Global Markets Research

Fixed Income: Weekly Strategy

14 February 2011

Swap curves under pressure and Queensland under the microscope

- The Australian rates market tested new highs in yield this week but reversed course on Thursday.
- The bonds have been lagging the rally and we switch our paid 3Y EFP trade to a paid Oct-14 ASW position.
- We examine Queensland's credit rating outlook and expect no change.

The Australian rates curve started last week beholden to the increases in US yields, because the momentum from last week's sell-off carried over. However, the momentum spluttered when the labour force data was released on Thursday and reversed once Governor Stevens spoke to the House Economics Committee on Friday. Since last Monday, the 3Y bond has rallied 8bp and the 10Y bond has rallied 3bp.

After the strong sell-off, the market had been showing signs of fatigue. The employment data was reasonably strong, but still triggered a rally. The headline number of jobs was larger than expected at 24K, though this did include a fall of -8K full-time positions. The unemployment rate remained at 5.0% and would have fallen had the participation rate not increased to 65.9%.

Governor Stevens was reasonably upbeat about the medium term outlook for rates, but the market reacted to his short-term comments. Governor Stevens emphasised the strong growth in China and India and that the terms of trade were likely to peak higher (and later) than previously expected. On the shorter-term outlook, Governor Stevens did make the point that the RBA intended to be on hold for "some time". The market reacted to the short term view, rallied hard and steepened.

On top of these two domestic drivers, the uncertainty in Egypt has also added to the rally in bonds near the end of the week. Events are gathering pace in Ireland too. Moody's downgraded four banks to non-investment grade and mortgage rates have risen steeply. The Irish election is scheduled for February 25th.

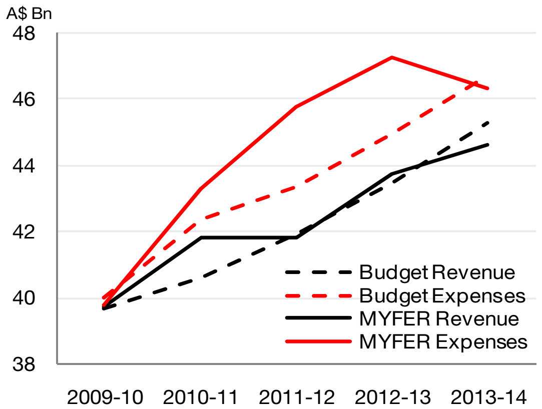
During the sell-off over the last two weeks, the body of the curve has tended to sell-off faster than the short and long rates. This is not the usual outcome. Philip Brown examines this in his article on page 3 and also notes the way the bonds have tended to lag the recent rally.

Alex Stanley takes an in-depth look at the Queensland Government's ratings outlook in his article on page 5. While there is now greater downside risk, we continue to view "no change" as the most likely outcome for the next few years. This morning, QTC announced a new 2018 bond. Philip Brown examines the new QTC bond and finds the indicative pricing of 56-59bp over ACGB seems about right. This article begins on page 10.

This coming week will, likely, have the RBA back centre-stage. There is not much Australian data of note, but the RBA minutes are scheduled for release tomorrow. In the US, the highlight is likely to be the CPI data on Friday morning. The Retail Sales data (Wednesday morning) and FOMC minutes (Thursday Morning) will also attract attention.

Contents:

Queensland General Government Sector revenue and expenses



Source: State Budgets, CBA

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Key Positions

The market was not particularly kind to us this week. The continuing sell-off in the US stopped us out of our Aus-US spread trade. The strong reaction to the speech by Governor Stevens stopped us out of our paid 1Y*1Y position. However, this was a revised trailing stop, we still made a profit of 19bp on the trade.

We have shifted out of our paid 3Y EFP trade, in favour of a paid position in the Oct-14 ASW. The general arguments are the same, but the bonds have lagged in the recent rally.

Key Trades

Trade	Entry	Curent	Profit	Target	Stop	Comment
Buy the NSWTC Jun-20 (Government Guaranteed) as an ASW	-12bp (3-Feb-10)	-11bp	-1bp	-35bp	0bp	**Hold**: A long-term buy-and-hold trade.
Pay 3yr AUD EFP	35bp rolls to 27 bp (9-Aug-10)	24.5bp	-2.5bp (roll was 8bp)	45bp	30bp	**Exit**: Replace this trade with the Oct-14 ASW trade.
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-Aug-10)	5.37 and 6.20	-0.4bp (premium)			**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	11.5bp	+18bp	0bp	40bp	**Hold:** This bond is Government Guaranteed. It should be much tighter. Repurchases of GG bank bonds becoming common.
Sell 3M, 20bp OTM bond put on Apr-20 ACGB, strike is 5.61%	5.61 / 10bp (15 Nov-10)	Current yield is 5.68	n/a	n/a	5.71bp	**Hold:** Expires tomorrow. At current prices we have made a 3bp profit.
Sell the ACGB Apr-20 against the UST 2.625% Nov-20	219bp (19-Jan-11)	200bp	-19bp	250bp	200bp	**Stopped Out:** The US sell-off proved stronger than expected..
Pay AUD 1Y*1Y	5.41% (19-Jan-11)	5.60%	+19bp	5.90%	5.60%	**Stopped out at revised stop.** The Australian market is underpricing the RBA.
Buy the Jun-16 vs the May-13 and May-21	+11bp (24-Jan-11)	+13bp	-2bp	+3bp	+15bp	**Hold:** PCA analysis suggests this is likely to fall. A flattening would also assist the trade.
But 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.
Receive 10Y AUD-USD basis vs 3Y	8bp (31-Jan-11)	9bp	-1bp	3bp	10bp	**Hold:** The mismatch between issuance and borrowing suggests the curve should flatten
Pay the ASW of the ACGB Oct-14	31bp (14-Feb-11)			40bp	25bp	**New Trade:** We replace our 3Y EFP with this ASW instead. The bonds have lagged swap.

Pay swap against the Oct-14 ACGB

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- We switch our paid EFP position into a paid Oct-14 ASW position.
- The bond curve has lagged the a move in swaps.
- The Oct-14 ASW has been drifting tighter (bond underperforming swap) while the EFP has widened.

US sell-off important, but not everything

The recent sell-off was widely attributed to the move in the US interest rates. We think this overstates the case, though. True, the US 10Y rate has made new highs in yields over the past week after a significant sell-off. However, this underplays the extent to which the expectations of the RBA have affected the Australian curve over the past few weeks.

The market interpreted the Statement on Monetary Policy on February 4 as being very hawkish. Governor Stevens' speech to the Economics Committee on Friday was interpreted as Dovish and caused a dramatic rally. As it happened, the RBA SMP occurred when the US market was selling off. Friday's rally managed to easily overcome the US sell-off that lead into the speech.

RBA expectations affecting curve too

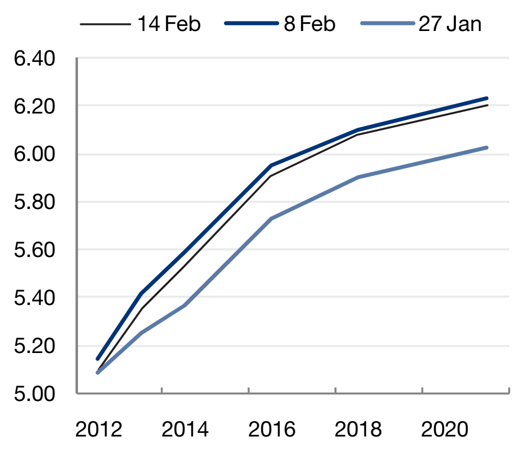
Over the first week of February, the US sell-off coincided with a substantial change in RBA expectations. The combination of the two caused a strong move higher in AUD rates. (See Figure 1.) The Governor's appearance to the Economics committee caused a severe move down in yields.

Body of the curve lead the sell-off

Over the course of the move higher in rates, the body of the swap curve tended to lead the front and back ends. We think this was because of the overlaying of the RBA-led move (which focuses on the front end) with the US-Treasury-led move (which focuses on the back end). Although neither move affects the body of the curve most, both moves affect the middle of the curve a moderate amount. The total of the two moves was felt most in the middle of the curve. Putting that another way, the body of the curve had two medium strength drivers (RBA and UST), while the front end and long-end had one strong driver each. However, the two medium-strength drivers outweighed a single strong driver in both cases.

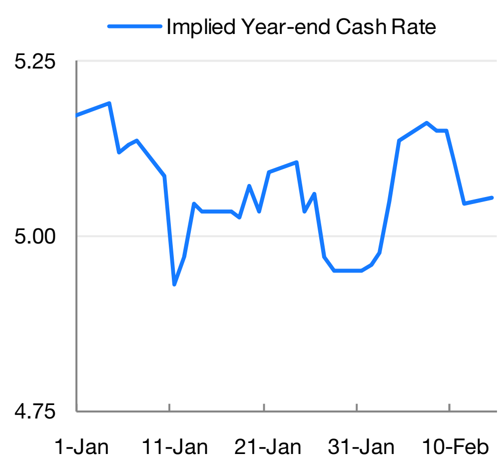
The swap curve has been quick to incorporate Friday's rally along the length of the curve. The ACGB curve, in contrast, has been a little slower. The body of the ACGB curve shows up as cheap on our PCA analysis, while the body of the swap curve shows as being fairly priced. (See Figures 3 and 4.)

Figure 1 –AUD Swap curve shows dual influence



Source: CBA, Bloomberg

Figure 2 – Implied December RBA rate



Source: CBA, Bloomberg

Our automatic reaction to figure 4 would be to implement a bond butterfly. Unfortunately, we already have implemented a 13/16/21 bond butterfly. With the benefit of hindsight, that was slightly early. Although the trade has performed poorly overall, we would keep it on as the overall outlook is good. (The butterfly has also recovered a few bp in the last few days as the curve rallied in response to Stevens.)

Bonds have been lagging, while swaps have not

However, the difference between the swap and bond results makes us curious about ACGB swap spreads. We note that the ACGB Oct-14 has been cheapening to swap consistently, even as the 3Y EFP is broadly unchanged to slightly wider. This is a complicated area of the curve, because the swap changes from Quarterly to Semi at 3Y. However, the result is undeniable; the Oct-14 has been drifting cheaper while the EFP has not. Figure 5 shows the spread to swap of the Oct-14 and the 3Y EFP.

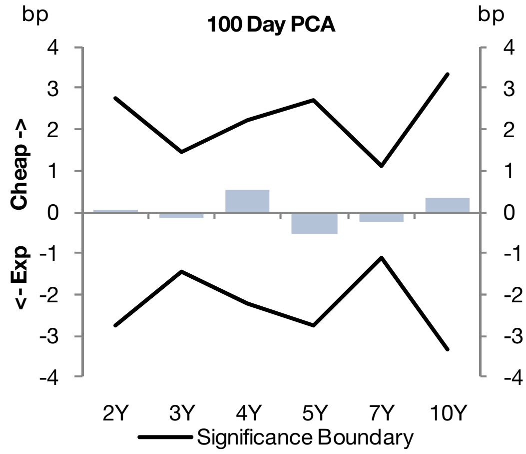
Pay the Oct-14 ASW at around current levels

We pay the ASW of the Oct-14 at current levels. The PCA analysis shows that part of the bond curve has been lagging, while Chart 5 shows the spreads are diverging. The switch to quarterly at 3Y makes this a relatively short term trade. We do not want to hold the position into the 3Y point.

We generally look for spreads at the front end to widen. The curve is likely to flatten and the recent spike higher in rates (that has now been reversed) may tempt some more payers out of the woodwork. Governor Stevens did acknowledge that rates are currently about right, but also indicated the overall bias was for higher rates. The curve which Stevens described as “about right” had more than one rate hike priced for the second half of the year. We will use this new Oct-14 trade as a replacement for our current 3Y EFP position. The underlying rationales are the same, but the Oct-14 looks cheap compared to the 3Y EFP.

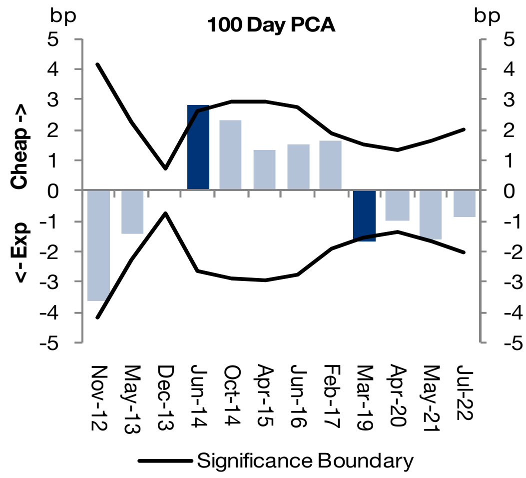
As well as a general view, there are particular reasons to believe the Oct-14 is worthy of a trade. The bond is relatively new, but the AOFM auctioned it again on Friday. Once this new supply is absorbed the extra liquidity should see the bond outperform. If there is any hint of widening in advance of the auction, then the swap spread trade should capture this too.

Figure 3 – PCA results for Swaps



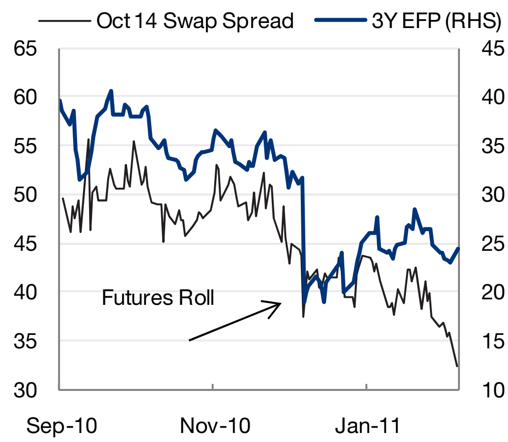
Source: CBA, Bloomberg

Figure 4 – PCA results for Bonds



Source: CBA, Bloomberg

Figure 5 – Swap spreads and EFPs



Source: CBA Spectrum, Bloomberg

Queensland Credit Rating Outlook

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- The downside risks to Queensland's rating have increased, but the AA+/Stable rating is likely to be maintained.
- There are limited credit risks in Queensland's economic outlook.
- There are downside fiscal risks in the path to an operating surplus and in the reduction of capital expenditure.

We retain our view that an upgrade to AAA is unlikely.

We recently considered whether Queensland could regain a AAA credit rating (see Weekly Strategy of 19 January). Our conclusion was - and still is - that an upgrade is a long way off. The Queensland Government's Mid-Year Fiscal and Economic Review (MYFER) reinforced our view on the low probability of an upgrade (see Weekly Strategy of 7 February).

We consider the downside risks to Queensland's AA+/Stable (S&P) rating.

Prior to the MYFER, S&P and Moody's stated that the ratings on Queensland are unaffected by the flood crisis. This indicates there is a low probability of a near term adverse ratings action. However, clients have asked what factors could lead to a downgrade. Specifically, what are the risks of a downgrade or an adverse change in outlook on Queensland's AA+/Stable (S&P) long term rating?

We consider Queensland's major ratings factors, as identified by S&P. In mid December, S&P affirmed their AA+/stable rating on Queensland. The strong ratings factors, according to S&P, are: a supportive institutional framework, a robust and a diversified economy, excellent financial management and very positive liquidity. The weaker ratings factors are: a poor budget performance and an imbalance between revenue raising power and expenditure (like all states). In the key budget flexibility ratings factor, Queensland has both strengths and weaknesses.

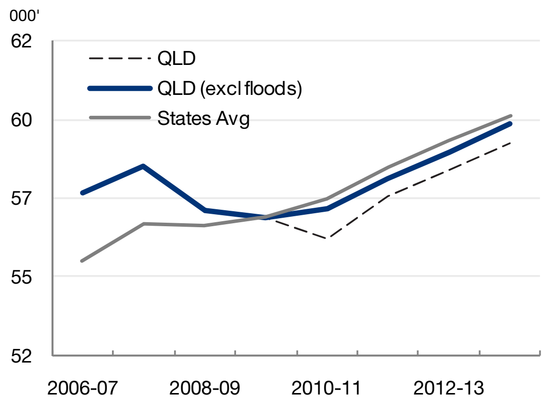
The pressure on Queensland's ratings weak points have increased but not by enough for us to expect a change in the credit rating.

Since S&P's assessment, the floods have exerted additional pressure on all aspects of Queensland's outlook. In our view, S&P's description of Queensland's strengths and weaknesses is still accurate. But the degree of pressure on the budget performance and flexibility has increased. While there is now greater downside risk, we continue to view "no change" in Queensland's credit rating as the most likely outcome for the next few years.

The Queensland economy

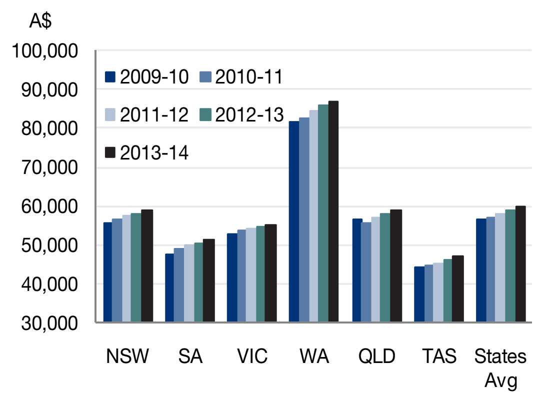
Queensland's economic outlook is unlikely to be a significant source of ratings weakness. The widespread damage caused by the floods adds a degree of economic uncertainty to Queensland. We've covered this ground before (see Weekly Strategy 19 January), but the MYFER gives us some additional insight. Like

Figure 1: Queensland GSP per capita



Source: ABS, State Budgets, CBA

Figure 2: State GSP per capita forecasts



Source: ABS, State Budgets, CBA

the RBA's assessment of the Australian economy in the February SOMP, Queensland's medium term economic outlook is quite strong.

The floods are expected to change the near term Queensland economic growth profile.

The Queensland government is expecting any weakness in economic conditions because of the floods to be temporary. Gross State Product (GSP) growth in 2010-11 is expected to be 1.25%, instead of 3% without floods. In 2011-12, GSP looks set to benefit from the re-construction effort. Queensland is forecasting growth to be 5%, compared with 4.25% without the floods. This near term growth profile looks reasonable, but the floods add a large degree of uncertainty to the growth outlook. The MYFER doesn't provide new GSP forecasts beyond 2012-13, but outcomes averaging 4% a year look achievable over the long term.

Queensland's GSP per capita is comparable with other states.

S&P often cite the GSP per capita metric when comparing state economies. Figure 1 illustrates that annual GSP per capita in Queensland, in the $50-$60k range, is comparable with the national average and slightly better than AAA-rated Victoria. S&P noted in December that the composition of growth in Queensland is weighted more towards mining than New South Wales and Victoria, but less than Western Australia. So Queensland enjoys the benefits of resources sector growth, but has some diversification away from it.

Unemployment in Queensland is higher than in other states.

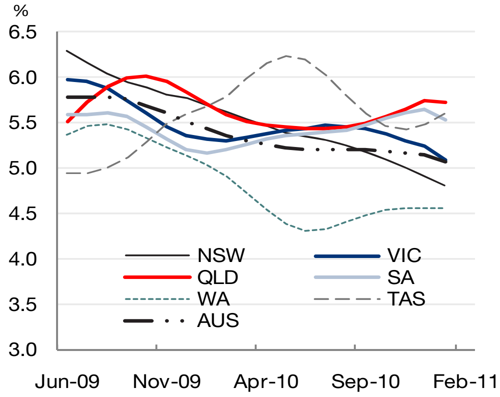
Last Thursday's Labour Force figures showed Queensland's unemployment rate is 5.6%, which is higher than the 5.0% national rate (see Figure 3). But the absolute level is not high and further improvement is likely. The MYFER predicts a fall to 5.25% by 2012; a better outcome than the 5.5% expected without the flood re-construction benefit.

The Queensland housing sector and non-resources export sector have been subdued recently.

There are some risks to the economic outlook. Housing construction in Queensland has remained subdued since the GFC. The flood re-construction effort provides support to the sector as a whole, but not necessarily to the construction of new homes. Further tightening from the RBA could also limit demand for new housing. Another downside risk in Queensland is in the non-resources export sector. The high value of the Aussie dollar is adversely impacting tourism and education exports. Looking ahead, CBA FX Strategists are forecasting a decline in the Aussie dollar over late 2011 and early 2012, which could provide some respite to non-resource exports in Queensland.

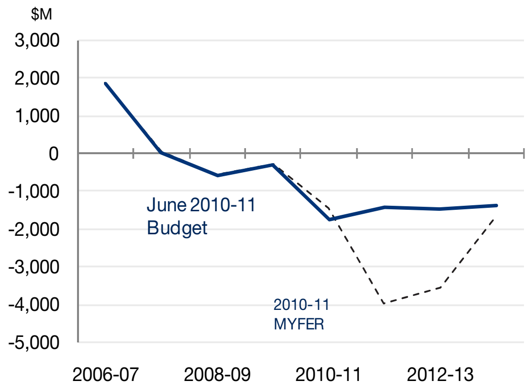
There are downside risks in the Queensland economy and new challenges from the floods. However, we don't think Queensland's economic performance will present a large risk to their credit rating in the foreseeable future.

Figure 3: State unemployment rates (trend)



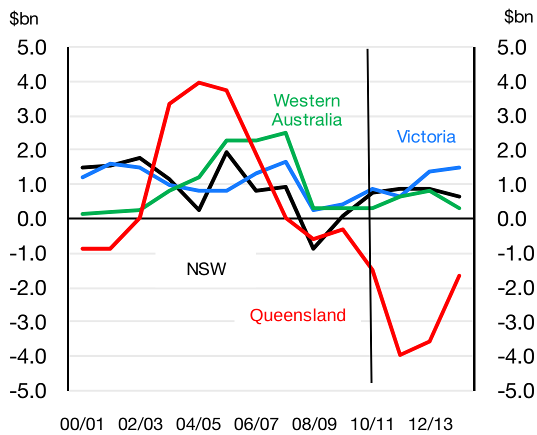
Source: ABS, CBA

Figure 4: QLD Net Operating Balance (General Government Sector)



Source: Budget papers, CBA

Figure 5: States net operating balance (general Government sector)



Source: State Budgets, CBA

The fiscal outlook

The federal government will cover 75% of the flood damage bill.

Queensland is facing significant new fiscal pressure. The MYFER estimates the floods will cost an additional $5b over 2010-11 to 2012-13. The Commonwealth is responsible for 75% of the bill – including relief measures and the restoration of public assets. Federal support improves Queensland's 2010-11 deficit by $300m, relative to the June budget.

Even with federal support, the floods still place a significant burden on Queensland's finances. The State's net operating deficit is expected to peak at $4 billion in 2011-12 (Figure 4). Figure 5 illustrates that the large deficits faced by Queensland stand in stark contrast to the surpluses expected its AAA-rated peers.

The floods will place an additional burden on Queensland's fiscal position.

Queensland was last downgraded (to AA+) in February 2009. The main driver of the downgrade was the state's mounting debt task. Since the downgrade, $7.3bn of asset sales (QR National, Port of Brisbane and Forestry Plantations Queensland) have helped stabilise the key net financial liabilities/operating revenue ratio. The Queensland Government estimate the ratio would have reached 147% without the benefit of asset sales. The MYFER estimates in Figure 5 don't yet include the benefit of the planned Queensland Motorways and Abbot Point Coal Terminal transactions, or the remaining share in QR National. The MYFER notes that the sales yet to be completed could reduce the ratio to 87% in 2010-11 and 129% in 2013-14.

Asset sales reduce the potential debt-to-revenue ratio, which is well above S&P's upgrade zone.

Even with asset sales, the debt-to-revenue ratio is not yet showing any sign of falling. Figure 7 shows it's also clearly above S&P's AAA upgrade zone of 100-110% and that the trajectory remains worrisome.

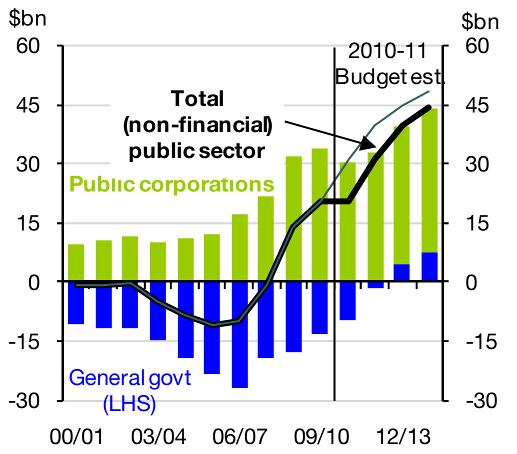
The key fiscal risks

Queensland is expecting sharp expenditure growth over the next couple of years.

Queensland's operating balance is a key source of risk from a ratings perspective. The Government has maintained their commitment to reach a surplus in 2015-16, but the MYFER shows the path (up to 2013-14) is a challenging one (see Figure 8). Queensland expects compound average revenue growth of 3% and average expenses growth of 4% between 2009-10 and 2013-14. Most of this divergence is because of the large expenditure growth this year and in 2011-12.

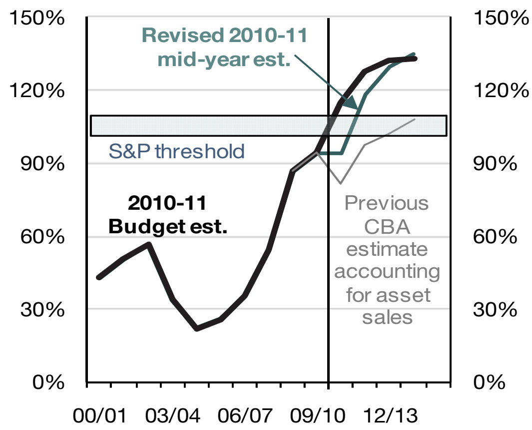
Queensland will require a sharp recovery in the net operating deficit to reach a surplus by 2015-16. Between 2011-12 and 2012-13 the MYFER projects a 5% lift in revenue and a moderation in expenditure growth. In 2013-14, the MYFER projects a 2% decline in expenses. That seems highly ambitious and is unprecedented.

Figure 6: Queensland net debt



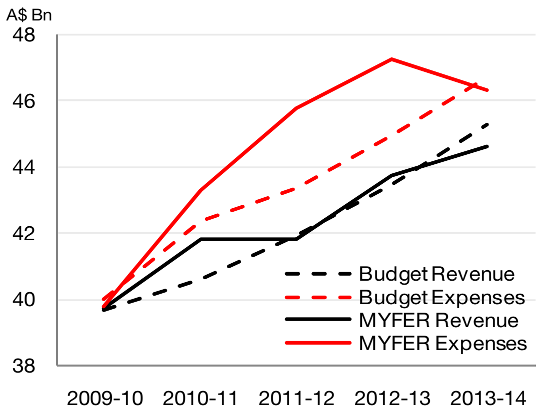
Source: Budget papers, CBA

Figure 7: QLD Net Financial Liabilities/Operating revenue (Non-Financial Operating Sector)



Source: Budget papers, S&P, CBA

Figure 8: Queensland General Government Sector revenue and expenses



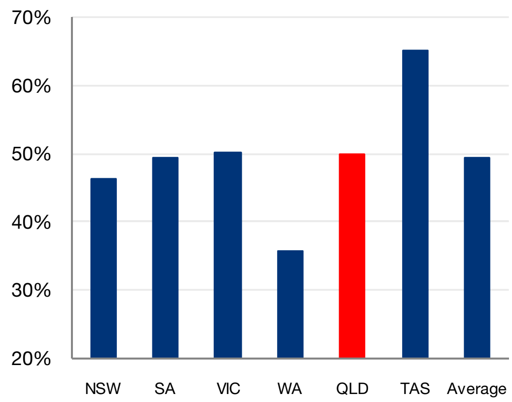
Source: State Budgets, CBA

Federal grants make up around 50% of Queensland's general Government sector revenue.

Part of the operating balance is beyond Queensland's control. According to S&P, all Australian states face some degree of budget inflexibility. All states have substantial expenditure responsibilities, but only limited control over revenue. The extent of this issue differs across the country. Figure 9 compares federal grants as a percentage of general Government revenue. Queensland is in line with the national average, but Federal grants still account for half of its general Government revenue.

In the MYFER, Queensland revised its total taxation revenue down by 4.2% in 2010-11 because of lower than expected turnover in the housing market. We expect the RBA to raise the cash rate by a further 100bp by 2012, which could further limit housing activity and associated tax revenue. It's also difficult to predict if the floods will have any longer lasting adverse implications for the Queensland property market.

Figure 9: Federal grants (% of general Government revenue)



Source: State Budget, CBA

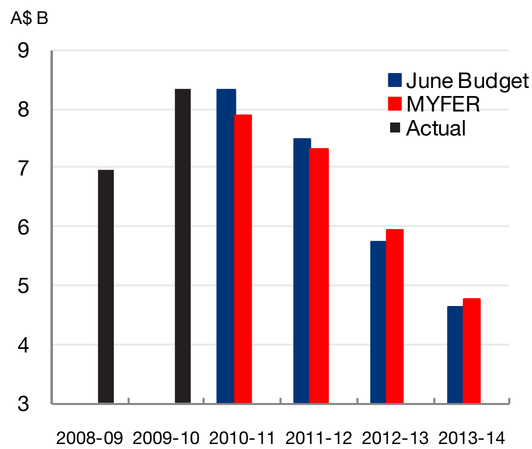
Savings measures are important for eventually reaching an operating surplus.

To support the path to a surplus, the Queensland Government outlined a range of savings measures. In total, they expect around $800m of savings between 2010-11 and 2014-15. A significant portion of savings is expected to come from changes to the Queensland public sector in the form of efficiency targets and a reduction in the public sector workforce. If these measures fall short of forecasts, the targeted surplus in 2015-16 could be at risk.

Managing capital expenditure is another key fiscal risk for Queensland. Large capex needs have been a key driver behind Queensland's high debt levels. Queensland has had a greater proportion of total expenditure directed towards capex in recent years than other states.

A higher portion of state expenditure directed towards capex is generally considered to be a positive for credit. Capex improves the capacity of the economy to produce revenue in the future. Also capex is, at least in principle, easier to cut or delay than operating expenses (such as superannuation expenses).

Figure 10: Queensland Capital Purchases (General Government Sector)



Source: State Budget, CBA

Reducing capital expenditure is a key risk for Queensland.

S&P stated in January that the flexibility to delay and re-prioritise capex is a key driver behind their assessment that the state's rating will be unaffected by floods. Figure 10 illustrates two positive credit attributes of Queensland's proposed capital program. The first is the overall trajectory of capital spending is expected to reduce from $7.8b in 2010-11 to $4.8b in 2013-14. The second positive aspect of the capital spending outlook is timing. Queensland expects to be able to push back some of their expenditure into future periods.

However, the extent to which Queensland is able to deliver on its proposed reduction in capital expenditure is a key point of ratings risk. Figure 11 illustrates the tendency in recent years for capital expenditure estimates to rise in respective future budgets. Queensland faces major infrastructure bottlenecks due to the rapid growth in its population.

The Queensland Government may face political pressure to maintain or increase capital expenditure.

Part of the problem is the political pressure on state leaders to deliver infrastructure upgrades. This problem maybe especially relevant in Queensland as a state election approaches next year. After securing a narrow victory in the 2009 election, opinion polls suggest the Labor Government is lagging behind the Liberal National opposition. The latest Newspoll survey, shown in Figure 12, suggests the Labor Party is behind in the primary and two party preferred votes. However, the latest survey pre-dates the recent floods and Cyclone Yasi (which apparently boosted Premier Anna Bligh's popularity). The polls indicate a tough fight ahead for Labor to retain power.

Weighing up the risks

Downside risks have increased, but we still expect Queensland to maintain its AA+/Stable rating for the foreseeable future.

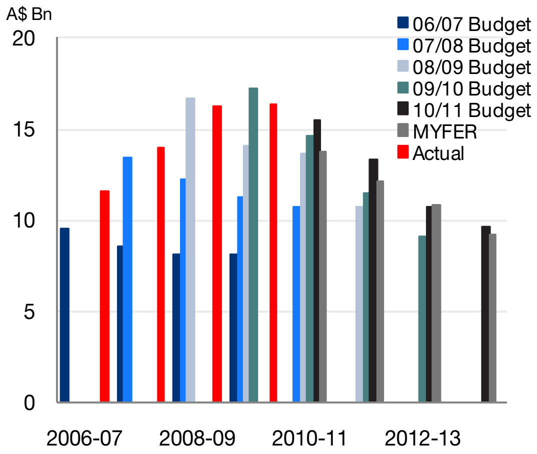
Overall, we think it's likely that Queensland will maintain its AA+/Stable rating for the foreseeable future. The floods have placed additional pressure on the state's finances and lead us to believe that the downside credit risks have increased. However, the higher downside risks aren't yet pressing enough for us to conclude that an adverse ratings move is likely in the near future. Still, the fiscal path ahead for Queensland is a challenging one. The floods have driven a sharp deterioration in the near-term operating balance. The MYFER forecasts a sharp turnaround in the deficit position within a few years. But that is partly contingent on savings policies that are yet to materialise.

A key risk for Queensland is in controlling capital expenditure. According to S&P, Queensland's flexibility in capital spending is a positive ratings factor. But signs of overspending and difficulties in delaying projects could add downside risk for Queensland's rating. A recent history of upward revisions to capex plans indicate the Government may not be able to withstand the political pressure to deliver.

We think the stresses that have emerged on Queensland's budget position have limited its capacity to withstand adverse shocks in the future, without impacting the ratings outlook.

However, while natural disasters always present a challenge, a strong relationship between the federal and state Governments provides strong credit support for all states. There is also potential upside for Queensland from asset sales that are yet to be finalised.

Figure 11: Past Budget Capex Estimates*



**Purchases of non-financial assets – Non-Financial Public Sector*

Source: State Budget, CBA

Figure 12: Queensland voter preferences**

PRIMARY VOTE	Labor	LNP	Greens	Others
	%	%	%	%
Election March 2009	42.2	41.6	8.4	7.8
Newspoll July - September 2010	29	44	14	13
Newspoll October - December 2010*	26	45	13	16

**4% "uncommitted" and 1% "refused" excluded*

TWO PARTY PREFERRED	Labor	LNP
	%	%
Election March 2009	50.9	49.1
Newspoll July - September 2010	43	57
Newspoll October - December 2010	41	59

***Poll Question: If a state election was held today, which one of the following would you vote for? If uncommitted, to which party do you have a leaning?*

Source: Newspoll, CBA

QTC joins NSWTC in the 2018 segment

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- QTC have announced a new Feb-18 bond.
- The deal has no maximum size but is designated a "benchmark deal".
- The lead managers have indicated that the spread is likely to be 56-59bp over ACGB. We agree.

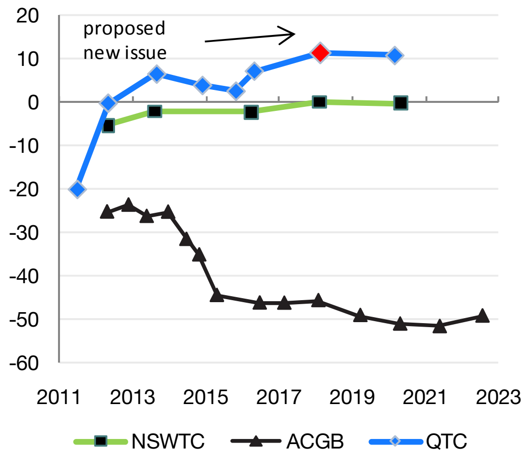
QTC have announced a new 6% coupon, 21 February 2018 bond*. The managers of the syndication have suggested the bond will price at a spread of between 56 and 59 basis points over the ACGB Jan-18.

QTC have announced a new Feb-18 bond

The bond deal has been designated as "benchmark size", but QTC have not indicated a maximum size. The recent QTC debt update outlined a borrowing requirement for the remainder of 2010-11 of around $12bn, though with $3bn of that is likely to be in CP. QTC have $8bn of bonds maturing in June across three bond lines (GG global, GG domestic, SG domestic). Most of the remaining 2010-11 borrowing requirement is to cover the Jun-11 maturities.

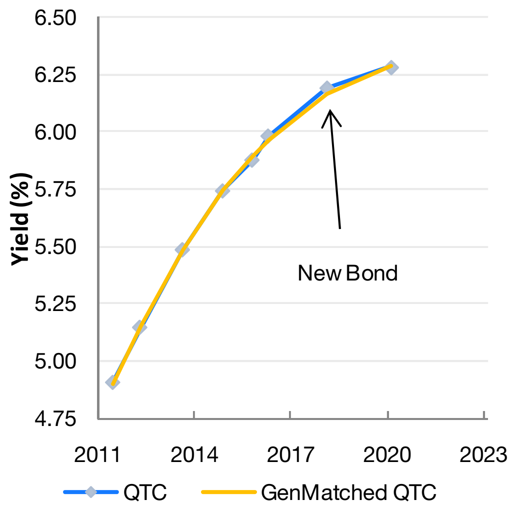
The two QTC bonds either side of the new 2018 each have between $4.5b and $5b on issue. We think that around A$5b would be the natural eventual size for this new line, though it is not clear how quickly QTC will try to take it there. A $5bn line may not be enough to fully cover the maturing bonds. We think that QTC may yet issue another new bond this financial year.

Figure 1 – Spreads to mid swap of various bonds



Source: CBA, Bloomberg

Figure 2 – Fitted QTC curve with spread



Source: CBA, Bloomberg

Pricing guidance seems accurate

The indicated margin of 56-59bp seems likely

Our preferred approach to pricing this bond would be to use a fitted QTC curve. However, we would need to add a spread to capture the premiums that are normal for a new issue. When NSWTC issued a new bond in late January, the spread was 3bp. This is the about the normal level of new-issue spread.

When we used this procedure to price the new bond this morning, we arrived at a point estimate of the new yield of 6.195%. (See Figure 2.) At the time, that was equivalent to a spread of 57.4bp above the ACGB Jan-18.

Our spread is neatly within the 56-59bp range nominated by the deal leaders. We expect the bond's book-build will price near the centre of the nominated range.

**Disclaimer: CBA is a co-manager of this deal and does receive fees from QTC.*

Key Views

United States

	Tactical (<1 mth)	Strategic (>3 mths)
Policy rate	0.1%	0.1%
10yr bond	3.40%	3.25%
2/10 curve	270bp	250bp
USD/JPY	82.5	85
EUR/USD	1.33	1.42

The outlook for US yields is changing. The Fed is worried about excess capacity in product and particularly the labour market and concentrating on warding off deflation risks. But the recent data has been brighter and the market is embracing recovery, while still concerned about the fiscal backdrop and potential inflation impacts of QE.

Overall, we expect a stronger economic recovery to take hold in 2011 and for bond yields to head higher as the situation becomes clearer. But the market has run far quickly, and appears to be pricing an excessive inflation profile given the risks and capacity at hand. We look for a pull-back in the near-term as data continues to unveil a weak pricing environment. However, the strength of the activity data suggests we may not see this consolidation. The Fed is likely to be very slow to adjust its views and respond to such a recovery with tighter policy. When it does, we see room for the curve to flatten markedly.

USD/JPY is finally showing signs of responding to higher US yields. We are targeting USD/JPY to reach 94 this year. The short-term pull back in US yields we anticipate will provide better entry points for this trade.

Australia

	Tactical (<1 mth)	Strategic (>3 mths)
Policy rate	4.75%	5.00%
10yr bond	5.60%	5.50%
3/10 curve	40bp	25bp
10yr EFP	52bp	55bp
10yr v US	220	225
AUD/USD	0.97	0.99

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 benchmark widen noticeably. But the impact of that tightening on 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).

A main dynamic in the domestic markets is tension between a comparatively weak current picture of the economy and a very strong medium term outlook. An example of this dynamic is the very strong labour market but consumers' reluctance to spend. 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. However, with no "smoking gun" likely in the near term and a new flood levy on the way, timing on rate rises is harder to predict.

We expect AUD to fluctuate around parity (0.97-1.02) over the next few months. This week's Chinese CPI report is likely to lead to the usual concerns the Chinese authorities will over tighten policy and hurt demand for commodities and the AUD. We do not think China is overheating and do not believe the Chinese authorities will over tighten.

New Zealand

	Tactical (<1 mth)	Strategic (>3 mths)
Policy rate	3.00%	3.00%
10yr bond	5.50%	5.50%
2/10 swap curve	145bp	145bp
10yr v US	210	225
10yr v AUS	+10	0
NZD/USD	0.74	0.77
AUD/NZD	1.34	1.32

The RBNZ is on hold and our economists believe it will remain so until the third quarter. The income boost coming through from growth in Asia points to eventual extension of the cycle and further RBNZ tightening thereafter once the economy recovers some traction.

The NZ curve has been steepening because weaker domestic outcomes have lowered front end rates while higher offshore rates have kept the long-end elevated. Markets expect the RBNZ to leave rates alone and the offshore movements are likely to continue driving the slope of the NZ curve.

Today's retail report reinforces our view that New Zealand's economy remains weak and is likely to see NZD underperform AUD. The Reserve Bank of New Zealand may put off rate hikes for longer than market pricing and therefore keep AUD/NZD well supported.

CBA Forecasts:

Cash rate	14-Feb	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	3.00	3.00	3.00	3.25	3.50	3.75	4.25	4.50	4.50
United Kingdom	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.75
Eurozone	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.75	2.00
Japan	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
2-yr bond yield	**14-Feb**	**Mar-11**	**Jun-11**	**Sep-11**	**Dec-11**	**Mar-12**	**Jun-12**	**Sep-12**	**Dec-12**
US	0.83	0.50	0.80	1.10	1.40	1.70	2.00	2.30	2.50
Australia	5.13	5.10	5.40	5.60	5.70	5.70	5.70	5.65	5.60
New Zealand	3.80	3.80	4.00	4.20	4.60	4.90	5.00	4.80	4.80
United Kingdom	1.56	1.20	1.80	2.10	2.40	2.70	2.80	2.90	3.00
Eurozone	1.41	0.90	1.00	1.20	1.40	1.70	2.00	2.30	2.50
Japan	0.24	0.15	0.15	0.20	0.20	0.30	0.60	0.70	0.70
10-yr bond yield	**14-Feb**	**Mar-11**	**Jun-11**	**Sep-11**	**Dec-11**	**Mar-12**	**Jun-12**	**Sep-12**	**Dec-12**
US	3.63	3.00	3.10	3.30	3.50	3.70	3.80	3.90	4.00
Australia	5.71	5.50	5.60	5.70	5.75	5.80	5.75	5.70	5.70
New Zealand	5.61	5.50	5.70	5.80	5.90	5.90	5.90	5.80	5.80
United Kingdom	3.87	3.30	4.00	4.30	4.40	4.60	4.60	4.50	4.50
Eurozone	3.29	2.80	2.80	2.90	2.90	3.00	3.10	3.20	3.30
Japan	1.31	1.00	1.10	1.10	1.20	1.30	1.40	1.60	1.70

Currencies	7-Feb	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
AUD/USD	1.01	1.02	0.99	0.94	0.92	0.90	0.88	0.85	0.85
AUD/JPY	83.47	86.70	85.14	81.78	80.96	79.20	77.44	74.80	74.80
AUD/EUR	0.75	0.73	0.68	0.66	0.66	0.66	0.65	0.64	0.65
AUD/GBP	0.63	0.63	0.58	0.56	0.56	0.56	0.55	0.54	0.54
AUD/CAD	1.00	1.03	1.01	0.97	0.96	0.95	0.92	0.92	0.92
AUD/NZD	1.32	1.34	1.32	1.31	1.30	1.29	1.28	1.25	1.25
USD/JPY	82.24	85.00	86.00	87.00	88.00	88.00	88.00	88.00	88.00
USD/EUR	1.36	1.40	1.45	1.42	1.40	1.36	1.35	1.32	1.30
USD/GBP	1.61	1.62	1.70	1.68	1.65	1.60	1.59	1.58	1.58
USD/CAD	0.99	1.01	1.02	1.03	1.04	1.05	1.05	1.08	1.08
USD/NZD	0.77	0.76	0.75	0.72	0.71	0.70	0.69	0.68	0.68

Calendar – February 2011

Monday	*Tuesday*	*Wednesday*	*Thursday*	*Friday*
31 January **AU Private sector credit, Dec** NZ Building permits, Dec NZ Trade balance, Dec JP Industrial/vehicle production, Dec JP Housing starts/construction orders, Dec UK GfK consumer confidence survey, Jan, Index	1 **AU AI-Group PMI, Jan, Index, (46.3)** **AU NAB Bus conf/cond, Dec, Index, (6/4)** **AU ABS House price indexes, QIV, q%ch, (0.1)** **AU RBA cash rate, %, 4.75, (4.75)** NZ Avg Hourly Earnings, QIV, q%ch, (1.0) NZ Labour Cost - Priv Sect, QIV, q%ch, (0.5) EU/GE/UK PMI manufacturing, Jan, Index, (56.9/60.2/58.3) UK Net consumer credit, Dec, £bn, (-0.1) US ISM manufacturing, Jan, Index, (57) US Total vehicle sales, Jan, mn, (12.53)	2 **AU HIA new home sales Dec, m%ch, (-0.2)** EU PPI, Dec, m/y%ch, (0.3/4.5) UK PMI construction, Jan, Index, (49.1)	3 **AU CBA/Ai-Group PSI, Jan, Index, (46.4)** **AU Build approv, Dec, m%ch, 2.0, (-4.2)** **AU Trade balance Dec, $bn, 1.8, (1.9)** NZ Emp Growth/Unemp Rate, QIV, (1.0/6.4) CH Non-Manuf PMI Jan, Index, (56.5) EU PMI services/composite, Jan, Index, (55.2/56.3) EU ECB announces int. rate, %, 1.00, (1.00) GE/UK PMI services, Jan, Index, (60/49.7) US ISM non-manufacturing, Jan, Index, (57.1) US Factory orders, Dec, m%ch, (0.7)	4 **AU RBA Statement on Monetary Policy** UK New car registrations, Jan, y%ch, (-18.0) US Non-farm payrolls, Jan, '000, (103) US Unemployment rate, Jan, %, (9.4) US Avg hrly earnings, Jan, m/y%ch, (0.1/1.8) CA Net change in employment, Jan, '000, (22) CA Unemployment rate, Jan, %, (7.6) CA Ivey purchasing manager index, Jan, (50)
7 **AU Ai-Group PCI, Jan, Index, (43.8)** **AU ANZ Job ads, Jan, m%ch, (2.0)** **AU Retail trade, Dec, m%ch, 0.5, (0.3)** **AU Retail sales ex inf., QIV, q%ch, -0.5 (0.7)** JP Leading / Coincident index CI, Dec, , (100.6/102.4) GE Factory orders, Dec, m/y%ch, (5.2/20.6) US Consumer credit, Dec, $bn, (1.346) CA Building permits, Dec, m%ch, (-11.2)	8 JP Curr a/c total/adj., Dec, ¥bn, (926.2/1145.1) JP Trade balance - BOP basis, Dec, ¥bn, (259.7) GE Industrial production, Dec, m/y%ch, (-0.7/11.1) UK RICS house price balance, Jan, %, (-39) CA Housing starts, Jan, '000, (171.5)	9 **AU MI/WBC Consumer Sent, Feb, Index, (104.6)** NZ Card spending, Jan, m%ch, (-0.9) JP Consumer confidence, Jan, Index, (40.2) JP Machine tool orders, Jan, y%ch, (64.0) GE Trade bal, Dec, €bn, (12.9) UK Total trade balance, Dec, £bn, (-4.1)	10 **AU Labour force, Jan** **employment, '000, 25, (2.3)** **unemployment rate, %, 5.0, (5.0)** **participation rate, %, 65.9, (65.8)** **AU MI Consumer Inflation Expectat, Feb, %, (4.6)** **AU MI Unemp. Exp., Feb, Index (108.7)** CH Trade balance Jan, (13.1) JP Machine orders, Dec, m/y%ch, (-3.0/11.6) EU ECB Monthly report UK Industrial production, Dec, m/y%ch, (0.4/3.3) UK BoE announces rates, %, 0.50, (0.50) US Wholesale inventories, Dec, m%ch, (-0.2)	11 **AU RBA Parliamentary Testimony** NZ Food prices, Jan, m%ch, (-0.8) CH PPI/CPI, Jan, y%ch, (5.9/4.6) CH Industrial production, Jan, y%ch, (13.5) CH Fxd Ass Investment, Jan, y%ch, (24.5) CH Retail sales, Jan, y%ch, (19.1) GE CPI, Jan, m/y%ch, (1.0/1.7) UK PPI Input/Output/core, Jan, y%ch, (12.5/4.2/2.9) US Trade balance, Dec, $bn, (-38.3) US Uni. Of Michigan confidence, Feb, Index CA Trade balance Dec, C$, (-0.1)
14 **AU Housing finance, Dec, m%ch** **No. of own-occupiers, %, 4.0, (2.5)** **Value of all loans, %, 3.0, (2.9)** NZ Retail sales ex inflation, QIV, q%ch, (0.7) NZ Retail sales, Dec, m%ch, (1.5) JP GDP, QIV, q%ch EU Industrial production Dec, m/y%ch, (1.2/7.4)	15 **AU RBA Board Minutes** **AU NAB Bus conf/cond, Jan, Index** JP Industrial production, Dec, m/y%ch, (1.0/4.2) JP BoJ target rate, %, 0-0.10 (0-0.10%) EU GDP, QIV, y%ch, (1.9/3.9) EU/GE ZEW survey (econ. sentiment), Feb, (25.4/15.4) UK CPI, Jan, m/y%ch, (1.0/3.7); core, y%ch, (2.9) US Import price index, Jan, m/y%ch, (1.1/4.8) US Retail sales, Jan, m%ch, (0.6) US Business inventories, Dec, m%ch, (0.2)	16 **AU DEWR skilled vacancies, Feb, m%ch, (-4.6)** **AU New motor veh. sales, Jan, m/y%ch, (0.8/-3.1)** UK ILO unemployment rate (3mths), Dec, %, (7.9) UK Bank of England Inflation Report US Building permits, Jan, '000, (635) US Housing starts, Jan, '000, (529) US Producer price index Jan, m/y%ch, (1.1/4.0) US Capacity utilisation, Jan, %, (76.0) US Industrial production, Jan, m%ch, (0.8) CA Leading indicators, Jan, m%ch, (0.5)	17 **AU RBA Ass Gov Lowe speaks in Sydney** NZ Business PMI, Jan, Index, (53.1) NZ Producer prices, in/outputs, QIV, q%ch, (0.7/1.2) JP Leading / Coincident index CI, Dec, EU Current account, Dec, €bn, (-11.2) EU Construction output, Dec, m/y%ch, (-0.9/-6.8) US CPI, Jan, m/y%ch, (0.5/1.5); core, (0.1/0.8) US Leading indicators, Jan, m%ch, (1.0) US Philadelphia Fed, Feb, Index, (19.3) CA Wholesale sales, Dec, m%ch, (1.2)	18 GE Producer prices, Jan, m/y%ch, (0.7/5.3) UK Retail sales, Jan, m/y%ch, (-0.8/0.0) CA CPI, Jan, m/y%ch, (0.0/2.4)
21 **AU HIA Housing Affordability Index, QIV** NZ PSI, Jan, Index, (52.5) NZ Credit card spending, Jan, m/y%ch, (-1.4/2.0) GE IFO - Business climate, Feb, Index, (110.3)	22 **US S&P/Case-Shiller home price ind., Dec,** US Richmond Fed, Feb, Index CA Retail sales, Dec, m%ch, (1.3)	23 **AU Prelim. construction wk done, QIV, q%ch, , (-2.1)** **AU WPI QIV, q/y%ch, 0.9/3.8, (1.1/3.5)** JP Trade bal total/adj, Jan, ¥bn EU Industrial new orders, Dec, m/y%ch, (2.1/19.9) UK Bank of England minutes US Existing home sales, Jan, mn/m%ch, (5.28/12.3) CA Teranet House Prices, Dec, y%ch, (4.9)	24 **AU Capex, QIV, q/y%ch, 5.0, (6.2)** **AU AWE Nov, q/y%ch, 1.4/3.8 (0.4/4.5)** GE GDP, QIV US Durable goodes orders, Jan, m%ch, (-2.5) US New home sales, Jan, m%ch, (17.5)	25 JP CPI, Jan, GE CPI, Feb, UK Total bus investment, QIV, q/y%ch, (3.1/8.9) UK GDP, QIV, q/y%ch, (-0.5/1.7) US GDP, QIV US Uni. Of Michigan confidence, Feb, Index
28 **AU Company profits, QIV, q%ch, 0.0, (-1.5)** **AU Private sector credit, Jan,** **AU Inventories, QIV, q%ch, -0.2 (-0.8)** **GDP contrib, %, 0.2 (-0.2)** **AU RP Data house prices, Jan,** NZ Building permits/Trade balance, Jan NZ NBNZ Business confidence, Feb, Index JP Industrial/vehicle production, Jan EU CPI, Jan, m/y%ch, (0.6/2.2); core, y%ch, (1.1) US Personal income/spending, Jan US Pending home sales, Jan, m/y%ch, (2.0/-3.6) CA GDP, QIV, q%chsaar, (1.0)			***Early March*** AU Balance of Payments, QIV (1 Mar) AU Govt Finance Stats, QIV (1 Mar) AU Retail trade, Jan (1 Mar) AU GDP, QIV (2 Mar) AU Trade in Goods & Services, Jan (3 Mar) AU Building approvals, Jan (3 Mar)	***Central Bank Meetings*** AU RBA (1 Feb) EZ ECB (3 Feb) UK BOE (10 Feb) JP BoJ (15 Feb) CA Bank of Canada (1 Mar) NZ RBNZ (10 Mar) US FOMC (16 Mar)

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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