Global Markets Research

Fixed Income: Weekly Strategy

8 December 2010

Revising bond forecasts in wake of US developments and RBA pause

- The RBA has paused and US market sentiment has changed significantly, so we are revising our forecasts.
- We believe rates globally have risen too far and are likely to fall in the short term, before rising through H2-11.
- The Australian outlook is stronger than the recent data suggests and we look for a return to flattening soon.

For the first time in a while, Australia's yields have been lagging a global sell-off. The weakening of the domestic data – a temporary weakening in our view – has seen Australian interest rates fail to follow a significant global sell-off. The US 10Y has risen 25bp since last Monday, but in the same period the Australian 10Y bond has sold-off only 6bp, while the 3Y bond has rallied 7bp.

This is likely to be only a short-term phenomenon, in our view. Australian bond and swap rates have lifted sharply over the past three months due to a combination of domestic and offshore factors. The move initially reflected domestic economic strength and associated inflation risks, resulting in a marked flattening of the yield curve and widening of spreads to US benchmarks. This pressure has recently faded as the Reserve Bank has adopted a more dovish tone, with the curve and AUS-US spreads reversing course. However, yields overall have continued to rise (at the longer end of the curve) due to upward momentum in the US. This pattern continued last night as the new US tax package sparked a large rise in US yields.

Although our longer-term confidence in the Australian recovery is unchanged, we have pushed the timing of our forecast monetary tightening back a little in response to the RBA's change in rhetoric. Adam Donaldson details our forecasts on page 3 and Alex Stanley discusses the recent behaviour of the front end rates on page 9. While there has also been some softer data of late, we continue to expect that substantial tightening (+100bp) will be required over the next 18 months.

In our view, this flattening will be reinforced by a pull-back in US bond yields in the near-term. The market has suffered a squeeze recently amid some brighter data and perhaps some disappointment at the size of the Fed's QE2 policy. However, the recovery remains fragile and abundant spare capacity continues to suggest disinflation. We think too much inflation risk is priced into the market and that this will subside as the data filters through over the next few months.

Ultimately, however, we forecast US bond yields to rise again in H2-11 as the US recovery eventually becomes self-sustaining. At which point, the Australian curve should start to normalise and spreads to the US begin to contract more meaningfully.

Domestically, the Government is likely to announce shortly a package aimed at increasing competition in retail banking. Specifically, an extension of the Commonwealth guarantee for smaller banks has been suggested. Unlike the last time such a guarantee was enacted, we don't expect a significant market reaction this time. Philip Brown discusses the likely outcomes of these new developments in his article on page 6.

The main focus of the remainder of this week will be the Australian employment figures released tomorrow (Thursday) and the Chinese data deluge, which includes CPI, on Saturday.

Contents:

We have revised our forecasts

	Current	Jun-11	Dec-11
Official Cash (%)	4.50	5.00	5.50
90-day BBSW (%)	5.00	5.30	5.80
3-year swap (%)	5.37	5.95	6.20
5-year swap (%)	5.72	6.05	6.30
10-year swap (%)	6.04	6.20	6.40
Aus 3yr bond (%)	4.98	5.50	5.75
Aus 10yr bond (%)	5.53	5.60	5.75
Aus 3-10yr Curve (bp)	55	10	0
US 2yr bond (%)	0.52	0.65	1.30
US 10yr bond (%)	3.13	2.70	3.20
AU-US 10yr sprd (bp)	239	290	255

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Key Positions

The US sell-off continues, but we believe this has limited scope for further moves. The equity market has already retraced the original spike, but bond markets are lagging. We remain of the view that the Australian economy will improve before the US and we look for the Aust-US 10Y spread to widen.

We also take advantage of the sharp steepening of the curve to implement a flattener. While we also support a standard 3Y/10Y flattener, we are looking for a trade to hold for reasonable period. As such, the Nov-12 to Jan-18 represents an RV opportunity too. The Jan-18 is likely to richen as more is issued and the Nov-12 would react quickly to any RBA rate hike repricing. Both of these outcomes would contribute to flattening of the curve.

Key Trades

Trade	Entry	Curent	Profit	Target	Stop	Comment
Buy the NSWTC Jun-20 (Government Guaranteed) as an ASW	*-12bp (3-Feb-10)*	*-8bp*	*-4bp*	*-35bp*	*0bp*	***Hold**: A long-term buy and hold trade. The behaviour of bank GG bonds recently shows.*
Pay 3yr AUD EFP	*35bp (9 August)*	*33bp*	*-2bp*	*45bp*	*30bp*	***Hold**: Increased mortgage fixing may force this wider as curve flattens.*
10yr ACGB BEI widening	*255 bp (18 August)*	*288bp*	*33bp*	*300bp*	*260bp*	***Hold:** Spread has widened in the sell-off, inflation expectations growing.*
*OTM Conditional Steepener. 6M*2Y vs 6M*10Y. Buy 100m 6M*2Y 3.75% receiver. Sell 24.1M 6M*10Y 4.28% receiver.*	*3.75% and 4.28% 0.4bp premium (25 August)*	*5.29 and 6.02*	*-0.4bp (prem-ium)*			***Hold:** An insurance trade for a global double dip. Very unlikely to be used now, but 0.4bp well spent.*
Buy the Suncorp Metway Govt Guaranteed Apr-11 Floater.	*TM of 29.5bp*	*17bp*	*+12bp*	*0bp*	*40bp*	***Hold:** This bond is Government Guaranteed. It should be much tighter. Can hold to maturity in 6 months. Investec have announced a repurchase of their Feb-12 line and Citi have repurchased A$1.2b of the Jun-12.*
Pay the 20Y AUD swap vs 10Y and 30Y in a butterfly	*23.5bp (8 Nov)*	*24bp*	*0.5bp*	*27bp*	*20bp*	***Hold**: The 20Y has rallied too far on what appears to be a short-term flow.*
Sell 3M, 20bp OTM bond option on Apr-20 ACGB, strike is 5.61%	*5.61 / 10bp (15 Nov)*	*Current yield is 5.52*	*n/a*	*n/a*	*5.71bp*	***Hold:** Bond options are better to sell for investors than swaps. Despite US sell-off the AUD bonds are not moving too far.*
Buy the Jan-18 bond vs the Nov-12	*58bp (8 Dec)*			*10bp*	*85bp*	***New Trade:** The curve should flatten in medium term, by which time Jan-18 will have richened somewhat too as new issuance increases liquidity.*
Sell the ACGB 5.75% May-21 against the UST 2.625% 15 Nov 20	*242bp (8 Dec)*			*280bp*	*220bp*	***New Trade:** The US market has outstripped the Aust in the sell-off on US enthusiasm and inflation expectations. We expect both to wane and AUD economy to recover.*
Pay the AUD 10Y swap vs NZ 10Y swap	*58bp (1 Nov)*	*54bp*	*-4bp + 7bp carry = +3bp*	*90bp*	*45bp*	***Hold:*** The recent rally in AUD seems overdone vs. NZ. Carry is also very attractive at circa 5bp per month.

Forecast revisions: An RBA pause and short-term US pullback

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- The RBA has indicated a pause is likely and the US market is changing character. As such, we shift our forecasts.
- We think the strength in the Australian economy will reassert in 2011, allowing Australian bonds to underperform.
- The US move seems to have gone further than fundamentals warrant – a pullback is likely before a sell-off in H2-11.

Australian bond and swap rates have lifted sharply over the past three months due to a combination of domestic and offshore factors. The move initially reflected domestic economic strength and associated inflation risks, resulting in a marked flattening of the yield curve and widening of spreads to US benchmarks. This pressure has recently faded as the Reserve Bank has adopted a more dovish tone, with the curve and AUS-US spreads reversing course. However, yields overall have continued to rise due to upward momentum in the key US market, with last night's increase the biggest so far.

We have pushed the timing of our forecast monetary tightening back a little in response to the RBA's change in rhetoric. But while there has also been some softer data of late, we continue to expect that substantial tightening (+100bp) will be required over the next 18 months as Australia enjoys the fruits of a booming terms of trade and an investment-led recovery. That should see the curve flatten again and spreads to the US re-widen.

We expect these trends to be reinforced by a pull-back in US bond yields in the near-term. The market has suffered a squeeze recently amid aggressive profit taking ('buy the rumour, sell the fact') and perhaps some disappointment at the size of the Fed's QE2 policy. However, the recovery remains fragile and abundant spare capacity continues to threaten disinflation through the economy. We think too much inflation risk is priced into the market and that this will subside as the data filters through over the next few months.

Ultimately, however, we forecast US bond yields to rise again in H2-11 as the US recovery eventually becomes self-sustaining. At which point, the Australian curve should start to normalise and spreads to the US begin to contract more meaningfully.

Domestic drivers

Figures 1, 2 and 3 show how a reassessment of the outlook for domestic monetary policy translated through to sell-off across the domestic bond curve from early September. In the early phases of the move in September, this occurred despite an on-going rally in US Treasuries in the lead-up to the US Fed's QE2 announcement, resulting in a sharp widening in AUS-US bond spreads (Figure 2). But domestic pressure has diminished since the RBA delivered its 25bp rate hike in November. The additional increase in bank mortgage rates and a 'pot-hole' in economic data, together with on-going anecdotes of tough pricing conditions in the retail sector, have left the market convinced the RBA will hold off tightening for some time. That view has now been validated by RBA commentary indicating a pause in the cycle is likely.

CBA has shifted the timing of our next forecast rate hike from February to April. As discussed on page 9, we see few potential catalysts for the market to reassess this view over coming weeks, with the Q4 CPI in late January clearly shaping as the next major data release. However, like the RBA and most economists, we continue to anticipate that monetary

Table 1: CBA AUD bond and swap forecasts

	Current	Jun-11	Dec-11
Official Cash (%)	4.50	5.00	5.50
90-day BBSW (%)	5.00	5.30	5.80
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Figure 1: Aus bonds continue to sell-off

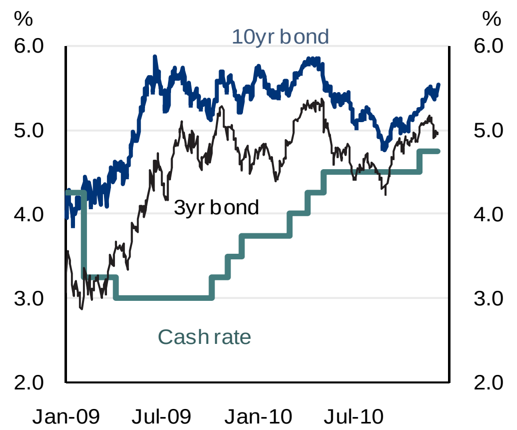
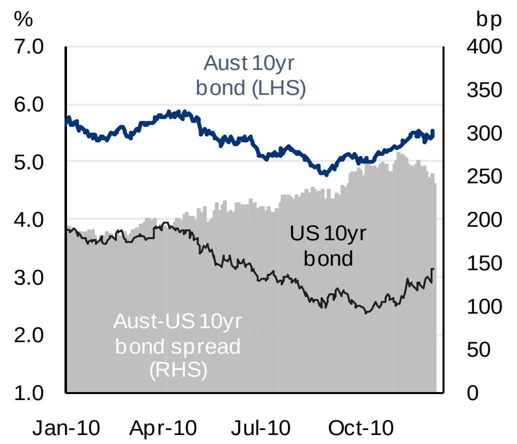


Figure 2: Though global factors now the driver



policy will be tightened by substantially more than the market is now pricing.

We expect the boost to national income, investment and employment from the unfolding boom in export volumes and prices will underpin strong growth for a number of years to come. While the tightening in monetary policy and associated rise in the AUD to date are exerting a dampening impact on domestic activity and prices, we see this as a necessary part of the adjustment process for an economy enjoying this type of external shock. (Though markets and policy-makers should also be sensitive to the risks surrounding this outlook, particularly in Asia). We anticipate household spending and confidence will recover quickly when the RBA retreats to the sidelines, as now appears to be the case, such that pauses in tightening are not lengthy. A more decisive turn in the advanced economies would likely filter through to a less cautious household approach to spending.

We therefore continue to forecast that the RBA will lift the cash rate 100bp to 5.75% by Q1 2012, substantially more than market pricing for a 25bp increase. So, while timing of short-end trades is difficult at present, our bias is firmly to be positioned for a turn in domestic sentiment and pricing over coming months. We forecast 3 year bond and swap rates will rise 50-70bp respectively over the next six months.

Global backdrop

Assessing the impact of these expected domestic influences on the shape of the yield curve is complicated by the significant volatility and uncertainty attached to the global bond market outlook at present. The recent unexpected (in our forecasts) steepening of the yield curve has reflected not just the change in RBA view but a powerful sell-off in US bonds since the Fed announced the expansion of its quantitative easing program (QE2) in early November. Similarly, the 10yr AUS-US spread has retreated from a peak of 276bp on November 5 to 239bp at present amid these two divergent trends.

US 10yr Treasury yields have jumped around 60bp over the past month despite on-going weakness in the economy, further falls in key inflation gauges, dovish Fed commentary and deterioration in Europe's sovereign crisis. We highlighted the risk in early November that the market could extend its sell-down of bonds as it took profits on the QE trade and adopted a more pro-growth attitude. But we assessed that too much inflation risk was being priced and that yields would retreat as the Fed started its purchase program and economic activity and inflation data generally disappointed.

Figure 4 suggests that we misjudged the role that market positioning could play in this unusual and uncertain environment. Bond investors were clearly caught very long the market when the turn came and have effectively been playing catch-up ever since. This impact has been reinforced by an improvement in economic data, which while not uniform has been enough to support the market's 'don't fight the Fed' reflation attitude. That has also now been reinforced by the agreement to extend (both in time and scope) the Bush-era tax cuts.

Figure 5 shows, however, that there is also a strong element of hope over reality in the market's inflation pricing. Further analysis shows that the market's 5y/5y inflation pricing is now at its highest in at least 10 years, other than for a brief period earlier this year (which preceded the strong April-August 160bp 10yr bond rally). Looking ahead, we continue to expect that the disinflation pulse pumping through the US economy will see the market scale back this pricing in the weeks and months ahead. That continues to be the Fed's base case as well, judging by the Fed's actions and Chairman Ben Bernanke's comments on Sunday night.

This leaves us reticent to jump on board the recent bond sell-off and

Figure 3: RBA cash rate pricing

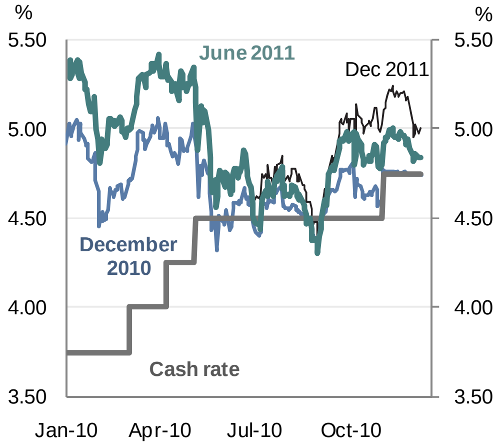
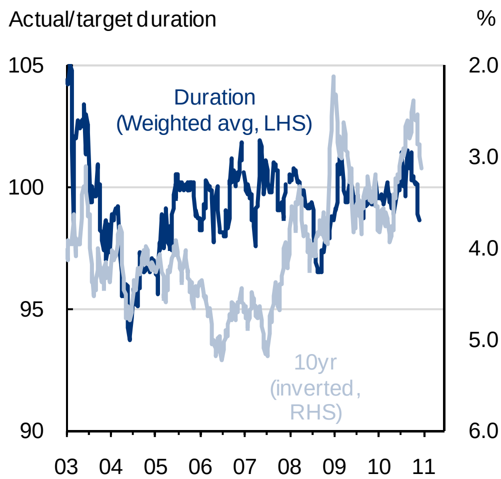
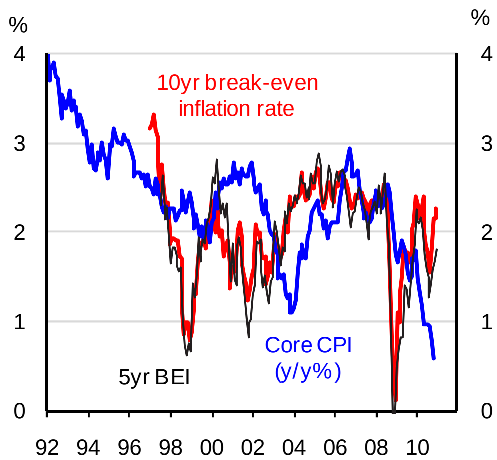


Figure 4: US market was excessively long



Source: *Stone & McCarthy*

Figure 5: Excessive inflation risk priced ?



position for an extension of the move in US 10yrs to well above 3%. While nervous that we live in volatile and uncertain times and that positioning factors could drive the market further in the short term, (and that there is scope for it to run further with the recovery and excessive government debt themes), our sense is that the sell-off in the US bond market is probably near its zenith. We forecast US 10yrs to retreat to 2.7% in Q1 as a consolidation takes hold.

Further out, we expect US bond yields to drift higher over the remainder of 2011 amid the conflicting pressure of economic recovery, weak inflation and completion of the Fed's QE program. Our more detailed quarterly forecasts are on page 13.

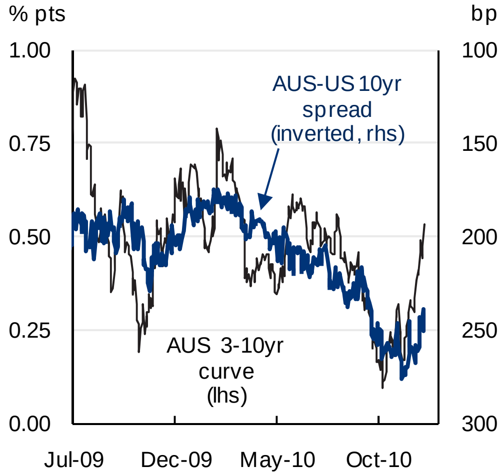
Trade views

There is significant uncertainty on the global outlook at present and we are cautious entering into a thin trading period for the year. However, recent price action appears indicative of a capitulation in views in both the US bond market and for the domestic monetary policy outlook. This leaves us preferring to enter the fray and take advantage of opportunities that we don't think will last on a fundamental basis. As detailed on page 2, we look to enter a curve flattening and 10yr AUS-US spread widening trade today.

For the Aust-US spread trade we use a 10Y spread. Given that we intend to hold the trade for a while we have decided to use the Australian May-21 bond, rather than the Apr-20, and the on-the-run US 10Y treasury, the Dec-20.

For the flattening trade we have elected to overlay an RV position also. We expect to hold the flattener for a moderate period – until April or so next year. Hence, we have selected a Nov-12 to Jan-18 spread. The Jan-18 is currently sitting well above the ACGB curve but this is likely to reduce as more bonds are issued (see Weekly Strategy of 29 November). The Nov-12 is also likely to react strongly to any repricing of the RBA expectations as it is slightly shorter than a standard 3Y. We would also be happy with a standard 3Y/10Y flattener, but we think the current situation lends itself to the 2Y/8Y instead.

Figure 6: We look for the pre-November pattern of a flattening curve and widening AUS-US spread to resume



How a fifth banking pillar might change the wholesale market

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- The Government will soon announce a new suite of policy changes to encourage competition in banking.
- If smaller banks regain the ability to issue government guaranteed bonds, the result will likely be small.
- The Government is also likely to continue to support the RMBS market.

The Australian Government is expected to announce a new suite of policy changes to encourage competition in retail banking, possibly as early as today. That the Government would move to increase competition in the banking sector is not a surprise. There has been significant discussion of banking policy recently and discussion of the "dominance" of the big four banks.

Of most interest for Fixed Income investors are the mooted proposals to:

- Re-establish the Commonwealth Guarantee of bank borrowing for a subset of credit unions and smaller banks too.
- Add further support to the RMBS market.

Thoughts to bear in mind for the Government proposals

Re-establishing the guarantee for smaller banks

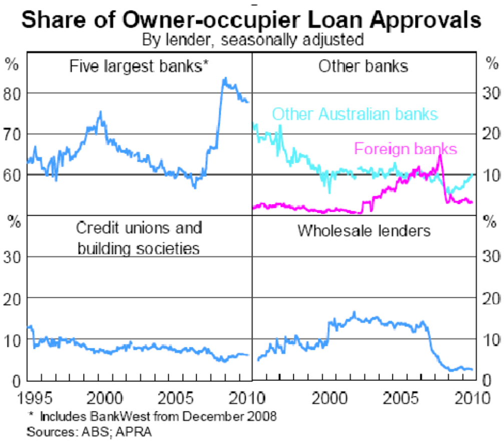
The original Commonwealth guarantee of banks was very successful overall but, in conjunction with the GFC, tended to benefit larger banks at the expense of smaller. The smaller banks found that the tiered fee structure (see Figure 2) provided them with less of an advantage than it did the larger banks. Nevertheless, it also allowed the smaller Australian owned banks to access wholesale markets for significant volumes. The middle panel of Figure 3 shows that the "Other Australian owned banks" were able to raise much more with the guarantee than without it (either before or since).

The same panel also shows that when the door to the guarantee was first opened, the small banks used it with gusto. The data from Figure 3 is slightly old, however, and do not show the Suncorp and Bank of Queensland deals which have come to market in recent days (without a guarantee). Suncorp raised $900m of 2.5Y funding at swap +110bp while BoQ paid swap +150bp for $200m of a similar maturity. Nonetheless, Figure 3 does show that, with the aid of the guarantee, the smaller banks raised more money, if not cheaper money.

Part of the reason that the smaller banks found the guarantee fees expensive was that the smaller banks GG paper traded above paper of the same maturity from a big-four bank. Figure 4 shows the Suncorp GG Apr-12 and the WBC GG Mar-12. Note the significant and consistent spread between them, despite the bonds having a very similar maturity and amount on issue (Suncorp $1270m and WBC $1475m). That additional margin added to the overall cost of funding and provides a reason to expect a smaller fee structure for the lower rated banks if a new scheme is introduced. (In addition to the broader rally in credit spreads since 2008.)

Nor is it only the smaller banks that find the guarantee fee expensive at current levels for credit. The NAB buyback of their guaranteed Mar-12 line (completed today) at swap flat also indicates that at least one of the major banks finds the guaranteed issuance more expensive than other

Figure 1: Where the competition is for loans



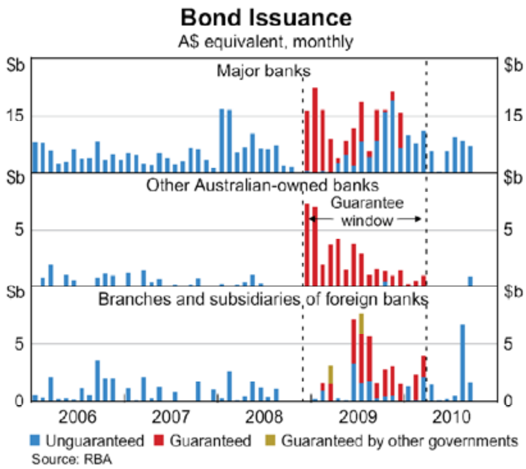
Source: RBA Submission to Senate Competition Review http://www.aph.gov.au/senate/committee/economics_ctte/banking_comp_2010/submissions.htm

Figure 2: Original Bank Guarantee Fee Structure

Credit Rating	Fee (bp per annum)
AAA to AA-	70
A+ to A-	100
BBB+ or unrated	150

Source: http://www.guaranteescheme.gov.au/rules/pdf/schedule-5.pdf

Figure 3: Other banks not borrowing wholesale



Source: RBA September FSR, chart 42

forms of funding.

We think it is likely that the guarantee, if it is reopened, will be reopened with a smaller fee (and perhaps a cap on issuance). If the fee is not lowered it is likely that the smaller banks will still find the non-GG format cheaper to issue. The original fee scheme was devised with a deliberate “natural exit mechanism”. This approach could be repeated. The funding markets are still “not normal” and funding costs, particularly for the smaller banks remain elevated. A fee struck lower than the original fee but still materially above zero would allow a natural exit mechanism. For example, a BBB fee of 75bp-125bp would appear to be in the zone to both assist smaller banks now, but also preserve the natural exit mechanism should funding markets continue to improve.

We have recent examples which show exactly where Suncorp and BoQ can raise non-GG 2.5Y money (swap plus 110 and 150 respectively). Where BoQ and Suncorp would have raised GG money at the same maturity is an interesting question. The big-four GG paper is about 5-7bp for 3Y with no comparable 2.5Y maturity. Let’s call the 2.5Y GG big-four paper a spread of swap +5bp. Now, we need to add at least 10bp for the non-big four name (as per figure 4). That’s swap +15bp – which is in line with where ING and Citi have 2.5Y GG paper. Next we need to add the guarantee fees.

Suncorp is A+ and so would pay 100bp under the old pricing scheme while BoQ is rated BBB+ and so would pay 150bp. Once you add the fees the GG paper is dearer (125 and 165) than the non-GG paper just issued. So, if the new policy is to have any effect, the fees will need to be reduced from the present level by at least 25bp and possibly more.

Also, this policy is aimed more at increasing competition rather than avoiding calamity – which allows the Government to provide a deliberately limited amount of assistance. There would be no reason for the government not to allow a limited amount of guaranteed paper to be issued under reasonably generous fee terms. That would increase competition without becoming an overwhelming large contingent liability on the Government’s balance sheet nor allow any one issuer to raise too much money.

More support for RMBS

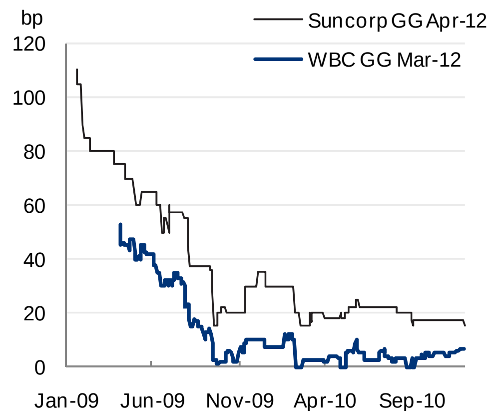
Wholesale funders (who primarily used RMBS or ABCP) used to have a significant share of the mortgage market (See Figure 1) though this fell dramatically as the RMBS market dried up in the GFC. The Government has been supporting the RMBS market for two years through the purchasing of low-risk bonds. Although there are some promising signs, it does not appear that the wholesale funding model is about to recover as a viable business strategy. (As a side-point, nor is it clear that a solely wholesale funding strategy should be viable. It has now been amply demonstrated that the model is very risky in times of stress. Moreover, the regulators are focusing more than ever on continuity and diversity of funding.)

However, arguing against a wholesale-only funding strategy is not the same as arguing that the Government should forsake the RMBS market. If the RMBS market recovers all lenders could access a new funding source and increase the diversity of funding.

There has been some discussion of an RMBS guarantee – though this seems to be fading and unlikely to attract Government support. We expect the AOFM to be given a mandate for further funds to be invested in the RMBS market, and possibly an extension of the mandate into higher risk tranches.

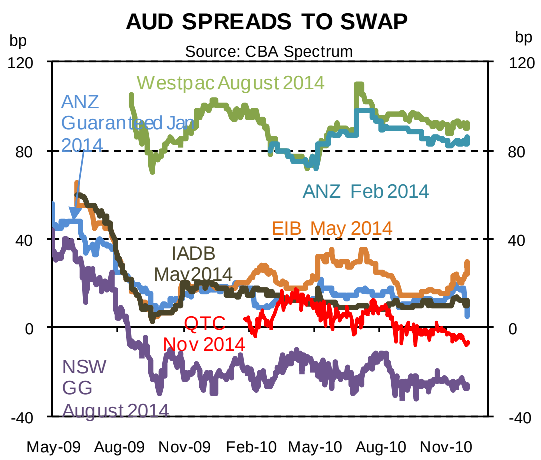
As a side point, if the retail deposit guarantee (or some updated version of it) becomes permanent, one of the main arguments against Covered

Figure 4: Not all GGs are created equal



Source: CBA

Figure 5: Not all GGs are created equal



Source: CBA

Figure 6: Spread to Swap spikes in Dec-08

Source: CBA

Bonds will be somewhat lessened. Namely, that covered bonds reduce the standing of retail deposits. However, there is little evidence that regulators are yet convinced of the desirability of covered bonds.

What effects could this announcement have on the markets?

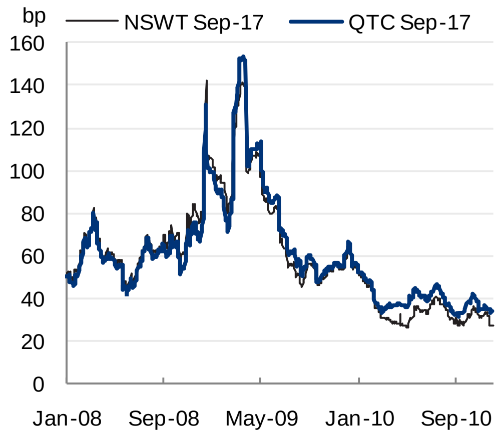
The guarantee of smaller bank bonds is the policy most likely to have an immediate impact on Fixed Income markets. Recently, the buy-backs of the Investec, Citi and NAB guaranteed deals have caused the spreads on GG bank paper to tighten (Figure 5). If there is a new supply in the market this tightening may be somewhat reversed. However, this process may be more of a churn than a continuation. The existing bonds issued by the larger issuers may be replaced by new bonds issued by smaller entities.

The take-up of the first bank guarantee caused a significant increase in borrowing costs for semi-Governments and similar high grade credits. The spread to swap for NSWTC and QTC is shown in Figure 6. There was a much more muted increase in the spread to bond shown in figure 7. However, the reaction of the semi swap spread, in part, reflects the movement of the swap-to-bond spread. The granting of the bank guarantee made banks significantly less risky and so tightened swap-to-bond spreads.

We expect a significantly more muted reaction this time. The volume of new issuance will likely be much smaller. Please take a second look at Figure 2, panel 2 and notice how much smaller the scale is than in the top panel. Moreover, the volume of AAA issuance already in the market is now much higher (see Figure 8). Any extra issuance as a result of the new policy will be much smaller and in a much larger pool. In fact, the new issuance may only serve to sustain the current level of issuance if other issuers continue to repurchase their bonds. If the new arrangements are implemented for a sustained period then the new issuance may serve to slow the reduction in AAA issuance, not increase the total volumes (Figure 8). With major banks no longer issuing guaranteed paper and semis to lose the right to issue in guaranteed format very soon the total AAA issuance in AUD will likely be plateauing. That makes it hard to see a significant underperformance in those names.

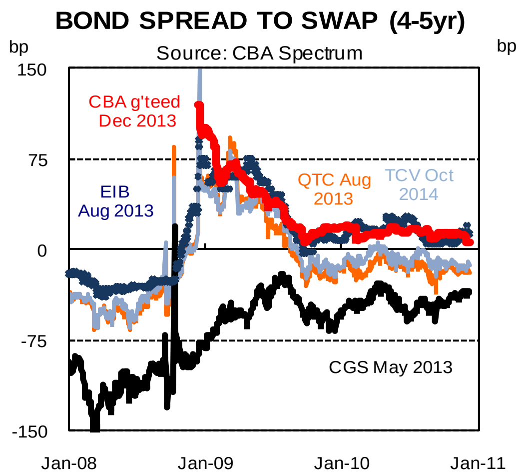
That is a marked contrast to the previous instance in 2008, where there was huge volume of issuance and a distinct flight to quality present in the market at that time. (Along with a deteriorating economic and revenue climate.) Assuming the European sovereign concerns stay somewhat controlled, neither of those is true this time, so the effect should be much smaller. The smaller banks' GG bonds also lack the liquidity to be truly comparable to state bonds and so will attract a slightly different type of investor. Still, one would expect that the emergence of a new AAA bond class could weigh on other spreads in the high-grade bond sector.

Figure 7: Spread to bond moves less



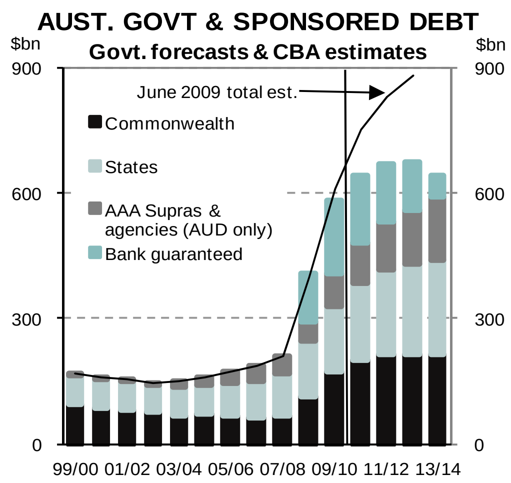
Source: CBA

Figure 8: Swap Spreads



Source: CBA

Figure 8: Issuance totals



Source: AOFM, CBA, Bloomberg

Negative data surprises and RBA hold short term rates down

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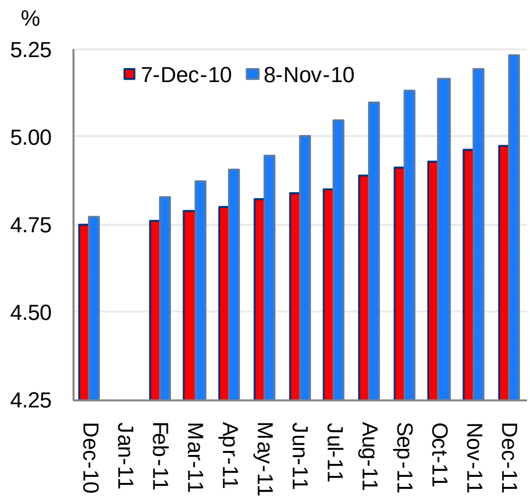
- The RBA's December meeting statement confirmed the cash rate is on hold for the near term. CBA forecasts now see the RBA on hold until beyond Q1 2011.
- Recent below consensus data has helped drive a short end rally, but the trend in downward surprises is not significant from a historical perspective.
- There is an historical tendency for employment to surprise on the upside, but yesterday's RBA statement takes some the relevance away from tomorrow's figure.
- Market Pricing has just one rate hike priced for 2011. We think this is insufficient, but hold-off on a trade recommendation as there are few near term catalysts to drive a re-pricing.

There is now just one 25bp rate hike priced in for 2011

The outlook for monetary policy tightening has changed markedly in recent weeks. A combination of weaker data, additional tightening from banks and dovish remarks from the RBA led to a substantial reduction in implied RBA rate hikes over the next year. There is now less than one 25bp rate hike priced between now and December 2011 (Figure 1). If we look beyond the immediate future, the outlook for the Australian economy remains quite bright. But the fragile nature of market sentiment, risk of further disappointment in data and fewer important releases, leave us reticent to recommend trades to capture the limited pricing at this stage.

Figure 1: IB Futures implied rate hikes



The December RBA statement confirmed the RBA is on-hold

Yesterday, the RBA left the cash rate on hold, which was unsurprising to economists and the market. The accompanying statement suggested the RBA is happy with the current level of rates (our emphasis):

"Following the Board's decision last month to lift the cash rate, and the subsequent increases by financial institutions, lending rates in the economy are now a little above average. The Board views this setting of monetary policy as ***appropriate for the economic outlook****."*

Recent data and comments by Glenn Stevens have driven a rally in the front end of the curve

The statement affirmed Glenn Stevens' testimony in late November that indicated a pause in tightening is likely, which drove a sharp rally in the front end of the curve (Figure 2). Recent negative data has also played a part in downgrading market expectations of further tightening. The Q3 GDP figures released on Dec 1 reported softer than anticipated 0.2% quarterly growth (consensus 0.5%). This was followed by weakness in retail sales and it exacerbated the slide in front end rates. The softness in GDP and retail sales caught many economists (and the market) by surprise. The CBA data surprise index (Figure 3) depicts the recent momentum in economic data relative to consensus. Data has surprised on the downside lately, but the level of the index is not too far below normal.

Figure 2: Implied yield: 2nd versus 6th bank bill contract

The trend in negative data surprises is downward, but within normal ranges

The next significant piece of data is Thursday's November Labour Force report. While other

Employment has a history of surprising on the upside, especially in the last year

data has surprised on the downside of late, the employment figures have exhibited an historical tendency to surprise on the upside. In the last year, 10 out of 12 employment numbers have surprised on the upside (Figure 4). In the last 10 years, employment growth has exceeded forecasts in 60% of releases (we allow a 5k margin for error in measuring a consensus outcome).

We expect a strong outcome for this week's employment figures

But even with the past outperformance of employment growth relative to forecasts, one needs to be cautious about the market reaction. The October figures reported a strong rise in employment of +29.7k, which exceeded economists' expectations of 20k. But the front end of the curve barely changed because the unemployment rate rose on the back of a higher participation rate.

But we think the market reaction will be limited after RBA said rates are on hold

Our economists are expecting a stronger outcome on Thursday (Figure 5). CBA forecasts are for a 25k rise in employment in November (consensus 20k) and an unwind of the surge in the unemployment rate (a 0.3% fall in the unemployment rate to 5.1%, versus consensus of 5.2%). But with the RBA comments yesterday confirming they're on hold, it will take a larger rise in employment to drive a significant re-pricing of rate hikes.

We think there is insufficient tightening priced in

Looking ahead to 2011, we think market pricing of just one 25bp rate hike over the whole year is under-done. While the last week has seen softer Q3 GDP and retail sales figures, the growth outlook for Australia is still strong. In addition to our strong jobs growth outlook, the latest Capex figures show firms are expecting to increase investment spending by 23% in FY 2010/11. The RBA governor highlighted in a speech on November 30 that even with a fall over the next few years, Australia's terms of trade will still be near century highs.

We now expect the RBA to be on hold until beyond Q1 next year and we see the cash rate at 5.50% by the end of 2011

CBA economists expect the RBA to remain on hold until beyond Q1 next year and begin further tightening in April. We see the cash rate reaching 5.50% by the end of 2011.

But due to a lack of near term drivers, we don't recommend re-entering trades to capture the under-pricing of rate hikes at this time

If we shift our focus back to the near term, after Thursday's employment figures, there is very little domestic data for the market to get excited about until 2011 (see calendar on the final page). Hence we hold-off recommending trades in the short end of the curve for the time being.

Figure 3: CBA Economic Surprise Index

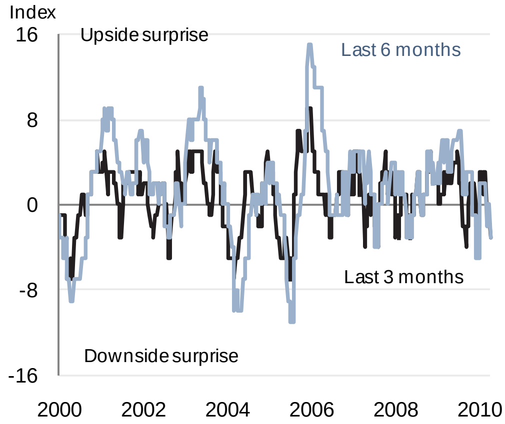


Figure 4: Employment (mthly chg from Oct 08)

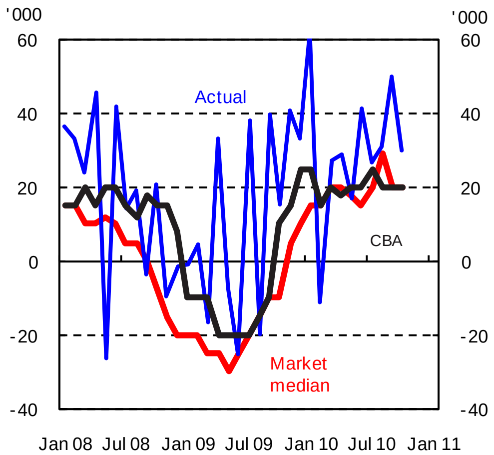
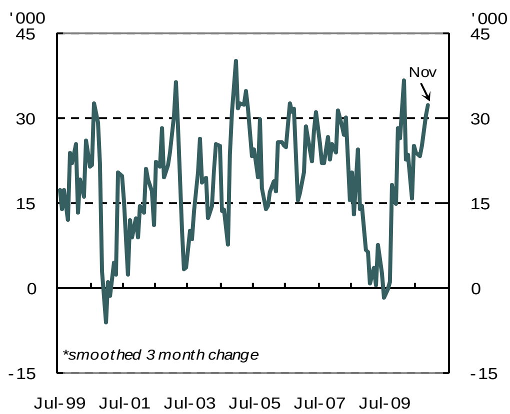


Figure 5: CBA Jobs Indicator (implied jobs growth)



The Christmas Roll is here again

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- The December futures roll is Wednesday December 15.
- Fair value for the 3Y roll is 6bp and for the 10Y roll is 4.4bp.
- The roll convexity presents the largest risk to these values, though there is some chance of repo specialness too.

December is upon us and the 15 December futures roll is next Wednesday. Currently, the fair value of the 3Y roll is 6.0bp and the fair value of the 10Y roll is 4.4bp.

There have been minor changes to both the 3Y and 10Y futures baskets between December and March. In both baskets the shortest bond has been dropped. In the 3Y basket the Nov-12 has been replaced with the Dec-13. However, in the 10Y basket the Mar-19 has been dropped with no replacement – the basket reducing from four bonds to three. (See Figure 2.)

The upward sloping curve implies that dropping the shortest bond from the basket raises the average yield of the bond basket. This increases the value of the roll. By our reckoning the change in composition is adding 2.3bp to the 3Y roll and 1.7bp to the 10Y roll.

The new bond in the 3Y basket, the Dec-13, does not have a large amount on issue: only $6.5bn. However, this is not much less than the Nov-12 bond it is replacing. Similarly, the Jul-22 line is not large, only $5.3bn. There is a small scope for either of these bonds to "go special" on repo and force up the value of the roll. This is a conceptual risk, however and we see no reason to assume this outcome will actually occur.

With most repos seemingly behaving fairly well, the outright change in yields is likely to be the largest influence on the roll through a concept known as "roll convexity".

As is always true, the fair value of the roll will change if the bond yields change but the repo rates do not. Given that the RBA seems to be firmly on hold in the short term, any large offshore influence would likely change the bond yields but leave front end yields little changed. That was exactly the case last night and has seen the fair value of the rolls rose (as well as the market value of the 3Y).

The 3Y bond futures have a futures convexity of 0.9bp per 10bp sell-off. i.e. if the yield on all bonds rises 10bp, the fair value of the roll rises 0.9bp. For the 10Y, the convexity of the roll is 0.3bpp per 10bp sell-off. In the event of a rally the convexity of the roll causes the fair value to fall.

The ASX has also announced the composition of the June contracts. The May-13 will be dropped from the 3Y basket in favour of the Oct-14. The 10Y basket will be unchanged from March to June.

Figure 1: The 3Y Roll

3Y Roll	
Near Bond Basket	4.75 Nov-12, 6.50 May-13, 6.25 Jun-14, 6.25 Apr-15
Far Bond Basket	6.50 May-13, 5.50 Dec-13, 6.25 Jun-14, 6.25 Apr-15
Implied Price	6.0
Market Price	5.5
Roll Convexity (bp per 10bp sell-off)	0.9

Source: CBA, Bloomberg, Reuters

Figure 2: The 10Y Roll

3Y Roll	
Near Bond Basket	5.25 Mar-19, 4.50 Apr-20, 5.75 May-21, 5.75 Jul-22
Far Bond Basket	4.50 Apr-20, 5.75 May-21, 5.75 Jul-22
Implied Price	4.4
Market Price	4.25
Roll Convexity (bp per 10bp sell-off)	0.3

Source: CBA, Bloomberg, Reuters

Key Views

United States

		Tactical (<1 mth)	Strategic (>3 mths)
Investors, broadly, have a decidedly more confident flavour after the continued QE buying and the new agreement on extending the Bush tax cuts. However, the market appears to be somewhat thin and, whilst inclined towards temporary runs, lacking commitment to any move. This pattern may well continue until the new year.	Policy rate	0.1%	0.1%
	10yr bond	2.90%	2.70%
The increase in confidence is despite weak payrolls data (only 39K jobs and a rise in unemployment to 9.8%). There is a long way to go yet in reducing the unemployment rate (the household jobs survey is much worse than non-farm payrolls on this score) or increasing the underlying rate of inflation.	2/10 curve	240bp	220bp
	USD/JPY	85	90
Ultimately, we expect QE2 will keep real bond yields low. We think the recent back-up in inflation expectations (as the Fed 'targets' higher inflation) will be reversed as weak growth and persisting disinflation pressure are revealed in the data. We expect the curve to flatten as 10Y yields rally, though uncertainty remains very high.	EUR/USD	1.32	1.30
We expect the USD to correct higher in the near term as short USD positions are further unwound, supported by the recent lift in US bond yields. With volatility low, upside to USD/JPY in particular is considerable. We expect the USD to garner support this week as Europe's government debt problems keep the USD well bid.			

Australia

		Tactical (<1 mth)	Strategic (>3 mths)
The RBA has again paused their cash rate cycle. Our economists have recently revised their forecasts and see the next rate rise as being in April. However, the RBA continues to focus on the medium-term growth of the economy which is likely to see rates rise over 2011. Australia's economic growth remains strong and is supported by the high terms of trade.	Policy rate	4.75%	4.75%
	10yr bond	5.40%	5.40%
The RBA believes it is ahead of the curve on interest rates, which gives it the ability to pause for a month or three and remain at an appropriate setting. This makes picking the exact timing of moves very difficult. However, the RBA is likely to continue raising rates in the medium term. We forecast 5.50% by end 2011.	3/10 curve	40bp	20bp
	10yr EFP	55bp	65bp
With minimal RBA hikes priced in (5.0% by end 2011), we look for the former curve flattening and AUS-US spread widening trends to resume, particularly when/if US bonds consolidate as we forecast. We have recommended entering a flattening trade at these levels.	10yr v US	250	270
	AUD/USD	0.97	1.00
With the USD likely to consolidate, the AUD/USD is going to be on the back foot in the near term. Further interest rate hikes or lifts in China's Reserve Requirement Ratio (RRR) will also apply some short-term downward pressure on the AUD. But we do not expect a significant dip in AUD. The USD bid tone as a result of the European sovereign debt problems will see the USD remain firm and the AUD under some mild downward pressure. But AUD/EUR should outperform in a low volatility environment.			

New Zealand

		Tactical (<1 mth)	Strategic (>3 mths)
The RBNZ remains on hold, but the income boost coming through from solid growth in Asia points to extension of the cycle and further RBNZ tightening thereafter. Confidence in NZ has been improving but house prices remain weak.	Policy rate	3.00%	3.00%
	10yr bond	5.70%	5.50%
The RBNZ is comfortable that inflation expectations will remain in check as further tax increases push inflation above 5%, but this remains a key source of risk to the outlook. We look for the RBNZ to resume rate hikes early in 2011.	2/10 swap curve	150bp	130bp
The RBNZ is very likely to leave rates unchanged at tomorrow's meeting.	10yr v US	270	280
In line with some expected short-term strength in the USD, the NZD is likely to head lower in the short-term. Our forecasts have AUD/NZD heading higher over the next six months.	10yr v AUS	+30	+10
	NZD/USD	0.74	0.77
	AUD/NZD	1.31	1.32

CBA Forecasts:

Cash rate	8-Dec	Dec-10	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	0.25	0.50	0.75	1.00	1.25	1.50
Australia	4.50	4.75	4.75	5.00	5.25	5.50	5.75	5.75	5.75	5.75
New Zealand	3.00	3.00	3.25	3.75	4.25	4.50	4.50	4.50	4.50	4.50
United Kingdom	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.75
Eurozone	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.75	2.00
Japan	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.30	0.30
2-yr bond yield	**8-Dec**	**Dec-10**	**Mar-11**	**Jun-11**	**Sep-11**	**Dec-11**	**Mar-12**	**Jun-12**	**Sep-12**	**Dec-12**
US	0.53	0.40	0.40	0.65	1.00	1.30	1.60	1.90	2.20	2.50
Australia	4.82	4.80	5.10	5.40	5.60	5.70	5.70	5.60	5.60	5.60
New Zealand	3.80	4.00	4.20	4.60	4.90	5.00	4.80	4.80	4.70	4.70
United Kingdom	1.04	0.90	0.90	1.00	1.10	1.30	1.50	1.80	2.00	2.10
Eurozone	0.87	0.80	1.00	1.10	1.20	1.40	1.70	2.00	2.30	2.50
Japan	0.20	0.15	0.15	0.15	0.20	0.20	0.30	0.60	0.70	0.70
10-yr bond yield	**8-Dec**	**Dec-10**	**Mar-11**	**Jun-11**	**Sep-11**	**Dec-11**	**Mar-12**	**Jun-12**	**Sep-12**	**Dec-12**
US	3.15	2.90	2.70	2.70	2.90	3.20	3.40	3.50	3.60	3.70
Australia	5.54	5.40	5.50	5.60	5.70	5.75	5.70	5.70	5.70	5.70
New Zealand	5.78	5.60	5.50	5.70	5.80	5.90	5.90	5.90	5.80	5.80
United Kingdom	3.46	3.30	3.10	3.10	3.20	3.40	3.50	3.60	3.80	4.00
Eurozone	2.95	2.80	2.60	2.50	2.60	2.80	3.00	3.10	3.20	3.30
Japan	1.22	1.10	1.00	1.10	1.10	1.20	1.30	1.40	1.60	1.70

AUD Swap Rates	8-Dec	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
2-year	5.25	5.25	5.50	5.85	6.10	6.20	6.10	6.00	6.00	6.00
3-year	5.35	5.35	5.65	5.95	6.10	6.20	6.10	6.05	6.05	6.05
5-year	5.71	5.60	5.85	6.05	6.25	6.30	6.20	6.15	6.15	6.15
10-year	6.05	5.90	6.05	6.20	6.35	6.40	6.30	6.30	6.30	6.30

NZD Swap Rates	8-Dec	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
2-year	3.88	3.85	4.20	4.55	5.00	5.10	5.10	5.10	5.10	5.10
3-year	4.24	4.15	4.35	4.70	5.10	5.25	5.20	5.20	5.15	5.15
5-year	4.74	4.70	4.90	5.20	5.50	5.60	5.50	5.50	5.45	5.45
10-year	5.49	5.40	5.30	5.50	5.70	5.90	5.90	5.90	5.85	5.85

Calendar – December 2010

Monday	Tuesday	Wednesday	Thursday	Friday
Early January AU Building approvals, Nov (6 Jan) AU Retail trade, Nov (10 Jan) AU Trade in Goods & Services, Nov (11 Jan) AU Housing finance, Nov (12 Jan) AU Labour force, Dec (13 Jan)	***Central Bank Meetings*** AU RBA (7 Dec) NZ RBNZ (9 Dec) UK BOE (9 Dec) EZ ECB (2 Dec) CA Bank of Canada (7 Dec) JP BoJ (21 Dec) US FOMC (15 Dec)	**1** **AU AI-Group PMI, Nov, Index, (49.4)** AU GDP, QIII, q/y%ch, 0.7/3.7 (12/3.3) CH PMI Manufacturing, Nov, Index, (54.7) JP Vehicle sales, Nov, y%ch, (-26.7) EU/GE/UK PMI manufacturing, Nov, Index, (55.5/58.9/54.9) US ISM manufacturing, Nov, Index, (56.9) US Construction spending, Oct, m%ch, (0.5) US Federal Reserve Beige Book US Total vehicle sales, Nov, mn, (12.25)	**2** **AU Trade balance Oct, $bn, 2.5, (1.76)** **AU Retail trade, Oct, m%ch, 0.5, (0.3)** EU GDP, QIII, q/y%ch, (0.4/19) EU PPI, Oct, m/y%ch, (0.3/4.2) EU ECB announces int. rate, %, 1.00, (1.00) UK PMI construction, Nov, Index, (51.6) US Pending home sales, Oct, m/y%ch, (-18/-24.9)	**3** **AU CBA/Ai-Group PSI, Nov, Index, (50.7)** CH Non-Manuf PMI Nov, Index, (60.5) EU PMI services/composite, Nov, Index, (55.2/55.4) EU Retail sales, Oct, m/y%ch, (-0.2/1.3) GE/UK PMI services, Nov, Index, (58.6/53.2) US Avg hrly earnings, Nov, m/y%ch, (0.2/1.7) US Non-farm payrolls, Nov, '000, (151) US Unemployment rate, Nov, %, (9.6) US ISM non-manufacturing, Nov, Index, (54.3) US Factory orders, Oct, m%ch, (2.1) CA Net change in employment, Nov, '000, (3.0) CA Unemployment rate, Nov, %, (7.9)
6 **AU Ai-Group PCI, Nov, Index, (44)** **AU TD inflat gauge Nov, m/y%ch, (0.3/3.8)** **AU ANZ Job ads, Nov, m%ch, (0.6)** UK New car registrations, Nov, y%ch, (-22.2) CA Building permits, Oct, m%ch, (15.3) CA Ivey purchasing manager index, Nov, (56.7)	**7** **AU RBA cash rate, %, 4.75, (4.75)** JP Leading / Coincident index CI, Oct, (98.6/102.1) GE Factory orders, Oct, m/y%ch, (-4.0/14.0) UK Industrial production, Oct, m/y%ch, (0.4/3.8) UK NIESR GDP estimate, Nov, m%ch, (0.5) US Consumer credit, Oct, $bn, (2.1) CA Bank of Canada, %, 1.25, (1.00)	**8** **AU Housing Finance, Oct** **Value of all loans, m%ch, -2.0 (0.6)** **No. of own-occupiers, m%ch, 0.0 (1.3)** **AU RBA Ass. Gov. Lowe speaks in Sydney** NZ Manufacturing activity QIII, q%ch, (3.1) JP Curr a/c total/adjusted, Oct, ¥bn, (1959.8/1661.3) JP Trade balance - BOP basis, Oct, ¥bn, (926.9) JP Machine orders, Oct, m/y%ch, (-10.3/4.2) GE Trade bal, Oct, €bn, (16.8) GE Industrial production, Oct, m/y%ch, (-0.8/7.9) CA Housing starts, Nov, '000, (167.9)	**9** **AU Labour Force, Oct** **employment, '000, 25 (29.7)** **unemployment rate, %, 5.1, (5.4)** **participation rate, %, 65.8, (65.9)** NZ RBNZ official cash rate, %, 3.00, (3.00) NZ Card spending, Nov, m%ch, (0.8) JP GDP, QIII, q%ch, (0.9) JP Machine tool orders, Nov, y%ch, (71.0) EU ECB Monthly report UK Total trade balance, Oct, £bn, (-4.6) UK BoE announces rates, %, 0.50, (0.50) US Wholesale inventories, Oct, m%ch, (1.5)	**10** NZ Terms of Trade Index, QIII, q%ch, (2.1) CH Trade balance Nov, US$bn, (27.15) JP Domestic CGPI, Nov, m/y%ch, (0.2/0.9) JP Consumer confidence, Nov, Index, (41.1) UK PPI Input/Output/core, Nov, y%ch, (8.0/4.0/3.3) US Trade balance, Oct, $bn, (-44.0) US Import price index, Nov, m/y%ch, (0.9/3.6) US Uni. Of Michigan confidence, Dec, Index CA Trade balance Oct, C$, (-2.5)
13 NZ Food prices, Nov, m%ch, (2.2) CH PPI/CPI, Nov, y%ch, (5.0/4.4) CH Retail sales, Nov, y%ch, (18.6) CH Industrial production, Nov, y%ch, (13.1) CH Fxd Ass Investment, Nov, y%ch, (24.4)	**14** **AU NAB Bus conf/cond, Nov, Index, (8/2)** **AU Dwelling commence, QIII, q%ch, -5, (0.8)** NZ Retail sales, Oct, m%ch, (1.6) JP Industrial production, Oct, m/y%ch, (-1.6/11.5) EU Industrial production Oct, m/y%ch, (-0.9/5.2) EU/GE ZEW survey (econ. sentiment), Dec, Index, (13.8/18) UK CPI, Nov, m/y%ch, (0.3/3.2); core, y%ch, (2.7) US Producer price index Nov, m/y%ch, (0.4/4.3) US Retail sales, Nov, m%ch, (1.2) US Business inventories, Oct, m%ch, (0.9) US FOMC rate decision, %, 0-¼, (0-¼)	**15** **AU MI/WBC Consumer Sent, Dec, Index, (110.7)** **AU DEWR skilled vacancies, Dec, m%ch, (-1.0)** **AU New motor veh. sales, Nov, m/y%ch, (-0.6/3.3)** **AU RBA Ass. Gov. Debelle speaks in Sydney** JP Tankan Index, QIV, Index, (8) EU New car registrations Nov, y%ch, (-16.6) UK ILO unemployment rate (3mths), Oct, %, (7.7) US CPI, Nov, m/y%ch, (0.2/1.2); core, m/y%ch, (0.0/0.6) US Industrial production, Nov, m%ch, (0) US Capacity utilisation, Nov, %, (74.8) US NAHB housing market index, Dec, (16)	**16** **AU MI Consumer Inflation Expectat, Dec, %, (0.03** **AU MI Unemp. Expt., Dec, Index, (110.0)** **AU RBA Bulletin - QIV 2010** **AU Financial accounts, QIII** NZ Business PMI, Nov, Index, (49.7) NZ NBNZ Business confidence, Dec, Index EU CPI, Nov, m/y%ch, (0.4/1.1); core, y%ch, (1.1) UK Retail sales, Nov, m/y%ch, (0.5/-0.1) US Current account balance, QIII, US$bn, (-123.3) US Housing starts/Building permits, Nov, '000, (519/550) US Philadelphia Fed, Dec, Index, (22.5)	**17** EU Construction output, Oct, m/y%ch, (-2.1/-8.1) EU Trade balance Oct, €bn, (2.4) GE IFO - Business climate, Dec, Index US Leading indicators, Nov, m%ch, (0.5)
20 JP Leading / Coincident index CI, Oct, EU Current account, Oct, €bn, (-13.1) GE Producer prices, Nov, m/y%ch, (0.4/4.3) CA Wholesale sales, Oct, m%ch, (0.4)	**21** **AU RBA Board Minutes** AU Population growth, QII, q/y%ch, (0.5/1.8) NZ Credit card spending, Nov, m/y%ch, (0.6/4.6) JP BoJ target rate, %, 0-0.10, (0-0.10) CA CPI, Nov, m/y%ch, (0.4/2.4) CA Retail sales, Oct, m%ch, (0.6)	**22** NZ Current account, QIII, % of GDP, (-3.0) JP Trade balance, Nov UK Bank of England minutes UK GDP, QIII, q/y%ch, (0.8/2.8) UK Current account balance QIII, £bn, (-7.4) US GDP, QIII, q%chsaar, (2.5) US Existing home sales, Nov, mn/m%ch, (4.4/-2.2)	**23** NZ GDP, QIII, q/y%ch, (0.2/1.9) US Personal income/spending, PCE deflator, Nov US Durable goodes orders, Nov US Uni. Of Michigan confidence, Dec, Index US New home sales, Nov	**24**
27 **Christmas Day Holiday, Aus** JP Vehicle production, Nov JP Housing starts, construction orders, Nov US Dallas Fed, Dec, Index	**28** **Boxing Day Holiday, Aus** JP CPI, Industrial production, retail sales, Nov US S&P/Case-Shiller home price ind., Oct, US Richmond Fed, Dec, Index	**29** GE CPI, Dec UK BoE Housing equity withdrawal, QIII, £bn CA Teranet House Prices, Oct	**30**	***31*** AU RP Data house price index, Nov, AU Private sector credit, Nov AU RP Data house price index, Nov, UK GfK consumer confidence survey, Dec, 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

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

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