RBA liquidity facility as we had believed. To recap, the RBA announced in December that it will establish a committed secured liquidity facility that will allow banks to count all RBA repo-eligible assets they hold as qualifying for the LCR.

SSAs are likely to be eligible for the RBA repo facility

The liquidity facility will enable banks to overcome the problems presented by the shortage of qualifying liquid assets in Australia. However, use of the facility will be subject to an as-yet-undisclosed fee. APRA also says that it *"will require the larger ADIs to demonstrate that they have taken all reasonable steps towards meeting their LCR requirements through their own balance sheet management, before relying on the RBA facility."*

The RBA argues that the announcements don't affect the demand for SSAs

RBA Assistant Governor Guy DeBelle recently reiterated APRA's view that the liquidity facility shouldn't affect *"relative demand for securities, other than CGS or semis."* He added that:

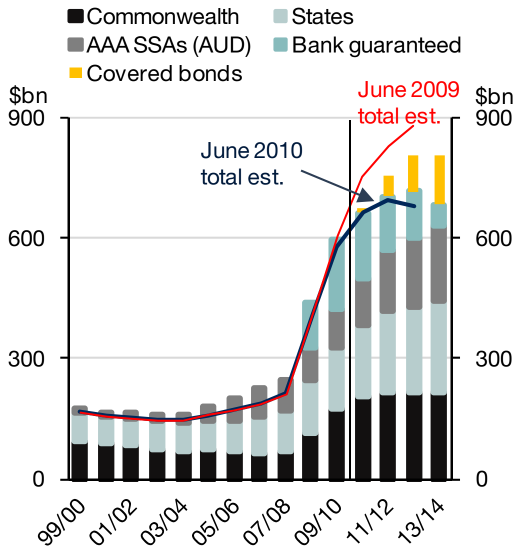
> *"Banks currently hold a range of assets to satisfy their liquidity requirements, with each asset having different credit, maturity and market liquidity characteristics. Our view of how much we are willing to lend against each asset under repo are based on these characteristics, and will continue to be so.*
>
> *In the future, we are moving to a world where there will be a formalised liquidity facility where a flat, positive fee is charged. So that should affect all asset classes equally and should not affect their relative attractiveness. So I would not expect this to change bank balance sheet's demand for the non-government assets they hold in their liquidity portfolios. For example, to the extent they hold SSAs today, they should still hold them in the future."*

Table 1: Qualifying Basel III LCR assets

Level 1	Level 2
Cash	None
Balances at RBA	
CGS	
Semi-govt securities	

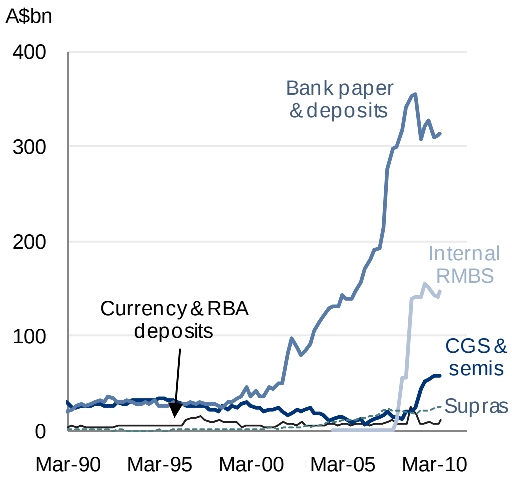
Source: Australian Prudential Regulation Authority

Figure 3 – High-grade bond outstandings



Source: CBA, State Budgets, RBA, Bloomberg

Figure 4 – Bank liquid assets (Q3 2010)



Source: Bloomberg, CBA

Table 2: Eligible assets for repo with the RBA

General Collateral	Minimum Rating^	Margins 0-1 yrs	1-5 yrs	5-10 yrs	>10 yrs
1. Commonwealth Government Securities	n/a	2	2	2	2
2. Semi-governments Securities	n/a	2	2	2	2
3. A$ Domestic Issues by Supranationals & Foreign Govts	AAA*	2	2	2	2
4. A$ Securities with an Australian Government Guarantee	n/a	2	2	2	2
5. A$ Securities with a Foreign Sovereign Government G'tee	AAA*	2	2	2	2
Private Securities					
Short-term Securities					
1. Bills and Certificates of Deposit	n/a	2	not eligible	not eligible	not eligible
2. Commercial Paper	A–1	10	n/a	n/a	n/a
3. Asset-backed Commercial Paper (ABCP)	A–1	10	n/a	n/a	n/a
Long-term Securities					
1. ADI-Issued Debt Securities	AA–	2	4	6	8
2. Asset-backed Securities (RMBS and CMBS)	AAA	10	10	10	10
3. Other AAA-rated Debt Securities	AAA	2	4	6	8

* In the case of securities guaranteed by the New Zealand government, at least AA+
^ S&P rating, or equivalent from another major rating agency.

Market impact and outlook

Bank paper

Banks used to hold bank debt and RMBS

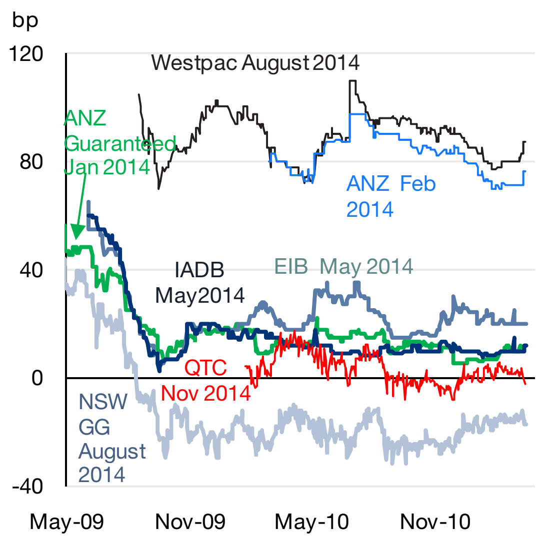
Australian banks have typically held large volumes of bank debt (and RMBS) for liquidity purposes. But demand had waned over the past couple of years (in favour of high-grade assets) due to regulators' desires to reduce systemic risk in the system (figure 4). In our view, the announcement of the RBA liquidity facility in December gave the market a boost because it confirmed that repo-eligible assets such as these will remain eligible for liquidity purposes.

Bank spreads have tightened recently

Figure 5 shows bank spreads have tightened recently, though they are yet to break the trading range and most of the observable trades are for maturities of less than 2015 implementation date of the LCR. It is also true that supply of bank paper remains limited due to healthy levels of deposit funding, which may have helped spreads to tighten (and is why we have been bullish on the sector).

At face value, indications that the fee for the RBA liquidity facility will be flat implies banks will (and perhaps that investors should) buy substantial volumes of bank paper since this (together with RMBS) yields the most within the repo-eligible class. After all, that was the pattern for the eight years before the GFC and proposals for regulatory change began to emerge. As DeBelle says, the current proposals should not "*change bank balance sheet's demand for the non-government assets they hold in their liquidity portfolios.*" Remember

Figure 5 – Bank spreads vs high-grade & swap



Source: Bloomberg, CBA

that the RBA has not flagged any changes to the haircuts for different repo eligible assets that may influence the composition of bank holdings.

Banks likely to hold more than minimum liquidity

It is, however, also true that banks are not purely incentivised to do the minimum that the rules allow. Even in the absence of regulatory change, the lessons learned from the GFC will no doubt encourage banks to hold more higher-rated and liquid assets than in the past.

Still, at this stage, it appears there is less pressure for banks to alter the composition of their portfolio than had been feared. In the absence of much supply of bank paper, we view the environment as quite supportive for bank paper. It is also positive for RMBS, as we saw through the large SMHL deal done last week without AOFM support.

SSAs

In the long end of the market, we saw Semi-government bonds strongly out-perform swap and SSAs following the APRA announcement (Figure 6). However, the knee-jerk reaction following the announcement didn't extend further (as we had thought it might), with some buying interest quickly re-emerging due to the widening in spreads.

We are concerned the recent demand for SSAs was on the assumption they would be eligible for liquidity books

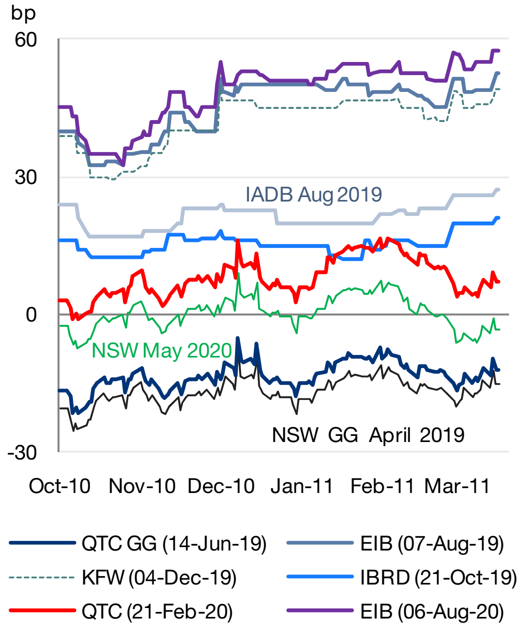
Our concern has been that demand for SSAs had recently been boosted by an expectation that they would qualify for LCR purposes. We think this helped to explain the out-performance of the sector versus semi-governments in January despite record issuance (see Figure 8).

On a broader timescale, however, not much has changed. SSAs have never accounted for a large share of liquidity books (Figure 4). But, as Figure 8 shows, the liquidity books are so large that the banks account for around 12% of the holdings of SSAs. That should mean they continue to play a role in underpinning demand for the sector and new deal issuance. In fact, arguably, appetite could increase relative to the past 10 years due to the greater desire to hold a diversified portfolio of liquid assets (even if they don't qualify for LCR).

Continue to see a narrowing in the basis swap

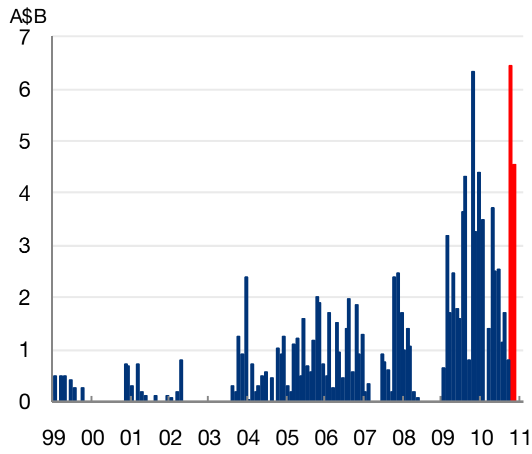
As detailed previously (Weekly Strategy January 31), the real key for performance of SSAs relative to the rest of the AUD high-grade sector is the cross currency basis swap. We continue to see potential for this to narrow going forward. In the short term, the crisis in Japan has led to greater volatility in the basis swap. The adverse impact of the crisis on market sentiment has led an expectation of less offshore issuance by Australian banks and corporates. As the situation has stabilised the basis has started rising back toward its recent ranges.

Figure 6 – SSA and Semi-govt spreads to swap



Source: Bloomberg, CBA

Figure 7 – SSA Kangaroo Issuance (monthly, Jan and Feb 2011 in red)



Source: CBA

Figure 8 – Ownership of bonds issued in

Risk of Japanese selling

The other key concern at present is whether the events in Japan and related fall in the AUD contribute to selling in the sector. Figure 8 shows that foreigners dominate holdings of AUD kangaroos and there must be a risk that selling due to repatriation into Japan or AUD concerns weighs on the sector. The recent widening in SSA and semi-government spreads to swap shows the market is concerned by these developments, even if not much has happened yet.

We estimate Japan owns over A$50b of debt

We estimate that Japanese investors currently hold over $50b in Aussie debt as a whole (the latest ABS figure is $45b, but is for 2009). The magnitude of the disaster in Japan is still coming to light, even a week after the event. Any possible outflows may take some time to come through, as investors in Japan assess their portfolios. Japanese investor selling would likely impact CGS, semis and SSAs. However, the relative illiquidity of SSAs compared with CGS and semis could see a slight underperformance by the sector over the coming weeks.

We will wait and see how this plays out before acting to close out our IBRD/QTC 2020 spread widening trade.

Australia by the rest of the world

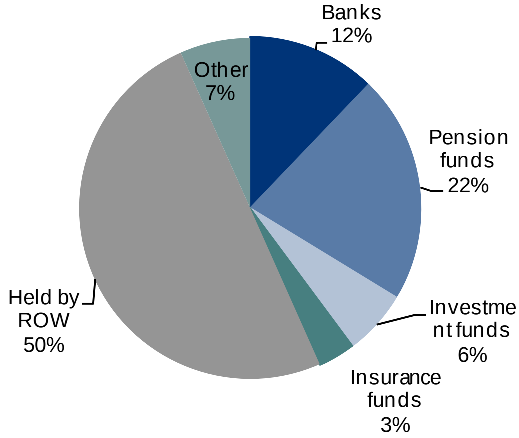
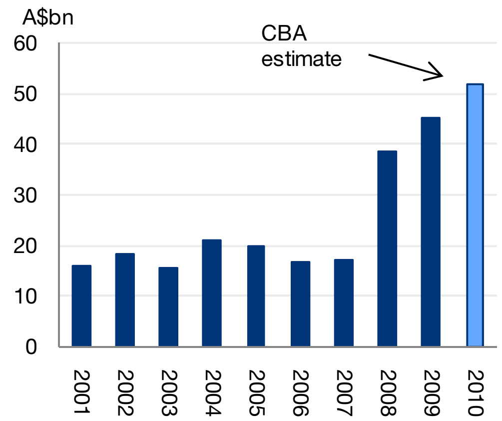


Figure 9 – Japanese holdings of AUD bonds



Source: CBA, ABS

Key Views

United States

	Tactical (<1 mth)	Strategic (>3 mths)
Policy rate	0.1%	0.1%
10yr bond	3.40%	3.60%
2/10 curve	280bp	270bp
USD/JPY	81.00	83.50
EUR/USD	1.42	1.45

The underlying data in the US continues to improve, though global events are clouding the picture. Uncertainty about the stability of the Middle East and the Japanese earthquake are dominating headlines for the moment. The US Government is also struggling to pass a budget and the debt ceiling is approaching, which are both adding to unease.

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 very low level of inflation and the slow recovery in the labour market (though even this is now starting to show signs of life). The Fed is likely to be very slow to adjust its views and respond to recovery with tighter policy. When it does, we see room for the curve to flatten markedly. We expect the Fed will keep the current QE policy (dubbed "QE2") in place until it expires on 30 June.

FX trading ranges are likely to shrink compared to the earthquake-inspired blow-out last week. We expect EUR/USD to keep lifting to our 1.45 target reflecting a more hawkish ECB compared to a dovish Fed. The narrower trading range is also likely to be reflected in USD/JPY. The threat of intervention by the major central banks is likely to prevent a surge in JPY of the scale seen last week. Equally, the USD is likely to stay heavy while the Fed has capped bond yields.

Australia

	Tactical (<1 mth)	Strategic (>3 mths)
Policy rate	4.75%	5.00%
10yr bond	5.60%	5.80%
3/10 curve	30bp	20bp
10yr EFP	52bp	55bp
10yr v US	220	220
AUD/USD	1.0100	1.0200

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).

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 tighten another 75bp this year to ward off inflation pressure generated by the tight labour market. That will flatten the curve and could temporarily widen spreads to the US. However, with no "smoking gun" likely in the near term, Japan causing markets to be unsettled and a new flood levy on the way, timing on rate rises is harder to predict. Australian spreads to US should tighten quickly when the Fed starts to raise rates.

AUD/USD has recovered most of last week's sharp falls. We think AUD/USD can bring towards the top of its recent 0.97-1.02 range as the market takes out the chances of a near term cut by the RBA and replaces with RBA rate hikes mid-year.

New Zealand

	Tactical (<1 mth)	Strategic (>3 mths)
Policy rate	2.50%	2.50%
10yr bond	5.40%	5.60%
2/10 swap curve	185bp	195bp
10yr v US	200	200
10yr v AUS	+20	+20
NZD/USD	0.73	0.75
AUD/NZD	1.35	1.35

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 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. Inflation factors continue to suggest inflation is not a concern.

Even though New Zealand is in or close to recession, the weak USD and firm global agricultural prices have put a floor under the NZD. We expect the USD to remain weak in the near term and keep NZD comfortably above 0.70. 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, albeit the Middle East unrest is a cloud over the global economic outlook.

CBA Forecasts:

Cash rate	21-Mar	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
US	0.25	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	5.75
New Zealand	2.50	2.50	2.50	2.50	2.75	3.00	3.25	3.75	4.25
United Kingdom	0.50	0.50	0.75	1.00	1.25	1.50	1.75	2.00	2.25
Eurozone	1.00	1.00	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	0.10
2-yr bond yield	**21-Mar**	**Mar-11**	**Jun-11**	**Sep-11**	**Dec-11**	**Mar-12**	**Jun-12**	**Sep-12**	**Dec-12**
US	0.58	0.65	1.00	1.40	1.70	2.00	2.30	2.60	2.80
Australia	4.83	5.10	5.40	5.70	5.90	5.90	5.80	5.70	5.70
New Zealand	3.80	3.50	3.50	3.70	3.90	4.30	4.60	4.70	4.60
United Kingdom	1.19	1.50	2.00	2.40	2.60	2.80	3.00	3.10	3.20
Eurozone	1.63	1.50	1.70	1.90	2.20	2.50	2.80	3.00	3.00
Japan	0.22	0.20	0.20	0.25	0.25	0.35	0.65	0.75	0.75
10-yr bond yield	**21-Mar**	**Mar-11**	**Jun-11**	**Sep-11**	**Dec-11**	**Mar-12**	**Jun-12**	**Sep-12**	**Dec-12**
US	3.27	3.40	3.60	3.90	4.00	4.10	4.20	4.30	4.30
Australia	5.42	5.60	5.80	5.90	6.00	6.00	5.90	5.90	5.90
New Zealand	5.55	5.40	5.60	5.70	5.80	5.90	5.90	5.80	5.80
United Kingdom	3.51	3.60	4.10	4.40	4.50	4.60	4.70	4.60	4.60
Eurozone	3.19	3.10	3.30	3.40	3.40	3.50	3.60	3.70	3.80
Japan	1.22	1.20	1.30	1.30	1.40	1.50	1.60	1.80	1.90

Currencies	21-Mar	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
AUD/USD	1.00	1.02	0.99	0.94	0.92	0.90	0.88	0.85	0.85
AUD/JPY	80.96	86.70	85.14	81.78	80.96	79.20	77.44	74.80	74.80
AUD/EUR	0.71	0.73	0.68	0.66	0.66	0.66	0.65	0.64	0.65
AUD/GBP	0.62	0.63	0.58	0.56	0.56	0.56	0.55	0.54	0.54
AUD/CAD	0.98	1.03	1.01	0.97	0.96	0.95	0.92	0.92	0.92
AUD/NZD	1.37	1.34	1.32	1.31	1.30	1.29	1.28	1.25	1.25
USD/JPY	80.94	85.00	86.00	87.00	88.00	88.00	88.00	88.00	88.00
EUR/USD	1.42	1.40	1.45	1.42	1.40	1.36	1.35	1.32	1.30
GBP/USD	1.62	1.62	1.70	1.68	1.65	1.60	1.59	1.58	1.58
USD/CAD	0.98	1.01	1.02	1.03	1.04	1.05	1.05	1.08	1.08
NZD/USD	0.73	0.76	0.75	0.72	0.71	0.70	0.69	0.68	0.68

Calendar – March 2011

Monday	*Tuesday*	*Wednesday*	*Thursday*	*Friday*
Central Bank Meetings AU RBA (1 Mar) CA Bank of Canada (1 Mar) EU ECB (3 Mar) UK BOE (10 Mar) NZ RBNZ (10 Mar) JP BoJ (15 Mar) US FOMC (15 Mar)	**1** **AU AI-Group PMI, Feb, Index, (46.7)** **AU Current acc deficit, QIV, $bn, -7.5, (-7.83)** **AU Net export contrib, QIV, ppt, 0.1, (-0.4)** **AU Retail trade, Jan, m%ch, 0.3, (0.2)** **AU Government Finance Statistics, QIV,** **AU RBA cash rate, %, 4.75, (4.75)** NZ Terms of Trade Index, QIV, q%ch, (3.0) CH PMI Manufacturing, Feb, Index, (52.9) EU/GE/UK PMI manufacturing, Feb, Index, (59/62.6/62) US ISM manufacturing, Feb, Index, (60.8) CA Bank of Canada, %, 1.00, (1.00)	**2** **AU HIA new home sales Jan, m%ch, , (-0.6)** **AU GDP, QIV, q/y%ch, 0.7/2.7 (0.2/2.7)** EU PPI, Jan, m/y%ch, (0.8/5.3) UK PMI construction, Feb, Index, (53.7) US Federal Reserve Beige Book	**3** **AU CBA/Ai-Group Perf of Serv Index, Feb, (45.5)** **AU Build approv, Jan, m%ch, 3.0, (8.7)** **AU Trade balance Jan, $bn, 1.5, (1.98)** CH Non-Manuf PMI Feb, Index, (56.4) EU PMI services/composite, Feb, Index, (57.2/58.4) EU GDP, QIV, q/y%ch, (0.3/2.0) EU Retail sales, Jan, m/y%ch, (-0.6/-0.9) EU ECB announces int. rate, %, 1.00, (1.00) GE/UK PMI services, Feb, Index, (59.5/54.5) US ISM non-manufacturing, Feb, Index, (59.4)	**4** UK New car registrations, Feb, y%ch, (-11.5) US Non-farm payrolls, Feb, '000, (36) US Unemployment rate, Feb, %, (9.0) US Avg hrly earnings, Feb, m/y%ch, (0.4/1.9) US Factory orders, Jan, m%ch, (0.2) CA Ivey purchasing manager index, Feb, , (41.4)
7 **AU Ai-Group PCI, Feb, Index, (40.2)** AU TD inflat gauge Feb, m/y%ch, , (0.4/3.4) AU ANZ Job ads, Feb, m%ch, (2.4) JP Leading / Coincident index CI, Jan, (101.4/103.5) US Consumer credit, Jan, $bn, ($6.1) CA Building permits, Jan, m%ch, (2.4)	**8** **AU NAB Bus conf/cond, Feb, Index, (4/-6)** NZ Manufacturing activity QIV, q%ch, (1.3) JP Curr a/c total/adjusted, Jan, ¥bn, (1195.3/1555.9) JP Trade balance - BOP basis, Jan, ¥bn, (768.8) GE Factory orders, Jan, m/y%ch, (-3.4/19.7) UK RICS house price balance, Feb, %, (-31.0) CA Housing starts, Feb, '000, (170.4)	**9** **AU RBA Ass Gov Philip Lowe speaks in Sydney** **AU MI/WBC Consumer Sent, Mar, Index, (106.6)** **AU Housing finance, Jan, m%ch** **No. of own-occupiers, %, 1.0, (2.1)** **Value of all loans, %, 1.0, (2.3)** **AU RBA Governor Glenn Stevens speaks in London** NZ Card spending, Feb, m%ch, (2.4) JP Machine orders, Jan, m/y%ch, (1.7/-1.6) GE Industrial production, Jan, m/y%ch, (-1.5/0.1) UK Total trade balance, Jan, £bn, (-4.8) US Wholesale inventories, Jan, m%ch, (1.0) CA Housing price index, Jan, m%ch, (0.1)	**10** **AU Labour force, Feb** **employment, '000, 20, (24.0)** **participation rate, %, 65.9, (65.9)** **unemployment rate, %, 4.9, (5.0)** **AU MI Consumer Inflation Expectat, Mar, %, (4.3)** **AU MI Unemp. Exp., Mar, Index (99.7)** NZ RBNZ official cash rate, %, 2.50, (3.00) NZ Business PMI, Feb, Index, (53.7) CH Trade balance Feb, US$bn, (6.45) JP GDP, QIV, q%ch, (-0.3) EU ECB Monthly report UK Industrial production, Jan, m/y%ch, (0.5/3.6) UK BoE announces rates, %, 0.50, (0.50) US Trade balance, Jan, $bn, (-40.6)	**11** NZ Food prices, Feb, m%ch, (1.8) CH PPI/CPI, Feb, y%ch, (6.6/4.9) CH Industrial production, Feb, y%ch CH Fxd Ass Investment, Feb, y%ch CH Retail sales, Feb, y%ch GE CPI, Feb, m/y%ch, (0.5/2.0) UK PPI Input/Output/core, Feb, y%ch, (13.4/4.8/3.2) US Retail sales, Feb, m%ch, (0.3) US Uni. Of Michigan confidence, Mar, Index US Business inventories, Jan, m%ch, (0.8) CA Net change in employment, Feb, '000, (69.2) CA Unemployment rate, Feb, %, (7.8)
14 NZ PSI, Feb, Index, (50.8) NZ Retail sales, Jan, m%ch, (-1.1) JP Industrial production, Jan JP Capacity utilisation, Jan, m%ch, (3.0) JP Consumer confidence, Feb, Index, (41.1) EU Industrial production Jan, m/y%ch, (-0.1/0.8)	**15** **AU RBA Ass Gov Guy Debelle speaks in Sydney** **AU RBA Board minutes for March** **AU New motor veh. sales, Feb, m/y%ch, (-1.9/-2.8)** JP BoJ target rate, %, 0-0.10, (0-0.10) EU/GE ZEW survey (econ. sentiment), Mar, (29.5/15.7) US Import price index, Feb, m/y%ch, (1.5/5.3) US NAHB housing market index, Mar, (16) US FOMC rate decision, %, 0-¼, (0-¼)	**16** **AU Dwelling Starts, QIV, q/y%ch, 10.0/5.5 (-13.2/12.4)** EU New car registrations Feb, y%ch, (-1.4) EU CPI, Feb UK ILO unemployment rate (3mths), Jan, %, (7.9) US Building permits, Feb, '000, (562) US Housing starts, Feb, '000, (596) US Producer price index Feb, m/y%ch, (0.8/3.6) US Current account balance, QIV, US$bn, (-127.2)	**17** **AU Labour force, Quarterly data** **AU RBA Bulletin - QI 2010** EU Construction output, Jan, m/y%ch, (-1.8/-1.2) US CPI, Feb, m/y%ch, (0.4/1.6); core, (0.2/1.0) US Capacity utilisation, Feb, %, (76.1) US Industrial production, Feb, m%ch, (-0.1) US Philadelphia Fed, Mar, Index, (35.9) CA Wholesale sales, Jan, m%ch, (0.8)	**18** JP Coincident / Coincident index CI, Jan, EU Current account, Jan, €bn, (-13.3) EU Trade balance Jan, €bn, (-2.3) GE Producer prices, Feb, m/y%ch, (1.2/5.7) CA CPI, Feb, m/y%ch, (0.3/2.3)
21 NZ Credit card spending, Feb, m/y%ch, (3.8/5.6) US Existing home sales, Feb	**22** UK CPI, Feb, m/y%ch, (0.1/0.4); core, y%ch, (3.0) US Richmond Fed, Mar, Index, (25) CA Leading indicators, Feb, m%ch, (0.3) CA Retail sales, Jan, m%ch, (-0.2)	**23** NZ Current account, QIV, % of GDP, (-3.1) EU Industrial new orders, Jan UK Bank of England minutes US New home sales, Feb	**24** **AU RBA Financial Stability Review** **AU RBA Ass Gov Malcolm Edey speaks in Sydney** NZ GDP, QIV, q/y%ch, (-0.2/1.5) UK Retail sales, Feb, m/y%ch, (1.9/5.3) US Durable goodes orders, Feb	**25** **AU Financial Accounts, QIV** JP CPI, Feb GE IF [illegible] .1.2) US G[illegible] US Uni. Of Michigan confidence, Mar, Index
28 US Personal income/spending, Feb, US PCE deflator/core, Feb, US Pending home sales, Feb, US Dallas Fed, Mar, Index	**29** **AU RBA Ass Gov Malcolm Edey speaks in Sydney** **AU Population growth, QIII 2010, q/y%ch, (0.3/1.7)** NZ Trade balance, Feb, GE CPI, Mar, UK Current account balance QIV, (-9.6) UK GDP, QIV, UK Net consumer credit, Feb, US S&P/Case-Shiller home price ind., Jan, m%ch, (-4.1)	**30** **AU DEWR skilled vacancies, Mar, m%ch, (-0.012)** **AU HIA new home sales Feb, m%ch,** **AU ABS Job vacancies, Feb,** NZ Building permits, Feb, JP Industrial production, Feb, JP Vehicle production, Feb, CA Teranet House Prices, Jan,	**31** **AU Build approv, Feb** **AU Retail trade, Feb** **AU Private sector credit, Feb,** **AU RP Data house prices, Feb,** NZ NBNZ Business confidence, Mar, Index JP Housing starts/Construction orders, Feb, UK GfK consumer confidence survey, Mar, Index US Factory orders, Feb,	***Early April*** AU Trade in Goods & Services, Feb (5 Apr) AU Housing finance, Feb (6 Apr) AU Labour force, Mar (7 Apr)

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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